

# Wood Supply Research Institute

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### Supplier/Consumer Relationship Study Lake States Region Report

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#### Executive Summary:

The forest industry has just come through one of the most painful economic recessions within the last 50 years. The solid wood business continues in a trough and immediate relief in housing starts is not imminent. The country as a whole is in a lot of economic pain in all areas of the U.S. All segments of the forest industry have been stressed since early 2009.

The two most important supplier issues found in this study are:

1. Lack of ability to earn a decent return on investment for their harvesting or trucking businesses
2. Lack of firm volume commitments

The two most important consumer issues found in this study are:

1. Need for better communications from suppliers
2. Concern about the adequacy and sustainability of logging capacity

In conclusion it is argued that the industry is at a **critical turning point**. What is known is that the general population of logging contractors has not been able to replace equipment for several years and each month more logging capacity demand is increasing. Logging company morale and outlook has been very low. There is an urgent need for the consumer companies and logging/trucking company organizations to stabilize the situation to create a more viable business environment so the forest based industry can avoid long-term damage to the supply chain. Rebuilding trust between suppliers and consumer organizations must be a priority. There needs to be basic cultural change on both sides in order to make a lasting structural change in the system. Contracts need to be of value to both the consumer companies and the suppliers. Contracts need to have credibility to the financial institutions and for business succession purposes to build a stable supply chain for the future

This paper provides a qualitative assessment of the current state of the relationship and offers recommended actions to improve the supply chain relationship and steps to strengthen logging/trucking capacity looking forward.

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## Methodology

The objective of this study was to evaluate the working relationship between suppliers and consumer mill procurement. The study was structured to obtain quantifiable data on how routine interactions actually function between suppliers and consumer procurement.

I conducted over 225 face to face interviews across the U.S. with suppliers and consumer procurement people over a seven month period beginning in late spring of 2011 through January of 2012. Each interview had three parts. The first part was comprised of a set of structured questions that participants selected a range of responses that best described the nature and quality of the interactions. The categories of the interactions were divided into four categories as follows:

- 1. Negotiations**
- 2. Joint-Planning**
- 3. Feedback**
- 4. Problem solving/Communications**

Each category had a set of questions that were designed to measure the quality of those basic interactions. It is important to note that both suppliers and consumer procurement were asked mirrored questions. The rationale was to enable a comparison of perceptions and examine how the relationships were viewed from both sides. If a pattern of significantly different perceptions between suppliers and procurement organizations were detected then a follow-up analysis was conducted.

The second part was to allow open-ended comments on how the supplier or consumer procurement participants viewed the working relationship. Comments that I perceived to have impact on the working relationship were recorded and analyzed on a qualitative basis. In the event that a supplier or consumer procurement participant described a pattern of dysfunctional interactions, a follow up discussion was conducted to explore if that pattern resulted in lost production and therefore caused inefficiencies that could be avoided. If the dysfunctional pattern was determined to be the cause of lost production, then an annual volume was calculated on a conservative basis. Examples had to be provided of the incidents that caused lost production within the last 12 months. Likewise, when best practices were stated and confirmed in actual examples, they were recorded and entered into the database.

All data was entered into a database and reports were generated for analyses. Dr. Brenden Kendall of Clemson University was engaged to provide assistance with the database and analysis of results. The reports were then prepared on a regional basis as follows:

- Mid-Atlantic Region (North Carolina, Virginia, West Virginia)
- North-East Region (Maine, New Hampshire, Vermont, New York)
- Lake States Region (Michigan, Minnesota, Wisconsin)
- South-East Region (Georgia, South Carolina, Florida, Alabama)
- South-Central Region (Mississippi, Arkansas, Texas, Louisiana, Oklahoma)
- Western Region (Oregon, Montana, Washington, California)

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The interviews were all confidential and entered into the database without names or company affiliations. Each participant was classified in the categories in the table below:

<b>Suppliers</b>	<b>Consumers</b>
Direct Contractor/Operator	Pulp-Paper
Dealer	Composite
Larger Landowner (TIMO, REIT, Private)	Solid Wood
Producer Indirect	Combination

## Issues That Impact the Working Relationship

The objective of this study is to provide a straightforward evaluation of the current state of the business working relationship between suppliers and procurement organizations. It should be pointed out that the economic environment in which this study was undertaken was extraordinary. The forest industry has come through the worst economic recession since the great depression. Some of the paper markets have partially recovered but some product lines are still weak. The wood products markets are for the most part still in a depression.

