



Issues in corporatisation in Australian forestry

with particular reference to the Victorian auction system

David Pollard

May 11, 2007

Presented by the
BC Forum on Forest Economics and Policy

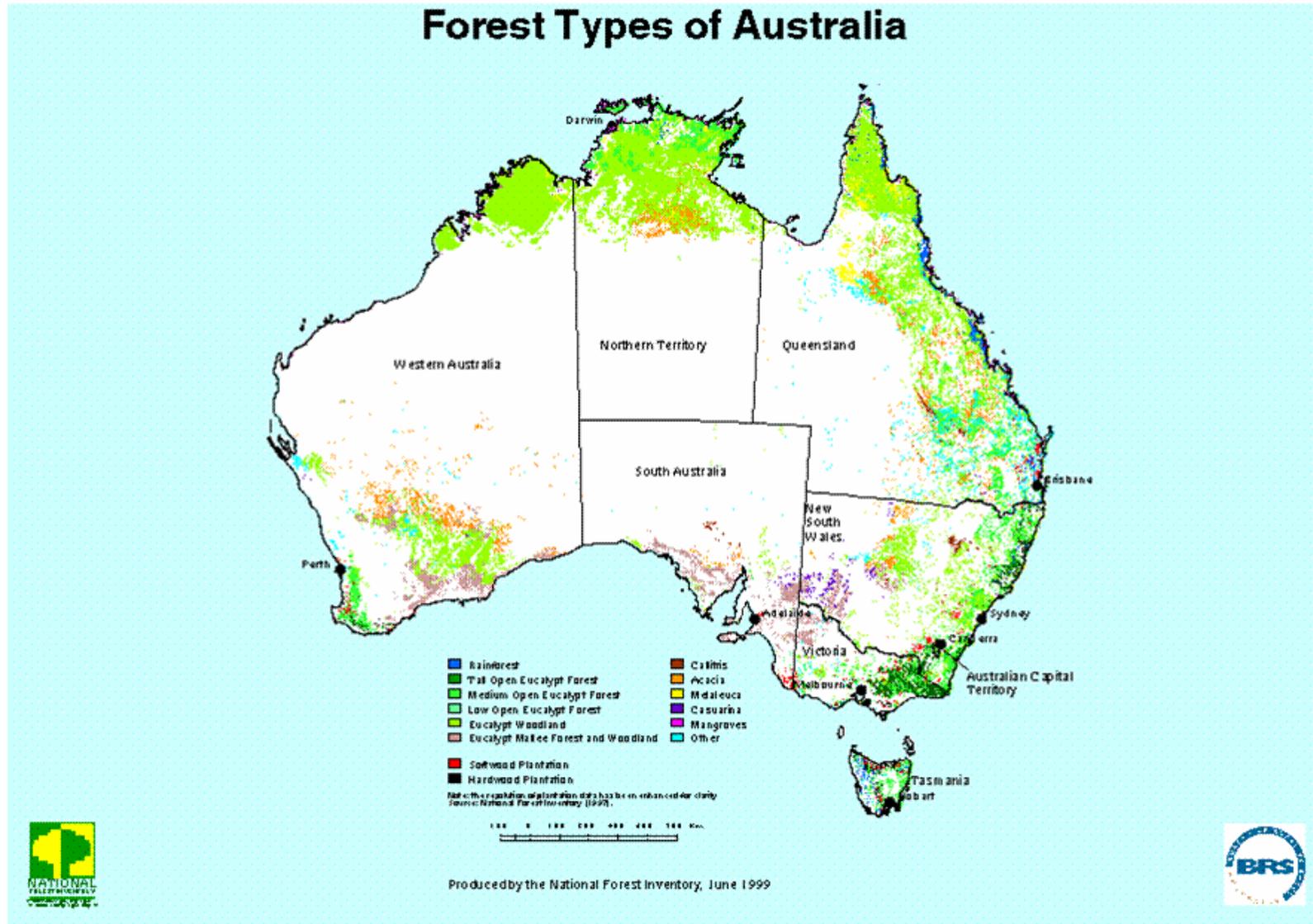
Topics

- > Australian forestry – overview
- > History of public native forest management
- > Views of corporatisation
- > Science and forestry
- > VicForests' auction system – what it tries to solve
- > VicForests' auction system – development, implementation and benefits

Australian forestry – overview

- > Australian land area: 768 million ha
- > Population: 21 million
- > Total forest: 164 million ha
- > Native forest: 162 million ha
- > Plantation: 2 million ha

Forests in Australia (much of the rest is desert!)



