Cutting Cost$

The Politics of Trees and Fees in BC

by Fred Wilson

Canadian Centre for Policy Alternatives–BC Office
815–207 West Hastings St, Vancouver, BC V6B 1H7
Tel: 604-801-5121 Fax: 6041-801-5122
email: ccpabc@intouch.bc.ca
www.policyalternatives.ca

February 1999
CAW 567

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This paper had its origins in notes for a consultation of the Communications, Energy and Paperworkers Union and the Pulp, Paper and Woodworkers of Canada with Premier Glen Clark, October 19, 1998

About the Author

Fred Wilson is a National Representative for the Communication, Energy and Paperworkers Union and a research associate with the BC office of the Canadian Centre for Policy Alternatives

Acknowledgements

The author would like to thank the following people for their feedback, advice and editorial assistance: Ed Finn, Seth Klein, Phillip Legg, Chris Luke, Gideon Rosenbluth, Garry Worth and Brian Payne.

The contents, opinions and any errors contained in this paper, however, are those of the author, and do not necessarily reflect the views of the CCPA.

Layout: Shannon Daub

ISBN# 0-88627-947-X
Cost: $3.00

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Executive summary

In January 1999, the BC government launched the Forest Action Plan, a series of measures aimed at cutting costs and improving cash flow for BC forest companies. The companies have welcomed the cost cutting, but they want much more. Led by the Council of Forest Industries (COFI), BC forest companies are demanding a wholesale reversal of the province's forest policy.

COFI's demands would radically cut stumpage beyond the substantial cuts already delivered and imperil funding to Forest Renewal BC. COFI seeks to undermine the Forest Practices Code, cancel appurtenance clauses tying timber rights to jobs, and increase harvests to unsustainable levels.

Cutting Costs argues that the BC forest industry is in a cyclical trough and that short-term measures to prevent mill closures and enhance employment are warranted. However, if government reverses fundamental policies aimed at enhancing forest management and environmental protection, or undermines Forest Renewal BC, it will be horribly shortsighted and negligent.

Among the findings of *Cutting Costs* are:

- Company profits show a mixed perfomance in 1997 and 1998, with some companies losing large amounts of money and other companies earning significant profits. In general, those companies with more value added production have fared better than companies focused mainly on commodity products. According to Price Waterhouse's survey of 15 major forest companies, 1998 third quarter earnings saw a return to profitability.

- Government has greatly reduced costs for companies. Since introducing the Forest Practices Code in 1994, the BC government has announced a series of measures to offset the costs associated with the Code. By the end of 1998, the net cost of the Code for companies had been reduced to $2.33 per M^3 of wood harvested. The impact of the Forest Action plan will effectively reduce this cost to zero.

- Stumpage rates in BC are today just $4 to $5 per M^3 higher than before the Forest Renewal Fund was established. As a result of major reductions in stumpage rates to assist companies, Forest Renewal BC's projected funding over the next five years will be less than 50% of the envisaged $400 million per year set as the goal when FRBC was created.

- Increasingly, forest company business decisions are driven by financial markets and share prices. BC forest companies' current share values have dropped by up to 50% and for many companies are currently below book value. However, workers often experience "perverse rewards" when companies attempt to make gains on stock markets. Cost cutting, mill closures and other measures that result in a loss of productive capacity can improve share prices. Government policy cannot be designed to improve speculative stock market performance for companies. To the contrary, short term speculative investment should be discouraged.

Public policy in BC is not responsible for the market problems faced by BC forest companies. It is important that British Columbians see past the disaster headlines and understand better the self-serving agenda of forest companies.

Instead of retreating from a leadership role in the forest sector, government should continue the reform of the BC industry by linking timber supply more closely to jobs and manufacturing. Government should not hesitate to use the ownership and stewardship of the resource to protect jobs and mills, and to assist in restructuring that will restore viability to threatened companies and mills. Government should also play a stronger role in counteracting market chaos by coordinating the marketing of commodity products such as pulp.

How much is enough from government to address the current problems of the BC forest sector? Government will have fallen short if mill towns and companies are allowed to fail because investors and politicians lack the will to work for a better outcome. Government will have gone too far, if in its efforts to cut costs for companies it undermines the Forest Practices Code, Forest Renewal BC, sustainable harvest levels or other fundamental elements of BC forest policy.

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In January 1999, the BC government launched its latest forest sector initiative – the Forest Action Plan. The plan is essentially a series of measures affecting administrative and timber appraisal decisions to reduce costs and improve the cash flow of forest companies. Although both the government and the companies are reluctant to put a value on these measures, some estimates place the savings to the industry as high as \$5 per M^3 of wood.

These measures are over and above the \$293 million stumpage reduction in June 1998 and other substantial savings for companies through the streamlining of the Forest Practices Code, which have already been delivered. Because of unemployment in the forest sector, the forest unions have given their approval to the Forest Action Plan. But the companies are demanding far more. They hope to use the current economic downturn in forestry to advance a radically different agenda for public forest policy in BC.

This paper makes two overall arguments. First, it will be shown that the forest sector is currently in a cyclical trough, with depressed commodity prices. But this industry also faces long-term environmental and structural issues that have been the motivation for historic changes in public forest policy in BC over the past five years. To the extent that government decisions address the cyclical issues and cash flow problems facing the industry to prevent mill closures and company failures and to enhance employment, they will be well directed. But if the government responds to these cost issues by reversing policies that address long-range structural and environmental issues, it will be horribly shortsighted and negligent.

For most of the last decade, people in BC have insisted on higher standards from forest companies. As a result, the government was emboldened to introduce major reforms such as the creation of Forest Renewal BC. FRBC was funded through higher stumpage, but redirected this revenue to investments in the land base, the environment and the workforce. The Forest Practices Code established laws for better logging practices. There has been a major review of harvest levels — the Timber Supply Review — which has set long-term sustainable yield projections for the public forests. A Protected Area Strategy has seen the establishment of many new parks in different parts of BC. And, through the 'Jobs and Timber Accord,' the government attempted to address the failure of the BC industry to create more jobs in relation to the amount of wood harvested.

This ambitious reform program ran into many problems, and too often the lofty vision that inspired an initiative would be compromised in political deal-making with companies. But now, at the end the decade, there has been a dangerous sea-change in public discourse about forest industry issues. Now the companies sense that economic failure can be pinned on the government and that they can once again hold the hammer. Years of progress are about to be undone, unless British Columbians see past the disaster headlines and understand better the self-serving agenda of the big forest companies.

