Devolving forest ownership through privatization in New Zealand

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Some of the questions raised by the selling of government-owned forests in the 1990s.

The years from 1987 to 1996 marked a decade of change for New Zealand's plantation forestry sector.[1] The first apparent change occurred in 1987 when the New Zealand Forest Service was dismantled and the government's commercial forestry operations were taken over by a state-run enterprise, the New Zealand Forestry Corporation. However, the seeds of change were sown long before this. Indeed, the changes that took place could be regarded as a natural and logical evolution of forest management in New Zealand: as the industry grew from an "infant" in need of nurturing to a mature and competitive force, the need for state involvement diminished. The most recent stage of this evolution has been the privatization of New Zealand's forests. Between 1990 and 1992 the government sold more than 350 000 ha of planted forests to the private sector. An additional 188 000 ha of government-owned forests were sold in 1996.

1 *Ed. note:* For details on the earlier stages of the privatization, readers are referred to an article by C.L. Brown and J. Valentine in *Unasylva,* 178 (1994), "The process and implications of privatization for forestry institutions: focus on New Zealand".

This article traces the process of privatization, discusses the policy intentions and results and examines the issues and outcomes.

An indigenous forest In New Zealand

FROM GOVERNMENT AGENCY TO CORPORATION

From 1919 to April 1987, the government's forestry operations were run by a single agency, the New Zealand Forest Service. The department's governing legislation of 1949 established that its primary objective was to produce and market forest products profitably. This objective was amended in 1976 to take other factors into consideration, including policies and directives to undertake afforestation in regions requiring economic development, employment provision, utilization of low productivity lands and respect of planting targets and environmental objectives.

By the mid-1980s, a number of converging factors suggested that it was time for the government to rethink how it managed its forest assets:

- A surge in the supply of wood from the forests was forecast for the 1990s, and a more commercial operating environment was regarded as necessary to maximize returns; this would require downstream investments.

- The environmental movement was seeking to ensure that the government broadened its focus to consider not only wood supply, but also other aspects of sustainable management, including environmental issues.

- The government's economic policy was to deregulate industries and thereby to expose business enterprises to the pressures of a competitive environment for efficiency.

- As a subset of the above, government policy was to clarify organizational objectives and thereby enable transparency and accountability.

In 1985, a decision was taken to corporatize the commercial functions of the New Zealand Forest Service, i.e. to transfer these functions to a state-run enterprise. Thus, in April 1987, the New Zealand Forestry Corporation was established as a limited liability company empowered to manage the government's commercial forestry operations (550 000 ha of forest plus sawmills, nurseries and other assets). The non-commercial functions of the Forest Service were transferred to two new government departments: the Department of Conservation (which would manage the state's natural forest estate) and the Ministry of Forestry (which would have policy, forest health and protection and forestry research functions). The roles of the Ministry of Forestry were transferred to the new Ministry of Agriculture and Forestry in 1997.

The New Zealand Forestry Corporation was a much leaner organization than its predecessor. Some jobs were transferred to the newly established government departments; others were turned into positions for contractors as part of a strategy to improve labour efficiency; still others, particularly head office jobs, were lost.

The principal objective of the New Zealand Forestry Corporation, as with all state-owned enterprises, was to operate as a successful business. A clear commercial focus was regarded as a prerequisite to enable the corporation to compete effectively with the private sector.

Indeed, the New Zealand Forestry Corporation proved very successful in turning a loss-making government agency into a highly profitable corporate enterprise (Figure 1). No longer constrained by social and environmental objectives - which were now the domains of the newly established government departments - it focused on its profit objective.

THE IMPETUS TO PRIVATIZE

Commercial success was not sufficient, however, to entrench the new institutional approach to managing the government's commercial interests in forestry. The following considerations suggested that further change was needed and that the answer would be to sell the government's forests.

FIGURE 1 Turning losses into profits

> *Note:* The higher profits of the New Zealand Forestry Corporation are partly attributable to the fact that, with profit maximization as its primary objective, it did not carry out several of the multiple functions - economic, environmental and social - of the New Zealand Forest Service.
> *Source:* Kirkland (1996).

Economic context: free market philosophy, deregulation and government privatization

policy

Since 1984, New Zealand's programme of economic reform has been underpinned by a free market philosophy. Protectionism and regulation had dampened any need or incentive to be competitive. Exposing industries to the realities of the international marketplace forced New Zealand's business enterprises either to seek continuously to create anew and build on their existing competitive advantages, or to face ultimate demise. The programme of deregulation in forestry included the removal of price controls that had existed for some products, the adoption of a market pricing strategy for export logs from state forests, a scaling-down of tariffs and other constraints on the import of forest products, the establishment of a stand-alone, commercially oriented forest research institute, the commercialization of the state's planted forestry operations and, subsequently, the sale of the forest assets managed by these corporate bodies.

