

17 August 2005

Review of the Taxation of Plantation Forestry
C/- Department of Treasury
Langton Crescent
PARKES ACT 2600

plantations@treasury.gov.au

Dear Sir

Please find attached A3P's submission to the Review of the Taxation of Plantation Forestry. Thank you for providing an extension to the time available for us to make a submission on this important review.

A3P is the national representative body for the Australian plantation products and paper industry. The industry represented by A3P has annual sales exceeding \$14 billion, employs 50,000 people and harvests 15 million cubic metres of logs each year which are converted into a wide range of products including 3 million cubic metres of softwood sawn timber and 3.2 million tonnes of paper.

The members of A3P include the major Australian plantation growers, wood processors and paper manufacturers. The diversity of membership and representation from the three sectors allows A3P to develop innovative and constructive positions that reflect the interests of all parties along the production chain.

The terms of reference for the review are very broad and could encompass almost every financial aspect of plantation establishment and management. However, discussion with the review team and Government officials would suggest that the Review's scope will be more limited than the terms of reference might imply with a primary focus on the appropriateness of the current taxation arrangements. Therefore, we have restricted our comments in the attached submission to focus primarily on the need for stability and certainty and the need to encourage more investment in long rotation timber plantations that are vital for the future supply of sawn timber.

We would like to encourage the review team and the Government to consult with us in relation to any options being considered for changes to the taxation arrangement for plantation forestry. We would be very happy to provide input, on a confidential basis if necessary.

Yours sincerely



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Review of the Taxation of Plantation Forestry

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Recommendations

A3P would like to make the following recommendations to the Australian Government's Review of the Taxation of Plantation Forestry.

1. The taxation regime for plantation forestry should be supportive of and consistent with the Australian Government's commitment to *Plantations for Australia: the 2020 Vision*.
2. The recommendations of the report '*Impediments to Investment in Long Rotation Plantations*' should be pursued as a priority and particularly, in the taxation context, Paragraph 48 of TR2000/8 should be re-interpreted to assist the development of secondary markets for immature plantations.
3. The current taxation treatment whereby non-capital plantation establishment expenditure is an eligible deduction against other income at the time of establishment should be retained and confirmed.
4. The Government should provide explicit endorsement of the Managed Investment Scheme model for raising funds for plantation establishment along with a commitment to minimising the overhead costs (including compliance costs) associated with this type of investment model.
5. The 2008 sunset on the 12-month prepayment rule should be removed.
6. Government and industry should commit to working together to establish a plantation information system which demonstrates, at an industry-wide level, the performance of the plantation industry and trends in key financial indicators for the industry.

A more detailed explanation of the rationale for the above recommendations and specific responses to the Terms of Reference of the Review are provided below.

Rationale for Encouraging Plantation Resource and Wood/Paper Processing Industry Expansion

A3P is a strong supporter of the joint industry and government (State and Commonwealth) strategy – *Plantations for Australia: The 2020 Vision* and its overarching principle:

“enhancing regional wealth creation and international competitiveness through a sustainable increase in Australia’s plantation resources, based on a notional target of trebling the area of commercial tree crops by 2020”.

The 2020 Vision is predicated on the need to expand the plantation resource in key regions to provide a critical mass of wood available to support the development of internationally competitive, integrated wood and paper manufacturing industries. Without this critical mass the socio-economic and environmental benefits (discussed briefly) below cannot be realised.

There is no absolute definition of the plantation area or volume of wood that is required in a given supply zone to support internationally competitive, integrated wood and paper manufacturing industries. The National Plantation Inventory provides statistics for industrial plantations in fifteen regions in Australia. With respect to softwood production, only three of these regions, the Green Triangle, Murray Riverina and South East Queensland, could be considered to be world competitive scale. In all of the other twelve regions there are significant softwood plantation resources but further expansion of that resource is required to achieve the scale necessary to ensure that the maximum socio-economic benefits are obtained from the significant investment in the existing plantation resource.

Measured purely on the basis of area of plantation established, it would appear that the 2020 Vision has so far been a success and is on track to achieve the headline objective of trebling the size of the Australian plantation estate from around 1 million hectares in 1994 to 3 million hectares in 2020. However, A3P has a number of significant reservations about this conclusion.

