A Critique of Western Australian Native Forestry

Peter Lane March 2016

Native forestry in Western Australia is conducted at a substantial financial loss, is a cost to the state and presents unfair competition to the private plantation sector. It is a small employer and releases an increasing amount of greenhouse gasses.

The government needs to decide whether the Forest Products Commission (FPC) is to operate as a commercially viable entity or is to continue as a charitable corporation providing low cost timber to prop up technically obsolete mills.

Note, this analysis does not take into account many financial and environmental benefits that would flow from a significant reduction/cessation in logging our native forests.

Summary

- Western Australia's south-west forests have been renowned for production of high quality jarrah ("Swan River Mahogany"). When FPC "acquired" the forests in 2000 production of premium, 1st and 2nd grade jarrah sawlogs, clearly FPC's most important native forest products, was about 245,000 m^3/yr. On acquisition the forests were valued at zero, \$0. Production of these logs now ranges from 60,000 m^3/yr (2104) up to 100,000 m^3/yr (2015) and decline in the production of all quality and species of sawlogs has paralleled this. Despite this the forests are now valued at \$84 million. This claimed increase in value has been booked as profit. This alone is sufficient to illustrate the absurdity of FPC's statement of financial performance.
- As well as this decline in the production of quality sawlogs, there has been a decline in actual and predicted rainfall, since the time of forest acquisition the value of the \$A has increased and the Global Financial Crisis has impaired international trade. It is only due to changes in accounting policies that FPC has been able to claim the value of the forests has increased.
- Even though FPC has counted this (supposed) increased value of the forests as profit, FPC's cumulative profit (including plantations and sandalwood) since formation has been only \$16 million.
- In 2015 financial year native forestry was conducted at a pre-tax operating loss of \$3.6 million and an accounting pre-tax loss of \$3.0 million. This followed the 2014 results of a \$1.7 million operating loss and a \$14.8 million accounting loss (had FPC not reduced the discount rate applied to the projected cash flows by which forests were valued the 2014 accounting loss would have amounted to \$29.3 million).
- Even based on FPC's generous treatment of accounts, over the past three years, by "producing" over 1.5 million tonnes of native forest logs FPC has lost over \$40 million.
- Since 2005 the state government has given FPC \$106.4 million which FPC has recorded as *equity injections*. As the government owned 100 percent of FPC no equity has been involved. This amount has been a gift, presumably so that FPC could avoid insolvency.
- No cost forests and government cash support results in unfair competition against private sector agroforestry.

- The federal Department of Environment reports that to June 2015 national CO_2 emissions from deforestation increased by 11.2 percent from the previous year.
- WA native forestry directly employs some 300 people.

Note. In correspondence from FPC of 8 February 2016 I was advised that "….. (FPC) would not be seeking to account for management decisions and changes in accounting practices made more than ten years previously". Clearly FPC no longer wish to defend the argument that changes in accounting practices were a valid reason, indeed the core reason FPC had been able to report profits and give the appearance of financial viability.

As at 30 June 2005 (after which no apparent changes in accounting standards were made), native forests were valued at $120.3 million (FPC 2006 annual report, note 14 to the accounts. Note, this is as amended from the 2015 annual report). By the 30 June 2015 native forest value had fallen to $84.5 million (FPC 2015 annual report, note 25 to the accounts), a 30 percent decline in value. Note also that the 2005 discount rate applied to the cash flows was 11.15 percent whereas in 2015 it was 9.5 percent. Had the same discount rate been applied the difference between the 2005 and 2015 values would have been increased by a further estimated $12 million.

While there may be nuances, such a decline in the value of this asset is demonstrable of the unsustainability of FPC native forest management.

Critique

The principal reason FPC has been able to claim that native forestry has been profitable is that, under provisions of Australian Accounting Standard AASB 41, the forests have been revalued each year and the change in value has been incorporated into the profit/loss account.

1. **FPC's "Profit"**

Biological Asset Valuations

At the end of each financial year FPC revalues its biological assets. These include state-owned south-west native forests which the FPC has the right to exploit. The only value ascribed to these forests is that of timber. This value is assessed by predicting logging rates over 50 years and discounting the resultant cash flow. Any change, for whatever reason, in the value of the south-west forests has been incorporated into the FPC's profit/loss.

