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House Natural Resources Committee

May 21, 2009 ~ *The Future of the Forest Economy*

Forest Capital Partners, LLC (FCP) is a private forestland owner and operator with stewardship over 2.1 million acres of American forests. Our lands are located in Oregon, Washington, Idaho, Louisiana, Texas and Minnesota. As is the case with nearly every participant in the forest product sector, FCP's business is facing major challenges in the current economic downturn. In recent months, two major corporations in the North American forest products industry have filed for bankruptcy (Abitibi-Bowater and Smurfit-Stone), and in every region in which FCP operates, numerous mills have suspended operations. Although not commanding the same level of attention afforded to larger, higher profile sectors such as the auto industry, the forest economy is similarly fighting to maintain a critical mass that will support the industry's existing infrastructure and supply-chains and allow the industry to move forward when market conditions improve.

In this testimony, I will try to:

- Provide some perspective on the state of the forest product sector;
- Explore key factors contributing to the industry's current downturn and the major trends that will shape the forest economy moving forward;
- Outline some areas of possible future growth for the forest sector, and;
- Touch on some key issues confronting private forest landowners attempting to adapt in this rapidly evolving landscape.

The forest products sector is struggling with the worst market fundamentals in the past 50 years. The protracted collapse in housing markets has been particularly devastating for U.S. solid wood products (lumber, wood panels and engineered wood products). Between 2005 and 2008, U.S. softwood lumber production, a bell-weather for the industry, dropped 30% (Chart 1). The other major product category in the forest product economy, pulp, paper and paperboard, initially fared better than solid wood products (Chart 2), but as the overall economy sank in the second half of last year, pulp and paper markets plunged. The pulp and paper industry quickly responded to the drop-off in demand, and according to data from the American Forest & Paper Association, production in the first quarter of 2009 was down 17.8%, or 4.0 million tons, from the first three months of 2008.

Falling prices and profitability have taken a huge toll on the U.S. forest economy. From their peak levels in 2004, softwood lumber and plywood prices have fallen over 50% (Chart 3), and pulp prices have retreated since the middle of last year by 30% (Chart 4). In current markets, a large segment of U.S. producers of lumber, wood panels, pulp and paper are selling products at or below their total costs of production. Significant cash short-falls and unclear prospects for the future are forcing permanent mill closures, contributing to the rising unemployment rate and undermining the long-term economic viability of many rural communities. This loss of converting capacity is particularly evident for producers of lumber and wood panels, where markets have experienced a sustained decline for over four years, draining companies' financial reserves and leaving them ill-equipped to persevere until better times.

In addition to being acutely deep, the current set-back in the forest economy has been unusually broad, and is now affecting the full spectrum of forest products across all U.S. producing regions. The current downturn also extends well beyond our borders, and has compromised important overseas markets in both

the advanced (Japan) and emerging (China) economies (Chart 5). The expansive scope of the downturn has touched the entire industry supply chain including manufacturers, suppliers, contractors and forest landowners, as well as the many rural communities that are dependent on the forest products industry. The large declines in timber demand have pushed prices for sawlogs to near historic lows (Chart 6), forcing major cut-backs in harvest levels, and undermining landowner's ability to maintain their commitment to continued investment in their lands as working forests.

Economic statistics released over the past two months suggest that we may be near a low-point for the current economic cycle. Recent encouraging economic indicators include: a 2.2% increase in consumer spending in the first quarter; a stabilizing in residential construction activity; improved liquidity in credit markets; and, a large amount of government stimulus that is just beginning to enter the system. Even with these "glimmers of light", prospects for a sustained recovery in the economy still remain clouded. For the forest products sector, significant imbalances remain to be resolved in the key cyclical drivers of demand, housing and the overall economy.

