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Department of Agriculture, Fisheries & Forestry

Review of '*Structural Assistance Programme for Tasmanian  
Forest Contractors*' as proposed by Tasmanian Forest  
Contractors Association (TFCA)

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## PREFACE

This report is issued by Poyry Forest Industry Pty Ltd (Pöyry) to the Department of Agriculture, Fisheries & Forestry (DAFF) for its own use. No responsibility is accepted for any other use.

The report contains the opinion of Pöyry as to the proposal submitted by the Tasmanian Forest Contractors Association (TFCA) titled 'Structural Adjustment Programme for Tasmanian Forest Contractors'. Nothing in the report is, or should be relied upon as a promise by Pöyry as to the future supply or harvest volumes or product pricing. Actual outcomes may be different from the opinion contained in this report, as anticipated events may not occur as expected and the variation may be significant. Pöyry has no responsibility to update this report for events and circumstances occurring after the date of this report.



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## SUMMARY

In July 2007 the Tasmanian Forest Contractors Association (TFCA) submitted to the Commonwealth a proposal for a further \$93 million assistance programme for Tasmanian forestry contractors. Essentially, the TFCA has requested funding to support the amalgamation of businesses, development of specialised harvesting operations, and relocation of contractors to other Australian states and training. The TFCA also requests funding to assist some businesses and employees to exit the industry.

In 2007, DAFF commissioned a report by URS Forestry named “Pressures Facing Harvesting Contractors in the Tasmanian Forest Industry”.

Pöyry has been asked to:

- Provide a review of URS Forestry’s report with particular focus on the medium and long term outlook for the Tasmanian harvesting sector
- Comment on the merits of each element of the TFCA’s proposal,
- Comment on the long-term implications for the Tasmanian forest industry of a reduction in the number of contractors
- Analyse and comment on the likely demand for each element of assistance proposed by the TFCA
- Analyse and comment on the costings of each element of the TFCA proposal.

Pöyry has also been asked to provide a review of the financial status of a representative sample of harvesting contractors, and report to the Commonwealth on the likely effectiveness of the TFCA’s proposal in overcoming the problems affecting the harvesting sector.

The market for hardwood woodchip is expected to improve, both in terms of volume and price. A significant regional supply deficit is likely to emerge in the medium term as Chinese demand builds and supply from competing countries declines. The potential supply into Asian markets will largely depend on the ability of Indonesian companies to recommence native forest harvesting/conversion, and the level of demand for woodchips from European pulp producers that will be affected by the rapidly increasing Russian log export taxes. This European demand may divert the attentions of some competing suppliers such as South Africa and Chile. Australia will be well positioned to take advantage of this emerging regional deficit.

The TFCA proposal is built on the premise that a decline in native forest harvesting will result in a significant reduction in the number of harvest contractors and total employees. Pöyry forecasts of both native and plantation availability supports this premise. However, it is unclear for which time period the TFCA refers to when stating ‘Future Situation’, and the short term market for native woodchip could improve.

A forecast of contractor numbers, based on forecast volumes, indicates an average requirement of 90 contractors for the next decade, reducing to 85 in the following decade, and reducing further to 70 by 2028. There seems to be room for an immediate reduction to achieve an appropriate level of contractor numbers. This reduction, if the current 133 is correct, is an adjustment of around 40 contractors or 140 employees. The further reduction in contractor numbers is over a whole decade, and some reduction is likely to occur naturally.

A review of the TFCA proposal in light of the likely reduction in contractors concluded that:

- There is some merit in having a body providing assistance to those wishing to exit through ‘Amalgamation’. However, the process by which a contractor offers his business for sale is relatively straight forward and presumably most of the cost of the transaction will be carried by the party acquiring the quota.
- The supporting evidence that a small scale selective harvest operation is economically viable is lacking. This type of selective operation is extremely expensive, and it is questionable whether the market price can support such an operation. Industry participants who could provide a business plan for such an operation may have been eligible to receive funding under TFIDP.
- It is difficult to envisage that Tasmania will have such a surplus of mechanical harvesting skills that the exportation of this skill labour would be desirable. The plantation harvest volumes alone support the employment of a further 100 operators. The move from old growth to regrowth will also result in an increase in mechanical harvesting.
- The TFIDP provides for \$42 million of funding to assist the Tasmanian native timber industry to adjust to changes in forest resources arising from the Tasmanian Community Forest Agreement. The programme includes financial assistance for the upgrade of harvesting equipment. The number of contractors that have not already applied for funding under the TFIDP, is estimated at 25. It is unlikely that there will be demand for funding from a further 64 contractors, as the TFCA proposal indicates.
- Further detail of Proposal 5 ‘Development and implementation of ‘pre-qualification’ standard for contractors’, is needed to fully assess the benefit to the industry. This proposal is targeting new entrants. If such a qualification was introduced, it should also apply to existing contractors, and be phased in over time to enable a minimally disruptive training period. The proposal goes further than setting safety and operating standards, appearing to impose rate setting arrangements and quota restrictions. It is likely that this will not be well received, nor will it be enforceable.
- Some contractors are unable to make the transition to plantation harvesting, either due to a lack of quota or the inability to fund the business development, with or without funding assistance. The base volume reduction supports the exit of an estimated 30-40 contractors. There appears to be a current over-capacity, supporting an immediate adjustment. If 5 businesses amalgamate, 5 businesses move into high value selective logging operations and 10

contractors relocate to the mainland, it is likely that around 20 contractors will exit the industry. A realistic base cost of exiting has been estimated as \$311 000 per business. On this basis, the total budget required to support 30-40 businesses is \$9.3-12.4 million. TFCA has requested that \$42 million be made available to support 42 businesses.

We obtained FYE 2006 financials for only 14 of the 29 operators. Of these 14, 8 experienced a decline in contract income during the year. A further 2 of these operators were only in their first full year of operations (hence no comparisons available for prior year).

As per our original assessments, 22 of the 29 applicants contained a “high” level of financial risk. Typically, these operators had declining revenues, low/marginal profitability, low net asset position (or deficiency in net assets) with relatively high debt levels.

The reduction in contractor numbers will almost certainly occur as a result of both rationalisation/consolidation and a reduction in native harvesting. It is unlikely that this natural reduction will result in any disruption to the Tasmanian forest industry. However, any funding that supports the exiting of the industry or the relocation to the mainland should be carefully managed to ensure that this does not become sufficiently attractive to lower the contractor numbers below the required capacity.

A reduction in contractor numbers and an increase in the scale of each operation will almost certainly result in reduced operating cost, thus improving the competitiveness and viability of the contractors as well as the customers.

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## 1 INTRODUCTION

The Tasmanian Community Forest Agreement (TCFA) was announced on 13 May 2005. The TCFA is a joint commitment of the Australian and Tasmanian Governments to enhanced protection of Tasmania's forest environment, and growth in the Tasmanian forest industry and forestry jobs. The governments have committed over \$250 million to revitalise the timber industry and preserve old-growth forests.

As part of the TCFA the Australian and Tasmanian Governments agreed to implement the Tasmanian Forest Industry Development Programme (TFIDP) which provided grants of \$42 million over three years from 2005 to facilitate forest industry retooling and investment in new plant and technology to assist the industry in adjusting to changes in the public forest resource available. The objectives of this programme were to assist the continued development of a sustainable, efficient, value-adding and internationally competitive industry that will provide sustainable employment opportunities in Tasmania's forest and wood products industries. Harvest contractors with contract security have been invited to apply for funding support in order to purchase machinery suitable for plantation and regrowth harvesting in order to adjust to the reduction in old growth harvesting.

In July 2007 the Tasmanian Forest Contractors Association (TFCA) submitted to the Commonwealth a proposal for a further \$93 million assistance programme for Tasmanian forestry contractors. This proposal contains six elements:

- Amalgamation of businesses
- Development of small-scale, high-value selective harvesting operations in native forests
- Relocation of some Tasmanian contractors to other states
- Assistance for the purchase of new equipment
- Improved training for contractors and their employees
- Assistance for contracting businesses and their employees to leave the Tasmanian forest industry.

In order to evaluate the funding proposal it is important to understand the market for Tasmanian wood products and the current health of the industry. Over the past two years there has been a significant decline in the volume of hardwood woodchips exported from Tasmania. As a consequence, harvesting quotas have been reduced, putting some harvest contractors, in particular native forest contractors, under financial pressure.

Given that much of the available information regarding the reasons for the downturn in woodchip exports is anecdotal, the Department of Agriculture, Fisheries and Forestry engaged URS Forestry in 2007, to report on "Pressures Facing Harvesting Contractors in the Tasmanian Forest Industry".