On formation the FPC was given state-owned native forests and recorded their value as zero, $0 . This meant that any value subsequently ascribed to the forests could (not necessarily "should") be recorded as profit for the FPC.

In 2002 the FPC valued the forests by projected cash flow analysis, valuing them at $67 million. This bookkeeping increase, from $0 to $67 million, was due to a change in an accounting practice. Nevertheless, it was called "profit". (Note, these forests were transferred from CALM, yet that corporation did not record the equivalent loss).

In 2005 the FPC again increased the value of native forests, on this occasion by a further $33 million. This was due to *"exclusion of an allocation of Corporate Overheads*" from the 50 year cash flows, again a simple change in accounting policy. After allowing for the reduction in discount rates, the impact of removing these overheads from the cash flows was in the order of a $75 million increase in the FPC's value of native forests.

Both the 2002 and 2005 increases in forest values were due to a change in accounting practices. Both changes were recorded as profit, yet clearly such increases could not be reasonably considered as profit. They were at best bookkeeping entries.

In 2015 financial year native forestry was conducted at a pre-tax operating loss of $3.6 million and an accounting pre-tax loss of $3.0 million. In the previous year the results were an operating loss of $1.7 million and an accounting loss of $14.8 million. Had FPC not reduced the discount rate by which forests were valued the accounting loss would have amounted to $29.3 million[i]. FPC now values native forests at $84 million.

FPC's reported cumulative pre-tax profit (native forests, plantations and sandalwood) since formation has amounted to just $16 million. Had the value of the forests not been initially recorded as $0 and had they not been revalued and the revaluations incorporated into FPC's profit/loss, the FPC would have reported a cumulative loss over this period of $69 million.

FPC recorded the increases in the value of the forests despite:

a) Decreases in the production of jarrah sawlogs, especially quality sawlogs
b) Demonstrated unsustainability of karri sawlog production,
c) Declining actual and predicted rainfall. This will reduce growth rates, increase the risk of fire (for which FPC are not insured) and of biological infestations.
d) A material increase in the value of our currency (at the time of FPC acquisition of the forests the exchange rate was approximately $A = $US0.52). This has had a detrimental impact on the profitability and value of all agricultural products, and
e) The Global Financial Crisis.

FPC have advised they do not compare the projected cash flows with actual performance and that they are "too busy" to do this[ii]. In view of the operating losses incurred in the past two years it is improbable that the earlier valuations based on projected cash flows would be verified by actual performance.

There is good argument that the value of our native forests has materially fallen and the real loss experienced by FPC would be far greater than the $69 million referred to above. The magnitude of this can be estimated by assuming that had the initial value of the forests been stated as $67 million (as published in FPC 2002 Annual Report) and has since declined to $0 (that is with no changes in accounting policies), as appears reasonable, the cumulative FPC losses would have amounted to some $140 million.

(A proposal to remedy the use of this extraordinary and misleading accounting standard is to apply the principle of "impairment". This is used in many other industries. In simple terms an asset cannot be valued more than what it cost, but should a discounted projected cash flow valuation show it to be worth less, then that reduction in value is considered a loss).

2. **FPC Dividends, Government Return on Equity and Government "equity injections"**

The *Forest Products Act 2000* Section 3 states: “profit, in relation to the exploitation of forest products produced on public land, means an appropriate return to the State for that exploitation” and Section 12 states: “The Commission (FPC) in performing its functions must try to ensure that a profit that is consistent with the planned targets is made from the exploitation of forest products …”. This is a clear and unambiguous directive. Yet over the past 13 years FPC has paid cumulative dividends to the state of only $16.8 million, equating to an annualised return on equity of about 0.4 percent.

Since 2009 the state has given FPC $106.4 million in cash. This amount was given in a series of so called “equity injections”, but as the state owned 100% of FPC there was no equity involved. These “injections” were simply gifts. Allowing for these gifts, the net return to the state has been negative $89.6 million. Annualised, this is a net “return” to the state of negative approximately 2.5 percent. Note also, the forests were given at no cost to FPC.

Despite being given a major publicly owned asset, the FPC has been running at a cash loss since its incorporation.

3. Impact on Plantation Industry

The FPC operates as a government subsidised corporation (in terms of both cash contributions needed to keep it running and its original “no-cost” forests). This means that the plantation industry, which includes many farmers, suffers from unfair competition.

