

Review of the Taxation of Plantation Forestry**A Joint Submission from****National Association of Forest Industries
and
Tree Plantations Australia**

The forest and timber industry provides both economic and social lifelines for many communities throughout rural and regional Australia. A very large proportion of the \$15bn worth of timber products manufactured in Australia each year is derived from a small number of timber-growing regions. Those regions provide jobs for many of the 135,000 people employed in the timber growing, harvesting and processing sectors of the industry.

To maintain the supply of timber to existing industries and encourage new investment in value-adding facilities that will help reduce Australia's trade deficit in forest products of almost \$2bn per annum, it is essential that there is a continued expansion of the nation's plantation resources. The industry-Government strategy, *Plantations for Australia: the 2020 Vision*, envisaged that the rate of plantation establishment should be approximately 80,000 hectares per annum. However, the more recent restrictions on industry access to native forests means that for Australia to meet its future timber needs, the community will become more heavily dependent on plantations.

Plantation forestry is quite different to many other investment activities, with large up-front costs at the time of establishment and lengthy periods between planting the trees and the receipt of income. These characteristics present numerous risks for growers, in terms of the projected returns from their forestry investments. To overcome these difficulties in every country around the world where there has been a significant growth in plantations, Governments have played an important role in terms of delivering a stable investment climate through the use of taxation measures and/or expenditure programs.

Over the past 6 years, successive changes to the taxation laws governing plantation activities in Australia have led to quite large variations in the level of investment in new timber resources, the area of plantations established, and confidence over the future of the industry. The 12-month prepayment rule has played an important part in regaining some of the lost support and confidence in the plantation sector.

This review provides the Government, the timber industry and regional communities with an important opportunity to address these fluctuations in investment and our future wood supplies, by considering the merits of the existing tax laws and identifying potential improvements in the taxation arrangements and regulatory systems applying to plantation forestry. These improvements should help raise the level of transparency surrounding these activities and attract a greater level of investment into long-rotation timber plantations.

The forest and timber industry is willing to complement the efforts of the Government in this regard and establish a sustainable industry that can supply the growing timber markets in Australia and overseas. This can only be achieved through the introduction of a series of changes, which are detailed in this submission.

Catherine Murphy
CEO
NAFI

Phil Townsend
CEO
Tree Plantations Australia

A summary of recommendations

To retain some degree of alignment with the 12-month prepayment rule, the sunset clause on the licence condition over land should be extended by ASIC until 30 June 2008.

The Federal Government should recognise within the tax legislation that managed investment schemes are an acceptable investment structure and that the scheme investors are deemed to be carrying on a business.

The significant costs of conforming with the regulatory regimes of the ATO and ASIC should be recognised in any discussion about the managed investment projects. To reduce these costs of compliance, it would be most beneficial if all managed investment projects were assessed for a Product Ruling from the ATO in accordance with a common set of criteria and objectives.

Transparency associated with the managed investment projects could be improved by allowing the trading of immature plantations. By preventing the market from determining a value for immature plantations established through managed investment schemes, it is possible that the ATO decision may be partially responsible for distorting investment decisions between projects, including the proportion of investment directed towards either short or long-rotation plantations.

A more complete assessment of the markets for timber products and wood resources indicate that Australia's suppliers have, in general, had a small, historical comparative advantage over our competitors in the export markets. These combined factors indicate, in economic terms, that a large proportion of the less costly, newly-established plantations should be commercially viable.

To counter numerous uninformed claims about the plantation forestry sector, the industry should take on a greater role in providing information on timber markets and reporting on the proportion of plantations that are achieving their stated growth targets.

Given the Government's interests in plantation forestry and ensuring that financial resources are being most effectively delivered into the establishment of regional timber resources, ABARE should be adequately funded to provide an on-going analysis of the timber industry. This would require the collection of sufficient domestic and international industry information to prepare an informed analysis of the supply and demand conditions facing the forest growing and timber processing sectors.