Pöyry has been asked to provide a review with the following terms of reference:

- Review the findings and conclusions of the URS Forestry report, commenting in particular on whether there are any recent developments in Australian or overseas markets that could affect the medium and long term outlook for the harvesting sector of the Tasmanian forest industry
- Comment on the merits of each element of the TFCA's proposal in assisting the harvesting sector in the short and medium term
- Comment on the long-term implications for the Tasmanian forest industry of a reduction in the number of contractors
- Analyse and comment on the likely demand for each element of assistance proposed by the TFCA
- Analyse and comment on the costings of each element of the TFCA proposal
- Review the financial status of a representative sample of harvesting contractors and report to the Commonwealth on the likely effectiveness of the TFCA's proposal in overcoming the problems affecting the harvesting sector.

## 2 REVIEW OF URS FORESTRY REPORT

### 2.1 Brief Summary of URS Forestry Report

The URS Forestry report, “Pressures Facing Harvesting Contractors in the Tasmanian Forest Industry” (2007), commissioned by DAFF, examines the impacts of the downturn in hardwood woodchip exports from Tasmania through an analysis of the outlook for the hardwood woodchip market, the nature and structure of the contracting sector and the implications for the future. In broad terms, the report can be summarised as follows:

- The market for native forest hardwood woodchips is likely to remain weak as a result of:
  - Preference by Japanese buyers for plantation woodchips.
  - The increasing supply of plantation woodchips both from Australia and overseas.
  - The availability of lower cost sources of plantation woodchips (e.g. South America).
  - Despite the increasing demand for hardwood woodchips of China and other south-east Asian countries, these countries pay lower prices than the Japanese.
  - Real prices will continue to decline.
  - The proposed construction of a pulp mill at Bell Bay in Tasmania will provide a new market and mitigate against adverse export demand, provided it occurs.
- The Tasmanian forest contracting industry can be characterised as:
  - Encompassing a wide range of operations but generally small, family-owned businesses with contracts up to 50 000 m<sup>3</sup>/a.
  - Contracts are based on pulpwood production volumes with premiums paid for sawlogs. This is unlike other states where contracts are based on sawlog production volumes.
  - Contract rates are negotiated annually based on performance. This has occurred over a long period, which means base rates have not been adjusted beyond the movement in a range of cost indices, effectively locking in current contractors and removing flexibility.
  - Profitability and returns are varied depending on individual business structures and circumstances. Businesses with high fixed costs and high gearing are more vulnerable to contract volume, (and therefore revenue), reductions impacting adversely on profitability.
  - The rates of failure of forest contractors in the Tasmanian forest industry are not significantly different to those in other states. However, the rate of failure in the broader Australian forest industry as a whole does appear to be high when compared to other industries.

## **2.2 Discussion of Findings and Conclusions of the URS Forestry Report**

The reasons for the downturn in woodchip exports from Tasmania, particularly from the native forests sector, as outlined in the URS Forestry report are valid to varying degrees.

There is considerable evidence, both anecdotal and factual that would indicate that the downturn in the market for native forest hardwood woodchips is primarily driven by the preference of Japanese buyers for hardwood plantation woodchips sourced from mainland Australia, and the increasing availability of supply of the same. This has had the greatest impact in Tasmania, where the majority of hardwood woodchip supply for export has been sourced from native forests.

The availability of lower cost sources of plantation woodchips may be somewhat overstated. Australian woodchip producers and exporters maintain a competitive cost advantage in terms of shipping costs and time over other sources to the major Japanese markets, and are predicted to have an increasing supply of eucalypt hardwood woodchips available for export. Australia's main competitors in the supply of hardwood woodchips to international markets do not enjoy the proximity to market advantage, and may not have a significant volume of supply available in medium to long term.

The influence of China and other south-east Asian nations on hardwood woodchip demand, though positive, is not strong. The volumes exported are significantly less than the demand from Japan. In terms of price, the Japanese pulp and paper manufacturers will continue to be the market price leaders for hardwood woodchip, and it is expected that other countries will follow, particularly given that Asia-Pacific virgin wood pulp consumption is expected to continue growing strongly, especially bleached hardwood kraft pulp (BHKP), the key driver for hardwood woodchip demands. However, it is expected that prices for hardwood woodchips, particularly native forest eucalypts, will continue to decline in real terms.

Although difficult to quantify, Tasmanian woodchip exports may also have suffered in the short-term due to the planned construction of a new kraft pulpmill by Gunns at Bell Bay near Launceston. The advent of a new and potential competitor to Japanese and international pulpmakers may be encouraging international buyers of hardwood woodchips to develop relationships for supply from secure long-term sources. At the same time, Gunns may be retaining supplies of plantation hardwood woodchip on the stump in anticipation of supplying its own pulp facility in the near future. On the other hand, once operational, it is expected that this mill will provide a demand boost for Tasmanian hardwood woodchips, both native forest and plantation sourced.

### **2.2.1 Review of URS Forestry recommendations**

The URS Forestry report recommends that in the light of a continuing tight market outlook for hardwood woodchips, particularly native forest hardwood woodchips, the Tasmanian forest contracting industry could benefit from having increased flexibility in order to reduce the adverse impact of adjustments to a changing market. Actions to achieve this include:

- Greater use of market based approaches to letting contracts through open and competitive tenders
- Consolidation of the number of contractors currently operating
- The provision of contracts with base volumes and potentially differential rates for base and marginal volumes and/or compensation should actual volumes be less than base
- Address skill shortages through provision of additional resources for training
- Provide support for small contractors to develop business management and planning skills
- Encourage the development of new markets for hardwood woodchips
- Recognise the costs of compliance with environmental and health and safety statutory requirements for contractors.

Pöyry believes the first two recommendations go hand in hand but neither can be forcibly controlled, and the reality is that contracts would be won on price and standards. The larger operations will likely have a cost advantage over smaller operators, and it can also be assumed that a company would be able to grow because of an ability to deliver whilst meeting customer environmental and safety requirements. Like many industries, the smaller operations will have difficulty competing against larger ones unless they have a unique offering providing some competitive advantage.

The native hardwood contractors are in a relatively weak negotiating position, given the limited quota and strong competition. A tender based system will not necessarily benefit the industry, and may well result in a reduction in rates and an escalation of consolidation as small businesses fail to secure contracts.

Pöyry agrees that industry participants would benefit from support in the form of operational and business management training. The expansion in plantation harvesting requires operators with a different skill set to those working on native old growth harvesting. Much of this training is currently undertaken on the job. Although this will continue to be the most important training ground, it should be supported by a formal training programme including OH&S, basic maintenance, environmental management etc.

Pöyry believes there is also a need for Small Business Management training for business owners.

It is unclear what URS Forestry means by “encourage the development of new markets for hardwood woodchips”. The international markets are well understood, and there will remain a significant market for native hardwood chips albeit at lower than plantation prices. The development of domestic markets is likely limited to large scale processing such as the proposed Gunns pulp mill. This mill will provide some additional market for native hardwood. However, it should be understood that the area of native forest harvested in the state will continue to decline in accordance

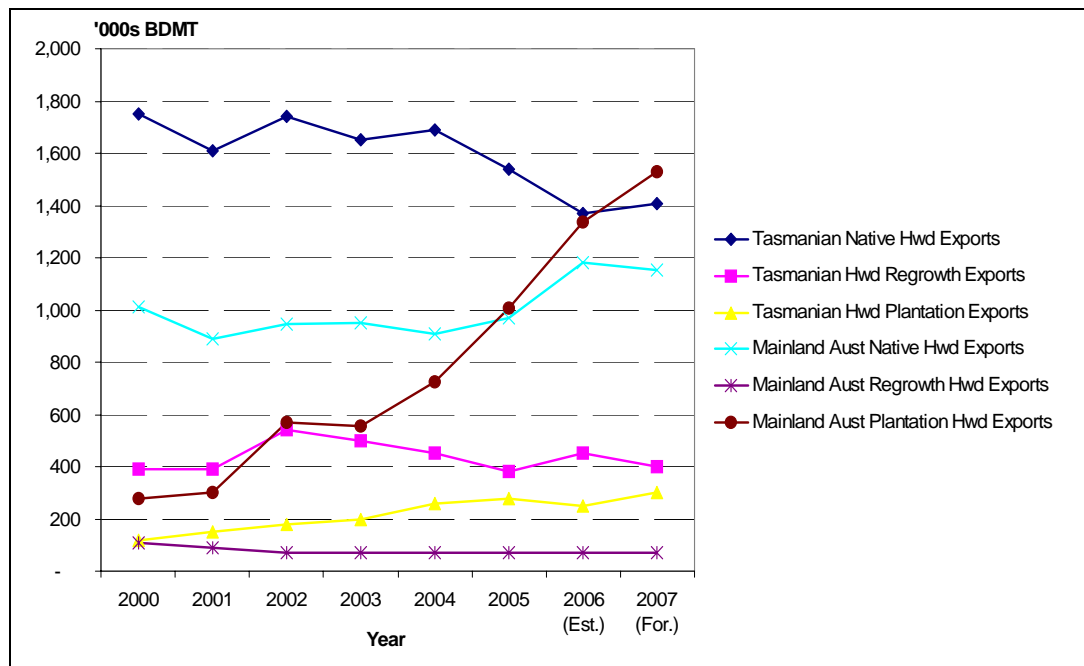
with existing agreements. Consequently, the supply of native forest sourced pulpwood will also decline, and this will occur irrespective of whether the pulp mill proceeds.