The second case that this paper makes is that now is not the time for the government to retreat from its leadership role in this industry. On the contrary, now is the time to carry forward the reform of the industry to its next logical steps. These steps must include a renewed commitment to Forest Renewal BC and the stabilizing of sustainable harvest levels through intensive forestry management. We need stronger government intervention to ensure that BC's forest harvest flows where jobs will be created through value-added production that protects our resource communities from the instability of commodity markets. In short, the "Jobs and Timber Accord" cannot be allowed to suffer the scornful death that the companies intend.

Perhaps most important is for the government not to be intimidated by the ruthless competitive demands of the forest industry to sacrifice companies, mills, towns and workers to satisfy institutional investors. When a mill closure in BC is announced, industry voices trip over each other to emphasize how bad it is to do business in BC. But if the workers, the community and government step forward with special measures to save these jobs, the chorus then turns on government demanding the harshest treatment for the economic losers. Like Roman patricians watching Christians thrown to the lions, they want blood.

We can choose instead to stop the bleeding and to support workers and communities. The government must not be afraid to use its stewardship and control of *public resources* to restructure and renew threatened mills and companies. There are new roles as well for the government, such as coordinating the marketing of commodity products like market pulp.

The problems that the industry faces today are not the result of the current government's policies. It was the environmental irresponsibility of the companies and the previous government that resulted in the regional wood shortages, putting at risk many forestry towns. It was the previous government's low stumpage rates, not current stumpage rates, that provoked US protectionism against BC softwood exports. Nor was it BC public policy that was responsible for pumping up markets and profits in Asia until they collapsed under their own weight.

Tough times and radical demands

These are tough times for forest industry workers and for many forest-dependent BC communities. Thousands of workers in logging, sawmilling and pulp and paper lost their jobs during 1998, and there will be more hardship announcements in 1999.

As 1998 progressed, things just seemed to get worse. By September 1998, there were 7,304 unemployed workers active in the Forest Renewal BC transition program, established to give a helping hand to unemployed forestry workers to retrain for another job, in or out of the forest sector. Many of these workers lost their jobs in 1997; however, between April and September there were 2,601 *applications* to the program. The worst month was August, with 791. But the fall of 1998 took a much more ominous tone when a rash of mill closures made headlines. These are some of the mills that have been closed in 1998:

- Canfor Eburne sawmill, Vancouver – 220 workers

- Crestbrook Forest Products sawmill, Cranbrook – 60 workers
- * Interfor Squamish sawmill, Squamish – 185 workers
- Northwood PG Wood sawmill, Prince George – 60 workers
- Canadian Woodworks, Prince George, (remanufacturer) – 136 workers
- Canfor PG Nederlands sawmill - 140 workers
- Slocan Cantree plywood, New Westminster – 140 workers
- * Interfor Flavelle Cedar, Port Moody
- Weyerhaeuser Lumby/Merrit sawmill and other restructuring – 200 workers
- Riverside Soda Creek – 25 workers
- Bowater Gold River pulp mill – 380 workers

* *these mills are closed indefinitely, but permanent closures have not yet been announced.*

Mill closures in BC, of course, represent more than the personal tragedies of workers and their families. Each of these announcements was a political event that was seized upon by the forest companies and the opposition to attack BC's NDP government. A chorus of loud voices, led by the Council of Forest Industries (COFI), blamed the policies of the NDP government for the economic failures. The unrelenting message from the forest companies is that BC's forest sector has been ruined by the government, and so it is up to the government to fix the situation by making wholesale changes to public forest policy. Here are some of the demands to government from COFI and forest company executives:

- Reduce stumpage and regulatory costs to forest companies by $15 M^3 of wood harvested or by 17% over 1997 costs. To put this in perspective, the 1997 BC 'annual allowable cut' was 70 million M^3. This represents a potential windfall of more than $1 billion for forest companies.
- Change fundamentally the stumpage system by eliminating a 'target rate' and making stumpage dependent on profits.
- Major changes to the Forest Practices Code to require only an initial forest development plan, with all further reporting and monitoring to be done by the company without government supervision. Repeal sections of the Code that force companies to make greater efforts to identify fish-bearing streams. Allow more debris and waste wood to be left behind after logging.
- Increase the BC harvest to 90 million M^3 annually over the next 20 years.
- Change the tenure system by introducing the US system of selling the right to harvest timber by auction (proposed by MacMillan Bloedel).
- Cancel all "appurtenance clauses" which tie forest tenures to commitments to operate mills.
- Reduce energy costs by lowering BC Hydro costs to industrial users by 7.5%, or $40 million annually for forest companies. Deregulate BC Hydro to allow private competitors to sell electricity directly to forest companies.
- Eliminate the property tax for schools on machinery and equipment. (Industrial machinery is appraised for property tax purposes and paid directly to the provincial government.) Eliminate the corporate capital tax.
- Cancel the BC regulation to eliminate organochlorines from pulp mill effluent and instead adopt the current US standard.
- Cancel health and safety regulations, such as the requirement to provide a heated shelter when the temperature is below minus-7 degrees, and require hearing tests every two years instead of every year. Reverse recent safety regulations by the Highways Department that reduce the size of a load that can be carried by a logging truck.
- Reverse BC government policy decisions to consult First Nations as a result of the Delgamuukw Supreme Court ruling.

These are just some of the demands that the forest companies are pressing. All of these proposals are under consideration by the BC government, and many of them will be at least partially met. If Gordon Campbell and the Liberals were to form the government in BC, expect almost all of the above to be implemented—and more.

Profits and losses

Before agreeing to COFI's 'disaster plan' for the forest industry, it would be a good idea to take a closer look at how the industry is performing.

1997 was a mixed year. Of the 14 companies listed by Price Waterhouse in its 'net earnings summary' for Western Canada, seven made money, and seven lost money. Some companies made healthy profits, i.e., Weldwood at $46.8 million and West Fraser at $69.5 million. Others hemorrhaged red ink, i.e., Canfor losing $32.9 million and Crestbrook losing $59.9 million.

•Although the industry as a whole is predicted to lose money in 1998, third quarter results showed a modest return to profitability. Price Waterhouse's survey of 15 major BC forest companies showed 1998 third quarter earnings of $117.7 million.