The combined benefits of:

- delivering investment into regional Australia;
 - the introduction of new timber growing and processing industries;
 - the requirement to continue establishing regional timber resources until they reach a critical mass of resources; and
 - the provision of greater market transparency by the industry
- all support the retention of the 12-month prepayment tax rule.

In many analyses of the prepayment rule, it is often forgotten that the primary purpose of this rule is to allow the collection of investor funds in a manner that allows the companies to acquire land and undertake the activities for establishing plantations in a manner that is guided by the weather.

What industry is seeking from this Review process is certainty over the taxation rules that will apply to managed investments, including the 12-month prepayment rule, and a more complete alignment of other regulations applying to plantation projects (such as the sunset clause on the 9-month licence condition of ASIC for securing land).

To support a greater level of investment in long-rotation plantations, the taxation legislation should be altered to allow immature plantations, established with funds collected through managed investments, to be sold once they have been held for a reasonably long period of time or the growers have earned

some income from thinning the plantations. The text contained in paragraph 48 of Tax Ruling TR2000/8 could provide the legislative framework for supporting the sale of immature plantations that have been established through the managed investment schemes.

Both the profits a prendre and period inequity issues were identified prior to the release of the National Forest Policy Statement (1992). Successive Federal Governments made a commitment to address these anomalies through the *Wood and Paper Industry Strategy* (1996) and *Plantations for Australia: the 2020 Vision* (1997). Unfortunately, they are still outstanding matters for the industry and these issues should be addressed in the context of the current review.

Instead of focussing on whether there is competitive neutrality between private and public plantation growers, it would be more appropriate for the Commonwealth to request that the State and Territory Governments take all possible steps to reduce the regulatory burden facing plantation growers. By all accounts, the additional regulations applying to all aspects of plantation forestry unnecessarily raise the costs of obtaining plantation development approvals by between \$300 and \$1,000 per hectare.

It would be more appropriate for the Commonwealth to request that as it improves the tax system to support plantation forestry, that the State and Territory Governments should comply with their commitments to the 2020 Vision. In particular, they should respond to the first action, requiring the development of a comprehensive policy framework for addressing the impediments to investment in the plantation sector.

Industry is willing to participate in the establishment of multi-purpose plantations and supports a stronger integration of natural resource management and plantation policies. However, a greater level of engagement in the design of such programs is required in order to improve the processes for aligning the multiple objectives – environmental benefits, wood supply for industry, and reasonable rates of returns for investors. In addition, there must be a recognition that these plantations are not likely to produce the same volumes of timber as industrial plantations established through the managed investment schemes and that there must be a demonstrated commitment to maintain those programs for a sufficiently long period in order to develop a critical mass of resources.

Detailed Submission

Introduction

The primary purpose of *Plantations for Australia: 2020 Vision*, as indicated with its release in 1997, was to support the establishment of plantation resources for supplying an internationally-competitive, domestic forest and timber industry. Actions contained in the Vision strategy provided a template for addressing the impediments to investment in plantation forestry. Unfortunately, many of those impediments remain and in some cases, there is a growing regulatory burden being placed onto the industry. In spite of this, the plantation sector has been successful in attracting sufficient funds to deliver regional investment in plantations on a suitable scale for supplying local timber processors and/or the timber export markets.

Plantation forestry has some special characteristics that are not found in any other investment activity. A significant proportion of the total costs are incurred during the plantation establishment phase and growers are required to wait a long time before any returns on their investments can be realised. There is no annual source of income and in the most simple forestry investments, the trees are established in the first year of the project and income is received when the trees are harvested a minimum of ten years later.

With the long-rotation activities, growers may be fortunate enough to earn small, periodic amounts of income as the plantations undergo commercial thinning operations, with the best trees grown on to saw and veneer log resources for harvesting at the end of the rotation. In most cases, approximately

three-quarters of the income across the life of the plantation investment will only be returned after a growing period of between 25 and 40 years, depending on the species that is being grown.

