

ABITIBIBOWATER DEALS WITH A PERFECT STORM: A Business Case Study

Emma Jane Riddle, College of Business, Winthrop University, Rock Hill, South Carolina, 29733, riddlee@winthrop.edu

ABSTRACT

This paper presents a case study of the expropriation of resource assets belonging to AbitibiBowater (AB), a large paper manufacturer, by the Canadian province of Newfoundland and Labrador. The assets were seized after AB announced the closure of the Grand Falls-Windsor (GFW) paper mill and a wood processing facility in the province. After an unsuccessful attempt to obtain compensation for the seized assets, AB filed a Notice of Intent to Submit a Claim to Arbitration under the North American Free Trade Agreement (NAFTA). The case would be appropriate for senior-level and MBA courses in International Business and International Management.

THE CASE STUDY

AbitibiBowater

AB was created in October, 2007, by a "merger of equals" between Canadian paper giant Abitibi-Consolidated and Bowater, a paper manufacturer headquartered in South Carolina. The combined company is incorporated in Delaware and has its operating headquarters in Montreal, Canada. In 2008, AB operated fifteen pulp and paper mills in Canada, seven in the United States, and one each in England and South Korea (AbitibiBowater, 2009b). The company also had fourteen hydroelectric plants and eight cogeneration plants that process waste biomass into power; these plants provide much of the electric power needed for the company's manufacturing (AbitibiBowater, 2008c).

Paper is made from wood fiber, which can be obtained from pulp wood or from recycled paper. To ensure a steady supply of pulp wood, AB has leased timber rights on 44.7 million acres of public land in Canada; the company also owns 1.3 million acres of timber land in Canada and the southeastern United States. (AbitibiBowater, 2009b). In addition, the company purchases timber from loggers and timber brokers. About 38% of the wood fiber in AB's paper products comes from recycled paper.

In 2007, AB reported revenues of 3.9 billion U.S. dollars, an operating loss of 400 million dollars, and a net loss of 490 million dollars (AbitibiBowater, 2008c). The company's 2007 sales were distributed as follows: newsprint – 41%; coated and specialty papers – 35%; market pulp – 16%; and wood products – 8%. The North American market accounts for more than half of AB's sales, but the company sells its products in more than ninety countries around the world.

AB faced challenges from the start. Declining demand for newsprint and commercial printing papers had left the company, and the industry, with excess capacity. One month after the Abitibi-Bowater merger, the company announced plans to reduce its paper-making capacity by approximately one million metric tons per year (AbitibiBowater, 2007). Several paper mills in Canada and one mill in Texas would be closed;

the GFW facility was not included in this round of plant closings. As the company had hoped, eliminating unneeded capacity enabled AB to raise prices (AbitibiBowater, 2008c).

The capacity reduction was part of an ambitious action plan to improve the company's financial situation (AbitibiBowater, 2007). The company also expected to reduce operating costs by 375 million dollars per year, a target that it met in one year (AbitibiBowater, 2008a). The cost reduction plan included renegotiating union contracts in Canada and making benefits for salaried workers in various countries more consistent. To raise cash and reduce its debt, the company announced plans to sell 500 million dollars worth of assets, including selected timber lands. A substantial amount of the company's debt was scheduled to mature in 2008. To meet debt payments and improve cash flow, AB restructured its debt and suspended dividends to shareholders (AbitibiBowater, 2007, 2008b).

These measures did not solve the problem of declining demand for newsprint and coated paper. In December 2008, AB announced plans to reduce its annual papermaking capacity by an additional million metric tons (AbitibiBowater, 2008a). When those reductions have been completed, AB will have reduced its capacity by about one-third, to approximately 4.1 metric tons, since the merger of Abitibi-Consolidated and Bowater (Yakabuski, 2008a).

The Grand Falls-Windsor Facility

The GFW pulp and paper mill was built in 1909 by the Anglo-Newfoundland Development Company (Yakabuski, 2008b). Before building the plant, Anglo-Newfoundland leased large tracts of public land from the provincial government and obtained the right to harvest timber from those lands. The province also granted Anglo-Newfoundland the right to use water from a local river for manufacturing, and the right to build and operate dams and a hydroelectric power plant on the river. In addition to the pulp and paper mill, Anglo-Newfoundland built a hydroelectric plant and at least one dam. The company also set up logging operations to supply raw material for the mill. To attract workers and provide housing for them, Anglo-Newfoundland built the town of Grand Falls, which has since grown to a community of 13,500 (Roberts, 2008).

