MILLER THOMSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents

Robson Court
1000-840 Howe Street
Vancouver, BC Canada
V6Z 2M1
Tel. 604.687.2242
Fax. 604.643.1200
www.millerthomson.com

VANCOUVER TORONTO CALGARY EDMONTON LONDON KITCHENER-WATERLOO GUELPH MARKHAM MONTRÉAL

Rate Dispute Arbitration Awards Under Revised Rate Test

Stephen R. Ross
Ryan W. Morasiewicz

Truck Loggers Association Training Session
January 22, 2010

This article is provided as an information service only and is not meant as legal advice. Readers are cautioned not to act on the information provided without seeking specific legal advice with respect to their unique circumstances.

© Miller Thomson LLP 2010. All Rights Reserved. All Intellectual Property Rights including copyright in this publication are owned by Miller Thomson LLP. This publication may be reproduced and distributed in its entirety provided no alterations are made to the form or content. Any other form of reproduction or distribution requires the prior written consent of Miller Thomson LLP which may be obtained by contacting mt_vancouver@millerthomson.com

TRUCK LOGGERS ASSOCIATION TRAINING SESSION
RATE DISPUTE ARBITRATION AWARDS UNDER REVISED RATE TEST

Presented January 22, 2010 by Stephen R. Ross
Prepared by Stephen R. Ross and Ryan W. Morasiewicz

INTRODUCTION

The Timber Harvesting Contract and Subcontract Regulation (BC Reg.258/91) came into force in August, 1991. It was replaced by the Timber Harvesting Contract and Subcontract Regulation (BC Reg.22/96) in April, 1996. This in turn was substantially amended effective June 21, 2004 (BC Reg.278/2004). The Regulation continues to dictate much of the form and content of contracts between licensees and their contractors and between those contractors and their subcontractors.

The Regulation was intended to "level the playing field" between licence holders and contractors. There had been an inequality of bargaining power between those parties, with licence holders controlling the process. As protection for contractors and subcontractors the Regulation introduced requirements that logging contracts be in writing, that some contracts be replaceable, that replaceable contracts be assignable, and that all disputes between contractors and licence holders be submitted to a dispute resolution process of mediation and arbitration. The Regulation also provided for the amount of work entitlement under replaceable contracts, and an amount of work dispute process. Finally, it provided for a process for resolutions of disputes regarding logging rates.

When the Regulation was changed in 2004, one of the most significant changes was to the test for an arbitrator determining rates in a rate dispute. Previously, rates were to be determined with reference to the contractor's own costs and productivities, with an allowance for profit and risk. The Regulation previously provided:

> **25**(1) A replaceable contract must provide that if a rate dispute is referred to arbitration, the arbitrator must determine the rate according to what a licence holder and a contractor acting reasonably in similar circumstances would agree is a rate that
>
> (a) is competitive by industry standards, and
>
> (b) would permit a contractor operating in a manner that is reasonably efficient in the circumstances in terms of costs and productivity to earn a reasonable profit.

In making this determination, the Regulation specified that an arbitrator could take into account the following factors:

> (a) rates agreed to by the licence holder and contractor for prior timber harvesting services;
>
> (b) the costs and productivity of the contractor for prior timber harvesting services carried out by the contractor;

(c) relative to prior timber harvesting services, the impact on costs and productivity likely to arise from:

(i) changes in operating conditions including, without limitation, changes to terrain, yarding distances, hauling distances, volume of timber per hectare;

(ii) changes in the total amount of timber processed;

(iii) changes in the required equipment configuration;

(iv) changes in the law if the changes affect costs or productivity of the timber harvesting operation;

(v) changes in the underlying costs of timber harvesting operation including, without limitation, the cost of labour and the impact of inflation on wages, fuel, parts and supplies;

(d) the costs in the logging industry for each phase or component of a similar timber harvesting operation;

(e) the rates in the logging industry for similar timber harvesting operations;

(f) any other data or criteria that the arbitrator considers relevant in ascertaining the rate that a licence holder and a contractor acting reasonably in similar circumstances would agree to.