A company's performance depends largely on its region, market or sector. Not all forest companies are unprofitable. Three companies – Canfor, Western Forest products (Doman), and Interfor – account for a large portion of the current losses. But many other companies, such as MacMillan Bloedel and West Fraser, are now profitable.

Paper manufacturers are making modest to substantial profits. Pulp producers are losing money, but are performing better than the coastal timber companies, which continue to lose substantial sums. Most pulp and paper workers are on the job. However, one pulp mill has been closed – Bowater's Gold River mill with 380 workers. The Pulp, Paper and Woodworkers of Canada and the community of Gold River are exploring options to rescue the mill. Another major pulp mill —Celgar, Castlegar—is in receivership, although continuing to operate.

Companies that produce more value added products are doing better than those companies that are

Forest sector profits—selected BC companies
Millions of Cdn dollars (bracketed figures indicate losses)

Company	Product mix	1998 3rd quarter net earnings	9 month net earnings to Sept30/98	1997 net earnings
MacMillan Bloedel	75% lumber, 25% packaging	77 (includes $67 million gain from asset sale)	38	(368)
Timber West	raw logs & lumber - major private lands	7.1	28.3	4.0
Pacifica Paper	paper	19.1	30.7 (5 months to Sept. 30)	N/A
Fletcher Challenge	65% paper, 35% pulp	15.3	N/A due to strike	468.5 (results include $513.7 million from asset sales
West Fraser	25% pulp	11.9	(2.6)	69.5
Weldwood	40% pulp	14.3	6.6	46.8
Harmac	pulp	(4.2)	(13.9)	(8.8)
Western	33% pulp	(20.4)	(54.6)	N/A
Riverside	lumber - interior	6.2	(2.9)	(5.6)
Interfor	lumber - coast	(1.6)	(57.7)	0.4
Canfor	lumber (coast/ interior) pulp/paper	(9.4)	(55.4)	(32.9)

Source: Price Waterhouse Coopers

focused exclusively on commodities. For example, MacMillan Bloedel is performing far better than its competitors in the lumber business (mostly as a result of its non-lumber divisions).

The table on page 4 is a sampling of third quarter results from some major BC forest companies:

Some additional significant notes on company profits include:

- Timber West continues to be among the most profitable BC companies, almost exclusively through the sale of raw logs. For the first nine months of 1998, 82% of the company's sales revenue was log sales, and the volume of logs harvested and sold in the most recent quarter (3rd quarter) increased by 42% over the same period a year before.
- MacMillan Bloedel's substantial turn-around is due primarily to its packaging and panel board (mainly OSB) divisions (much of which is located outside of BC), which accounted for $63 million and $60 million respectively – or 80% of operating earnings before restructuring costs.
- Pacifica Paper (former MacMillan Bloedel paper assets) earned healthy profits due to a continuing strong North American market for specialty grades of printing papers. The company reports that both its Powell River and Port Alberni mills operated at near capacity over the last quarter.
- Fletcher Challenge returned to profitability after the start-up costs following the strike. The company closed the 3rd quarter with $801 million in the bank and no debt. It benefited from a US$40 tonne price increase in North American markets for specialty grades of paper in September, offsetting weaker demand in Asia.
- Many BC forest companies require particularly good markets to carry their heavy debt loads. For example, Western Forest Products scored $17.8 million EBITDA (earnings before interest, taxes, depreciation, amortization) in the third quarter, but its debt charges were $29.1 million for the same period.
- The value of the Canadian dollar continues to be a primary factor for profitability. Canfor's results, for example, include a $5.1 million gain resulting from the devaluation of the Canadian dollar against the company's foreign currency cash accounts (this windfall is additional to operating profits). While pulp prices dropped 6% in the 3rd quarter from the previous quarter, half of this drop was offset by a weaker Canadian dollar which produced higher US dollar returns for pulp sales.

What about costs?

The foregoing survey is a mixed bag at best, and certainly does not add up to a banner year for current profits. But neither is the industry about to declare collective bankruptcy. It is from this balance that the companies' demands for cost relief should be assessed. Although the industry is demanding cost relief on everything from health and safety regulations to hydro rates, there are two central issues that are key to public policy: stumpage and forest practice code regulations.

Forest Practices Code

The companies contend that the Forest Practices Code has built in a cost structure that will destroy the BC forest industry. It is a tangle of bureaucratic red tape that makes it uneconomical to do business in BC, say the companies.

According to the 1997 KPMG/HA Simons report, *The Financial State of the Forest Industry and Delivered Wood Cost Drivers*, the actual cost increase to harvest wood in BC as a result of the Forest Practices Code and related factors was $12.22 per M^3. As a result of the report and government/industry negotiations, administrative changes to 'streamline' the Code were implemented in June 1998. These changes were reported to reduce costs by $5 per M^3, but COFI insists that the actual savings were far less, only about $1 per M^3.

(Forest companies today argue that they did not realize the projected savings from the 'streamlining' of the Code. However, they did not argue with the projected savings when announced. Could it have been that Code-related costs were inflated for political purposes, and the reduction in these costs are now difficult to show on the balance sheet?)

No one disputes that the Forest Practices Code makes harvesting more expensive. But these costs must be put in the context of prices. During 1997, lumber prices dropped dramatically. The SPF (spruce, pine, fir 2 X 4s) price in January 1997 of US $415 per thousand board feet (MBF) had dropped to US $285 by December *(Madisons Lumber Reporter, January 24, 1997, December 12, 1997).* This price cut of $130 per MBF is equal to $US28.80 per M^3 ($C40.00 at average 1997 exchange of .7221). In other words, the impact of price reductions over one year on the bottom line for producers was more than three times greater than the impact of the Forest Practices Code.

Should the government reduce costs further by making more changes to the Forest Practices Code? Given all the facts, most people would consider the cost of meeting the Code today to be a modest cost to ensure good forest practices. Further cuts to the Code are almost certain to go beyond 'streamlining' and administration and would directly affect standards. The risks for the environment and for BC's international reputation as a result of further weakening the Code far outweigh any potential benefit. Moreover, this view will be much stronger when British Columbians appreciate the extent to which the government has already reduced stumpage payments to cover most, if not all, of the cost of meeting the Forest Practice Code.

