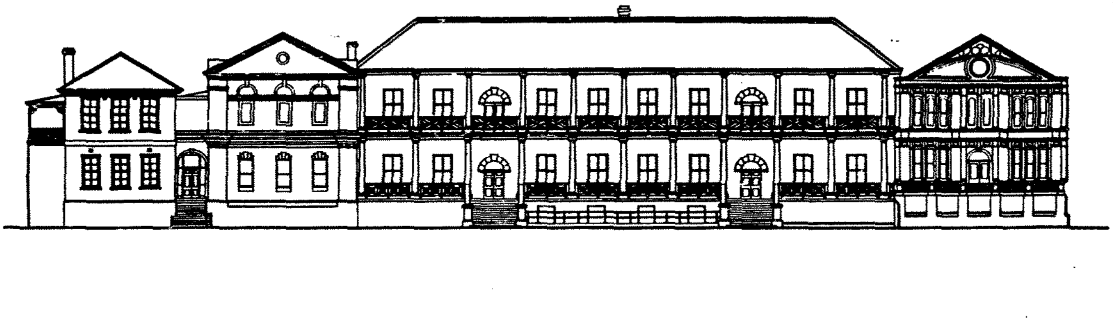
PUBLIC ACCOUNTS COMMITTEE

State Forests of NSW

Inquiry into the Practice of Trading with Customers who have Defaulted on Renegotiated Repayment Terms



Report No. 142

December 2002

[No. 24/52]

This report was compiled using *Word 97*

and printed by the Parliamentary Printing Services.

This report will also be available on the Internet via:

http://www.parliament.nsw.gov.au

New South Wales Parliamentary Library cataloguing-in-publication data:

New South Wales. Parliament. Public Accounts Committee

State Forests of NSW : inquiry into the practice of trading with customers who have defaulted on renegotiated repayment terms : [report] / Public Accounts Committee. [Sydney, N.S.W.] : The Committee, 2002. – ii, 27 p. ; 30 cm. (Report ; no. 142 / Public Accounts Committee) ([Parliamentary paper] ; no. 24/52)

At head of title: Parliament, NSW.
"December 2002".
Chair: Joseph Tripodi.

ISBN 0 7347 6623 8

1. State Forests of New South Wales—Customer services.
2. Payments—New South Wales.
3. Forests and forestry—New South Wales—Financial aspects.

I. Title.
II. Tripodi, Joseph.
III. Series: New South Wales. Parliament. Public Accounts Committee. Report, no. 142
IV. Series: Parliamentary paper (New South Wales. Parliament) ; no. 52/24

DDC 333.75

Table of Contents

Charter of the Committee

The Public Accounts Committee has responsibilities under the *Public Finance and Audit Act 1983* to inquire into and report on activities of government that are reported in the State's Public Accounts and the accounts of the State's authorities.[1] The Committee, which was established in 1902, scrutinises the actions of the Executive Branch of Government on behalf of the Legislative Assembly.

The Committee recommends improvements to the efficiency and effectiveness of government activities. The sources of inquiries are the Auditor-General's reports to Parliament, referrals from Ministers and references initiated by the Committee. Evidence is primarily gathered through public hearings and submissions. As the Committee is an extension of the Legislative Assembly, its proceedings and reports are subject to Parliamentary privilege.

Members of the Committee

The Committee comprises members of the Legislative Assembly and assumes a bi-partisan approach in carrying out its duties.

Chairman:	Joseph Tripodi MP, Member for Fairfield
Vice-Chairman:	Pam Allan MP, Member for Wentworthville
Members:	Ian Glachan MP, Member for Albury
	Katrina Hodgkinson MP, Member for Burrinjuck
	Richard Torbay MP, Member for Northern Tablelands
	Barry Collier MP, Member for Miranda

[1] See Part 4 of the Act – The Public Accounts Committee.

Committee Secretariat

Secretariat members involved in the Inquiry were:

Committee Manager:	David Monk
Project Officer:	Vicki Buchbach
Committee Officer:	Jacqui Isles
Assistant Committee Officer:	Mohini Mehta
Advisor to the Committee	John Viljoen

To contact the Committee:

Public Accounts Committee	Telephone (02) 9230 2631
Parliament House	Facsimile (02) 9230 2831
Macquarie Street	E-mail pac@parliament.nsw.gov.au
Sydney NSW 2000	

Chairman's Foreword

The Auditor-General reports to Parliament each year on the results of the financial audits of agencies. One long-running issue in relation to State Forests has been the inconsistent application of its credit policy to debtors. Several clients of State Forests have been allowed to renegotiate their payments outside the credit policy.

The Auditor-General's concerns were this approach placed excessive risk on State Forests, as well as placing other firms at a competitive disadvantage.

The Committee's functions include following-up Auditor General's reports. The Committee resolved to include this issue in its follow-up program for 2002.

State Forests has very wide powers as to how it manages New South Wales' forest resources and argued that it made these decisions to protect regional jobs. The agency takes its wider responsibilities seriously and issues a "triple bottom line" report that provides economic, social and environmental indicators. The report includes indirect forestry jobs as a social indicator.

However, credit policies are commercial instruments. They are designed to make commercial decisions, rather than to pursue social goals. Accordingly, the Committee has recommended that State Forests consistently apply its credit policy in future. It can address regional employment through a specific program based on good program design principles.

I would like to thank State Forests and the Audit Office for assisting the Committee during the inquiry. I would also like to thank John Viljoen on the secretariat, who researched and drafted the report.

