The 2006 Softwood Lumber Agreement – Blunder or Diabolical Trap?

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May 2007, Western Forest Economist Conference, Wemme Oregon.

Tuesday, May 8

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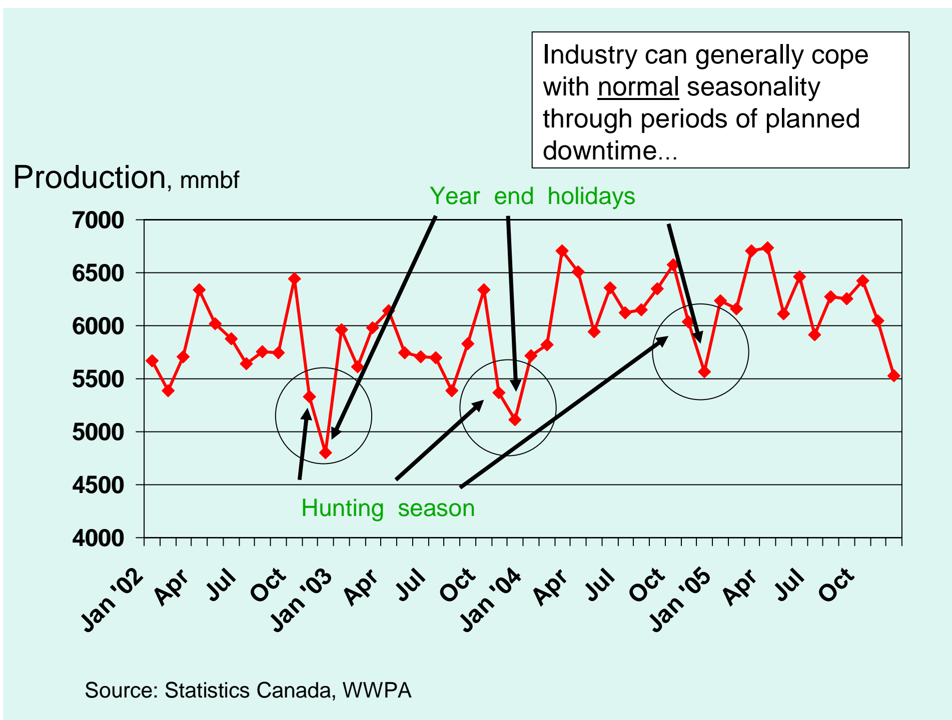
Let's start with some basic realities about the softwood business.

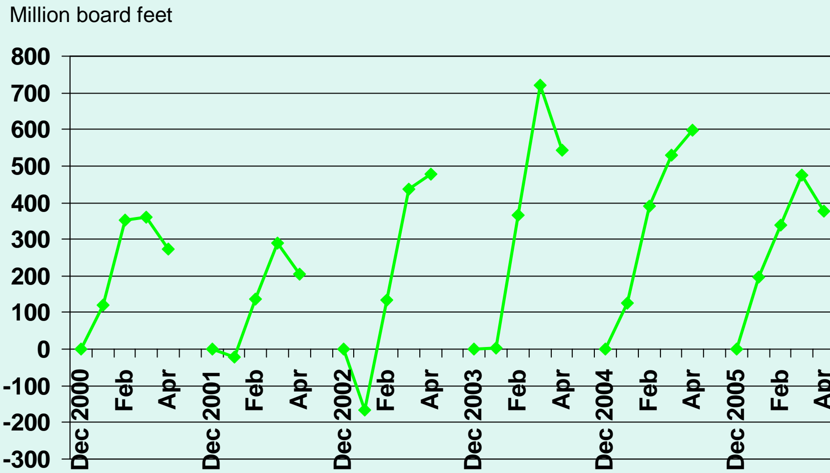
It depends on construction for 80% or so of its markets. Construction, however, is an outdoor activity subject to changes in the weather. And weather in the northern hemisphere is seasonal. So demand for softwood products tends to be the same.

On the other hand owners of facilities engaged in industrial processes like lumber manufacturing prefer, for efficiency's sake, to operate on a continuous schedule. Employees too generally want those lines of work that offer some degree of stability. Such preferences create pressure to run plants on a more or less constant basis.