Stumpage

Stumpage is the principal royalty on BC's public forests, and it is the cost item that the government can most easily manipulate to affect industry profits. BC's stumpage rates were increased dramatically in 1994 in response to US charges that our stumpage rates amounted to subsidies. The majority of the increased stumpage revenue was directed into the Forest Renewal Fund that is administered by the Crown corporation, Forest Renewal BC. However, the government has reacted to the downturn in the industry by substantially lowering stumpage rates over the last year by 38% on the coast, and by 36% in the interior. Starting in January 1999, the target rate for coastal stumpage was $4.79 M^3 higher than before the Forest Renewal Fund was created, while the interior target stumpage was $5.59 higher.

The largest reductions in stumpage occurred in June, 1998 specifically to address concerns about the cost of the Forest Practices Code. Claiming that they had already compensated companies for the projected costs of the Code in 1994 by $5.05 M^3, the province reduced stumpage by a further $4.89 M^3 (provincial average) to cover the share of additional logging costs that the KPMG report attributed to government policy. This translated into an average stumpage reduction on the coast of $8.10 M^3 and of $3.50 M^3 in the interior, an amount equal to $293.4 million annually for forest companies in BC, based on a 60 million M^3 harvest.

But the government went further. In June 1998, it also made changes to the stumpage formula that assesses the value of timber for determining actual stumpage payments. The stumpage rates referred to above are 'target' rates, or average rates. Actual stumpage may be above or below those rates, depending on the assessment of the value of the wood harvested. Previously, the value assigned to timber was based on lumber prices in the region harvested; now the assessed value will be a blend of lumber and chip prices that includes 10% chip value on the coast and 12% chip value in the interior. The result (so long as chips have lower values) is lower overall values and lower stumpage.

The combined effect of market conditions and the new formula resulted in further stumpage reductions in October 1998 of $2.19 M^3 on the coast and $1.21 M^3 in the interior. In January 1999, there was a small revision upward of $.56 on the coast, and $1.19 in the interior, reflecting higher lumber prices.

The companies insist that this is still not enough. But how much **is** enough? Of course, the government and the companies disagree on the impact of the decisions to date. But by any measure, the government has greatly reduced the cost of wood in BC. For the sake of this argument, let us set aside the government's claim that it took the cost of the Code into account when setting rates for the Forest Renewal Plan back in 1994, but assume it was correct in estimating a \$5 M^3 cost reduction by streamlining the Code in 1998. The KPMG report estimated \$4.52 M^3 for "planning and administration" costs associated with the Code. If anywhere close to \$5 M^3 was eliminated, this should offset those costs completely.

Combined with the reduced stumpage, today's current cost to companies of the higher standards set out in the Forest Practices Code is modest indeed. The table below does not take into account the impact of the current Forest Action Plan. If the cost reductions are anywhere near the \$5 estimate, there is effectively no cost to BC forest companies for providing the higher standards of the Forest Practices Code.

In general, the government still takes more per M^3 from companies than it did before the forest renewal plan was introduced in 1994. But after the impact of the Forest Action Plan, assuming that significant cost reductions will be delivered, overall cost increases as a result of government policies are modest indeed.

The chart on page 8 tracks the costs imposed by the government on the industry from May 1994 until today on the BC coast. The coastal stumpage rate of \$17.20 was increased in 1994 to create the Forest Renewal Fund. Almost immediately afterward, another layer of cost was added by the introduction of the Forest Practices Code. Offsetting measures, however, reduced the cost of the Code. If it is estimated that the Forest Action plan will deliver \$4–\$5 of additional cost relief to the industry, as the chart below assumes, the remaining "cost" to the industry of the Code in 1999 drops to zero.

Stumpage changes driven by quarterly market appraisals and formula changes have also seen a steady decline until the small rise again in January 1999. The combined effect shows that the government did raise costs considerably in 1994, and then dramatically reversed the trend.

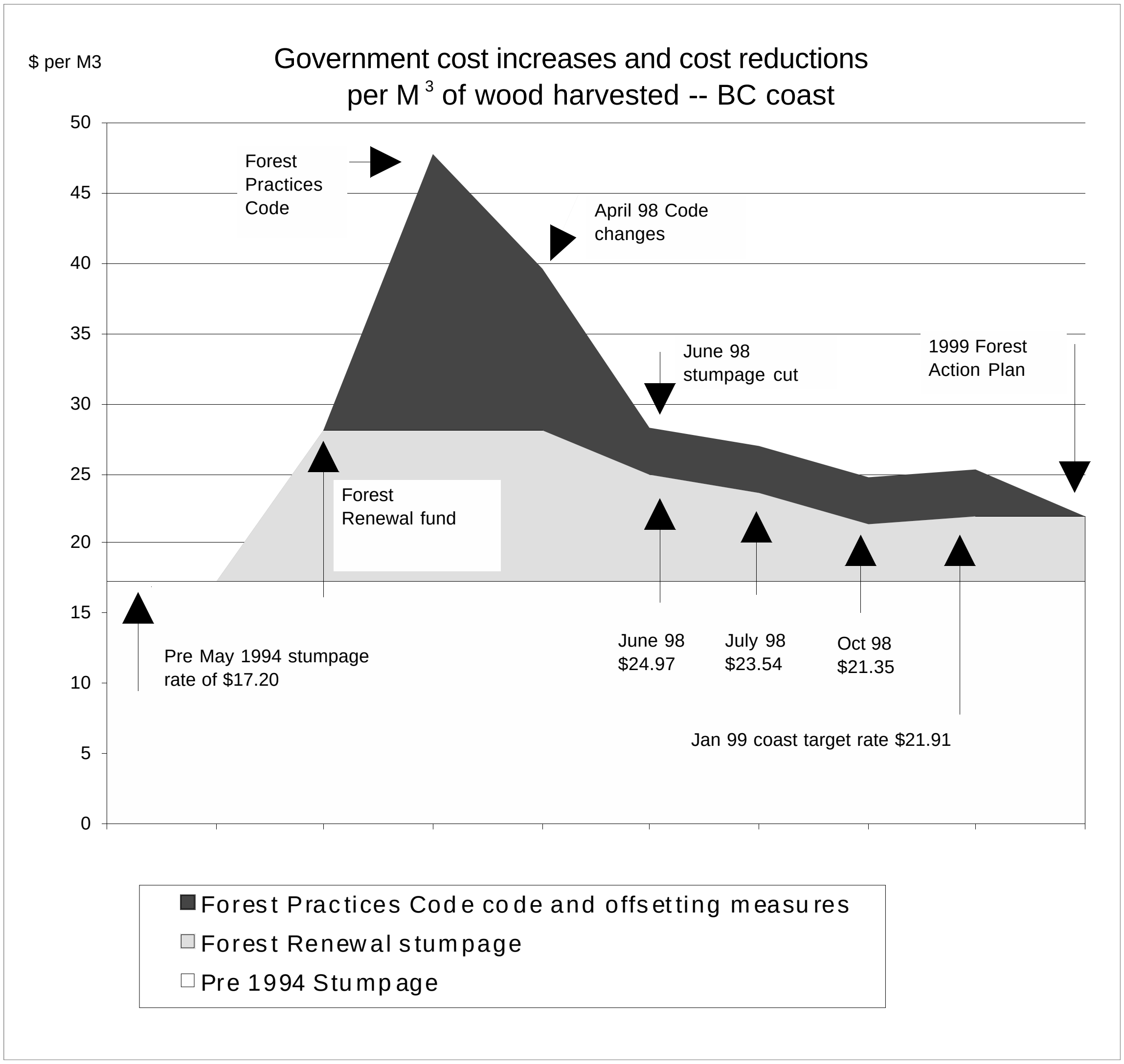
Admittedly, BC continues to have the highest forest royalties in Canada – but the gap is narrowing. Price Waterhouse conferences never miss an opportunity to compare BC's stumpage to Alberta's. Obviously, BC's rates are far higher, reflecting the central importance of forestry to BC's economy and to government revenues. But there are many complexities to the stumpage system, and the average or target rate that is compared between jurisdictions can be misleading. For example, a great part of Alberta's forest harvest is hardwood aspen, the most important species for the Alberta pulp sector. The stumpage is low, reflecting the policy of the Alberta government to build up the pulp industry through