Within this wider programme of economic reform, in December 1987 the government announced a privatization strategy aimed at substantially reducing the level of public debt. The policy was to sell state-owned corporations to maximize revenue, unless there were good economic or social reasons to retain ownership. The 1988 budget established criteria for determining which government businesses would be sold (Clarke, 1996):

- the government would have to receive more for the sale of the business than it expected to receive if it retained ownership;

- the sale of any particular business would have to contribute to, and not impede, the social and economic objectives of government.

The 1988 budget included the commercial forest assets - 550 000 ha of planted forests - among the government businesses to be sold.

Ambiguous status of the New Zealand Forestry Corporation

Despite its commercial success, many regarded the New Zealand Forestry Corporation as a hybrid between a government department and a full commercial entity. Some believed that its structure, caught between two worlds, would only convey the worst of both (Clarke, 1996). Indeed, provisions in the State-Owned Enterprises Act allowed for political interference: the act granted shareholding ministers powers of intervention and access to all the information relating to the affairs of the corporation. While ministers deliberately restrained from interfering on the political level, this did little to sway perceptions that, because the New Zealand Forestry Corporation was state-owned, the government could intervene in the name of other than commercial objectives.

Need for greater security of supply to facilitate value-added processing

The New Zealand Forestry Corporation was constrained in its ability to process the wood derived from its forests. It was argued that its contractual supply arrangements with processors did not provide sufficient resource security to enable processors to expand their operations or establish new facilities. Another impediment was the New Zealand Forestry Corporation's limited ability to raise capital and the requirement that any intended investment first received the approval of shareholding ministers. It was hoped that the privatization of the government's planted forests would overcome these impediments.

Disagreement over the value of the state's forest assets

When the government's commercial forestry operations were corporatized, the intention was to transfer the forest assets from the government's books to those of the new state-owned enterprise. However, the government and the New Zealand Forestry Corporation came up with widely divergent estimates of the value of the forest assets (Kirkland, 1996). As the disagreement could not be resolved, officials ultimately suggested that a pragmatic way of resolving the dispute would be to sell the assets.

PRIVATIZATION

The 1990-1991 sales

Shortly after the sale of forests was announced in 1988, a Forestry Working Group, comprising government officials and private sector consultants, was appointed to recommend the optimal process for delivering the Crown of its forestry assets. The working group advised that only the forests should be sold, and not the land on which they stood. It recommended that the forests be sold as transferable cutting and management rights and that the forest estate be split up into a number of sale parcels (Forestry Working Group, 1988). The New Zealand Forestry Corporation was appointed the government's sales agent in November 1988.

The Crown Forest Assets Act 1989 established the government's right to sell its forest assets and divided the forest estate into 90 units ranging in size from 51 to 132 112 ha. Each unit was assigned tradable property rights, called Crown Forestry Licences and containing individual terms and conditions of sale.

The government intended to accept sealed bids for individual units or groups of units. The combination of bids giving the best return would decide the forest allocation. The sales process was designed to allow bidders the flexibility to tailor their own packages, to attract a large number of bidders and thereby to facilitate a competitive bidding process.

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Tenders for 66 of the 90 units were called for in April 1990. The remaining units were removed from the public tendering process because of uncertainties involving contractual supplies to New Zealand's two major forestry companies.

By the time bids closed in July 1990, 82 parties had registered. About half of these were foreign-based. However, only two bids met the mark:

- 47 030 ha of forest were sold to New Zealand's Tasman Forestry Limited;
- 24 000 ha and a sawmill were sold to the Singaporean-Malaysian interest, Ernslaw One Limited, for the combined sum of $NZ 364 million.[2]

2 $NZ 1.92 = US$ 1.00 (December 1998).

A substantial round of bids and negotiations followed between potential buyers and the New Zealand Forestry Corporation, the Treasury and outside experts. As a result, a further 175 676 ha of state forests were sold, including some of the units previously removed from tender, whose sale ended the legal disputes. The 1990 sales process grossed over $NZ 1 000 million.

Government's residual role

Three new state-owned enterprises were established to take control of the 55 percent of forest assets that remained unsold. These enterprises, which commenced operations in December 1990, were Timberlands Bay of Plenty (later renamed the Forestry Corporation of New Zealand), controlling 170 000 ha that remained on the government's sales agenda;

Timberlands West Coast, managing 24 000 ha of natural forests that were withdrawn from the sales agenda; and New Zealand Timberlands Ltd, managing 109 000 ha in 36 forests throughout the North and South Islands. The New Zealand Forestry Corporation ceased to exist, but it remained as a shell company to receive dividends from the new state-owned enterprises.

Sale of New Zealand Timberlands

The government's intention to sell New Zealand Timberlands was announced in 1991. The government indicated that it would maintain a flexible sales approach. Bids for individual forests, regions of forests and the entire planted forest estate managed by the state-owned enterprise would all be considered.