## 2.3 Hardwood Woodchip Market Analysis

### 2.3.1 Australian hardwood woodchip export performance

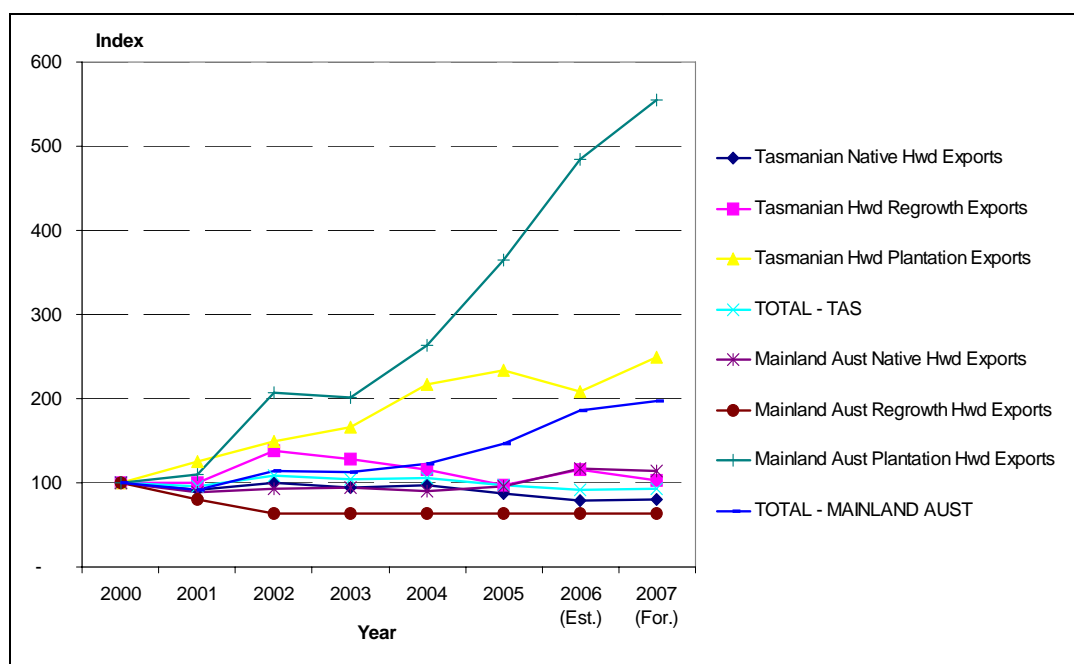
Hardwood woodchip exports from Australia have increased significantly in the last decade. They have increased 84 % since 1995, to 4.7 million BDMt in 2006 (WTA). The export market for hardwood woodchips from Australia as a whole was strong in 2006, up 9 %. There appeared to be a continuing high level of native forest woodchip exports, but no significant increase. In fact, exports of native forest hardwood woodchips have remained flat or declined slightly since 2000. The increase was entirely due to sharply increasing exports of hardwood plantation woodchips, mainly from Western Australia. (Figure 2-1 and Figure 2-2).

**Figure 2-1:**  
**Australian Hardwood Woodchip Exports by Forest Type, 2000 - 2007**



Source: RISI 2007

**Figure 2-2:  
Indexed Australian Hardwood Woodchip Exports by Forest Type, 2000 - 2007**

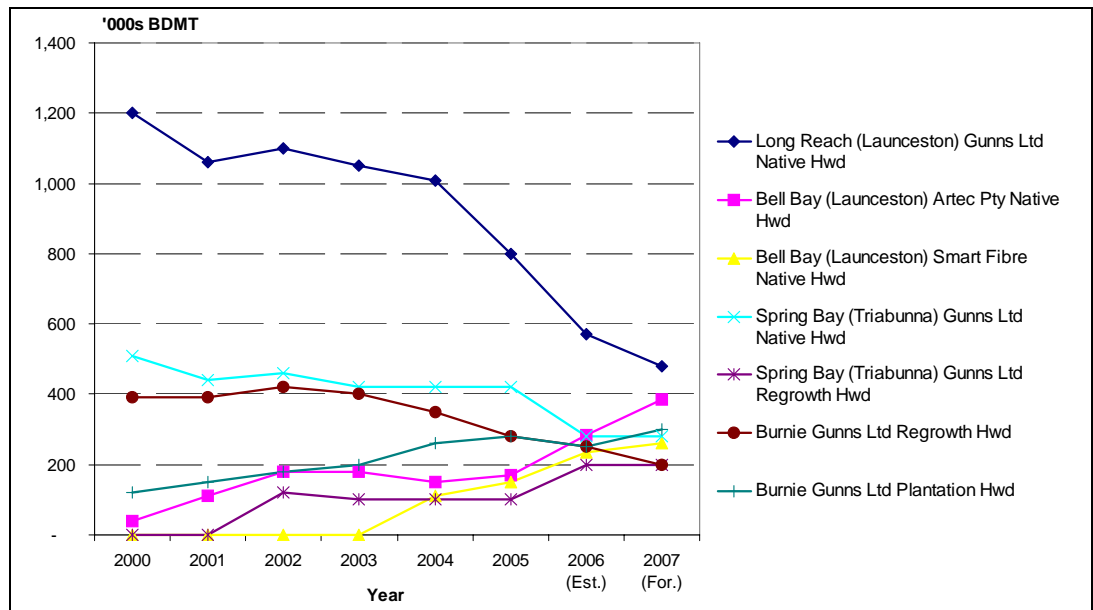


Source: RISI 2007

This rapid change in supply sources from native forests to plantation sources is also reflected in the market dominance of Gunns as exporter of hardwood woodchips from Australia. Although Gunns is still the dominant supplier of hardwood woodchips from Australia, its market share of exports has decreased from 54 % in 2004 and 43 % in 2005, to 34 % in 2006. As Gunns currently sources most of its hardwood woodchips from native forests in Tasmania, the negative impact of this overall market transition to plantation grown hardwood fibre would be greatest there.

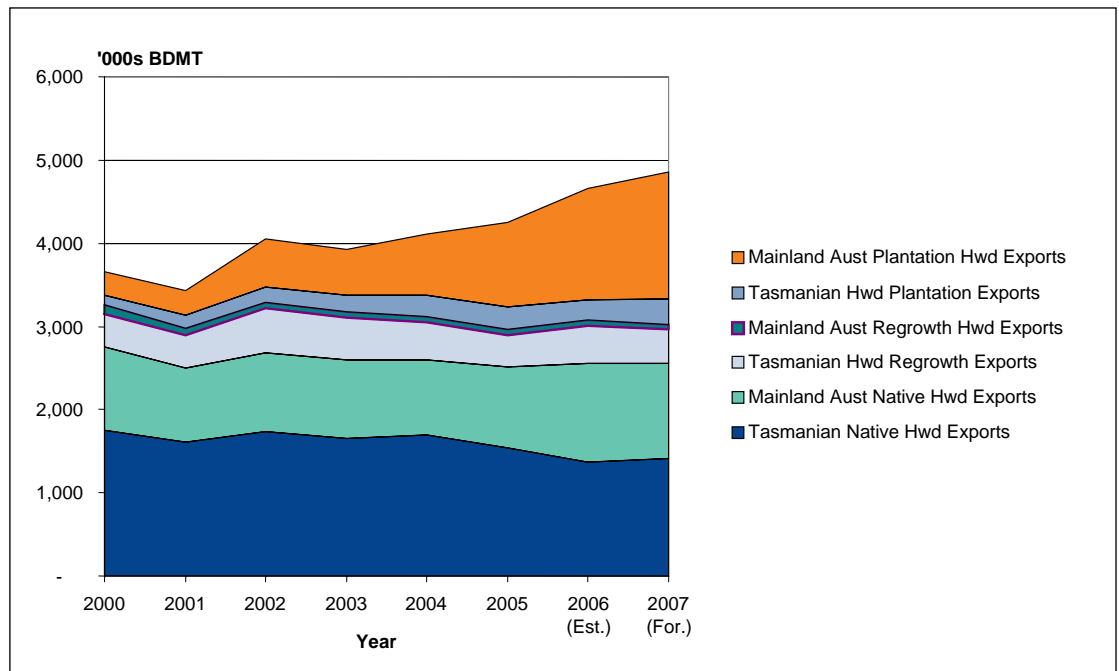
Further examination of the hardwood woodchip exports from Tasmanian ports presents interesting trends (Figure 2-3). In particular, it is evident that the exports of native forest hardwood woodchip from Gunns Long Reach site have declined significantly, by more than 400 000 BDMt since 2004. In contrast, exports of native forest sourced hardwood woodchip from Artec and SmartFibre ex. Bell Bay, and plantation and regrowth native forest sourced hardwood woodchip from Gunns ex. Burnie and Triabunna have increased during the same period. These increases are not sufficient to compensate for the decreases elsewhere, contributing to an overall decline in Tasmanian woodchip exports (Figure 2-4). These trends indicate that hardwood woodchip buyers are preferring plantation to native forest hardwood, which has an impact on Tasmania. In particular the decline is greatest from Gunns' Long Reach export terminal. The significant decline in exports from Gunns may also indicate an underlying secondary motivation for woodchip buyers to reduce their reliance on supplies from a company that has proposed the construction of its own pulpmill next to the Long Reach export facility.

