

# Uncoated Freesheet Market to Rely On Continued Capacity Control in 2007



Industry consolidation and the closing of over 1.5 million tons of uncoated freesheet capacity since 2005 led to strong price gains on all major grades in 2006. With U.S. demand growth expected to be negligible at best in 2007, following on the heels of a contraction of demand in 2006, continued capacity control is needed if producers are to sustain prices at current high levels.

By Harold Cody

Early last year the idling of considerable uncoated freesheet capacity due to poor financial returns caused by rising costs for energy, transportation and fiber and exacerbated by changes in the Canadian dollar, had just begun to give mills some pricing power. However, while some improvement in transaction prices was expected, the outlook at the time was uncertain as U.S. uncoated freesheet demand remained sluggish. Of course, not only did the initial price gains stick, but subsequent additional increases were enacted that moved prices up to the highest levels seen in a decade. They remain more or less at those levels today.

None of us should have been surprised by the sudden and substantial turnaround in pricing and profits because

what played out last year in uncoated freesheet is something we've seen before in other sectors. It was first accomplished in the containerboard sector and more recently it has also been successfully followed by newsprint producers, who aggressively shut down sufficient overcapacity that pricing actually improved as demand contracted.

Weak demand has certainly plagued uncoated fine paper mills in the last couple of years and in fact demand has been flat or declining since the peak level of demand reached in 2000. North American uncoated freesheet demand declined 1.5% in 2006 vs. 2005 levels, falling to 12.2 million tonnes. Shipments were 12 million tonnes, down 2.4% from 2005, while a 24% rise in imports to 552,000 tonnes contributed to the smaller drop in demand than indicated by the fall in shipments. This followed a 3.4% decline in shipments in 2005 for a two-year decline of 856,000 tonnes.

Clearly the key to the direction of pricing, however, is that operating rates remained solid for most of the year, which led to the strong gain in prices. Prices surged for much of 2006 as there were 3 major rounds of increases, and by the third quarter, transaction prices had risen by \$125 - \$150/ton, as the exact increase varied by grade. Prices finally approached levels not seen since the record prices set back in the 1994-95 period. Cut-size prices are reported to have hit the \$950/ton level while offset prices hit about \$850/ton. In contrast, pricing in 2004 on the same grades averaged about \$800/ton and \$675/ton, respectively, and as recently as early 2006, prices were \$100 below current levels.

NORTH AMERICAN PRINTING/WRITING PAPER STATISTICS				
(000 tonnes)	December 2006	% change year ago	Year-to-date 2006	% change year ago
<b>Uncoated Freesheet</b>				
Shipments	929	-5.0	11,996	-2.4
Operating rate	85	84 <sup>1</sup>	93	90 <sup>1</sup>
Imports	50	150.0	552	23.7
Demand	953	-2.4	12,211	-1.5
<b>Total Printing &amp; Writing</b>				
Shipments	2,176	-2.8	27,316	-2.2
Operating rate	87	86 <sup>1</sup>	92	90 <sup>1</sup>
Imports	280	14.5	3,767	19.0
Demand	2,377	-1.3	30,143	0.1

1. Shipments/capacity. Actual figure, not a percentage change.  
r=revised  
Source: Pulp and Paper Products Council

While imports rose, it should be noted they still only account for about 5% of North American demand for uncoated freesheet, the lowest share for any major printing and writing grade. For example, imports account for over 20% of coated freesheet demand. Uncoated freesheet imports rose considerably from off-shore sources, mainly from mills in Asia, due to a surge of capacity in that region. Canadian shipments to the U.S. fell as capacity was reduced at high cost facilities. While imports rose last year, the added supply was unable to counter the surge in prices. This year, if imports from Asia remain high, they could exert a more important influence in pricing and thus bear watching.

**Further Capacity Constraint Needed**

For 2007, the direction of the market will again depend on the ability of producers to manage supply to match demand. Demand weakened late in 2006 and was sluggish in early 2007. For the year, demand is expected to be about flat and may be better during the second half.

However, there is concern that demand could contract even further this year due to two factors. First, while expected to be positive this year, economic growth is

forecast to be weaker than last year. And secondly, postal rates are set to go up again in 2007. For example, first class mail rates will rise from 39 cents to 41 cents. In the short

term this will tend to hurt demand for offset grades used in direct mail.

As a result, it appears clear that for the recent price gains to be maintained, producers will need to carefully manage capacity. One factor working in

the mill's favor is that capacity will drop about 3% in second quarter 2007 with the shutdown and conversion of International Paper's 350,000 tpy machine in Pensacola, Florida to linerboard.

Additionally, everyone is watching to see what happens following the merger of Domtar and Weyerhaeuser's fine papers business. This merger could provide further opportunities for capacity rationalization that would leave producers with a balanced market and many observers think it will in fact result in further mill and machine closures.

It was all about capacity control in 2006 and it will be more of the same in 2007. ■

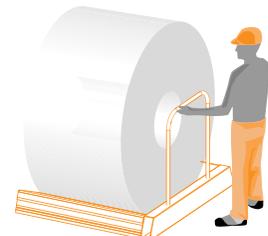
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