Following is a prioritized listing of the most prevalent and common thread issues that were consistently stated by the suppliers and consumer procurement participants of the Lake States Region in Minnesota, Wisconsin, and Michigan. These issues are somewhat negative but are clearly areas that need the full attention of the forest industry. On the other hand, there were several “best practices” that were apparent in the Lake States wood supply system and the overall quality of the relationship is better than most other regions.

## Supplier Perspective

- Number one issue** cited by the Lake States Suppliers is the inability to obtain a consistent return on their investment under the current rate negotiation environment. Based on financial data provided by a limited number of suppliers (from accounting firms) it is estimated that 50% of both delivered wood suppliers and harvesting/trucking service contractors either have very tight margins or operating at a loss. There is broad recognition from the suppliers that the forest products industry has been under severe economic pressure and that all had to suffer pain. Through anecdotal information, a significant number of suppliers have exited the business and the surviving suppliers know that there have been some sectors of the forest industry that have experienced a limited level of recovery. However, for the last several years they have not seen any significant easing in hard-line negotiations for rates. Many of the procurement representatives offer tract specific delivered rates to regular suppliers that purchase stumpage and that has been very helpful. However, many of the suppliers interviewed stated that they were unable to purchase stumpage in the current market and maintain realistic margins for their logging-trucking businesses. Suppliers that have made it through the recession say they have become as efficient as possible but they are still having a hard time staying in business. In addition, much of their equipment is well beyond the replacement cycle. Older equipment is hurting productivity and adding stress to already tight margins. Suppliers and Consumer procurement interviewees were asked ***“how would you characterize rate negotiation with your procurement representatives (or your suppliers)?”*** The structured response to the nature of rate negotiations tabulated in Table #1

**Table One**

**Harvesting / Trucking Rates (Negotiations Methods Only)**

Answer Options	Supplier Response	Consumer Response
non-negotiable and may be changed without notice	18.2%	0.0%
non-negotiable but changed with sufficient notification	9.1%	36.4%
<b>conditionally negotiable - good faith discussions</b>	<b>54.5%</b>	<b>63.6%</b>
fully negotiable and changed only after mutual agreement	18.2%	0.0%

Table #1 provides a mixed response between suppliers and consumers related to the ***“nature of the rate negotiations”***. It is important to understand the sample population of suppliers interviewed. The supplier sample included 56% of the operators purchase their own stumpage and work primarily under a delivered price system. The remaining sample (44%) are primarily cut/haul service contractor and work under a service contract system. The results from this population show that over one half of suppliers and around 63% of consumer procurement described rate negotiations as ***“conditionally negotiable with good faith discussions”***. Conditionally negotiable was described to the participants as procurement staff working within tight pricing guidelines but having a limited degree of flexibility to make adjustments to recognize special conditions. It is notable that another 18% of the suppliers said that their rates were “fully negotiable”. On the other hand 27% of the suppliers said the nature of their rate determination is “non-negotiable” and may be changed with or without notice.

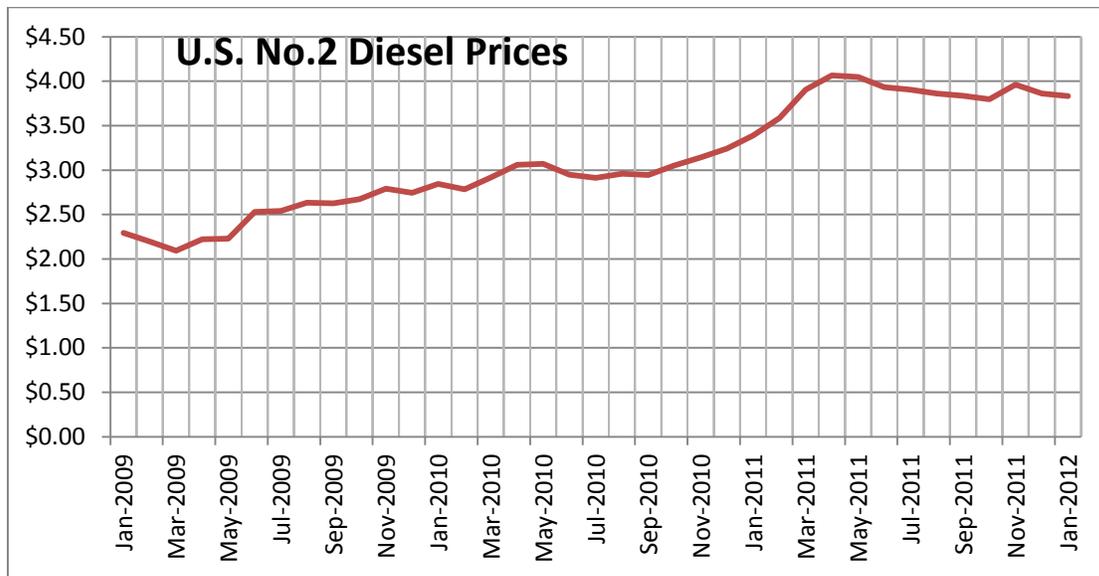
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In summary, it appears that about one third of the suppliers currently operate under a non-negotiable rate system and another 55% are conditionally negotiable under a restrictive rate pricing structure. The remaining 18% enjoy some degree of open discussions and negotiations with their customer mills. This response is reflective of a balanced logging capacity to current consumption demand, and has some degree of flexibility. Compared to other regions, the Lake States has a much better relationship this area. Most of the suppliers still stated they are still not meeting their rising costs.

