

SOFTWOOD LUMBER AGREEMENT 2006
How it is Working: A Progress Report

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President, B.C. Lumber Trade Council
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Presentation to TLA Convention



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British Columbia's forest industry is going through one of the worst times in its history. Its main market, the U.S. housing sector, has collapsed in the wake of the sub-prime mortgage crisis and the ensuing financial meltdown. Within the past few months it has become clear that these events have triggered a global recession, likely the worst since the Great Depression of the 1930's. What might have been a fairly normal cyclical downturn of the kind our industry has learned to deal with is now a crisis of global proportions.

In Canada, we have to cope with this situation within the confines of the 2006 Softwood Lumber Agreement. That means that B.C.'s lumber exports to the United States are currently subject to a 15% export tax. On top of that, in British Columbia's interior region the mountain pine beetle epidemic has now destroyed a significant share of our timber resource—raising costs and reducing values.

The inevitable result is that harvest and production levels are down; mills are also closing; and workers are being laid off. Forestry dependent communities, of which there are well over 100 in BC, are starting to experience severe social and economic impacts. And yes, Vancouver is far more dependent upon the forest sector than most people realize and it too will feel the impact.

In times like these people start looking for answers. What has gone wrong? What can we do to fix things?

To isolate our forest sector's challenges from the global financial crisis would be a mistake but there are some specific targets that have come under criticism.

I hear a number of voices within British Columbia and elsewhere in Canada calling for the termination or renegotiation of the Softwood Lumber Agreement. After all, they must reason, eliminating that 15% export tax couldn't hurt! Interestingly, there are also voices within the United States saying much the same thing—the agreement isn't working!

I believe the Agreement is working. This places me in the challenging position of having to defend it against the opposing views of different constituencies both here and in the United States.

The Softwood Lumber Agreement or SLA was signed a little more than two years ago in October 2006. It was designed to settle the so-called Lumber IV trade dispute and put in place a more stable trading environment for the future. Since it was signed the current

recession and the mountain pine beetle epidemic have assumed greater importance. There were hints of a forthcoming market downturn in 2006. And the mountain pine beetle epidemic was well underway. However, it is probably fair to say that the consequences of both have been greater than many people expected at the time. These events have affected peoples' views about the SLA.

What I would like to do today is speak to both of these issues and how they relate to our trading relationship with the United States. That will then provide the necessary context to discuss what is right about the agreement and why it is the best option we have for maintaining a mutually beneficial trading relationship between Canada and the United States.

The Current Recession

The forest products industry was among the first casualties of what has now become a global recession. As we all know now, the US housing market grew rapidly in the first half of this decade, fueled by cheap credit and innovative financial instruments. People in the U.S. were encouraged to buy homes they could only afford if house prices kept rising. Everyone knew a market correction was due and that it would affect the forest sector. However, it was only when the bubble burst that the fragility of the underlying financial framework became clear. What might have been a correction of the kind we are used to turned into a rout.

As late as early fall last year, there was still a chance that the financial meltdown could be contained with limited impact on the "real economy" or "main street" outside of the forest sector. That hope has been dashed. The damage has spread. The U.S. is in the worst recession in decades; and the crisis facing our forest sector will be deeper and longer than anyone could have anticipated.

