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Ref: AT1200B

14 March 2003

Mr Andrew Snedden
Secretary
Senate Rural and Regional Affairs and Transport (RRAT) References Committee
Suite SG 62
Parliament House
CANBERRA ACT 2600

Dear Mr Snedden

INQUIRY INTO PLANTATION FORESTRY

I refer to your letter of 11 March 2003 on the RRAT Committee's inquiry into plantation forests and the Committee's interest in the issue of competitive neutrality and state government forestry operations.

The Commonwealth, States and Territories signed three agreements relating to National Competition Policy (NCP) in April 1995. These agreements included the Competition Principles Agreement (CPA). The two clauses of the CPA which are relevant to forestry are: clause 3 which relates to competitive neutrality, and clause 5 which relates to legislation review.

Competitive neutrality (CN) policy aims to ensure that no significant government businesses should enjoy competitive advantages as a result of their public sector ownership. Principal features of competitive neutrality policy are that, provided the benefits outweigh the costs, significant government business enterprises (GBEs) should be corporatised and subject to full Commonwealth and State taxes or tax equivalents, debt guarantee fees if they enjoy interest rate advantages in borrowings, and regulations to which private sector businesses are normally subject. Other significant government businesses should be subject to these principles or charge prices that reflect full cost attribution. Clause 3 of the CPA required all governments to publish CN policy statements by June 1996, including a mechanism for receiving and dealing with complaints from private sector companies about possible breaches of CN policy by government businesses.

The guiding principle under CPA clause 5 is that legislation (including Acts, enactments, ordinances and regulations) should not restrict competition unless it can be demonstrated that the benefits of the restriction to the community outweigh the costs and the objectives of the legislation can only be achieved by

restricting competition. Since 1995, governments have reviewed around 1800 pieces of legislation and most have reviewed their forestry legislation.

Governments carry the responsibility for implementing CN policies and reviewing and reforming their legislation. The Council's role with respect to CN is to assess the effectiveness of jurisdictions' CN policies and practices and their consideration of complaints against the approach agreed by governments in the CPA. The Council consults with a jurisdiction if it has any concerns about its CN policies or implementation. If it remains dissatisfied, there is the potential for the Council to recommend to the Commonwealth Treasurer that there should be a reduction in the competition payments to that jurisdiction.

Similarly, the Council assesses progress in reviewing and, where appropriate, reforming legislation that restricts competition. Where jurisdictions choose to retain restrictions on competition, the Council needs to be satisfied that the review and reform process accords with the agreed principles. As is the case with CN, there is the potential for the Council to make an adverse recommendation with respect to competition payments.

The Council has reported on the competitive neutrality and legislation review activities of governments with respect to forestry in its last two annual assessments of governments' progress in implementing the national competition policy and related reforms (June 2001 and August 2002).

In your letter, you raise the specific questions of whether the Council has considered the issue of competitive neutrality in forestry operations per se and in relation to particular States, and the nature of any findings or recommendations that the Council may have in this area. To date, the Council has not made any recommendations to the Commonwealth Treasurer on jurisdictions' application of CN to forestry because a number of complex issues are yet to be resolved. Some of this complexity was discussed in the 2001 and 2002 assessments.

The 2001 assessment reported that submissions to the Council had suggested that biases exist in favour of the exploitation of native forests, which are largely publicly owned, relative to mainly privately owned plantation timber due to inappropriate pricing of native hardwood (page xiii). The assessment referred to findings in economic studies[1] that government forest agencies are underpricing timber, which could lead to an unsustainable rate of exploitation of native forests, slow growth of the timber processing industry, and hinder development of plantations. The assessment noted (see pages 14.2-14.3) some parties' views about timber pricing:

- The Commonwealth Competitive Neutrality Complaints Office (CCNCO) — an autonomous unit within the Productivity Commission — found in its 2001 research paper (referred to above) that 'to help assess compliance with competitive neutrality, the market value of logs can be estimated by calculating their residual value — a value derived by subtracting

[1] These findings are summarised in chapter 4 of Commonwealth Competitive Neutrality Complaints Office (CCNCO) 2001, *Competitive Neutrality in Forestry*, CCNCO Research Paper, Productivity Commission, Canberra, May. (Accessible on the CCNCO website: http://www.ccnco.gov.au.)

harvesting, transport and processing costs from prevailing international prices of processed wood products.'

- Marsden Jacob Associates (MJA), however, contend that the residual value may not be the most appropriate method for setting actual timber prices. MJA recommended that forest agencies sell timber via auctions or tenders subject to a cost-based reserve price.

- A discussion paper released by the Victorian Government in 2001 noted that, in areas where there is not much competition between processors, the residual value method may give a better indication of market values for timber.

The Council's 2002 assessment (pages 4.138-4.139) noted that the residual value method relies of the revelation of cost information to governments by government forestry agencies and private processors, and these entities may bias the information in their favour. Reported rates of return may not be sufficient to effectively monitor State forest enterprises, suggesting that governments may find it necessary to monitor the pricing policies and practices of these enterprises. However, the corporatisation model, which CN policy recommends for GBEs and other significant government businesses, involves the enterprises having autonomy in making pricing decisions. A renewed interest by governments in product pricing could undermine this feature of corporatisation and lead to underpricing, with the attendant effects described earlier. The 2002 assessment suggests that one solution may be for shareholder governments to negotiate pricing transparency mechanisms with State forest enterprise boards.

Some legislation review issues that have been considered by jurisdictions are also likely to interest the Committee. The 2001 assessment (pages 14.7-14.8) referred to the impact of restrictions on competition in native forests and plantation forestry. The impacts would interact across the two segments of forestry. Restrictions on competition in native forest exploitation include entry requirements (including licences, permits, leases). Environmental planning restrictions can affect competition between plantations, and may also affect plantation forestry's capacity to compete with production from native forests. The restrictions in place should satisfy the CPA clause 5 principle that their benefits exceed their costs.

The 2002 assessment (pages 4.123-4.127) commented that governments have the following key objectives in native forest regulation:

- protecting the availability of non-tradeable forest values (for example, biological diversity and recreational experiences) while maximizing economic benefits arising from exploiting tradeable forest values (e.g. timber, firewood, gums and natural oils and grazing); and

- promoting employment in forest-related industries and rural and regional areas.

