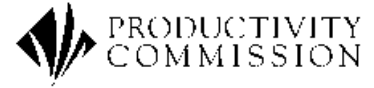




*Commonwealth
Competitive Neutrality
Complaints Office*



Competitive Neutrality in Forestry

CCNCO
Research Paper

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The Commonwealth Competitive Neutrality Complaints Office

The Commonwealth Competitive Neutrality Complaints Office is an autonomous unit within the Productivity Commission. It was established under the *Productivity Commission Act 1998* to receive complaints, undertake complaints investigations and advise the Treasurer on the application of competitive neutrality to Commonwealth Government activities.

Information on the Office and its publications may be found on the World Wide Web at <http://www.ccnco.gov.au>

Preface

The Productivity Commission has been researching a number of competitive neutrality issues as part of its role as the Commonwealth Competitive Neutrality Complaints Office (CCNCO). This research is likely to be of general interest to policy makers, agencies implementing competitive neutrality and businesses that compete with publicly owned businesses.

This CCNCO research paper was prepared by Siobhan Davies and Gary Samuels, with assistance from Neil Byron and Garth Pitkethly. It outlines progress in implementing competitive neutrality in forestry and discusses some related issues.

The CCNCO would like to thank competitive neutrality policy advisers in the States and Territories, along with officers in State forest agencies, who provided helpful comments on drafts of this paper. Nonetheless, the views in the paper are those of the CCNCO and do not necessarily reflect the views of the States and Territories. Comments on the paper are welcome.

Mike Woods
Commissioner

May 2001

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Key messages

- States and Territories have agreed to apply competitive neutrality (CN) requirements to their commercial forestry activities. The implementation of CN varies between jurisdictions and encompasses some differences in approach.
- Several studies have pointed to underpricing of logs by State forest agencies in past years. Underpricing can affect the balance between public and private sector wood production. It can also affect the return the community achieves on its forest assets and may adversely influence agency investment and harvesting decisions.
- CN requires forest agencies to act more commercially, including covering all costs and earning a commercially acceptable rate of return on assets. This should reduce the likelihood of agencies underpricing logs, although difficulties in interpreting rates of return and related information can make it difficult to judge if logs have been sold at their full market value.
- To help assess compliance with CN, the market value of logs can be estimated by calculating their residual value — a value derived by subtracting harvesting, transport and processing costs from prevailing international prices of processed wood products.

Summary

Forestry is an important industry at both the national and regional level. Although there is increasing private participation in the industry, a substantial share remains under public ownership:

- Of the 10 million hectares of native forests available for wood production, 70 per cent is publicly owned, with the remainder under private ownership. In addition, there are about 1.3 million hectares of plantation forests, with softwood comprising nearly three-quarters of the planted area. Some 40 per cent of softwood plantations and 80 per cent of hardwood plantations are privately owned.
- Wood production from native and plantation forests accounts for about \$3 billion, or 0.5 per cent, of Australia's gross domestic product. Total employment in the industry, including all value adding activities, is around 83 000. In some areas, forestry accounts for up to 40 per cent of employment.

In response to concerns over the sustainability of harvesting in native forests, and as part of the general reform program of the 1980s and 1990s to improve the efficiency of public sector bodies, government forestry agencies have been subject to considerable change over the last decade. This has encompassed initiatives to place forestry agencies on a more commercial footing and to remove or reduce their regulatory responsibilities.

Inter-government agreements such as the National Competition Policy (NCP) package, the National Forest Policy Statement and subsequent Regional Forest Agreements have provided the impetus for many of the changes.

This paper focuses on the application of competitive neutrality (CN) to State forestry agencies. CN seeks to ensure that significant government businesses do not enjoy net competitive advantages (or suffer from a competitive disadvantage) over their private sector competitors simply by virtue of their public sector ownership. Although CN policy is formally a part of the NCP, the key concepts embodied in CN were also important components of earlier institutional reforms.

As forestry agencies are deemed to be significant government businesses, they are subject to CN. This requires them to: charge prices that reflect costs; pay all

relevant government taxes and charges; pay commercial interest rates on their borrowings; earn commercially acceptable returns on their assets; and operate under the same regulatory regime as their private sector counterparts.

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.