In April 1992, it was announced that New Zealand Timberlands had been sold to ITT Rayonier New Zealand (now known as Rayonier New Zealand) for $NZ 366 million. Some forests were excluded from the sale because of environmental concerns or grievances of New Zealand's indigenous people, the Maori.

Sale of the Forestry Corporation of New Zealand

In 1996, the Minister of Finance announced the government's intention to sell its shares in the Forestry Corporation of New Zealand (formerly Timberlands Bay of Plenty). The corporation's assets were Crown Forestry Licences to planted forests, which had expanded to 188 000 ha in the central region of North Island, processing plants in various locations, a nursery and a seed orchard.

A handful of large forestry companies and consortia submitted bids. The sole criterion was price. However, as the strength of the bids was not as great as hoped, bidders were asked to resubmit their bids. In August 1996, it was announced that the Forestry Corporation of New Zealand had been sold to a consortium led by Fletcher Challenge in a deal that valued the assets at $NZ 2 026 million.

ISSUES AND OUTCOMES

The privatization of New Zealand's state forest assets gave rise to a number of issues. The following are a handful of the more topical points:

- What would be the best way to preserve the rights of New Zealand's indigenous people, the Maori, to reclaim land proved to be rightfully theirs?
- What would be the implications of the institutional changes for the competitiveness and profitability of forestry?
- How would jobs be affected?
- Would the new owners replant and expand plantations?
- Would privatization enable greater on-shore processing or further encourage log exports?

Preserving the rights of the Maori

The Treaty of Waitangi, signed between the Crown and the Maori in 1840, guarantees the Maori ownership and governance of their land and other possessions. However, throughout New Zealand's history successive governments had taken land from the Maori for a variety of purposes and by a variety of means, some more questionable than others. There are now legal and institutional mechanisms for hearing Maori grievances and working towards their resolution.

The Maori have made claims against most forests on the North Island and all forests on the South Island. The 90-odd forests owned by the state before 1990 have been subject to more than 125 claims - an average of 1.5 claims each (Crown Forestry Rental Trust, 1997). One forest has as many as five claims from different tribal groupings.

The Forestry Working Group of 1988, which informed the government's privatization process, was also directed to analyse how to preserve the rights of the Maori without compromising the government's objective of revenue maximization. Following consultations with representative Maori groups, the Working Group recommended (Forestry Working Group, 1988) that the government:

- sell the trees and not the land;
- charge a land rent and hold proceeds in trust for whomever the Waitangi Tribunal might rule to be the ultimate owner of the land;
- provide for the gradual return of land to successful Maori claimants as the existing tree crop is harvested;
- compensate the Maori for the lost opportunity to utilize their land, as they see fit.

These recommendations were given legislative effect in the 1989 Crown Forest Assets Act. To date, only one claim has been fully resolved, largely using strategies that were not contemplated in the legislation. Resolution strategies are being developed in respect of another two successful claims. There are concerns about the capacity of the Waitangi Tribunal to hear and rule on claims, and controversy about whether alternative resolution processes should be followed.

Competitiveness and profitability

Prior to the forest sales, the New Zealand forestry industry was dominated by the government (which either owned or leased 52 percent of the forest estate) and a handful of large domestic corporations. An Australian company held the only significant foreign investment in the industry (Figure 2).

As a result of the sales and subsequent private sector transactions, the government now owns less than 7 percent of the planted forest area. New foreign players have entered the industry. The first round of forest sales in 1990-1991 saw the entry of Asian investors, who today account for just over 12 percent of the forest estate. After the second round of sales, United States investors now account for one third of the New Zealand forest estate (Figure 3).

FIGURE 2 Forest ownership in 1989 (based on a forest area of 1.2 million ha)

Source: Clarke (1996).

FIGURE 3 Forest ownership in 1998 (based on a forest area of 1.5 million ha)

Source: New Zealand Ministry of Forestry, unpublished data (1998).

Have these changes enhanced the competitiveness and profitability of forestry, as many of the proponents of change claimed it would? It is not easy to answer this question. However, Figure 4 may serve as an indicator. The rate of markup on input prices in forestry relative to the non-tradable sector is an internal rate of exchange that measures the relative ability of forestry to attract resources from other sectors of the New Zealand economy. Graphically, an upward movement represents a deterioration in competitiveness as the markup on input prices in forestry has narrowed relative to those in the non-tradable goods sector, enticing resources out of the former sector and into the latter. Conversely, a downward movement represents an improvement, as forestry has become more profitable relative to the non-tradable goods sector.