Outside national parks and reserves, the assessment suggested that the least restrictive approach to meeting these objectives in public native forests is to define and allocate tradeable rights to delineated areas of forest. Such rights (or forest leases) would oblige holders to protect specified non-tradeable forest values

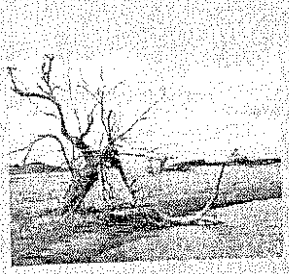
(with the potential for cancellation should holders not meet these obligations), and be long term to encourage right-holders to maintain forest productivity.

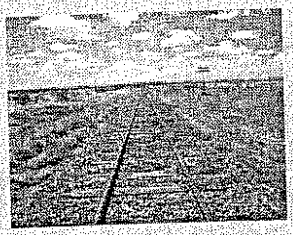
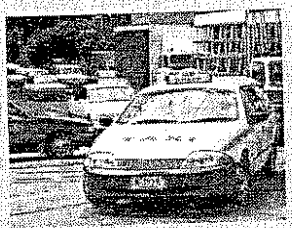
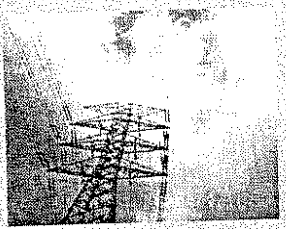
Please find enclosed copies of relevant sections of the 2001 and 2002 assessments.

Yours sincerely

Deborah A Cope

Deborah Cope
Acting Executive Director
Encl.



Restrictions on the services that professionals can provide, or on the ways that they provide them, should only be retained where there is a good public interest reason, such as the protection of consumers. The regulation of service standards will often be desirable in relation to the provision of professional services, particularly because consumers may find it difficult to form judgments about service standards. Where this is the case, competition restrictions via standards regulation meet the NCP tests.

But some regulation of the professions may not be in the interests of the community as a whole. For example, reviews of the regulation of some medical professionals in Queensland recommended the removal of many restrictions on commercial practices that do not have an impact on care. Generally, however, the reviews have recommended retaining registration requirements, reservation of title (such as 'doctor') to professionals with the necessary qualifications, and disciplinary procedures to maintain consumer protection. Regulation review and reform activity in relation to the professions is discussed in chapters 13 (veterinary services), 16 (health and pharmaceutical services), 17 (legal services), 24 (planning, construction and development services) and 18 (other professional and occupational groups).

Forestry and fisheries

The forestry and fisheries industries are important parts of the economy where regulation of exploitative activities is critically important to ensure protection of the environment, preservation of resources and the long-term viability of the industries. Equally, however, excessive regulation may overly burden businesses and undermine the health of these industries. The application of the NCP principles is helping to ensure effective regulation in the interests of the community.

There are also important competitive neutrality issues in the forestry industry, particularly in relation to the environment for the exploitation of (usually privately owned) plantation timber vis-à-vis the exploitation of (usually publicly owned) native forests. Submissions to the Council suggest that biases currently exist in favour of the exploitation of native forests due to inappropriate pricing of native hardwood.

This is an area that has not been a focus of the NCP assessment process to date. Governments are now examining their application of the NCP principles to forest management. The Victorian Government, for example, released an issues paper for its review of timber pricing in June this year, for report in October 2002. The NCP issues in relation to forestry and fisheries are outlined in chapter 14.

14 Forestry and fisheries

This NCP assessment is the first to consider progress by governments in fulfilling their Competition Principles Agreement (CPA) obligations relating to forestry and fisheries. The CPA clauses that are relevant to forestry are clause 3 (competitive neutrality) and clause 5 (the review and reform of legislation that restricts competition).[1] For fisheries the most significant obligation is CPA clause 5 (the review and reform of restrictive legislation).

Forestry

Native forest covers 155.8 million hectares or about 20 per cent of Australia's landmass (ABS 2001). Of this, 27 per cent is privately owned. Of the publicly owned remainder, 16 per cent is reserved, 12 per cent is managed by forest agencies for various uses including wood production, 14 per cent is on other Crown land and 59 per cent is leased. Industries based on harvesting of timber from native forests are located in New South Wales, Victoria, Queensland, Western Australia and Tasmania.

Plantations covered 1.3 million hectares as at September 1999, of which 71 per cent was softwood and 29 per cent was hardwood. The plantation estate is evenly split between public and private ownership.

The wood and paper products industries contribute about 1 per cent to GDP and employed just over 60 000 people as at June 1999 in the growing and harvesting of wood and the manufacture and processing of wood and paper products. Exports of forest products were valued at $1293 million in 1998-99 and imports at $3262 million.

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1 The CPA obliges governments to ensure that regulatory and commercial responsibilities relating to forestry are not vested in the same public entity. This is relevant to public forest agencies, which have usually had both commercial and regulatory functions. The Council considered functional separation for forestry as part of the regulatory neutrality obligation in CPA clause 3. Clause 4 of the CPA (structural reform of public monopolies) also discusses functional separation. It obliges governments to relocate regulatory responsibilities when they are introducing competition to a public monopoly market or are privatising a public monopoly so as to prevent the former monopolist enjoying a regulatory advantage over its rivals. While public forest agencies generally dominate the supply of unprocessed timber in local markets, they have never been public monopolies in the conventional sense as there have always been competing privately-owned suppliers of timber. With the growth of the private plantation sector, this competition is increasing.

However, this conclusion does not mean that the 'residual value' method is most appropriate for setting actual timber prices. A report recently prepared for the Australian Conservation Foundation (Marsden Jacob Associates 2001) argued that forest agencies that set timber prices in this way effectively subsidise the processing industry by making 'ability to pay' the main pricing criterion. This resulted, according to the report, in the exploitation of native forest that is uneconomic to log and in inefficiency in the processing industry. The Marsden Jacob Associates report recommended that forest agencies sell timber via auctions or tenders subject to a cost-based reserve price.

The sale of timber via auction or tender was also discussed in a paper recently released by the Victorian Government's Timber Pricing Review (Jaakko Poyry Consulting 2001). However, the discussion paper also noted that, in areas where insufficient competition exists between processors, other approaches such as the residual value method may give a better indication of overall market values. Victoria is to complete its Timber Pricing Review by November 2001. Western Australia has also commenced an independent review of native forest timber pricing.

