A target Return on Equity for Forestry Tasmania

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Executive Summary

i. The state should expect a total return from Forestry Tasmania of around $43 million each year from its commercial forestry operations.
ii. ForestrySA, the South Australian forestry corporation, returned $45 million to the state in 2010 from a smaller revenue and sales base than Forestry Tasmania.
iii. The actual return to the state by Forestry Tasmania has been zero for three of the last four years, and was only $1.3 million in the year in which it was positive. Management of 'non-commercial zones' costs at most $9 million each year and thus does not explain the significant underperformance against target. Needing higher sales volume is also not Forestry Tasmania's problem, as the South Australia example illustrates.
iv. If Forestry Tasmania was performing to target, its $43 million contribution to state finances would finance 500 public sector jobs at $87,000 each.

Forestry Tasmania's current Return on Equity

Return on Equity ("ROE") measures whether owners are getting a decent return on their investment. It looks at the size of profit being generated compared with the equity (or net assets, i.e. the assets after liabilities are deducted) of the business.

The Auditor General reports on the ROE achieved by Forestry Tasmania each year. In calculating the ROE, the Auditor General makes a large number of adjustments, including removing any costs attributable to non-commercial zones and removing accounting valuation adjustments, superannuation costs and tax.

The ROE calculated by the Auditor General is therefore a commercial ROE – it has already been adjusted to reflect all non-commercial obligations of Forestry Tasmania. It can therefore be compared with pre tax ROEs achieved by commercial organisations. The Auditor General's ROE figures are shown below.

Table 1 Forestry Tasmania ROE achieved since 2007

	2007	2008	2009	2010
Profit after adjustments listed above - $000's	5,112	8,567	18,346	1,265
Total equity - $millions	586	548	582	275*
Return on Equity	2.4%	3.1%	3.2%	0.3%

** Note that Forestry's equity has reduced by some $300 million between 2009 and 2010. This is due to a change in accounting policy whereby the value of Crown Land is no longer included as part of Forestry Tasmania's assets or equity. The effect of this will be to make achieving a target ROE much easier, as the equity is much lower. As Forestry Tasmania does not pay for or lease the Crown Land, unlike other commercial forestry operations, this change should be accompanied by an increase in the target ROE.*

The ROE achieved by Forestry has ranged from 0.3% to 3.2% over the last four years. Over the last 12 years it has ranged from -1.6% to 4.0%. It has never achieved the risk free rate (the rate that could be achieved by investing in government bonds).

The ROE target should also reflect how profit and equity are calculated. There are a number of aspects of the Auditor General's ROE calculation that make it somewhat generous to Forestry Tasmania:

- The annual costs of Forestry Tasmania's defined benefit super scheme (ignoring actuarial gains or losses) are excluded from the profit result. This has inflated the reported ROE above by about 1.4%.
- That component of the fall in the forest valuation which relates to current year activities has also been excluded from the ROE calculation. Again, this may have inflated the reported ROE above.

In the attachment I consider different methods for setting target Returns on Equity. These range from 8.1% to 12.5%. Historically, the Tasmanian Treasury has set a target ROE for GBE's of around 12.0% with adjustments depending on the riskiness of the industry.

Comparison of Forestry Tasmania with ForestrySA

The South Australian Forestry Corporation ("ForestrySA") is a public corporation (similar to a GBE) established in 2001 to manage the commercial state forests in South Australia. It is useful to compare the performance of the two forestry GBE's as they had very similar forest revenues in 2010 ($135 million for FT versus $126 million for ForestrySA). Their operations are therefore of a similar scale.

Table 2 Forestry Tasmania versus ForestrySA

	ForestrySA		**Forestry Tasmania**	
	2009 $ m	2010 $m	2009 $m	2010 $m
Forest sales revenues	108	126	155	135
Costs	85	87	161	158
Return to state (dividend plus tax paid)	23.2	44.8	nil	nil
Pre Tax ROE	9.3%	11.5%	3.2%[1]	0.3%[1]

Note 1 The ForestrySA ROE is an unadjusted ROE, taken directly from the pre tax net profit divided by equity. It therefore includes the movement in the biological asset valuation. By contrast, the Forestry Tasmania ROE calculated by the Auditor General has been heavily adjusted to eliminate superannuation costs, changes in the value of the commercial forests and so on.