After many rate dispute awards were made by arbitrators, licence holders complained to government that the above rate test was a cost-plus exercise that encouraged contractors to increase their costs, and to be inefficient. As a result, in 2004 the rate test in the Regulation was changed. Rates are now to be determined with reference to fair market rates, as follows:

26.01(1) If a rate dispute is referred to arbitration, the arbitrator must determine the rate according to what a willing license holder and a willing contractor acting reasonably and at arm's length in similar circumstances would agree is a fair market rate….

The factors that the Regulation said an arbitrator could take into account when considering this test were also expanded and changed. Now, when determining what is a "fair market rate", an arbitrator may consider:

(a) rates agreed to by the licence holder and contractor for prior timber harvesting services;

(b) rates agreed to under another contract by either the licence holder or contractor for similar timber harvesting services;

(c) rates agreed to under another contract by either the licence holder, the contractor or another person for each phase or component of a similar timber harvesting operation;

(d) rates agreed to by other persons for similar timber harvesting services;

(e) if necessary to make meaningful comparisons to any of the rates agreed to in paragraphs (a), (b), (c) and (d) above, the impact on fair market rates likely to arise from differences between the timber harvesting operations that pertain to the rate in dispute, and the timber harvesting operations that pertain to any rate described in paragraphs (a), (b), (c) and (d), including the following:

(i) differences in operating conditions including, without limitation, differences in terrain, yarding distances, hauling distances, volume of timber per hectare;

(ii) differences in the total amount of timber processed;

(iii) differences in the required equipment configuration;

(iv) differences in required phases;

(v) differences in operating specifications;

(vi) differences in law;

(vii) differences in contractual obligations;

(viii) differences in the underlying costs of timber harvesting operations in the forest industry generally which would affect fair market rates, including changes in the cost of labour, fuel, parts and supplies;

(ix) differences in the cost of moving to a new operating area, if any;

(f) any other similar data or criteria that the arbitrator considers relevant.

To date, only two logging rate arbitrations have considered the new "fair market rate" rate test. This paper summarizes those two decisions and provides a commentary on how the law on the "fair market rate" test is developing.

WESTERN V. HAYES (ARBITRATOR TAYLOR), APRIL 11, 2005

Background

The first Arbitrator to consider the new rate test was Colin Taylor, Q.C., on April 11, 2005. Western took Hayes to arbitration to determine the 2004 conventional logging rate for Hayes' timber harvesting services (under a replaceable logging contract) at Plumper Harbour on Nootka Island. Western offered a rate of $\$44.39/m^3$; Hayes sought a rate of $\$47.74/m^3$.

In his decision, Arbitrator Taylor first discussed the change in the rate test. He noted that his new task to determine a "fair market rate" stood in "marked contrast" to the previous one requiring him to permit a contractor "in terms of costs and productivity to earn a reasonable profit".

The Ministry of Forests Backgrounder, released with the amendments to the Regulation on June 21, 2004, described the change in the rate test:

> [The regulation] establishes a new method to set contract rates that reflect market conditions . . .
>
> British Columbia's forest sector must be globally competitive to be sustainable. The amended regulation allows forestry operators to manage their businesses in ways that better reflect the market. For example, the regulation: introduces a new test to determine market rates, ensuring negotiated rates fairly and reasonably reflect market conditions.

In determining a "fair market rate", an arbitrator "may take into consideration" the comparables identified in Section 26.01(2)(a) to (d) of the Regulation set out above. Section 26.01(2) of the Regulation further provides that the arbitrator may have regard to "the impact on fair market rates likely to arise from differences between the timber harvesting operations" in order to make "meaningful comparisons". Those "differences" may include those factors identified in section 26.01(e)(i) to (ix) set out above.