Firstly, the major plantation expansion has been in hardwood. These are primarily plantations of *Eucalyptus globulus* (Tasmanian Blue Gum) being grown on 8-12 year rotations for the production of fibre intended for export to Japanese (or other Asian) paper manufacturers. While this is a legitimate objective, it does not contribute to the objective of expanding the pre-existing plantation resources to the required size at a regional level to support internationally competitive wood processing. In fact the recent plantation expansion has led to the creation of three

new regional hardwood plantation resources (south west Western Australia, Great Southern and Green Triangle) which are approaching the scale required to be internationally competitive. The Tasmanian hardwood plantation resource is also of world competitive scale particularly when combined with additional native forest resources.

Secondly, it is not reasonable to assume that the plantation expansion will continue at the current rate for another fifteen to twenty years unless there is a further increase in plantation investment. Once the new plantations reach maturity and are harvested, in the case of much of the new plantation area this will occur in the next five to ten years, a significant proportion of the available capital will have to be spent replanting the harvested area, not in expanding the plantation resource. Significant investment is now required to maintain the one million hectare softwood plantation estate, with some 30,000 ha being replanted each year, and the hardwood plantation estate will reach this situation more rapidly because of the shorter rotations involved.

Investment in plantation growing and wood or paper product manufacturing is a very long-term venture. Investment horizons range from 10 to more than 30 years. One of the major factors determining the attractiveness of long-term investments is the stability of the investment environment, including the taxation arrangements. A more stable operating environment will assist in delivering well managed plantations and wood flows that do not fluctuate significantly overtime creating gluts and shortages that would undermine the profitability of wood and paper manufacturing operations.

At its most recent meeting the Primary Industries Ministerial Council (PIMC) considered progress in the implementation of the *2020 Vision*. As a result of this consideration PIMC endorsed a number of actions to ensure implementation of the *2020 Vision*. These actions included maintaining apposite policy environment for plantation investment and supporting early planning of infrastructure provisions to support existing and future plantations (PIMC Communique, 14 April 2005).

Recommendations

The taxation regime for plantation forestry should be supportive of and consistent with the Australian Government's commitment to *Plantations for Australia: the 2020 Vision*.

The current taxation treatment, whereby non-capital plantation establishment expenditure is an eligible deduction against other income at the time of establishment, should be retained and confirmed.

Socio-Economic Benefits

Socio-economic analyses conducted at various times and in various plantation regions have demonstrated the significant regional socio-economic benefits of plantations and associated wood and paper products manufacturing industries. The key direct socio-economic benefits for towns and regions are enhanced employment and income generation and diversification.

The latest socio-economic study has been commissioned by the Forest and Wood Products Research and Development Corporation and undertaken by the Bureau of Rural Sciences within the Australian Government Department of Agriculture Fisheries and Forestry. The report on this study is due to be published in the near future and will once again demonstrate that expansion of plantations has contributed to stable economic growth in the regions studied and to stable or growing populations in towns which otherwise would have experienced the population decline which is so common in much of rural Australia. Towns with a large proportion of the workforce in the plantation sector have experienced more rapid growth in working age population than towns in areas with less diverse economies, particularly those highly dependent on broad-acre agriculture.

Environmental Benefits

Plantation establishment also provides a range of direct and indirect environmental benefits including:

- o binding the soil and reducing soil erosion and compaction;
- o intercepting groundwater movement and preventing water-logging and salinity downslope;
- o sheltering wildlife in remnant vegetation and reserved areas within the plantation; and
- o absorbing carbon from the atmosphere and storing it for long periods in solid wood products.

These benefits have been documented in a large number of studies and it is not appropriate to provide a full account of these benefits here. However, these environmental benefits, many of which are public benefits, are a significant part of the rationale for Government support for the 2020 Vision and related initiatives to encourage plantation expansion.

Perspectives of Potential Plantation Investors

The report - *Impediments to Investment in Long Rotation Timber Plantations* (FWPRDC 2005) provides a good summary of the various

types of investors who have previously invested or are currently investing in plantations in Australia and the drivers that influence the extent to which these investors are currently seeking to expand the Australian plantation resource. These types of investors include:

- State governments
- Wood processing industry
- Managed Investment Schemes
- Timberland Investment Management Organisations (TIMOs)
- Institutional investment

In relation to this review the key point to note is that the Managed Investment Schemes have been responsible for a significant proportion (possible in excess of 60%) of the greenfield plantation expansion in Australia in recent years.