Victorian forestry - overview

- > Victorian land area: 23 million ha
- > Population: 5 million
- > Total forest: 8.3 million ha
- > Native forest: 7.9 million ha
- > Plantation: 400,000 ha (all privately owned)
- > Approx 450,000 m³ sawlog
- > Approx 1.2 million m³ pulpwood

History of Australian public native forest management



- > Management of crown land a State responsibility
- > State forests proclaimed in the early 1900s
- > State-based Forest Commissions managed State forest for production and protection
- > Multiple-use management from 1970s
- > Growth of conservation movement from late 1960s
- > Movement of public land from State forest to National Parks from 1970s, and particularly 1980s as a result of pressure from conservation groups
- > Commonwealth Government given strong support to expansion of plantations (via taxation system) to counter reduced timber production from native forests across Australia and redress balance of trade issues

History of Australian public native forest management



- > Commonwealth and State Governments developed a National Forest Policy Statement (NFPS) in 1992 to:
 - provide a strategy for ecological sustainable management of forest
 - to seek agreement between the relevant jurisdictions with responsibility for forest management; and
 - to honour the international commitments to sustainable forest management made by the Australian Government.

- > The Statement included:
 - A goal for Australia to develop internationally competitive and ecologically sustainable wood production and wood products industries
 - An objective for forest conservation to provide for a comprehensive assessment of forest values and protection of sufficient forest areas to ensure the long term survival and health of all forest ecosystems
 - a principle that the pricing of timber should be market based

History of Australian public native forest management



- > A key outcome of the NFPS was a set of Regional Forest Agreements (RFA) which cover about 23 million hectares of productive forest across Australia
- > The 20-year RFAs try to balance the full range of environmental, social, economic and heritage values that forests can provide for current and future generations.
- > Australia's reserve system expanded considerably following the RFA process
- > However, native forestry an issue in most elections, with reduction in harvestable area a common outcome

History of Australian public native forest management



- > National Competition Policy agreed between Commonwealth and State Governments in 1995
- > Policy aimed:
 - at promoting efficient competition between public and private businesses
 - at eliminating resource allocation distortions arising from public ownership of entities engaged in significant business activities – that is, to eliminate the cross-subsidisation of native forest harvesting from the forest management and regulatory functions of Government

Governments agreed to:

- > Charge prices that reflect costs
- > Pay relevant taxes
- > Generate commercially accepted return on assets
- > Pay commercial rates of interest on borrowings

History of Australian public native forest management



- > State governments were slow to implement all of the National Competition Policy (NCP) outcomes
- > The public forest management agencies in the late 1990s were generally all part of larger, integrated land and resource management agencies
- > A number of these agencies created semi-autonomous 'business units' within the agency to comply with NCP principles. Others separated the commercial/management functions from the regulatory.
- > The Australian Conservation Foundation, a peak Australian environmental NGO reviewed application of NCP reforms in 2001 in the State forest management agencies and found a lack of competitive neutrality, insufficient focus on structural reform, and in Victoria, no independent, transparent processes for standard setting, monitoring or enforcement.

