



MBIE SPOTLIGHT PAPER

Forest Economic Advisors LLC (“FEA”), a US-based forestry consulting company with offices in four countries, has been engaged by the Ministry of Business Innovation and Employment (“MBIE”) to provide an overview paper on the NZ forestry and forest products sector including a series of brief Spotlight Papers targeting a key theme. The theme of this Spotlight Paper is...

Commentary on key characteristics of a wood supply agreement.

1.0 Introduction

For the purposes of this Spotlight paper, a wood supply agreement is a contract between a forest owner (or their agent) and a wood processor around the supply of logs. The wood processor is generally considered to be a sawmill (saw logs) but could be other types of wood processors such as a plymill or LVL plant (peeler logs) or a pulp and paper mill (pulp logs).

MBIE, at the request of MPI, has asked FEA to make some observations and commentary around the state of wood supply agreements in New Zealand including what an “ideal” wood supply agreement might look like. This insight has been collected largely through field visits to a number of sawmill operators. Some additional commentary is provided on the nature of wood supply agreements in British Columbia, Canada and the Pacific Northwest region of the USA.

2.0 Initial Findings

Although not a hard and fast rule, general consensus among sawmill operators is that a wood supply agreement (as opposed to a short-term supply arrangement) includes the following two conditions:

1. An agreed minimum annual volume of logs to be supplied
2. A minimum term of three years, ideally 5+ years.

The main requirement for this is to give some “surety of supply” if the sawmill owners want to seek reinvestment (debt or equity) and/or wish to sell the business. For prospective investors who know the sawmilling industry well, this is less of a requirement as they will understand the quarterly supply/pricing negotiations that typify the sector (see below). However, for new investors from outside the industry who typically look for some contracted supply-side volume and product-side volume (i.e. sales) to act as a hedge, having no surety of supply on the log purchasing side can be an eye opener.

[As an aside, the implication is that for any overseas investor(s) in a new, greenfield sawmill, lack of any meaningful supply-side contracts giving surety of log supply will be a potential deal-breaker].

Other factors that are deemed important in a wood supply agreement include:

- No premium to “export parity” pricing that the forest owner may insist upon as an option payment for entering into a wood supply agreement.
- Evergreen option. Rather than an agreed termination date for re-negotiation, an evergreen option allows the wood supply agreement to continue to roll-over until one party or the other gives notice.
- No take or pay arrangement. Neither party really want this clause as each may have reason from time-to-time to temporarily miss a supply deadline e.g. forest owner on a “run” to fill a logging ship and avoid demurrage charges or the sawmill has an unexpected major breakdown.
- Mediation option. Pricing is normally by direct negotiation between the parties without recourse to a pricing formula so an option for mediation in the event there is a major disagreement over price points is an important consideration.

Interestingly, most wood processors accept that they need to pay “export parity” pricing and are conditioned to the requirement for quarterly price negotiations. It is seen as a good discipline and they need to meet anyway with their log suppliers on a quarterly basis to agree exact volumes for the next quarter depending on sales orders, mill operating rates, maintenance shut requirements etc. Also, no-one wants to feel over-exposed and be out of sync with the market which could occur with longer price re-negotiation periods.

The issue becomes where there is no wood supply agreement with a minimum annual volume already set in place. Then the negotiation becomes not just about price but, with the current log export market to China so bullish, more a question of “do you want the volume at this price or not?” There is a definite sense of frustration by some sawmillers at the moment, that the forest owners and log sellers have the upper hand in any negotiations and can simply threaten to walk away from the table knowing their actions may well result in unscheduled sawmill downtime.

There is also some disquiet that the export parity pricing is being driven by Chinese domestic sawmills purchasing NZ logs based on some form of subsidy in China. Hence these Chinese domestic sawmills are able to pay “unfair” higher prices for logs which is affecting the NZ domestic market competitiveness. There have been discussions with MPI around this issue leading to a sense of frustration that there is little action the NZ government is prepared to take, due to a sense of retaliatory action by the Chinese against our dairy sector. Please note that FEA has no insight into exactly what internal government processes may or may not be happening. We are simply reporting the perception from our field interviews with wood processors.

3.0 New Zealand Situation

There are very few wood supply agreements in place between forest owners and sawmill operators in New Zealand today. Historically, several wood supply agreements were put in place when corporates disaggregated their forest product businesses and sold the forests to third parties. This was to give their remaining wood processing assets some surety of supply in the medium term, but these have now expired for sawlog supply to sawmills.