This is a complex area of competitive neutrality application, with potentially important implications for forest agencies and other interests in forestry alike. The conclusions of available reports and papers are (so far) largely consistent. However, governments have had limited opportunity to consider these conclusions in the context of their own institutional settings, and relevant work is still underway in two jurisdictions. The Council also needs to consider further the implications of the studies that have been undertaken to date, and to work with governments and other parties on appropriate pricing obligations for public forestry activities.

There is also an obligation on governments under competitive neutrality principles (CPA clause 3(4)(b)(iii)) to ensure that regulatory and commercial responsibilities relating to forestry are not vested in the same public entity. This obligation is relevant to public forest agencies, which have usually had both commercial and regulatory functions. All but one jurisdiction separately regulate public and private forestry to some extent. While most jurisdictions have taken some steps to separate regulatory from commercial forestry responsibilities, the adequacy of such separation is not always clear. Further development of regulatory arrangements is therefore necessary, particularly on the location of policy and regulatory responsibilities.

The Council will consider compliance by States and Territories with their competitive neutrality obligations in forestry in the 2002 NCP assessment. Table 14.1 summarises the current status of State and Territory application of competitive neutrality to forestry.

Table 14.1: continued

Jurisdiction	*Agency and status*	*Timber pricing*	*Financial performance*	*Tax and debt equivalence*	*Regulatory neutrality*	*Assessment*
Queensland	The Department of Primary Industries undertakes commercial forestry activity within a commercialised business unit.	Most forest products are sold via competitive processes.	Long run and annual rate of return targets. Native forests are not valued. Plantations valued using net realisable value method.	Pays all State taxes. Pays a loan guarantee fee.	State forest operations regulated by the *Forest Act 1959*. Private forests regulated under the *Integrated Planning Act 1997*.	Council to assess progress in 2002.
Western Australia	The Forest Products Commission is a commercial statutory authority (established November 2000).	Timber is priced to cover the cost of establishing and maintaining forest. Timber pricing is currently under an independent review.	Financial targets are set in the annual business plan approved by the Treasurer. Native forests and most plantations are valued using the net present value method.	Pays all State taxes. Pays local rate equivalents for premises but not forests. Pays a loan guarantee fee.	State forest operations regulated by *Conservation and Land Management Act 1984*. Private forests regulated under *Soil and Land Conservation Act 1945*.	Council to assess progress in 2002.
South Australia	Forestry SA is a Government Business Enterprise (established January 2001).	Log prices are market based.	Financial targets set in annual performance statement. Mature plantations valued using net realisable value method. Immature forests are valued using the cost of growing method.	Pays all State taxes. Pays local rates. Pays Commonwealth tax equivalents. Pays a debt guarantee fee.	Both State and private forest operations are regulated under the *Development Act 1993*.	Council to assess progress in 2002.

(*continued*)

Legislation review

Legislative restrictions on competition

The main classes of restrictions on competition in relation to native forests are:

- restrictions on market entry, for example requirements that operators obtain a licence, permit, lease or other authority, that prohibit foreign ownership or ownership by certain legal persons, and that impede the trading of such authorities;
- quantitative restrictions on supply, for example maximum (and sometimes minimum) quantities of timber able to be removed, authorisation of export quantities; and
- restrictions on market conduct via licence conditions and codes of practice, such as required logging practices.

Plantation forestry is usually regulated by general environmental planning laws. These laws impose restrictions on how plantation forestry operations are conducted and, in the extreme, may prohibit conversion of land to plantation forestry from another land use.

Regulating in the public interest

Forests comprise two distinct resources that have largely different policy concerns for governments — native forests and plantation forests.

Society derives a range of benefits from native forests and managing these forests sustainably generally maximises these benefits. However, markets alone are unlikely to manage native forests sustainably because, while some benefits of native forests are tradeable (principally timber production, mining and grazing) others (such as water production, biological diversity, recreational experience and aesthetic amenity) often are not. Moreover, the availability of non-market benefits may be reduced by exploitation of native forests for market benefits.

Native forests are diverse and hence the relative value of their market and non-market benefits varies between forests. Those forests that are highly valued for their non-market benefits are generally reserved as parks to prevent any exploitation that might compromise these benefits. Other native forests less highly valued for their non-market benefits are made available for exploitation for market benefits subject to regulations that seek to make such exploitation sustainable. That is to restrict, say, logging to a rate not exceeding that at which the forest regenerates (with or without assistance),

Table 14.2: Review and reform activity of legislation regulating forestry

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Commonwealth	*Export Control (Unprocessed Wood) Regulations 1986*	Licensing of unprocessed wood exporters	Currently under review by the Department of Agriculture Fisheries and Forestry.		Council to assess progress in 2002.
	Export Control (Hardwood Chips) Regulations 1997	Licensing of hardwood chip exporters	Currently under review by the Department of Agriculture Fisheries and Forestry.		Council to assess progress in 2002.
	Export Control (Regional Forest Agreements) Regulations 1997	Maximum aggregate mass limits for woodchip exports	Currently under review by the Department of Agriculture Fisheries and Forestry.		Council to assess progress in 2002.
New South Wales	*Forestry Act 1916*	Licensing of timber harvesting Licensing of sawmills Permits for grazing, hunting or occupying State forest	Not scheduled for NCP review but included in program of forest regulatory reform.		Council to assess progress in 2002.
	Threatened Species Conservation Act 1995	Licensing of conduct that harms threatened species, populations or ecological communities	Not scheduled for NCP review but included in program of forest regulatory reform.		Council to assess progress in 2002.