Joe Tripodi

Joseph Tripodi MP
Chairman

Chapter One

Introduction

Terms of reference

Under its powers to follow-up Auditor-General's reports under section 57(1) of the *Public Finance and Audit Act 1983,* the Public Accounts Committee resolved to inquire into State Forest's practice of continuing to trade with customers who have defaulted on renegotiated repayment terms. This matter was raised in the *Auditor-General's Report to Parliament 2001 – Volume 7.*

The Committee was also interested in State Forest's ability to manage its debtors and minimise the risk of financial loss through continuing to trade with customers who have defaulted on renegotiated repayment terms.

Background

State Forests of NSW is the registered business name of the Forestry Commission of NSW. It is constituted by the Forestry Act 1916 under which it has extremely wide objectives and powers.

Its objectives include:

- conserving and utilising the timber on Crown-timber lands and land owned or under its control or management to the best advantage of the State;
- providing adequate supplies of 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 those lands;
- promoting and encouraging forest use for recreation and conservation of birds and animals; and
- taking all practicable steps considered necessary or desirable to ensure the preservation and enhancement of the quality of the environment.

Source: Forestry Act 1916

Its powers include:

- controlling and managing State forests, timber and flora reserves in a manner that best serves the public interest and establishing, maintaining and improving plantations of indigenous species and exotic species of trees;
- controlling the utilisation, sale and disposal of timber and associated products; and
- constructing, purchasing or taking on lease or licence sawmills, factories or

other premises for the purpose of enabling it to carry out any operation together with such plant, machinery and equipment as may be necessary for the purpose of enabling it to carry out any such operation.

Source: Forestry Act 1916

Auditor-General's Reports to Parliament

The matter of State Forests allowing some of its customers to accumulate debts and then negotiate repayment terms has been a long running issue and was first reported by the Auditor-General in 1998.

Auditor-General's Report to Parliament 1998

The Auditor-General reported that two mid north coast timber companies were not paying royalties for timber within trade terms and that this had contributed to an increase in receivables.

He reported that these customers had been adversely impacted by the Comprehensive Regional Assessments/Regional Forest Agreements (CRA/RFA) process and according to State Forests were likely to be eligible for compensation under the Forest Industry Structural Adjustment Package.

State Forests continued to supply these customers, increasing their outstanding balances by $1.7 million. The Auditor-General had concerns that these arrangements had the same effect as interest free loans which gave them an advantage over their competitors.

He advised that one of the debtors had almost completed negotiations for the sale of its business and that State Forests believed its interests were being adequately protected. State Forests held a guarantee for $380,000 from one of the customers.[2]

Auditor-General's Report to Parliament 1999

The Auditor-General reported that State Forests had negotiated repayment terms with one of the companies, but that the debt with the other company had increased to $1.7 million. This company had started to meet its current payment obligations during early 1999, but repayment terms for timber deliveries prior to this had not been agreed.

Despite holding a security of $395,000, the Auditor-General believed State Forests was exposed to this customer and reiterated his concerns that the arrangements for these two companies amounted to an interest free loan, which was a benefit not available to their competitors.[3]

---

[2] Auditor-General, *Auditor-General's Report to Parliament 1998*, Volume 3, Sydney, 1998, p432

[3] Auditor-General, *Auditor-General's Report to Parliament 1999*, Volume 3, Sydney, 1999, p281

Auditor-General's Report to Parliament 2000

The Auditor-General reported that the total balance outstanding for both companies as at January 2001 was $2 million. Of this, $1.6 million was over 90 days old. State Forests had negotiated repayment terms with both companies and repayments (including interest on the larger debt) were being received in compliance with these terms.

Despite the financial difficulties these debtors were obviously facing, State Forests was satisfied that the provision for doubtful debts of $30,000 at 30 June 2000 was adequate.

The Auditor-General considered that competitors of the two companies may view the situation as providing the companies with an unfair competitive advantage. State Forests had received a complaint to this effect.[4]

Auditor-General's Report to Parliament 2001

The Auditor-General reported that an increasing number of customers appeared to be failing to pay royalties for timber within trade terms. The practice of allowing customers to accumulate debts and then negotiate repayment terms was extended during the year to another customer who had accumulated debts of $3.8 million at 30 June 2000.

Because of repayment difficulties, State Forests had fully provided for this balance as a doubtful debt, but continued to trade with the customer after negotiating repayment terms.

The Audit Office was not convinced that the negotiated terms would recover the debt because the customer was not complying with the repayment terms. On 28 January 2002, State Forests suspended supply and the agreement with the customer because the debt had increased to $6 million.

The Auditor-General advised that the debtor had since gone into voluntary administration and State Forests was investigating avenues to recover the moneys owed. Another customer, while paying for current purchases, had defaulted on payment of debts from previous years, despite negotiated repayment terms being in place. The amount involved was approximately $1 million.[5]

The Inquiry

This long running issue appeared to be deteriorating each year. As a result, the Public Accounts Committee wished to get an understanding of the circumstances giving rise to the increasing level of doubtful debts and find out what State Forests was doing to recover these amounts and prevent the situation from getting worse.

---

[4] Auditor-General, *Auditor-General's Report to Parliament 2001*, Volume 1, Sydney, 2001, p107

[5] Auditor-General, *Auditor-General's Report to Parliament 2002*, Volume 1, Sydney, 2002, p48

The Committee sought written submissions from State Forests and held a hearing in Sydney on 24 October 2002. The names of the companies concerned have not been used in this report because the Committee does not want to jeopardise recovery procedures or cause financial disadvantage or adverse consequences for the parties concerned.