Forest Practice Code Cost Increases to Delivered Wood Cost[1] and Offsetting Cost Reductions (per M^3 harvested)

Code Component	Interior	Coast	Provincial Average
Planning and Adm.	\$2.57	\$8.21	\$4.52
Forest Practices	\$5.84	\$11.47	\$7.70
Code cost total	\$8.41	\$19.68	\$12.22
April 98 "streamlining" [2]	-\$2.57	-\$8.21	-\$5.00
June 98 stumpage cut	-\$3.50	-\$8.10	-\$4.89
Net cost of the Code	**\$2.34**	**\$3.37**	**\$2.33**

Notes: 1 KPMG, April 1997

2 MOF estimate of \$5 is greater than \$4.52 estimate of KPMG for planning and administration. The government insisted that the Code changes had no effect on forest practice standards. It is therefore assumed in this model that the planning and administrative costs of the Code were entirely offset by the 'streamlining' of the Code.



Forest royalties (stumpage): BC, Ontario and Alberta

BC Coast (Oct/98)	$21.35 M ^{3}	
BC Interior (Oct/98)	$19.57 M ^{3}	
Ontario - Pine (Nov/98)	$18.67 M ^{3}	applies to red and white pine sawmill logs used mainly in furniture
Ontario - SPF (Nov/98)	$16.11 M ^{3}	rate for softwood lumber producers with US quota
Ontario - paper (Nov/98)	$16.01 M ^{3}	includes $10.01 M ^{3} stumpage and $6 average forest renewal charge
Ontario - Grade 1 hardwood (Nov/98)	$26.87 M ^{3}	top rate in Ontario applies to oak, maple, hickory sawmill logs
Alberta - softwood lumber (Oct/98)	$12.31 M ^{3}	includes $3.54 M ^{3} resource improvement charge which can be partially reclaimed for work performed towards tree improvement
Alberta - FMA pulpwood	$2.60 M ^{3}	Alberta Pacific (Athabasca) Forest Managament Agreement rate

Approximate annual savings in stumpage payments (selected BC companies)

Company	Annual crown land harvest	Potential Stumpage Reduction
Canfor	4,970,000 M^3	$23,618,000
Doman	4,000,000 M^3	$36,000,000
Interfor	3,600,000 M^3	$32,400,000
MacMillan Bloedel	4,800,000 M^3	$43,200,000
Riverside	2,500,000 M^3	$8,500,000
Slocan	5,200,000 M^3	$21,080,000
Timber West	1,400,000 M^3	$12,600,000
West Fraser	4,600,000 M^3	$15,640,000

Source: (Carter, Reid, Death of an Industry, BC's Wood Products Industries, First Marathon Securities, April, 1998)

direct subsidies. But there are also low stumpage rates in BC for a lot of the wood that ends up in pulp mills. About 15% of the harvest on the coast of BC, and about 20% of the harvest in the interior pay stumpage rates of \$5 M^3 or less, and a substantial portion of this amount is paid at the minimum rate of just \$.25 per M^3.

Inter-provincial comparisons for softwood lumber can also be misleading. Comparing rates for benchmark SPF (spruce, pine, fir – the most common dimension lumber species), BC interior stumpage is today about 20% higher than is charged in Ontario, with a greater difference between BC's coastal stumpage and Ontario's SPF rates. However, BC's higher rates also reflect the higher value of BC's premium logs that are unmatched elsewhere in Canada. For example, almost 20% of the BC coastal harvest fetches stumpage well above the target, in the \$45 M^3 to \$55 M^3 range.

BC stumpage is not high by world standards. A study by Reid Carter for First Marathon Securities compared BC stumpage to those in other jurisdictions and found that BC stumpage is less than in the US northwest, US southeast, Finland, Sweden, Germany, Austria and New Zealand. Stumpage rates for pulp logs were found to be lower in BC than in China, Chile and Brazil.

Carter estimated that the planned stumpage reductions in BC in 1998 will result in stunning bottom-line improvements for BC's major licensees. These potential savings, however, assume that each licensee harvests its entire Annual Allowable Cut.

Should the BC government lower stumpage further? The answer to that question today depends on the degree to which the government should subsidize forest companies through lower resource royalties in order to stimulate economic activity. As we have seen, further stumpage reductions are not necessary because of increased costs as a result of public policy such as the Forest Practices Code.

However, there is a major public policy issue involved in further stumpage reductions. Are we prepared to fight a trade war with the US over lumber exports that could result in new barriers to our exports? The government must carefully balance its policy on stumpage with its obligations under the Softwood Lumber Agreement. If the Americans can demonstrate that government cost reductions offset the effect of the penalty in the softwood lumber agreement and result in increased exports to the US beyond the agreed quotas, we can expect a reaction.

