

CAN STUMPAGE REFORM SAVE THE BC INTERIOR FOREST INDUSTRY?

By Jim Girvan and Russ Taylor

North American lumber prices peaked in mid-2018 and some thought it may have been the last hurrah for the BC Interior forest industry.

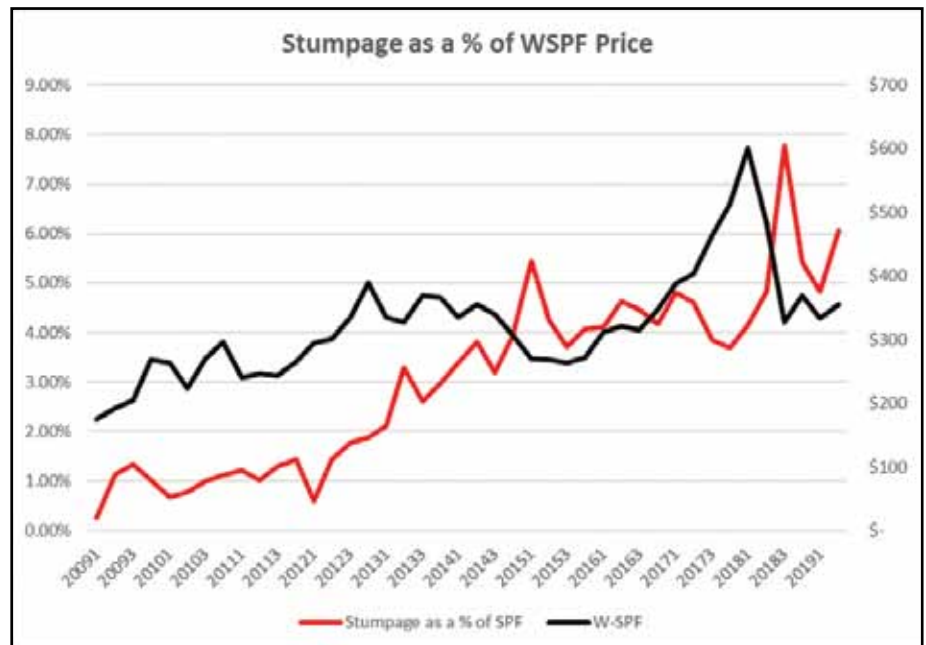
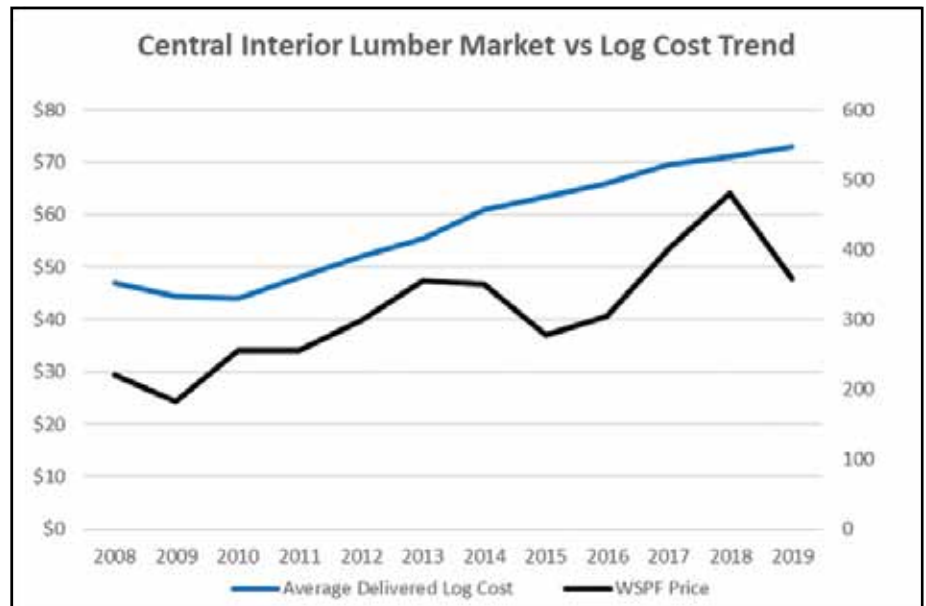
Since the peak of that market cycle, lumber prices fell quickly to below cost levels as global supply out-stripped demand. A flood of low-cost lumber from Europe precipitated by a massive spruce bark beetle infestation provided a plethora of cheap logs for central European sawmills, with many mills exporting to world markets, including BC's two largest markets: the United States and China. Combined with rising log costs for the BC Interior, these various factors accelerated an unprecedented number of mill closures through the summer of 2019, as was predicted by the authors. With the first mill closure being announced in May of 2019, by the fall, six sawmills had closed permanently, four had eliminated shifts permanently and many more had announced some form of periodic downtime or indefinite closure.