At the hearing, the Audit Office reconfirmed its concerns with the practice adopted by State Forests:

> **Mr COLLIER:** What were your specific concerns about these trading practices and what risks, if any, did they create for the agency?
>
> **Mr WHITFIELD:** Well, the specific concerns related to the fact that they were continuing to trade with these agencies allowing them to keep their debt going, not charging interest, so that it could appear that they were giving those customers a commercial advantage over other customers. In fact they were acting as a pseudo-banker for those particular customers. The risk that has come to bear is that ultimately a number of those debts had to be written off and not recovered.
>
> **Mr COLLIER:** So you had a pseudo-banker not charging interest?
>
> **Mr WHITFIELD:** Well, basically that is what was happening: You are trading with someone, they are in default, you are not charging them interest, they are using your money to continue their operation and there is a higher risk of not being repaid.[6]

State Forests does charge interest and penalty interest on overdue accounts. However, this is not necessarily applied on a consistent basis or at a uniform rate. The rate of interest and/or penalty interest charged is dependent on State Forests' assessment of the credit risk of the customer.

> **Mr GLACHAN**: You do charge them interest if they owe you money?
>
> **Dr SMITH**: Yes. It varies, but in the main, particularly in the last couple of years, there have been interest rate penalties put on our customers, and that rate varies considering what we consider to be the risk to that customer.
>
> **Mr COLLIER**: So you are saying the higher the interest rate, the higher risk?
>
> **Dr SMITH**: Yes, basically. There are some variations to that where it is stepped up in time depending what the debt is, but it is also matched against a guarantee. The majority of our customers have some form of cash guarantee that actually are in a risk category and, as I said, the fall-back position is basically the term agreement.[7]

---

[6] Deputy Auditor-General, Audit Office of NSW, transcript of hearing, 24 October 2002, p1

[7] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002, p8

Chapter Two

Customer A

What Happened

In a written submission to the Committee, State Forests outlined what happened with Customer A, a softwood processor.

Customer A had accumulated debts of $3.8 million at 30 June 2001. Because Customer A was not making payments against this debt, State Forests became concerned about the customer's ability to pay and fully provided for the balance owing as a doubtful debt in its financial report.

State Forests' Financial Policy for Credit Management requires that:

> A receivable must only be recognised as a doubtful debt if it is probable State Forests will not receive the amount. State Forests must ensure the appropriate steps are taken to manage the credit exposure.[8]

State Forests continued to trade with Customer A, however, after renegotiating repayment terms a number of times. This effectively extended Customer A's repayment period significantly beyond the period granted to other customers under State Forests' normal trade terms.

During this time the debt continued to grow, the renegotiated payment terms were not met, and by the end of January 2002 the debt had increased to $6.0 million.[9]

The repayment plan was renegotiated with Company A six times. Up until the final repayment plan was negotiated, State Forests continued to calculate and charge interest and penalties on the overdue amounts:

> **Mr COLLIER**: How many times were repayment terms negotiated with the company and who approved the repayments of them?
>
> **Mr KEATING**: I believe we had six repayment plans in all and they were approved initially at my level, but my delegation only goes so far, so as the debt became more significant the CEO was involved.[10]

And according to State Forests submission:

> Until replaced by another repayment plan negotiated to commence from October 2001, State Forests continued to calculate and charge interest and penalties on the overdue amounts.[11]

---

[8] Financial Policy, Credit Management, State Forests of NSW, effective 3 August 1998.

[9] State Forests' submission to the PAC, dated 9 August 2002, p3.

[10] General Manager Marketing, State Forests of NSW, transcript of hearing, 24 October 2002, p13

State Forests determined to continue supplying Customer A, despite it continually failing to comply with the repayment plans because:

> The customer's operations were of such a scale as to be of significant regional, social and economic importance, especially in terms of local employment. A number of contracting businesses were reliant on the continued supply of logs and were simultaneously producing different log types for other customers. As a result, State Forests made the judgement not to cease log supply but to continue to work closely with the customer and its bank in an attempt to develop options to address the escalating problem.[12]

At the same time State Forests believed it had adequate security and control over Customer A's business through a Tripartite Agreement between the customer, its bank and State Forests. Further, State Forests could reallocate the Wood Supply Agreement to a third party:

> State Forests continued trade with the customer against security provided to State Forests by a Tripartite Agreement which was entered into between the customer, its bank and State Forests. This Agreement provided for the bank to remedy any payment breach by the customer to protect its security against which the customer had borrowed. In the event that the customer or bank did not make good any outstanding debt, the Agreement allowed State Forests to terminate the Wood Supply Agreement which would substantially reduce the overall value of the customer's assets. In the event of such termination, State Forests would then be in a position to allocate the Wood Supply Agreement to another party as it saw fit.[13]

State Forests did not necessarily believe, however, that continued supply would enable Customer A to pay for its current purchases as well as its overdue account. Rather, it continued to supply the company whilst pursuing a guarantee of performance from a third party:

> **Ms HODGKINSON**: ...Why did State Forests think that continued supply would enable this customer to pay for its current purchases as well as its overdue account? What made you think that it would be able to trade its way out of debt?
>
> **Dr SMITH**: A couple of issues there. First of all, the company actually had two processing operations one at Bombala and one at Holbrook, and they were basically separate companies under that one ownership. What gave us hope that they could trade their way out of it, we had a number of submissions and requests from third parties that they were interested in financially guaranteeing performance of this particular company. One was an international company based in New Zealand; another was a major timber processor and merchant in Australia;[14]

And:

---

[11] State Forests' submission to the PAC, dated 9 August 2002, p4.

