

LESS THAN FREE ENTERPRISE

In 2005, Congress passed an alternative energy bill designed to promote the use of bio-fuels. The estimated cost of the program was \$61 million. Before we offer an updated projection of the final cost, let's cover a few basics, and then review the sequence of events that has occurred over the last year.

During the standard process of producing kraft pulp, recovery boilers "recover" black liquor and chemicals. The chemicals are then re-used. The black liquor, a 100% bio-fuel byproduct of the pulp production process, is burned to produce energy for mill operations. All kraft pulp producers, including those integrated paper companies producing kraft pulp in conjunction with printing papers or packaging grades, can become eligible for this subsidy.

Groundwood pulp producers and recycled pulp operations are excluded from this program. This is important for several reasons. First, in some cases, subsidized kraft pulp producers are competing against unsubsidized, non-integrated paper producers and grades of paper that do not contain kraft pulp. Second, both recycled and groundwood pulps are environmentally more "friendly" than kraft pulps, and yet are being disadvantaged by this "environmental" bill. Last, most producers of groundwood pulp have invested in boilers that convert wood waste into energy. So even if one stretches the point of the legislation to include bio-energy operations in general, then groundwood pulp producers are again being left out.

It all started late in 2008 when IP and Verso found a loophole in the alternative energy bill. Rather than adding bio-fuel to a fossil fuel product, as intended by Congress, these companies were able to qualify for the tax credits by adding a little fossil fuel to their normal production of bio-fuel. Adding a miniscule volume of fossil fuel to the black liquor bio-fuel created magic. Remarkably, these few vapors of diesel fuel were converted into hundreds of millions of dollars. We sought an analogy —

"This diesel fuel was worth its weight in..." — but there is no adequate analogy. Nothing — not gold, not platinum, not diamonds — can compare, pound for pound, with the enormous value of that diesel fuel.

How did this fossil fuel become so valuable? Congress wrote bad legislation, and then the IRS interpreted the alternative energy bill in such a manner that black liquor qualified for tax credits. (Calling these payments "tax credits" is actually a misnomer. They do not offset taxes, so profits are not necessary in order to receive them. The IRS simply sends a cash payment directly to those kraft pulp producers that have become "qualified" by adding diesel to their normal process.)

There are so many deeply disturbing elements of this legislation, and the subsequent actions taken by the IRS and Congress over the last year, that it is hard to know where to begin.

First of all, the intent of the alternative energy bill was not to produce cash for kraft pulp producers. There was never any debate, or discussion, that this might occur. The intent was to assist fledgling bio-fuel companies that were in start-up.

Despite a long history of passing legislation with dreadful unintended consequences, Congress just never gets it right. This little \$61 million bill was not difficult legislation to draft correctly, and yet Congress still wrote the bill without logical parameters.

The IRS had the opportunity to deny the IP and Verso applications. It did not have to interpret this bill by the letter of the law. What were the paper companies going to do — sue the IRS

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to receive funds that were not intended for them in the first place? By the way, if those responsible for this IRS decision had had business backgrounds, the response would have been something like, "Nice try, but this was not meant for you." No, it took a group of lawyers to make a decision that so grossly violated the spirit of the law.

In Q4/08, the IRS was aware that hundreds of millions of dollars would soon be flowing out to paper companies, but this was apparently never reported to Congress. You would think that the bureaucrats who interpreted this legislation so liberally would have written a memo or two to give Congress a heads-up — to suggest, perhaps, that Congress might want to look into how this bill was written, and make a few changes, so that spirit of the original legislation could be retained. It is inexcusable that this lack of communication and lack of concern is tolerated. Nevertheless, this is routine, and is our government at work.

Only after Verso and IP announced their earnings in late January did we all begin to catch on. Other pulp producers woke up to the enormous potential benefits they were losing out on. At the same time, recycled and groundwood pulp and paper companies in the U.S., as well as all pulp and paper companies in Canada and Europe, began to panic and raise objections.

We finally heard from Congress in March. Senate finance committee chairman Max Baucus (D-Montana) was the first to object, and prepared to draft legislation to "ensure that the credit is used in a manner that is consistent with the spirit and intent of the law". Senator Jeff Bingaman (D-New Mexico), confused about how the tax credits work, said, "Congress never intended that the credit would be used in this way to avoid payment of taxes." And Senator John Kerry (D-Massachusetts), perpetually confused, refused to accept responsibility for the poorly constructed legislation. He blamed the pulp companies: "Bad economic times are no excuse to cheat, and that's the only word for what these companies are doing."