While BC harvest reductions due to the mountain pine beetle (MPB) epidemic can be blamed for some mill closures, the catalyst for these curtailments was the steadily rising cost of sawlogs when lumber market prices were falling. During 2019, the BC Interior became one of the highest-cost producing regions in North America—and essentially the world—under these unfavourable conditions.

So, what is driving the steady increase in log costs in the BC Interior?

Many factors are to blame following the mountain pine beetle epidemic including declining volumes of low-cost, but uneconomic MPB-killed logs as the industry transitioned back to green timber; longer haul distances; increases in logging rates as the contractor sustainability review progressed; steeper slopes; and stumpage increases.

At the recent annual Global Softwood Log & Lumber Conference, Russ Taylor echoed his perspectives from the TLA's 2020 Annual Convention + Trade Show where he pointed to stumpage fees as a leading culprit to the steadily rising log cost issue in the BC Interior.



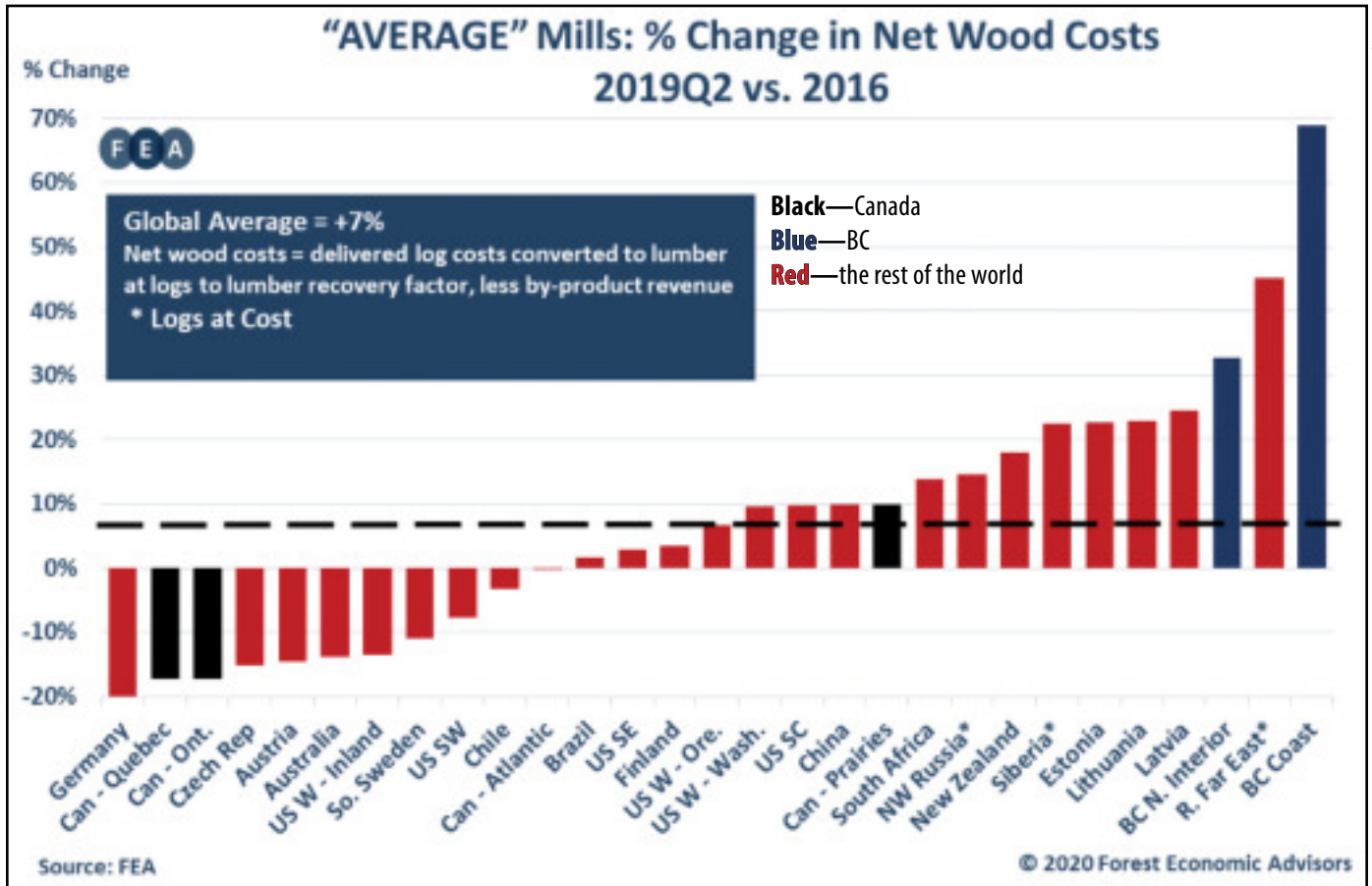
Perhaps he is right given Alberta has a stumpage system that is more responsive to market change and has seen most sawmills continue to operate over the past two years when compared to the catastrophic mill closure story playing out in BC. A major difference in log costs between BC and Alberta is stumpage and the methodology used to derive it.