The Nootka Contractors - Comparables

Plumber Harbour is on Nootka Island. This area was comprised of two Western timber harvesting operations and six independent full-phase logging contractor operations (Onion Lake Logging Ltd., Russell & Lilly Ltd., Spirit Lake Timber Ltd., Friell Lake Logging Ltd., Frank Beban Logging Ltd., and Hayes Forest Services Limited). Collectively, they were known as the Nootka Contract Administration ("NCA").

Both Western and Hayes agreed in the arbitration that the contractor operations in the NCA were substantially similar.

Determining the Fair Market Rate

In a previous arbitration award (February 12, 2004), Arbitrator Borowicz, Q.C. had set conventional timber harvesting logging rates for Hayes' Plumper Harbour operation as follows:

1998 - $\$44.50/m^3$;
1999 - $\$46.90/m^3$;
2000 - $\$45.00/m^3$;
2001 - $\$46.10/m^3$.

These rates were all set under the former Regulation to allow Hayes to earn a "reasonable profit".

Regarding logging rates under the new rate test, Arbitrator Taylor commented as follows:

> The determination of a fair market rate for timber harvesting services… is an exercise in discerning timber harvesting market and economic realities. It requires appropriate objective criteria, the best evidence of which is the pattern of rates reached in freely negotiated contracts for similar timber harvesting services performed in similar working conditions. It is a rational matching of like circumstances. The arbitrator's function is not to fashion a settlement based on a reasonable compromise between the negotiating positions of the two parties but to act adjudicatively and base the final result on rational objective criteria…
>
> The best evidence of a comparable market in this arbitration is the NCA contractors. The similarity of the logging contractors in the NCA was considered and accepted by Arbitrator Borowicz…

Hayes submitted that the fair market rate for 2004 was $\$47.74/m^3$. It derived that figure by taking the rate awarded by Arbitrator Borowicz for 2001 ($\$46.10/m^3$) and rolling it forward by 3.55% (50% of IWA increases; 50% of inflation).

In Arbitrator Taylor's opinion, the difficulty with this approach was that the 2001 rate was not a rate "agreed to by the licence holder and contractor for prior timber harvesting services". It was a rate awarded in a rate dispute by Arbitrator Borowicz under a different regulatory scheme – one the rate test assessed a contractor's profitability. The last rate that Western and Hayes had agreed to was the 1997 rate of $\$40.59/m^3$.

As a result, Arbitrator Taylor concluded that the NCA contractors were the most appropriate market upon which he could assess the 2004 Plumber Harbour logging rate. He specifically noted that the NCA contractors (except for Hayes) had over 10 years of freely negotiated rates upon which he could ground a fair market rate (even though those rates were negotiated under the prior regime).

The average conventional logging rate negotiated between Western and the NCA contractors (excluding Hayes) for the 2004 logging season was $43.77. Arbitrator Taylor ruled that this rates represented the "fair market" rate for timber harvesting at Plumper Harbour during the 2004 season. As Western had offered Hayes a conventional logging rate of $44.39 per cubic metre, Arbitrator Taylor concluded it was a fair market rate and it was so awarded to Hayes.

WESTERN V. HAYES (ARBITRATOR BOROWICZ), OCTOBER 7, 2008

Background

The only other arbitrator to consider the new rate test was Frank Borowicz, Q.C. on October 7, 2008. At issue in this arbitration was the 2008 rates to be paid by Western to Hayes. Hayes proposed a rate of $\$58.67/m^3$ for stump to dump logging and an additional $\$4.75/m^3$ for related dump and boom work. Western proposed a rate of $\$49.57/m^3$ as an all inclusive blended rate for all phases.

In this case, the last agreed upon rates between Western and Hayes were for 2001 and 2002, and had been settled in the context of the prior regulatory scheme.

Rolling Forward Old Rates

Hayes contended that it was common practice in the industry to establish new rates by rolling forward the prior year's rate, with an adjustment for some standard inflation factors.