(*continued*)

Table 14.2 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Queensland	*Sawmills Licencing Act 1936*	Licensing of sawmills at absolute discretion of corporation Licenses specify maximum productive capacity of mill	Reviewed in 2000 and report under preparation for Cabinet.		Council to assess progress in 2002.
Western Australia	*Conservation and Land Management Act 1984*	Exclusive control and management of State forests by the Conservation Commission Licensing of timber collection and of taking of other resources Administrative discretion over how licences and produce are allocated and priced Permits to occupy and use State forest Registration of timber workers	The Act was substantially amended by: • *Conservation and Land Management Amendment Act 2000*; and • *Forest Products Act 2000*. These Acts vested State forests and other lands in the Conservation Commission and established the Forest Products Commission to undertake commercial forestry functions on State forests and private land. An independent economic adviser reviewed the Act prior to its amendment. The amending legislation was also reviewed. However, the previous Government did not consider these reviews before the amending legislation was passed. The reviews are now awaiting consideration.		Council to assess progress in 2002.
	Sandalwood Act 1929	Caps the quantity of naturally-occurring sandalwood harvested from Crown and private land Licensing the harvesting of sandalwood Individual licences capped at 10 per cent of the total limit	Review completed. It recommended retaining the overall cap on the quantity sandalwood harvested while removing the restriction on the proportion of the annual sandalwood harvest that may be taken from private land.		Council to assess progress in 2002.

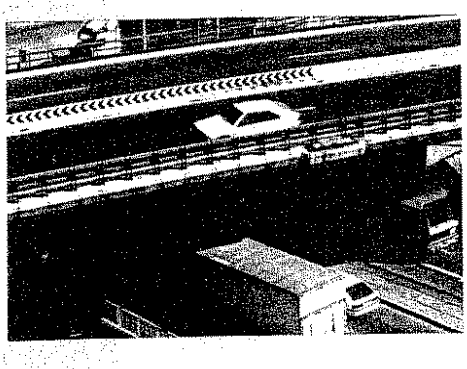
(*continued*)

Table 14.2 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Tasmania (continued)	*Forest Practices Act 1985*	Requires preparation and certification of forest practices plan before timber harvesting can start Declaration of private timber forests Prescribes forest practices under Forest Practices Code Operators harvesting more than 100 000 tonnes per annum must submit a 3 year plan for approval by Forest Practices Board	Reviewed in 1998 by Forest Practices Advisory Council. The review recommended no changes to the Act.		Council to assess progress in 2002.

NATIONAL COMPETITION COUNCIL

Assessment of governments' progress in implementing the National Competition Policy and related reforms



Forestry

Native forest covers 164 million hectares or 21 per cent of Australia's land area (ABS 2002). Of this, 76 per cent is on public land and 23 per cent on private land. Of publicly-owned forests, 16 per cent is held in conservation reserves, 14 per cent on other Crown land, 10 per cent managed for multiple uses including timber production, and 60 per cent on pastoral leases. Almost 70 per cent of Australia's native forest is therefore under some form of private management.

Plantations account for 1.5 million hectares. Two thirds of these are softwood (mainly pinus radiata) and the balance hardwood (eucalyptus). Ownership arrangements are diverse encompassing sole public or private ownership and joint ventures.

Table 4.15: Forest estate by State/Territory and type

Type ('000 ha)	*NSW*	*Vic*	*Qld*	*WA*	*SA*	*Tas*	*NT*	*ACT*
Public native forest	17 641	6532	39 990	33 207	9538	2233	18 182	121
- conservation reserve (%)	28	46	9	13	41	35	0	89
- other Crown land (%)	10	3	5	40	4	8	2	-
- pastoral lease (%)	52	1	76	42	55	-	98	9
- multiple use incl wood (%)	10	51	11	5	0	58	-	2
Private native forest	6938	1183	9182	1502	852	901	16 694	-
Other native forest	2117	1	54	90	399	-	3	-
Plantation	319	319	191	314	136	185	7	15

Note: Other Crown land includes land reserved for educational, scientific, defence or other institutional uses. Multiple use Crown land is land managed for wood and other values. Other native forest land is land where tenure is unresolved.

Source: National Forest Inventory 2001 via ABS.

Australia's native and plantation forests provide a range of benefits to the community.

Forests are a reservoir of biological diversity and functioning ecosystems. They provide protection for soils and water resources, and are increasingly being recognised for their potential as carbon sinks. They provide for a vast array of recreational and educational activities.

Forests and plantations are the basis for important wood-based industries which produce sawn timber, fibreboard, plywood and paper. In 1999-2000 the wood and paper product industries generated $13.7 billion of turnover, including exports of $1.6 billion, and employed 74 500 workers as at 30 June 2000. Other forest-related industries produce honey, wildflowers, natural oils, gums, resins, medicines, firewood, craft wood, grazing and minerals.

In Australia, there are around 1126 hardwood mills and 259 softwood mills. The hardwood mills are generally small scale and scattered, and the softwood mills large and integrated with other processing facilities. There are also 22 pulp and paper mills, and 30 veneer and panel board mills.

Australia produces about 83 per cent of its sawn timber needs. It obtains 36 per cent mostly from native forests and 64 per cent from softwood plantations (AFFA 2002).

Governments intervene in forestry through:

- regulating the use of native forests and the development and harvesting of plantations; and
- operating enterprises in the business of managing forests and plantations.

Hence the CPA clauses most relevant to forestry are clause 5 (legislation review) and clause 3 (competitive neutrality).

Forestry is a complex area of competition policy implementation. The Council first began to consider forestry as a priority assessment matter in 2001. Since then it has endeavoured to isolate the key issues and to draw some conclusions about how it will assess implementation activity and outcomes. It has not been possible, however, for the 2002 NCP assessment to reach conclusions on compliance by each jurisdiction. The Council therefore intends to finalise its assessment of governments' compliance with CPA clauses 3 and 5 in 2003. This will also allow the Council to consult further with governments and interested parties on NCP issues relating to forestry.

Legislation review

Legislative restrictions on competition

State governments regulate the commercial use of public native forests and plantations principally through their forests Acts or similar. This legislation generally provides for certain forested Crown lands to be designated as State forests, for management and control of State forests by a government agency, for the preparation of forest management plans and for the licensing of certain uses of State forests by private parties.

The principal restrictions on competition found in this legislation relate to licensing. These are:

- eligibility restrictions – such as requirements that licence holders own a processing mill or not be foreign owned;
- tradeability and divisibility restrictions – such as requiring official approval before licences may be transferred or split;

- security restrictions – short licence terms or powers to alter allocation volumes, grades and pricing; and

- conduct conditions – conditions mandating certain logging practices.