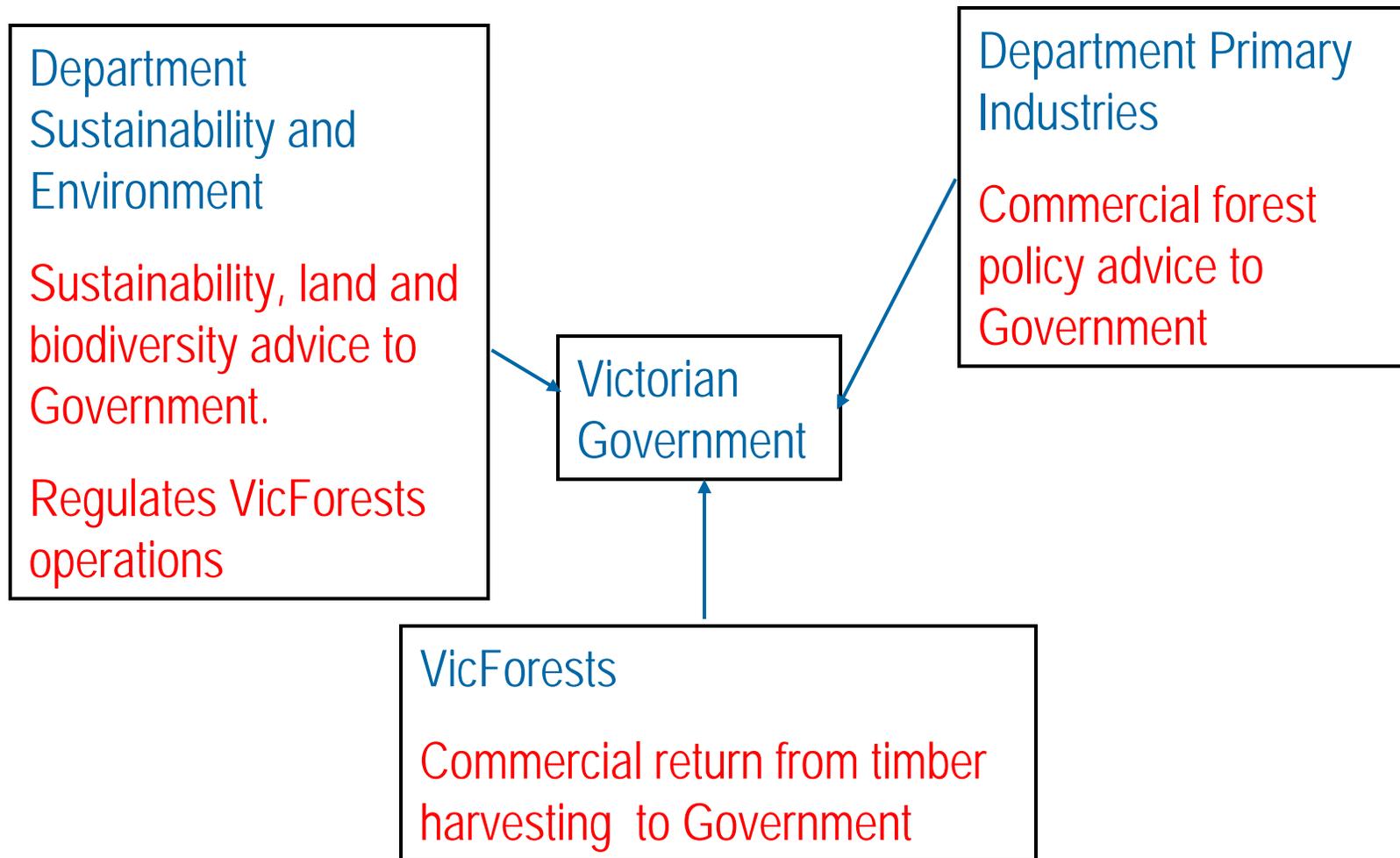
Victorian native forest management

- > Forests Commission operated until 1983
- > Management of State forests integrated into a department responsible for all public lands, biodiversity conservation, commercial forestry and fisheries and fire protection
- > An internal business unit, Forestry Victoria, commenced operation in 1999
- > In 2002, the Victorian Government released the 'Our Forests Our Future' policy statement. This statement addressed many of the National Competition Policy principles and ACF criticisms by:
 - establishing a comprehensive sustainable yield monitoring program
 - establishing VicForests as a separate, fully commercial entity
 - clearly separating forest policy, regulatory and commercial functions to eliminate cross subsidisation
 - improve transparency in the allocation of rights and use of forest produce
 - allocate timber on a mix of short term and long term supply arrangements
 - phasing in market-based sawlog pricing and allocation

Victorian native forest management

- > Management of Victorian State forests changed when VicForests commenced operations in August 2004
- > The Victorian Government Department of Sustainability and Environment (DSE) is responsible for managing Victoria's 3.4 million hectares of State forest and for providing policy guidance for a further 3.7 million hectares of forested parks and reserves.
- > DSE manages State forest to balance a variety of uses. These values include conserving flora and fauna, protecting water catchments and water supply, providing timber for sustainable forestry, protecting landscape, archaeological and historic values, and providing recreational and educational opportunities
- > The Department of Primary Industry is responsible for Victoria's commercial forest policy
- > VicForests is a State-owned business corporation responsible for the sustainable harvest and sale of native forest timbers from the public forest state in eastern Victoria