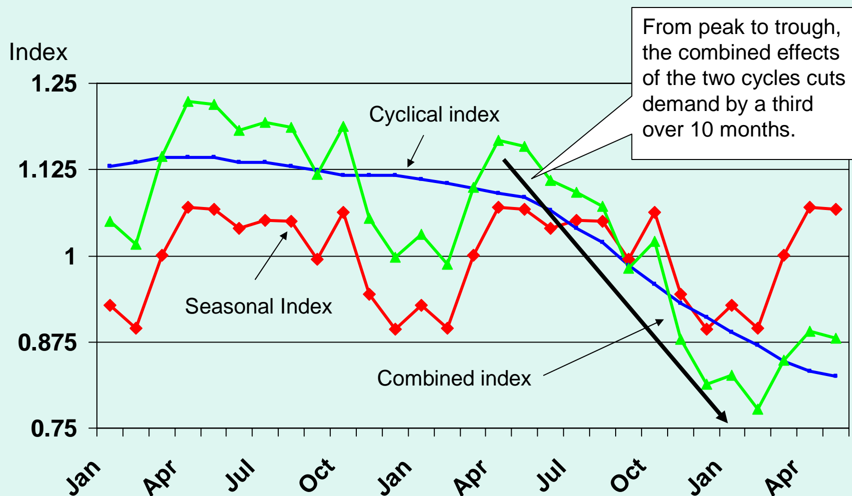
These two modes of operation clash. They lead to market instability that concern those engaged in it.

Coping strategies have evolved in the industry to deal with some of this. Extra downtime is normally scheduled in the fall around the hunting season and year end holidays. When production resumes in the New Year, firms also normally soak up some of the excess supply by temporarily stockpiling inventory. These measures help to ameliorate the seasonal mismatch between demand and supply in normal years.





However, construction is also cyclical. And when the cyclical and seasonal cycles coincide, swings in demand can overwhelm the normal coping mechanisms. That is when the usual dogfights over market share take on aspects of an existential struggle.



In varying degrees this has vexed people in many industries and one that they have sought over the years to alleviate. Economist Adam Smith made a similar point in this oft-quoted observation.[1]

"*People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices*."

In 19th century America the tension between notions of free enterprise and what industrialists termed “ruinous competition” resolved themselves by sectors coalescing around Trusts. These imposed order over industrial sectors but they also concentrated economic power in the hands of a few. This led to political pressure to counter that through anti-Trust laws. By the 1920’s those laws and the resulting court rulings restricted private sector initiatives to organize and exert control over markets.

With the New Deal, however, governments often took on that role. In the oil industry, from the 1930’s through the late 1970’s the Texas Railroad Commission and its peers in Oklahoma and California set explicit limits on how many days a month each producer could pump oil from its wells[2]. Until recently we still had vestiges of government programs that controlled acreage allotments for certain crops. On the global level, organizations such as OPEC try to allocate production among members so as to maintain market order and reduce price fluctuations.

In the highly fragmented lumber industry such supply discipline has been elusive. With the growing importance of imports from Canada since the 1960s, however, the U.S. industry saw a possible way to partially corral some of the excesses through the application of trade laws. The summit of these hopes was realized in the 2006 Softwood Lumber Agreement (SLA).

The SLA is a complex, multi faceted document. Boiled down to its essentials, its two main features are that Provinces in Canada can choose to operate under one of two options:

1. Variable export charges (tariffs)
2. Variable volume restraints (quotas) combined with reduced variable export charges

As a means of controlling supply, the less effective of the two is likely to be the first. Because tariffs are essentially a cost of business, firms can, within limits, blunt their impacts by efficiency and cost reduction efforts. This was the Canadian response to tariffs leveled against lumber imports in 2001.

A volume restraint system, however, sets explicit bounds on physical shipments. As such, it is more difficult to circumvent through accounting, legal or technological measures.

