

# UNECE TIMBER COMMITTEE – SEPTEMBER 2008

## UK Timber Market Statement

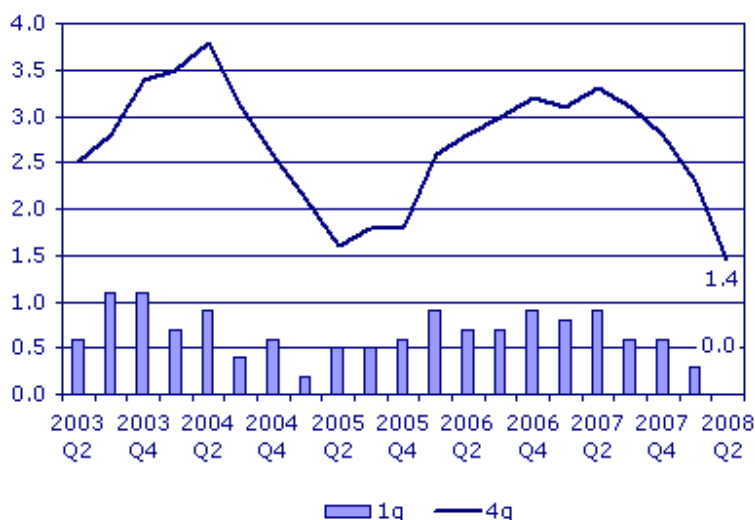
### 1. General Economic Trends affecting the Forest and Forest Industries Sector

Economic growth, as measured by Gross Domestic Product, came to a halt in the second quarter - April to June 2008, compared to the previous quarter. Compared to the second quarter in 2007, growth in the second quarter 2008 was 1.4%.

Economic growth in 2008 has slowed dramatically, compared to the middle of 2007, when GDP growth was registering quarterly growth year-on-year of 3.3%.

#### Gross Domestic Product

Percentages



Source: Office for National Statistics (ONS)

While some sectors of the economy were still growing in the second quarter 2008, others were shrinking. Output of the production industries **fell** 0.8 per cent compared with a fall of 0.2 per cent in the first quarter 2008. This was driven by **falls** of 0.8 per cent in manufacturing output and 1.9 per cent in the supply of electricity, gas and water.

Growth in the service industries was 0.2 per cent (higher) in the second quarter, compared to 0.3 per cent growth recorded in the previous quarter. Weaker growth was recorded in all the main service categories, apart from transport, storage and communication.

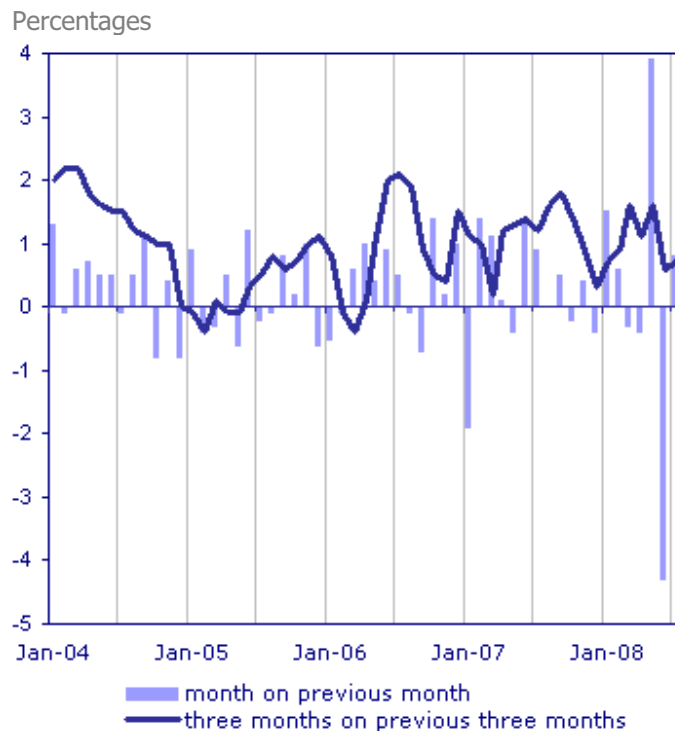
Construction output **fell** 1.1 per cent in the second quarter 2008 compared with an increase of 0.4 per cent in the first quarter.