For many long-rotation investment activities, current prices and the forecasts of future prices alone, cannot justify the length of the investment period or the risks associated with those projects. It is these structural characteristics of plantation forestry that require some additional support mechanism be put in place to attract investors.

In all countries around the world where there has been a significant increase in plantation resources, Governments have played an important role in driving that investment by introducing grant programs and/or favourable taxation regimes (Attachment A). In each case, the successful expansion of the plantation resources has depended on those Governments maintaining an investment climate for a period of time that is sufficient for the industry to expand the resources to a critical mass for supplying local and/or export markets on a sustainable basis. Whenever those grant programs or favourable taxation regimes have been removed, there is an immediate reduction in the rate of plantation establishment.

For Australia, the combined effects of the 2020 Vision, the advent of short-rotation (10-year) pulpwood crops, the utilisation of managed investment schemes, and a taxation regime that assists the delivery of that investment, has resulted in almost 700,000 hectares of new plantation establishment during the last decade. As a direct result, Australia is building the capacity to supply wood for new timber processing mills and to help meet the growing international demand for wood fibre.

Responses to the Inquiry Terms of Reference

i. The commercial viability and current tax treatment of plantation forestry

There can be little doubt that the taxation treatment of plantation forestry has been the major driver of new investment in this sector for the past decade. In the latter part of the 1990s, managed investment companies operated under the 13-month prepayment rule. This allowed investment funds to be collected up until the 30 June each year and expended over the following 13 months on establishing and tending plantations on land already acquired. In 1999, the 13-month rule was withdrawn, based on one of the recommendations in the Review of Business Taxation (the Ralph Report).

In 2000, the managed investment companies had to establish plantations with funds collected in June 1999 (on land that had already been acquired prior to 30 June 1999) and funds collected under a new regime for raising funds in 2000 (on land acquired prior to raising the funds). This new regime had the companies collecting investor funds around May-June and completing plantation establishment by the end of June in the same year. Using this approach, the forestry companies had to predict how much land they would need to acquire so that they were ready to commence the establishment activities immediately after the collection of the investors' funds.

In 2001, this approach to plantation establishment led to major difficulties for all forestry managed investment scheme companies. A number of other contributing circumstances, including the ATO and ASIC raising doubts about the bona fide nature of managed investment schemes, resulted in a significant decline in new investment. Many companies were left with much larger parcels of land than they needed, compared to investor interests in plantation forestry. One of the largest forestry managed investment companies went into liquidation at that time and several others almost suffered the same fate.

Late in 2001, the former Minister for Fisheries, Forestry and Conservation gained the Government's support for introducing a 12-month prepayment tax rule. It allows managed investment companies to collect the funds up until 30 June each year and to spend the money collected on plantation establishment over the next 12 months. This rule, combined with the immediate deductibility provisions for expenditure on plantation establishment (as allowed under Section 8-1 of the *Income*

Tax Assessment Act 1997), has drawn a significant level of investor interest back to the forestry sector. It also allows the managed investment companies to acquire the land after they have collected the funds. That is, to match the land requirements with the planting regimes.

Although the Federal Government announced in May 2005, an extension of the sunset clause for the 12-month prepayment provision until 30 June 2008, there has been no complementary change in the ASIC policy on land acquisition for the forestry projects. As part of the licence conditions for the managed investment schemes, land to be planted with trees needs to be secured within nine months of the initial investment. There is a sunset clause on this rule that comes into effect from 30 June 2006.

To retain some degree of alignment with the 12-month prepayment rule, the sunset clause on the licence condition over land should be extended by ASIC until 30 June 2008.

Managed investments are a proven form of capital-raising for many agricultural sectors, including plantation forestry. However, from time-to-time, the question of whether these projects are managed investments or trusts is raised. The specific elements of the Puzey case (*Puzey v The Commissioner of Taxation*, Federal Court, February 2004) clearly identifies that most forestry projects sold to investors are managed investments and therefore, the forestry activities represent the carrying on of a business.