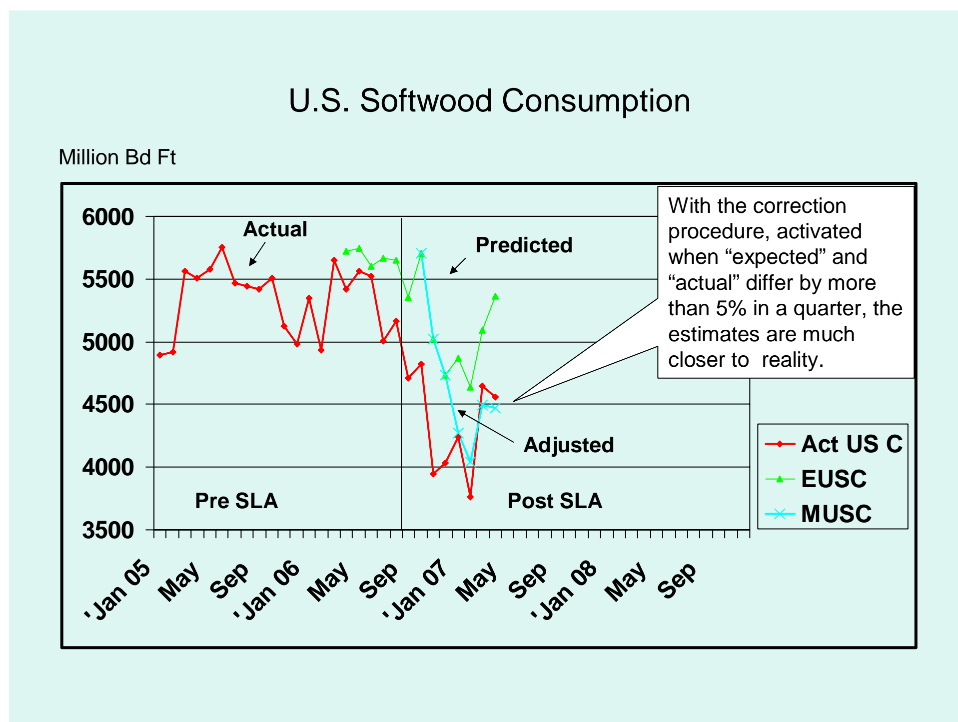
A key feature of the 2006 SLA is that its market allocation system is tied directly to demand so that the allotted shares change in tandem with market fluctuations. Therefore how the quotas are derived is central to its effectiveness.

The process starts with data on current U.S. lumber consumption. The most recently available data are averaged over a rolling 12-month period, which is then adjusted for current seasonality. Because of the

[1] Adam Smith, The Wealth of Nations, vol. 1, bk. 1, ch. 10 (1776).
[2] Simmons, Matthew R. Twilight in the Desert, John Wiley & Sons, Inc. (2005).

delays in data reporting and the lagging nature of a trailing average, the "expected consumption" thus arrived at is reasonably representative of current conditions only when demand is stable. When a major cyclical change sets in, the estimates can get grossly out of sync.

So an important feature in the procedure is an adjustment obtained by comparing the predicted and actual consumption for the most recent quarter. If the difference is greater than 5%, then it is divided by three and added to or subtracted from the estimates for the next three months. This results in a much closer approximation of reality, as shown below.



It is important to remember that the variable export charge option that Provinces can elect to work under don't involve "quotas", just markers ("surge triggers") where merely a higher tax is levied. With its payment, the volumes that can be shipped are unlimited.

So far so good, but when the first quarter of 2007 rolled around, the quotas and surge triggers were still based on the lagging rather than the adjusted indicator despite a 17% difference between expected and actual consumption in the third quarter of 2006. What happened?

In regards to this the Agreement contains the following:

- If U.S. Consumption during **a Quarter** differs by more than 5% from Expected U.S. Consumption during that Quarter, as calculated under paragraph 12, the calculation of Expected U.S. Consumption for the following Quarter **for which quotas are being determined** shall be adjusted as follows… (Emphasis added). Annex 7D(#14);
- "Quarter" means, unless otherwise specified, the three-month periods commencing January 1, April 1, July 1 and October 1 of each Year. Article XXI(44);

The Agreement was supposed to go into effect October the first, but last minute wrangling postponed it till October 12. Thus the Canadian theory is that the first "quarter" of the Agreement, as defined above, commenced on January 1, 2007. And, because of the lags in data reporting, the adjustment element of the Export Measures cannot be implemented until the 3rd quarter of 2007. The contrary U.S. view is that the quarter in the document is "any" quarter, not explicitly limited to quarters within the period covered by the Agreement. Thus, even if the "Effective Date" did not start until October 12, the Export Measures should have been fully applied from that date. This part of the Agreement contains ambiguity and is subject to interpretation. On appeal, a ruling in favor of the American standpoint is possible.