**Figure 2-3:  
Tasmanian Hardwood Woodchip Exports by Supplier and Port, 2000 - 2007**



Source: RISI 2007

**Figure 2-4:  
Australian Hardwood Woodchip Exports by Forest Type, 2000 - 2007**



Source: RISI 2007

It is clear that hardwood woodchip exports from Australia are increasingly being sourced from hardwood plantations. It is estimated that up to 42 % of total hardwood woodchip shipments from Australia in 2006 were sourced from plantations. This is a continuation of sharp increases over the last few years, from 12 % in 2001, 25 % in 2004 and 28 % in 2005 (RISI 2007). It is expected that supply from fast-grown plantations will continue increasing into the future. This supply has evidently become a preferred source for the pulp and paper manufacturers, owing to plantation grown hardwood woodchips having greater

market appeal than supplies from natural forests, due to its generally higher pulp yield, higher degree of uniformity, consistency in processing and the environmental appeal to end-users. Furthermore, the need to supply from certified forests is an emerging market trend that is expected to eventually become a normal industry practice, as an increasing number of industry leaders ratify the concept over time to mitigate against consumer concerns with regards to sustainable forest management.

### **2.3.2 Review of woodchip export markets – medium to long term**

The dominance of Japan as a buyer of hardwood woodchips from Australia is reflected across Asia-Pacific. Japan has been by far the largest importer of hardwood woodchips in the region, representing 84 % of Asia-Pacific woodchip imports in 2006, and around 85 % of total Australian hardwood chip exports. The balance was imported by China, South Korea and Taiwan. Exports to the South Korean and Taiwan markets have been stable for some years. China is a relatively new market with the most potential for expansion.

Japan is expected to continue to dominate the Asia-Pacific hardwood woodchip trade in the foreseeable future. That country's wood pulp production is predicted to remain at present levels, whilst the trade into other traditional markets, Taiwan and South Korea, is not expected to increase, owing to capacity constraints. In contrast, China's demand for hardwood pulpwood, though uncertain, is expected to grow considerably in the short to medium term, resulting in the country remaining the second largest importer of hardwood woodchip in the region over the next decade. Over the longer term, China's aggressive pulpwood plantation programmes could ease the country's net deficit of hardwood pulpwood considerably, depending on the leading manufacturers' wood procurement strategies. India is not foreseen to become a major importer of hardwood woodchip in the near future. However, their fibre shortage could become more evident during the 2010s.

The Indonesian Government's hold on permits for pulp and paper companies to harvest and use Mixed Tropical Hardwoods ("MTH") pulpwood in Sumatra has forced those companies to step up harvesting in their plantations. The move to a much larger reliance on the plantations is premature, and the companies may face problems to sustain current harvest levels while the permit uncertainty continues. This has the potential to result in a significant regional deficit which would benefit Australian exporters.

### **2.3.3 Review of supply of hardwood woodchips – medium to long term**

Australia has been the largest exporter of hardwood woodchip into the Asia-Pacific region in recent years, followed by South Africa and Chile. Exports from these three nations represented 68 % of the regional hardwood woodchip import in 2006. As a result of China's increasing domestic demand for pulpwood, Vietnam took the fourth largest position from that country in 2005, and increased the volume during 2006. Shipments from the US have been insignificant since 2002.

Owing mainly to the huge increase in fast-growing hardwood plantations and much slower growth in demand for wood residues from domestic production facilities, Australia will maintain an increasing exportable surplus of hardwood woodchips



over the next 10 years. Pöyry estimates that the surplus hardwood woodchip volume available for export from Australia by 2011 will be around 11.6 million m<sup>3</sup>/a, and by 2016 around 13.8 million m<sup>3</sup>/a. In 2021, the volume is estimated to be 13.7 million m<sup>3</sup>/a. The 2016 and 2021 surplus estimates are based on the assumption of increased demand from pulp, reflecting the Australian Paper expansion, and the Gunns pulpmill becoming operational by the end of 2009. If the Gunns pulpmill does not go ahead, it is likely the surplus of available hardwood woodchips will be even greater, particularly in Tasmania.

Of particular note is the prediction that the supply of native forest sourced hardwood woodchip from Australia will not increase over the medium to long term, but will likely decrease. Again, this will have significance for the Tasmanian forest industry, dominated by native forest production.

South Africa is currently the second largest hardwood woodchip supplier into Japan and the Asia-Pacific region. However, a continued decrease in exports is predicted, due to increased domestic processing, and difficulties in expanding the existing plantation area.

Chile is forecast to remain a major net exporter of hardwood woodchips into Asia, though the country is likely to experience a short-term decline in its pulpwood availability for export over the next 5 years. Other Latin American countries will develop and expand their domestic industries over time for both domestic and export markets, thereby limiting their potential to increase the surplus volume available for exports to Asia in the short to medium term. Should that scenario (expansion of respective domestic pulp industries) not develop, then significant increases in hardwood pulpwood availability could occur.

Despite the US' abundant potential supply of hardwood pulpwood, the fibre has proven to be relatively expensive over the last decade, and Asian buyers switched to alternative supply sources and developed long-term business relationships. At current (Q3 2007) exchange rates, the US seems to be competitive on a delivered cost into Asia basis. Despite this, we forecast limited exports only, of hardwood woodchips from the US south to Asian countries in the near future. As for the US northwest, declining harvests and strong domestic pulpwood demand will reduce export volumes, with the exception of token volumes from Alaska.

Several countries in southern Africa are currently showing some interest in establishing hardwood plantations for woodchip export, specifically Mozambique, Angola, Tanzania, and the Republic of Congo. Limited areas of plantations are already established in some of these countries, and if the available land areas were planted, they could become significant woodchip suppliers. However, the volumes generated might be redirected to overcome predicted shortfalls in South African supplies. Indeed, a number of recent industry reports have been suggesting the near-future potential of a major woodchip export facility in southern Mozambique, immediately to the north of South Africa.

In summary, despite ongoing plantation developments that are expected to ease the supply constraints in some countries, Asia-Pacific will continue to be a major wood products deficit region.

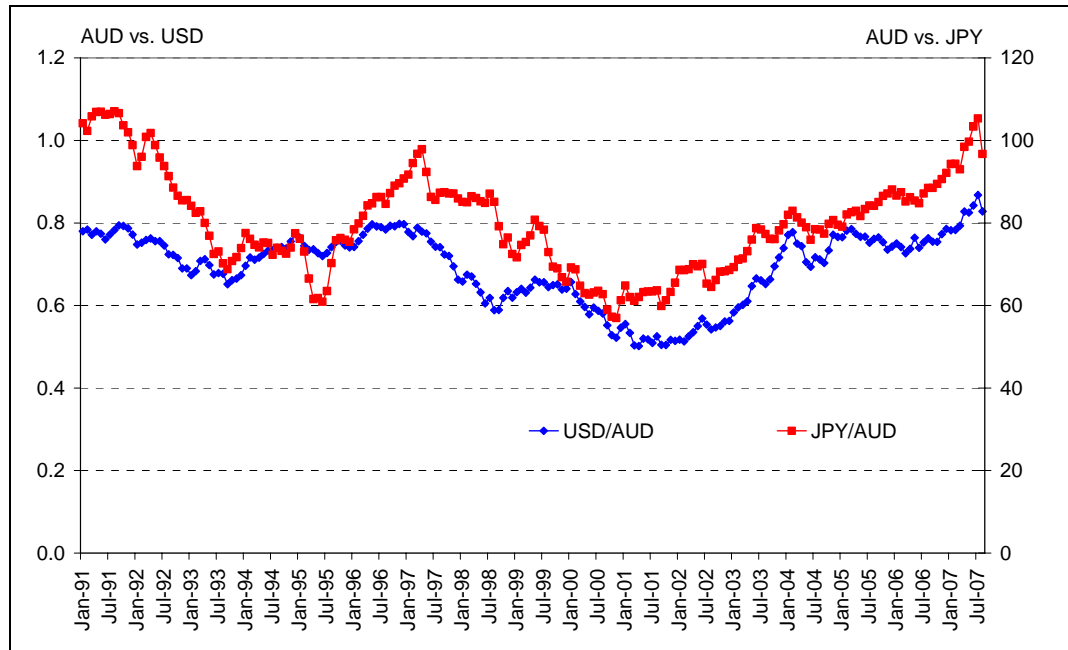
### 2.3.4 Hardwood woodchip price developments

The price for Australian hardwood woodchips, set by annual negotiation between the major suppliers and the Japanese pulp and paper manufacturers in conjunction with their trading houses increased in 2007. Gunns is the leading Australian hardwood chip exporter (LAHCE) price negotiator for Australian native forest woodchips, and the price agreed for native forest woodchips exported by Gunns from Tasmania in 2007 was AUD166.50 /BDt FOB, which is an AUD4.50 /BDt (2.8 %) increase from 2006.