Household expenditure **fell** by 0.1 per cent, down from growth of 1.1 per cent in the previous quarter. Contributing to this were **falls** in the consumption of goods, especially food and non-alcoholic beverages and to a lesser extent cars, and net tourism.

The performance of the economy by this measure of quarter on quarter comparisons (the current quarter compared to previous quarter) is supported by the longer-term measure of current quarter over the same quarter a year earlier. By the longer-term measure of current quarter over the same quarter last year, production output has **fallen** by 1.1% and manufacturing output is **down** by 0.8%.

Retail sales appear to be faring better however with growth in the three months to July 2008 higher than the previous three months, by 0.7%. The longer-term measure over the same three months in 2007 shows an increase in retail sales of 3.9% in 2008. However, there is currently great volatility in the measurement of retail sales, as shown by the last three months data in the chart below.

### Retail Sales



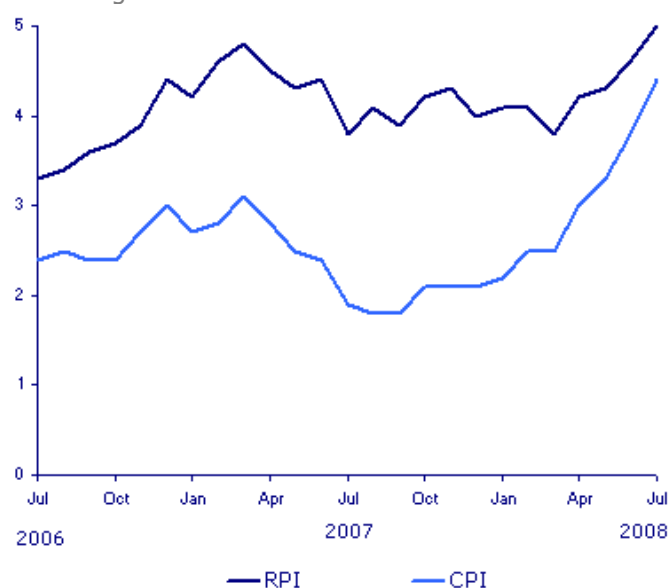
Source: Office for National Statistics (ONS)

Slowing growth has been accompanied by rising inflation in the economy.

By both measures of the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), inflation is sharply higher and, to demonstrate the differences between the relatively benign economic climate in the early part of 2007 and the rapid reversal of fortune by the first half of 2008, the chart below describes the doubling of the rate of inflation over the period of a year - since July 2007.

## Price Inflation

Percentages



Source: Office for National Statistics (ONS)

Energy and fuel costs have been rising, driven by the rapidly escalating costs of oil and other raw materials, which has helped to reduce the profitability of many businesses and dampen consumer spending. Food costs have also risen during 2008 and were 12% higher in July, compared to July 2007. Producer prices, equivalent to 'factory gate' prices rose by over 10% on a quarter-by-quarter comparison of a year earlier.

Inflationary pressures were beginning to build during 2007 and in order to combat these, the Monetary Policy Committee (MPC) of the Bank of England raised interest rates to 5.75% in July 2007 and this level was maintained until December 2007. With the Government's inflation (CPI) target of 2% breached on several occasions in 2007 and throughout 2008 to date, the MPC has been trying to balance the needs of bringing inflation under control and the need to avoid the prospects of rapidly slowing growth turning into an economic recession. These economic ills have been compounded by the consequences of personal and corporate indebtedness and the effects of a failing housing market in North America and many countries in Europe. The 'credit crunch' has seen bank failures in the USA and in the UK and measures taken by lending institutions to limit exposure to bad debt has resulted in restrictions on the availability of finance for both business investment and house purchase in the UK.

These difficulties have begun to affect employment prospects in the UK with unemployment rising both on the claimant count measure (those claiming unemployment benefits) and the wider International Labour Organization (ILO) measure.