The Federal Government should recognise within the tax legislation that managed investment schemes are an acceptable investment structure and that the scheme investors are deemed to be carrying on a business.

The ATO and ASIC play an important role in protecting the interests of those investing in plantation forestry through the managed investment schemes. However, conforming with all of the rules and regulations applying to the managed investment adds a significant cost to the projects, which may be as high as \$1,000 per hectare.

One of the additional industry concerns with the preparation of product rulings is the differences in the processes being used for assessing projects by the various offices of the ATO prior to the issue of a product ruling.

The significant costs of conforming with the regulatory regimes of the ATO and ASIC should be recognised in any discussion about the managed investment projects. To reduce these costs of compliance, it would be most beneficial if all managed investment projects were assessed for a Product Ruling from the ATO in accordance with a common set of criteria and objectives.

The actions of the regulatory authorities in attempting to control and restrict the activities of the managed investment companies have inadvertently reduced the transparency associated with the plantation projects and raised the project costs by a considerable amount. Two important events removed a considerable proportion of the transparency – ASIC preventing the use of forward-looking statements and the ATO preventing the sale of immature plantations established with funds collected through the Managed Investment Schemes.

When ASIC prevented the inclusion of forward-looking statements (forecasts and projections) in Product Disclosure Statements, it removed an important avenue for scrutiny and comparing the returns from similar forestry projects. Although this role has been transferred to the agribusiness research houses, it means that the comparison of plantation projects is based on a more subjective set of criteria – not just the fundamental economics of the projects.

To address any concerns that fees charged for establishing plantations through the Managed Investment Schemes are excessive, the Government should support, rather than prevent, the trading of immature plantations. **Having a more active secondary market would aid price discovery and**

help investors to assess the value of immature plantations. Investors could then compare the value of immature plantations part way through a rotation with the costs of entering into the schemes.

When the Australian Securities and Investment Commission withdrew the capacity for including forward-looking statements in the managed investment's Product Disclosure Statements, this market information could not be conveyed to potential growers, in terms of providing forecasts or projections of future income and timber prices. Inadvertently, this decision led to a considerable reduction in transparency around the managed investments, which could be returned by having growers report on the growth rates of their plantations part way through the rotations and by introducing legislation to support a secondary market for the trading of immature plantations established through the managed investment schemes.

Transparency associated with the managed investment projects could be improved by allowing the trading of immature plantations. By preventing the market from determining a value for immature plantations established through managed investment schemes, it is possible that the ATO decision may be partially responsible for distorting investment decisions between projects, including the proportion of investment directed towards either short or long-rotation plantations.

While some industry commentators claim that there will be a future 'wood glut' in Australia, this demonstrates their limited understanding of the changing nature of timber supplies and wood fibre demands around the world. The single greatest factor that will drive the future demand for wood fibre alone, is the increasing per capita consumption of paper and paper products. Who will supply those resources? It is not a simple matter of balancing supply and demand. Instead, the major suppliers of resources into the international arena will be those who can maintain a comparative advantage over their competitors.

Australia maintains a number of comparative advantages over other countries that could supply timber resources into the Asia-Pacific region (Attachment B). Not only do the majority of our new plantation resources supply the most highly sought after paper-making resource, but we have shorter shipping times to the major markets of our economic region and Australian companies can supply those resources on a long-term basis. In some markets, we have, up until the recent improvements in our exchange rate, had the advantage of being a low-cost supplier of wood.

In China, per capita paper product consumption levels are around one-tenth of that in the United States. For India, their per capita consumption is around one-tenth of that in China, or one per cent of the level for the United States. It is therefore not hard to see the potential demands for paper products from what are currently the developing economies of the Asia-Pacific region. Over the last decade alone, the increasing demand for paper products in our economic region has seen requirements for wood fibre grow by an amount that is equal to supplying one new world-scale pulp and paper mill each and every year.