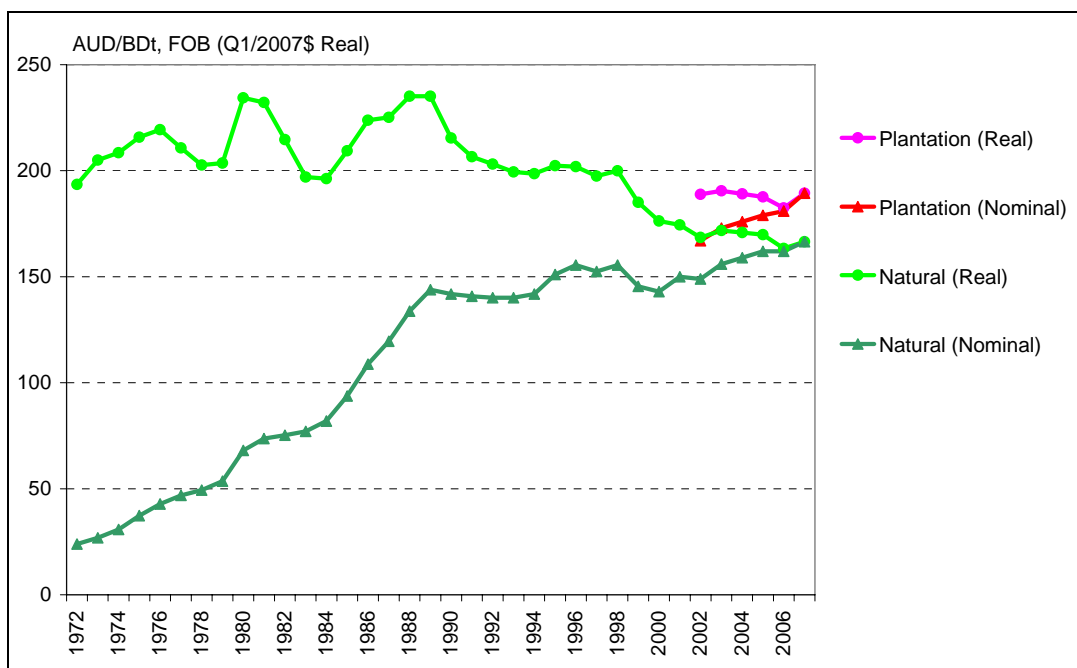
Of interest, the linkage in pricing negotiations between native forest and plantation hardwood woodchip decoupled in 2007, further reinforcing the market shift away from native forests sourced woodchips. Up until 2006, the prices for the higher quality plantation grown woodchips were directly related to the LAHCE price via a percentage premium of between 10 and 13 %. In 2007, the woodchip price for plantation eucalyptus from Albany (WA) was negotiated by the Plantation Pulpwood Exporters Pty Ltd (owned by Timbercorp Ltd and ITC Ltd) at AUD189.40 /BDt FOB, which is an AUD8.40 /BDt (4.6 %) increase from 2006.

An important factor in the price (and therefore cost to importers) of Australian sourced woodchips is the strength of the AUD relative to other major currencies. Since 2001, the AUD has strengthened significantly against the USD and the JPY (Figure 2-5). As Australian hardwood woodchips are sold to Japan in AUD, the landed cost of the woodchips in Japan has also increased significantly, although the recent declines in the AUD/YEN exchange rate have reversed some of the gain.

**Figure 2-5:**  
AUD against USD and JPY, Daily 1996-2007



**Figure 2-6:  
LAHCE Benchmark Prices, 1972 - 2007**



It is expected that AUD FOB prices will increase in real terms, for plantation grown hardwood woodchips. The position on the native forest woodchip price is less certain, with demand expected to fall when the increased supply of plantation-grown woodchips becomes available. The demand for native woodchip may increase in the short to medium term if Indonesia continues the moratorium on harvesting of native forests in Sumatra.

Exchange rate fluctuations are also very critical in cost relativities from different sources. In particular, the recent appreciation of the AUD has helped improve the competitiveness of more distant suppliers such as South Africa and Chile, who sell their woodchips in USD. As a result, Australia is currently positioned as among the most expensive hardwood woodchip sources in recent years.

The price rise post 2003 was driven in large parts by the significant appreciation of the AUD against the USD. Australia is the only major hardwood woodchip exporting country fixing the price in local currency for shipments to Japan, whereas most other countries' prices are settled in USD. Because of the rapidly strengthened AUD against the USD, the benchmarked Australian hardwood woodchip prices in USD-denominated terms have risen considerably over the last 4 years. This in turn has enabled other countries to also achieve some price gains.

The supply and demand balance has also played a major part in the rebounded FOB prices, as the anticipated oversupply situation never arrived, and the regional demand remains solid. Though not in a direct competition, the substantial softwood woodchip prices increase, observed in early 2007, influenced positively on the bargaining confidence of hardwood woodchip suppliers in the region.

Traditionally, the Taiwanese pulp industry has not been prepared to pay Japanese prices for woodchips. Instead, the pulpmills have tended to seek lower grade

sources, such as mixed tropical hardwoods. South Korean prices are also lower than in Japan, and so is the average quality of woodchips purchased. Typically and historically, South Korean prices have tended to be situated between those for Japanese imports and Taiwanese imports, on an equivalent quality basis.

### 2.3.5 Costs of Supply – Hardwood Woodchips

South-east Asia and China have traditionally been the lowest priced hardwood woodchip suppliers to Japan, and Australia the most cost competitive supplier amongst non-Asian suppliers. Shorter shipping distances generally provide these countries with a notable cost advantage, as this is a primary driver of cost competitiveness in the woodchip trade.

Although Australia is not the lowest cost producer of hardwood woodchips, it does enjoy a competitive advantage due to the relatively close proximity to major markets, as exemplified by the shipping times to selected Japanese and Chinese ports shown in Table 2-1 below. Given the market prices applied, and the respective processing costs, the Australian producers generally maintain a high stumpage/margin. The main competitive supplier of eucalyptus species is South Africa. Indonesia is the lowest cost producer of woodchips (acacia), largely as a result of a competitive cost structure and a relatively short distance to market.

**Table 2-1:  
Shipping Times to Japan and China**

Country	Export Port	Number of sailing days to Port of:	
		Akita Japan	Qingdao, Shandong China
Australia	Geelong	17.3	17.2
Australia	Tasmania	17.5	17.7
Australia	WA	17.0	15.3
Indonesia	Dumai	11.0	8.8
Chile	Coronel, Corral	30.0	32.8
Brazil	Macapa	33.0	34.6
Uruguay	Montevideo	35.0	37.2
South Africa	Richards Bay	25.5	24.6
US South	Mobile	28.7	32.8
US West	Tacoma	13.0	16.5
US Alaska	Port McKenzie	11.0	14.4

Shipping distances between suppliers and customers naturally have a large impact on sailing times and therefore shipping cost. Australian eucalypt woodchip producers and exporters hold a significant competitive advantage over eucalypt woodchip exporters located in Latin America, South Africa, and the US south.

### **3 TFCA PROPOSAL**

In July 2007, the Tasmanian Forest Contractors Association submitted to the Commonwealth a proposal for a structural adjustment programme for Tasmanian forestry contractors. The proposal is based on a desire for further government assistance to enable the Tasmanian forest contracting industry to adjust to the negative influence of a number of external factors. These external factors are:

- Repeated government initiatives to remove wood production from native old growth forests, ('locking up forests'), as a result of minority community influences.
- Slower maturity rates for plantations, complicating the whole scale transition from harvesting old growth native forest, to harvesting regrowth native forest and eucalypt plantations.
- Repeated efforts by minority groups to destabilise the Tasmanian forest industry amongst overseas markets.