Interest rate rises in May and July 2007 helped Sterling to climb to a 26-year high against the Dollar and maintain relative strength against the Euro and other currencies, but towards the end of 2007, weakness in the economy, including concerns over the large UK trade deficit and reducing interest rates saw Sterling fall against the Euro, resulting in an effective 15% devaluation by July 2008, compared to a year earlier.

## 2. Policy Developments potentially affecting Trade in Wood Products

Timber bought and used in the public sector is coming under increasing scrutiny, with buyers and contractors required to procure timber products from only legal and sustainable sources. Government timber procurement policy in the UK requires central departments to *actively seek* to purchase legal and sustainable timber products. The emphasis is changing however and a more rigid policy, from 1st April 2009, will be adopted whereby *only* timber and timber products originating either from independently verifiable legal and sustainable sources or from a licensed Forest Law Enforcement, Governance and Trade (FLEGT) partner will be demanded.

Within the provisions outlined, a key requirement is described, “*Any such body (all central departments in England, Executive Agencies and Non-Departmental Public Bodies) receiving government funds is mandated to follow the timber procurement policy*”.

Contractors will be obliged to demonstrate that timber is from a legal and sustainable source by having chain of custody certification or FLEGT licensed timber. Other types of evidence will be necessary to show that the forest from which timber was purchased was managed legally and sustainably.

Additionally, within the new policy, there is the inclusion of risk assessment. Where material is purchased from a ‘low-risk’ source which has a good record of forest governance and responsible management, evidence could be acceptable if a region or a country demonstrates equivalence that the laws and practices meet the standard of an operational certification scheme e.g. PEFC or FSC.

However, for material coming from sources where forest governance is poor and forest management not always considered to be responsible, proof will need to be routinely requested and, if found to be inadequate, independent verification required. In practice, the ability to demonstrate ‘equivalence to certification’ would only apply to the USA, Canada and parts of the European Union currently.

The existing voluntary requirements will continue to apply until the licensing scheme is operative. This is usually where timber from the Partner Country is supplied under a FLEGT Voluntary Partnership Agreement (VPA) between the EU and a Partner Country.

Ghana became a signatory to such an agreement in September 2008.

There are certain circumstances however, where timber sourced from a non-VPA Partner Country would be accepted and which might continue to apply following the change in policy as from 1 April 2009. In such circumstances, it would be necessary for the Government Department buying the timber to demonstrate a business case i.e. there are no certified or FLEGT alternatives, whilst additionally providing evidence of legality and sustainability.

While these European-wide initiatives are being incorporated into UK procurement processes, the UK Timber Trade Federation has, in 2008, made its “Responsible Purchasing Policy” (RPP) mandatory for all members. Underpinning the RPP is the

requirement for all members to exercise 'due diligence' in their purchasing processes. The RPP is a risk management tool to gather evidence of legality and sustainability of the timber source. It risk assesses products and provides a framework to improve sourcing practices and remove suppliers that cannot prove their products are from legal and sustainable sources.

The proposed introduction of EU legislation is considering, among other options, whether to adopt a due diligence approach for all countries of the EU to be able to ensure that all necessary steps have been taken to eradicate the purchase and use of illegal and unsustainably produced timber. This is likely to be instituted under a "FLEGT Due Diligence Regulation", should EU member states agree to its adoption.

The FLEGT programme has a number of activities including the funding of private sector initiatives. A number of Trade Federations throughout Europe established the Timber Trade Action Plan which is managed by the Tropical Forest Trust. This provides funding and technical support for suppliers to ultimately verify the legality of the timber sources.

Other policy measures in the UK include Dfid (Department for International Development) Government funding to help support better practice and improve forest governance in countries such as Indonesia, China, Malaysia, Brazil, Ghana and Cameroon. The work has included market research, country guidance information as well as country roadshows to put buyers in touch with suppliers and raise awareness of European and UK requirements for purchasing timber.

In November 2008, the Timber Trade Federation, in concert with the Department for the Environment, Food and Rural Affairs (Defra), the Department for International Development and the Construction Industry Research and Information Association (CIRIA) will be holding a joint seminar as part of the process involved in informing the construction industry of the benefits of responsible purchasing policies and the need to eradicate the use of illegally logged materials.