In recent years, the GFW plant had two paper production lines (AbitibiBowater, 2009b), which are called paper machines. According to a union official, Gary Healey, the newer of the two machines was installed in 1968 (Yakabuski, 2008a). The GFW facility had a capacity of about 200,000 metric tons of newsprint per year (AbitibiBowater, 2009b). In contrast, AB's two largest plants, which are located in South Carolina and Tennessee, each have a capacity of about 900,000 metric tons of paper per year. Jean-Philippe Cote, a spokesman for AB, said that the GFW plant was "the most expensive [paper] mill to run in North America" (Moore, 2008a). Mr. Cote cited labor costs and transportation costs as particular problems.

Newsprint was the only product line that GFW could produce (AbitibiBowater, 2009b). Canadian newsprint producers must compete with manufacturers in Asia and South America. These overseas competitors usually have more modern technology, larger facilities, and lower labor costs than Canadian plants. Consequently, North America's share of global newsprint production dropped from 44% in 1996 to 31% in 2006, while Asia's share increased from 19% to 30% (Atlantic Provinces Economic Council, 2008). With the availability of online news, newspaper readership has dropped sharply in Europe and North America. As a result of these developments, shipments of newsprint from North American plants dropped by 40% between 2000 and 2007 (Atlantic Provinces Economic Council, 2008). Consequently, a number of Canadian paper mills have been shut down.

Fluctuations in currency exchange rates have also created problems for Canadian paper producers (Atlantic Provinces Economic Council, 2008). In world markets, products are usually priced in a major

currency, such as the U.S. dollar, the euro, the British pound, or the Japanese yen. Canadian paper producers pay for their inputs in Canadian dollars, but their exports are priced in U.S. dollars. The value of one U.S. dollar fell from \$1.57 Canadian. on January 1, 2002, to \$0.98 Canadian on January 1, 2008 – a decrease of 57%. (Currency exchange rates were obtained from www.oanda.com.) Canadian paper producers could not raise their prices enough to compensate for the declining value of the U.S. dollar. The companies were caught in a "cost-price squeeze", where costs rose or remained stable, while revenues dropped.

To deal with these problems, AB's predecessor company, Abitibi, followed a strategy of acquisition, consolidation, and cost cutting. This strategy was designed to increase efficiency and pricing power. The merger between Abitibi and Bowater was another step in Abitibi's consolidation strategy.

A Plant Closure and An Expropriation

As stated earlier, AB's cost reduction plan included renegotiating its labor contracts in Canada. The company was determined to reduce costs and vowed not to continue operating the GFW plant at a loss (Moore, 2008b; Roberts, 2008). There were two rounds of negotiations between the company and the Communications, Energy, and Paperworkers union, which represented workers at GFW and related logging operations (Moore, 2008b). When the first round of negotiations ended in failure, AB revised its proposal and tried again. The company has not revealed the details of its proposals to the public. However, there was a widespread belief among workers that the company's "renewal plan" would result in the loss of 150 jobs in the mill and at least 20 in the logging division (Roberts, 2008). A leaked AB memo suggested turning logging operations over to a contractor, implementing new logging methods, and changing the seniority rights of equipment operators. In September, 2008, union members voted overwhelmingly against the company's second and final proposal (Moore, 2008b).

Gary Healey, the union official, was critical of the company's decision to focus on cost reduction and its refusal to invest in improvements at the mill. He said that at least \$20 million Canadian was needed to make the mill more functional, and that a \$225 million investment in new technology would be required to make the mill competitive (Roberts, 2008). Jean-Philippe Cote, the company spokesman, disagreed. He said, "Investment alone won't fix the ... cost structure and the labor structure of that mill. Without that, the mill will never be competitive." (Roberts, 2008)

On December 4, 2008, AB announced that the GFW mill would permanently close by the end of March, 2009 (Yakubuski, 2008a). About 400 mill workers and 350 loggers would lose their jobs; Grand Falls would lose its largest employer. On Friday, December 12, Kathy Dunderdale, Newfoundland's Minister of Natural Resources, sent a written message to AB's headquarters, demanding that the company "surrender forthwith entitlement to [all] resources" (Moore, 2008a). According to Jean-Philippe Cote, the message arrived after working hours and demanded a response by noon on Monday. Cote said that the company sent a reply, which suggested the creation of a working group to address issues related to the closing of the GFW plant.

On Tuesday, December 16, the legislature of Newfoundland and Labrador province passed Bill 75, which expropriated all of AB's hydroelectric plants, dams, water rights, timber leases, and timber rights in the province (Moore, 2008a); the company owned three hydroelectric plants and several dams (AbitibiBowater, 2008c). The new owner of the seized assets is Nalcor, a recently created corporation that is owned by the provincial government (Brautigam, 2008). Bill 75 allowed AB to seek compensation from the provincial government for its hydroelectric plants and dams, but not for its leases, water rights, and timber rights. The amount of any compensation will be determined by Newfoundland Premier Danny Williams and his Cabinet. Bill 75 forbids AB from bringing lawsuits in the provincial courts to recover the seized assets or contest the amount of compensation (AbitibiBowater, 2009b).