Logging and trucking contractors stated that only a few major consumer companies provided any relief for rising fuel prices over the last few years. Assuming that to be true then the economic impact continues to be problematic as illustrated in Table #2 on the following page:

**Table Two**



Diesel prices continue to rise into the first quarter of 2012 without much hope for easing in the near future. Logging and trucking operations are very fuel intensive. From data provided from actual operations diesel fuel along with other petroleum consumables amounted to 28% of total cash outlays in 2010 and 35% of total cash outlays in 2011. In-woods chipping would be at a higher rate.

Professional logging/trucking company owner-operators have additional challenges. That is the steady increase in equipment, parts prices, tires, and insurance that has occurred over the last few years in spite of the recession. Many of the logging contractors cite similar examples tabulated in Table #3.

**Table Three**

Item	Price in 2007	Price Now 2012	Total Increase
New Skidder	\$185,000	\$250,000	35%
New Loader	\$150,000	\$200,000	33%
New Truck	\$115,000	\$130,000	13%

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Insurance	\$15,000	\$25,000	67%
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Financial institutions in many of the areas across the country are requiring profit/loss statements and running debt/equity ratios on the logging business owners before approving equipment purchase loans regardless of past credit history. The implications are obvious. If the profit margins are not supporting the loan application then equipment replacements will not happen. Banks and financial institutions are also requiring higher down payments - some stated as much as 20% to 30%.

The situation is not helped by the legal construct of the Master Contracts or Service Contracts provided to the suppliers. It is universally agreed from both suppliers and consumers that the master contracts and cut-haul agreements issued to the supplier favor the consumer's legal interests. Standard contracts are prepared by the consumer legal departments and are not negotiable except for an occasional volume target that is not enforceable by either party. From the viewpoint of bankers or financial institutions, there are basically no firm commitments for the suppliers. Table #4 tabulates the responses to the question *“For contracts received from your consumer customers (or contracts provided to suppliers), is it written in a way that protects both parties – supplier and consumer, mostly protects consumer interests, or mostly protects supplier interests?”*

**Table Four**  
**Negotiations Interface**  
**Contract Structure**

Answer Options	Supplier Response	Consumer Response
protection for both parties - supplier and consumer	4.5%	18.2%
mostly protects consumer interests	95.5%	81.8%
mostly protects supplier interests	0.0%	0.0%

95% of the suppliers responded that the contracts they receive mainly protect the consumer company's interests. 18% of consumer procurement makes the case that it protects both parties by requiring insurance, compliance to all laws-regulations are beneficial to all businesses.

The bottom line for these issues expressed by many suppliers are (a) working relationship is becoming more and more strained as consumer mills continued the restricted rate negotiations, and (b) there is no consideration for their business sustainability. Suppliers typically stated that procurement policies have significantly impacted their confidence in the future of their business and therefore their willingness and financial ability to invest in new equipment.

It should be noted at this point that over the last several months, several consumer companies have implemented some longer-term volume commitments to their key suppliers in terms of price stability and firm volume commitments. The results of those initiatives are having a positive impact on a limited amount of suppliers. According to conversations with procurement managers, the interest from suppliers in these longer-term commitments is mixed primarily due to the uncertainty of the business environment over the last few years.