[12] ibid.

[13] ibid.

[14] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002, p11

Mr COLLIER: ...With the benefit of hindsight, do you believe that ceasing to supply this customer would have triggered its collapse or failure or was this simply inevitable?

Dr SMITH: I do not think it was inevitable. We were getting very strong signals, and backed up by the companies that were actually looking at this particular company with due diligence, that it was a viable business long-term. This company was also fully supported in a very major way by its financier, a bank, and we were in constant discussions with those banks. So basically the decision to continue trading was based on taking all those factors into account.[15]

However, the third parties withdrew their interest in guaranteeing the company's performance. At this point, State Forests decided Customer A was no longer viable and terminated the existing arrangements.

Dr SMITH: ...but none of [the guarantees] actually came to fruition and when those particular options did not come off, that is when we took the decision that they were no longer viable.

CHAIR: So that was the trigger?

Dr SMITH: Yes.

CHAIR: When you realised those sureties were not coming?

Dr SMITH: Yes.[16]

State Forests maintains that the Wood Supply Agreement between State Forests and Customer A represents an asset with real market value. Under the terms of the Wood Supply Agreement, State Forests is entitled to either receive the overdue payment or terminate the contract and negotiate sale of the resource to a third party.

Ms HODGKINSON:...What was the nature of the security provided to State Forests and the bank under the Tripartite Agreement and does the bank's claim on the company's assets rank higher than State Forests'?

Dr SMITH: Yes, the Tripartite Agreement was guaranteed by the bank and they actually guaranteed the performance of the company for the payment of its debt. Under that Tripartite Agreement we had obligations also to continue to supply under that agreement. My understanding is in terms of the hierarchy of debt, State Forests is an unsecured creditor. The bank actually has a higher level of priority.

CHAIR: So State Forests is taking the risk, it is the lower quality of debt?

Dr SMITH: Yes, but our supplier and our continued arrangement were not based on that. This company had a timber supply agreement, which we know has got value, and in negotiation with the administrator and potential purchasers of those two

---

[15] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002., p12

[16] ibid., p11

operations, all the indications are that we will get back a significant proportion of that debt from the new owners of those contracts.[17]

By the end of January 2002, the debt plus interest and penalties had reached a level such that:

State Forests judged it was unable to extend the interim arrangements any further. At this point, State Forests ceased trading with the company which was subsequently placed into voluntary administration.[18]

What has State Forests Done to Remedy the Situation?

State Forests has worked and continues to work closely with the administrators of the company under administration. It has continued log supplies, on negotiated terms, to assist in the sale of the business as a going concern. It hopes this will limit the socio-economic impact on the local community by limiting job losses etc.

The Administration process applying to Customer A has not yet been resolved, and according to State Forests, the significant asset value represented by the Wood Supply Agreements is giving State Forests an influential say in the outcome.

Dr SMITH: ...but from State Forests' point of view we made an assessment that we had a wood supply agreement with this company which actually had value, and we are currently negotiating with the administrator. We expect to get a significant proportion of that debt back as the company is restarted under new ownership, and that is in the process of being negotiated now.[19]

But the process is proving to be complex and the administrator and State Forests appear to be having some difficultly in closing out an agreement with prospective buyers of the business:

CHAIR: With [Customer A] you are working with the administrator to try to recover your money. In that situation, the fact that you have chosen to continue to work with that administrator, would that indicate that you believe that that business is viable under a different management to the management that has been replaced?

Dr SMITH: All the indications are - on one of the processing plants we have actually offered to a successful company a new wood supply agreement and part of that is recovery of the debt. With the other processing plant negotiations are still continuing. The administrator has two viable companies which he considers can operate commercially.

The business itself seems to have little value and this appears to be hindering the sale process:

---

[17] ibid., p12

[18] State Forests' submission to the PAC, dated 9 August 2002, p4.

[19] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002, p11

CHAIR: Is there any value that you could attach to those businesses' capitalisation?

Dr SMITH: Very very small to my understanding.

CHAIR: They are small anticipated margins?

Dr SMITH: Yes.

CHAIR: Marginal operations?

Dr SMITH: Yes.[20]

Most of the business's value appears to reside in the wood supply agreement. The supply agreement is key to the business's operations as without it the business would not be able to operate, rendering it almost valueless. Theoretically the wood supply agreement does have value if it can be on-sold to a third party, but to date State Forests has never sold a wood allocation:

Ms HODGKINSON: Your submission asserts that State Forests can terminate a contract and sell the resource to a third party. Are there any instances where State Forests has sold the log allocations to other log processors? Is there any instance where State Forests has redirected those log allocations?

Dr SMITH: Not to date. We actually have one at the moment where we have bought back part of an allocation which we will be looking to reassign. In the past we have not had to do it, but the capacity is there to do it, and that is actually what has occurred. In the case of the company that is under administration, that agreement is actually basically passed back to the State Forests and we are in the process of reassigning. So basically we are on-selling.[21]

It is not clear how State Forests is valuing the log allocation or how and when any such value will be paid by the purchaser. However, according to the evidence, this is under negotiation and State Forests is confident of recovering the major portion of the debt.

CHAIR: So the purchaser of the allocation would then pay you, State Forests?

Dr SMITH: Yes.

CHAIR: And how do you value it, how do you value this sale?

Dr SMITH: In the case of administration, it would be basically with negotiation. It becomes a fairly complex business where if a company is willing to pay a certain amount for the business and the various components of that business are the physical processing, the goodwill associated with the customers of that business, and also the value of our wood supply agreement, it becomes a negotiation between us and the administrator about who gets the share and what the new company is willing to pay.