Residential construction has dropped from a peak annual rate of activity of over 2.0 million housing starts in early 2006 to just 0.5 million units in the first quarter of this year (Chart 7). A return to the overheated pace of construction of a few years ago is highly unlikely, given the greater oversight and controls that will be placed on credit markets in the wake of the recent crisis in financial markets. The speed and strength of a recovery in new home construction will also be moderated by the large overhang of unoccupied homes that must be absorbed into the market. The current vacancy rate of existing homes is over 2.5%, which is a full percentage point above historical levels. With 75 million homeowner occupied homes in the U.S., the elevated vacancy rate implies an excess inventory of 750,000 units. With foreclosures still occurring at record rates, the inventory of existing homes available for sale will be difficult to reduce from the current high level.

Demand for pulp, paper and paperboard is closely tied to the strength of the overall economy, which determines the strength of print media and packaging consumption. With the back-to-back declines in inflation adjusted gross domestic product (GDP) of over 6% (annualized) in the past two quarters (Chart 8), this recession is on track to be the most severe since the Depression of the 1930s. Moving forward, the U.S. economy will be facing strong headwinds which will hinder a quick turn around in the pulp and paper sector. Over the past year, U.S. households have experienced a major markdown in their household wealth, due to the sharp declines in the stock market and home prices. In addition, U.S. consumers entered this recession with a high-level of debt (Chart 9). To reduce consumer debt, rebuild retirement accounts and repair household balance sheets, savings rates will need to rise. In the coming decade, a more prudent consumer will place new limits on spending and will be a moderating influence on economic growth.

Companies throughout the forest economy are assessing their ability to weather the storm, considering their options and re-evaluating future plans. Substantive changes are already occurring in the forest economy, and an economic recovery will not necessarily be sufficient to carry the U.S. forest product sector back to the status quo of a few years past. Besides the questions surrounding the future of housing and the economy, the forest products sector is confronting a number of industry specific trends that could block a return to business as usual. Two of the most prominent of these secular trends are: the accelerating shift away from the use of paper to electronic media for the distribution and storage of information; and, the expanding volume of over-seas investment in plantation forestry and new converting capacity.

The recent wave of newspapers and magazines stopping publication or switching to a web only presence clearly illustrates the accelerating use of electronic media as a direct substitute for print media. Responding to falling circulation and sliding advertising revenues, newspapers and magazines are

reducing staff and coverage and curtailing the frequency of publication to reduce costs. Traditional print publications have passed a tipping point in their competition with internet based products and have slipped into a self-reinforcing downward spiral. A new generation of electronic products are already far-along in the development process that have the potential to capture other market segments (an example is Amazon's Kindle electronic book reader). Consequently, U.S. graphic paper producers will probably experience further erosion in domestic demand even when the economy eventually regains forward momentum. In the first quarter of 2009, U.S. shipments of printing and writing papers declined 24.1% compared to the same period in the previous year.

Recent investment patterns in the global forest products sector are another factor that will limit the potential for a recovery for the U.S. forest economy. Over the past decade, investment in new mills (particularly in the case of pulp and paper) has been concentrated on regions outside of the U.S. to take advantage of: growing demand in emerging economies; dedicated high-yield plantation forestry that can provide a dependable supply of certified sustainable fiber; and cost competitive production. Leading up to the current global economic downturn, a significant number of large-capacity, state-of-the-art plants were built in Asia and Latin America. In contrast, no new green-field pulp and paper facilities have been built in the U.S. in over 20 years. As the forest products industry recovers from the current downturn, U.S. producers will be facing an extremely competitive playing field, where both overseas and domestic markets will be targeted by a range of international suppliers.

Although painful, a cyclical downturn can trigger "creative destruction" in the economy, correcting excesses, re-orienting investment and spurring greater productivity. A wider view of the forest economy looking beyond the set of traditional forest products reveals potential opportunities for the development of new markets and products. A key driver of the expected innovation in the forest economy will be the increased recognition of the ability of forests and forests products to help mitigate climate change. Forests and their products can contribute to reductions in the concentration of greenhouse gases in our atmosphere, by: providing a carbon-neutral alternative to fossil fuels; replacing energy-intensive building products and systems, such as steel and concrete with more carbon-efficient wood products; and acting as a carbon-sink sequestering carbon in standing forests or long-lived forest products.