### **3. Market Drivers**

The main markets for timber and wood-based products are construction, the pallets and packaging industries, furniture, fencing and outdoor-use markets and a wide selection of other markets, ranging from the manufacturing of kitchen utensils, picture frames and toys to ladders, transport components and more recently, the emergence and development of energy markets for timber products on a domestic and industrial scale.

Many UK timber and wood-based product markets grew in 2007, following a year in 2006 where raw material supply shortages limited growth opportunities. However, consumption in the main markets for timber products fell in the first half of 2008 with little prospect for any recovery in the second half of the year.

The drivers of demand in construction are consumer spending on home improvements, housing starts, public sector procurement and, to a lesser degree, industrial and commercial building and refurbishment programmes. Similar drivers affect the development of fencing and outdoor use markets, such as decking, landscaping, garden

products and infrastructure projects, such as motorway fencing. In the pallets and packaging markets, manufacturing output and consumer spending are important drivers of demand and in furniture markets, consumer spending and business investment have a direct impact on sales.

A further and increasingly important driver of greater usage of timber products is the ability to re-use and recycle in all of the above-named markets.

In construction, the difficulties encountered by the new home building sector has reduced volumes of timber products consumed, although of all new build sectors, timber frame housing and timber frame commercial projects have fared better than the masonry and other material sectors. In 2007, timber frame housing was thought to account for around 22% of all new housing in the UK, with further growth predicted for 2008. Timber frame is especially strong in the social housing sector where the downturn in housing starts is less marked than in the private new housing sector, thereby limiting the reduction in sales of timber products.

In the repair, maintenance and improvement (RMI) sectors of construction, consumer and local authority spending is important to the volumes of timber products purchased and although more consumers will be directing monies that might have been spent on moving home to refurbishments, the competition from electricity, fuel, food, rates and other essentials will, it is believed, reduce the overall amount spent on refurbishments from household budgets. The overall level of activity in RMI markets in 2007 and 2008 is – as in new build markets – downward.

Longer-term, initiatives to raise the quality of new home building, such as the Code for Sustainable Homes, will drive changes in the Building Regulations which are expected to favour the increased use of timber products. The Government aim that all new homes built by 2016 will need to be 'carbon neutral' is also expected to drive the development of timber frame construction and stimulate the demand for timber products.

In the pallets and packaging industries, the downturn in manufacturing output and lower growth in consumer spending is expected to reduce the demand for packaging materials generally.

Fencing and related outdoor markets have also witnessed a sharp downturn in activity in 2008. The domestic fencing sector especially has experienced falls in the volume of orders of over 20% and to exacerbate these lower levels of activity, prices have fallen steeply in 2008. Many fencing manufacturers are unable to recover increased costs through higher prices. Less badly affected are suppliers to motorway and road maintenance works and the Highways Agency (responsible for much of the UK's road network) has reported that activity is at a similar level to 2007. Suppliers of timber products to landscaping and garden products markets (e.g. sheds, pergolas) have also not experienced the large falls in demand reported by fencing manufacturers. This is because of the imperative to maintain these types of product, but also these markets are believed to be part-beneficiaries of the, "stay put and improve, rather than move" group of consumers. The market for decking is also believed to have performed relatively well in such difficult market conditions. In 2007 decking sales benefited from the various smoking bans in the UK where establishments erected outdoor 'smoking areas' which were often deck-constructions. The market for decking is expected to continue to benefit

from demand in the commercial construction sector in 2008, limiting the impact of lower demand from the domestic sector.

Although sections of some markets are currently able to maintain reasonable levels of trade, the overall impact caused by the difficulties of the UK economy in 2008 should not be underestimated in terms of the serious effect it is having, and will continue to have, on corporate viability.

## **4. Developments in Forest Product Markets Sectors**

### **a) Wood Raw Materials**

In overall terms, the year 2007 was described as buoyant for the UK forest products sector and the first half of 2007 especially so. However, there is a stark contrast between the first half of 2007 and the first half of 2008 where optimism has been replaced by very serious concerns over weak demand, the very real prospect of economic recession and in some areas, corporate viability.

In 2007, private sector softwood removals increased by 11% to around 4.4 million green tonnes and 1.6% more softwood was removed from the public estate. Total softwood removals of over 9 million green tonnes in 2007 were 6% higher than in 2006.