---

[20] ibid., p13

[21] ibid., pp13-14

CHAIR: So the purchaser is not buying the allocation, he is buying the old business?

Dr SMITH: Yes, he is buying the old business, but to run that business he or she needs to get a wood supply agreement from us, which is completely separate from administration. The two assets are handled differently. The administrator has no control over the wood supply agreement.

CHAIR: Is the value of that reallocation separate from the value of the business?

Dr SMITH: Yes.

CHAIR: It is identifiable?

Dr SMITH: Yes.

CHAIR: And quantifiable?

Dr SMITH: Yes.[22]

The Committee understands that State Forests is willing to reallocate the wood supply agreement to the successful purchaser without necessarily directly attributing a value to it, to facilitate the sale of the business, help its economic viability and thereby benefit the regional economy and local community.

The issue of obtaining a guarantee (as required by State Forests' own credit policy) for Customer A was discussed at the hearing. State Forests only obtained a token guarantee from Customer A because it was a start up operation and State Forests had a wood supply agreement in place as security.

Mr KEATING: It is going back a while and I do not recall the exact category that was apportioned to the two companies. The company in administration I think would have at best been category 3, but I would need to confirm that. The other I am not sure. Our business with them goes back a long way and in each case we had the security of the wood supply agreement, so I am not sure that the credit rating was the overwhelming consideration in that case.[23]

A customer in category 3:

Mr KEATING: ...requires full security, as we put it, and that is we are prepared to trade with you on credit terms, but you would require typically eight weeks' log supply as your cash guarantee...[24]

And:

Ms HODGKINSON: What guarantees did you actually seek from those customers?

---

[22] ibid., p14

[23] General Manager Marketing, State Forests of NSW, transcript of hearing, 24 October 2002., p16

[24] ibid., p16

Mr KEATING: With the company in administration we sought the maximum guarantee we could get and that triggered some negotiations which basically saw us getting not much more than a token guarantee, I would have to say, in bank guarantee terms, but that was a consideration against the fact that it was a greenfield business; they were reviving two dormant log licences and timber allocations and it was a regional enterprise where we had an interest in getting them up and running, so you make some trade-offs.

I think one of the themes of our submission is the interdependence between ourselves and customers. There are not a lot of customers; there are not a lot of log suppliers and we are the dominant ones, so in a case where we are looking to them to make significant regional investment sometimes the outcome of the negotiation is that we intend to build the guarantee over a period rather than start with a maximum guarantee on day one.

Mr GLACHAN: So what you are saying really is that you take a bit more of a risk to achieve certain outcomes?

Ms HODGKINSON: To get a commercial operation up and running rather than knocking them back.

Mr KEATING: Well, any greenfield operation is tougher, yes. Like any negotiation, we start with our requirements in full, but we listen to the other side's case and we try to understand their businesses. In the old days I suppose it would have been very easy to be dictatorial and choose to trade or not trade. These days the revenue demands on State Forests are more onerous than they have been historically, I suspect, and certainly our understanding of our place in the value chain is more sophisticated than it used to be, so it is not win/lose outcomes with customers, it is working together to ensure that what is a very competitive industry performs strongly right up the value chain. For example, softwood timber competes with steel in house framing, so it is in our interests to make sure that the timber processing industry of New South Wales is competitive.[25]

In a submission responding to matters raised during the hearing, State Forests advised that a credit assessment for customer A could not be provided to the Committee because Customer A's:

> ...credit-worthiness was not assumed but start up arrangements were by negotiation...The capital-hungry greenfields nature of the proposed investment inclined State Forests, on commercial grounds, to rely primarily on the security represented by the newly-issued 20 year Wood Supply Agreement rather than on a substantial bank guarantee.[26]

State Forests was asked to comment on why it has not taken legal action to recover the outstanding balances from the current and former directors of Customer A. In its submission State Forests responded:

---

[25] ibid., pp16-17

[26] State Forests' submission to the PAC, dated 22 November 2002, p2

> State Forests does not hold a personal guarantee from the [principal] director of both companies. Any right of action against a director personally is only available if the director has breached the Corporations Act.
>
> Whether there are grounds to proceed against [the directors] personally will become clearer when the companies have been liquidated as it is the Liquidator's obligation to report such matters to ASIC. Both companies will be liquidated at the conclusion of the administration process, ie when the Administrator has finalised the sale of the company assets under the Deeds of Company Arrangement.
>
> On receipt of the Liquidator's report, any decision to commence recovery proceedings (providing there are sufficient grounds) against current or former directors will need to be weighed up against the prospect of recovery. Anecdotal advice is that the [principal director] may be declared bankrupt in which case recovery proceedings would be uneconomical.[27]

Normal commercial practice would be to make formal inquiries to establish whether there are sufficient grounds to initiate legal proceedings against the directors of Customer A and to determine the likelihood of success in recovering any outstanding amounts from those directors.

Conclusion

State Forests' decisions have placed it in a difficult position. This has been brought about, in part, by State Forests not using normal commercial practices. State Forests' actions appear to have been an attempt to keep a new, but marginal business in operation and to limit the socio-economic impact of that business failing on a regional economy and community.

The Committee is not in a position to make recommendations about this particular case because it has not been privy, for commercial reasons, to the detailed arrangements State Forests is pursuing with prospective purchasers of the business.

However, State Forests could generally structure its terms of trade so that risks are minimised and outcomes are more likely to be achieved before entering into supply arrangements with customers. This includes start up operations where risks of business failure are greater than those for going concerns.