Woody biomass as a source of renewable energy has the potential to substitute for fossil fuels in a wide range of applications, including; electrical power generation; heating for home, institutional and industrial uses; and second-generation biofuels for transportation. In Europe, wood in the form of densified wood pellets are being extensively co-fired with coal in existing electrical generating facilities to meet goals for carbon emission reductions. Plants in the U.S. and Canada are already exporting wood pellets to Europe to satisfy their growing demand. If national renewable electricity standards are enacted in the U.S., a large domestic market for wood pellets could quickly develop at our own coal-fired plants. In addition to pellets, woody biomass, such as logging residue, can be used to generate electricity in facilities specifically designed for this renewable fuel source. Wood pellets and waste wood biomass also have the potential for an expanded role in replacing fossil fuels in a variety of heating systems, and would provide a possible fit for more localized markets that would be strained to supply the wood fiber necessary to run a commercial-scale electrical generating plant. Technology is also rapidly developing that will allow the commercial production from wood biomass of liquid fuels such as cellulosic ethanol and biodiesel. Cost competitive production of liquid bio-fuels from domestically sourced woody biomass would not only contribute to reductions in the use of fossil fuels, but it would also decrease U.S. dependence on foreign oil. The emerging market for wood fiber in the production of renewable energy could have an especially important role in the forest economy, helping to offset lost markets as the erosion in paper demand progresses.

Another potential area of growth in the forest economy is an expanded use of wood-based building systems to take advantage of their smaller carbon footprint compared to steel or concrete. Regulatory

caps on carbon emissions should eventually result in upward cost pressure on building systems that are more energy intensive, providing wood building systems with more of a competitive advantage. However, the independent measurement, documentation and certification of the carbon footprint of wood-based building products through life-cycle analysis could help accelerate the process by allowing more meaningful comparisons with steel and concrete.

The volume of carbon sequestered in U.S. forests and long-lived forest products could be boosted through a number of avenues, including: forest management that is focused on increased productivity or extended rotations; expanded reforestation and afforestation programs; reducing risks of forest fires; and avoided loss of forestland through land-use changes. Carbon sequestration will not become a management priority for private landowners until the U.S. has instituted a clearly defined national policy on GHG emissions and a market infrastructure is in place to value and trade carbon credits generated from forestry projects. Further research is also needed to better understand and measure the total carbon volumes held in the different components of the forest (both in the trees and in the soil) and the dynamics of the carbon cycle (rate of carbon capture and carbon release associated with, decay, harvest and fire).

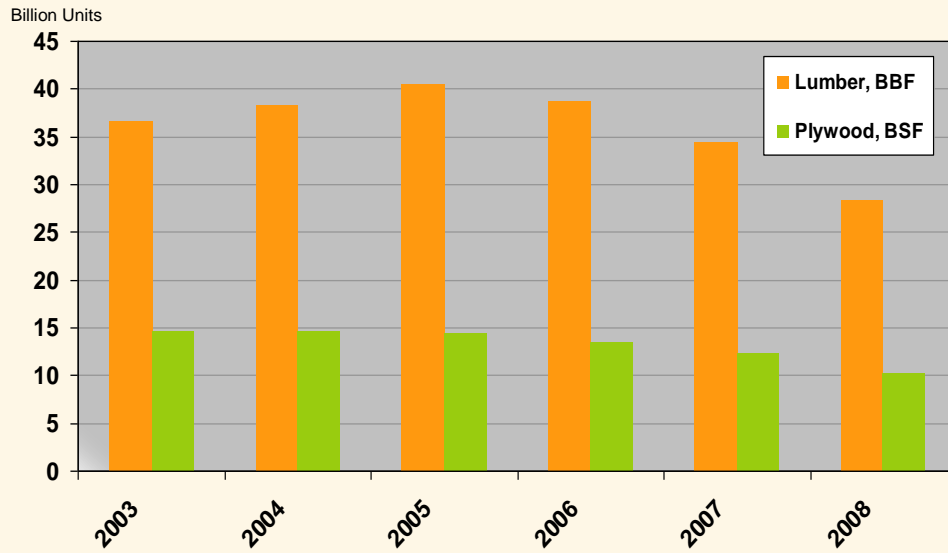
In addition to opening possible new markets for wood fiber, climate change will have on impacts on our actual forest resources and their management. Changes in seasonal patterns of temperature and precipitation could have consequences for forest productivity, the resiliency of ecosystems, biodiversity and water quality. Research will be needed to better understand the impacts of climate change, and whether they will impose additional constraints on timber production or suggest new objectives for the management of private and public forests.