The concerns previously expressed over the development of timber markets for 2008 will influence softwood removals in the UK and the possibility exists that removals could be lower by 20% or more for 2008 as a whole.

Roundwood imports in the first half of 2008 are running at similar levels to the first half of 2007.

### **b) Wood Energy**

Approximately half a million green tonnes of UK grown softwood and hardwood was consumed as woodfuel in 2007, substantially higher than in 2006.

Short-rotation coppice, arboricultural arisings, forest arisings and brash and sawmill co-products form the majority of the materials used in wood energy generation. Uses range from small domestic to community heating systems, but in the next year larger installations on an industrial scale will become significant users of woody biomass material.

The 50 MW combined heat and power plant at the UPM Caledonian Paper 'Targe' project is likely to begin operations in May 2009 and when fully operational, the E.On electricity generating plant at Lockerbie and the Sembcorp installation in Middlesbrough will consume significant quantities of sawmill products and biomass materials. Predictions for SembCorp Utilities installation suggest around 300,000 tonnes of woodchips a year will be used to generate enough electricity for 30,000 homes. An important outcome from this activity will be a saving of 200,000 tonnes of CO<sup>2</sup> emissions compared with conventional fossil fuel-burning power stations. Nearly one half of the wood requirement is expected to come from recycled timber while 7,500 acres of new coppice in sustainably managed forests in the north-east of England will furnish the plant

with much of the remainder. A new electricity generation facility at Port Talbot will also use wood fuel which is aimed to provide a high proportion of the future electricity needs in South Wales.

In the north of Scotland, a wood pellet making plant owned by Balcas is likely to be commissioned in December 2008 with production commencing from March 2009. It is anticipated that "Brites" wood pellets will achieve full production by late 2009. This plant, with a maximum eventual output of 100,000 tonnes will also have the capacity to generate electricity which will be sold to the National Grid.

Of other developments, a collaborative approach by three harvesting operations in 2008 is aimed at developing environmental standards for forest removals destined for the biomass market, to be consistent with existing standards in other markets.

#### c) Certified Forest Products

At 42% of all mills, a higher percentage of sawmills in the UK held chain of custody certificates in 2007 than in 2006. Fewer mills operated without certificates, down from 80 in 2006 to 73 in 2007.

#### Chain of Custody Certificates, 2007

	With certificates	Without certificates	Not reported	Total
<b>Sawmills</b>				
< 5,000m <sup>3</sup> sawnwood	15	60	3	78
> 5,000m <sup>3</sup> and < 25,000m <sup>3</sup> sawnwood	13	12	2	27
> 25,000m <sup>3</sup> sawnwood	28	1	0	29
<b>All sawmills</b>	<b>56</b>	<b>73</b>	<b>5</b>	<b>134</b>
<b>Round Fencing Manufacturers</b>	<b>15</b>	<b>34</b>	<b>3</b>	<b>52</b>

With virtually all of the larger sawmills holding chain of custody certificates, the proportion of certified volume is larger than the proportion of mills holding certificates. While 42% of mills hold certificates, over 60% of sawmill production and 78% of sawmill consumption was certified in 2007.

#### Percentage of Volume Certified, 2007

Year	Removals (softwood)	Saw Consumption (softwood and hardwood)	mills Production (softwood and hardwood)	Round Fencing Manufacturers Consumption (softwood)
2003	54	67	50	36
2004	74	80	63	58
2005	69	76	71	53
2006	67	81	64	46
2007	74	78	65	54



Differences in the percentage of volume certified between years needs to be viewed with caution as changes in demand for sawn goods from different markets – particularly from the larger mills - can alter the proportion of production that is certified from year to year.

d) Value-added Forest Products and Engineered Wood Products

Demand for value-added products, such as planed, square-edged and finger-jointed softwood continued to grow in 2007 with, especially, imports of planed whitewood higher than in previous years. Engineered wood products, such as glulam, laminated lumber, chemically modified wood and lightweight engineered components used in construction are also growing in acceptance and providing new opportunities for timber manufacturing operations.