- **Number two Issue** is that suppliers in general cite a significant lack of solid volume commitments. In the area of “joint-planning” interface, the question was asked to suppliers, large landowner contract administrators, and mill procurement; **“what is your planning window of delivered volumes received from your procurement representatives or large landowner contract administrator?”**

**Chart One Joint-Planning Window for Volume Delivery**

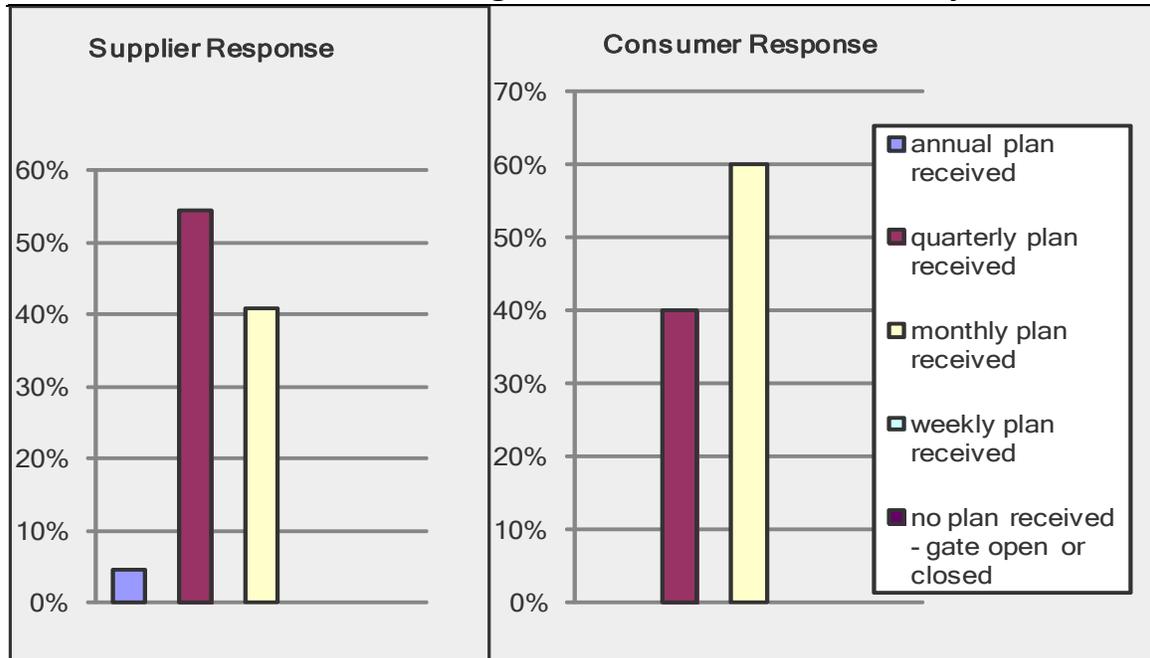


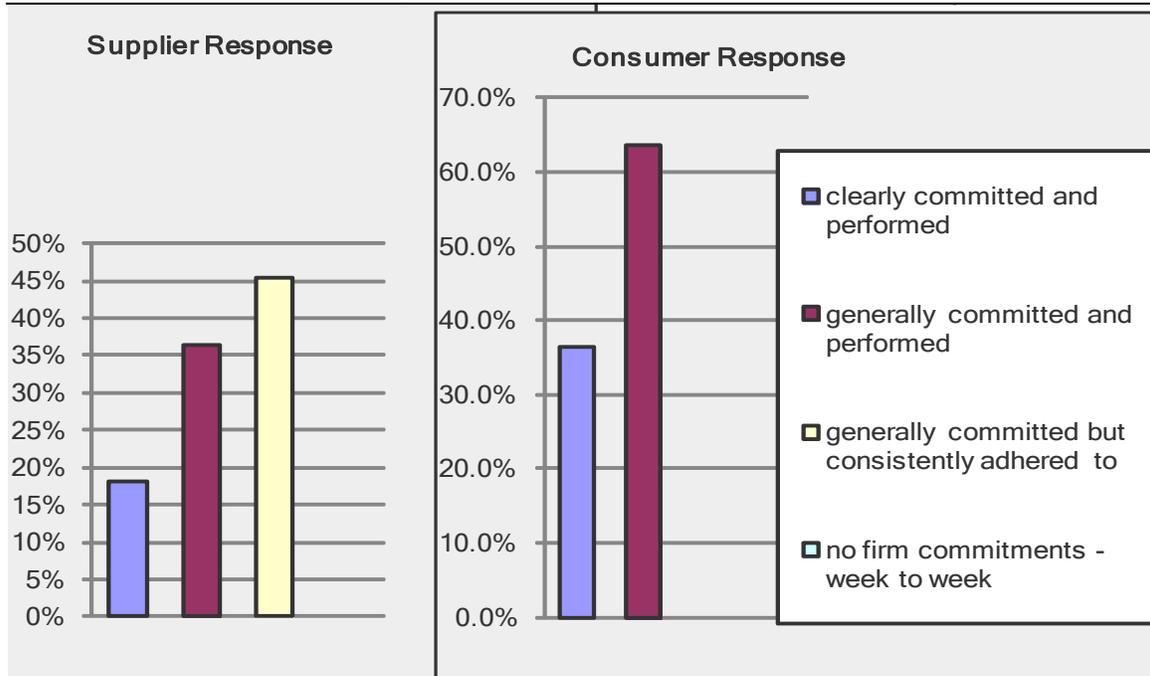
Chart 1 illustrates a pattern with a slight variance in responses. Both suppliers and consumers agree that the predominant system involves a quarterly plan that may be adjusted monthly. This works well with the seasonal nature of logging in the Lake States. The suppliers focused a little more on the quarterly plan while the consumer procurement on the monthly. But there is no major disconnect here.