Expanding markets for wood-based energy, bio-fuels and green-building products offer hope for a revitalized U.S. forest economy, but questions remain how the transition to these new markets will be accomplished, whether these new markets will adequately fill the holes left by weakened domestic demand and increased international competition, and to what degree these new projects will compete with existing demand for wood fiber for traditional wood products. An even more pressing concern to forestland owners is the continued viability of large components of our existing forest products industries. Healthy markets for higher value solid wood products are in many cases a pre-requisite for generating the logging and manufacturing residuals and the small-sized, lower quality logs, which are the target wood supply for many of the proposed biomass energy projects. Research is sorely needed to answer these basic questions as well as to improve the productivity and efficiency of our industry in order to remain competitive in a global marketplace.

To avoid reaching a tipping point in which we lose critical mass in the U.S. forest economy, investment will be needed to boost the competitive position of our existing forest industries as well as to pave the way for the development of a new tier of energy and carbon markets. To attract the necessary capital to the U.S. forest economy, investor's need assurance of dependable long-term wood supply from private and public lands. Increased clarity as to the direction of federal forest policy and increased confidence in the public forests role as a source of commercial timber supply could be a major factor in helping to trigger the investments needed to build deeper and more diversified markets for U.S. forests. Commitments by federal agencies to implement forest health programs that reliably generate thinning material for commercial use could be an important step in launching a new generation of energy and bio-fuel enterprises while reducing the risk of catastrophic wildfire. Putting the U.S. forest economy on a broader and more solid foundation will encourage the continued management of private lands as working forests, and enhance the ability of private forestland owners to maintain a high level of stewardship on their lands.