With structural capabilities equal to, and in some cases stronger than, steel and concrete, engineered wood products are finding increasing use where speed of assembly and ease of handling are important considerations and where the construction industry is developing low-carbon building solutions in order to meet current and future Building Regulations.

The use of engineered wood products is allowing greater freedom of design, with the capability to build higher and obtain wider spans, as witnessed by the world's tallest timber built building of 9 storeys recently erected as flats in London.

Further development will hindered in 2008 by the postponement of a number of private and public building projects and the downturn in the housing market, despite an increasing level of interest in these products by architects and specifiers and the desire to promote their use by product manufacturers and suppliers. A leading merchant chain, Wolseley opened a 'Sustainable Building Centre' in 2008, showcasing many engineered wood building products and components, including timber frame panels, I-joists, treble-glazed wood windows, cladding, decking and roofing cassettes.

e) Sawn Softwood

The contrasting fortune between 2007 and 2008 experienced in the wood raw material sector has been mirrored in the market for sawn softwood.

While 2007 was a record year for production from UK sawmillers, with the volume of sawn softwood exceeding 3 million cubic metres for the first time, 2008 is likely to see this volume return to below this level under current market conditions.

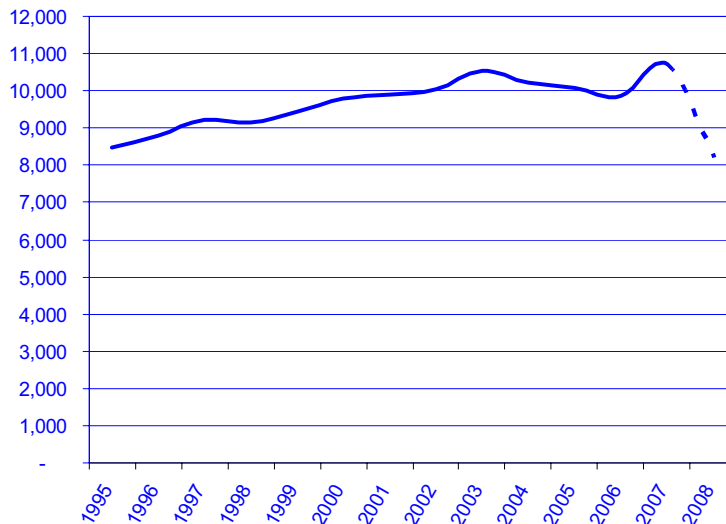
Sawn softwood imports will be substantially lower in 2008 compared to 2007. With imports lower by around 25% in the first half of the year, the annual import volume for 2008 is forecast to be less than 6 million cubic metres, down from nearly 8 million in 2007.

The sharply lower level of activity in construction markets will account for a significant part of this shortfall in 2008, but fencing manufacturers and pallet makers are also consuming less material, resulting in one of the lowest estimates of sawn softwood consumption in the UK since 1996. Despite currently lower levels of consumption, investments made by UK sawmillers have continued with expansion of the BSW Timber plc sawmill at Kilmallie and similar mill developments by Howie Forest Products, James Callander and Son Ltd., and James Jones and Sons Ltd.

For 2008 however, sawn softwood volumes will be much lower and the projected fall in consumption shown against recent levels, is given in the chart below.

### UK Sawn Softwood Consumption

000s m<sup>3</sup>



Source: Forestry Commission; Timber Trade Federation; *timbertrends*

#### f) Sawn Hardwood

The UK sawn hardwood market is extremely diverse, in terms of the types of products consumed and in the variety of end-use markets.

UK production has been declining for many years, falling from a volume of nearly 150,000m<sup>3</sup> in 1997 to around 45,000m<sup>3</sup> in 2007. Hardwood imports too have been declining, volumes having fallen from over 700,000m<sup>3</sup> in 2003 to just over 450,000m<sup>3</sup> in 2007.