The real problem: Share prices and the 'BC discount'

It is long established that forest sector profits are cyclical. But COFI now argues that the companies' problem is not cyclical but structural, resulting from the higher costs of the regulatory framework and BC's higher labour costs. COFI and the industry's chief accountants, Price Waterhouse Coopers, have strongly argued that the industry as a whole has failed to meet 'the cost of capital' over the past decade. The cost of capital is the rate of return they believe is required to attract new investment. COFI/PW contend that a 10% – 11% return on equity is required to meet the cost of capital, but the poor performance of the BC industry has produced only half that, just 5% on average, over the past decade. This performance, coupled with the intangible political reaction of capital to an NDP government, has resulted in 'the BC discount.' The BC discount means that share values and the market value of BC forest companies are less than prevail at comparable forest companies in eastern Canada or in the US.

If there is a 'BC discount,' it only underscores the short-term memory of capital. A December 1998 report by the BC-based Sierra Legal Defense Fund argues strongly that current forest profits are entirely cyclical and are following predictable patterns. Tracking seven major public forest companies from 1972 to 1997, Sierra found a combined net profit of $7.2 billion for the seven companies over the period.

A big part of the present cries of despair from the industry are not related to profit and loss performance per se, but to low share prices for investors. In many cases, share prices have plummeted below book value. Employers have been more than forthright with the unions and the public: the business decisions they are making at this time are primarily concerned with improving performance in the financial markets. Mergers, acquisitions, hiring and firing of executive officers, plant closures and restructuring plans are all driven to improve share prices.

Even companies like West Fraser and Abitibi, which earned healthy profits in 1997, saw dramatic declines in share prices as investors reacted to the Asian crisis and moved money away from resource-based industries.

Unfortunately, workers have experienced "perverse rewards" when

Share prices for selected forest companies

Company	52 wk high/low ($)	Year end 1997 ($)	Current Price ($)	% change	1998 book value ($)
Canfor	14.70 – 5.25	8.60	5.75	(33%)	10.00
Crestbrook	11.35 – 3.00	5.00	3.75	(25%)	8.50
Doman	9.80 – 1.60	5.25	2.35	(55%)	6.50
Fletcher	24.25 – 14.30	19.50	16.05	(18%)	16.00
MB	21.65 – 11.50	14.85	14.65	(1%)	10.00
West Fraser	47.00 – 25.50	35.50	26.00	(27%)	30.00
ABITIBI	24.95 – 12.00	19.95	14.60	(27%)	15.00

Source: Canadian Paper Analyst, Sept. 1998 companies make gains on the stock markets. Cost-cutting of any kind, including plant closures and unemployment, can improve share prices, regardless of the negative impact on people or the loss of productive capacity. Moreover, financial markets are fundamentally speculative and react immediately to the intention of companies to restructure or merge, whereas long-term productivity may not result in any immediate benefit to share prices.

While stock market performance undoubtedly is a primary motivating factor for forest companies, it is wrong to use it as a basis for public policy in the forest industry. On the contrary, government policy must be an antidote to the speculative nature of financial markets. Short-term speculative investment in the BC forest industry should be discouraged.

The more the BC forest industry is managed to produce results in the financial markets, the greater the risks will be for long-term sustainability and productivity. Who owns BC forest companies today? Increasingly, the new owners are institutional investors and insurance companies with no background in the forest sector and no commitment to its future.

The big problem—markets (and MacMillan Bloedel's privatization solution)

The current problems in the forest industry are overwhelmingly market-related. The effect of the Asian crisis on markets has been profound in reducing both demand and prices for BC's commodity exports.

For example, Canadian pulp and paper shipments during 1998 declined by one million tonnes from the record year of 1997, and two thirds of this decline is attributed to weak Asian markets (*Canadian Pulp and Paper Association, January 25, 1999*). BC producers generally have been hit hardest by this decline. Weak demand in Asia has been a major factor in lowering prices. Whereas the industry predicted US$560 to US$600 prices for northern bleached softwood pulp in 1998, actual list prices at the beginning of October were US$500 to US$525 with transaction prices as low as US$480 in Europe and US$415 in Asia (*Pulp and Paper Week, Oct. 12-16, 1998*).

The lumber market also faced enormous price cuts and was further complicated by the limits placed on producers by the Softwood Lumber Agreement. This agreement is really the opposite of "free trade." It sets a quota for the amount of lumber that Canada can ship into the US tariff free. Anything over the quota is hit with a stiff tariff fee. Canada has divided its quota between provinces, and allocates a quota to each sawmill with established markets in the US. The agreement with the US has had major repercussions on the BC industry, and it has opened deep divisions between companies about what to do when the agreement comes up for renewal.

The softwood lumber agreement has affected the current market crisis in three ways:

- Canadian producers with a quota established by the Softwood Lumber Agreement are already selling as much as they can into the US market, and those without a quota cannot afford to pay the tariffs at current prices.
- The Softwood Lumber Agreement has provided a guaranteed US market share for other Canadian provinces, generally to BC's disadvantage.
- BC coastal producers are largely without US quotas because they had relied on Asian markets over the last decade, and current quotas reflect past US market share.

What can or should BC do about markets in Asia and the US? Of course, there is a vital role for government on the trade front, opening up markets for Canadian businesses in countries where our trade is presently limited but there is almost nothing that BC can do in the short term to improve the economy of Japan or Korea. The government and the industry are focused on lowering costs to improve access to these markets, but there are limits to the possibilities here. Government measures that look like subsidies will violate trade agreements, notably the softwood lumber agreement with the US, and risk retaliation against our exports.

Government policy can more directly affect domestic consumption. About 10% of market pulp, 13% of newsprint and 15% of lumber is shipped within Canada. These markets can and should be enhanced with lower interest rates and other government measures to stimulate the Canadian housing market, printing and publishing.

One of the more radical propositions to address the markets issue is that of MacMillan Bloedel CEO Tom Stephens, who advocates a change in the stumpage system by moving to a competitive timber sale system. Instead of a forest company holding a tree farm license or timber license, the Crown would auction off stands of timber ready to harvest to the highest bidder. Stephens' theory is that this 'free market' approach would resolve the subsidy issue in the US and allow for unrestricted access to the US market. It would also result in market-based prices for wood that would allow companies to be financially viable, he argues.

Stephens' proposals have been strongly criticized by IWA Canada economist Doug Smyth. Smyth questions whether such a system would prevent protectionist measures in the US. After all, US protectionism has little to do with how Canada structures its forest sector and much to do with market share. No product that competes with US domestic industries has unrestricted access to the US market.

