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Chief Kathy Francis
Klahoose First Nation

and

Kathy Smail
Cortes Ecoforestry Society

Via email

Dear Kathy and Kathy:

This addendum under separate cover addresses a key issue that is not for widespread public distribution, at least until a thorough review of my business plan assumptions and estimates has been carried out.

My initial calculations show that under the current stumpage regime, the Cortes Community Forest will lose \$9.50 per cubic meter of wood cut, despite my assumption that Community Forest wood will be ecocertified ASAP and sell ecocertified logs for a premium.

This discouraging forecast is caused by current government stumpage revenue targets and the stumpage appraisal system..

I have prepared a 12 page discussion on stumpage for the business plan, which I have not attached. I would be happy to forward it if required. As briefly as possible, what is going on is that the government has decreed that an organization which cuts average value wood at average logging costs on the coast shall pay the Crown \$22 per cubic meter in stumpage. Unfortunately, the math of current average log value minus current average logging costs produces a net log value of $-\$7/\text{m}^3$, that is, a $\$7/\text{m}^3$ loss. After losing $\$7/\text{m}^3$ while logging, the government sends a bill for the $\$22/\text{m}^3$ for "average stumpage". Net loss: $\$29/\text{m}^3$.

It gets worse. If an organization is logging high value sawlogs on easy terrain, the government increases stumpage costs until the net result is a $\$29/\text{m}^3$ loss. If logging low value wood with helicopters on rugged terrain, the government decreases stumpage costs to "bring them up" to a $\$29/\text{m}^3$ loss.

I assume that major Licencees survive in this regime by making their money on milling. Log at a loss, but recover the money from processing wood.

The current financial analysis for the Community Forest uses additional revenue from certification and cost savings from operating as inexpensively as possible to reduce the \$29/m³ loss to a \$9.50/m³ loss. An improvement, but still far from an attractive picture. The Community Forest can service its debt and pay its rent, but makes no profits whatsoever. All revenues above costs goes to the government as stumpage, and we are still short \$9.50/m³.

The sources of hope for an improved financial picture are:

1. I have made an error. I do not believe this to be the case, but further review by Herb and others may reveal a mistake in my calculations.
2. The government revises stumpage to reduce the overall stumpage burden on the forest industry. With the upcoming change in administration, and the known business bent of the Liberal party, this appears likely.
3. The government revises the stumpage system to reflect that fact that Woodlots and Community Forests sell logs, not lumber. As Community Forest and Woodlots are largely associated with the current government, I think that this is much less likely than #2.
4. The Community Forest manages to achieve an additional \$9.50/m³ premium on sales of certified timber, above the average \$6.80 premium used in the current analysis. This appears optimistic, but may be feasible.
5. The lumber market rebounds spectacularly, so that there is sufficient money left after paying for logging and administration costs to pay the stumpage bill in full and have money left over for profit. Does not appear likely this year. Depends on US economy and softwood lumber talks.
6. The Community Forest becomes a timber processor to capture additional value from milling. This is discussed below.

Becoming a timber processor is not without challenges. Small processing operations face difficulties related to economies of scale. Small sawmill operators assert that the small mill can not compete with the giant industrial complex when producing standard lumber for the commodity market. The Cortes Community Forest would likely be able to access developing markets for certified forest products which are sold with a significant premium. Selling to this specialty market might enable a small timber processing facility to thrive on Cortes Island.

There are three arguments against the community forest entering the timber processing business. These are:

1. the inherent conflict of interest between timber processing and forest management;
2. the need for additional capital and management expertise during the start-up phase of the community forest business; and
3. the difficulty in creating and maintaining an institutional entrepreneurial spirit.

There is an inherent conflict of interest between managing forest ecosystems and maintaining financial viability in the timber processing industry. A recurrent problem in BC forestry has been the requirements of the sawmill dictating the type of timber products harvested from the forest landbase. In the sawmilling business, the greatest financial returns for all parties generally come from the largest trees. This often leads to pressure on forest management personnel to find “good wood” to help the milling business turn a profit. Plainly, the Cortes Community Forest has every intention of implementing ecosystem-based management on Cortes Island. Any milling system designed for the island and for the community forest would be built to handle smaller diameter logs from initial harvesting and thinning operations. However, once the community forest had invested the significant resources required to start a milling operation, the day could well come where a difficult business choice was faced: switch to cutting some larger diameter wood for a “brief period” to see the milling operation through some difficult financial times, or face the likelihood that the community forest business would go bankrupt due losses accumulated by the mill (if forced to survive on small logs from thinning s only). Of course, the difficulty always comes when trying to bring the brief period to a close and switch back to processing the lower value product.

Exposing the community forest to increased business risk, as it attempts to operate in both the forest management and sawmilling spheres, causes an increase in risk of poor forest management choices due to short-term economic factors. To an extent, a community forest based on log sales has the option of simply shutting down during the worst periods of a cyclical market. This becomes much more difficult to do when debt load has been increased in order to develop a sawmilling infrastructure, and when business resources have been invested in developing a consistent, dependable presence in the wood products market.

There will be very substantial capital and managerial requirements to commence community forest operations. Developing a business infrastructure, carrying out extensive planning operations to government and ecoforestry standards, laying out field operations, and constructing road networks will require a minimum capital investment of \$120,000.

Developing a timber processing facility will require additional large capital investment above the \$120,000 needed for the Community Forest startup, as well as requiring a significant investment in managerial expertise to bring the required milling, distribution, and marketing operations online. Are sufficient capital and human resources available to the community forest to meet these requirements?

Small businesses, and certainly the small milling and secondary and tertiary manufacturing businesses in British Columbia, are traditionally run by entrepreneurs. Entrepreneurs traditionally invest a very high proportion of their personal capital in their business operations, and often an even higher proportion of their time and energy to establish their business. This, generally combined with enthusiasm for the project and strong belief in the desirability of the outcomes, tends to produce extremely dedicated and creative management. I am not suggesting that tenacious self sacrifice is suitable or progressive long-term business model. However, in the short term, the personal effort and dedication shown by an entrepreneur, whether stimulated through dedication to the concept or enlightened self-interest in the hope of long-term financial benefits, are generally required

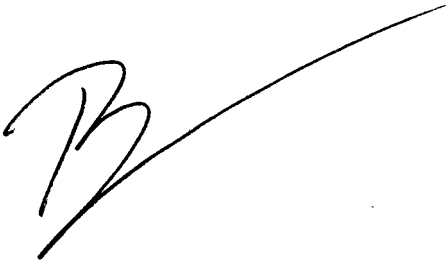
to successfully initiate a small business. Would an employee of the Cortes Community Forest have the freedom, the dedication, and the reasonable expectation of long-term financial benefits which seem to be required to stimulate entrepreneurial effort?

I outlined the difficulties inherent in becoming both a timber processor and a Community Forest in detail because I do not see that as a desirable course of action. However, I think that we should at least discuss it.

I am greatly concerned by the \$9.50/m³ shortfall, but I think that we should recognize that this is likely a temporary situation. We have every reason to believe that change is coming, but no clear idea what form it will take, and how it will affect the Cortes Community Forest.

I look forward to receiving your thoughts on this matter. I think conference call to discuss this issue at a time which is feasible for Herb, after he has gone over my work, would be useful.

Sincerely,

A handwritten signature in black ink, appearing to be 'Tom Bradley', with a long, sweeping horizontal line extending to the right.

Tom Bradley