Forest Acts usually leave State forest agencies considerable discretion over how they allocate and price logging licences. This discretion could allow restrictive licence allocation and pricing practices – for example, favourable treatment of incumbent timber processors relative to potential entrants – although, strictly speaking, the Acts themselves do not restrict competition. Nevertheless, there are important reasons for governments to have in place regulatory and/or structural arrangements that, where possible, promote open competition – most notably to:

- obtain adequate returns to the community from the use of a valuable public resource;

- give more certainty to the timber processing industry and to other forest owners about the government's future behaviour as a timber supplier; and

- allow ready public scrutiny of State forest administration.

Similar issues are raised by forest agreement Acts, such as Victoria's *Forestry (Woodpulp Agreement) Act 1996*. Legislation of this type ratifies agreements to provide long term rights to timber supply – 35 years in the case of this particular Act – usually on a take-or-pay basis. The potential restriction on competition is not the term of these rights – long term property rights are often consistent with promoting competition – but how such rights are allocated between potential holders. Again, though, allocation decisions of this kind are typically not governed by legislation, and therefore not directly subject to review under CPA clause 5 (although, for the reasons above, allocation decisions should where possible be made in an open and competitive manner). There are also the agreement Acts themselves but these usually only ratify agreements already reached.

Private native and plantation forestry is principally regulated by general landuse planning and environmental protection laws. These laws impose restrictions on how forestry operations are conducted and, in the extreme, may prohibit conversion of land to plantation forestry from another land use. Chapter 13 assesses the review and reform of these laws where relevant.

New South Wales and Tasmania specifically regulate plantation forestry through requiring plantations to be approved and through setting conduct standards intended to minimise environmental harm. These laws are discussed here.

The Commonwealth regulates the export of unprocessed wood via regulations made under the *Export Control Act 1982*. These regulations prohibit exports without an export licence unless the wood comes from a forest or plantation subject to a regional forest agreement between the Commonwealth and the relevant State.

Regulating in the public interest

As noted earlier, native forests provide a wide range of benefits to the community, from the conservation of biological diversity to recreational experiences, timber production and stock grazing. Governments intervene in native forest use principally because some of these benefits are difficult for holders of forests or forest rights to trade – it is too costly to exclude those who have not paid for a particular benefit from enjoying it. In addition, those forest benefits that are readily tradeable are, above a certain of intensity of use, competitive with non-tradeable (ecological) benefits. Consequently, without government intervention, community welfare will tend to be reduced because forest rights holders have an incentive to produce too little of, for instance, biological diversity and aesthetic amenity, and too much of timber and grazing.

The key objective of native forest regulation is therefore to protect the adequate availability of non-tradeable forest values while maximising economic benefits to the community from the exploitation of tradeable forest values. Another important objective of governments is often to promote employment in forest-related industries in rural and regional areas.

Outside national parks and similar reserves, the least restrictive approach to meeting these objectives in public native forests is to define and allocate tradeable rights to delineated areas of forest. Such rights (or forest leases) would:

- oblige holders to:
  - protect specified non-tradeable forest values, including public access;
  - regularly obtain certification of fulfilment of these obligations by accredited independent certifiers;
- allow cancellation should holders persistently fail to meet these obligations;
- allow any use of the forest – not just timber production – subject to these obligations;
- be long term – possibly two cycles of harvesting and regeneration – to ensure right-holders have a stake in maintaining forest productivity; and
- be initially allocated either competitively, or to existing holders of timber licences, or a mix of both.

A return to the community could be recovered via resource rents set competitively or as a set proportion of attributable revenue.

Such forest leases would allow competition in all aspects of managing native forests. In particular, by allowing alternative uses to timber production, and

by being long term, such rights would foster more innovation in native forest management and utilisation.

There are, however, some potential problems in practically implementing such forest leases. First, skills and experience in productive management of native forests are likely to be in short supply outside the public sector, and hence there may be limited demand for such rights, at least in the short term. Second, in certain forest ecosystems there may be as yet insufficient understanding of ecological processes and hence the long term impact of certain forest uses, to decide whether reservation or production is the most appropriate long term use. Third, knowledge about the productive capacity of some forests may be poor, making it difficult for potential lease holders to select and value such rights. Fourth, given strong public concern about native forest management and use, potential holders may judge the risk of future policy change leading to the resumption of these leases to be too high.

These problems may all be overcome in time, at least for some public native forests, although at some cost.

In the meantime, and in situations not suited to such rights, governments must offer less complete rights to public native forest resources. In the case of timber these are licences to harvest specified areas or to take delivery of specified grades and volumes of logs. Such licences will generally be in the public interest where:

- there are few if any eligibility restrictions;
- they are initially allocated and priced competitively – preferably but not necessarily through public auctions or tenders;
- they are freely tradeable between eligible holders;
- of a sufficient term and security to justify downstream investment; and
- impose the minimum conditions on conduct necessary to protect other forest values.

These licences or rights need not be statutory instruments. Indeed, statutory instruments may present disadvantages, such as inflexibility, to State forest agencies constituted as corporatised public forest enterprises, and competing with other forest owners.

An important factor for governments in past timber allocations has been the objective of supporting employment in particular rural areas. The Council understands that governments have pursued this objective by excluding potential competitors from rights to certain forest resources and by concessionary pricing of such rights. It is likely that this has led to lower returns to the community from public forests and less efficient production in some parts of the timber processing industry than would otherwise be the case. These costs may in some circumstances be exceeded by the regional employment benefits, but generally there are alternative means of seeking

such outcomes that do not involve restricting competition for rights to forest resources. These alternatives, such as conventional employment programs and structural adjustment assistance offered by the Commonwealth and the States as part of the regional forest agreement process, also have the advantages of avoiding the rewarding of inefficient production practices and of being more open to public scrutiny.

With plantation forestry the main concern is that establishment and harvesting of plantations may impose costs outside the boundary of the plantation, for example, harm to water quality and local roads. The aim of regulation here should be to require the plantation owner to take steps to minimise the harm (for example, to protect water quality through using settling ponds) or to compensate for harm done (for example, to contribute towards the maintenance of local roads). A sound regulatory regime will:

- impose minimum restrictions to effectively mitigate or remedy clearly identified harms; and
- be stable and predictable so that potential plantation investors can be certain what costs they face before investing.