More importantly, Smyth warns that timber sale auctions are more likely to create speculative bidding excesses that will drive up the cost of wood, much like a hot real estate market. The big losers will be small- and medium-sized businesses, who will be effectively shut out of the market. Smyth cites the experience of the US northwest where precisely this kind of speculative bidding brought the forest sector in that region to near collapse in the early 1980s, requiring a massive bail-out package from the US Congress to save many companies.

The MB proposal would be the first step towards the privatization of forest lands, a proposal also advocated by many in the industry and some in the environmental movement. The IWA's Smyth also warns of the potential from this idea: "(The) idea that privatizing timberlands will somehow magically transform BC log markets into efficient operating systems is naive. Eventually the large timber trusts will wind up owning most of the fibre and the major sawmilling companies will be restricted to the conversion business. Given the vastly superior asset bases enjoyed by the large insurance companies, they will easily be in a position to outbid the lumber industry. And as private owners, the trusts will be more interested in shipping raw logs to Japan, as they are now doing on the US and the BC West coast" (*Cited in Madison's Lumber Reporter, Dec. 11, 1998).* (To appreciate Smyth's point about trusts and insurance companies it is useful to know that some insurance companies are major investors in the trust units that make up Timber West, a company heavily involved in log exports.)

The fibre crunch and Forest Renewal

To a significant degree, the market situation has masked a more fundamental issue: fibre supply. Fibre supply refers to the wood needed by our sawmills and pulp mills. When this supply runs short, and manufacturing jobs are lost in forest-dependent communities, the resulting situation has been termed the "fall-down" effect. Fall-down is already affecting the BC forest economy. Here are some examples:

- Long-term adequate fibre supply is a key issue that may determine the future of the temporarily closed Bowater Gold River pulp mill.
- Fibre supply was also the main issue cited by Western Pulp for its recent extended downtime at Port Alice.
- Fibre supply was cited as the principal reason for the closure of the MB sawmill at Powell River, and the Canfor Eburne mill in Vancouver.
- Weyerhaeuser says the future of its four remaining interior sawmills depends on approval of its Innovative Forestry Practices Agreement in the Merritt Timber Supply area which will increase future harvests.

The fibre crunch is bringing in other radical schemes to change BC forest management. On the supply side, COFI argues that BC should return to much larger harvest levels – 90 million M^3 within two decades (Crown lands and private lands). This proposition is absurdly at odds with the results of the Timber Supply Review, the extensive review of 'long-term sustainable yields' on BC's Crown timberlands. Although recent studies on the timber volumes that can be expected in second-growth forests are promising, the current facts point to a long-term harvest in BC at about today's level – 60 million M^3 .

There is a widespread hope that intensive forestry and new investments in the land base will improve the long-term sustainable yield. Forest Renewal BC and many government initiatives, such as the Innovative Forestry Practices program, have been established to attempt to stop the fall-down effect before it's too late. But the cost reductions already given to the forest companies will also drastically impact the funding to Forest Renewal BC.

The Forest Renewal Plan in 1994 established a sliding scale which allocated a share of stumpage payments to the new Crown corporation. The formula was based on a target of providing $400 million annually to FRBC for reinvestment in the land base, the environment and the workforce. But the concessions to the forest companies means that not once in the next five years will FRBC have anywhere near the revenue that was imagined. As a result, FRBC has been forced to severely cut back its crucial programs. Given the fundamental problem of fibre supply for the BC industry, it is difficult to imagine any more short-sighted policy.

Estimated FRBC Stumpage Revenue, $ millions

	1998/1999	1999/2000	2000/2001	2001/2002	2002/2003
Target revenue	400	400	400	400	400
Projected	155	167	198	228	238

Note: FRBC estimates before impact of the current Forest Action Plan
Source: FRBC

What should government do? The market pulp case study

COFI and the forest companies want to return to the past when stumpage rates were lower, when companies ran the forest industry with little government interference, and when there was no Forest Practices Code or Forest Renewal BC. In fact, the companies want to go much further back and to undo the basic tenets of public forest policy in BC, which since the 1940s has tied tenure, or the right to harvest Crown timber, to specific commitments to operate mills.

COFI and the companies advocate a kind of free market chaos that would allow anyone with money to use timber for whatever short-term use they choose. They want the right to close mills, with no consequences for their timber licenses. They want us to believe that the profits that will result will benefit everyone. They heap scorn on all who disagree, alleging that their critics do not understand the fundamentals of a market economy.

If the forest companies get their way, enormous tragedy awaits many more forest towns. So long as the industry owes its existence to the exploitation of public resources, free market chaos cannot be allowed. To the contrary, this industry has proven once again that more, not less, government stewardship is essential.

Just as the ill-fated "Jobs and Timber Accord" proposed, BC's forest resource must now be strategically targeted to achieve the most value-added production possible and to ensure the stability of forest communities. BC's little understood but economically important market pulp sector provides a useful case study.

This is a sector that cries out for coordination and leadership. Pulp companies are less and less integrated as producers and less coordinated as an industry. Formerly integrated companies like Fletcher Challenge and MacMillan Bloedel have now cut direct business ties between forest tenure and pulp and paper operations. Although pulp continues to be key to wood harvesting and sawmilling, several BC pulp companies now have no forest licenses. As a result, they have moved to the edges of the BC forest industry, where they are not directly affected by government policies.

This free market independence, however, has not resulted in better economic performance. At least four mills are on the "trouble" list, and many others face a range of serious problems, including fibre supply, environmental standards and crushing debt loads. The most serious problem faced by pulp companies is low pulp prices. This, too, is worsened by price cutting by some companies that has at times undermined efforts to stabilize prices for the particular grades of pulp made by BC producers.

To address these issues, some companies have already considered joint marketing of their market pulp, and it has been suggested that government should consider a marketing board approach to the sector. Although no doubt complicated, it is an idea worth pursuing. Why shouldn't BC's market pulp producers coordinate marketing to help stabilize prices for the "northern bleached softwood kraft" (NBSK) grade of pulp made by most BC producers? This coordination could assist BC mills in sharing the downtime that is required occasionally to ensure a balanced international market, and perhaps prevent one or more mills from being sacrificed entirely to reduce capacity.