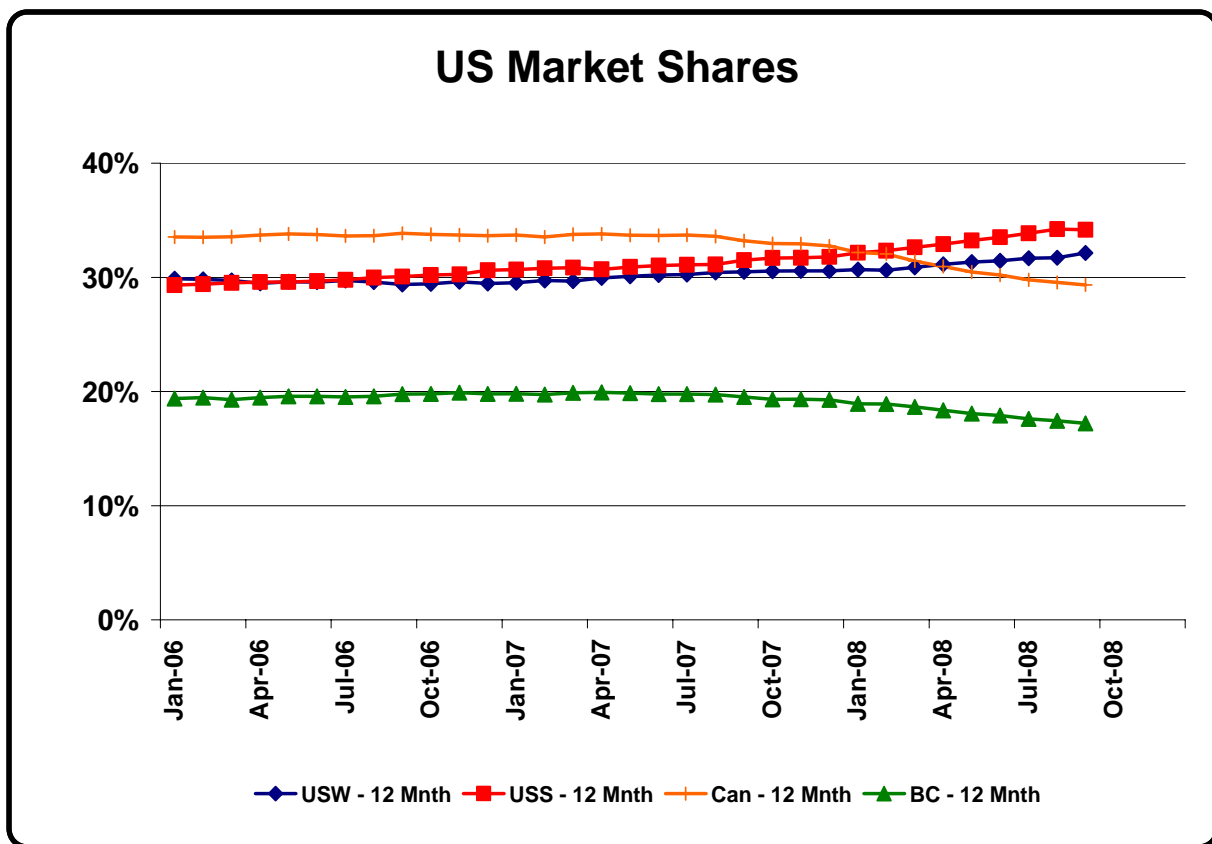
The most recent data we have on U.S. softwood lumber consumption, for September 2008, shows a decline of almost 35% since the softwood agreement was initiated in April of 2006. Almost certainly, it is still declining. Housing starts fell again in November and are now running at a seasonally adjusted annual rate of 625,000: remember not too long ago when housing starts were over 2 million per year. Obviously, the U.S. housing market is still in deep difficulty. Sales prices of existing homes are still falling; and foreclosures are rising. The situation will not stabilize unless something is done to deal with this foreclosure issue.

Under the SLA, Canada is subject to trade restrictions linked to U.S. lumber consumption. At lower US consumption levels and lumber prices, more onerous restrictions are imposed. In the case of British Columbia that means, at present, an export tax of 15%. The basic idea is that when markets are very strong there is less need for the United States to protect its lumber industry and a good case for allowing Canada to increase its market share to meet rising US demand and supplement the U.S. industry's limited supply capability. Conversely, when markets are weak our market share is restricted to historical levels.

Since the recession is turning out to be longer and deeper than anyone thought, the SLA export tax penalty has been set at a higher rate longer than many expected. This has definitely had an adverse impact on our industry.

As a result, our share of the U.S. market has declined. One of the key U.S. objectives in the softwood lumber agreement was to ensure that Canada “shared the pain” in market downturns. As the following chart demonstrates, this is happening. To be clear: while production is down everywhere, in Canada, including British Columbia, it has declined by more than in the United States. Thus we have a smaller share of a smaller market.

In principle, we could do better under free trade. However, I believe that a realistic assessment requires us to acknowledge that the current managed trade arrangement is probably better for all parties than the no doubt bitter dispute that we would otherwise be in today.



Note: Graph shows twelve-month moving averages of monthly data on shipments from indicated regions as a percent of U.S. consumption.