When both suppliers and consumers were asked the question about the dependability of those negotiated volume commitments, the pattern was less positive.

Chart #2 provides a tabulation of those responses:

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**Chart Two Negotiated Volume Commitments**



Here the responses between suppliers and consumers diverge. Consumer procurement all responded at “clearly committed and performed” to “generally committed and performed”. Contrast that with over 45% of the suppliers saying the volumes were not consistently adhered to. Here are some examples (see appendix for all comments) of comments received about this question. Each comment is from a different supplier.

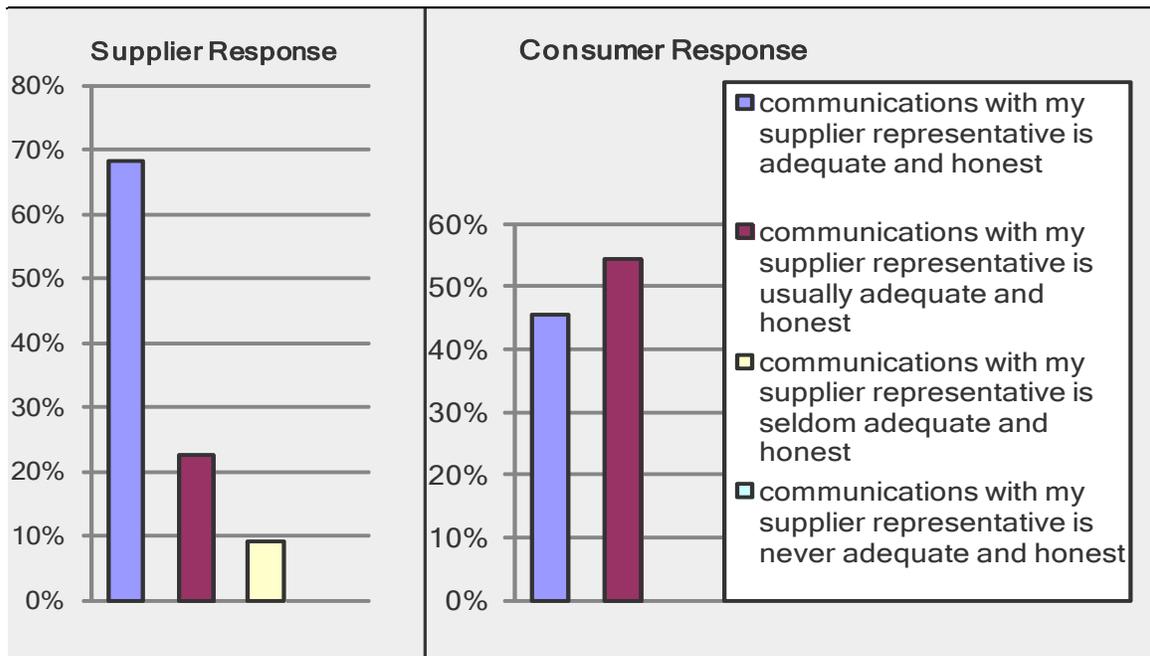
- > Most mills never give me a sense of confidence or consistency – can change at anytime
- > Larger logging contractors with more volume can get a higher price and won't be cut back like the rest of us.
- > Volume commitments are never firm. One company sent out a letter to say they were reducing delivered rates next week.
- > Mill procurement will not stay with the plan and often buy wood outside the normal supply basin that causes disruptions in the production they committed to us at the beginning of the quarter or monthly plan
- > We do not have strong volume negotiations
- > Some mills will shut down deliveries at any time without notice
- > Logging contractor was on schedule with deliveries in the fall and he received an e-mail notification of canceled contract.
- > Before the end of the winter season, we may get cut off when the TIMO is ahead of budget
- > Consumer company calls at the beginning of the season with firm commitment - then calls back after we are producing well into the season and drops commitment.



