
Forestry Commission of New South Wales (trading as Forests NSW)

AUDIT OPINION

The audit of the Commission's consolidated financial report for the year ended 30 June 2008 resulted in a qualified Independent Auditor's Report. The qualification related to the valuation of biological assets.

The Commission made various assumptions relating to the valuation of native forests. We were unable to confirm the assumptions used were statistically reliable. The auditor's report for 2007 was similarly qualified.

The Independent Auditor's Report also drew attention to the Commission's deferred tax liability. The Commission intends to obtain a private ruling from the Australian Taxation Office over the deductibility of plantation establishment costs for biological assets. Until the outcome of this matter is known there is uncertainty over the deferred tax liability recorded in the financial report.

The audit of the Forestry Commission Division's financial report for the year ended 30 June 2008 resulted in an unqualified Independent Auditor's Report.

KEY ISSUES

Native Forest Valuation (Repeat Issue)

We recommend the Commission review and modify its valuation model for native forests.

The present valuation model for native forests incorporates the use of statistical sampling. The nature of native forests creates practical difficulties in obtaining the necessary precision to confirm the reliability of valuation results. These difficulties arise from the variability of the species and shape of the trees; restrictions on logging due to legal, environmental and other factors; variations in the quality and nature of the products resulting from the harvest; and difficulties in estimation of the total estate based on sample measurements. We note that considerable effort has gone into review of the valuation model during the year including input from expert forest valuation consultants.

The Commission advised it is continuing its review of the valuation model in 2008-09. At 30 June 2008, native forests were valued at \$333 million.

Softwood Plantation Valuation

Last year we recommended the Commission continue reviewing and validating its valuation model for softwood plantations. This was satisfactorily completed this year. We believe an annual validation of the model is essential to ensure its relevance and integrity are maintained.

Compliance with Regional Forest Agreements

As reported in our 2007 Report, the Commission is a party to the Regional Forest Agreements (RFA) under the *Forestry and National Park Estate Act 1998* for the Eden, Upper and Lower North East Regions and Southern Region. These agreements are 20-year plans to achieve a balance between conservation and sustainable management of the Commission's native forests. The intentions include:

- reducing uncertainty in the forest industry and avoiding duplication of government processes for land use decision making
- providing long-term solutions that meet the requirements of government, the community and industry, while also being consistent with the principles of ecologically sustainable development
- the equitable balance of competing objectives and coordinating the policies and activities of government.

The RFAs are underpinned by the Forest Resource and Management Evaluation System (FRAMES), a forest inventory system that provides information about timber available for harvest. In addition to calculating the sustainable harvest under the RFAs, this system determines the value of forests and plantations for reporting purposes.

Last year we noted some areas of non compliance with RFA milestones. The Commission advised that it is addressing areas of non compliance.

PERFORMANCE ISSUES

Financial Performance as a Government Trading Enterprise

The Productivity Commission's *Financial Performance of Government Trading Enterprises 2004-05 to 2006-07* provides information on the financial performance of the Commission and the Australian forestry industry. The report states only two of the six forestry Government Trading Enterprises (GTEs) in Australia achieved a return that exceeded the risk-free benchmark return on assets. The Productivity Commission suggests the remaining forestry GTEs including Forests NSW, are not operating on a commercially viable basis. We note, however, that the different GTEs manage different types of forests and value their forest assets in significantly different ways.

The risk free rate of return on a ten-year Australian Government bond was 5.8 per cent (2006-07). The Commission's return on assets in 2006-07 was three per cent.

The following table compares the Commission's performance indicators with the whole of sector performance.

Performance Indicators	Commission			Whole of Forestry Sector		
	2007	2006	2005	2007	2006	2005
Return on assets (%)	3.0	7.5	3.8	2.4	8.5	5.2
Return on total equity (%)	3.2	3.1	0.6	0.5	2.4	1.2
Debt to equity (%)	15.6	19.4	19.7	22.0	24.0	20.0
Current ratio (%)	67.1	64.0	49.9	133.7	126.5	86.7
Dividend to equity ratio (%)	1.8	3.4	3.9	3.5	4.3	4.2

Source : Productivity Commission - Financial Performance of Government Trading Enterprises 2004-05 to 2006-07.

OTHER INFORMATION

New South Wales Greenhouse Abatement Certificates (NGACs)

The Commission started trading in the NGACs market in 2005. The Commission advised that the spot market prices in the New South Wales scheme have been volatile and few or no reliable trends have been observed. Forecasting price and volume movements over time has been difficult as the market is immature. Carbon security prices in other countries are currently higher than in Australia, which has led to expectations of increased prices on domestic markets in the longer term.

As at June 2008, the Commission held one million certificates and the annual sales of NGACs generated \$133,000. This is well below sales of NGACs for 2007 of \$9.6 million. The Commission advised the reasons for this significant fall include:

- changed market conditions - the announcement of the Federal Carbon Pollution Reduction Scheme has created significant uncertainty about the future of the New South Wales Green House Gas Scheme
- market price and demand - demand is low and the market has a significant supply of unsold NGACS
- a reluctance by the Commission to sell its carbon securities at low prices given the obligation for it to maintain plantations linked to these carbon securities for 100 years.