Similar Operations

Western, in contrast, presented rates from other operations that it contended were similar timber harvesting services performed in similar working conditions. Of these, Arbitrator Borowicz found that the most useful comparable was the contract between Western and Island Pacific Logging ("IPL").

Hayes agreed that the IPL contract was the best comparable operation, but contended that a number of adjustments (volume difference, hauling distance, and phase work) needed to be made to that contract rate to make it more accurately comparable to their own situation.

Regarding an adjustment for volume difference, Arbitrator Borowicz ruled that such differences were “generally significant” to rates. The BC Court of Appeal in *Hayes Forest Services Limited v. Pacific Forest Products Limited*, 2000 BCCA 66, had recognized that volume has a global impact on operating costs. It is “a generally accepted fact that harvesting costs per unit diminish as the volume of harvest increases”.

In this case, the volume differences between Hayes and IPL were substantial. Arbitrator Borowicz concluded that these differences impacted the fair market rate of Hayes’ contract and needed to be considered as a factor in appropriate adjustments.

Regarding an adjustment for hauling distance, Arbitrator Borowicz also found that average hauling distance was “also a significant and self-evident difference in an important industry metric”. Hayes proposed to adjust for the difference by doubling the hauling distance cost allocation in the IPL contract (since their haul distance was about twice as long as IPL’s); Western contended it was not that simple. Arbitrator Borowicz ruled that, in the circumstances, a doubling was not an inappropriate way to account for vital hauling factors like fuel use and driving time.

Finally, Hayes and IPL performed slightly different phase work: Hayes maintained a dump and boom while IPL operated a dryland sort. Hayes therefore sought to adjust the IPL rate by removing the cost of their dry land sort component and adding the fair market value for dump and boom work.

Western proposed an adjustment of $\$2.11/m^3$, in reference to their own dump and boom costs. Hayes proposed $\$4.60/m^3$, being an average of dump and boom rates obtained from several other companies, as well as the rates that Hayes paid to other companies to do dump and boom work.

Arbitrator Borowicz ruled that using Hayes’ own particular union costs as a basis for adjustment was, in essence, a return to the former “cost plus” approach to rate determination. That was to be discouraged. He therefore set the adjustment at $\$4.13/m^3$, being a travel adjustment to Hayes’ comparable dump and boom rates.

Hayes also sought further adjustments to IPL’s rate. Arbitrator Borowicz declined to make such adjustments, concluding that comparables need only be close, not perfect:

> …While it may be appropriate to make adjustments in some circumstances where, like here, there is a single comparable contract for consideration, it would be presumptuous to conclude without compelling evidence that IPL had not reconciled for itself a comprehensive assessment of all of the factors it chose to integrate into its rate proposal. Comparables are not required to be identical to each other to be reasonable comparators, and only those adjustments that re material need be made.
>
> Hayes also contended that some adjustments should be made to the IPL rate to reflect certain fixed costs that had to be incurred by Hayes but not incurred by IPL, like stand-by and mobilization costs. These, however, are similarly not necessary for the IPL contract to be a reasonable comparator, and also tend to be of an operational and accounting nature more compatible with the former “costs plus” regulatory scheme than the new fair market rate scheme.

Determining the Fair Market Rate

In his rate analysis, Arbitrator Borowicz noted that rolling forward Hayes' 2001-2002 rates (in accordance with common industry practice) would ordinarily produce "a persuasive comparable rate" for 2008. In this case, however, there were two difficulties with this approach:

1. The rates needed to be rolled forward 6-7 years. A roll forward of this magnitude was arguably less reliable, and

2. The 2001-2002 rates pre-dated the new regulatory rate setting scheme. They were calculated so that the contractor could earn a "reasonable profit".

There was also a problem with comparing similar logging operations to Hayes. There was only one other operation (IPL) that was a current, meaningful comparable, and even it required adjustments to account for differences between operations. Having a single comparable was not desirable; the existence of multiple comparators minimizes the impact of individual idiosyncrasies when determining a market rate.

