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National Audit Office of Estonia

Sale of timber by the State Forest Management Centre under long-term contracts at negotiated prices

Is the sale of timber by the State Forest Management Centre under long-term contracts based on negotiated prices transparent and are all market participants treated equally?

Report of the National Audit Office to
the Riigikogu
Tallinn, 2 July 2024

Summary of audit results

Long-term contract – a contract whereby the State Forest Management Centre sells timber to a company at negotiated prices and for a long period (usually five years).

Audit focus – the audit of the National Audit Office focused on the long-term contracts of the State Forest Management Centre, which were valid in the period of 2017–2022.

Where appropriate, both earlier and later periods were also reviewed to understand the background and circumstances of the conclusion of these contracts and to assess changes in the way the State Forest Management Centre works in relation to the conclusion, amendment and performance of contracts.

Conclusion of long-term contracts at negotiated prices has not been transparent and has led to special treatment. The audit indicated that when selling timber¹ under long-term contracts, the State Forest Management Centre has unduly favoured certain contract partners by creating special conditions for them and selling them timber at a more favourable price.

The rules regulating negotiations on long-term contracts and agreement of prices do not ensure that timber is sold at the market price, i.e. at the usual value, because these contracts are not concluded by public auction, which would determine the market price of the timber. In proceedings of selling timber at negotiated prices, the prices are agreed in closed negotiations, where the prices offered by the bidders have the decisive impact, but these prices are usually lower than the prices in public auctions. Entering into long-term contracts through public auctions would also be more transparent.

The State Forest Management Centre has favoured some companies over others in the conclusion of long-term contracts and has offered them long-term contracts at more favourable prices. The audit showed that the Centre had concluded three confidential preliminary agreements with two companies² from 2011–2014 for which there was no legal basis. The impact of these agreements also covered part of the audited period, which covered the years 2017–2022. It was agreed on how much timber would be sold and at what price. The preliminary agreements were later turned into long-term contracts, which guaranteed the companies a stable low price during the entire five-year contract period. How such preliminary agreements were made could not be clarified during the audit. The agreements were signed by the head of the Timber Marketing Department.

A long-term contract that lasted for 15 years and had a pricing mechanism that made it possible to buy timber at lower prices during this time was concluded with the third company³.

However, in the opinion of the National Audit Office, this practice led to a risk of corruption and prohibited state aid, as well as to a potential decrease in profitability.

¹ The terms 'timber' and 'wood' are used in the same meaning in the audit report, as this has also been done in legislation as well as the internal procedures and guidance materials of the State Forest Management Centre.

² AS Graanul Invest, AS Latvijas Finiers.

³ AS Estonian Cell.

The price differences of the long-term contracts are significant for customers buying the same timber assortment. Pricing in the negotiations of long-term contracts creates the conditions for very different prices. For example, in 2022, the prices of a long-term contract for pine logs up to 6 m in length and 18+ cm in diameter ranged from €98 to €130, for small pine logs from €50 to €108, for firewood from €28 to €82, and for birch veneer block €141 to €252 per m³. The audit showed that the reasons for the lower prices are not larger quantities or shorter transport distances to the buyer's warehouse.

The prices agreed in the long-term contracts are significantly below the prices in public auctions. Although the State Forest Management Centre is required to ensure that timber is sold at market prices pursuant to the Forest Act⁴ and the Regulation of the Government of the Republic⁵ established on the basis of the Act, the audit revealed that the prices agreed in the long-term contracts are significantly lower than the prices at public auctions: timber was sold at prices that were up to 30% lower. Such a large difference in prices indicates that the rules for negotiating long-term contracts and agreeing on prices for timber are unlikely to guarantee that the market price is received for timber.

Supervision of the performance of timber sales contracts is difficult on the basis of the sales reports sent to the National Audit Office. The analysis carried out in the course of the audit revealed a number of questionable points indicating that the sales prices are not the same as those in the contracts and the data are illogical and inconsistent. For example, there were prices in the sales reports that were not agreed in the contracts; sales reports showed negative interim prices, i.e. situations where the State Forest Management Centre received a financial loss from timber sales; differently reported assortment information, etc. Data had not been collected in a uniform manner for the preparation of sales reports, which makes analysis of sales reports difficult and the data hard to compare.

Main recommendations

Recommendations of the National Audit Office to the Minister of Climate:

- instruct the State Forest Management Centre to abandon the current practice of concluding long-term contracts on terms that restrict competition and to organise the conclusion of future long-term contracts through the most transparent and competitive method of timber sales – public auction.

⁴ Forest Act, § 46 (5).

⁵ Government of the Republic Regulation No 1 "Procedure for Sale of Felling Rights to Standing Crop in State Forest and of Timber" of 4 January 2007, § 17 (1).

Response of the Minister of Climate: the Minister of Climate did not agree with the recommendation to instruct the State Forest Management Centre to stop entering into long-term contracts on terms that restrict competition and to organise the conclusion of long-term contracts through public auctions.

According to the Minister, the terms and conditions for the conclusion of long-term contracts have been changed and they now ensure the highest possible valorisation of timber in Estonia. According to the Minister, the prices of the long-term contracts are also comparable with the prices of timber sold on the private market, both in general and by type of timber. According to the Minister, a price that corresponds to the usual value can be obtained regardless of the method of sale: the price of long-term contracts is, metaphorically speaking, the wholesale price and the price at an auction is the retail price, but both are market prices. According to the Minister, the use of public auctions is restricted by the fact that they cannot establish conditions that exclude bidders, such as a ban on the export of non-valorised timber, which means that the condition of valorising timber in Estonia as much as possible would not be met.