Victorian State Government native forest management



VicForests



- > **VicForests**
- > Independent board of directors
- > Pays dividend to Treasurer (sole shareholder)
- > 140 staff
- > 3 regions in eastern Victoria and Corporate Support Office in Melbourne
- > **Department of Sustainability and Environment**
- > State Government Department reporting to a Minister
- > Agency responsible for sustainability of natural and built environments - public land management, coasts, biodiversity protection, parks policy, fire management, land titles and administration, water management
- > About 2700 staff across Head Office and 5 regions

VicForests - role

- > Department of Sustainability and Environment provides VicForests with an area-based allocation
- > VicForests determines wood volume on allocated area
- > VicForests prepares a Timber Release Plan identifying individual coupes
- > TRP approved by DSE following assessment of non-timber values
- > VicForests engages harvest and haul contractors to harvest and deliver sawlogs and pulpwood to Sales Agreement holders
- > VicForests regenerates harvested coupes
- > VicForests reports back to DSE on area and volume harvested

VicForests – has it achieved its objectives?

- > VicForests was created by the Victorian Government to:
 - Undertake the sale and supply of timber resources and related management activities in Victorian State forests
 - Develop and manage an open and competitive sales system for State timber resources
 - Pursue other commercial activities as agreed by the Treasurer and the Minister (for Primary Industries)
- > VicForests has made a profit both financial years it's been in operation
- > VicForests has successfully taken over harvesting and haulage operations
- > VicForests has achieved certification to the Australian Forestry Standard
- > An open and competitive sales system has been introduced

VicForests – has it achieved its objectives?

- > Government and DSE perspective
- > The separation of the management, regulatory and commercial aspects of forest management only partially successful:
 - A number of roles undertaken by DSE (for example forest inventory) could be considered to have a commercial function
 - There is increase duplication between the land manager/regulator (DSE) and the operator (VicForests), particularly with road management
 - VicForests' commercial remit can inhibit other government priorities such as biodiversity protection
 - Another Government-owned monopoly was created
 - One small forest business was divided into two smaller businesses
 - DSE has not yet fully taken on its role as regulator (as opposed to manager) which creates unnecessary tension
- > Government receives a greater return from its timber resource
- > Government receives forest policy advice from 3 rather than 1 agency

VicForests – has it achieved its objectives?

- > Stakeholder perspective
- > Separation of commercial from management functions has not substantially changed environmental NGO's negative perception of native forest management – both DSE and VicForests are the enemy
- > Majority of community have no understanding nor concern about forest management arrangements. It is still under government control
- > The timber industry recognises a better alignment with VicForests' commercial focus
- > The industry has less opportunity to use the political process to resolve commercial disputes

Green politics

- > Numerous government processes and inquiries (including the RFAs) have failed to end the production – protection debate
- > Majority of Australian environmental NGOs continue to oppose native forest harvesting
- > Debate driven by a small number of activists
- > Debate is emotion driven and usually irrational
- > Lack of recognition of positive sides of native forest harvesting:
 - Carbon positive
 - Alternative to illegal rainforest hardwood imports
 - Social sustainability of rural communities
 - Scale of operations is very small (~ 5,000 ha out of 480,000 ha harvested annually)

Green politics

- > Consequence of debate is:
- > Native forestry a political football at every election
- > Over regulation by DSE
- > Precautionary principle
- > Irrational policies:
 - Biofuels
 - Charcoal production
 - Native hardwood excluded by 'green' building organisations
- > Poor stakeholder reputation as opponents tar VicForests with same brush as unsustainable, illegal operations

Science and forestry

- > VicForests advocating evidence-based decision making
- > Promotion of positive aspects of timber production
- > Carbon outcomes
- > Social and environmental sustainability
- > Much bigger environmental issues facing Australia and the world:
 - Greenhouse
 - Water
 - Deforestation of tropical forests
 - Air pollution in Asia

VicForests' role – to develop an open and competitive market

> Forests Commission Victoria

- Pre 1980s sawmills had exclusive allocated area rights with licences which specified the annual quantities and type of timber permitted to be harvested
- Early 1980s transition from allocated area rights to three year licences
- Sawlog pricing based on Royalty Equation System

> DSE (and its predecessors)

- Timber Industry Strategy (1986)
 - Resource reviews resulting in significant reductions to harvest levels.
 - Alignment of log grade specification and resource allocation based on purchaser's value adding performance, with longer term licenses (10 years)
 - Limited new entrants: New allocations of predominantly low grade logs by way of open sealed bid tenders.
 - Sawlog pricing based on revised Royalty Equation System