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Chart Three

## Open and Honest Communications



The suppliers were almost 70% very positive saying they received good communications from their procurement representatives and 20% in the “usually” category. In contrast the consumer procurement staffs were hesitant to say “always”. In fact 45% indicated “always” with the highest response in “usually”. This may look like a minor nuance in how procurement views the communications but putting that together with individual procurement participant’s comments below indicate a deeper problem. Consumer procurement talking about communication break-downs provides some insights:

- > *Had one long-term supplier - took his production to another mill without notification*
- > *Mainly the suppliers don't communicate when their timber situation changes and we are left in the dark*
- > *Would like for our suppliers to be more communicative - may not be forthright when they chase additional dollars*
- > *Some suppliers don't communicate changes in delivered wood volumes like going to another buyer.*
- > *One issue is there are not enough give and take communications with our suppliers.*
- > *Some suppliers just are not communicative especially when they decide to take their production elsewhere.*
- > *There is a communication gap with the county and state foresters in that they are overreacting to forest certification audits and it is holding up timber sales.*
- > *Some marginal suppliers are non-communicative.*
- > *Need to do more in quality feedback.*
- > *Could be better in responding to my suppliers*

Obviously there are some issues that need work between the parties. Suppliers that purchase their own timber complain that their volume commitments are not stable. Then procurement cites examples of suppliers not communicating when they decide to move their production elsewhere or

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change harvest units. As communications break-down, the trust level goes down on both sides and the relationship is damaged and each begin to behave in ways counter to each other.

Adequate communications are highly important to the supply chain efficiency. The timeliness and openness of communications is critical to the logging/trucking operations in order to avoid lost production. Conversely, communications from the suppliers to procurement in regards to moves, changes in product-species mix, etc. is highly important to forecasting deliveries and inventory management.

Another factor mentioned by procurement interviewees is with various levels of down-sizing procurement staffs. They simply do not have the time to spend with their suppliers that would really help both communications and joint-planning. That trend of reductions in procurement staffs are typical U.S. wide. Most procurement organizations are operating with 30% to 50% less staff as compared to five years ago. Without a doubt some reductions were necessary but the question must be asked – do we have enough to adequately manage the supply chain?

- **Number Two Issue** is the concern from consumer procurement about adequate logging capacity. Logging capacity in the Lake States is difficult to gage due to the seasonal nature of the operations. In the 2007 Logging Capacity Study by WSRI, logging capacity utilization in the Lake States was at 86.5%. That was one of the highest levels in the nation at that time. It was classified to be at maximum (85%) in 2007. The logging capacity report strongly recommended that the industry implement some actions to strengthen the capacity at the time of publication in 2008 at the beginning of the recession. It is unknown how much capacity was lost over the last three years but based on anecdotal data, it was significant. Since the recession has lasted so long it can safely concluded that further erosion in logging-trucking capacity has occurred. Currently (early 2012) there have been spot shortages in capacity reported throughout the Lake States. When the building products business recovers along with some level of bio-fuels demand, the logging capacity situation will be exacerbated unless strong actions are taken.