The need for governments to provide additional fiscal stimulus to get us through the present crisis is however a potential source of additional tension. Most everyone is agreed that it is in all of our interests for the leading economies to make a concerted effort to boost global demand. For example, in the U.S., President-elect Obama has recently announced

a massive new stimulus program he hopes to bring into effect soon after he takes office. This follows earlier measures, including a bailout of the “Big Three” automakers.

For Canada, including British Columbia, the challenge is to promote economic recovery without putting the SLA at risk. There is no doubt that the SLA limits our freedom of action in this regard. However, Canada’s forest industry has been very clear that there are ways in which governments can act and which ought not to jeopardize our trading relationship.

We are advocating that fiscal stimulus take the form of broad-based measures that affect the entire economy, not just the forest industry. This could comprise greater support to workers and communities affected by the downturn; and general support for infrastructure, research and development, and market development that will enhance Canada’s future productivity. We also support an enhanced role for government in extending credit, on commercial terms, until such time as credit markets have returned to normal.

I am hopeful that Canada and British Columbia will follow our advice; and hopeful that the United States will recognize our sincere effort to foster economic recovery on a trade neutral basis.

Mountain Pine Beetle Epidemic

The second issue I would like to discuss is the mountain pine beetle epidemic. It seems to me sometimes that our American friends think that we have won the lottery, that somehow this epidemic is of great benefit to us. They should know better and quite frankly I think they do. They have experienced epidemics, fires and hurricanes, none on the scale of this one, but all of which have affected their timber supply in much the same way. And they have reacted in the same way. Like us, they have sought to salvage as much value as they could from the wasting resource and they have moved quickly to re-establish the impacted forest. These are appropriate market responses to this type of natural calamity. It is as much good common sense as it is good economics or public policy.

In the case of the mountain pine beetle, the scale of the epidemic is truly massive and is having proportionally large impacts. We have adjusted our plans to harvest as much dead pine as we can. However, inasmuch as this timber is of lower value, it has resulted in lower stumpage revenues. The reduced stumpage simply reflects the reality of dealing with the beetle: it costs more to harvest dead and dry timber; it costs more to manufacture lumber from the affected pine; lumber recoveries are lower due to increased wastage; and product quality (and revenue) is lower. We conservatively estimate that the combined effect of higher costs and lower revenues reduces the value of affected pine logs by something like \$20 per cubic meter.

In the face of this challenge, our mills have had to make significant investments and innovations in order to utilize this poorer quality timber and get something of value from it. The fact that they can and have done so is, I think, to the industry’s credit. This is not just value for companies and their shareholders but for their employees who continue to work,

the communities they live in and for public programs including health care and education that benefit from forest sector revenue to government.

The “bottom line” though is that there is no good news for British Columbians in any of this; and matters are only going to get worse as we run out of salvageable pine and confront a much reduced economic standing timber inventory.

Somehow the U.S. lumber industry has convinced itself that we haven’t been harmed enough, that the fact we have so far been able to continue “struggling on”, albeit with a much reduced market share, is evidence we must be violating the agreement. Accordingly it has stepped up its activities in Washington, including recent submissions to the U.S. government in which it renews and extends its claims of massive subsidization. This is starting to create stress on the SLA.

As I will discuss further below, we think the agreement is worth preserving and to that end are willing to work with the Governments of Canada and British Columbia to see if there is any legitimate basis to the expressed concern.

The Softwood Lumber Agreement

The Softwood Lumber Agreement is, like virtually every other agreement, a compromise in which no one gets all that they want and everyone gets something that they need. Typically such agreements are not too “one-sided”.

In the case of the current Softwood Lumber Agreement, not everyone in British Columbia or Canada was immediately convinced that the deal proposed was a good one. Much of the eventual support for the agreement was grudging, reflecting a fairly widespread view that the advantages were only a little more compelling than the disadvantages.

The rationale for most agreements such as the SLA is that they are better than the alternatives. It is fair enough to criticize agreements if they are not. But it is all too easy to criticize them because they fall short of some ideal. Any considered assessment of the SLA should seek to avoid that fallacy. A quick look at past history provides a useful starting point.