VicForests' role – to develop an open and competitive market

- > Administered system lacked flexibility to be responsive to incremental erosion of timber resources for other purposes, resulting in significant over-harvesting of the reduced forest estate, in the latter years.
- > Returns to the grower (royalties) negotiated in a political, not open market, commercial environment. Perception of corruption and low prices
- > Lack of competition to drive efficiencies in the industry and value adding by processors
- > Log allocation based on historical arrangements and renegotiated with existing customers, limited opportunities for new entrants
- > Impeded the development of private forestry
- > Inconsistent with National Competition Policy commitments

VicForests' role – to develop an open and competitive market

- > Our Forests Our Future
- > Objective to re-position the timber industry onto a sustainable footing with the reduced annual harvesting levels.
 - \$80 million for program implementation
 - Voluntary Licence Reduction Program
 - Contractor and timber worker exit packages
 - Transition projects for impacted rural communities
 - Investment in enhanced timber resource data
- > New Licensing and pricing system
 - Transition to market-based sawlog allocation and pricing
 - Allocate timber on a mix of short and long term supply arrangements

VicForests' role – to develop an open and competitive market

Specific Remit for VicForests:

- > To introduce a commercial market-based framework for the pricing and allocation of native forest timber products for future supply to timber processors.
- > Management of administered licenses transferred to VicForests from DSE.
 - Supply commitments extending out to 2014
 - Bulk of commitments cease in 2010
 - Influence on the amount of timber for sale at auction
- > Issue of “5 year step down” transition supply contracts to current processors
- > Development and management of an open and competitive sales system (Pricing Allocation Model: PAM)
- > Collection of sales revenue
- > Additional administrative supply for 5 years declining by 17% per annum from licence expiry
- > Reduce sawlog supply by another 10%
- > A requirement for bidders to meet OHS standards and for logs to be processed in Australia
- > Preclude companies who had received OFOF exit packages
- > Contractual provisions in 5 year TSA's linking administrative and future auction prices

D+ Supply 2005/2006 to 2014/2015



Objectives in creating an open and competitive market

- > Achieve allocative efficiency
- > Sustainable competition
- > Industry participation
- > Maximise revenue
- > Transparency and fairness

Why not undertake a tender?

- Transaction costs
- Lack of transparency
- Inability for bidders to react to price levels
- Concern about collusion
- Time lag between submission and contract award
- Complexity of evaluating mill door price bids

Price - Allocation Model

- > VicForests created the Price - Allocation Model (PAM) to achieve the objectives of creating an open and competitive market
- > PAM is a transparent and open market-based process for determining the way timber is priced and allocated to customers.
- > It replaces the administrative approach of renewable licences and collective bargaining approach to price setting
- > The model was implemented through an on-line auction system which was open to mill owners who:
 - pre-qualified for the auction
 - Nominated delivery destination
 - Passed independent credit assessment

What was to be auctioned?

