Forestry managed investment schemes
...past, present, future

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What’s coming?

- ‘Weathering the storm’
  - Recent agri-MIS failures – impacts and causes
- Retail forestry’s integral role in the wood and paper industry
- Tax arrangements for retail forestry
  - Similar to all primary production
  - Tax mythbusting
  - Integrity measures
- MIS forestry – the future
- Carbon trading?

‘Weathering the storm’

- Collapse of Timbercorp and Great Southern is having profound, painful and far-reaching impacts
  - Severe knock-on effects already on FY2009 woodlot sales, and thus on future woodflows to markets
- Cause? – Business strategies; narrow forest product focus; diversity of non-forestry projects; drought and temporary water purchases; ATO test case; excessive debt; adverse asset, equity, and credit markets (especially credit)
  - Not poor forestry or inherent flaws in the MIS model
- By contrast, remaining companies have features that favour their continued survival and growth
First – some history

- Plantation estate built up over decades by State Governments and large-scale industrial processors
  - With Commonwealth assistance, which was terminated in the 1980s
- Since mid-1990s ...
  - ~ 4 million ha of public native forest taken out of production
  - State forest agencies have focused on replanting not expansion
  - Most industrial processors have divested their ‘captive’ plantations
- Institutional investors prefer standing plantations
- ‘Retail forestry’ (managed investment schemes) is ‘filling the gap’

What is ‘retail forestry’? (1)

- Retail forestry is the shorthand name for a forestry managed investment scheme
  - Because it is available mostly to ‘retail’ investors
- A managed investment scheme (MIS) is a legislated form of pooled investment
  - Managed Investments Act 1998 … became
  - Chapt 5C of the Corporations Act 2001
- Similar pooled investments existed for decades as ‘prescribed interest schemes’
  - but with different trustee arrangements
What is ‘retail forestry’ (2)

- An MIS collects and pools funds, through an ‘offer document’, from numerous (often small) investors into larger investments, and pays returns to investors in proportion to their contributions
  - Examples ... cash management trusts, property trusts, equity trusts, time-share units, some superannuation schemes, primary production schemes, and many more
- An MIS forestry manager charges investors (growers) lease and management fees to establish, manage and harvest the plantation and market the produce

Retail forestry has ‘arrived’

- Total plantation estate increased from ~1 mill ha in 1997 to 1.97 mill ha in 2008
- Retail forestry accounts for ~65% of that increase
  - Up from ~5% of the total in the mid-1990s
  - Now over 700,000 ha
- Now 80-90% of all new plantings each year
  - And a large proportion of replanting next rotations
- Replantings are slowing the rate of expansion
  - Easing the competition for suitable land
Estimated decline in NEW plantation area

Source: Bureau of Rural Sciences, 2009

Retail forestry – export and domestic

• Initially mostly short-rotation pulpwood for export woodchip
  • Replacing the resource lost in reserved native forests
  • Suited short investment horizons (~10 years)

• More recently an increase in plantations growing longer-rotation sawlogs
  • Softwood (pine), hardwood (eucalypt, acacia), tropical cabinet timbers
  • Mostly for domestic market
  • Specialty plantation products (eg sandalwood) for export
Retail forestry funds raised for short- and long-rotation projects

Source: AAG

Growing wood for domestic industry

- Retail forestry increasingly growing sawlogs to supply domestic, regionally-based wood and paper processing industries
- $ millions being invested in new and upgraded facilities that will use this future resource
- Four major retail forestry companies are vertically integrated, with their own processing facilities
  - Gunns, FEA, Willmott, TFS
    [and ITC until Gunns takeover]
- Trend will continue with critical mass and maturing plantations
Retail forestry is ‘embedded’

- Studies conclusively show a significant increase in permanent jobs, businesses and community services in the harvest, transport and processing phase of a new plantation industry
- Retail forestry now so embedded in the production and distribution chain that stopping it would have severe, far-reaching and long-lasting impacts

Market failure in plantation investment

- Private investment in plantation forestry suffers market failure
  - Historically undertaken by governments with long-term investment and ‘public good’ horizons
- “Inherent disincentives” (PJC Report)
  - Normal agricultural risk
  - Long-term enterprise
  - High establishment costs
  - Illiquid assets
  - Few income events
  - Inequitably large tax liability at harvest
Tax treatment recognises market failure

- All other countries with large plantation industries have encouraged private investment with grants, subsidies, bounties, concessionary loans, and/or special tax incentives
- Australia has relied on a standard tax deductibility of eligible expenditure available to all businesses (s8-1 of ITAA 1997, originally s51-1 of ITAA 1936)
- Denying this entitlement to plantation forestry would discriminate against one rural industry already inherently challenged

Retail forestry and tax (past)