The softwood lumber dispute has been almost continuous since the early 1980s. We have either been in litigation and subject to onerous duty deposit requirements; party to a negotiated settlement agreement under which our exports are subject to an export tax or quota; or threatened by imminent U.S. trade action. We have not had free trade in lumber in any meaningful sense of the word.

The dispute is one of the largest most complex trade cases ever seen, reflecting the interplay of a number of factors: large trade volume, many participants, political influence and complex economic issues. In addition, the limitations of international trade law make it difficult to ever achieve “closure”.

From the standpoint of the U.S. industry it doesn't matter that much whether they have a winning case in litigation because they can achieve almost the same trade restricting effect through duty deposit requirements put in place during the adjudication process; and then, if or when they lose, start the process and the duty deposits all over again.

When Lumber IV was initiated in 2001, both Canada and the U.S. agreed to try to end this seemingly endless cycle by finding a policy-based resolution that would address the stated U.S. concerns. Considerable progress was made in defining the elements of a durable solution. British Columbia brought in extensive policy reforms to fully establish a market based system. But, in the end the U.S. could not bring itself to agree with a policy based resolution. It is evident that the U.S. lumber industry is determined to use its political clout to maintain protection for its industry.

This determination on the part of the US lumber industry was clearly demonstrated throughout the Lumber IV litigation. Canada had virtually achieved a complete legal victory in Lumber IV by 2006. But the U.S. industry refused to recognize our win and, instead, pursued novel legal strategies, including a constitutional challenge, outside of the established WTO and NAFTA procedures. At the time the SLA agreement was initialed in April 2006, Canada was at least one year away from a final decision. Moreover, had Canada eventually prevailed, the U.S. would simply have launched a new round of litigation.

This is the reality that we faced. In this context, it only makes sense to be willing to accept a settlement—if reasonable terms can be agreed. In 2006 this was possible. Although the U.S. had a strong political position based on the foregoing considerations, Canada also had a strong legal position—it was in sight of a major legal victory. The terms reflected this balance.

The 2006 SLA had two main aspects. First, it settled Lumber IV. The litigation ended and 80% of the duty deposits were returned to Canadian lumber exporters. Second, though, it avoided a new round of litigation, Lumber V. To get this, Canada had to accept ongoing trade restrictions in the form of an export quota and/or an export tax on lumber shipments to the United States.

On the plus side, for British Columbia, export taxes are paid to Canada, not the United States, and are remitted back to the B.C. government. Through September 30, 2008 this has resulted in \$627 million to our government to invest in public services, that would otherwise have been paid to the United States. Also, on the plus side, the seven-to-nine year term of the agreement provides a period of relative stability and certainty in the trade environment, certainly much more than in the alternative Lumber V scenario. On the negative side, our exports are restricted. As noted in the preceding section, the export constraints are structured to provide more protection to the U.S. in weak markets and less in strong markets.

Was this fair? We think that in the circumstances it was a fair and workable deal. Remember, both sides had elements of considerable strength in their respective bargaining positions.

However, looking at the situation today, with the severe difficulties facing our forest sector, one might be tempted to conclude otherwise. That, I think, would be wrong. Even with the benefit of “20-20 hindsight”, to me the SLA is holding up pretty well. Let’s step back and take a look at the bigger picture. Most of our current difficulties are due to market factors. US housing starts have collapsed and U.S. lumber consumption has declined accordingly. In this respect, British Columbia is in the same boat as other producing regions.

Of course, it is more troubling that British Columbia, along with the rest of Canada has lost market share in the U.S. While the SLA has no doubt contributed to the problem, it is useful to remember that our competitiveness has also been affected by other factors, such as the Mountain Pine Beetle epidemic.

To the extent the SLA has contributed to our current woes, it is because the agreement was structured to require Canada to bear more of the burden in economic downturns, to “share the pain”, more than it had in the past. This was something that we agreed to do. Now we are paying that price. Had we not agreed to this, there would be no SLA. And if there were no SLA we would currently be in a trade dispute with the U.S. in the midst of the worst economic conditions in recent times. Who thinks we could get a better outcome today?

We should also bear in mind one very positive feature of the SLA that we fought hard to achieve and which is now paying off for us. Specifically, the SLA does recognize British Columbia’s market-based forest management system. One consequence is that we have had the freedom to adopt reasonable, economic measures to manage the mountain pine beetle crisis. For example, as timber value has declined, so too have our stumpage rates. This might not have been the case; and in that event our current predicament would be much, much worse.