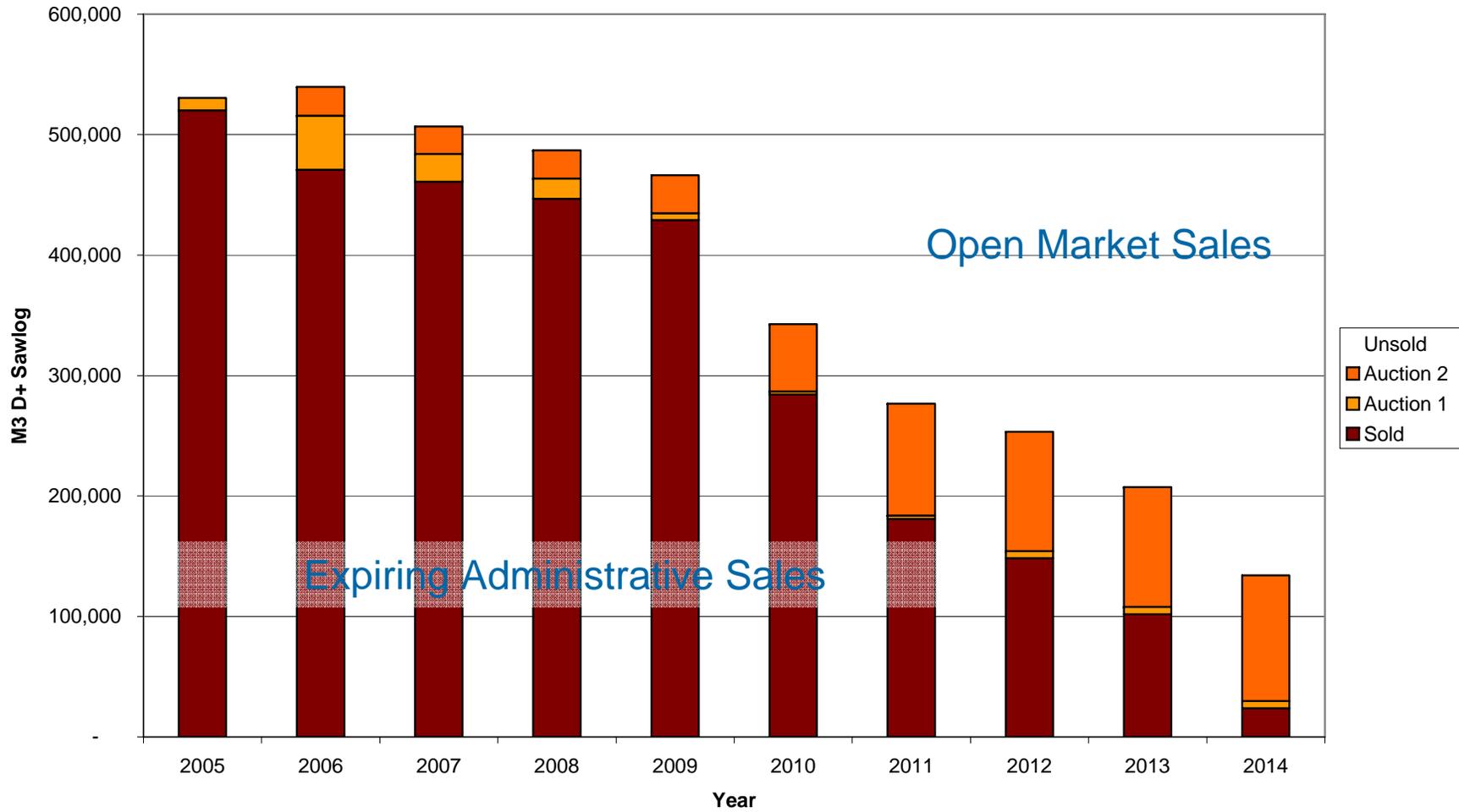
- > Timber lots were auctioned by location, species and grade for varying terms, up to 10 years

Lot Number	Zone	Species	Grade	m3/Yr	Contract Term	Contract Volume
1003	Benalla	Alpine Ash	C+	1000	2007-2009	2000
1004	Benalla	Alpine Ash	D	1500	2006-2007	1500

- > The point of sale was at the mill door rather than at stump. VicForests took over harvest and haul activities in July 2006 to coincide with delivery of first auctioned timber

Profile of 2006 auctions

D+ Supply 2005/2006 to 2014/2015



Auction design

- > Final design developed with an external system provider (BOMweb) and industry
 - Real Time Online Auction System
 - All bids updated in real-time
 - Bid guidance provided in real-time
 - Multi-Attribute Auction
 - Bids submitted as 'Mill Door Price'
 - Simultaneous Multi Round Auction
 - All Lots auctioned simultaneously
 - Bids must be placed in each round (Activity Rule)
 - Continuous Private Value Disclosure of single lots
 - Combinatorial Auction
 - Bidders can package lots to create new preferred lots
 - Bids on the package lots are compared against the single lots
 - Continuous Private Value Disclosure of package lots
 - Bid guidance on leading options provided in real-time

Auction page screen shot

Web site: <http://www.forestauctions.com>

Example of auction site:

VicForests **BOMweb**
Best Outcome Management

PROFILE | COMBINATIONS | REGISTRATION | **AUCTIONS** | PORTFOLIO | RULES | GLOSSARY | HELP | LOGOUT

Schedule
Download
Print
Bid History
Ceiling Bid
Activity History
Dashboard
Combination Summary

Auctions

ROUND INFORMATION						AUCTION INFORMATION				
Round	Start Time	End Time	Time Remaining	Next Round	Status	Start Time	End Time	Time Remaining	Server Time	
2 / 4	18 Apr 2006 16:57:00 AEST	19 Apr 2006 13:31:00 AEST	20h 28m 58s	24h 24m 58s	Active	18 Apr 2006 16:44:00 AEST	20 Apr 2006 17:45:00 AEST	48h 42m 58s	17:02:02 AEST	