State Governments

Virtually all State governments are making some ongoing investment in plantation expansion. However, the level of investment is significantly below that which occurred during the major period of softwood plantation expansion in the late 1960s and early 1970s under the Softwood Forestry Agreements Acts. Current State Government investments in plantation expansion tend to be focused around incremental growth and rationalization of the existing plantation resource or the pursuit of public good outcomes such as environmental benefits, including replacement of native forest resources which have been transferred to conservation reserves.

State Government investment in new plantation establishment has generally declined because of competition for public funds for other higher priority public services and because of a view that plantation growing is a commercial activity more appropriately funded by the private sector.

Wood Processing Industry

A significant proportion of the initial plantation establishment in Australia was undertaken by companies, particularly paper manufacturers, who were seeking to secure a proportion of their raw material requirements.

More recently there has been a trend away from plantation ownership by wood processing companies in Australia and also in other countries including New Zealand and the United States. The sale of plantations has freed up large amounts of capital which has been required for investment in the increasingly capital intensive wood product and paper manufacturing plants. The type of investment profile that is interested in

large industrial wood product processing companies is not generally interested in the investment profile of long-term plantation ownership. There has been a trend to separating these assets so they can be more specifically tailored to different types of investors.

While the major wood processing companies are not generally investing in greenfield plantations in Australia, they continue to show their confidence in the industry by committing large amounts of capital to new wood processing investments. The investments which have occurred or are under consideration, valued at several billions of dollars, have been documented in a number of studies undertaken for the Department of Agriculture Fisheries and Forestry. Some recent examples of major capital investments that has occurred or is occurring are listed in the table below.

Company	Location	Investment Type	Value (AUD million)
Norske Skog Aust	Albury, NSW	Paper mill upgrade	130
Kimberly Clark	Millicent, SA	Paper mill upgrade	200
Hyne & Son	Tumbarumba, NSW	Sawmill rebuild	110
Weyerhaeuser	Tumut, NSW	Sawmill upgrade	40
Australian Paper	Morwell, Vic	Paper machine rebuild	10
Green Triangle Forest Products	Mt Gambier, SA	Sawmill upgrade	30
Visy Industries	Tumut, NSW	Pulp & paper mill	400

TIMOs & Institutional Investors

The sale of plantation resources by the wood processing industry and Governments in Australia and other countries has facilitated the involvement of institutional investors. Institutional investors have purchased large multi-aged plantation estates attracted by the steady cash-flows from on-going harvesting and the stable nature of the associated real estate investment.

To date institutional investors have not shown significant interest in taking on the agricultural risk associated with investing in new plantations. However, there is some suggestions that, as the institutions become more comfortable with plantation investment and as the funds at their disposal increase, they may become more interested in investing in new plantations.

Managed Investment Schemes

As noted above, MISs have been the major driving force of plantation expansion in Australia in recent years. MIS investors are interested in

taking on the agricultural risks associated with new plantation establishment because the non-capital expenditure associated with plantation establishment is deductible against income from other sources in the year in which it is incurred. It is common for these investors to be planning on receiving returns from plantation investment as part of retirement income, when their marginal tax rate will be lower than at the time of the original investment.

It has been suggested that the high prices for land being paid by the MIS companies may be deterring other potential plantation investors such as wood processing companies, State agencies and institutional investors. There may be some limited circumstances where this is the case. However, it seems more likely that other factors, principally competition for investment funds, are deterring investment in new plantations by these other groups of investors.

The wood processing industry is most interested in investing in new processing facilities and there are ample opportunities available for such investment in Australia and many other parts of the world. State Governments also have many other demands on the funds they have available for investment such as schools, hospitals and transport infrastructure.

The land prices paid by MIS companies seem to be primarily determined by competition between MIS companies and with other sectors such as sheep and cattle grazing and dairying

TOR (i) – The commercial viability and current tax treatment of plantation investment.

Commercial viability is not a simple concept to define as different investors have different circumstances and expectations in terms of the quantum, nature and timing of returns on investment. Ultimately only an investor can make a genuine assessment of the commercial viability of an investment in plantation forestry.

Provided they are well managed, plantations can be a commercially viable investment but rates of return would generally be considered modest and are very sensitive to up-front costs because of the long timeframes involved. Wood production in plantations is highly competitive (in an international context) and sensitive to economies of scale.