Chart #1

U.S. Softwood Lumber and Plywood Production



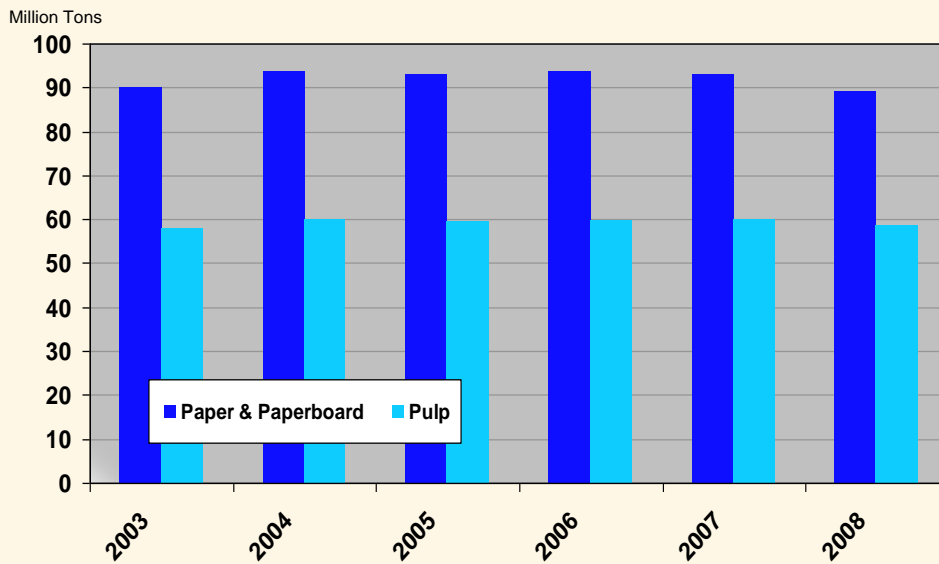
Source - RISI



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Chart #2

U.S. Paper & Paperboard and Pulp Production



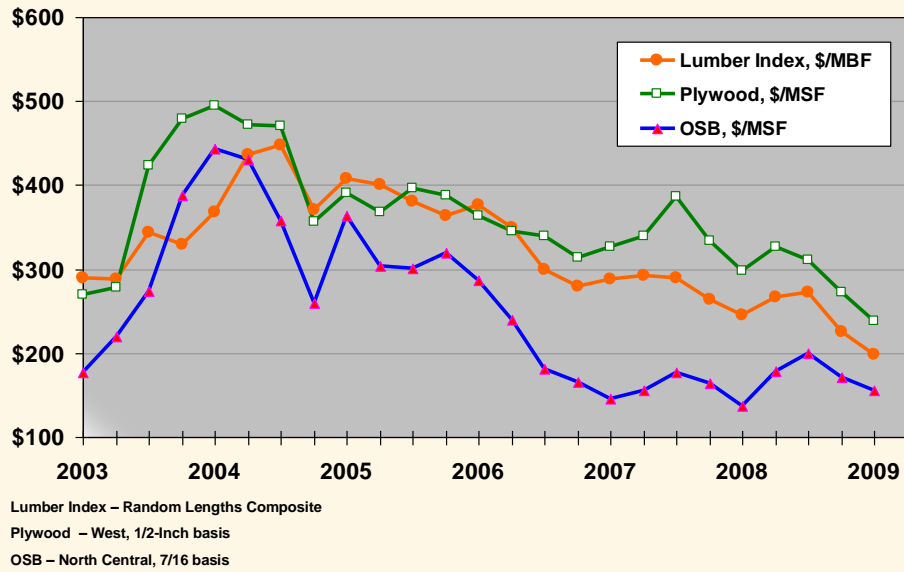
Source - RISI



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Chart #3

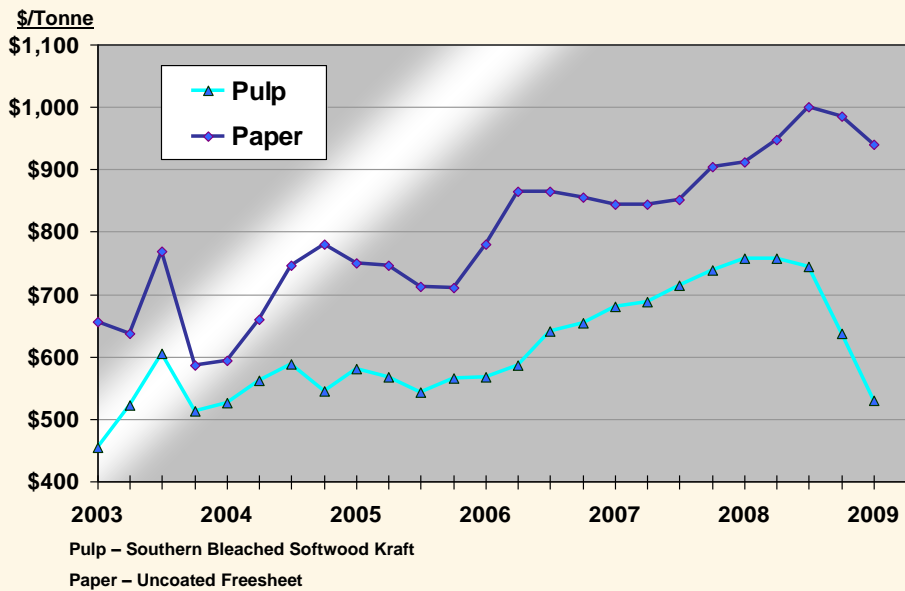