Such measures could include royalty free periods in the early stages of a business's operations or, as the Committee understands has occasionally occurred, the ramping up of royalties over time.

The circumstances of this case and State Forests' actions to date raise a number of questions about the forest industry and State Forests' role in that industry. These issues are dealt with in chapter four of this report.

---

[27] ibid., pp2-3

Chapter Three

Customer B

What Happened

In its written submission,[28] State Forests advised the Committee that "Customer B", a hardwood processor, had experienced significant operational problems following the introduction of native forest policy reforms in the upper north east of the State.

According to State Forests, it worked closely with Customer B and its bank over three years and entered into negotiated payment arrangements for its debts from previous years whilst continuing to receive payment for current log supplies. The amount of this debt (including interest) amounted to approximately $1 million. As with Customer A's debt, State Forests fully provided for this as a doubtful debt at 30 June 2001.

The Government's forestry reforms heavily affected Customer B and State Forests advises that this customer is still adapting to changes in log supply. In addition a number of log contracting businesses were reliant on continued log supply to the mills involved, as was local employment and wood supply to other mills not involved in the payment issue.

State Forests' submission asserts that it thoroughly investigated all possible options to assist the customer overcome the problems it faced, judging that a proactive approach would produce an optimal outcome for all parties. As a result, log supplies were not terminated during the negotiation period.

As with Customer A, State Forests continued to calculate and charge interest on the overdue account at the rates provided for in the Term Agreement.

Customer B is servicing its current debt within agreed terms, which include penalty interest where State Forests' normal trading terms are exceeded.[29]

What has State Forests Done to Remedy the Situation?

After the Auditor-General's report was issued, State Forests negotiated a reduction to Customer B's long term log supply allocation. Hassall & Associates Pty Ltd, a natural resource economic consultant, independently determined the

---

[28] State Forests' submission to the PAC, dated 9 August 2002, p4-5

[29] ibid., p4-5

value of the log allocation reduction.[30] An amount equivalent to this valuation was credited to Customer B.

The Committee was concerned that this action by State Forests was in fact a forgiveness of debt. This is not State Forests' view as they expect to reassign the log allocation and obtain an up front payment from the purchaser of the allocation as well as continuing royalties.

> **CHAIR**: In your submission the following comment was made:
>
> > Subsequent to the Auditor-General's report being issued, State Forests has negotiated a reduction to the customer's long-term log supply allocation. The value of the log allocation reduction was independently determined and an amount equivalent to this value was credited to the customer... The agreement volume resumed by State Forests remains available for allocation to another customer at State Forests' discretion.
>
> Once again, just to revisit this, the Audit Office may be of the view, or any observer may be of the view, that this in effect is forgiveness of debt, because the asset is the value of the contract, plus there is actually money owing. You would concede that that is the case?
>
> **Dr SMITH**: No, not at all. There was an independent valuation made. Again, part of the process was that a detailed business planning process was conducted with the company and with their financiers about what they needed to restructure their business to enable them to have some chance of surviving in the long-term. Part of that was that they offered to retire, for us to re-purchase 15,000 cubic metres of wood, which we did, and that purchase was based on an independent valuation. That asset now is held with us. We expect to reassign that, and if that is reassigned, there will be an up front payment associated with the transfer of that asset, in addition to the continuing levels of royalty.
>
> I could also state, just for clarification, there is a substantial trade in hardwood supply agreements between saw millers, where they do on-sell part of their agreements or even the whole agreement. So there is a significant trade in these wood supply agreements.[31]

The Committee understands that State Forests has never sold a resumed log allocation before and that Customer B, as with all customers, was never required to pay an up front fee for the original allocation.

Conclusion

State Forests has borne additional costs and risks by accepting this arrangement to settle the $1 million owed by Customer B. If, as State Forests asserts:

---

[30] Valuation of Log Allocation Report, Executive Summary, prepared by Hassall & Associates Pty Ltd.

[31] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002, p14-15

> there is a substantial trade in hardwood supply agreements between saw millers, where they do on-sell part of their agreements or even the whole agreement[32]

Customer B itself could have entered that market and sold the log allocation to a third party. It did not need to enter protracted negotiations with State Forests to sell this asset. Also, as customer B never paid for the original allocation, treating the subsequent reduction as a "repurchase" of that allocation is not consistent with commercial practice.

As a result of these actions, State Forests:

- has borne the costs of administering these negotiations, including obtaining the independent valuation of the resumed allocation;
- bears the costs of negotiating the sale of the resumed allocation to a third party; and
- carries the risk of any market volatility (ie the cost of any shortfall between the price obtained for the allocation and the $1 million owed by Customer B).

To date State Forests has not on-sold the resumed allocation to recover Customer B's unpaid debts. The Committee notes the agreement to reduce the log allocation, reached in May 2002, only takes effect from 1 January 2003.