There was still time to cut off payments, of course. Baucus just needed to ask some assistant to send the legislation through. IP and Verso would enjoy a short-term windfall, based on their Q4/08 pulp production, but no real harm done. Good for them that they were so creative. We all thought that the end of this

subsidy was near. Mark Wilde, a leading paper analyst, spoke for us when he wrote, "Recent reports suggest that the paper industry's application of the program is attracting scrutiny and could be curtailed in the coming weeks."

And then what happened? Absolutely nothing! But why? Why would an anti-business, democratically controlled Congress and the President allow the IRS to send \$8 billion to specially selected pulp and paper companies? We are not talking about a little financial help to get over a rough spot. **The U.S. Treasury, in effect, is providing a bonus equal to about one-third of these companies' manufacturing costs. It's unprecedented!**

In addition, since the pulp companies added fossil fuel to the process, this has become an anti-environmental bill. The environmental impact is actually inconsequential, but the direction is clear — atmospheric carbon *did* increase as a result of this environmental bill.

Senator Kerry was so filled with outrage that we sensed he might call Senate hearings to look into all this corporate cheating. Then he suddenly went mute — a highly unusual occurrence. If Kerry does decide to talk about this issue in the future,

Alternative Fuel Credits — Public Companies

Public Company	U.S. Kraft Pulp Capacity (approx.) (short tons/yr)	Credits Accrued Through Sept. 30 (\$US millions)	Estimate of Total Credits Through Dec. 31 (\$US millions)
AbitibiBowater	1,100	198 *	278
Boise Inc.	1,700	135	200
Buckeye Technologies	500	92 *	130
Clearwater Paper	800	123	173
Domtar Corp.	2,900	336	496
Graphic Packaging	1,000	97 *	132
International Paper	11,000	1525	2,055
Kapstone Paper & Packaging	1,200	123	178
MeadWestvaco Corp.	2,700	281	386
P.H. Glatfelter	600	76 *	111
Packaging Corp.	1,300	129	179
Rayonier	800	141	196
Rock-Tenn	400	55	80
Sappi	1,000	77 *	117
Smurfit-Stone Container	3,900	294 *	449
Temple-Inland	2,400	153	233
Verso Paper	900	190 *	235
Wausau Paper	100	10	14
Weyerhaeuser	2,400	229	349
			\$5,991

*Q3 credits estimated

Sources: Industry Sources, ERA

Alternative Fuel Credits — Private Companies

Company	U.S. Kraft Pulp Capacity (approx.) (short tons/yr)	Estimated Credits Accrued Through Sep. 30 (\$US millions)	Estimate of Total Credits Through Dec. 31 (\$US millions)
Alabama River Pulp	900	\$81	\$108
Evergreen Packaging	1,000	154	205
Georgia-Pacific	7,600	1,084	1,446
Green Bay Packaging	300	39	52
Inland Paperboard	900	109	145
Interstate Paper	300	37	49
Lincoln Paper & Tissue	200	24	31
Longview Fibre	1,000	121	161
Mid-America Packaging	100	17	23
NewPage	1,700	200	280
Packaging Dynamics Corp.	100	18	24
Port Townsend Paper	200	27	36
			\$2,561

Data Sources: BLRBAC; Industry Sources: Lockwood-Post

tax dollars and the tax dollars of future generations of Americans should be used to assist them. This is even more the case when assisting a portion of an industry creates a disadvantage for competitors that do not receive the subsidy, and fosters unhealthy international trade relations. (We will not dwell here on the potential for serious harm to international trade. We covered this concern in the May issue of *Reel Time* in the article "Burning Black Liquor and Trade Relations".)

And in regard to the second part of the Snowe defense, how is removing an unintended subsidy "punishment"? No one promised the kraft pulp and paper producers assistance. If the IRS accidentally adds a few million dollars to the refund check of a taxpayer, does the taxpayer get to keep it? Not in the other 49 states. In this case, the chosen pulp and paper companies are being sent "accidental" refund checks totaling \$2 bil-

I have a question for him: if accepting legal but unintended tax credits is cheating, what would he call the congressional non-action that has allowed this subsidy to continue?