As a result of the Ministry of Forest's stumpage system being based on the market pricing system (MPS), at its core, stumpage is driven by the market

behaviour of independent loggers in the timber auction system used by BC Timber Sales. One would expect that as the market price of western SPF (spruce-pine-fir) lumber rose, so too would bids for standing timber; conversely, as lumber prices moderated, so too would bid prices.

However, what we saw was a disproportionate rise in stumpage as the value of standing timber at auction was bid up in an environment of rising lumber markets and tight restrictions in log supply.

Charts: Jim Girvan

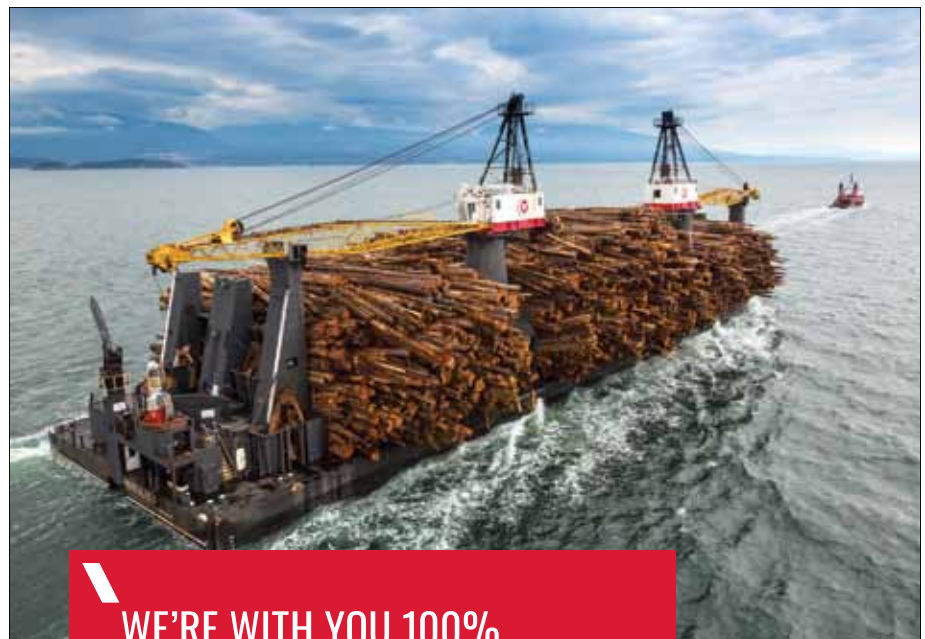


The timber auction price is an input in the stumpage formula, and with scarce incremental timber supplies in the BC Interior, the price for timber was driven higher and often well beyond a mill's ability to break-even.