Review and reform activity

Commonwealth

The Commonwealth has completed the review of various regulations under the Export Control Act affecting wood.[14] The review, principally by AFFA officials, was unable to find any significant benefit from the regulations – either in encouraging domestic processing or sustainable management of forests. It recommended that the Government remove export controls on:

- sandalwood;
- plantation-sourced wood, if plantation codes of practice in Queensland and the Northern Territory are found to meet National Plantation Principles; and
- hardwood chips, or allow the export of hardwood chips from non-regional forest agreement regions under licence.

The Government expects to respond to these recommendations during 2002.

14 Export Control (Unprocessed Wood) Regulations, Export Control (Hardwood Wood Chips) Regulations 1996 and Export Control (Regional Forests Agreements) Regulations.

New South Wales

New South Wales's *Forestry Act 1916* was not scheduled for review under the NCP. The Government has however completed a parallel review and reform program intended to improve the efficiency and sustainability of the forestry sector in New South Wales. This program resulted in the *Forestry and National Park Estate Act 1998* and *Plantations and Reafforestation Act 1999*. The Government considers this new legislation and the Forestry Act to be consistent with CPA principles.

Victoria

Victoria completed an independent review of its *Forests Act 1958* in April 1998.[15] The review found the Act and its regulations themselves contain few restrictions, but that administration of the Act and regulations could give rise to restrictions. It recommended (among other things) that the Victorian Government:

- amend the Act to:
  - allow a purchaser-provider separation in State forest management; and
  - remove any requirement under the sustainable yield provisions for a minimum level of logging regardless of timber demand;
- enhance competitive neutrality by:
  - clearly separating the department's policy, regulatory and commercial forestry functions; and
  - assessing the costs and benefits of corporatisation of the commercial function;
- develop more transparent and market-based processes by:
  - reviewing the present system of administered log allocation and pricing; and
  - reforming minor forest product licence and permit practices.

In August 2000 the Government established its commercial native forestry business as Forestry Victoria. This is a distinct commercially-focused unit within the Department of Natural Resources and Environment.

15 Other Victorian forestry legislation includes the Forests (Wood Pulpwood Agreement) Act 1996, which ratifies a 34 year long agreement to supply pulpwood to AMCOR Limited, and the Forestry Rights Act 1996, which provides a voluntary framework for agreements between landowners and forest developers. These Acts do not in themselves restrict competition.

In early 2001 the Government commissioned independent consultants to review timber pricing. This review released a discussion paper in June 2001 evaluating a variety of approaches to pricing public native forest produce. A report is expected soon.

In February 2002 the Government announced that, following research on sustainable yields from public native forests, sawlog supply volumes would fall substantially. It also released a major policy statement, 'Our Forests, Our Future', which set out directions for further native forest management reform. These include:

- establishing a separate commercial enterprise, VicForests, to operate public native production forests and funded to provide identified community services;
- phase-in of market-based pricing and allocation of timber via a mix of short and long term supply arrangements.

A taskforce of industry and departmental members is advising the Government on implementation of these reform directions, including the preparation of a revised response to the NCP review, and the development of new forests legislation and new licensing processes.

Queensland

Queensland completed a departmental review of its principal forestry legislation, the *Forestry Act 1959*, in April 1999. The review recommended retention of the 'non-competitive' native forest sawlog allocation system (Queensland Government 2001). It found that the efficiency gains of reform to the system would be outweighed by significant social costs for several small rural communities. The Government accepted the recommendation and passed the Forestry Amendment Act 1999. This Act exempts the allocation system from the Commonwealth *Trade Practices Act 1974* until 2009. In January 2000 the Government removed a stumpage levy that funded the Timber Research and Development Advisory Council.

The Government expects to repeal the *Sawmills Licensing Act 1936* in September 2002 following the implementation of a new Forest Practices Management System.

Western Australia

Western Australia's principal forestry legislation is the *Conservation and Land Management Act 1984*. A review by an independent economic adviser recommended the repeal of various limits on beekeeping in State forests and the exemption of tree values from local body rating. The Government is implementing these changes in 2002 via an omnibus Bill.

The review also examined the then Conservation and Land Management Amendment Bill and the Forest Products Bill, both now enacted, and found the identified restrictions to be in the public interest. These Acts vested State forests and other lands in the Conservation Commission and established the Forest Products Commission to undertake commercial forestry functions on State forests and private land.

The *Sandalwood Act 1929*, which controls the harvesting of sandalwood on private and public land, has been reviewed. The review recommended removal of the cap on the amount of sandalwood which can be harvested from private land. The Government has decided to retain restrictions on harvesting sandalwood on public land in the public interest, however. The Act is to be amended accordingly this year via an omnibus Bill.

South Australia

South Australia considers that its principal forestry legislation, the *Forestry Act 1950*, does not restrict competition.

The Government reviewed the *Sandalwood Act 1930* in 1999. The review recommended repeal of the Act and the South Australian Parliament is currently considering the Sandalwood Repeal Bill 2001.

Two new Acts passed in 2000 were the *South Australian Forestry Corporatisation Act 2000* and the *Forest Property Act 2000*. The former established ForestrySA as a public corporation. The latter provides a voluntary framework for separating ownership of land and trees. South Australia considers neither Act restricts competition.

Tasmania

Tasmania reviewed its *Forestry Act 1920* in 1998. The Government is to remove all but one of the Act's restrictions on competition. The remaining restriction, relating to minimum supply requirements for eucalypt veneer logs and sawlogs to the veneer industry and sawmilling industries, was found to be in the public benefit during the regional forestry agreement process.

Tasmania also completed a review of the *Forest Practices Act 1985* in 1998. The review found all restrictions on competition contained therein to be in the public interest.