In short, the TFCA is seeking additional monies to the \$42 million already allocated through the Tasmanian Forest Industry Development Programme (TFIDP), to allow expenditure of up to \$93 million to assist the industry with structural adjustment. The stated objective of the TFCA is to “resolve the short term crisis and establish a stronger industry sector that is better equipped to respond to industry fluctuations without widespread loss of jobs and the corresponding negative community impacts.”

#### **3.1 Summary of TFCA Proposal**

- The TFCA proposal identifies a number of structural adjustment issues facing the Tasmanian forest contracting industry. These are:
  - “Pure” cost reductions for harvesting operations have reached their limit
  - The two major factors continuing to force change are:
    - resource availability and its variability
    - customer needs in terms of quality, price, volume and alternate supply options.
  - The determination of pricing for contract operations being determined by the resource, the duration of the agreement and the annual production task
  - The change to specialised equipment has enhanced production reliability but limited alternative uses when quotas are reduced
  - There is a significant oversupply of contractor capacity in Tasmania, whether the Bell Bay pulp mill proceeds or not.

The TFCA proposes a number of stages to be implemented “that will be aimed at retaining a sound, experienced and financially stable harvesting industry.” These stages are:

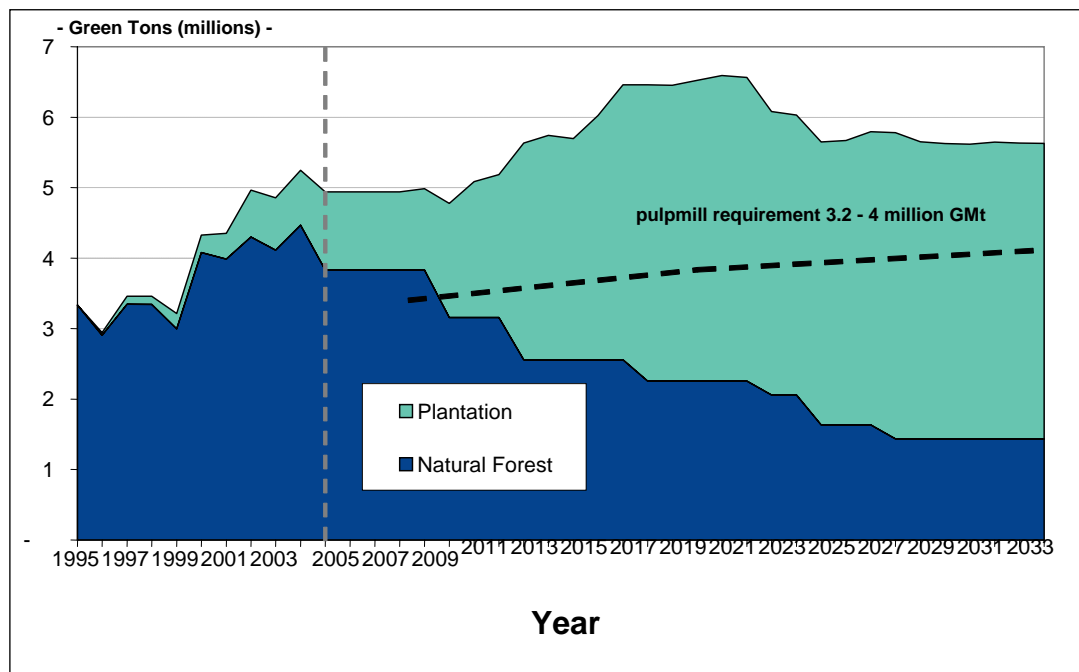
- Amalgamation of some of the smaller regrowth operations into larger production units
- Development of business opportunities for small scale, high value selective harvesting operations in native forest old growth
- Funding relocation of Tasmanian contractors to the states where local expertise in running mechanised operations to the appropriate standards is not available
- Provide financial assistance to assist in purchase of new equipment to meet the changing nature of the forest resource and the market demand for alternative products
- Development and implementation of a “pre-qualification” standard for contractors with nominated environmental, safety, employment and operating standards to run alongside action items 1-4 above
- Development of an exit package to allow those unable to continue in the industry to exit without financial ruin.

**4 ANALYSIS OF ASSISTANCE PROPOSAL FROM TFCA**

The proposal is built on the premise that a decline in native forest harvesting will result in a significant reduction in the number of harvest contractors and total employees. Pöyry forecasts of both native and plantation availability supports this premise. However, it is unclear for which time period the TFCA refer to ‘Future Situation’.

Pöyry believes that native harvesting will reach 1.5 million GMt by 2028. For this same period plantation volumes are estimated to be 4.4 million GMt. These volumes are 0.9 million GMt higher than those presented by the TFCA proposal. In the medium term volumes have the potential to reach 6.5 million GMt (Figure 4-1).

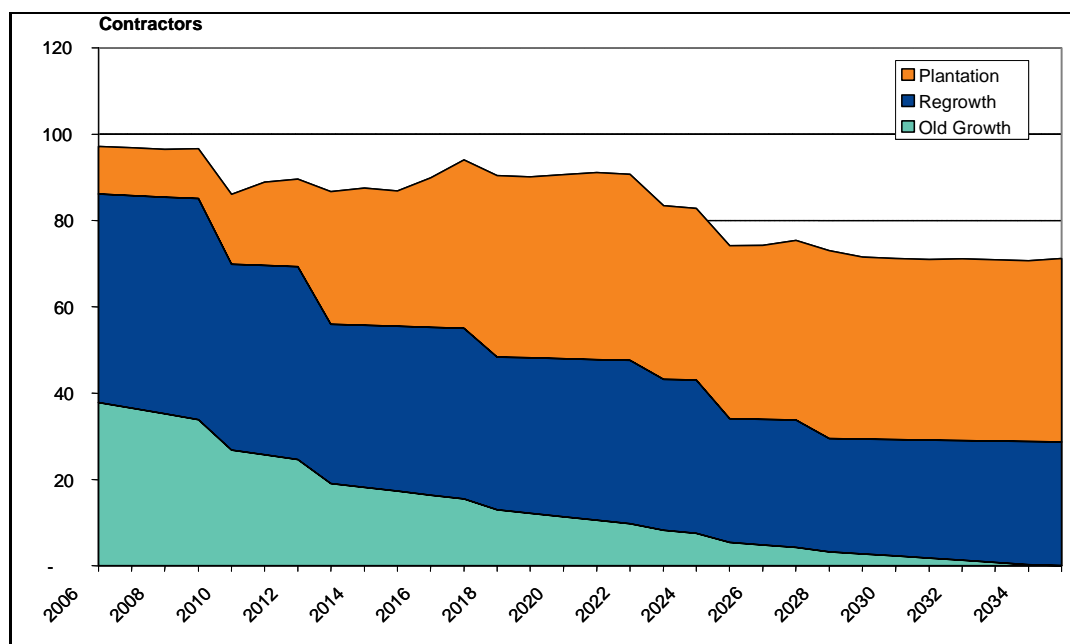
**Figure 4-1:  
Native and Plantation harvest volumes**



Pöyry agrees that the current harvest volume is around 5 million m<sup>3</sup>/a. This comprises old growth, regrowth and plantation. If the average contractor volume is 37 500 m<sup>3</sup>/a, (although this has not been verified), the total number of contractors is estimated at 133.

A forecast of contractor numbers, based on forecast volumes, indicates an average requirement of 90 contractors for the next decade, reducing to 85 in the following decade, and reducing further to 70 by 2028.

**Figure 4-2:  
Forecast Contractor Numbers**



There seems to be room for an immediate reduction to achieve an appropriate level of contractor numbers. This reduction, if the current 133 is correct, is an adjustment of around 40 contractors or 140 employees. The further reduction in contractor numbers is over a whole decade, and some reduction is likely to occur naturally.

#### 4.1 **Proposal 1 – Amalgamation of smaller re-growth operations into larger production units**

The rationalisation of small operators or consolidation into larger enterprises has been happening and will continue to happen as smaller operators find it more difficult to remain competitive and secure contracts. The term amalgamation is perhaps misleading, as in reality one party will have the opportunity to acquire the exiting party. The purchase may be limited to the quota or the machinery or both. There is some merit in having a body providing assistance to those wishing to exit. However, the process by which a contractor offers his business for sale is relatively straight forward and presumably most of the cost of the transaction will be carried by the party acquiring the quota.

##### **Likely demand for assistance**

TCFA states that it envisages that around five businesses will participate. Given the potential overall reduction in contractor numbers, this number appears low. Again, this is dependent on the time frame for the funding, and this is still unclear.

##### **Cost of proposed assistance**

The TFCA request funding of \$12 500 per business. It is unclear exactly what this amount will support but it seems that the accounting fees for any amalgamation would alone cost more than this amount.