[32] ibid., p15

Chapter Four

Discussion

Credit Policy and Terms of Trade

The purpose of State Forests' Credit Policy is contained in its Policy Statement for Credit Management, effective 3 August 1998:

> The primary objective of granting credit to customers is to allow forestry operations to be conducted with minimum risk for State Forests and to:
>
> - provide a flexible range of options allowing the customer and State Forests to negotiate the most suitable option;
> - ensure that State Forests undertakes appropriate and regular risk assessment ensuring risk is controlled within approved levels following a rigorous and disciplined credit assessment process;
> - evaluate customer credit worthiness;
> - categorise customers, allowing credit to be extended or partially extended as considered appropriate;
> - require the provision of other suitable forms of security in addition to bank and other guarantees when considered appropriate;
> - provide flexible invoicing arrangements and payment terms to reduce the level of credit exposure and therefore reduce the level of security required; and
> - provide appropriate monitoring and reporting systems to support credit management.[33]

Policy Requirements and Application

The Credit Policy applies to new and existing customers and states that all customers under the credit policy will be assigned a credit grading. These are:

- Category 1 – Full Credit – No security required;
- Category 2 - Partial security required with some credit extended;
- Category 3 – No Credit – Debt fully secured (Guarantee/Security Bond); and
- Category 4 – No Credit – No security. Cash up-front before any supplies.[34]

The policy also sets out the evaluation criteria to be used in determining which credit category will apply. The criteria include:

- sales agreement/timber licence duration;

---

[33] Financial Policy, Credit Management, State Forests of NSW, effective 3 August 1998, p2

[34] Credit Policy, State Forests of NSW.

- payment history; and
- credit assessment for categories 1 & 2.[35]

The evaluation criteria vary according to the credit category a customer applies for. Credit assessments are required for customers seeking "full credit " or "security with partial credit" and are to be performed annually. They are not required where customers wish to deal with State Forests on a "cash up-front" basis or can provide full security.

The policy also sets out what forms of security State Forests considers acceptable for categories 2 and 3. These are:

- bank guarantees;
- security bonds from acceptable financial institutions;
- cash deposits;
- other approved forms of security – these require approval by State Forests' Financial Services General Manager and are assessed on a case by case basis; and
- in addition to the above, director's guarantees in some cases.[36]

Payment Terms

State Forests' payment terms are 14 calendar days from the date of invoice issue. The level of security may be reduced if customers pay in less than 14 days. State Forests must approve payment terms before any supply is arranged.[37]

Compliance with Credit Policy for Customers A and B

It appears that State Forests did not follow its own credit policies in the management of Customers A and B.

Firstly, the debts were not fully secured by way of bank guarantee or security bonds, unless State Forests considers the wood supply agreements to be "other approved forms of security". This is not specified in the credit policy.

> **Ms HODGKINSON:** What guarantees did you actually seek from those customers?
>
> **Mr KEATING:** With the company in administration we sought the maximum guarantee we could get and that triggered some negotiations which basically saw us getting not much more than a token guarantee, I would have to say, in bank guarantee terms, but that was a consideration against the fact that it was a greenfields business; they were reviving two dormant log licences and timber

---

[35] ibid

[36] ibid

[37] ibid

> allocations and it was a regional enterprise where we had an interest in getting them up and running, so you make some trade-offs.
>
> ...where we are looking to them to make significant regional investment sometimes the outcome of the negotiation is that we intend to build the guarantee over a period rather than start with a maximum guarantee on day one.[38]

In State Forests' view:

> **Mr KEATING:** ...The company in administration I think would have at best been category 3, but I would need to confirm that. The other I am not sure. Our business with them goes back a long way and in each case we had the security of the wood supply agreement, so I am not sure that the credit rating was the overwhelming consideration in that case.[39]

And:

> The Wood Supply Agreement between State Forests and the customer represents an asset with real market value.[40]

Secondly, credit assessments were not performed for either customer despite the requirement, since 1998, that where only partial security has been obtained a credit assessment has to be performed annually:

> Not included in this [submission] are the requested credit assessments for [Customers A and B]. Examination of our records showed that:
>
> (a) in respect of [Customer A] creditworthiness was not assumed but start up arrangements were by negotiation...The capital-hungry greenfields nature of the proposed investment inclined State Forests, on commercial grounds, to rely primarily on the security represented by the newly-issued 20 year Wood Supply Agreement rather than on a substantial bank guarantee
>
> (b) in respect of [Customer B], State Forests' trading with that company dates back to 1968 when a sawmill licence was initially issued. This clearly predates our modern credit assessment approach. That length of trading history became its own measure of credit-worthiness.[41]

And:

> **Ms HODGKINSON:** How often are credit ratings, credit limits, breaches of credit limits and compliance with payment terms reviewed and by whom, please?
>
> **Mr KEATING:** It depends on the performance of the customer. The instrument they hold with State Forests, the nature of the wood supply agreement we have between us, is a factor. If they are on a long term wood supply agreement and they

---

[38] General Manager Marketing, State Forests of NSW, transcript of hearing, 24 October 2002, p16-17

[39] ibid., p16

[40] State Forests' submission to the PAC, dated 9 August 2002, p4

[41] State Forests' submission to the PAC, dated 22 November 2002, p2

> are trading satisfactorily then it might be years between reviews. In another case where we are dealing on parcel sales that are not necessarily ongoing we would review the credit of the customer prior to every sale in the sense that we operate in a very cyclical market, a very volatile market in the sense of housing and economic factors can influence the demand for sawn timber enormously, so we have to look at it in the context of the market we are in at the time and the customer.[42]

Thirdly, personal guarantees were not obtained from company directors in a situation where the customer was involved in a start up (greenfields) operation that proved to be a marginal business.

Conclusion

State Forests has argued that it has social responsibilities to provide forestry-related employment opportunities in regional NSW. One of the performance indicators in its 2001 Annual Report is "indirect employment through forest dependent industries." This measure is placed under key result area three in its corporate plan "Accountability to the Community."[43]

The Committee notes that State Forests has wide-ranging powers. For example, section 11(1)(a) of the Forestry Act 1916 notes:

> Subject to this Act, the commission shall have the control and management of State forests, timber reserves and flora reserves and shall control and manage them in such manner as best serves the public interest...[44]

In the case of Customer A and Customer B, State Forests has attempted to serve the public interest by applying its credit policy less rigorously to promote regional jobs.

