

Submission to the Senate Inquiry on the

Sale of timber assets by the South Australian Government

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I wish to thank the Chairman and Senators for allowing me to make a brief verbal presentation at the Mount Gambier meeting. This written submission is provided after the verbal submission.

Risk

To me the critical issue is risk; how is risk to be identified and measured, who is to carry the risk, and how is it to be accounted for in the states accounts.

The reply by Treasurer Snelling to the three Green Triangle Mayors did not address this issue at all. It would seem almost as though The Treasurer does not understand the term risk, nor understand how important risk is in forest management, nor how it should be accounted for.

Risk includes the effect of fire on the future ability to maintain wood supply, the possible effects of insect or pathogenic attacks (such as the *Sirex noctilio* epidemic), and errors in predicting forward yields. There are many other uncertainties given the long time frame involved in forest management planning.

A paper by J.W.Leech (2002) "Allowing for risk in forward yield planning", Australian Forestry 65(4) p901-905, shows how the level of cut can be set at the level of increment allowing for some aspects of risk by setting contracts of varying lengths. It shows how revised estimates of future wood availability can be readily incorporated. In principle it is what ForestrySA has been doing for decades.

Growth rates

In my verbal submission I stated that in my opinion the growth rate had probably increased from 16-17 m³/yr to 23-24 m³/yr over the last 30 years.

Published information by J.F.O'Hehir and E.K.S.Nambiar (2010) "Productivity of three successive rotations of *P.radiata* plantations in South Australia over a century", published in Forest Ecology and Management 259 p1857-69, details the massive increase in productivity between the second rotation that largely existed in the 1960's and 1970's to the current crop, for example as shown in Figure 7 as third rotation. The paper details examples of the considerable gains in productivity. It should be noted that Jim O'Hehir is currently General Manager Planning and Development in ForestrySA.

The figures I provided in my verbal presentation are my best estimates of the overall gain across the ForestrySA forest estate in the Green Triangle region.

Rotation length

During the Inquiry the rotation length was variously described as 38 and 35. The objective rotation length for ForestrySA has apparently recently been reviewed and revised. There is believed to be an increase in the amount of wood available for sale and in my opinion this can only occur if the objective rotation length has been reduced, and even then the increase will be transient.

I will attach a Powerpoint presentation made to a meeting of Research Working Group #2, Forest Measurement and Information Systems, in Mount Gambier in 2010. I apologise for this not being user friendly but it was presented to a group of technical foresters with considerable experience in

forest management planning issues, a group who I knew would be very stern reviewers as the conclusion is that rotation length should be increased if risk is explicitly taken into account. In summary, for a mid productivity site and a reasonable but specific thinning regime slide 6 shows productivity by log size class over time. Slide 7 shows that the maximum sawlog volume production (V20 or 20 cm small end diameter log) is at age 41. Slide 19 shows the trend of value, based on reasonable costs and returns, for a range of discount rates. Slide 20 summarises the rotation length that provides the maximum return for a range of real discount rates. A real discount rate excludes inflation and is the most common way of evaluating long term investments. Thus 8.5% real is approximately 11% nominal at present. Slides 15-18 and 27 argue the case for the discount rate. Slide 29 shows the graph of Net Present Value at a real discount rate of 7% and the two alternatives, 8.5% assuming that risk is wholly built into the discount rate and an equivalent alternative of 7% plus risk handled separately. The naive assumption is made that the forest is going to be lost at each age. The conclusion is that the rotation length is considerably higher if risk is handled explicitly rather than implicitly including it in the real discount rate. The actual results are not the issue because the analysis does not use any organisations actual costs and returns but the data are believed to be reasonable for the industry. Slide 32 summarises the conclusions. The reference to Leech 1978 is J.W.Leech (1978) Growth and Yield Models for Radiata Pine, PhD Thesis, ANU Canberra, 262pp. See also N.B.Lewis, A.Keeves and J.W.Leech (1976) Yield regulation in South Australian Pinus radiata plantations. Woods and Forests Bull. 23, 174pp.

Future investment

The volume required to run a world class sawmill is increasing each year by about 1-2%. For the Green Triangle Region to remain world competitive would require either more forest to be planted or mills to be combined.

I have been told that within one large investment company the only group that continued to make a profit during the global financial crisis, albeit reduced, was their forestry focussed group of separate companies. Other large companies with forestry components are believed to have had the same experience. This indicates that forestry investment is in part counter cyclical to normal investment trends. This leaves the option for large investment funds to invest (say) 1-4% of their funds in forestry with one primary focus being to mitigate the effect of major financial fluctuations.

It would make sense to me for SuperSA, or other superannuation funds, to invest a small portion of their total funds by acquiring ForestrySA. This option would allay many of the fears in the community of the forestry industry going offshore. Given that last year the return on equity for ForestrySA was 11.5% it is not as though it would not be a good investment. It would parallel the arrangement between the State Government and SuperSA made many years ago to acquire the building now used for the state courts in Victoria Square in Adelaide.

Some figures relevant to the Inquiry

The Senate web site suggests in the information notes that the value of ForestrySA is \$2800 M. I suggest that is far too high.

From the ForestrySA Annual Report of 2009/10 which can be downloaded from the ForestrySA web site.

- Dividends and tax expense - \$44.8 M
- Net change in value of standing timber - \$80.6M
- Return on equity - 11.5%
- Non-current assets, standing timber - \$682M
- Land - \$477M
- Non-current assets - total \$1228M
- Current assets - total \$146M
- Total assets - total \$1375M
- Fair Value of standing timber - \$768M

There are two figures for standing timber, \$682M and \$768M. The former is believed to be the value for accounting purposes in order to meet the specific requirements of IAS41 and AASB141. The latter is stated to be the fair value of the forest. The difference does not surprise me.

Note that the value of standing timber and land is about 85% of the total asset value.

I hear figures of \$1300M being bandied around for the reduction in state debt, without any land sale and maintaining ForestrySA as the forest manager. This does not seem to be consistent with the published information.

If the State Government does not sell the land, and I believe that would be extremely challenging politically, then I would envisage the sale of ForestrySA timber assets could reasonably attain \$500-650M. The higher figure could be attained if all the ForestrySA assets are sold together with a 99 year lease on the land. The lower figure would be more realistic if the model is to retain ForestrySA as the forest manager. The more constraints that are placed on the sale the lower the value that could be expected to be achieved. Of course somebody might pay greater than \$650M but in my opinion they would be making a mistake and when they realise that fact the repercussions to the region might be considerable.

ForestrySA claim an 11.5% return on equity. I believe the information in ForestrySA's Annual Report and believe in their accounting practices. ForestrySA operates one of the most efficient forest management operations in the world. Given the return on equity I have great difficulty understanding why a state Government would want to sell their forestry asset that is earning 11.5% and reduce state debt when with a AAA credit rating they would be paying far, far less than 11.5% servicing their borrowings.

Unlike the Gunns sale of one rotation, the sale of ForestrySA, be it for one or more rotations, does not make sense.

Jerry Leech
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