There are concerns that investors in many of the current MIS projects are making an initial per hectare investment that is greater than a 'traditional' plantation operator is able to pay per hectare to establish and manage a plantation and make a reasonable return on investment. This view is generally based on anecdotal and ad hoc reviews of Managed Investment Scheme Product Disclosure Statements rather than on an objective and exhaustive analysis of the projects. Such an analysis would be very difficult to perform because of the different circumstances of investors and the different structures of the investment products.

As the MIS model involved aggregating the funds of a large number of relatively small investors, the projects involve significant additional costs associated with compliance with the *Managed Investments Act 1998*. While compliance is an important issue, every effort should be made to ensure that the compliance mechanisms achieve their objectives as efficiently as possible. There are also significant costs involved in marketing MIS products via financial advisers who receive commissions for sales.

Recommendations

A more explicit endorsement of the Managed Investment Scheme model for raising funds for plantation establishment should be provided along with a commitment to minimising the overhead costs (including compliance costs) associated with this type of investment model.

The 2008 sunset on the 12-month prepayment rule should be removed.

Given the concerns noted above, about the costs and performance associated with MISs, there would appear to be a need for a greater level of information about the performance of the Australian plantation sector and trends in the markets in which it operates. Collection and publication of this type of information requires cooperation of the industry, which would provide most of the raw data, and an independent party, possibly a government agency such as ABARE, which would collate and publish the information in a form that is useful to investors and policy makers but does not breach commercial confidentiality.

A3P would be willing to work with Government to develop an appropriate system for collection and reporting of the appropriate information.

Recommendation

Government and industry should commit to working together to establish a plantation information system which demonstrates, at an industry-wide level, the performance of the plantation industry and trends in key financial indicators for the industry.

TOR (ii) – whether the operation of the Income Tax Assessment Act impedes investment in longer term forest rotations which produce higher value products.

Impediments to Investment in Long Rotation Timber Plantations (FWPRDC 2005) provides an analysis of issues relating to investment in long rotation plantations. This is an issue of fundamental importance to A3P members because, as detailed above, many of the regions in which A3P member companies operate lack the critical mass of long rotation plantations needed to support internationally competitive processing industries.

In a general sense the taxation system does not make any differentiation between long and short rotation plantations. However, the above report does identify an issue with the ATO's interpretation of Paragraph 48 of TR2000/8. This interpretation is preventing the marketing of MIS investment products based on the sale of immature plantations. The ability to sell immature plantations through a secondary market would provide additional liquidity and thereby make long rotation plantations a more attractive option to potential investors who cannot contemplate a thirty year investment horizon.

Recommendation

The recommendations of the report *'Impediments to Investment in Long Rotation Plantations'* should be pursued as a priority and particularly, in the taxation context, Paragraph 48 of TR2000/8 should be re-interpreted to assist the development of secondary markets for immature plantations.

TOR (iii) – the role of State and Territory Governments in plantation industry development as investors, growers and land managers, and any implication this has for competitive neutrality with regard to tax liabilities and incentives;

Under the National Competition Policy the State and Territory Governments have agreed that the principles of competitive neutrality will be applied to Government forestry business enterprises. All State and Territory Governments have made changes to the operation of their forestry business enterprises in recent years.

The National Competition Council has included the performance of government forestry business enterprises in its assessment of Government's progress in implementing the National Competition Policy related reforms. The Productivity Commission has included Government forestry businesses in their annual assessment of the financial performance of government trading enterprises since 2001-02.

The most recent Productivity Commission report shows that, in 2002-03, forestry GTEs paid nearly \$60 million in dividends and \$50 million in tax-equivalent payments to Government.

Regardless of the ownership (public or private) of plantation assets, sound commercially focused management is essential to underpin the viability, growth and development of the plantation resource and dependent industries. It is desirable that the ownership arrangements enable and support continued investment in, and expansion of, plantations.

Any decisions regarding the ownership of plantations should have regard to the fundamental need to maintain supply certainty to encourage the large, long-term investment required in the wood processing and paper industries that provide the commercial driver for all plantation growing activity.

Certainty of wood supply is also dependent on the protection of the plantation resource from damage agents, particularly fire. Protection of the plantation resource is an important issue to consider in the context of privatisation of State plantation resources.

State plantation managers have made, and continue to make, a significant contribution to the development of regional infrastructure, particularly roads. Privatisation is likely to lead to a change in the requirement for, and nature of, this contribution to infrastructure and therefore this issue should also be considered by Governments.