In its Statement of Business Intent 2008, the Commission stated it will investigate possible options to participate in various carbon trading schemes, as well as direct and voluntary market sales opportunities. These efforts will be consistent with a defined carbon marketing strategy to identify increased revenues and offset the New South Wales scheme market volatilities.

Softwood Plantation Residue (Repeat Issue)

When softwood plantations are harvested by the Commission, the harvested trees are sold as sawlogs or pulp depending on availability of markets. Residue from harvesting operations is not used, but piled in windrows and burnt before an area is replanted. The Commission advised that until the residue is burnt, it provides environmental and silvicultural values including reduced erosion, improved soil conditions and better growth of the next crop. Management confirmed the residue is not used because:

- there is currently a limited market for residue
- the logs do not meet saw mill specifications
- the logs contain internal rot, knots or are fire damaged.

The Commission is not able to accurately quantify the extent of residue as it does not conduct formal surveys after a harvest.

As one of its business development initiatives, the Commission has finalised plans for a feasibility study into the collection and processing of residue from the harvesting of softwood plantations in the Macquarie Region. A two-year timeframe to complete the study is proposed. A two-stage tender was run from April to October 2008, and a contract has been issued to the successful proponent. We also note that the residue in the Monaro Region was successfully tendered to the third party customers and 75 per cent of the residue in the Hume Region is under a long term supply contract to a customer.

Financial Performance

The following table shows the Commission's performance over the last three years and its financial targets per its 2008 Statement of Business Intent:

Year ended 30 June	Actual	Target	Actual	
	2008 \$'000	2008 \$'000	2007 \$'000	2006 \$'000
Profit/(loss) before tax	117,651	40,916	(138,320)	11,420
Dividend provided	1,000	16,000	16,000	26,332
Income tax expense/(credit)	37,279	(9,177)	(39,965)	8,584

The Commission's financial performance was significantly affected by a fair value increment of \$80.0 million for biological assets in 2008 (\$173 million in 2007). This also resulted in the dividend provided and income tax expense being significantly different to target.

Other Control Issues

We have identified areas where opportunities exist to improve internal controls. These areas have been discussed and reported to the Commission.

FINANCIAL INFORMATION

Abridged Income Statements

Year ended 30 June	Consolidated		Parent	
	2008 \$'000	2007 \$'000	2008 \$'000	2007 \$'000
Sale of timber and related activities	252,848	223,621	252,848	223,621
Other	40,947	46,929	40,947	46,929
TOTAL REVENUE	293,795	270,550	293,795	270,550
Contract harvest and haulage	113,038	94,306	113,038	94,306
Employee related	83,525	73,863	83,525	73,863
Change in fair value (increment)/decrement biological assets	(79,959)	172,641	(79,959)	172,641
Other	59,540	68,060	59,540	68,060
TOTAL EXPENSES	176,144	408,870	176,144	408,870
PROFIT/(LOSS) BEFORE TAX	117,651	(138,320)	117,651	(138,320)
Income tax expense/(credit)	37,279	(39,965)	37,279	(39,965)
PROFIT/(LOSS) AFTER TAX	80,372	(98,355)	80,372	(98,355)

Profit before including market value increments and decrements and tax, increased by \$3.3 million in 2008 mainly due to increased sales of sawlogs and contract and haulage revenue.

Abridged Balance Sheets

At 30 June	Consolidated		Parent	
	2008 \$'000	2007 \$'000	2008 \$'000	2007 \$'000
Current assets	75,253	75,057	75,253	75,057
Non-current assets	2,727,493	2,628,856	2,727,493	2,628,856
TOTAL ASSETS	2,802,746	2,703,913	2,802,746	2,703,913
Current liabilities	73,660	113,401	61,963	102,398
Non-current liabilities	731,445	669,407	743,142	680,410
TOTAL LIABILITIES	805,105	782,808	805,105	782,808
NET ASSETS	1,997,641	1,921,105	1,997,641	1,921,105

COMMISSION ACTIVITIES

The Commission is a corporation sole constituted by the *Forestry Act 1916*. Its objectives include:

- conserving and utilising the timber on Crown-timber lands and other land it controls
- supplying timber from these lands for building, commercial, industrial, agricultural, mining and domestic purposes
- preserving and improving, in accordance with good forestry practice, the soil resources and water catchment capabilities of these lands
- identifying and meeting new market opportunities in wood supply, energy, carbon sequestration and third party investments which are seen as complimentary activities to traditional forestry.

It manages approximately two million hectares of native forests across New South Wales. With the largest areas concentrated on the coast and coastal escarpment. The dominant trees are more than 270 species of eucalypts. The Commission has established softwood and hardwood plantations to complement these native forests. These include approximately 192,711 hectares allocated to softwood plantations and approximately 27,353 hectares of hardwood plantations.

The Commission is a controlled entity of the Department of Primary Industries. It is subject to the control and direction of the Minister for Primary Industries, except in relation to the contents of a recommendation or report made by it to the Minister.

For further information on the Commission, refer to www.dpi.nsw.gov.au/forests.

CONTROLLED ENTITY

The following controlled entity has not been reported on separately as it is not considered material by its size or the nature of its operations to the consolidated entity.

Entity Name

Forestry Commission Division