As more and more cost pressures come to bare on the international timber industry, it is highly likely that more of the region's timber-processing mills will be located close to the timber resources. However, those resources need to be growing and available before investors will take the decision to install any new processing facilities.

A more complete assessment of the markets for timber products and wood resources indicate that Australia's suppliers have, in general, had a small, historical comparative advantage over our competitors in the export markets. These combined factors indicate, in economic terms, that a large proportion of the less costly, newly-established plantations should be commercially viable.

Although the outlook for the timber industry remains quite positive, there can be no doubt that some plantations established over the past decade will fail to meet their predicted growth targets or realise

the stated returns to growers. In response to the lower-than-expected growth rates, the industry has the potential to replant those areas with different species and to apply different management regimes to those plantations when they are replanted.

To counter numerous uninformed claims about the plantation forestry sector, the industry should take on a greater role in providing information on timber markets and reporting on the proportion of plantations that are achieving their stated growth targets.

Given the Government's interests in plantation forestry and ensuring that financial resources are being most effectively delivered into the establishment of regional timber resources, ABARE should be adequately funded to provide an on-going analysis of the timber industry. This would require the collection of sufficient domestic and international industry information to prepare an informed analysis of the supply and demand conditions facing the forest growing and timber processing sectors.

One form of assessment to consider is the flow-on regional economic and social impacts from the plantation forestry investments. While further research is required to clarify the extent of the impacts, initial evidence indicates that a shift in landuse from grazing and cropping to plantations has no negative effects on regional economic and social indicators. If anything, the new investment in plantation forestry prevents many regional economies and communities from suffering the fate of 'rural decline'.

The combined benefits of:

- **delivering investment into regional Australia;**
 - **the introduction of new timber growing and processing industries;**
 - **the requirement to continue establishing regional timber resources until they reach a critical mass of resources; and**
 - **the provision of greater market transparency by the industry**
- all support the retention of the 12-month prepayment tax rule.**

In many analyses of the prepayment rule, it is often forgotten that the primary purpose of this rule is to allow the collection of investor funds in a manner that allows the companies to acquire land and undertake the activities for establishing plantations in a manner that is guided by the weather.

What industry is seeking from this Review process is certainty over the taxation rules that will apply to managed investments, including the 12-month prepayment rule, and a more complete alignment of other regulations applying to plantation projects (such as the sunset clause on the 9-month licence condition of ASIC for securing land).

ii. Whether the operation of the Income Tax Assessment Acts impede investment in longer-term forest rotations which produce higher value timber products

Over the past decade, there has been a relatively small amount of investment in long-rotation plantation projects. While this has accounted for approximately 10% of the increase in plantation resources since 1997, some significant changes will need to be implemented if there is to be any substantive increase in the area of long-rotation plantation establishment in Australia.

Following the Regional Forest Agreements and successive decisions by State Governments to reduce the area of native forests available for timber production, the industry has been continually told that plantations will be established to provide the future high-quality timber resources sought by industry. However, in no State has that investment eventuated. While numerous investment strategies have been developed to promote investment into this sector of the industry, they have at best, had a very weak impact on new investment.

New investment in long-rotation timber plantations will be an essential component in maintaining the supply of high-quality resources to the timber industry beyond 2030. These plantation resources would complement the remaining native forest hardwood timber supplies and are needed to retain a critical mass of resources that underpin what is still an internationally-competitive sector of the industry.

It is industry's firm belief that a number of outstanding taxation issues need to be addressed if additional investment is to be drawn into long-rotation timber plantations. The revised taxation arrangements should also take into account the differing investor groups that have an interest in plantation forestry. Individuals have the capacity to utilise the taxation system to establish plantations for the purposes of producing timber, while institutional investors are interested in purchasing semi-mature, multi-aged plantation resources.

To gain an increasing level of interest in long-rotation tree crops, investors need some degree of assurance that they could sell their immature plantations without any fear of losing their initial tax deductions. At the present time, the tax laws have been interpreted by the ATO in such a way that if investors were to sell their managed investment plantation interests prior to the clearfelling date, they would be required to repay their original tax deductions. This would force a significant, and unnecessary, financial penalty onto the original plantation growers.