#### **4.2 Proposal 2 – Development of business opportunities for small scale selective harvest operations in native old growth**

The supporting evidence that this type of operation is economically viable is lacking. This type of selective operation is extremely expensive, and it is questionable whether the market price can support such an operation.

Industry participants who could provide a business plan for such an operation may have been eligible to receive funding under TFIDP.

Pöyry believes further analysis is required, assessing the delivered log cost from such an operation, and the willingness of the market to accept this material at a price sufficient for the operation to remain viable.

##### **Likely demand for assistance**

Similarly to the amalgamation proposal, TFCA envisages that five businesses would be interested in participating. There is a lack of evidence supporting the likely demand for funding for such a transition.

##### **Cost of proposed assistance**

TCFA estimates the cost per participant to be \$12 500. It is unclear how this amount will be spent. If reviewing this proposal from a commercial perspective, it would seem very likely that any proposed selective harvest operation that has a proven viability would be in a position to cover the \$12 500 expense.

#### **4.3 Proposal 3 – Funding relocation of up to 10 Tasmanian contractors to mainland states, where local expertise in operating mechanised operations to the appropriate standards is not readily available**

There is little doubt that the mainland, like Tasmania, will increase plantation hardwood harvest volumes significantly over the next decade. There will almost certainly be a skills shortage, and experienced mechanical harvester operators will be in demand. However, it is difficult to envisage that Tasmania will have such a surplus of skills that this exportation would be desirable. The plantation harvest volumes alone support the employment of a further 100 operators. The move from old growth to regrowth will also result in an increase in mechanical harvesting.

Another area that has not been covered is regrowth thinning operations. This is emerging as a viable means of improving the value of regrowth forests and requires skilled mechanical harvester operators

If businesses are relocated to the mainland without the necessary plantation harvest skills, they will most certainly require training assistance. There may be significant resistance from local mainland contractors who now see an opportunity to grow without the threat of subsidised entry of Tasmanian contractors. Experienced operators no doubt will be welcome, and will be required for expansion.

### **Likely demand for assistance**

The TFCA proposal seeks funding to support the relocation of up to ten contractors to the mainland. Pöyry believes there could be Tasmanian based contractors wanting to shift to the mainland in order to secure quota. A support package for the employees of an exiting contracting firm may be beneficial. The base skills, supported by additional training in mechanised harvesting, will likely result in a valuable employee to a mainland based contractor.

The financial support of a business is perhaps more difficult to justify. The contractor would likely be required to show that it has been disadvantaged by the TCFA, does not have a harvest quota in Tasmania and has taken all possible steps to remain viable. It may also be necessary for the contractor to prove that harvest quota has been approved by a mainland customer, and that the business is in a position to gear up for plantation harvesting and remain viable.

### **Cost of proposed assistance**

The proposed assistance budget is \$3.5 million, including \$100 000 maximum per business, and \$50 000 maximum per principal and employee. The budget appears to be more than sufficient to support relocation, and should be reassessed on a case by case basis.

## **4.4 Proposal 4 – Funds to assist with the purchase of new equipment**

The transition to plantation and some regrowth harvesting from old growth harvesting requires significant investment in machinery. The mechanical harvesting equipment provides operational efficiency whilst improving safety and environmental impact.

TFCA requests funding up to \$48 million for the purchase of new equipment in order to meet the changing nature of the forest resource.

### **Likely demand for assistance**

The TFIDP provides for \$42 million of funding to assist the Tasmanian native timber industry to adjust to changes in forest resources arising from the Tasmanian Community Forest Agreement. The programme includes financial assistance for the upgrade of harvesting equipment. An estimated 69 contractors applied for funding under the TFIDP programme in support of the purchase of new equipment to enable the transition to plantation harvesting. To date, 40 have been successful and further eligible applications are awaiting funding approval. Those that have been declined either lack secure contracts or do not appear to be financially viable.

The transition of the industry to plantation harvesting is spread over a number of years, as illustrated in Figure 4-1. There are a number of suitably equipped operators operating today, and many more have re-equipped with TFIDP support. The medium term forecast is for 90 contractors, including 70 operating on plantation and regrowth native. If applicants for TFIDP funding are removed from total contractor demand, there appears to be around 25 operations that could receive support. This number is likely to be much lower as some operators have

already made the transition to mechanical harvesting. It is unlikely that there will be demand for funding from a further 64 contractors, as the TFCA proposal indicates.

The long term implications of funding the purchase of new equipment must be considered. The nature of the business results in the high turnover of equipment. It can be assumed that within 5 years the contractor will need to replace equipment, but then without the assistance of a funding programme. If the business cannot support the debt burden now, what confidence is there that the business will support the full burden when machinery replacement is required?

#### **Cost of proposed assistance**

The proposed budget of \$48 million appears excessive. If <25 contractors were to receive support, the total value would reach approximately \$18.75 million. The allowance of \$750 000 per contractor could contribute between 50 % and 100 % of the cost of transition to mechanised harvesting depending on the scale of the operation and associated equipment needs. It is unclear how much the applicant for any funds would be expected to contribute to the investment, nor the criteria for assessment of applicants.

#### **4.5 Proposal 5 – Development and implementation of ‘pre-qualification’ standard for contractors, with nominated environmental, safety, employment and operation standards**

This proposal is targeting new entrants. If such a qualification was introduced, it should also apply to existing contractors, and be phased in over time to enable a minimally disruptive training period. The proposal goes further than setting safety and operating standards, appearing to impose rate setting arrangements and quota restrictions. It is likely that this will not be well received. Nor will it be enforceable. Further detail of Proposal 5 is needed to fully assess the benefit to the industry.

Environmental and operating practices are enforced by Gunns, Forestry Tasmania and Rayonier etc. when letting contracts and reviewing contractor performance. Those who do meet these standards will likely be disadvantaged in future negotiations. Some formal training may assist in getting the contractor buy-in to environmental and safety management and enable the operators to be more proactive.

#### **Likely demand for assistance**

Demand for this assistance will depend on whether this is targeted to all industry participants or limited to new entrants.

#### **Cost of proposed assistance**

A budget has not been provided within the TFCA proposal. It is impossible to estimate the cost without further detail of any proposed system.

#### **4.6 Proposal 6 – Development of exit package**

The exit package proposal is in support of those contractors who are unable to continue in the industry. There are numerous reasons why businesses have not been successful. It appears that debt funding has been relatively easy to obtain, and poor debt to equity ratios are common. For those businesses with weaker financial management skills, it has been easy to become caught in a financially non-viable position.

Some contractors are unable to make the transition to plantation harvesting, either due to a lack of quota or the inability to fund the business development, with or without funding assistance.

##### **Likely demand for assistance**

The base volume reduction supports the exit of an estimated 30-40 contractors. There appears to be a current overcapacity supporting an immediate adjustment. As previously covered, 5 businesses may amalgamate, 5 businesses will potentially move into high value selective logging operations and 10 contractors may relocate to the mainland. If this does occur, it is likely that around 20 contractors will exit the industry.

##### **Cost of proposed assistance**

The TFCA proposal indicates that \$42 million may be required to potentially support 42 businesses.

The cost of exiting the industry without bankruptcy status needs to be calculated on a case by case basis. Those businesses amalgamating with another business should receive commercial consideration during this transaction.

Those businesses that cease will generally have medium term debts secured by harvesting assets. The market value of these assets will be tested during the sale process. In some cases, the balance of the debt may have been secured by means of a personal mortgage.

Exit costs incurred would vary according to a range of factors (i.e. staffing, debt levels, ability to realise assets and repay creditors etc.). An estimate of the exit costs has been derived for a sample of 13 operators, each of whom generate annual turnover of less than \$1.5 million. Each of the operators selected was subject to an independent evaluation under the Tasmanian Forest Industry Development Programme. The estimate is based on either FYE 2005 or 2006 financial statements, dependent upon availability. Where possible, FYE 2006 financial statements were used. Other assumptions used in deriving the estimate of exit costs are as follows:

- All tangible non-cash assets realised for 70 % of written down value (i.e. discounted by 30 %). Note: a detailed analysis of resale values of fixed assets within the industry has not been performed. Accordingly, it should be noted that there is a possibility that actual proceeds from the sale of fixed assets could be materially different to the assumed percentage of 70 % of the written down values.

- Intangible assets and related party loans discounted to nil.
- All assets are sold to reduce external liabilities (i.e. related party loans not repaid).
- Redundancy costs based on:
  - 4 weeks per year of service
  - average wage is based on ABS data for transport and storage industry – non-managerial (Australia-wide) April 2007: \$1196.20
  - Average number of employees per contractor (as per ACFA data): 3.5
  - Average length of employment (for calculating redundancy payments) assumed to be 2 years (actual data not available)
- Re-deployment assistance of \$10 000 per affected employee (actual data not available). This is considerably less than the \$80 000 (maximum) as requested within the TFCA Structural Adjustment Proposal.