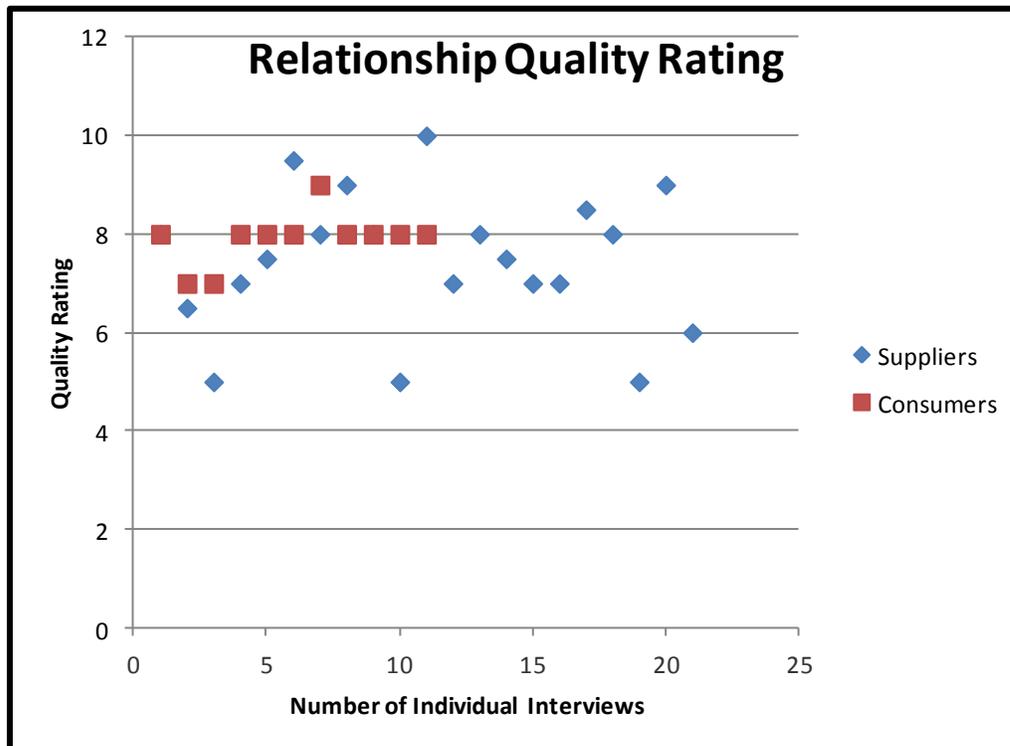
During my travels in the Lake States in early 2012, and talking to suppliers and procurement staffs, there is strong evidence that the logging capacity and mill demand is (at best) in balance. Some areas reported a deficit and procurement staffs were having a hard time finding enough logging and trucking contractors to meet demand. Procurement managers are all very aware of the situation and have various strategies to address the issue. They understand the economic pressures on the suppliers. It is clear to me that there needs to be a higher awareness of the real situation at the senior levels of the forest products industry.

## Is There a Problem?

Without a doubt, there are definite improvements that are needed to improve relationship between suppliers and consumer procurement. However, compared to other regions of the country, the Lake States has made significant progress. For example, in most of regions the interviews were ended with a request to provide a simple rating of 1-10 (1=very bad to 10=cannot get any better) on the quality of the

relationship. Chart #4 below provides the individual responses from both suppliers and consumer procurement interviewees.

**Chart Four Lake States 1 to 10 Relationship Rating**



The relationship quality rating between suppliers and consumer procurement was almost identical. Supplier’s averaged a rating of 7.25 and consumer procurement average of 7.9. Most other regions had significantly wider spread with consumer procurement ranged from 7 to 8, and suppliers ranged from 4 to 6. The follow up questions was – **“what would it take to get to a 9 or 10?”** Some of the best comments came from that follow-up that should serve as strong indicators on what areas need work.

- *perfect system would provide more longer-term commitments with tracts and volume out ahead*
- *perfect system prices would need to rise to match the cost of new equipment*
- *perfect system - include better communications with honesty.*
- *Perfect system - need more consistency for our businesses to be successful.*
- *Perfect system - would like to see more longer term commitments in both volume and price*
- *Perfect system - procurement appears to be improving and capacity is in balance - I am satisfied that we are making progress.*
- *Perfect would be a wood supply environment that would enable health insurance and retirement plans for our employees - to see all the workers in this business to have a decent life.*
- *Perfect wood supply system would include a preferred supplier program tied to FSC chain of custody using the Master Logging System. \*\*We would like to be rewarded for excellent work and responsible practices.*
- *Perfect system would include having a sit-down with senior consumer company people that would listen to our situation and would have more awareness of the senior management. We also would have a pay system that would provide a reasonable return on our investment.*

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The working relationships between suppliers and consumers are not just about feeling good about each other. Table #6 shows that participants generally like and respect each other. What is more important is that the working relationship has an impact on the productivity or efficiency of the supply chain. When suppliers described patterns of events that caused lost production related to the working relationships they were asked to quantify the number of lost loads annually. I recorded the lost volume only after carefully determining the frequency of lost loads on a very conservative basis. Table #6 is a tabulation of volume reported.

**Table Six**

### Lost Production due to Relationship Breakdowns

INTERACTION AREA	TOTAL TONNAGE REPORTED	AVG/SUPPLIER
Negotiations	14,700	668.18
Planning	13,700	622.73
Feedback	7,000	318
Problem Solving and Communications	-	-
<b>Annual Totals</b>	<b>35,400</b>	<b>1,609</b>
Total Sample Production	1,664,000	72,347.83
Loss Percent of Sample To	2.1%	2.2%
Approx. Total NE Producti	27,000,000	

Total production lost by suppliers interviewed in the Lake States region represents 2.1% of their annual estimated production. For the suppliers interviewed, annual production impacted by failures of the working relationship was a total 35,000 tons on a 1.7 million ton sample. For the average supplier, the data indicates over 1,600 tons per year or approximately 55 loads per year. The highest volume loss occurs in the areas of negotiations and joint-planning. These estimates are very subjective and cannot be statistically projected to the total population. Not all the suppliers credited any lost volume due to failure of the working relationship. However, the point is that anything that can be done to eliminate production losses is important to the supply chain in monetary value. Again the percentage in the Lake States of lost production is less than many other regions but still needs improvement.