Wood Product Prices on a Six Year Slide



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Chart #4

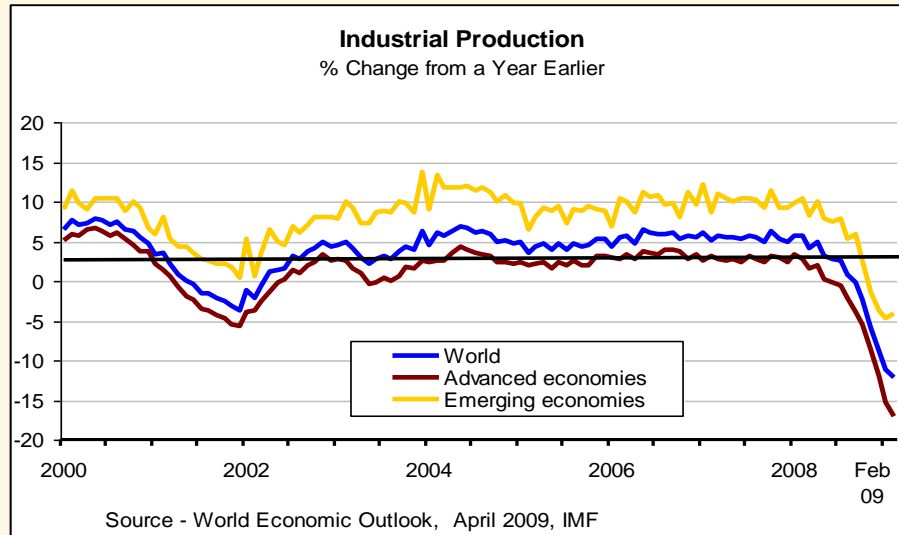
Pulp and Paper Prices Began Their Retreat in Late '08



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Chart #5

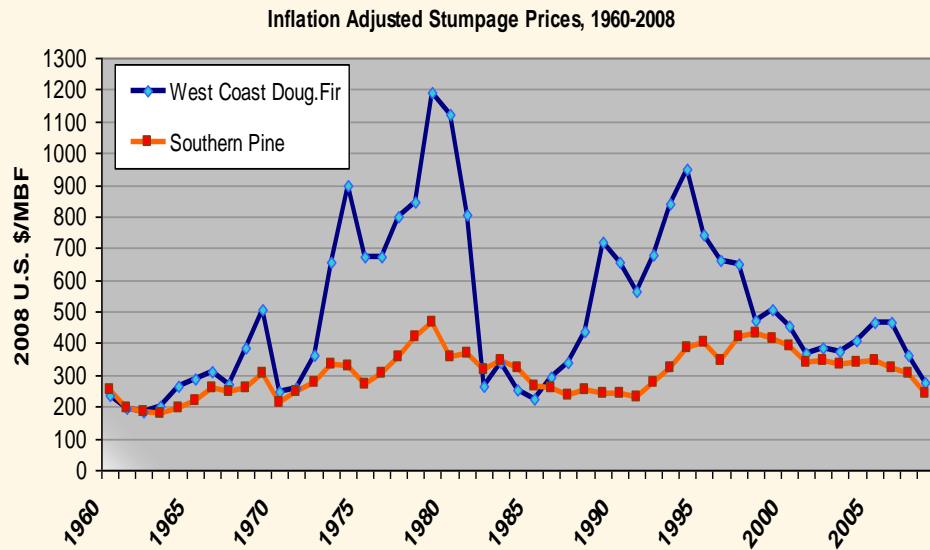
“Most Severe and Synchronized Global Recession in the Past 50 Years”