	Type	Lot Number	Zone	Species	Grade	Qty (P.A)	Supply Period	▲ Pref	Bid Incr	Target Bid	STATUS				
											Lot	Activity	Capacity	Bid	Option
<input checked="" type="radio"/>	C	010000	BM-BM	AS-AA	D+	mix	2006-2011	1	\$1.05	\$98.89	<input checked="" type="radio"/>				
<input type="radio"/>	C	010001	NE-NE	AS-AA	C+	mix	2010-2015	2	\$1.52	\$125.70	<input type="radio"/>				
<input type="radio"/>	C	010002	CT-CT	mix	B	mix	2007-2015	3	\$1.90	\$108.90	<input type="radio"/>				
<input type="radio"/>	S(C)	001003	BM-BM	AS-AA	C+	1,000	2007-2009	4	\$1.62	\$113.63	<input type="radio"/>				
<input type="radio"/>	S(C)	001004	BM-BM	AS-AA	D	1,500	2006-2007	5	\$0.48	\$84.03	<input type="radio"/>				
<input type="radio"/>	S(C)	001005	BM-BM	AS-AA	C	750	2009-2011	6	\$1.43	\$101.46	<input type="radio"/>				
<input type="radio"/>	S(C)	002003	NE-NE	AS-AA	B	1,000	2010-2015	7	\$1.90	\$141.90	<input type="radio"/>				
<input type="radio"/>	S(C)	002006	NE-NE	AS-AA	C	2,000	2012-2015	8	\$1.43	\$131.43	<input type="radio"/>				
<input type="radio"/>	S(C)	002007	NE-NE	AS-AA	C	2,000	2011-2015	9	\$1.43	\$120.51	<input type="radio"/>				
<input type="radio"/>	S(C)	003002	CT-CT	AS-AS	B	1,300	2007-2008	10	\$1.90	\$103.26	<input type="radio"/>				
<input type="radio"/>	S(C)	003005	CT-CT	AS-AA	B	4,000	2010-2015	11	\$1.90	\$156.39	<input type="radio"/>				
<input type="radio"/>	S(C)	003006	CT-CT	AS-AA	B	3,000	2011-2013	12	\$1.90	\$105.13	<input type="radio"/>				
<input type="radio"/>	S(C)	003009	CT-CT	AS-AS	B	1,500	2010-2013	13	\$1.90	\$102.95	<input type="radio"/>				

BID INFORMATION						CAPACITY INFORMATION				
Lot	Ceiling Bid	Auto Submit	Submitted Bid	Target Bid (Auction)	Target Bid (Option)	Auction Quantity	Maximum Quantity	Auction Value	Maximum Value	Activity Level
010000	-	-	\$97.85	\$98.89	\$98.89	11,500	15,000	\$1,309,500.00	\$2,250,000.00	16,050