As a result, Arbitrator Borowicz concluded that the most objective indication of a 2008 fair market rate for Western and Hayes was a blend between the rolled forward 2001-2002 rate and the adjusted IPL rate. The rolled forward rate was $59.07/m^3; the adjusted comparable IPL rate was $52.38/m^3. Arbitrator Borowicz awarded the average between them – $55.73/m^3 – as the fair market rate for stump to dump work, and awarded an additional $4.13/m^3 for dump and boom work.

COMMENTARY

A number of principles can be drawn from the above two awards which have applied the revised "fair market rate" test for setting logging rates for replaceable contracts in rate disputes:

1. There has been a marked departure from the prior regime of considering a contractor's actual costs and productivities, and awarding a rate that provided a reasonable profit to a reasonably efficient contractor.

2. The arbitrator must now determine a fair market rate for the contractor's timber harvesting services, based on prior rates agreed between the contractor and the licence holder, and rates agreed between licence holders and contractors for similar timber harvesting services.

3. The arbitrator will not consider the contractor's own costs, because that smacks of a "cost-plus" approach which has been rejected by the legislation.

4. The arbitrator will consider changes in industry costs for labour and for inflation of wages, fuel, parts and supplies.

5. Prior rates between the licence holder and the contractor will be of limited value if they were set by arbitration under the test set out in the prior regime.

6. Although Arbitrator Taylor commented that rates that pre-date the new rate test in June, 2004, "were not based on the 'fair market' which the Regulation now demands", he considered such rates of the NCA contractors to be the best comparable rates available.

7. The most appropriate comparable rates to consider are those for similar logging operations near to the operation in question, even if there is only one comparable.

8. However, it is preferable to have multiple comparable rates, as this minimizes the impact of individual idiosyncrasies in determining a market rate.

9. In addition to considering the logging rates of similar operations, arbitrators are prepared to consider "rolling forward" the last agreed rate between the licence holder and the contractor by making adjustments for increases in the costs of labour and inflation of industry costs.

10. Adjustments will be made for volume differences and haul distances, which are generally significant to rates.

In a 2004 rate dispute award between Western Forest Products Limited and Hayes Forest Services Limited, Arbitrator Borowicz described three approaches to settling rates under the prior regime:

(a) the previous rate approach, which adjusts rates previously agreed to between the parties for the same operation;

(b) the expert opinion approach, which derives a rate from the assessment of a qualified expert; and

(c) the reasonable cost/profit approach, which derives a rate from the reasonable costs actually incurred by the contractor plus a reasonable profit and risk margin.

Under the new test the first approach is still valid, but the third approach is not longer permitted. The second approach may still be used, provided that the qualified expert has an extensive knowledge of comparable logging rates, and adjusts agreed rates for industry cost changes only.

Several arbitrators in rate disputes under the prior regime expressed their frustration with attempting to compare and adjust the rates of different logging operations, referring to that process as a "nebulous exercise". Ironically, that nebulous exercise has now been mandated by the Regulation to be the primary criteria by which arbitrators are expected to set logging rates for disputing parties.

There is one qualification in the Regulation to the use of "comparable" rates in similar operations. The rate set by the arbitrator must be a "fair market rate". There is authority for the proposition that a "fair market" is one that is consistent and realistic, rather than one that is transient, panicked, ephemeral, stressed, or volatile. The forest industry in B.C. at the present

time is under significant financial stress as a result of poor demand, and many other factors. Many contractors are working for rates that are not sustainable in the long run. Some have been driven into bankruptcy and insolvency, as have their financial and service providers. Arguably, many of these non-sustainable rates being paid by licence holders today are not fair market rates, because of this market distortion. Why would any willing contractor acting reasonably agree that a rate that results in repeated significant losses and eventually insolvency and bankruptcy is a fair market rate?