Williams justified the legislation by saying that AB had broken a "covenant" with the province when it decided to close the plant (Moore, 2008a). According to him, the company's water and timber rights were dependent on operating logging and papermaking facilities in the province; to support his position, he quoted excerpts from a 1905 lease and a 1903 letter written by the first president of the Anglo-Newfoundland Development Corporation. He later told reporters, "We are not giving away these hydro assets and these timber assets to a company that is no longer doing business in the province" (Brautigam, 2008). Williams said that the company would be allowed to use the seized assets until the plant closed. He also stated that he was trying to find a buyer for the mill.

Robert Leckey, an expert in constitutional law at McGill University in Montreal, stated that Canadian provinces have broad authority to expropriate business property (Moore, 2008a). According to Leckey, provinces are not required to pay compensation for the seized assets. "The legislature has the power to state in the legislation that it can offer no compensation," he said.

According to AB, the value of the seized assets was more than \$300 million Canadian (AbitibiBowater, 2009b). The company and the provincial government began negotiations about a severance package for the laid-off loggers and compensation for the seized dams and hydroelectric plants (Gibbens, 2009). On March 23, 2009, Kathy Dunderdale told the provincial legislature that the company had withdrawn from the talks. She did not give any details about the negotiations or the unresolved issues. A company spokesman expressed surprise, saying that "we still hope to resolve this issue in a collaborative way" (Gibbens, 2009). Company officials in Newfoundland said that the government's offer was much too low. Industry analysts said that it would be hard for AB to get more than \$165 million Canadian for its dams and power plants.

The Aftermath of the Expropriation

As AB tried to negotiate with Newfoundland, the company's financial difficulties continued to mount. These problems were reflected in the company's Annual Report for 2008, which reported sales of 6.77 billion U. S. dollars, an operating loss of 1.43 billion dollars, and a net loss of 2.23 billion dollars (AbitibiBowater, 2009a). The net loss included a write-off of \$256 million dollars U.S. for the value of the assets seized by the province of Newfoundland and Labrador. During the first quarter of 2009, the company tried unsuccessfully to refinance a portion of its debt. On April 16, 2009, AB filed for protection from its creditors in both the United States and Canada.

Since the expropriation, AB has consistently said that it would take legal action to procure fair compensation for its assets if negotiations with the provincial government were unsuccessful. As stated earlier, Bill 75 barred the company from filing a lawsuit in the provincial courts of Newfoundland. Since AB is incorporated in Delaware, it is legally an American company. However, U.S. courts do not have jurisdiction in disputes between American companies and governments of foreign countries or provinces. Therefore, AB decided to take advantage of provisions in the North American Free Trade Agreement (NAFTA) that protect foreign direct investment among NAFTA countries. Specifically, an investor can request arbitration of its claim against the government of another NAFTA country. In this situation, AB can attempt to hold the government of Canada responsible for the actions of the province of Newfoundland and Labrador.

The NAFTA agreement sets specific requirements for expropriation of investment property (NAFTA, Article 11, 1994). The expropriation must serve a public purpose, and it must be done in a non-discriminatory way. "Non-discriminatory" means that the investor must be treated in the same way as other domestic and foreign investors. The expropriation must be done "in accordance with due process of law" (NAFTA, Article 11.10, section 1(c); 1994). The investor must be compensated for the fair market

value of the assets, and the compensation must be paid promptly. Expropriation cannot be used to retaliate against a company for actions that the government does not like.

On April 23, 2009, the company filed a Notice of Intent to Submit a Claim to Arbitration under the North American Free Trade Agreement. Under the NAFTA treaty, this notice must be submitted at least 90 days before an actual claim is submitted. AB's Notice of Intent alleges that (1) the expropriation of its assets does not serve a public purpose; (2) the expropriation was discriminatory and retaliatory; (3) due process of law was not followed; and (4) the company has not been offered fair compensation for its assets. AG could have submitted a NAFTA claim as early as July 22, 2009; as of August 15, 2009, it had not done so.

Case Questions

1. How has the global business environment contributed to AB's financial problems?
2. After the union rejected AB's final offer, did the company have any reasonable options for making the GFW plant profitable? Justify your answer.
3. Will the expropriation benefit Newfoundland's economy, or will it harm the economy? Consider both short-term and long-term effects.
4. Does AB has a valid claim under the NAFTA agreement? Why or why not?

DISCUSSION

This would be an appropriate brief integrative case for senior-level and MBA courses in International Business and International Management. The case integrates material related to the global business environment, public policy, business strategy, and NAFTA. While most of the NAFTA treaty focuses on trade, this case can be used to make the point that NAFTA also includes important provisions on foreign direct investment.