After a long black liquor sabbatical, we recently heard again from Senator Baucus. He told us not to lose hope. He is still drafting the legislation needed to close this loophole. With a lot of hard work on his part, he might get the legislation passed before it expires naturally at the end of the year.

It was no coincidence that Baucus and Kerry became quiet at the same time Senator Olympia Snowe (R-Maine) took up the cause of the kraft pulp producers. Maine, of course, is one of the nation's leading pulp- and paper-producing states. In addition, the industry makes up a major portion of the state's industrial base. Snowe made the argument that the pulp producers need the money, so we should give them our tax dollars. *Really...* that is what she said. In addition to that very persuasive line of reasoning, she added, "Do we really want to punish an industry that employs 1.3 million Americans?" She did not have to mention that many of these Americans live, and vote, in Maine.

When buying and selling are controlled by legislation, the first things to be bought and sold are legislators.

— P.M. O'Rourke

A rebuttal to Snowe's case is hardly needed, but, just for the record, many industries are struggling just as much as the kraft pulp and paper producers, but that does not mean that our

lion per quarter in 2009.

The point is that Senator Snowe was the key that kept this money flowing. She might as well have signed the checks herself. Snowe let it be known early this year that her health-care vote was available. We know that Baucus needed Snowe's Republican vote to be assured that the health-care plan would be voted out of committee, and to be able to claim some non-partisan support. As a result, Senator Snowe has been the belle of the ball this year, the prettiest girl in D.C. What Lola wants, Lola gets, and Olympia too. Kerry, Baucus and the President were willing to give Snowe whatever it took to keep her happy. And what kept her happy was the continuation of this egregious subsidy.

Early in October, Snowe fulfilled her end of the agreement. If she votes again for the health-care legislation when it reaches the floor, hers will likely be the only "yes" Republican vote. Snowe's rationale for voting for the health-care bill in committee was quite intriguing. She explained, "When history calls, history calls." I have been trying to decipher the deeper meaning here, but it has escaped me so far. Let's see, when... history...calls..., history...calls. Well, let's think about it.

The initial estimated cost of the health-care legislation would be roughly \$1 trillion plus the \$8 billion that kraft pulp producers will receive. We know the actual cost of the health-care bill will be dramatically higher than the initial estimate. Let's just hope that the final cost of the program is not 132 times

greater than the initial estimate, as will be the case with the alternative energy bill.

Concluding Remarks: Free enterprise systems work because they are relatively free from governmental interference. Government regulation is certainly crucial to our banking, legal systems, etc., but effective legislation is needed, not massive interference.

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.

— Adam Smith

When governments abuse their power by assisting friends and harming enemies — whether in the administering of social programs (Acorn), manufacturing operations or news media — free enterprise is no longer free. It is replaced by “a system of privilege”. Consider the decades of economic failure in the South and Central American countries. The populace of these countries seems to always be under the thumb of either a wealthy ruling class or a socialistic government, and neither form of leadership is conducive to economy opportunity and economic growth. Most recently, Russia is a fascinating example of an inappropriate and self-defeating partnership between government leaders and closely held business associates whom the government assists along the way. Now this system of privilege is increasingly evident in the U.S.

Bailouts, tax credits and other subsidies distort the free enterprise system, and result in dangerous unintended consequences. Subsidies always replace a cheaper product with a more expensive one, and drive at least some of the more efficient producers out of business. In the process, the taxpayer pays for this extra cost.

The alternative energy fuel credit legislation has given us an opportunity to peek into the future — a future complicated, confused and choked by atmospheric carbon-reduction legislation: a future in which the free market recedes in importance and no longer determines success and failure. The government will play an increasingly larger role in choosing who wins and who loses. Every time the government assists one company or industry, they harm another. Rather than simply providing a predictable business environment, with *easy taxes, and a tolerable administration of justice*, Congress is providing just the opposite set of conditions: political favoritism, unpredictability and high taxes. Legislative action is based on perceived environmental impact, politics (how should I vote to remain in office?) and a host of other personal reasons.

If Woodward and Bernstein were trying to “follow the money” right now, they would need a staff of hundreds. And if health care and carbon reduction legislation are passed, make that *thousands*. Congress is giving away money, with few strings attached, at a pace that is beyond belief. Every organization has its handout and no one with political capital goes away empty-handed. Just in the forest products industry alone, there are at least three major new subsidies being considered. Spending is totally out of control. This is not going to end well. □

— Verle Sutton

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