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Ideas for a More Prosperous Nation

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How can the crisis in the forestry sector be resolved?

The crisis in Quebec's forestry sector is attracting plenty of attention because of the many plant closings and resulting job losses. But this is hardly the first time the industry has faced a crisis. In the late 1970s, to make up for its declining competitiveness, the Quebec paper industry invested $1.25 billion of its own funds and $250 million from the federal and provincial governments to modernize its installations. Strong market growth meant that the higher productivity from these investments could be achieved without job losses.

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Just over a decade later, in the early 1990s, foreign competition caused another crisis, exacerbated by major spending to cope with new federal and provincial environmental regulations. This crisis forced a shift in orientation for many plants and led to thousands of layoffs. Meanwhile, the United States launched a series of challenges against the softwood lumber sector that ended with Canada agreeing to export quotas and taxes as well as countervailing duties. It is thus scarcely a surprise that, in the last 15 years, the return on capital used in the forestry sector[1] has nearly always been below the cost of borrowing the sums needed to enhance its facilities. The result is a weakened industrial sector that is gradually losing its ability to respond to global competition.

The challenges faced by the forest industry

The industry is facing many challenges that are especially problematic. The rise of the Canadian dollar against the U.S. currency makes our products costlier to export. With the Quebec forestry sector exporting 75% of its production to the United States, priced in U.S. dollars, each one-cent rise in the value of the Canadian dollar, with no adjustment in prices, costs the industry more than $100 million a year in lost income. Higher energy prices are also a major factor since the drying of paper requires more than 2,500 kilowatt-hours of electricity per tonne produced. Each one-cent rate hike thus adds $25 a tonne to costs. With newsprint prices struggling to reach $600 a tonne, these increases are comparable in scope to the mills' net profit margin. Paper mills, like most other businesses, are also saddled with the capital tax that the two governments have finally decided to abolish (though only very gradually), still costing about $10 a tonne.

The cost of raw material is also on the rise because of protection measures for the forest environment, higher royalties demanded by the Quebec government, massive red tape and the government's propensity to make the forest industry bear the entire cost of forest management, including non-wood items. U.S. actions in the lumber sector have caused losses of hundred of millions of dollars in lawyers' fees, interest charges on duties that the U.S. finally refunded, unrefunded duties, lost markets, etc. Finally, the recommendations of the Coulombe commission on the management of Quebec's public forests in 2004 led to a reduction of more than 20% in the

1. Most data from this document come from Ministère des Ressources naturelles et de la Faune, *Ressources et industries forestières (Édition complète)*, 2007, http://www.mrnfp.gouv.qc.ca/forets/connaissances/connaissances-statistiques-complete.jsp.

annual allowable cut, following the updating of data on the regeneration and growth of forest stands and the removal of land used for purposes other than timber production in calculations of the allowable cut. A number of mills have thus seen their supply seriously amputated.

A broad range of factors thus has gradually made the forestry sector vulnerable. This has caused one-sixth of all plants in Quebec to close since 2006, with the loss of more than 10,000 well-paying jobs.[2] The slowdown in the forestry sector, which produced 4.6% of Quebec's total economic activity in 2004, will weight heavily on the entire economy. Thus, the forest sector must necessarily innovate and raise its productivity as well as its efficiency in converting its inputs to higher-value-added finished products so as to remain profitable and competitive.

A return to competitiveness and profitability will not be easy to achieve. It will require the main companies in the sector to become bigger. From a Quebec standpoint, companies such as Abitibi, Bowater, Domtar and Kruger may seem like giants. However, if every forestry company in Quebec were merged into a single entity, with total sales exceeding $13 billion a year, this company would still barely rank among the world's 10 largest forestry firms. Recent or planned mergers will enable companies operating partly in Quebec to carve out a vital place in the global market for specific products: there is really no other choice than to accept and meet the challenges of huge scale to benefit from some of the advantages, which can be quite sizable.

Solutions to end the crisis

To cushion the impact of a crisis such as that described above, the normal reaction is to call for government assistance, mainly in the form of tax relief, investment assistance and subsidies crafted subtly enough to be tolerated by foreign competitors under the terms of international trade agreements and by taxpayers, who often have trouble making sense of all this. This approach has only a short-term effect and cannot lift the forestry sector sustainably out of the slump into which it has fallen.

To get an idea of the scope of changes, innovations and productivity gains that are needed, it should be noted that nearly 75% of the timber harvested is used to produce lumber and newsprint. Not only will the market for these two products be declining in the coming years, but they are among the items with the lowest value added within the panoply of forest products. To ensure the survival of at least part of the forestry sector, we must look to the most dynamic mills and companies and ensure that market forces play in their favour, enabling them to grow.

The cost of timber delivered to Quebec mills is an especially large item, making this an area where change in public policy could have a significant impact. In this context, developing an efficient competitive market for timber could offer numerous advantages that would tend to make the industry more competitive, more resilient and more stable.

In 2005, the Quebec forest industry used a total of 44 million cubic metres of timber, of which 66% came from public forests, 16% from private forests and the rest from outside Quebec. In public forests, nearly the entire volume is harvested under *timber supply and forest management agreements* that set conditions authorizing a plant to harvest all or part of the supply it needs.

The *Forest Act* does not allow wood to be transferred from one plant to another without the express authorization of the minister of natural resources and wildlife. This mechanism impedes the economies of scale and the higher productivity that consolidation of operations is likely to bring about. In fact, unless the periods set out in the *Act* have expired, the minister is legally and politically unable to revoke a plant's timber supply and forest management agreement, even if the plant is closed, as long as there is some remaining hope it could be reopened. In the context of the reduced harvests that the chief forester decided on, the government could modify the *Act* to allow the minister to transfer the agreements of closed plants immediately.