The position taken by the ATO is based on their interpretation of paragraph 48 in the tax ruling *TR2000/8 Income tax: investment schemes*. Paragraph 48 states that:

Where:

- (a) there is evidence that:
 - (i) the investor intends at the time of entering into the afforestation scheme to exit the scheme once tax deductions for the initial lease and management fees are claimed and the resultant tax savings obtained or before income is due to flow to the investor; or
 - (ii) the intention is not to maintain the afforestation scheme beyond the initial years; or
- (b) there is within a short time of commencement of an otherwise long term arrangement, intentional default by the investor/borrower or manager and, under the scheme arrangements, the interests of the investor are transferred to the lender in return for full discharge of the investor's outstanding loan liabilities under the scheme;

the inference will be drawn that the investor entered the scheme for the purpose of obtaining a tax deduction and the resultant tax savings. In these circumstances, the total anticipated allowable deductions will far exceed the total assessable income reasonably expected to be derived until the time of termination, and the outgoings will not be deductible.

This paragraph provides a number of tests that investors, particularly in long-rotation activities could pass. If the investor was to stay in the scheme for a period of say 10 years or until income from thinning is derived, they would satisfy the tests in (a)(i) and (a)(ii). Similarly if the investor were to sell their interests in the project to another investor as opposed to discharging their liabilities by selling the interests back to a project lender, they would satisfy the test in part (b). The final paragraph introduces a fourth test and if investors can demonstrate that they had undertaken all steps to establish and manage the plantation (including thinning and pruning for sawlog plantations) and that those costs do not 'far exceed' the sale price for the trees, they should also satisfy this test.

If anything, having paragraph 48 incorporated into tax legislation would support the initial investment through managed investment schemes and the sale of immature plantations to the superannuation, pension or vertically integrated companies. To satisfy the final test, the managed investment companies would be required to keep their initial establishment costs relatively low.

To support a greater level of investment in long-rotation plantations, the taxation legislation should be altered to allow immature plantations, established with funds collected through

managed investments, to be sold once they have been held for a reasonably long period of time or the growers have earned some income from thinning the plantations. The text contained in paragraph 48 of Tax Ruling TR2000/8 could provide the legislative framework for supporting the sale of immature plantations that have been established through the managed investment schemes.

This review also provides the Government with an opportunity to address two taxation impediments that have affected the timber-growing sector of the industry for a very long period of time:

1. Potential double taxation associated with the sale of the rights to standing timber through *profits a prendre*, where growers may face capital gains tax when they create the right to the standing timber and income tax when income is derived from that right (such as when timber is harvested); and
2. Period inequity, where the ‘lumpy’ nature of the forestry costs and returns means that more tax is paid on plantation activities than if that same income was spread out across the life of the plantation projects.

Both the *profits a prendre* and period inequity issues were identified prior to the release of the National Forest Policy Statement (1992). Successive Federal Governments made a commitment to address these anomalies through the *Wood and Paper Industry Strategy (1996)* and *Plantations for Australia: the 2020 Vision (1997)*. Unfortunately, they are still outstanding matters for the industry and these issues should be addressed in the context of the current review.

A third taxation anomaly that needs to be resolved and has some potential impacts on long-rotation tree crops, is the inability to claim plantation establishment expenses as immediately deductible costs where plantations are established for the primary purpose of sequestering greenhouse gases and/or to provide environmental services.

iii. The role of the 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

The third term of reference for the review refers to competitive neutrality between the public and private plantation growers. Numerous reports, including those completed by environmental groups and the Competitive Neutrality Complaints Office, have been commissioned to examine this issue. In no case has it been possible to clearly demonstrate that the Government agencies are acting in an anti-competitive manner.