#### **General Logging/Trucking Related Observations**

It is difficult to make a general statement on a summary level to properly characterize the state of the working relationships for this region. The major issues cited in the body of the sections above are generally negative but it is important to point out that the data also indicates some very good practices. Those practices are happening between the supplier-consumer relationships and some best practices can be seen by perusing the open-ended comments in the attached Lake States Region Appendix.

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## POSSIBLE SOLUTIONS:

Assuming that the Lake States supplier/consumer relationship assessment presented in this paper is generally accurate, below are some recommendations offered to begin to stabilize the wood supply situation:

- **It is strongly recommended that the first step is for the senior procurement managers to clearly communicate a factual account of the state of the independent wood supply situation to the company's top management.** This is a business strategy, not a feel good mission. The suppliers do not need charity or risk-free protection from the economic environment that all businesses have to experience. They need a chance to work together with their customer companies toward raw material supply security for the consumer plants. The operating mills are the future of all the stakeholders and must stay viable. Viability in the logging and transportation operations is a necessary part for that to happen. Senior management for the forest industry must have a true assessment of the supply chain situation and actions needed to begin to rebuild the system.
- **It is highly important for procurement organizations to build awareness throughout the corporations that the independent wood supply contract system is an essential asset to the forest industry and contributes to the industry's global competitiveness.**
  - The continuation and value of ethical and competent suppliers that have good management skills is as much a part of viable manufacturing as having experienced/competent employees and state-of-the art manufacturing equipment. If the raw-material supply chain asset is seriously damaged or killed off, then there is a huge price to pay to replace it. The remaining suppliers who have survived one of the worst economic downturns in our history have had to become as efficient as possible.
  - In addition, there are few younger supplier owner/operators who are willing to make a career in the business. Don't forget that the independent suppliers have critical skills to purchase stumpage, maintain credibility with landowners, and provide certifiable logging systems. These attributes are not replaced without years of careful development and capital investment.
  - The quality of the people in the business is still very high and these calibers of people need a healthy working relationship with their customers. The independent wood suppliers in the Lake States are producing a commodity in raw wood, but the complex function and organization of procuring stumpage and managing compliant harvesting/trucking systems is a very specialized function and is not a commodity. It is an asset to the industry and should be treated accordingly.

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**Provide a more stable operating environment to your key suppliers.** It is absolutely amazing that the bulk of the suppliers work with no security, no firm volumes (except week to week), and arbitrary decisions made from on high, under increasingly restrictive regulations, and huge risky capital investments of standing timber and equipment. That is not to mention the huge impact of changing weather conditions. It is strongly recommended that alliances with key suppliers could be established in terms of strategic planning for stumpage purchases, careful maximized wood yard storage plans, and a focused effort to revive the economic health of a significantly larger sector of capable suppliers.

**The industry is at a turning point and must respond to the reality of the situation or face some severe cost pressures.** The manufacturing companies and suppliers that have survived the last few difficult years have all gained tremendous efficiencies. It is time for each consumer company to take a fresh approach to their wood and fiber supply system on how it can be stabilized and take an intentional look forward. That will involve moving away from the current reactive stance to one of well planned strategies of working with its suppliers to nurture the system by planning ahead.

**Rebuilding trust** between suppliers and consumer organizations must be a priority. There needs to be basic cultural change on both sides in order to make a lasting structural change in the system. Contracts need to be of value to both the consumer companies and the suppliers. Contracts need to have credibility to the financial institutions and for business succession purposes to build a stable supply chain for the future. Suppliers of all sizes and all business structures need to adjust their attitudes to let the past go and focus on building a positive working relationship to do everything they can to make their customers successful.

## **In Closing:**

This is a great industry and it is the focus of the Wood Supply Research Institute to bring straightforward issues to the table that is in the interest of a healthy and sustainable Wood Supply System. It is not the intent to offend anyone but rather provide real data that can aid in developing intelligent approaches in working toward how the supply chain optimization. We will continue to face real and current issues that are important to all the stakeholders. Then each individual participant can develop sound business strategies based on the best data available.

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