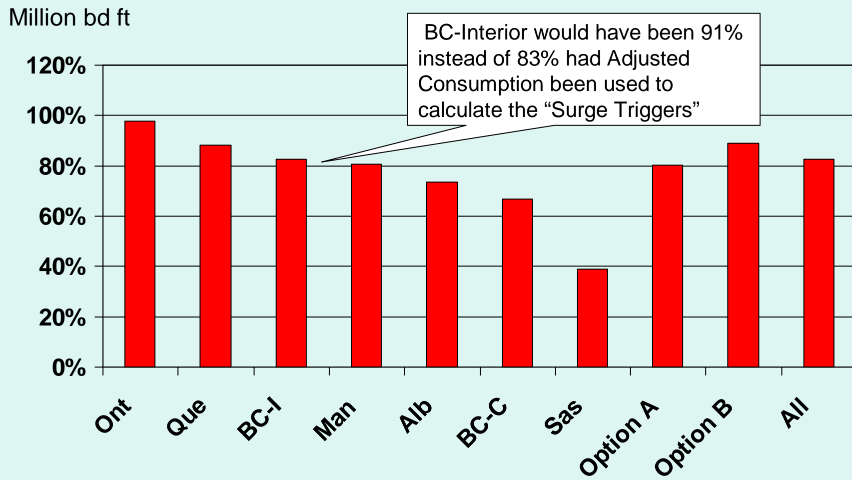
But the second and more critical point of contention concerns whether this method even applies to the determination of "surge triggers". The key passage lies in paragraph 14 of Annex 7D in which the phrase "**for which quotas are being determined**" stands out. This is specific language. By singling out "quotas", the signatories logically excluded all else. This leaves little room for interpretation. It is unlikely therefore that an arbitrator would rule otherwise.

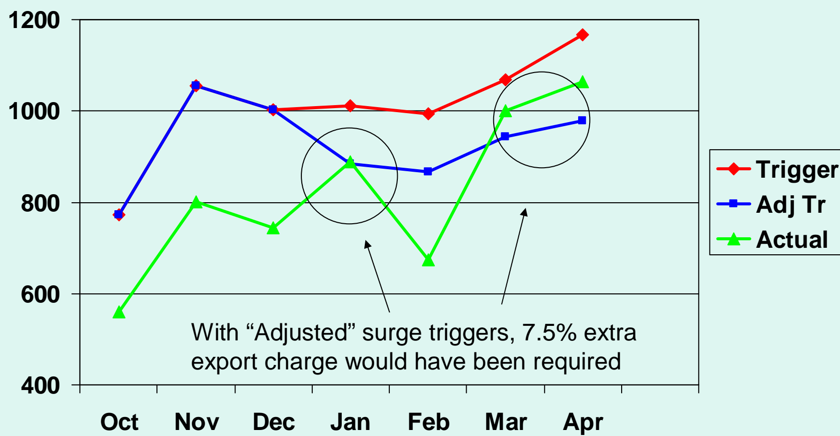
Since the American side is protesting this interpretation, at first blush this appears to have been a blunder. But was it? Consider the amount of legal oversight that vetted this Agreement. Before signing off, it is difficult to imagine that under such intense scrutiny a hole in so critical a component of the Agreement would have been missed. Another possibility must be entertained!

Consider the nature of a moving average. It trails cycles on the way down, but similarly lags on the rebound. In the downward phase, such as the one we are currently in, lumber prices are typically low and profits minimal to negative. Even if the higher quotas and surge levels theoretically permit greater access, market disincentives remain a deterrent. On the other hand, during the recovery phase, prices are rising and profitability returns. Then, however, the unadjusted trailing average would underestimate consumption which would hold down quotas and surge levels. Conceivably the U.S. industry may be giving up less on the way down than gaining on the way up!