Logged in: miller1
User type: bidder

SUBMIT BID **REFRESH**

Results – First Auction – February - March 2006

> Resource Release

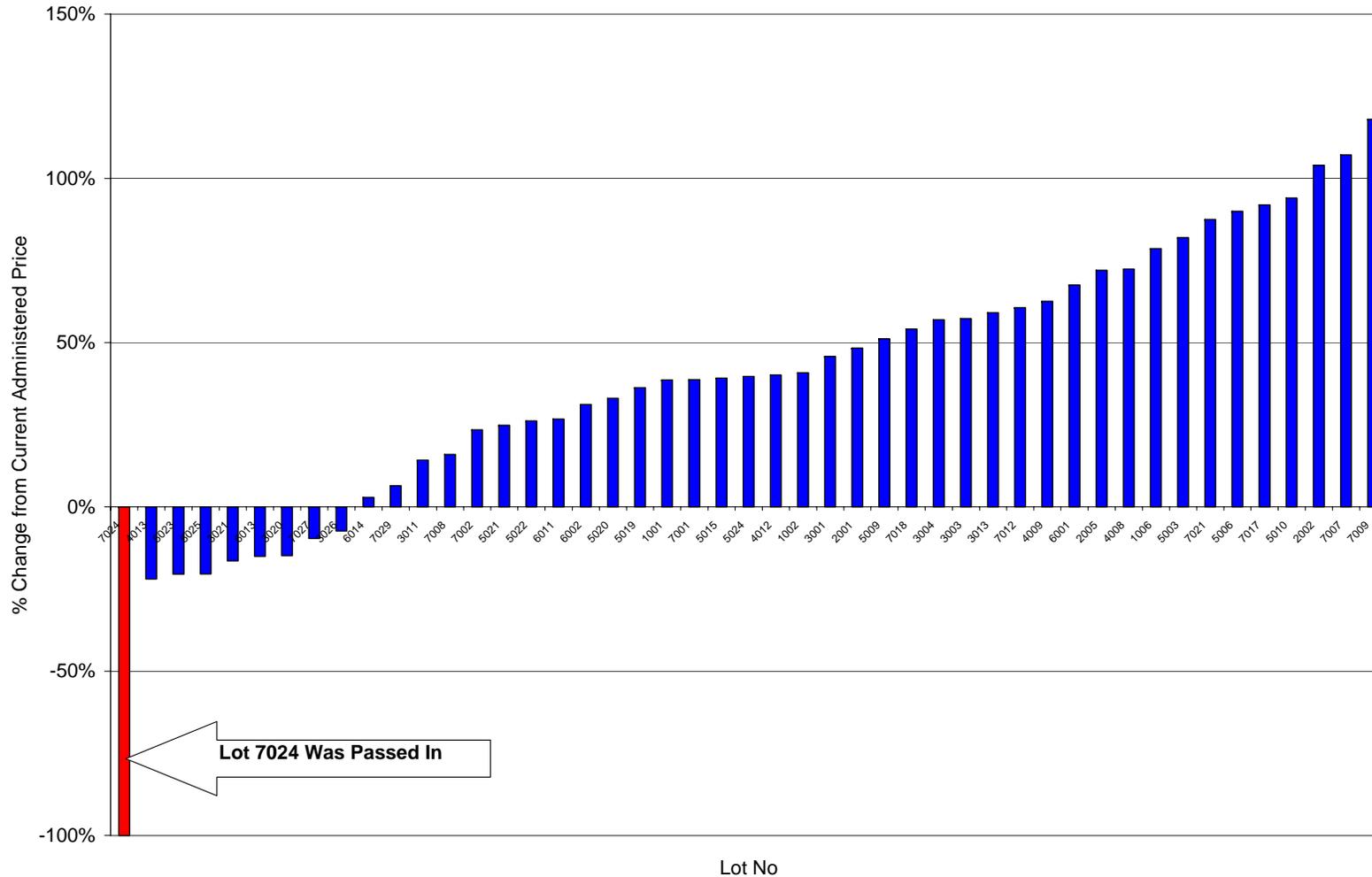
- Two auctions in 2006 for contracts between 1 and 9 years
- Subsequent auctions each year to maintain competitive environment, retain ability to respond to changing conditions.

> First auction results

- 47 lots
- 174,000m³ total
- 46 of 47 lots sold
- 18 of 36 bidders successful
- Weighted average prices +40% administered price
- Additional \$3M in revenue over 10 years

OnLine Auction 1 Results - % change from current administered price

OLA 1 - 2006 Auction Outcomes
% Change from Current Stumpage Price



Results – Second Auction – Mary – June 2006

- 71 lots
- 680,000m³ total
- 62 of 71 lots sold
- 19 of 33 bidders successful
- Weighted average prices +59% administered price
- Additional \$17M in revenue over 10 years

Objective One – Allocative efficiency

- > The resource was allocated to those with the highest willingness to pay
- > Auction complexity in the second auction, auction defaults and unsold lots had some detrimental impacts on achieve optimal allocative efficiency

Objective Two – Sustainable Competition

- > No evidence of collusion or anti competitive behaviour
- > Uneven market power

Objective Three – Industry Participation

- > Strong participation from incumbent firms
- > Few new entrants
- > Some impediments in training costs and lack of future timber resource information

Objective Four – Revenue Maximization

- > Very high prices
- > Need to be considered in context of small volume sold and marginal pricing
- > Are they sustainable?

Objective Five – Transparency and Fairness

- > Pricing and allocation full disclosed
- > Auction rules were consistent for every one.
- > Not all in the same starting position

Auction system - Lessons learnt

- > Appropriately designed auctions are very effective method of resolving pricing and allocation issues
- > No possible without a capable solution provider and the engagement of buyers
- > Property rights, auction rules and competitive position of buyers influence the result
- > You can outsmart yourself with complexity