Table 4.16: Review and reform activity of legislation regulating forestry

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Commonwealth	Regulations under the Export Control Act related to wood	Licensing of unprocessed wood exporters Licensing of hardwood chip exporters Maximum aggregate mass limits for woodchip exports	Review principally by AFFA officials completed July 2001. It recommended removing controls over export of sandalwood and over the export of plantation-sourced wood and hardwood chips subject to certain conditions.	The Government expects to respond in 2002.	Council to finalise assessment in 2003.
New South Wales	*Forestry Act 1916*	Licensing of timber harvesting Licensing of sawmills Permits for grazing, hunting or occupying State forest	Not scheduled for NCP review but included in program of forest regulatory review.	Review led to new *Forestry and National Park Estate Act 1998* and *Plantations and Reafforestation Act 1999.*	Council to finalise assessment in 2003.
	Threatened Species Conservation Act 1995	Licensing of conduct that harms threatened species, populations or ecological communities	See Forestry Act (NSW).	See Forestry Act (NSW).	Council to finalise assessment in 2003.
Victoria	*Forests Act 1958*	15 year non-transferable timber harvesting licences Permits and leases for grazing and other uses of State forest Administrative discretion over how licences and produce are allocated and priced Logs harvested to equal sustainable yield	Reviewed by independent economic advisers in 1998. The review recommended: • allowing purchaser/provider structure for management of State forests; • removing requirement for minimum level of logging; • developing market-based processes for log allocation and pricing; and • separating policy, regulatory and commercial forestry functions of the department.	In February 2002 Victoria released a major policy statement. The Government intends to establish a new commercial entity VicForests and to make pricing and allocation of forest produce more competitive and transparent. An industry/department task force is advising on implementation.	Council to finalise assessment in 2003.

(*continued*)

Table 4.16 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Queensland	*Forestry Act 1959*	Licensing of timber collection and of taking of other resources Administrative discretion over how licences and produce are allocated and priced Logs harvested not to exceed sustainable yield Levy to fund timber research	Reviewed by officials in 1999. The review recommended: • retaining the native forest sawlog allocation system as, while pro-competitive reform would bring economic gains, it avoided imposing significant social costs on several rural communities; and, • retaining the timber research levy. A subsequent review of agricultural levies recommended removal of the timber research levy.	Act amended in November 1998 to extend exemption from the Trade Practices Act for the native forest sawlog allocation system until 2009. Timber research levy removed in 2000.	Council to finalise assessment in 2003.
	Sawmills Licencing Act 1936	Licensing of sawmills at absolute discretion of corporation Licences specify maximum productive capacity of mill	Reviewed in 2000.	Act to be repealed (without replacement legislation) in September 2002.	Council to finalise assessment in 2003.

(*continued*)

Table 4.16 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Western Australia	*Conservation and Land Management Act 1984*	Licensing of timber collection and of taking of other resources Administrative discretion over how licences and produce are allocated and priced Permits to occupy and use State forest Registration of timber workers	A review by an independent economic adviser recommended the repeal of: • various limits on beekeeping in State forests; and • the exemption of State forest tree values from local body rating. Separately the Act was amended by: • *Conservation and Land Management Amendment Act 2000*; and • *Forest Products Act 2000*. These Acts vested State forests and other lands in the Conservation Commission and established the Forest Products Commission to undertake commercial forestry functions on State forests and private land. A review of this amending legislation found all identified restrictions to be in the public interest.	The recommendations of the review of the unamended Act will be implemented in 2002 via an omnibus Bill.	Council to finalise assessment in 2003.
	Sandalwood Act 1929	Caps the quantity of naturally-occurring sandalwood harvested from Crown and private land Licensing the harvesting of sandalwood Individual licences capped at 10 per cent of the total limit	Review completed. It recommended retaining the overall cap on the quantity sandalwood harvested while removing the restriction on the proportion of the annual sandalwood harvest that may be taken from private land.	Recommendations to be implemented in 2002 via an omnibus Bill.	Council to finalise assessment in 2003.

(*continued*)

Table 4.16 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
South Australia	*Forestry Act 1950*	Exclusive control and management of State forests by Forestry SA Licensing of timber collection and taking of other resources Administrative discretion over how licences and produce are allocated and priced	Not scheduled for review as Act is not considered to restrict competition.		Council to finalise assessment in 2003.
	Sandalwood Act 1930	Caps the quantity of naturally-occurring sandalwood harvested from Crown and private land Licensing the harvesting of sandalwood	Reviewed in 1999. The review recommended repeal of the Act.	A Bill repealing the Act has been introduced into the South Australian Parliament.	Council to finalise assessment in 2003.

(*continued*)

Table 4.16 continued

Jurisdiction	*Legislation*	*Key restrictions*	*Review activity*	*Reform activity*	*Assessment*
Tasmania	*Forestry Act 1920*	Exclusive control and management of State forests by the Forestry Corporation Licensing of timber collection and of taking of other resources Administrative discretion over how licences and produce are allocated and priced Minimum supply of logs for veneer and sawmilling industries Wood supply agreements to contain certain conditions Permits to occupy and use State forest Registration of timber workers	Reviewed by an external consultant in 1998. It noted that minimum supply restrictions are anti-competitive and recommended: • simplifying the Act; and • removing certain conditions of wood supply agreements. The minimum supply restrictions were found to be of public benefit during the process to establish a Regional Forest Agreement.		Council to finalise assessment in 2003.
	Forest Practices Act 1985	Requires preparation and certification of forest practices plan before timber harvesting can start Declaration of private timber forests Prescribes forest practices under Forest Practices Code Operators harvesting more than 100 000 tonnes per annum must submit a 3 year plan for approval by Forest Practices Board	Reviewed in 1998 by Forest Practices Advisory Council. The review recommended no changes to the Act.		Council to finalise assessment in 2003.

Competitive neutrality

All States and the ACT have publicly owned agencies which are recognised as undertaking significant forest-related business activities, most importantly the sale of logging rights and/or logs, in competition (current or potential) with private forest owners. State governments are therefore obliged under CPA clause 3, to the extent that the benefits outweigh the costs, to either corporatise their forestry business activities or to adopt cost-reflective pricing of forestry goods and services.

The key elements in corporatising a significant business activity (drawn from CPA clause 3 and the corporatisation model prepared by the Taskforce on Other Issues in the Reform of Government Trading Enterprises in April 1991) are:

- setting a clear value-maximisation objective for the enterprise and directly funding any non-commercial community services;
- separating policy advisory and regulatory functions from commercial functions;
- setting the enterprise's core business, valuation, target rate of return, capital structure and dividend policy;
- imposing on the enterprise:
  - Commonwealth and State/Territory taxes or tax equivalent systems;
  - debt guarantee fees; and
  - those regulations to which private enterprises are normally subject;
- delegating to the enterprise's board and management full authority over pricing, operational, employment, investment and financing decisions; and
- regular reporting and monitoring of the commercial performance of the enterprise.