However, there are risks in this approach. A credit policy is a commercial instrument that is designed to maximise the financial return to a trading entity. It provides clear rules for businesses to follow in handling debtors so firm decisions can be quickly taken. It is not sufficiently flexible to also allow a business to pursue social goals.

Further, the Industry Commission's 1996 report *State, Territory and Local Government Assistance to Industry*[45] noted that most industry assistance is kept confidential. However, secrecy raises suspicions of corruption and can create a conflict of interest for public officials who are publicly accountable for their actions

---

[42] General Manager Marketing, State Forests of NSW, transcript of hearing, 24 October 2002, p15-16

[43] State Forests of NSW, 2001 Annual Report, Corporate Plan, Accountability to the Community, Key result area three, Indirect employment through forest dependent industries.

[44] Forestry Act 1916, section 11(1)(a)

[45] Industry Commission's 1996 report *State, Territory and Local Government Assistance to Industry,* pxxviii and p82

(there was no evidence of corruption on the part of State Forests during this inquiry).

In addition, the Productivity Commission's 1999 report *Inquiry into the Impact of Competition Policy Reforms on Rural and Regional Australia*[46] confirmed that regional development assistance should be transparent. In addition, it should facilitate, rather than hinder, the necessary change.

State Forests' treatment of Customers A and B does not comply with this model. The arrangements have only been made public due to the actions of the Auditor-General. Further, they do not appear to be promoting necessary change. As noted in hearings:

> **CHAIR**: Is there any value that you could attach to those businesses' capitalisation?
>
> **Dr SMITH**: Very very small to my understanding.
>
> **CHAIR**: They are small anticipated margins?
>
> **Dr SMITH**: Yes.
>
> **CHAIR**: Marginal operations?
>
> **Dr SMITH**: Yes.[48]

In contrast, the Government has implemented the Forest Industry Structural Adjustment Program (FISAP) to assist firms and communities cope with its forest reforms. Funds are distributed to help hardwood businesses exit the industry, upgrade equipment to be more competitive, or to pay for training to help the workforce find jobs in other industries. In the 2002-03 Budget, the Government allocated $38.9 million to the Offices of Forestry Information for FISAP.[49] Details of payments to particular firms are publicly available.[50]

The Committee is of the view that a specific industry program that complies with good design principles is preferable to a selective application of State Forests' credit policy in promoting regional development. FISAP provides an example of how it can be done.

---

[46] Productivity Commission's 1999 report *Inquiry into the Impact of Competition Policy Reforms on Rural and Regional Australia,* chapter thirteen

[48] Chief Executive Officer, State Forests of NSW, transcript of hearing, 24 October 2002, p13

[49] NSW Government Budget Estimates 2002-03, p9-3

[50] Federal Minister for Forestry and Conservation, Senator Ian Macdonald, and NSW Minister for Forestry, the Hon. Kim Yeadon, press release down loaded on 18/12/2002 from http://www.affa.gov.au/ministers/macdonald/releases/2002/02095mj.html

Good design principles for government programs are readily available. The 1997 Mortimer Report, *Going for Growth*,[51] presents some principles for industry programs. They include:

- programs must have measurable objectives and be assessed against measurable performance indicators;
- there must be clear eligibility criteria;
- governments should fund activities, not providers;
- cost recovery should be adopted; and
- programs must be regularly evaluated, avoiding *ad hoc* reviews.

Recommendation

State Forests apply its credit policy uniformly for all its customers and discontinue using the policy as an instrument for regional development.

If State Forests wishes to pursue social goals such as regional jobs, it should do so through a specific program that includes good program design principles.

[51] Mortimer Report 1997, *Going for Growth,* chapter four, downloaded on 18/12/2002 from http://www.dist.gov.au/events/mortimer/index.html

Appendix A

Submissions and Documents Received by the Committee

No.	Submitted or Tabled by:	Subject
1.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	State Forests' submission to the PAC, dated 9 August 2002.
2.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	State Forests' submission to the PAC, dated 20 September 2002.
3.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	Credit Policy, State Forests of NSW.
4.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	Financial Policy, Credit Management, State Forests of NSW, effective 3 August 1998.
5.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	Valuation of Log Allocation Report, Executive Summary, prepared by Hassall & Associates Pty Ltd.
6.	Dr Bob **Smith**, Chief Executive Officer, State Forests of NSW	State Forests' submission to the PAC, dated 22 November 2002, including attachments numbered 1 to 15.

Appendix B

List of Witnesses Appearing Before the Committee

Witness	Position and Organisation	Hearing Date
Mr Anthony Thomas **Whitfield**	Deputy Auditor-General, Audit Office of New South Wales	24 October 2002 Sydney
Mr Jack **Kheir**	Director of Audit, Audit Office of New South Wales	24 October 2002 Sydney
Mr Sivarajah **Jeyapalan**	Audit Manager, Audit Office of New South Wales	24 October 2002 Sydney
Dr Bob **Smith**	Chief Executive Officer, State Forests of New South Wales	24 October 2002 Sydney
Mr Malcolm Ian **Clinch**	General Manager Finance, State Forests of New South Wales	24 October 2002 Sydney
Mr Gary Taylor **Keating**	General Manager Marketing, State Forests of New South Wales	24 October 2002 Sydney
Mr Ronald Victor **Wilson**	Marketing Manager, State Forests of New South Wales	24 October 2002 Sydney