In conclusion, on the whole the SLA is working reasonably well to balance the interests of both Canada and the United States.

Not everyone would agree. Some very reasonable people do feel that entering into the SLA was a mistake. However, even if the agreement might be criticized, this does not mean that termination would now be a sensible course of action. What is past is past. A termination decision requires us to examine the advantages and disadvantages of the alternative courses of action that are now available to us.

If we stick with the agreement, the likelihood is that it will take another one to two years before lumber markets recover. During that time, we will continue to be subject to the current trade restrictions. However, once markets have recovered, we could look forward to a period of economic growth and potentially much less restrictive export constraints. Of course, if we get to this better position, there is a risk that the United States could terminate

the agreement and plunge us back into litigation. However, if the economy is performing well there is little incentive for the U.S. to take this action. Even now, as Canada has reduced its market share, other countries have increased their presence in the U.S. market, preventing U.S. producers from benefitting fully from our restraint and providing dramatic proof that the U.S. industry has its own difficulties not linked to trade.

On the other if we terminate the agreement, we will, almost certainly, be into another round of litigation. Within a year, perhaps sooner, we would once again be subject to duty deposit requirements. As our past experience has shown, even if we have the stronger legal case, it will take on the order of five years, perhaps longer, to secure a legal victory. What this means, is that as the market is entering a recovery period our industry would remain hobbled by U.S. trade restrictions.

These trade restrictions would be imposed at a time when U.S. protectionist sentiment is rising and has a more sympathetic ear within the U.S. Administration than in several decades. They will be imposed during a period of severe market downturn. How likely is it that the initial U.S. decisions will be less than punitive? How likely is it that the U.S. will be willing to enter into a reasonable settlement? Clearly, any relief that we get by terminating the agreement will be short-lived! And our energy and resources will be spent on legal battles rather than making investments in innovations and R&D to help us survive the crisis and take the leadership role our industry can play.

Concluding Remarks – Looking Ahead

I have tried to defend the SLA as a reasonable compromise that is working to provide an element of stability in this current very difficult environment; and that in the years ahead will actually help our industry recover. This is not, perhaps, an ideal defense. What we have is “managed trade”, not free trade, and few people that I know have any great attachment to it. Is there an alternative?

As noted above, Canada and the U.S. seem trapped in a never-ending cycle of litigation and managed trade agreements like the current SLA. The legal system governing international trade disputes does not lend itself to closure. Thus, U.S. industry is able to bring case after case, tying up Canada in litigation and winning even while losing. Ideally, something would happen to break this cycle. This was tried at the outset of Lumber IV—the ill-fated attempt to negotiate a durable, policy-based resolution. It didn’t work. In many respects this remains the best option to break the cycle. Accordingly, in my view, Canada should continue to seek this kind of resolution. The SLA does provide a mechanism for regional “exits” based on policy change; but, unfortunately, there is no U.S. interest in utilizing this mechanism so it is, at best, a long shot.

Alternatively, the cycle could be broken if at some point Canada achieves a decisive, robust legal victory that tells the U.S. industry it is futile to continue to pursue legal action. Again, as above, Canada should always “aim for the fences” in its softwood legal strategy. It is worth pointing out, however, that any time we have come close to this point in the past, the U.S. has changed its domestic law, rendering our victory moot. Although, this stratagem

might not always be available to the U.S. industry, the mood of Congress is, if anything, likely to become more, not less, supportive of its industry.

The cycle could also be broken if circumstances change so that the U.S. industry no longer feels threatened by Canada's more efficient industry. For example, the U.S. industry could improve its own competitiveness. Or Canada's ability to export could be constrained, for example in the aftermath of British Columbia's mountain pine beetle infestation. However, we cannot count on any of these things. In the past, Canada has always maintained a two-track strategy. Track One: developing the best possible legal defense against U.S. allegations. Track Two: being prepared to take advantage of opportunities to settle disputes on reasonable terms. The two tracks work together: in particular, a strong legal position is necessary to establish a bargaining position for settlement talks. In my view we need to continue this approach. In the meantime, our best option is to honour our commitment to the SLA and see to it that the United States does so as well.