
**SUBMISSION OF THE COMPETITION COUNCIL
REGARDING REPORTS FROM THE
WOOD PRODUCTS AND PULP AND PAPER INDUSTRY ADVISORY COMMITTEES**

1. INTRODUCTION

The Competition Council is pleased to present its perspective on key recommendations from the reports of its Wood Products and Pulp and Paper Industry Advisory Committees (attached).

The Council has decided to submit these reports immediately in view of the complexity of these industries and the continued deterioration in their financial performance. The Council plans to present its report on all the industries that it has reviewed in June, 2006.

The Council welcomed the approach of both Committees that in the words of the Wood Products Letter of Transmittal: "the Committee (concluded) that the industry itself should take a leadership role by proposing market-based solutions, along with an implementation strategy."

The Council believes an industry-led plan, supported by the provincial government, has the greatest chance of success in dealing with the competitive issues facing the industries.

2. INDUSTRY ADVISORY COMMITTEES (IACs)

WOOD PRODUCTS

The Softwood Lumber Dispute substantially affects the competitiveness of the BC wood products industry. As there is a national process in place to deal with the dispute, no recommendations are made on this matter. However, it is implicit in this report that the dispute is eventually resolved and that the industry regains competitive access to the U.S. market.

Background - Interior

The B.C. Interior forest industry is a world competitive industry with current costs in the first quartile. Revenues grew by 28% from \$4.3 billion in 2000 to \$5.5 billion in 2004, accounting for 74% of BC's timber revenues. The Interior companies have consistently invested in state of the art equipment and large scale automated mills. As a result, despite the severe impact of the Softwood Lumber Dispute, which has cost the Interior companies more than \$2.6 billion in tariffs and deposits, the industry has been able to maintain its share of the U.S. market.

The Interior industry benefited from the Forestry Revitalization Plan in 2003 which reduced regulation and streamlined procedures. Its unions were supportive of work place changes that permitted significant productivity gains. As a result, the industry was able to continue its program of heavy reinvestment.

The Interior now faces the huge impact of the Mountain Pine Beetle (MPB) infestation. Already, ten million hectares and over 420 million cubic metres of Lodgepole Pine have been attacked. This volume is equivalent to more than six years Annual Allowable Cut of the whole Province. It is estimated that the eventual impact of the MPB could amount to more than double the area and volume so far affected.

2.1 BC Interior Transition Plan

The three highest priority recommendations in the Interior Plan relate to the MPB infestation. The Wood Products IAC Report describes the devastation caused by the MPB as “the most significant natural disaster in the history of the province.”

2.1.1 Mountain Pine Beetle Action Plan

The IAC calls for a province-wide forest industry strategy to provide co-ordinated regional planning and to identify ways to diversify and stabilize community economies during and after the infestation.

Position of the Competition Council

The Council supports the IAC recommendation. The burden of the work undertaken so far has been borne largely by the Provincial Government through the Ministry of Forests and Range. The primary initiative should continue to remain with the Government, but now is the time to increasingly involve the Communities, First Nations, and the Wood Products and Paper Industries. A task force could be created to oversee the creation and implementation of the recommended plan which would be drawn from representatives of the Provincial and Federal Governments, First Nations, and the stakeholders.

2.1.2 Timber Pricing and Value Slide

The IAC recommends that the existing method of calculating the stumpage rate (comparative value pricing (CVP)) should be replaced with a new market value based method. This method will incorporate a mechanism to reflect the decline in value of beetle attacked pine.

The IAC calls for a change in timber permitting which would reflect the salvage nature of forestry operations in the beetle ravaged areas so that permits and approvals are simplified and expedited.

Position of the Competition Council

The Council supports this recommendation. We understand that discussions to replace the CVP have been ongoing for some time. The discussions should be completed within an agreed time frame.

The changes in permit and approval processes that the IAC requests could be considered by the proposed MPB task force, again within a short time frame.

2.1.3 Rationalization and Consolidation

The IAC calls for the removal of barriers to exit the industry and for provincial government negotiations with the Federal Government to bring about “a single window provincially led review”.

Position of the Competition Council

The Council supports the concept of rationalization. The IAC believes that the interior industry will be reduced in size as a result of the MPB. The Council suggests that in assessing mergers and takeovers, the industry is considered as part of a world, rather than a local, wood products industry.

Background – The Coast

The coastal industry is in serious decline. Its costs are in the fourth quartile and are amongst the highest in the world. Revenues have fallen since 2000 by 24% from \$2.5 billion to \$1.9 billion in 2004. The Coast wood product industry is just a fraction of its former scale. The region's industry has been chronically unprofitable and its mills are old, undersized and unproductive. The lack of any likely return on investment has caused significant under investment in the industry for a number of years.