The figure indicates that forestry has clearly improved its competitive position since the late 1980s, concurrent with the period of corporatization and privatization. However, to attribute this entirely to the two processes would be misleading. A key factor underlying the movement in the graph is the log price spike in 1993. Nonetheless, economic theory, which states that contestability increases as the number of players in the industry increases, suggests that part of this movement can reasonably be ascribed to devolution.

Employment

Whether jobs have been gained or lost as a result of privatization is a debate that has generated more heat than light, which is compounded by a scarcity of empirical studies. Some jobs were simply transferred following acquisition; some new owners reduced staff numbers in pursuit of labour efficiency gains; others have created new jobs as they diversified forestry and wood-processing activities. Whatever the net outcome, its importance should not be exaggerated: forestry is not the fountain of jobs that many within New Zealand perceive it to be.

To plant or not to plant?

When the government first announced its intentions to privatize its forest as sets, there was a considerable debate regarding whether a condition of ownership should be the reforestation of logged areas. The first round of sales in 1990-1991 excluded any replanting requirements (unless conservation or other objectives deemed it necessary). The prevailing school of thought was that the new owners should be free to put the land to its most profitable use (Forestry Working Group, 1988). Given that the land was already in forests and since, at the time, forestry was a profitable activity, reforestation and afforestation were expected to be attractive options. Furthermore, the government was concerned not to include any sale condition that could result in a discounted price for its assets.

By the time of the 1992 and 1996 sales, the political sentiment had swayed. A condition of these later sales was that the land be replanted unless the forest owner intended to convert it to some other government-approved sustainable use. This provision was not introduced because planting levels had declined, as they had not (Figure 5). Rather it was to provide assurances to the advocates of reforestation. Such assurances were arguably unnecessary, as several factors - tax changes, forest product price increases, publicity - were encouraging replanting in the 1990s and bringing afforestation levels to historical highs.

FIGURE 4 The competitiveness of forestry

Source: Clarke (1998).

Processing

As discussed above, one of the goals of privatization was to enable growth in processing industries. Some observers, however, were not convinced that it would have this outcome. Independent processors were concerned that existing supply arrangements, however imperfect, would be threatened. Others argued that the new owners would export logs to provide an immediate cash flow to cover their purchase costs and that they would have little intention of processing the wood within New Zealand.

Replanting was a condition of the 1992 and 1996 sales, even though afforestation was already high at the time - in the photo, a nursery

FIGURE 5 Annual planting area

Source: New Zealand Ministry of Forestry, unpublished data (1998).

All new forest owners have invested, or intend to invest, in value-added processing

The government paid increasing attention to these concerns with successive sales:

- The 1990-1991 sales did not have as conditions any supply constraints or processing requirements. As for replanting, it was argued that the purchasers should be free to put the resource to the uses they judged to be most profitable.

- When New Zealand Timberlands was sold in 1992, the purchaser was required to honour five-year supply arrangements with existing clients.

- When the Forestry Corporation of New Zealand was sold in 1996, the sales process required potential bidders first to demonstrate their intention to add value to the resource within New Zealand. Public pressure was judged sufficient to hold the new owner to its claimed intentions: bidders were warned that any breach would be made known to the general public.

What has been the reality? All new forest owners have invested, or intend to invest, in value-added processing. Rayonier New Zealand, for example, has established an MDF plant. This is significant, as when the company first bought forests it had no intention of engaging in processing; it was open about its plans to export logs. Of the $NZ 1 600 million of intended investments in the period 1990 to 2005,90 percent is attributable to the purchasers of state forest assets (New Zealand Ministry of Forestry, various years).

While processing increased in the late 1980s, a large and increasing volume of logs continues to be exported. As New Zealand's wood supply grows, it is very likely that log exports will continue to increase.

The investment necessary to process the wood within New Zealand has been estimated at $NZ 4 000 million to $NZ 6 000 million (New Zealand Ministry of Forestry, 1995). Investment intentions are nowhere near these levels. The debate continues as to why this is so: is this the optimal market outcome, or are there market failures (such as investment information gaps) standing in the way of more domestic processing?

CONCLUSIONS

Privatization was a natural and logical change in the way New Zealand managed its planted forestry resources, consistent with the maturing of the industry. Changes in political sentiment and the commercial operating environment have shaped the outcomes:

- The right of New Zealand's indigenous people to claim land that is rightfully theirs is preserved in legislation. However, the process of advancing these rights has been slow to develop.

- The profitability and competitiveness of forestry have been positively influenced. Devolution can claim part, but certainly not all, of the credit for this.

- Whether devolution has led to a net gain or loss in employment levels remains unclear. However, given the very low labour intensity of forestry in New Zealand, this is more of a perceived than a real issue.

- Market fundamentals rather than policy prescriptions have seen investment in afforestation surge to new historical highs.

- On-shore processing has been facilitated. However, the level of investment is a long way from the supply-determined potential. Whether it accords with the market potential is debatable.

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