Looking at 2010, the difference in return to state and ROE achieved by the two GBEs is startling. From a sales base of only $126 million, ForestrySA returned $44.8 million to the state, and achieved an ROE of 11.5%.

Note that ForestrySA's 2010 balance sheet, on which these numbers are based, does include the value of crown land as an asset. If the value of crown land was removed from the balance sheet, as it has been for Forestry Tasmania in 2010, then the ROE achieved by ForestrySA would be considerably higher than the numbers shown above (17.5% and 15.4% in 2010 and 2009).

Defining a target ROE for Forestry Tasmania

Should the government adopt a commercial ROE target for FT, then it could either:

- Adopt a pre tax ROE target of 9.5% that includes some reflection of the value of the land used for commercial forestry operations (either through a lease payment or including the commercial land value in the balance sheet); or
- Adopt a pre tax ROE of 12.5% (at the higher end of the scale) that reflects the gratis use of the crown land in commercial zones.

In 2010-11 this would give a return to the state in the range of $34 to $52 million. This appears reasonable in light of ForestrySA's return of $45 million in 2010 from a slightly lower revenue base.

If we take a mid-point target return to the state of $43 million, we can consider this in light of funding for public servants, including nurses and police. The government uses $87,000 as the average cost of a public service worker. An annual return of $43 million from Forestry Tasmania (rather than the 2010 loss of $8 million or more) would fund about 500 workers.

Holding Forestry Tasmania financially accountable

It is currently extremely difficult to hold Forestry Tasmania accountable to a measure of financial performance because of the near continual change in accounting treatments, definitions used for financial ratios, asset valuation methods and so on. For example, in the determination of Forestry's 2010 ROE the equity amount is based on the start year value (which includes land values). Subsequent ROEs will exclude land values and therefore will double, other things being equal. However no lease payment is included in the accounts, meaning that Forestry Tasmania has full use of the land for commercial purposes with neither rental to pay nor an obligation to generate a return on the value of the land.

Either way, once a target ROE is set and its calculation method agreed, both should be held stable for as long as possible to enable year on year comparison of returns and to enable accountability of Forestry Tasmania. Accounting treatment of superannuation costs and forest assets should be stabilised with current year costs taken to profit and assumption changes taken to comprehensive income.

Removal of non-commercial zones from Forestry's management would greatly simplify the number of adjustments required to assess Forestry's performance.

Attachment - Methods for setting target ROE

The cost of equity capital is typically determined using the Capital Asset Pricing Model (CAPM), where the cost of equity capital equals the prevailing 10 year Commonwealth bond rate (presently about 5.5%) plus a risk premium. The Tasmanian Treasury has historically recommended the use of a 6.5% risk premium adjusted for the relative risk of the investment when compared to the market as a whole. This is at the higher end of the traditional risk premium range of 4% to 7%, which gives a target ROE range of between 9.5% and 12.5%.

Thus the pre tax cost of equity capital would range between 9.5% and 12.5% before tax for government businesses depending on the relative risk of the particular business compared to the market as a whole.

Another method of considering suitable target ROE's is to look at Forestry's asset valuation methods. Forestry Tasmania carries its forest assets at a 'fair value' valuation that uses forecast net cash flows discounted at a market determined rate. The market determined discount rate is, in essence, the return that a buyer of Forestry's assets would expect to generate on the assets over their lifetime. It is effectively an ROE. In its 2010 accounts Forestry Tasmania used a pre-tax real discount rate of 8.10% (2009: 9.00%). By carrying its forest assets at a valuation using an 8.1% discount rate, Forestry should be able to generate an 8.1% return on those assets each year.

Finally, we can also consider actual ROE's achieved in other companies. The average net of tax ROE achieved by ASX500 companies over the five years to 30 June 2010 was 6.0% or about 9.0% gross of tax. This period includes the entire period of the global financial crisis.

Table 3 Different methods of setting target ROE

	Target pre tax ROE
Using finance theory – CAPM	9.5% to 12.5%
Using Forestry Tasmania's forest asset discount rate	8.1%
Using ASX500 average ROE over last 5 years	9.0%

A target pre tax ROE of 9.5% for Forestry Tasmania would be a reasonable target – lower than that suggested by Treasury and CAPM modelling but very close to the average ROE achieved by ASX500 companies over a five year period that included the GFC.