Comment of the National Audit Office: the audit by the National Audit Office showed that the prices of long-term contracts are significantly lower than those of public auctions (see clauses 61–63). The Minister's suggestion that the price difference is due to the quantities sold is misleading, as the audit showed that a customer buying a larger quantity does not generally get a lower price and a customer buying a smaller quantity does not generally pay a higher price (see clauses 75–77 and Annex B for details). The position that no specific conditions can be established for purchasers in the case of public auctions, unlike in the case of sales at negotiated prices, is also incorrect. Similar legal qualification conditions can be set for both procedures.

- Alternatively, initiate an amendment to the Regulation of the Government of the Republic to stipulate the obligation of the State Forest Management Centre to determine the starting price of timber sold under long-term contracts and to describe in the Regulation the methodology for ensuring that timber is sold at the market price.

Response of the Minister of Climate: the Minister generally agrees that it is possible to clarify the regulation of the conclusion of a long-term contract and the formation of the price. According to the Minister, the amendments to the Regulation of the Government of the Republic will be prepared in 2025.

- Initiate a change in the expectations of the owner of the State Forest Management Centre to determine,

- the expected rate of return on timber sales;
- what the share of timber sales under long-term contracts should be in the total sales of timber.

Response of the Minister of Climate: the profitability expected by the State Forest Management Centre depends primarily on the market price of timber. The price is formed not only by the State Forest Management Centre, but also by the situation on the timber market in the region, important events affecting security of supply (such as Russia's war against Ukraine) and overall demand. Therefore, fixing the profitability of the sale of timber is not a measure that would change or improve the situation.

Comment of the National Audit Office: The audit by the National Audit Office showed that the prices of long-term contracts are significantly lower than those of public auctions. The Ministry's guideline on the expected profitability is primarily necessary to ensure that the State Forest Management Centre does not enter into long-term contracts on terms that are detrimental to the profit-making state agency.

- Instruct the Internal Audit Department of the Ministry of Climate to verify whether the State Forest Management Centre has implemented appropriate internal control mechanisms in the sale of timber under long-term contracts, including the conclusion, amendment and performance of contracts, to minimise the occurrence of the errors identified in clauses 123–141 of the audit. Also to check whether the organisation of timber sales by the State Forest Management Centre ensures equal treatment of companies and excludes the grant of prohibited state aid.

Response of the Minister of Climate: the Minister agreed that further inspections are needed at the State Forest Management Centre and that the Ministry, in cooperation with the supervisory board of the State Forest Management Centre, will assess how best to carry out these inspections when preparing the 2025 work plans. One option is that the Internal Audit Service of the State Forest Management Centre and the Internal Audit Department of the Ministry conduct a joint audit.

Recommendations of the National Audit Office to the Chairman of the Management Board of the State Forest Management Centre

- In order to ensure equal treatment and free competition also for new market entrants, to design the price negotiations of long-term contracts in such a way that new customers without a previous long-term contract have the possibility to participate in the price offers of notionally guaranteed quantity rounds.

- Abandon the principle that bids exceeding the average of the prices offered for long-term contracts by 15% are considered as market distortion.
- Increase the verifiability and transparency of the operations carried out when long-term contracts are concluded. Among other things, to introduce requirements for documentation of operations and to consider moving the conclusion of long-term contracts to an electronic bidding environment.

Response of the Chairman of the Management Board of the State Forest Management Centre: the Chairperson of the Management Board agreed with the recommendations of the National Audit Office in part. The Chairman of the Management Board noted that the position of the National Audit Office that the prices of the long-term contracts do not correspond to the usual value is erroneous. The State Forest Management Centre also found that the audit should have analysed in greater detail how the concluded long-term contracts have affected the stability of the timber market.

Comment of the National Audit Office: it is stated in the audit report that the rules regulating negotiations on long-term contracts and agreement of prices do not ensure that timber is sold at the market price, i.e. at the usual value, because these contracts are not concluded by public auction and conditions for selling timber at market prices have not been established in any other manner either. The National Audit Office also points out that the prices of long-term contracts are significantly lower than those of public auctions (see clauses 61–63). This is also confirmed by the graphs prepared by the State Forest Management Centre itself (see Figures 2 and 3 on page 61).

The National Audit Office emphasises once again that according to the Forest Act, when selling timber, it must be ensured that it is sold at a price that corresponds to its usual value, and according to the State Assets Act, when selling state assets, it is necessary to maximise the profit and avoid losses. The objective of stabilising the timber market is not formulated at the level of legislation. Therefore, the profit-making state agency must first ensure that the statutory requirements for the sale of timber are met, and only then can it undertake other tasks that do not conflict with the law.

The National Audit Office audited whether the sale of timber by the State Forest Management Centre under long-term contracts complies with the requirements of the Forest Act, including whether the sale of timber under long-term contracts and at negotiated prices is transparent and all market participants treated equally.

During the audit, the State Forest Management Centre justified selling timber with long-term contracts in the present manner with the

objective of stabilising the timber market. When the National Audit Office asked for analyses that would confirm that the sale of timber at negotiated prices and under long-term contracts has made the timber market more stable, the State Forest Management Centre did not submit such analyses to the National Audit Office.

According to the State Forest Management Centre, the National Audit Office itself should have analysed and proven whether the method chosen by the State Forest Management Centre for concluding long-term contracts at negotiated prices would best contribute to stabilising the timber market. However, the National Audit Office disagrees on this issue. In the opinion of the National Audit Office, the State Forest Management Centre itself must assess the impact of the conclusion of long-term contracts at negotiated prices on the stabilisation of the timber market, and this assessment should not be meaningless, but be based on analyses.

