

December 30, 2006

Mr. Murray Walsh
Executive Director
Southeast Conference
P.O. Box 21989
Juneau, Alaska 99801

Dear Mr. Walsh:

We have been asked to clarify and to the extent possible update key findings in our report *Timber Markets Update and Analysis of an Integrated Southeast Alaska Forest Products Industry*. That report was prepared for Southeast Conference in September 2004. McDowell Group worked with Walt Sheridan Associates and Leonard Guss Associates in conducting the study.

A key point of clarification concerns our conclusions about the timber supply needed in Southeast Alaska to sustain an integrated industry. In the report's executive summary, we state:

Based on preliminary analysis of a Medium Density Fiberboard (MDF) plant, the report identifies approximately 200 MMBF as the minimum harvest capable of sustaining an integrated industry. A more diversified industry that includes intra-regional competition among similar types of manufacturers could use twice that much timber. (page 1)

In the executive summary, we also state:

Preliminary indications are that an MDF facility in combination with the region's existing sawmills may be a viable industry structure with an annual Tongass timber harvest of as little as 200 MMBF. This amount of harvest is within the specifications of the 1997 Tongass Land Management Plan. However, the most efficient use of the Tongass timber harvest would likely also include other value-added manufacturing, such as a veneer mill. In theory, the industry would be most efficient with at least two of each type of manufacturing facility, as this would foster competitive bidding for materials and labor. Depending upon the types of facilities, this could require an annual harvest of 350 MMBF or more. (page 3)

Later in the report, we elaborate with the following:

Analysis for this study indicates that many of the benefits of an integrated industry may be obtained at harvest levels within the Tongass ASQ. However, this level would also impose limitations. At this scale, the industry would be too small to see truly competitive pricing among its constituent firms. The number of potential buyers for timber sales, logs and chips would be very limited. All sawmills likely would be dependent on a single MDF plant or other purchaser of low-grade material. Location would be a big factor in the value to a core operation of mill residues and low-grade timber. If there is only one core operation, businesses would tend to group around it for efficiency at the expense of other timber-dependent communities in the region. Yet total operations might still be too small to, for example, minimize transportation costs. (page 35)

These conclusions implied quite clearly that while an integrated industry may be possible with a Tongass harvest of as little as 200 mmbf, a more competitive, diversified, efficient and (by definition) more sustainable industry would require a Tongass harvest of perhaps 350 mmbf.

Within the time available it is not possible to prepare a full update of our 2004 study. However, we are aware of a couple factors that suggest a re-analysis of the Tongass ASQ requirements to support a fully integrated industry may be warranted. One critical factor is lower anticipated timber harvests from private (Native corporation) landowners and the State of Alaska. In our 2004 report we estimated the wood supply potentially available to develop an integrated forest products industry to include 237 mmbf from the Tongass, 100 mmbf from Native corporations, and 18 mmbf from the State, for a regional total of 355 mmbf. We now understand that the private harvest is more likely to average approximately 50 mmbf annually (very little of which is sold to local mills) and the state harvest 10 to 13 mmbf in the foreseeable future. At these levels the regional harvest would total approximately 300 mmbf annually rather than 355 mmbf, 15 percent below our earlier estimate.

Our 2004 estimates indicated the volume of utility/lower grade logs available to support a fiber-based manufacturer would be between 71 mmbf and 127 mmbf, depending on market conditions for sawn wood products (pages 16 and 17). Assuming that all (or practically all) of this low-grade material would be available to one processor, we concluded that an integrated industry was possible, including an 80 mmbf MDF plant. A 15 percent reduction in the regional timber supply, as described above, reduces the total potential supply for a fiber-based manufacturer to between 60 mmbf and about 110 mmbf. Further, as the amount of timber available declines, the probability that what is offered will be of a mix and location that an integrated industry can use efficiently also declines. Also, smaller mills typically do not have chipping equipment and the mills that do produce chips prefer to sell to more than one customer. Therefore, while the total potential supply for a fiber-based manufacturer may be between 60 mmbf and about 110 mmbf, the amount available to any single manufacturer could be significantly less.

We should also point out that the assumption that 90 percent of the 267 mmbf ASQ would actually be available for sale and feasible to harvest was a big question in 2004 and remains so. Since the ASQ was returned to 267 mmbf in 2001, never more than half has been offered, no more than a third sold, or more than 20 percent harvested.¹

In addition to basic timber supply concerns, this lower-than-anticipated regional harvest is important because it could exacerbate the timber industry's steadily diminishing economies of scale. As Southeast timber harvests have declined over the past 15 years, the number of businesses engaged in road construction, trucking, logging and other timber industry-related services have also declined. All other things being equal, fewer participants means less competition and higher service and supply costs. Southeast Alaska manufacturers have historically suffered competitive disadvantage relative to manufacturers located elsewhere in North America. As the regional harvest declines, this competitive disadvantage grows worse. Investors seeking to develop an MDF or other manufacturing plants in Southeast Alaska would face numerous challenges. Operating cost control and timber supply are the greatest of those challenges. In an environment where fuel, labor and transportation costs are rising relative to those experienced by manufacturers located elsewhere, a reliable, low-cost and long-term supply of fiber is all the more important.

In summary, in our 2004 report we suggested that 200 MMBF was the minimum Tongass harvest needed to sustain an integrated industry. This determination was based on several key assumptions, including:

¹ http://www.fs.fed.us/r10/ro/policy-reports/for_mgmt/index.shtml

- an MDF plant could be operated with variable costs similar to those in other regions.
- The mix of timber in the overall sales would be such that the plant would require and would acquire essentially all of the utility grade logs and mill waste produced in the region.
- 90 percent of Tongass ASQ of 267 mmbf would actually be harvested each year.

We recognize that it is debatable whether any of these assumptions is realistic. Thus our characterization that 200 mmbf is the *minimum* Tongass harvest needed, but that a harvest of “twice that much timber” or a harvest of “350 mmbf or more” will be required to produce a healthy, competitive and sustainable integrated industry in Southeast Alaska. Given the decline in the state and private harvests, coupled with an increasingly costly operating environment, the case for a Tongass harvest of 350 mmbf is even stronger today than it was two years ago.

We hope this clears up any potential questions about the findings of our 2004 study and its relevance today. If there are additional questions about our study, please do not hesitate to ask.

Sincerely,

/s/ Jim Calvin

Jim Calvin
Partner