

# Uncoated Groundwood Mills Benefit from Tight Supply, Shifting Grades



By Harold Cody

Uncoated groundwood mills, although facing weak demand due to a drop-off in advertising caused by economic weakness and rapidly rising costs, have also benefited from supply shortages, lower imports, and buyer's switching grades to reduce costs. With supply shrinking due to widespread and far reaching mill closures, and cost pressures unabated, the market should continue to favor producers despite the troubled economy.

Analyzing printing and writing paper markets is becoming a bit like listening to a broken record. It doesn't matter what market you look at, they all look the same when evaluating them using basic market fundamentals such as supply, demand, pricing and operating rates. For example, North American demand is weak for all printing and writing grades. Demand for newsprint is even worse. Another similarity is the constant stream of capacity shutdowns, which in turn have supported operating rates enough to drive prices on a steady upward trend.

Uncoated groundwood papers for the most part share these market similarities. However, there are a couple of differences. One is that demand is up about 3.8% in North America through the first six months of 2008 vs. 2007 for all uncoated groundwood grades, which include SC papers, directory/lightweight grades and a wide range of machine-finish grades. This is in contrast to demand for printing and writing grades, which is off by 3.7% over the same period. The overall drop in demand is led by steep declines in the demand for coated papers and a continuing contraction of uncoated fine paper demand. Last year, while overall N.A. printing and writing demand fell 3%, uncoated mechanical demand in contrast posted a modest 1% gain, with shipment rising 4% and imports plunging 16%.

The current weakness in paper demand surely isn't a surprise. Given the drag on the economy of the housing mess and weak job growth, a downturn in demand had been pre-

dicted. In turn, the chilling effect of this on print advertising, as shown by declines in magazine advertising pages and newspaper inserts, is typical. The impact of higher postal rates is also a factor that was expected to undercut demand

by having a dampening effect on catalog mailings, which in fact peaked in fourth quarter 2006 and have declined steadily since then on a quarter to quarter basis. The demand weakness has accelerated recently, as shown by a substantial drop recently in U.S. Postal Service catalog mailings. The USPS's standard mail volume fell 5.8% and 8.7%, respectively, in the second and third fiscal quarter of 2008 vs. the prior year. Higher postal rates were obviously a key factor in the drop, compounded by paper costs that are exceeding late 1990s highs. They remain, however, below

record price levels set in 1995.

While uncoated groundwood demand is up in contrast to the declines in other grades, unfortunately this is not due to any major countervailing trend that has somehow missed all other grades. It's mainly a result of users looking to control rapidly rising paper costs by grade shifting down from more expensive papers such as LWC. It's also due to short supply for coated grades due to a wave of capacity closures combined with high groundwood operating rates. In addition, imports are down due to the continuing fall in the dollar which makes it much less attractive for Canadian or European mills to sell paper to U.S. consumers. In coated grades, Asian imports have somewhat offset this trend.



## Non-integrated Mills Feel the Heat

Groundwood mills are also feeling the same huge and unremitting cost pressures impacting all grades brought on by high energy and fiber costs. These pressures are particularly acute for non-integrated mills such as is the case for many coated groundwood, coated freesheet and uncoated groundwood mills. These mills typically buy pulp, which is at very high prices currently, and purchase more energy (either electricity or oil or natural gas) per ton of production. This is a key reason that most of the mills being closed are non-integrated. For larger companies, e.g. NewPage, production is being shifted as much as possible from non-integrated to integrated mills to lower overall mill system costs.

High costs have led to the withdrawal of large chunks of capacity in both coated and uncoated papers including mill closures in early 2008 by AbitibiBowater that reduced uncoated groundwood supply significantly. Some of this capacity was restarted, but most remains shutdown.

However, despite a bit of easing on costs as oil prices drifted down into the fall, costs pressures remain acute. The

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latest casualty is Katahdin Paper Company, who announced in May the closure of the 180,000 tpy SC paper machine in Millinocket, Maine. The company noted the huge increase in the cost of oil used to generate heat and steam. More recent

coated paper capacity closure announcements have been astounding.

For example, NewPage, the largest coated producer in North America, announced capacity closures that equal about 5% of North American coated paper capacity (6% of coated mechanical and 4% of coated freesheet capacity).

Going forward, the combination of capacity closures and higher costs should continue to lead to a balance between the supply of paper from Canadian, European and U.S. mills and U.S. demand. In turn, operating rates for SC and other groundwood grades should remain sufficient to hold recent price gains. It should be noted that the recent surge in prices has only returned them to 2006 levels and recovered what was lost in the price fall-off in 2007. For the most part, rising prices were only able to partly offset surging costs for energy and fiber.

For Canadian mills, this is exacerbated by a continued strong Canadian dollar, which continues to suppress mill realizations for product sold in the U.S. European mills are "toeing the line" on prices as well due to the strength of the Euro and thus are unlikely to chase after demand in North America by offering paper at steep discounts.

Producers have successfully implemented price increases on SC grades and on machine finish grades such as high brightness papers including \$60/ton increases effective late in 2007, on April 1 and on July 1, 2008. It appears prices will remain high and given the continued pressure on costs, producers have started making noise about another round of price increases for October shipments.

The only dip in the road ahead might be the state of inventories. With the run up in prices that has occurred through all of 2008, publisher and printer stocks appear to be quite high as they tried to hedge against the continuing rise in prices. It's not without precedent that an inventory shift could lead to another price roller coaster by inducing an artificial demand collapse ...just like a broken record. ■

North American Uncoated Groundwood and Printing and Writing Statistics						
(000 metric tonnes)						
	June 2008	% chg	Year to date 2008	% change	Full Year 2007	% chg vs. prior year
<b>Uncoated mechanical</b>						
Shipments	446	7.9%	2812	5.4	5925	4.0
Imports	44	-8.6	267	-4.3	585	-15.7
Demand	490	6.2	3079	3.6	6144	0.9
Oper. rates (%)	88	82%	91	86	90	90
<b>Total Printing and Writing</b>						
Shipments	2062	-4.3	12590	-3.2	37379	-0.8
Imports	237	-10.6	1441	-8.0	3298	-11.3
Demand	2299	-5.0	14031	-3.7	29457	-3.0
Oper. rates (%)	92	91	93	90	93	92

Source: Pulp and Paper Products Council. Note: Operating rate is actual, not percent change.

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