Investments in new plantations and maintenance of existing plantations have come to a standstill. Since 2001 Western Australian annual hardwood plantings have fallen from 18,140 hectares to 360 hectares and softwood plantings from 3,440 hectares to nil in 2012[iii] *(ABRES*), partially due to the collapse of the tax effective investment schemes and other factors, but as well to unfair native forest competition. Due to the low price received for timber products, management of established plantations, vital to attaining a long term viable financial business, has significantly declined. Of interest, FPC plantations perform very poorly. The table below gives an indication (it depends on how costs are distributed) of this performance:

Year	Plantations (1)	Propagation & s/farms	P/L	Admin & other (2)
2008	-10.4	-0.1	-10.5	-15.6
2009	-6.8	-1.1	-7.9	-11.9
2010	0.5	-58.6	-58.1	-12.2
2011	-15.9	-9.0	-24.9	-13.0
2012	-2.0	-6.9	-8.9	-1.4
2013	2.9		2.9	-7.9
2014	8.6		8.6	-3.8
2015	8.8		8.8	-2.4
Totals			**-90.0**	**-68.2**

(1) = mature + new + maintenance (including bio revaluations

(2) None of these costs (proportionately) attributed to plantations

4. **Greenhouse Gas Emissions**

In December 2015 the Australian Government Department of the Environment reported that to June 2015 national CO^2 emissions from deforestation increased by 11.2 percent from the same period of the previous year

5. **Native Forestry Employment**

The impact on employment is often put as an argument to continue logging. The government must reject the view that subsidised, loss making, environmentally destructive work justifies protection of jobs. The numbers of employees in native forestry is small. I refer to Hansard 18 September 2014, re SW native forestry and plantations. This reveals that there are 734 "registered" loggers and truckers. Assume 80% of these work full time equivalent, that is 587 workers, and (noting that 2.5 times more tonnes of logs are taken from plantations than from native forests) assume 50% of these workers are employed full time equivalent in native forestry, this then results in perhaps some 300 people being employed directly in native forestry[iv].

An Observation

Following the 2000 State election Old Growth Forests (OGF) were excluded from logging. Although the definition of an OGF is very strict, it was then and remains of deep concern that 400 and more year old trees are still logged. But as a geologist I am even more appalled that our eucalypt forest ecosystem, an ecosystem that is considered to have taken some 45 million years to evolve (that is from when Antarctica split from Australia and we commenced our northward drift), one of extraordinary biodiversity and localised speciation, has been and continues to be so thoroughly trashed by logging.

Conclusion

Native forestry as practiced in Western Australia is loss making, a financial cost to the community, unfairly competitive, a relatively small employer, damaging to our environment and there is weak demand for its products. Rather than benefits to balance against environmental damage, there are costs, and it is difficult not to conclude that there are no plausible reasons for continuing the current practices of managing our forests.

The government must "bite the bullet" and take dramatic action to reverse this situation.

Qualifications of author

Peter Lane is a petroleum geologist. He has been conducting project and company valuations by the discounted cash flow method for over 40 years, he has written numerous independent valuation expert reports, has been an independent expert witness and has given talks on company and project valuations. Peter has been a member of the Audit Committee of an ASX listed company for 16 years, six of which he was chairman.

Note. Unless otherwise noted, all the above information has been sourced from FPC Annual Reports.

[i] In 2014 FPC reported a profit of $5.43 million. This “profit” included changes to values of its biological assets (native forests, sandalwood and plantations). These changes to values incorporated a decrease in the discount rate applied to the projected cash flows. This discount rate decrease resulted in an increase in the combined values the biological assets of $44.93 million (native forests $14.54 million, sandalwood $9.23 million and plantations $21.16 million). This was recorded as profit. One hopes that this alone would highlight the absurdity of FPC’s claimed “profit”.

[ii] As advised meeting 2/9/2015.

[iii] Awaiting more recent statistics

[iv] As for employment statistics for any industry this number refers only to those directly employed in the industry and not downstream from it. It therefore excludes those employed in milling. The WA milling industry is based on old to obsolete technology and it is irrational to keep doing what we have done to stave off modernisation of this industry. As well, transferring from native forests to plantation timber will see many and perhaps the majority of these jobs maintained.