Major markets such as Japan, partly caused by the Kobe earthquake and the resultant change in the Japanese building code, have been lost to European competitors providing the product that the market demanded and the Softwood Lumber Dispute has posed a major obstacle to the industry in competing in the U.S. market.

2.2 BC Coast Turnaround Plan

The purpose of the Turnaround Plan is the "creation of financial and operational conditions necessary to attract the new investment required to compete in the global forest products market place." The three recommendations with the highest priority are:

2.2.1 Land Use Certainty and Crown Forest Management

The industry welcomes the finalization of the Land Use Plan for the Central and North Coast. The industry's concern in the areas where it holds licenses is that it believes it does not have certainty to access economically viable timber. The recommendation calls for changes in regulations and administrative procedures which would give the industries access to fibre that can be profitably processed. These changes are intended to simplify regulation and streamline government intervention in the forest products processing industry.

Position of the Competition Council

The Council accepts the IAC's contention on access to timber and Crown forest management. The cash flow of the coastal industry is now precarious. The industry believes that the changes recommended in this proposal would have a significant positive impact on operating cash flow.

2.2.2 Reduce Lumber Production Costs

The recommendation outlines steps to reduce delivered wood costs and mill conversion costs by updating the market pricing system, removing unnecessary operating costs, and establishing a Sector Council with the unions and employees to oversee labour cost competitiveness.

The recommendation also proposes a series of tax changes that could be of benefit to the industry in encouraging reinvestment.

Position of the Competition Council

The Council supports the industry's proposed initiatives to improve its competitiveness. The steps outlined by the IAC, if successful, should help to improve the business climate in the coastal industry. Industry must provide the product that the export market demands and market it aggressively to regain market share. Major improvements in productivity are only likely to be achieved through significant new investment.

The Council is not proposing any tax changes until it has completed its final report, with the exception of the Municipal Property Tax (see 3.1 below).

2.2.3 Transition to Second Growth

The IAC's recommendation calls for a review of forestry policy to ensure that it supports a market driven transition to second growth harvesting.

Position of the Competition Council

The Council supports this recommendation. We understand that the long term competitiveness of the coastal industry depends on access to economic second growth timber, which would have to be supported by major investments in state of the art saw mills and kiln drying facilities.

Several of the traditional markets for Hemlock, which can comprise up to 60% of second growth forests, have been lost. There is justification for government and industry supported R&D to improve the competitiveness of the Hemlock species.

PULP & PAPER

Background

The Pulp and Paper Industry is an essential component of the overall forestry industry in B.C. It depends entirely on the by-products of the Wood Products sector for its raw material, whilst Pulp and Paper currently contributes around 30% of the revenues of the Wood Products Sector.

The transmittal letter from the Chairman of the IAC states that the "industry is facing the most severe economic condition in its history." This is the result of worldwide competition, particularly in pulp, and declining markets for newsprint. As 85% of its products are exported, the industry has been severely hurt by the appreciation of the Canadian dollar and the sharp increase in chemical and transportation costs.

The revenue and cost pressures have had a dramatic effect on profitability. The industry's problems have been compounded by uncertainty on its future fibre supply. The Coastal pulp industry is increasingly dependent on Interior and U.S. chips which are now cheaper than Coastal pulp logs, causing the Coastal wood products industry to lose another source of revenue. The supply of Interior chips will decline after the MPB epidemic and this is likely to force contraction in the Coastal pulp industry.

The Interior Pulp and Paper industry in the longer term will face an uncertain future fibre supply. Once the MPB wood has been harvested, the supply of Interior wood chips will shrink and will be insufficient to maintain present levels of pulp production in the Interior.

2.3 Plan for Pulp and Paper

The sustainable size and profitability of the Pulp and Paper Industry is dependent on the size and viability of the Wood Products sector. For this reason the IAC's key recommendation is that the Wood Products Industry and the Government take steps to ensure the future of Wood Products. The IAC's letter of transmittal states, "Without a viable and low cost Wood Products sector on the coast and in the Interior, the Pulp and Paper sector will not survive: this is a fundamental issue that cannot be overemphasized."

The three highest priority recommendations affecting the Pulp and Paper industry itself are:

2.3.1 Reduce the Cost of Social Rents

The principle social rent affecting the highly capital intensive Pulp and Paper industry is municipal taxation. Appendix C of the Pulp and Paper Report provides a detailed analysis of the impact of municipal taxation in B.C. It provides evidence to support the claim that "The ratio of the Major Industry Rate to the Residential Rate is extremely high in BC at a staggering 4.2 times the Residential Rate. This ratio is far lower in competing jurisdictions such as Alberta and Rural U.S.A. at 1.30 and 0.86 respectively."