Based on the above assumptions, the average exit cost (per operator) is summarised as follows:

<b>Exit Costs</b>	<b>\$000's</b>
Average shortfall in assets available to meet liabilities	278
Average redundancy cost	33
Average re-deployment costs	35
<b>TOTAL</b>	<b>311</b>

As noted above, the assistance package has requested \$80 000 for re-deployment costs (maximum) for each affected employee. This would increase the total (above) to an estimated \$591 000.

If the \$311 000 per business is accepted as a realistic base cost of exiting, the likely total budget required to support 30-40 businesses is \$9.3-12.4 million.

## 5 REVIEW OF FINANCIAL STATUS OF A SAMPLE OF HARVESTING CONTRACTORS

Table 5-1 below provides a summary of the financial position of a sample of 29 harvesters within the Tasmanian forestry industry. Each of these 29 operators was an applicant under the Tasmanian Forest Industry Development Program, and was subject to an evaluation by the independent assessment team. This analysis collates information obtained from the original evaluation. It should be noted that only 14 of the 29 operators within the sample submitted FYE 2006 financials. For consistency, we have performed our analysis on FYE 2005 financial statements, which were provided by all applicants included in the sample.

**Table 5-1:  
Contractor Financial Analysis**

Analysis of Forestry Operators by Contract Income					
Analysis	< \$0.5m	\$0.5m-1.5m	\$1.5m-3m	->\$3m	Total
Total number of operators	4	9	8	8	29
Loss incurred in FYE2006	3	7	2	1	13
Average profit/(loss)	(53)	(86)	142	434	125
EBITDA	92	201	573	1 713	706
Net Assets	(53)	24	283	878	320
Debt	512	859	1 435	3 574	1 719
External debt	479	719	961	2 972	1 374
Current ratio-average	3.69	0.70	1.10	1.08	1.33
Current ratio (exc. related party)	1.15	0.76	1.45	1.08	1.09
Average debt/tangible assets	1.27	1.23	0.82	0.74	0.99
Average external debt/ tangible assets	1.22	0.75	0.60	0.63	0.74
Assessed level of financial risk					
- high	4	9	5	4	22
- medium	-	-	3	4	7
- low	-	-	-	-	-

For the purposes of our analysis, we have divided the sample into 4 categories, as follows:

- a. Turnover less than \$0.5 million
- b. Turnover of between \$0.5 million and \$1.5 million
- c. Turnover of between \$1.5 million and \$3.0 million
- d. Turnover of greater than \$3.0 million.

Included in the table is a summary of the financial risk associated with the operators within the sample (i.e. “high”, “medium”, or “low”). During the original evaluation of these operators, a level of financial risk was assigned to each operator. The assessment of this financial risk involved technical financial analysis and commercial judgement based on our own knowledge of the industry and

commercial enterprises more broadly. This assessment took into account a range of factors, including:

- Profitability
- Net asset position
- Level of accumulated profits/losses on balance sheet
- Working capital position
- Debt levels
- Reliance on other parties for funding support
- Ratio analysis (i.e. debt to equity, current ratio, debtors turnover)
- Ability to service debt based on historical financials, and forecast cash flows
- Reasonableness of forecast cash flows, including a review of all underlying assumptions

A summary of each category is as follows:

**a. Turnover less than \$0.5 million**

- average profit (before tax) is in fact a loss of \$53 000
- 3 of the 4 operators incurred a loss in FYE 2005
- Average net asset position is a deficit of \$53 000
- All 4 operators in this category were assessed as having a “high” level of financial risk.

**b. Turnover of between \$0.5 million and \$1.5 million**

- Average profit result (before tax) is in fact a loss of \$86 000
- Average net asset position of \$24 000
- All 9 operators in this category assessed as having a “high” level of financial risk.

**c. Turnover of between \$1.5 million and \$3.0 million**

- Operators in this category exhibited a stronger financial profile, with average profit result (before tax) of \$142 000
- Of the 8 operators in this category, 5 were assessed as having a “high” level of financial risk, while 3 were assessed as having a “medium” level of financial risk
- Average net asset position significantly stronger at \$283 000.

**d. Turnover of greater than \$3.0 million**

- Generally, operators in this category exhibited a stronger financial profile than other categories. It should be noted that often these operators generated revenue from alternate sources (i.e. typically transport/cartage operations)
- average profit result (before tax) of \$434 000
- Of the 8 operators in this category, 4 were assessed as having a “high” level of financial risk, while 4 were assessed as having a “medium” level of financial risk
- Average net asset position significantly stronger at \$878 000.

**5.1 Conclusion**

We obtained FYE 2006 financials for only 14 of the 29 operators. Of these 14, 8 experienced a decline in contract income during the year. A further 2 of these operators were in only their first full year of operations (hence no comparisons available for prior year).

As per our original assessments, 22 of the 29 applicants contained a “high” level of financial risk. Typically, these operators had declining revenues, low/marginal profitability, low net asset position (or deficiency in net assets) with relatively high debt levels.

Those applicants with lower revenue bases (i.e. with contract income below \$1.5 million) exhibited a far weaker financial profile than those with higher revenue bases. In addition, many of those operators with higher revenue bases (i.e. contract income greater than \$3 million) were able to generate a large percentage of their revenue from transport/cartage operations.



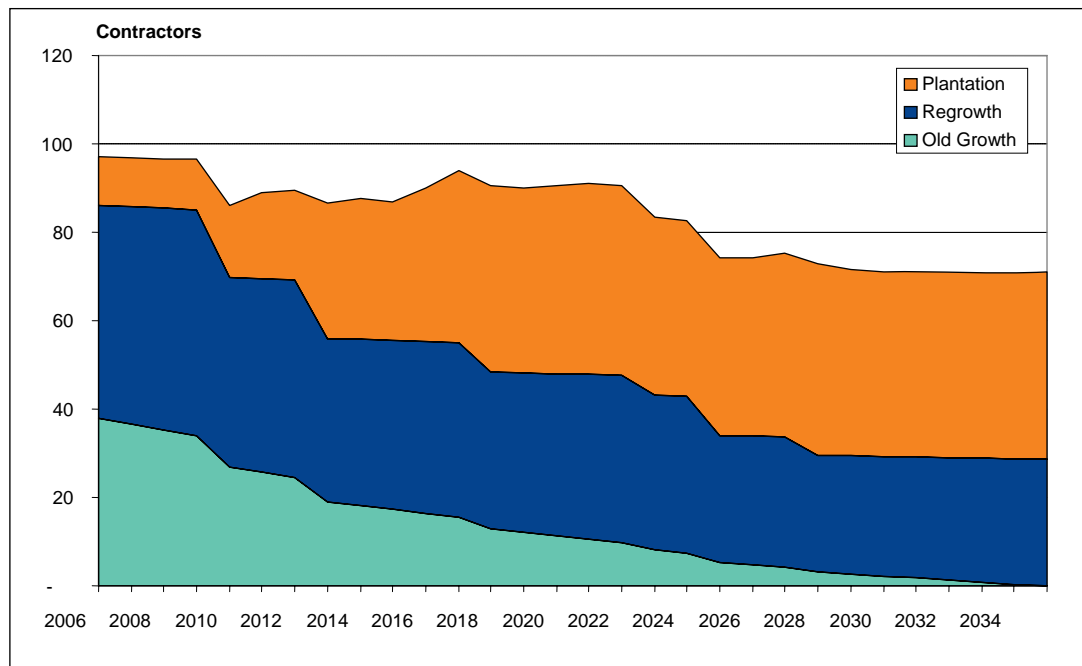
**6 LONG TERM IMPLICATIONS OF A REDUCTION IN THE NUMBER OF CONTRACTORS**

The reduction in contractor numbers will almost certainly occur as a result of both rationalisation/consolidation and a reduction in native harvesting. It is unlikely that this natural reduction will result in any disruption to the Tasmanian forest industry. However, any funding that supports the exiting of the industry or the relocation to the mainland should be carefully managed to ensure that this does not become sufficiently attractive to lower the contractor numbers below the required capacity.

A reduction in contractor numbers and an increase in the scale of each operation will almost certainly result in reduced operating cost, thus improving the competitiveness and viability of the contractors as well as the customers.

Figure 6-1 below indicates a required adjustment in contractor numbers by 2010/2011, then relatively stable numbers until 2016. The next significant reduction in contractors is not expected until 2023/24. Small increases in volume from 2016 will likely result in the expansion of current operations rather than new entrants.

**Figure 6-1:  
Forecast Contractor Numbers**



The total number of people directly employed (operators and owners operating machinery) is expected to drop from the calculated 337 in 2006 to 250 by 2026. This drop of around 87 positions will certainly have an affect on some areas however should be kept in perspective. The annual reduction is 4.5 employees, a number that is likely below the normal turnover rate.