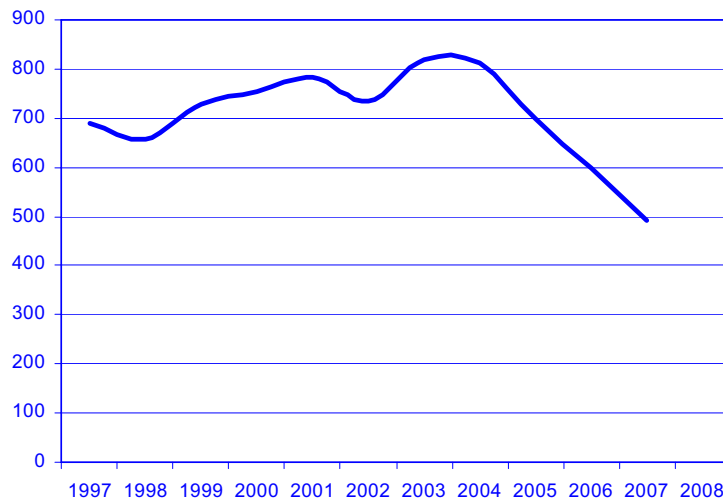
Temperate hardwoods are used in a wide variety of applications, from relatively low-value packaging materials to finely engineered furniture and building components and despite the difficulties encountered in many user markets, imports of temperate hardwood in the first half of 2008 are running at very similar levels to the same period in 2007.

Imports of tropical sawn hardwoods have continued to decline in 2008, around 10% lower in the first half of 2008 with a volume around 73,000m<sup>3</sup>.

There has been a significant fall in consumption since 2003, as shown in the chart below.

## UK Sawn Hardwood Consumption

000s m<sup>3</sup>



Source: Forestry Commission; Timber Trade Federation; *timbertrends*

### g) Wood-based Panels

As in other product areas, UK producers of wood-based panels experienced weaker demand towards the latter part of 2007, which has worsened in 2008, resulting in lower levels of production in 2008. The major cause is attributed to significant deterioration in the construction sector, although other markets too are demanding less volume in 2008.

Lower demand, coupled with increased costs has threatened profitability within the wood-based panels sector. Higher energy costs for gas, electricity and oil has affected production costs and transport costs too have risen sharply, for both delivery of raw materials and finished goods. Raw material costs have also risen, driven largely by high demand from China and other industrializing nations. Trade restrictions, such as export duties on resin exported by China, have also contributed to rapidly increasing costs.

### h) Pulp and Paper

Consumption of wood pulp in the UK in 2007 was just over 1.63 million tonnes, a little lower than in 2006. For 2008, consumption is expected to be lower again, by around 8% at 1.5 million tonnes. This reduction in consumption will be as a result of lower imports to the UK. Only two pulp mills remain in production and encouragingly, production for 2008 is forecast to be equal to the 264,000 tonnes produced in 2007.

Paper and paperboard production in the UK is forecast to be 1.5% lower in 2008 at 5.15 million tones, brought about more by the three mill closures than significant shortfalls in demand. The papermills that have closed are SCA Hygiene's Tawd mill at Skelmersdale and Curtis Fine Papers Guardbride Mill both of which closed in July 2008. Sappi Europe have announced their intention to close the Blackburn mill in the autumn of 2008.

Despite these difficulties however, considerable new capacity is planned for 2009, although should demand weaken further, these plans will be delayed.

## 5. Tables

**UK Economic Indicators (% unless otherwise indicated)**

	2003	2004	2005	2006	2007	2008 (Forecast)
<b>GDP growth<sup>1</sup> (at constant 2003 market prices)</b>	3.3	1.8	1.8	2.9	3.0	1.4 <sup>2</sup>
<b>Interest Rate (Minimum Lending Rate at year end)</b>	3.75	4.75	4.5	5.0	5.0	4.5 <sup>2</sup>
<b>Consumer Price Index</b>	1.4	1.3	1.9	3.0	2.1	4.3 <sup>2</sup>
<b>Unemployment (ILO)</b>	5.0	4.8	4.8	5.5	5.2	5.6 <sup>2</sup>
<b>Private Housebuilding Starts (000s)</b>	190.0	207.4	204.1	205.0	216.6	160.0 <sup>3</sup>

<sup>1</sup>GDP growth is measured on a current quarter compared to the same quarter of the previous year

<sup>2</sup> HM Treasury, Forecasts for the UK Economy: A Comparison of Independent Forecasts, August 2008

<sup>3</sup>*timbertrends*