Position of the Competition Council

The Council supports this recommendation. It agrees with the conclusions of the IAC Report that the tax burden is not consistent with the services received from the municipalities and that high property taxes are a disincentive to new investment in B.C.

In order to deal with this issue, the Council recommends the following possible solution:

- (a) Municipalities should reduce the tax burden on the pulp and paper sector, particularly where the ratio of industry vs. residential rates is high.

If this is not done:

- (b) The province could reduce the number of categories of municipal tax into, say, one category of business tax that would include industry and services.
- (c) An imposition by the Province of a ratio by which the municipal tax rate on industry and business cannot exceed that of the tax rate on residential homes.

It is estimated that of the 200 municipalities in B.C., 15 would lose a major source of revenue and would require some form of assistance from the Provincial Government.

2.3.2 Improve Regulatory and Cultural Labour Climate

The IAC recommends that industries and unions in B.C. move away from confrontation to a more stable and cooperative labour management culture. The IAC believes that the Pulp and Paper industry has achieved this as a result of management and union cooperation in formulating long term agreements prior to contract expiry.

Position of the Competition Council

The Council endorses efforts to improve the Labour Relations Climate in these sectors and will comment specifically on labour relations issues in the final report.

2.3.3 Consolidation

The IAC proposes that the Provincial Government should not prop up non viable assets and should encourage the Federal Government not to interfere with the industry's attempts to consolidate.

Position of the Competition Council

The Council concurs with the recommendation that the industry be allowed to consolidate. The IAC expects that as a result of reduced chip supply, the industry will contract on the Coast and in the Interior. This contraction could be facilitated by mergers and takeovers.

3. RECURRENT THEMES

There are two recurrent themes in the IAC Reports that warrant additional comment by the Competition Council.

3.1 Relations with the Provincial Government

Half of the thirty recommendations made by the Wood Products and Pulp and Paper IACs concern relations with governments, particularly the Provincial Government. It appears that the industries' concerns may arise from the multiplicity of functions that the Government conducts in relation to the industry. There are at least eight separate functions that the Government conducts: owner of the land, owner of timber, licensor, forester, operator, timber seller, regulator, and tax collector.

The forestry business model employed by the Province differs significantly from other extractive industries such as oil and gas, and mining which operate on Crown land. These industries, while complying with strict environmental, health and safety regulations, determine what they produce and how they will market the product.

Position of the Competition Council

The Council believes that the competitiveness of the industries would be strengthened if the Provincial Government took steps to reduce and eventually eliminate its role as operator and seller of timber produced from the Crown timber holdings.

3.2 Need for Reinvestment

No primary sector can be competitive in a worldwide exporting industry unless there is substantial reinvestment in plant and equipment. A lack of reinvestment is a prime indicator that the business climate is one in which companies are not prepared to risk capital.

(a) The Interior

In the case of the Interior, its modern mills have enabled the industry to maintain market share in the U.S. despite the severity of the Softwood Lumber Dispute.

The industry now faces the enormous problems of the MPB infestation but it believes that it can retain its competitiveness despite the contraction in productive capacity and the longer trucking distances that the MPB will cause.

(b) Coastal

The lack of investment has led to the continuing decline in the size of the Coastal industry. The IAC believes that future investment is dependent on access to adequate long term supplies of second growth timber which may require changes to existing tenure arrangements. Companies undertaking investment will have to provide the products that the export customers demand and aggressively market to regain lost market share. The largest market for kiln dried hemlock is the U.S. and we understand that the resolution of the Softwood Lumber Dispute is a critical part of a successful re-entry into that market.

Position of the Competition Council

The Council believes that companies that are prepared to invest in new saw milling and kiln drying facilities on the Coast should approach the Provincial Government with specific proposals on the changes that they or their timber suppliers require in the rights of tenure and in the operation and administration of timber licenses in order to make an investment commitment.

(c) Pulp & Paper

Although the IAC believes that there will be a reduction in the size of the chemical pulp industry in the next 10 years, particularly on the Coast, it does believe there are investment opportunities in mechanical printing paper. In the words of the Letter of Transmittal: "Mechanical printing papers are sustainable in BC and represent a significant investment opportunity."

Position of the Competition Council

The uncertainty as to the future supply of fibre after the harvesting of MPB damaged wood may make companies hesitant to make substantial reinvestment decisions in the industry. However, the plan for revitalization of the Interior should include a review of the conditions that would attract capital to this potential investment opportunity.

4. CONCLUSION

Success or failure to deal with the problems facing Wood Products and Pulp and Paper is primarily the responsibility of the management in these industries.

The Council believes that the role of the Province is to create the business conditions that will encourage investment by existing and new participants. The key to a sustainable future is new investment.

David Thompson
Co-Chair, BC Competition Council

Dan Miller
Co-Chair, BC Competition Council