One of the perverse features of the current political scene is the chorus of industry analysts waiting to cheer the closure of one or more BC pulp mills. According to their thesis, there are just too many pulp mills in an over-supplied market. Government should play no role in assisting these mills or the community, except to board up the ghost town after the mill closes.

However, it is not only BC producers who are facing lower demand and weak prices. It is estimated that downtime in the 'Norscan' (Scandinavia and North America) countries will remove 1.25 million tonnes of market pulp from the market in the last quarter of 1998. Market pulp downtime is occurring in Finland, Sweden, Portugal, Spain, Argentina, Indonesia, and in the U.S.

Pulp analysts project that a 'balanced' world market for chemical grade pulp would see producer inventories in the Norscan countries of about 1.5 million tonnes. For most of the past three years, inventories have been well above this mark, resulting in the weak prices that have prevailed. Weak prices, however, have also resulted in record shipments of pulp. September 1998 was the largest month for Canadian shipments of market pulp ever. That, combined with downtime, is reducing inventories. Market watchers predict that inventories will reach the target 1.5 million by early 1999, resulting in some price increases for producers.

The market balance for chemical grade pulp is an international equation. Canada is the single largest exporter of this grade, but it does not dominate world markets. To achieve market stability, all Norscan countries must limit expansion and reduce inventories relative to demand. We can only wonder why some in BC are so eager for one or several BC mills to be sacrificed to achieve this international balance.

Improved coordination and consolidation on the marketing side among BC producers could assist in maintaining balanced operating rates and reasonable inventories to help achieve a balanced market. BC producers, with the assistance of the government, also need to help put more order and discipline into a volatile international marketplace.

World demand for pulp is expected to continue to grow over the next decade. Nevertheless, the current situation demonstrates overwhelmingly the importance of moving beyond commodity pulp to value added paper grades. In short, BC does not need fewer pulp mills; rather, it needs more paper machines. The real test of pulp and paper viability in BC is fibre supply. To the extent that secure, sustainable fibre supply exists, there can be economically viable pulp and paper mills in BC.

Norscan chemical paper grade market pulp inventories and production

	Inventory end Sept/98 (000 metric tonnes)	Change from Aug/98 (000 metric tonnes)	Operating rate as % of capacity	total shipments, first 9 months of 1998 (000 metric tonnes)
Canada	767	-94	87%	6,041
US	570	-27	82%	5,487
Finland	101	+3	91%	1,259
Norway	41	-	104%	279
Sweden	279	-58	73%	2,331
Total	1,934	-177	84%	15,397

Source: Pulp and Paper Week, Nov. 2, 1998

It's time to pull together

This is a difficult period for the BC forest industry. The industry is in a cyclical downturn, mainly as a result of the Asian crisis. It is made worse by our over-dependence on commodity products. It appears as if hundreds, if not thousands, of jobs have been permanently lost. Without doubt, many of the mills closed will never re-open. But what should the government do?

The demands of the companies add up to a rollback of almost everything accomplished in BC's forest sector over the past decade. But the reasons for those crucial reforms are today as strong as ever.

Nothing less than the best, most environmentally responsible forest practices are acceptable in BC. In fact, the future will see even more demanding standards for forest practices – not a gutted Forest Practices Code. While lobby groups like COFI are pressing for lower standards, individual companies are already seeking certification of their forest practices from the Forest Stewardship Council (FSC) endorsed by many environmental groups around the world.

Stumpage has been cut dramatically. But it must be remembered that a very large part of the stumpage no longer being paid has been taken from the Forest Renewal Fund established to invest in the long-term future of the forest resource. It is more than ironic that, as companies turn to the FRBC for assistance in job training, road construction or other practical measures, they now find FRBC unable to assist.

Another victim of the stumpage cuts will be FRBC's transition program for unemployed forest sector workers. Perhaps the best transition program ever established for unemployed workers in BC, it must now be drastically retrenched, with smaller benefits and more restrictive eligibility requirements. Certainly, one of the government's first priorities must be to maintain the transition program with the most generous benefits possible.

The BC tradition in responding to tough times is to pull together. Traditionally, people look to the government to lead the way by softening the blows of the marketplace and preparing the ground for renewed prosperity. In short, BC will need more 'bail-outs' for workers, communities and even perhaps for some very large companies. Although the province continues to receive criticism from the industry for its role at Skeena Cellulose, it is noteworthy that the unemployment figures cited at the outset do not include the thousands of Skeena employees at the pulp mill, sawmills and in the woods who are today working. The direct payroll at the pulp mill alone will exceed $25 million this year. This is the positive result of government support for Skeena's restructuring, when many in the industry hoped it would just shut down.

A common thread running through the entire forest sector is the large amount of debt hanging over many companies and mills. Unless there is substantial price and market recovery, many restructurings are at hand. While Skeena is not a model for any other company, the downturn in forestry is an opportunity to establish a better financial basis for many companies. Greater worker involvement, including worker ownership arrangements in some circumstances, may also be part of the solution. The government should not retreat from the principle established at Skeena that it stands ready to partner with workers and communities who step forward to invest in their future.

This is also a time to respond positively to union initiatives for shorter working time alternatives. For example, at Powell River's Pacifica Paper, a new collective bargaining agreement reduced the standard work week by two hours per week, creating 21 permanent new jobs – but only after the union threatened strike action to achieve the reduction in hours. The union also took action to eliminate unnecessary overtime and has reduced overtime hours at the mill by almost 90% to just 1% of hours worked, thereby saving dozens more jobs and preventing a new round of trades layoffs.

There are more bad news announcements in store for forest industry workers and communities in BC, and with each announcement people will naturally look to the government for leadership and assistance. With each announcement we can also expect COFI and the companies to generalize about the terrible state of affairs that the NDP government has brought about. I am reminded of the **Vancouver Province** Krieger cartoon of a grim-faced Boris Yeltsin blaming Glen Clark for the meltdown of the Russian economy.

The BC government has delivered a new round of substantial cost reductions to the forest companies, and it is predictable that they will take the money and declare that it is still not enough. We can only hope that a vigilant public will begin to ask whether, when—and how much—the companies intend to contribute to their rescue plan.

How much is **not enough** from the government? The government has fallen short when mill towns and companies are allowed to fail, simply because of free market chaos and the lack of political will to ensure a better outcome. How much is **too much** from the government? It will be too much if the Forest Practices Code, Forest Renewal BC, sustainable harvest levels, or other fundamental elements of public forest policy in BC are sacrificed for the short-term benefit of forest companies.