If this was the expectation, we can now examine how it compares to reality as it unfolded under the first six full months of the SLA. Since November only Ontario came close to filling out its assigned cumulative quota and would have had to ship less under adjusted market calculations[3]. While Interior BC would have had to distribute its shipments differently, it could have exported as much and still remained under its surge limits. This suggests that not much would have been different had the more restricted calculation of quotas been in place and supports the view that the U.S. lost little as a result of the more liberal calculation of quotas and surge triggers. Time of course will be needed to see how much this method benefit U.S. producers when the rebound phase of the cycle sets in.

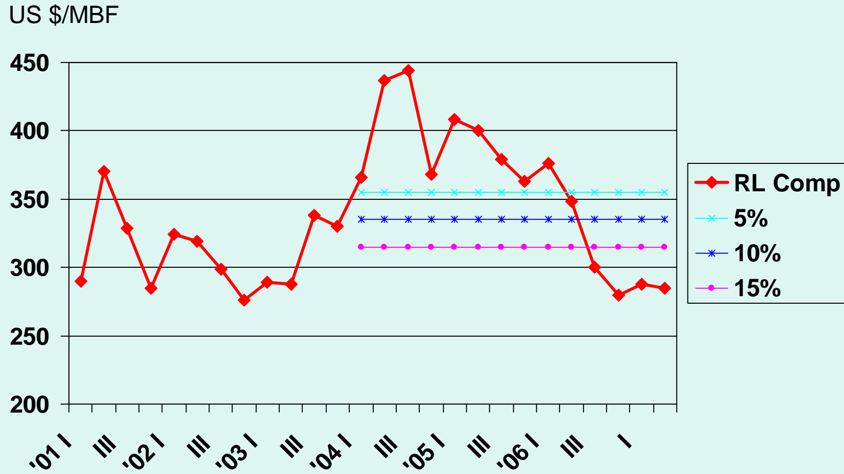
[3] In this regard the February Canadian railroad strike also played a role.

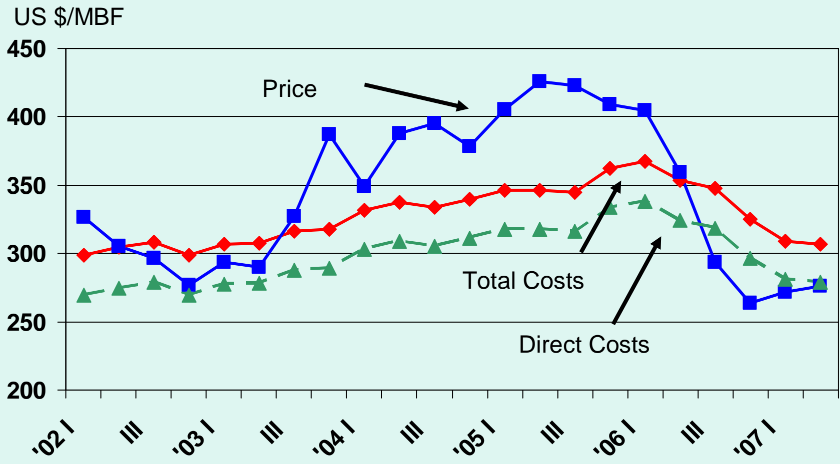




A potential problem with this line of reasoning, and the one that may have played a role in Canadian willingness to bear the risk, is that in an upswing prices may quickly rise to levels that would eliminate the requirement for quotas and surge triggers. Recall that the SLA is based on a graduated quota and tariff scheme, which is most restrictive when prices are below US$315, medium at prices between $315-335,

most mild between $335-355. They disappear entirely above $355, as shown below. If prices were to rally above $355, Canadian shippers would be freed of restraints.





However, there is one more caveat. In an extended slump costs, in particular wood, adjust downward, as shown above by recent data for a typical Georgia sawmill. Prices then may not have to rise to $315-355 to

restore a level of profitability that stimulates U.S. supply. In that case prices may remain under the $355 level longer and, under the present method of surge trigger calculations, make more expensive attempts by Option A Provinces to respond to a rising market.

In summary, any complex agreement like the 2006 SLA has elements that may unfold in unexpected ways. Despite some aspects that may appear to be flaws, the core of the Agreement is fundamentally sound. In time it will work toward its intended objective of moderating supply in extended downturns. When one takes the longer view of the Agreement's structure and likely effects, notions of abandoning the Agreement, especially from the U.S. perspective, are premature.