Over the past decade, stumpage as a percentage of the selling price for western SPF lumber has risen steadily and has been particularly offside for approximately 12 months after high lumber prices tapered in mid-2019.

Combined with the other cost pressures detailed above, the BC Interior has become one of the least competitive lumber producing regions globally when total delivered costs-to-markets are considered. In fact, Taylor estimates that the BC Interior net wood costs have risen a whopping 33 per cent between 2016 and the second quarter of 2019. By comparison, Alberta, with a more market responsive stumpage system, has seen net wood costs rise less than 10 per cent and close to the global average of 7 per cent over the same period.

These costs have put the BC Interior forest sector near the bottom of the global competitiveness list—with the



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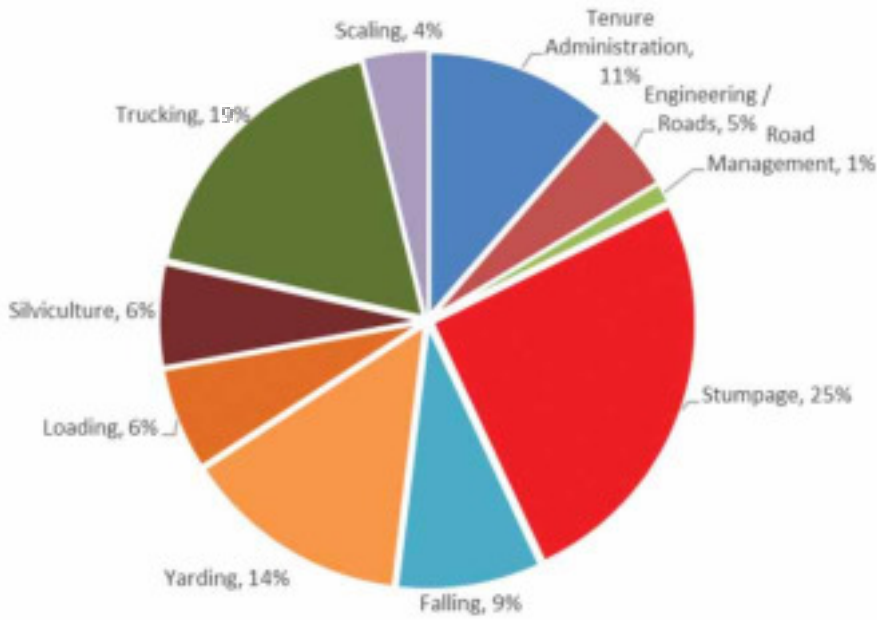
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Central Interior 2019 Average Delivered Log Cost



BC Coast at the absolute bottom—and speaks directly to why many mills have closed with some BC Interior mills remaining curtailed despite recent improvements in the market through 2020.

The Random Lengths Framing Lumber Composite index price hit a new, all-time high in August 2020. At the same time, western SPF lumber prices have exceeded their 2018 highs because of the

huge demand from the do-it-yourself trade due to renovation projects during the COVID-19 pandemic.

Simply put, BC Interior log costs are becoming too high from a global competitiveness perspective. In 2019, stumpage comprised approximately 25 per cent of the total delivered log cost and 6 per cent of the average western SPF selling price (up from less than 1 per cent in 2009). BC also has to pay a punitive import tax averaging 20.2 per cent on US shipments (about 60 per cent of all exports) and has high logistics costs to US destinations, given the large lumber volumes that need to be shipped out of BC, which further reduces our competitiveness.