Cost-reflective pricing involves pricing goods and services to cover their full costs of production including, where appropriate, taxes or tax equivalents, the opportunity cost of capital employed in producing the goods and services, and costs arising from complying with regulations that similar private businesses are subject to. Full cost attribution can accommodate a range of costing methodologies, including fully distributed cost, marginal cost, avoidable cost, as appropriate to particular cases. See chapter 2 for further discussion of the general principles and application of competitive neutrality.

Whichever approach governments adopt, forest agencies must charge prices for timber that, over the longer term, generate revenues that at least cover

the costs of managing their forests for timber supply and provide a commercial return on the assets employed in timber production.

There have been longstanding concerns that timber supplied by forest agencies is sometimes underpriced. Underpricing timber imposes various costs on the community, including:

- supporting exploitation of native forests at higher than economic levels;
- slowing productivity growth in the timber processing industry; and
- hampering the development of private plantations (and hence related benefits such as the contribution that private plantations make to controlling salinity in certain dryland farming areas and to sequestering carbon).

In May 2001 the Commonwealth Competitive Neutrality Complaints Office (CCNCO) released the research paper 'Competitive Neutrality in Forestry' which extensively discussed the implications of competitive neutrality for state forest agencies. The CCNCO noted some difficulties in monitoring the financial performance of forest agencies and the adequacy of timber prices.

> *Over the 'life' of a forest, the rate of return provides a useful measure of an agency's financial performance. However, annual rates of return need to be interpreted with care. For example:*
>
> - *revenues, and hence rates of return, will fluctuate from year to year because the quantity of wood available for harvest will vary, unless the forest age profile is consistent through time;*
> - *with a pronounced cyclical demand for many processed wood products, log prices (and hence forestry returns) can also be quite volatile; and*
> - *the use of expected future returns to determine the value of forestry assets introduces an element of circularity into an agency's reported rate of return. More specifically, it means that poor performance by an agency will lower the value of its forestry assets. As a result, the reported decline in returns, relative to the new asset base, is dampened, or perhaps even eliminated.*
>
> *This 'circularity', coupled with the sensitivity of rate of return measures to factors unrelated to the performance of the forestry agency (eg changes in market conditions), suggests that, for performance monitoring purposes, annual rates of return need to be assessed in the context of longer term trends and other relevant information. This should include details of, and reasons for, changes in asset values and longer term projections of the pattern of future log sales.*
>
> *The CN requirement that forestry agencies recover all costs and generate commercially acceptable returns should help address past*

> *concerns about underpricing of logs by forestry agencies. However, in view of the difficulties in assessing and interpreting rates of return and related information, it may often be difficult to judge whether logs are being sold at their 'full' market value. In these circumstances, a useful way of assessing the market value of logs is to compare log prices with their residual value — a value derived by subtracting harvesting, transport and processing costs from the prevailing international prices of processed wood products.*
>
> *Underpricing by forestry agencies of logs from native forests has hampered the development of private wood growing enterprises. However, with the reforms of the last decade or so, and with harvesting controls limiting the output of most forestry agencies, other factors — such as the future competitiveness of Australia's wood processing sector — may be more important for the future development of private wood supplies.* (CCNCO 2001, p. x)

The key conclusion of the research paper is that monitoring of public forest enterprise financial performance — and thus the assessment of competitive neutrality compliance — may be assisted by determining the market value of logs (for use in valuing the timber asset) using the residual value method.

This does not mean that the 'residual value' method is most appropriate for setting actual timber prices. A report recently prepared for the Australian Conservation Foundation (Marsden Jacob Associates 2001) argued that forest agencies that set timber prices in this way effectively subsidise the processing industry by making 'ability to pay' the main pricing criterion. According to the report, this results in the exploitation of native forest that is uneconomic to log, and in inefficiency in the processing industry. The report recommended that forest agencies sell timber via auctions or tenders subject to a cost-based reserve price.

The sale of timber via auction or tender was also discussed in a paper recently released by the Victorian Government's Timber Pricing Review (Jaakko Poyry Consulting 2001). The discussion paper also noted, however, that in areas where insufficient competition exists between processors, other approaches (such as the residual value method) may give a better indication of overall market values.

An obvious further difficulty with the residual value method is that, like price regulation generally, it relies on the revelation of cost information to governments by government agencies and private processors which have strong incentives to bias the information in their favour.

For this and other reasons noted by the CCNCO, reported rates of return are likely to be insufficient to effectively monitor State forest enterprises and hold directors and management to account for the enterprise's performance. Governments are likely to find it necessary to also monitor the pricing policies and practices of these enterprises.

This though presents another difficulty. Under the corporatisation model boards and management have autonomy from shareholding Ministers and departmental officials in making pricing decisions. Moving the focus of ownership monitoring to product pricing may invite undue influence by Ministers and officials in enterprise pricing decisions. Such influence was arguably a significant factor in past instances of underpricing.

The best solution to this dilemma may be for governments to negotiate with State forest enterprise boards a performance monitoring regime that includes pricing transparency mechanisms. Possible such mechanisms include:

- posted prices and pricing formulas for all sales – so that processors, competing timber suppliers and the community at large are able to scrutinise the enterprise's pricing performance and detect any instances of 'weak selling' or discrimination;

- periodic reviews of the enterprise's pricing policies and practices by an independent expert and reporting of review results in the enterprises' annual report; and

- gazettal or similar reporting of any directions from shareholding Ministers to the enterprise's board related to pricing.

The design of suitable transparency mechanisms would need to address confidentiality concerns – particularly where existing contracts or licences carry (legitimate) confidentiality obligations.

The CCNCO noted that currently there is very little published information on prices realised by forest agencies (CCNCO 2001 p. 43).

Forest agencies may argue that these types of transparency mechanisms are not imposed on their privately-owned counterparts and may disadvantage the public enterprises competitively. The appropriate response to this argument is that it makes up for the deficiency in management accountability that is unavoidable where ownership rights are not publicly traded, as is the case for public forest enterprises.

In assessing in 2003 the application by governments of CPA clause 3 to their forest enterprises the Council will focus on the effectiveness their performance monitoring arrangements – particularly the extent to which the problems noted above have been acknowledged and addressed – and related elements of competitive neutrality such as the identification, costing and funding of community service obligations.