- Historically (pre-2007-08), retail forestry accessed this same s8-1 general business deduction
  - 100% deductibility of eligible expenditure in the year the grower incurred the expenditure by paying establishment and lease fees to the manager
  - A prepayment rule gave the grower NO extra ‘incentive’
  - But it allowed the manager to secure the land, order the seedlings (8-12 months before planting), prepare the site (months before) and establish the plantation in a prudent and seasonally appropriate manner
Retail forestry and tax (present)

- New statutory deduction (Div 394 of ITAA 1997) retains the same basic principles...
  - 100% deductibility in the grower’s year-of-expenditure
  - A prepayment provision
- Enacted by Parliament to safeguard retail forestry from an adverse finding in the ATO test case
  - Federal Court found 3 to 0 against the ATO
- But Parliament also imposed a number of ‘integrity measures’ in the legislation (of which more later)
  - Strict conditions for the manager to meet so that the growers can claim and retain their tax deductions

Tax Mythbusting 101

- Neither the growers nor the manager in retail forestry receive tax subsidies
  - Land purchases are not subsidised by the taxpayer
- 100% tax deductibility for eligible expenditure in the year incurred is available to all primary producers
  - Who also receive other specific concessions
- Tax deductions in retail forestry do not lead to foregone revenue the Govt could otherwise spend on public services and infrastructure
  - The same investment would simply be redirected
  - Funds received by the manager quickly become the taxable income of the companies, employees, contractors and suppliers
Div 394 integrity measures

- Four strict conditions were imposed
  - 70% ‘direct forestry expenditure’ test
  - 18 months to establish the plantation, or else the grower loses the deduction and the manager faces ‘promoter penalties’
  - Minimum 4-year holding period before on-selling the interest in a secondary market, or else the initial investor loses the deduction
  - Company brings forward (ie, prepays!) its company tax into the same year the growers claim their deductions (‘tax neutrality’)

‘Tax neutrality’ condition

- A company tax prepayment on ‘gross’ receipts from growers brought forward into the same year the growers claim their deductions
  - Company can only offset the deductible expenditure incurred in managing previous years’ plantations
  - Unique condition aiming to achieve ‘tax neutrality’ (or ‘tax symmetry’)
  - But imposes a significant cashflow burden on the retail forestry company
‘70% DFE test’

- Company must demonstrate to the ATO that 70% of all funds raised will be spent as ‘direct forestry expenditure’ (DFE) over life of project
  - DFE = establishing, managing, harvesting, transport to mill, plus the annual costs of land
  - Net Present Value and arm’s length prices
- Excludes marketing, commissions, insurance, financing, contingencies, general overheads etc
- Very tight discipline on companies – tough test
- Greater security that growers’ funds are being spent for their principal purpose

Retail forestry – the future? (1)

- Commonwealth continues to support the Plantations 2020 Vision
- MIS still acknowledged as an effective means of attracting large-scale private investment
- No ‘agitation’ in the Govt to repeal Division 394
  - But some technical amendments are needed
- “We’ll see what the Henry Review says”
  - The Govt is now considering this! But is not in a hurry
- Interested in extra / complementary investment models
Retail forestry – the future? (2)

- Reports of two PJC Inquiries
  - Agribusiness MIS; Australia's financial services
- Senate Inquiry into impact of MIS
  - Report delayed until June 2010 ... but focus is dispersed
- ‘Henry Review’ of Aust’s future tax system
  - Who knows? Architecture, not builders’ drawings
- Ministers thinking about how to maintain what works (ie MIS) and improve investor protection
- The state of financial and credit markets

Better investor protection

- 70% DFE test is imposing new disciplines
- Some regulatory change is certain in the Government’s response to the PJC reports and other advice
  - eg, better disclosure in several areas, more secure provisioning of funds to carry out the contracted services, better scrutiny of the financial capacity of the Responsible Entities – all in an ASIC ‘benchmarking guide’; tighter regulation of financial advisers, and others
- Retail forestry sector will cooperate with the Government to find workable ways to raise the level of investor protection in these projects
Retail forestry is an integral part of Australia’s plantation products and paper industry

- New and replanted plantations face strong demand, especially by the domestic wood and paper industry
- Retail forestry has proven to be the most effective way to attract private investment, and is growing a large part of this plantation resource
- Managing the impacts of retail forestry expansion needs continuous attention
- Changes are certain to the regulatory framework governing retail forestry and the way it is marketed
- Appropriate tax and regulatory arrangements are important in maintaining the flow of private investment

Carbon trading? Well, we’ll see

- Emissions trading? Be very careful
- ‘CPRS’ is unlikely to expand retail forestry beyond current long-term investment trends
- Remember ... harvest of trees = 100% emission, thus any credits earned must be surrendered
  - until C in harvested wood products is recognised
- MIS forestry is different to ‘unitised’ forestry (with a single owner / manager of the land / forest / harvest)
  - The investor may be entitled to nothing
- The objective in designing an ETS is to prevent the only ‘carbon-positive’ sector being disadvantaged