When net raw material costs are too high in comparison to global competitors, market improvement needs to be very strong, as we have seen recently, before the Interior industry can start to recover.

Looking forward, there have been recent changes to the Interior MPS formulas that some hope will improve the market sensitivity of the stumpage system. On the other hand, the government's Interior Forest Sector Renewal initiative



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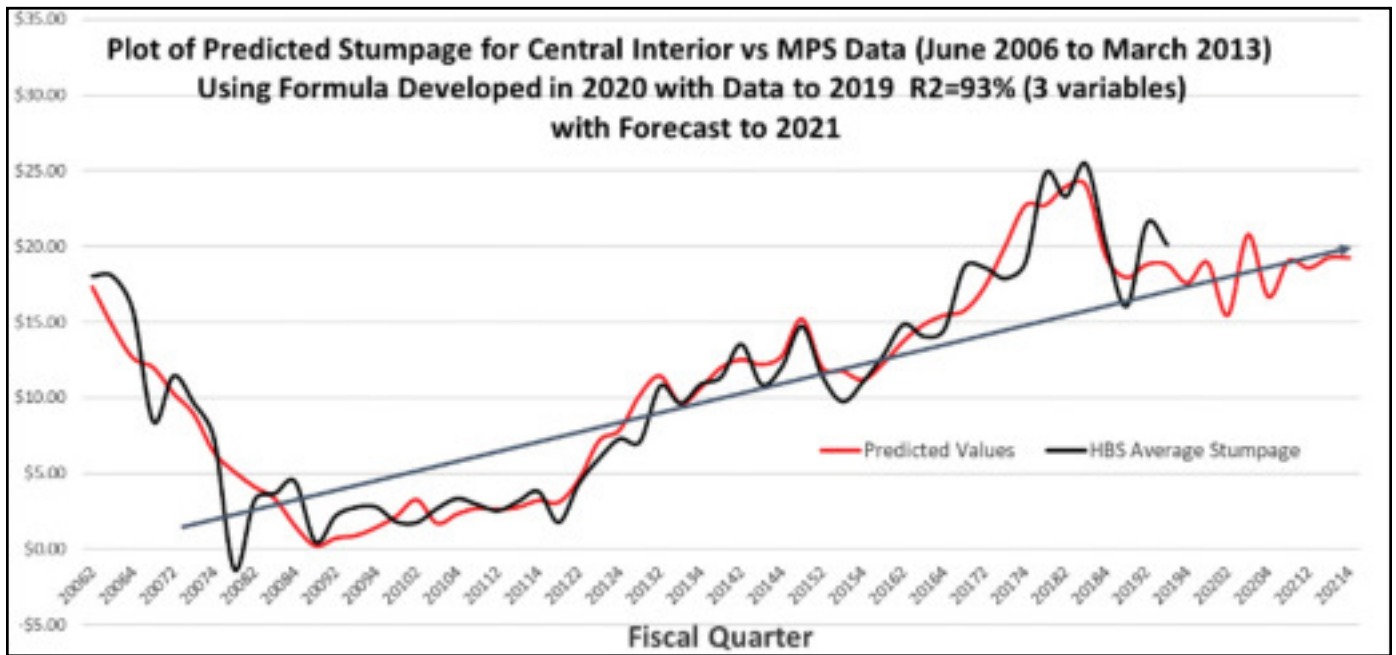
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is expected to add more costs to the industry. Time will tell.

Can we expect stumpage relief in the future with the current MPS system?

The authors correlated actual stumpage paid to key market indicators since MPS was instituted in 2006 and can now forecast relative stumpage rates

independent of the MPS model. With a forecast for rising US housing starts, improvement in western SPF prices in 2020, and moderation of prices into 2021, stumpage is expected to also moderate with some volatility as it continues its long-term upward trend. Given the market-based nature of the

MPS system and despite the potential for MPS changes to improve sensitivity to markets, this rising stumpage price outcome was not unexpected.

To become competitive on a sustainable basis, the BC forest industry must

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