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Chart #6

North American Timber Prices Heading To A 50 Year Low

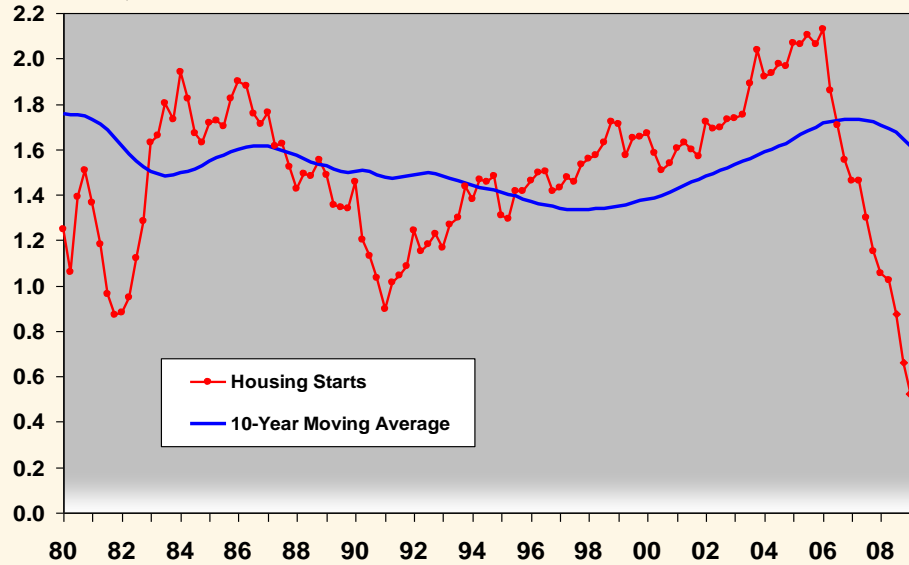


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Chart #7

A Historic Housing Cycle

Million Units, SAAR

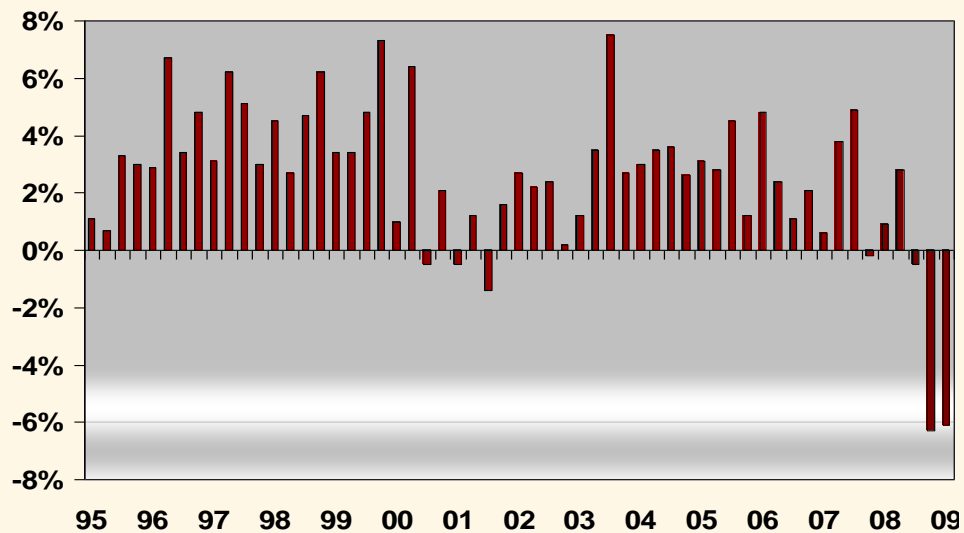


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Chart #8

U.S. Economy: A Very Hard-Landing

Real GDP Growth, Annualized Percent Change



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Chart #9

Recession Motivates U.S. Households to Repair Their Balance Sheets