TOR (iv) – the capacity to adapt existing tax policies to contribute to achieving the Australian and State Governments’ desire to achieve a greater integration of plantation and natural resource management policies to improve the management of salinity and water quality

Public Good Environmental Benefits of Plantations

As noted above, the establishment of a timber plantation can deliver significant environmental benefits particularly where the land on which it is grown has been used for intensive grazing or cropping in the past. These benefits are being delivered by the majority of the plantations that are currently being established, regardless of whether or not these benefits are being explicitly sought or acknowledged.

When planting an area of land to trees, plantation managers generally set aside a significant proportion of the total area in reserves which will not be disturbed or used for production. These areas include streamside or riparian areas, swamps, retained native vegetation and environmentally sensitive areas such as steep slopes. These areas may be set aside as a result of a regulatory requirement but are often supplemented with areas which the plantation manager voluntarily excludes from planting to achieve conservation objectives. The exclusion of areas from the productive land base represents a significant cost to the plantation owner both in terms of lost production and reduced economies of scale for planting and harvesting operations.

The reservation of areas mentioned above confers a range of conservation benefits many of which can be considered to be public goods. Streamside reserves help to prevent erosion and protect the quality of the water flowing out of the plantation. The protection of remnant vegetation and revegetation of some areas enhances biodiversity by providing habitat for a wide range of plants and animals.

Despite the inherent environmental benefits of plantations, as outlined above, plantations continue to be regulated to a far greater degree than other agricultural enterprises when the opposite should arguably be the case.

In the most extreme case of public good conservation involving a plantation, a plantation grower may be prevented from harvesting a plantation, specifically established for the purpose of timber production, in order to provide some public good conservation benefit. Under these circumstances the grower should be fully compensated for lost income and it could be argued that the processing industry involved should also be compensated for the loss of resource. Provision for compensation should be made in ‘right-to-harvest’ legislation. Such legislation exists in some States and is currently being considered in a number of others.

One means of acknowledging the public good conservation benefit of timber plantations, without the redistribution of public funds, would be for all three levels of government to deliver on their commitment to remove regulatory impediments to plantation expansion. Provision of an unambiguous right for landowners to plant and harvest timber plantations, provided they do so in accordance with codes of practice, would encourage further plantation expansion, delivering increased employment, rural income and a range of public good conservation outcomes.

Environmental Services

Utilising the ability of timber plantations to provide environmentally desirable outcomes, or environmental services, as part of the fundamental financial justification for establishing a plantation is a relatively new concept and one which has not been widely used in Australia to date.

Many people are now recognising the potential of such a system to use the efficiency of market forces to deliver environmental outcomes particularly in relation to climate change amelioration (carbon credits), salinity remediation (salinity credits) and biodiversity protection or enhancement (biodiversity credits). However, for market forces to be bought into play there are two fundamental requirements.

Firstly a mechanism is required to create a real economic demand for the environmental service. A significant demand of this nature can only be created either by Government using public monies (either directly or via the tax system) to purchase the environmental service or by legislating to penalise 'polluters' unless they offset their pollution by purchasing the equivalent amount of environmental services.

Secondly, before taking the business decision to supply the demand discussed above, investors need to be confident that a stable, secure and transparent marketplace has been created for the 'product', or environmental services, concerned.

A number of major players in the Australian plantation timber industry have demonstrated their interest and willingness to be involved in environmental services markets via development work and some trial trading. However, until the two fundamental requirements outlined above are met with respect to each prospective environmental service, it is unlikely that such trading will move beyond the trial and public relations phase.

TOR (v) – the relative roles and effectiveness of tax system and expenditure programmes in the delivery of assistance to the industry.

A3P is not in a position to make any detailed comments in relation to this term of reference. However, it is noted that there has been a great deal of doubt about the ability of environmental expenditure programmes to deliver cost effective on ground outcomes in terms of the establishment and maintenance of vegetation.

Despite the expenditure of large amounts of money on such activity there is little objective performance information to assess its effectiveness. On the other hand the, the MIS model has been highly successful in establishing large areas of plantations in a very short period of time. It has been estimated that 60-70% of the approximately 700,000 hectares of new plantations established since the launch of the 2020 Vision have been financed via MISs. Some of these plantations are now being harvested and providing returns to growers.