Expropriation without fair compensation is a growing problem for global firms. In recent years, there have been well-publicized examples in Russia, Venezuela, Bolivia, and Ecuador. Luthans and Doh (2009) note that this type of expropriation is most likely in extractive industries, agriculture, utilities, and transportation. Newfoundland's expropriation of BA's timber rights and hydroelectric assets fits this pattern. Luthans and Doh (2009) also state that expropriation without fair compensation is most common in countries that are poor, politically unstable, and suspicious of foreign companies. From that perspective, the expropriation of BA's assets in Newfoundland is unusual. However, Professor Leckey's comments in the case suggest that Canadian provinces have the power to seize assets without paying compensation.

Sample answers to the case questions are given below:

1. AB has faced increasing global competition from Asian and South American paper mills, which have larger plants and more efficient technology. The availability of online news has caused newspaper readership to drop sharply in Europe and North America. AB's Canadian plants pay for raw materials in Canadian dollars, but their exports are priced in U. S. dollars. Canadian paper producers could not raise their prices enough to compensate for the declining value of the U.S. dollar and were caught in a "cost-price squeeze".
2. It is unlikely that AB could have made the GFW plant profitable without major concessions from labor. AB does not have the financial strength to invest in more efficient technology at GFW, or even to make the existing facility more functional.

3. In the short term, Newfoundland can offer the seized timber and hydroelectric assets to any company that is interested in purchasing the GFW mill from AB. However, it may be hard to find a buyer. Any buyer would have to deal with the same cost, technology, and market issues that AB faced.

In the long term, the expropriation may deter new investment in the province. Nalcor could attempt to use the hydroelectric assets to offer low-cost electric power to computer server farms or other power-hungry facilities.

4. At least a portion of AB's case is strong. Law 75, and the manner in which it was implemented, violate NAFTA provisions related to due process of law and fair, prompt compensation. Due process requires an impartial judge, along with clear rules and procedures. Law 75 blocked the company's access to the provincial court system. The Premier and his cabinet, who initiated the expropriation and are not impartial, were given the authority to determine the amount of compensation. Law 75 does not guarantee that AB will receive fair market value for its assets, and the company has received no compensation. It is likely that this portion of the case is strong enough to show that AB is entitled to compensation.

The issues of retaliation and public purpose are more debatable. The expropriation occurred less than two weeks after AB announced the closing of the GFW facilities. One viewpoint is that the timing of the expropriation shows that it was retaliatory. Another perspective is that Newfoundland had a legitimate public purpose in securing assets that could be made available to companies that needed timber rights, water rights, or hydroelectric power in the future. According to that line of reasoning, the primary purpose of the expropriation may have been to improve the province's prospects for attracting future jobs.

Works Cited

- AbitibiBowater (2007). AbitibiBowater announces Phase 1 of action plan to address company challenges. AbitibiBowater press release, Nov. 29.
- AbitibiBowater (2008a). AbitibiBowater announces action plan to address market challenges. AbitibiBowater press release, Dec. 4.
- AbitibiBowater (2008b). AbitibiBowater announces comprehensive refinancing plan. PR Newswire-First Call.
- AbitibiBowater (2008c). Annual report for 2007. Wilmington, DE.
- AbitibiBowater (2009a). Annual report for 2008. Wilmington, DE.
- AbitibiBowater (2009b). Form 10-K filing for the period ending December 31, 2008. Wilmington, DE
- Atlantic Provinces Economic Council (2008). Building competitiveness in Atlantic Canada's forest industries: A strategy for future prosperity. Atlantic Provinces Economic Council: Halifax, Nova Scotia.
- Brautigam, T. (2008). Premier Williams takes on pulp giant. *Toronto Star*. Toronto, Canada, Dec. 17.
- Gibbens, R. (2009). Abitibi breaks off compensation talks. *The Gazette*. Montreal, Canada, Mar. 24.
- Luthans, F., & Doh, J. (2009). *International management: Culture, strategy, and behavior*, 7th ed. New York: McGraw-Hill.
- Moore, O. (2008a). Newfoundland seizes assets of AbitibiBowater. *Globe and Mail*. Toronto, Canada, Dec. 17.
- Moore, O. (2008b). Newfoundland workers await fate of paper mill after rejecting restructuring proposal. *Globe and Mail*. Toronto, Canada, Nov. 21.
- North American Free Trade Agreement (1994). North American Free Trade Agreement Final Text, Chapter 11.
<http://www.nafta-sec-alena.org/en/view.aspx?x=343&mtpiID=142#A1110>
- Roberts, Terry (2008). AbitibiBowater vote coming. *The Gazette*. Montreal, Canada, Aug. 30.
- Yakabuski, K. (2008a). Abitibi axes Newfoundland paper mill. *Globe and Mail*. Toronto, Canada, Dec. 5.
- Yakabuski, K. (2008b). Newfoundland seizes assets of AbitibiBowater. *Globe and Mail*. Toronto, Canada, Dec. 17.