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2. Ministère des Ressources naturelles et de la Faune, *Sommaire de l'emploi dans l'industrie forestière par catégories d'usines*, 15 août 2007, http://www.mrnf.gouv.qc.ca/publications/forets/entreprises/usine-emploi.pdf.

Tableau 1

New contract possibilities following the proposed reform to timber supply and forest management agreements

	Plants closed since April 1st, 2005	Volume (m^3) of timber supply and forest management agreements		Proportion of total agreements
		softwood	hardwood	
Permanent	13	1 031 000	365 000	3,9%
Undetermined	53	10 267 000	2 183 000	35,2%
Total	66	11 298 000	2 548 000	39,2%

Source: Estimates by the author using data from the Ministère des Ressources naturelles et de la Faune and the Conseil de l'industrie forestière du Québec.

Creating a competitive market for forest products and services

Forest land could come under a new type of agreement, not tied to a plant, which would let its holder sell the resources on the market in exchange for an annual rent and compliance with conditions aimed at preserving timber and wildlife.

This new type of agreement on public land would promote the development of a forest management industry distinct from the traditional forest industry, which sees this activity simply as a cost it aims to reduce as much as possible. This new approach would make companies responsible for the integrated management of all forest resources and would use market forces to mitigate the long-standing conflict over use between timber cutters and hunters, fishermen, campers, vacationers, nature lovers and any other forest users. In attempting to optimize their income, the holders of such agreements would be just as open to requests for any use of the forest as they would be to the cost of supplying each good and service. With the mill closings that have already occurred, a market for several million cubic metres of wood would be created, accessible to any new or existing mill able to pay the competitive price of this wood. The most profitable mills would be the most likely to put their hands on this supply since they would have the greatest room for manoeuvre.

Developing an efficient competitive market for timber could offer numerous advantages that would tend to make the industry more competitive, more resilient and more stable.

Creating an efficient competitive market for timber would also have an impact on the price of wood from private forests. This wood is marketed through syndicates and bureaus set up by producers in various regions, at a price ultimately set by the Régie des marchés agricoles et alimentaires du Québec. In the absence of a sizable market, this government board has trouble establishing an equitable price based on the scanty market data available to it, and its credibility is weakened with the industry, which finds that it leans more toward producers. A true market would tend eliminate this dispute, which has lasted for decades and represents a significant cost for private producers, industrial purchasers and the government.

Reducing administrative costs and simplifying procedures

Other measures could push down the price of wood in public forests. The administrative procedure required by the government to supervise harvest planning and follow-up is itself a major part of the cost of timber. The minister has promised to increase the effectiveness and efficiency of administrative processes so as to reduce the cost by the end of the year; he calculates the reduction at $2 a cubic metre. This saving may seem small compared to a total average cost of more than $60 a cubic metre, but it will grow substantially due to the effects of administrative simplification on harvesting and forest management operations. It could amount to tens of millions of dollars in recurring annual savings thanks to efficiency gains in administering procedures for overseeing the planning and follow-up of the harvest.

Sharing costs equitably

The *Regulation respecting Standards of forest management for forests in the domain of the State*, which governs forest harvesting and processing, makes forestry operators bear the cost of protection and management measures for other forest resources, such as wildlife and water. Companies operating in these latter sectors thus receive an implicit subsidy from the forestry sector. Without attempting to push the relative values of timber and wildlife out of the debate, it must be recognized that everyone can use the roads built and maintained to government standards by the forest industry and that very few users share these costs. Equitable sharing, based on a rigorous, transparent, independent and credible approach, would lower the cost of wood for forest operators since roads swallow about 20% of the total cost of each cubic metre of wood.[3]

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The secondary market for co-generated electricity

The cost of electric energy used by paper mills represents about 10% of Hydro-Québec sales. This government-owned corporation is required to supply electricity at a uniform rate right across the province (in this instance, the L rate intended for large businesses). It is not unusual for Hydro-Québec to suffer losses on the kilowatt-hours it sells to a business located far from hydroelectric dams, which is frequently the case in the forest industry. In addition to forest products, forest companies often produce electricity in co-generation as a sub-product of their operations. This electricity may be highly valuable to Hydro-Québec, which can reduce its costs, sometimes substantially, by buying it. With Hydro-Québec required by law to sell electricity at a uniform rate for each category of customers, the electric energy produced by forest companies is a product they could put to advantage by sharing the income it creates with Hydro-Quebec. The latter would have an interest in making use of the electricity eventually produced by forest company mills at a level equal to the difference between its L rate and the cost it incurs in supplying the mills in question. It would thus have millions of kilowatt-hours it could sell at a profit on outside markets or use to avoid building new installations. Sharing the profits connected to this secondary market for electricity co-generated by forest companies would provide the latter with substantial income.

Conclusion

Setting out and promoting competitive solutions and processes could enable the forest industry to meet competition effectively, maintaining its key role in Quebec's development without relying on subsidies. To reach this point, the government has to revise the approach it takes to ensuring protection of a vital natural resource – the forest. For its part, the industry has no choice but to reduce money-losing operations and focus its efforts on boosting the operations that are most likely to generate regular profits. Major adjustment and adaptation programs must be instituted right away both for companies and workers and for the regions concerned so that the forest industry can overcome the challenges it is embroiled in while enjoying sustainable development and truly contributing to the creation of wealth for all of Quebec.

3. Efficient sharing of common costs is a major factor in competitiveness. On this subjet, see M. Boyer, M. Moreaux and M. Truchon, *Partage des coûts et tarification des infrastructures*, CIRANO, 2006, http://cirano.qc.ca/pdf/publication/2006MO-01.pdf.

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