Most sawmills are negotiating with several log suppliers on a quarterly basis for both volume and price. This is not unusual and has been common practice for a number of years, by one account going back to the mid-1990s. As mentioned above, the issue is more the current tactics around threatening not to supply logs (and sending them to China) as part of the negotiating strategy given there is no pricing mediation option. For “peace of mind”, wood processors would appreciate say 50% of their supply tied up in some form of wood supply agreement, but they accept this is not current reality.

FEA is aware of one significant wood supply agreement between a major CNI wood processor and one of its log suppliers that includes:

- Three-year evergreen with five-year minimum term
- Minimum baseload volume (not stated) topped up with spot sales, as needed
- Annual estimate to give initial sense of how baseload volume is to be distributed
- Quarterly price negotiation and volume confirmation, with volume phased equally per month
- Force majeure
- Price mediation
- No penalty for not meeting targets (on both supply and demand side) i.e. not a “take or pay”

FEA is also aware of one five-year deal between a major wood processor and a forest owner in the South Island. This is for five years and took a number of years to negotiate due to the forest owner insistence on a premium to export parity pricing for the privilege of a wood supply agreement. In the end, the forest owner waived this condition as the wood processor would never agree to it.

Additionally, there is an interesting example in Northland where a forest owner has agreed to supply a sawmill directly adjacent to one of its forests with as much volume as can be realistically harvested at an annual fixed price i.e. no quarterly price re-negotiation. This is somewhat unusual and a little bit of an experiment by both parties. The intent is to re-negotiate the annual price and extend the arrangement for another 12 months if both parties agree.

4.0 British Columbia, Canada Situation

Unlike New Zealand where most commercial forestry is privately owned (96%), the majority of forests in British Columbia (B.C.) are owned by the government (coincidentally, also about 96%). The government issues timber licenses to companies to harvest timber giving high surety of supply for those companies to make re-investment in their sawmills. There are three main types of timber license in B.C. which have an Annual Allowable Cut (AAC):

1. Forest License – volume-based license (AAC) with normally a 20-year term that is renewable.
2. Tree Farm License – area-based license (AAC) with a 25-year term that is renewable (not offered any more)
3. Various Non-Renewable Forest Licences (mainly Timber Sale Licenses) – ranging from 1-4 years (and sometimes up to 10-15 years).

Stumpage must be paid to the provincial government for timber harvested from Crown land. The price is pre-determined and set by government using a calculation that reflects considerations such as market value, the species and quality of the wood and the cost of harvesting. Stumpage is usually adjusted quarterly to reflect changes in the markets for forest products. There is no right of mediation as the stumpage price is formula-driven, so there can be pressure applied to review the formulas if any increases are not seen as reasonable.

As part of a renewable license, the tenure holder is obligated to cut a maximum/minimum 50% +/- in any one year of its AAC and 10% +/- over 5 years. Any overcut results in a reduced subsequent 5-year AAC and any undercut can result in the loss of some of the AAC. The sawmills are under a social obligation to provide jobs to loggers, sawmill workers and communities, so tenures not utilized have been taken away and reallocated.

5.0 Pacific Northwest, USA Situation

The Pacific Northwest (“PNW”) of the USA is a little more like the situation in New Zealand where disaggregation of major forest companies in recent years has left significant volumes of forest in the ownership of private TIMOs (Timber Investment Management Organisations) and REITs (Real Estate Investment Trusts).

Most of the existing timber supply agreements were put in place during this wave of divestiture of timberland from the integrated forestry corporates to the TIMOs/REITs. It was basically the “price to play” for many of those deals. The terms of these agreements vary with FEA aware of most being in excess of 10 years. With these existing agreements, FEA does not believe the buyers (TIMOs/REITs) were in a position to negotiate any price premium as, at that time, there were multiple parties interested in investing in timberlands.

In terms of the current practice between an independent sawmill and a forest owner, reflective of what is seen in New Zealand, the situation in the PNW is broadly dependent on the size of the forest owner i.e. larger timberland owner like TIMO/REIT versus smaller land owner.

For larger timberland owners, two general approaches are prevalent as:

1. Negotiation directly with mills on a quarterly basis (both volume and price), especially where there is an established relationship between buyer/seller. This is almost identical to what is happening in New Zealand.
2. Remaining volume is sold on a sealed bid basis. Most of the private volume traded outside of quarterly supply negotiations is transacted in this manner.

Smaller land owner sales of specific timberland tracts are also typically sold via bid, usually with the assistance of a forestry consultant.