Instead of focussing on whether there is competitive neutrality between private and public plantation growers, it would be more appropriate for the Commonwealth to request that the State and Territory Governments take all possible steps to reduce the regulatory burden facing plantation growers. By all accounts, the additional regulations applying to all aspects of plantation forestry unnecessarily raise the costs of obtaining plantation development approvals by between \$300 and \$1,000 per hectare.

It would be more appropriate for the Commonwealth to request that as it improves the tax system to support plantation forestry, that the State and Territory Governments should comply with their commitments to the 2020 Vision. In particular, they should respond to the first action, requiring the development of a comprehensive policy framework for addressing the impediments to investment in the plantation sector.

iv. The capacity to adapt existing tax policies to contribute to achieving the Australian and State Governments' desires to achieve a greater integration of plantation and natural resource management policies to improve salinity and water quality

To support the integration of natural resource management and plantation forestry policies, it should be possible to use a combination of tax policy and expenditure programs to achieve the desired outcomes. This type of approach for supporting new plantation developments has been discussed and pursued by Governments for at least fifteen years. However, little on-ground investment has been delivered into the multiple-purpose plantation activities for at least two important reasons.

Firstly, industry needs a consistent policy approach to support investment in these types of plantations. It will take a minimum of fifteen years to achieve a critical mass of resources within any one region to supply future timber processing and/or exporting industries. There has been no demonstrated commitment to maintain these programs for any longer than three years. As a result, there has been very little confidence to deliver investment into the multi-purpose plantation programs.

Secondly, the government programs seeking environmental outcomes have fairly inflexible guidelines and quite often, there is a considerable degree of uncertainty around the precise benefits that program managers are attempting to obtain. In addition, the onerous nature of having to develop these multi-purpose plantation projects has meant that it is too costly for companies to prepare proposals that meet the objectives of natural resource managers and still provide a commercial return to the investors.

v. The relative roles and effectiveness of tax system and expenditure programmes in the delivery of assistance to industry

The record of plantation establishment in Australia over the past 50 years has demonstrated the importance of having some major driver of investment for plantation forestry. Without the softwood loans agreements, which supported most of the new plantation establishment during the 1960s and 1970s, there would be no major softwood plantation resource in Australia. After the completion of the softwood loans, the rate of new softwood plantation establishment fell away and has remained at relatively low levels for the past 20 years.

During the 1990s, a number of circumstances combined to drive plantation establishment. The Western Australians started to grow large areas of blue gum plantations on short rotations to service the international pulpwood markets. Some entrepreneurs drew together the 10-year time horizon of the blue gum plantations and the 13-month prepayment provisions in the tax law, to produce a new investment product that would prove very effective in drawing funds to the plantation sector. In the background to all of this was the 2020 Vision, a strategy agreed (in 1997) by industry, the Commonwealth and all State and Territory Governments, to treble the nation's plantation resources.

In the latter part of the 1990s, there was a proliferation of blue gum investment schemes that saw the rate of new plantation establishment accelerate dramatically, reaching a maximum of 137,500ha in 2000 (based on investment funds collected up until 30 June 1999 for planting during the following 13 months together with funds collected in April-May 2000 for planting to be undertaken prior to 30 June in the same year). As mentioned previously, the withdrawal of the 13-month prepayment rule saw plantation investment levels and establishment rates fall immediately. Having the allowance for immediate deductibility of plantation expenditure was, on its own, insufficient to retain investment.

As demonstrated for the years of 2001 to 2003, plantation establishment rates continually fell. The change in Government policy (withdrawal of the 13-month rule) reduced the confidence of investors and impacted on many of the small nursery and contractor businesses supporting the industry in rural areas. A major policy initiative (introduction of the 12-month prepayment tax rule in 2002) was required to restore investor and small business confidence in the industry.

However, there is some question over the effectiveness of current expenditure programs for delivering investment in plantations. What is required by industry to deliver investment is certainty in the 'rules' that will be applied to any expenditure programs. Given that it takes a minimum of 10 years to develop a regional plantation resource of the scale required to supply local and/or overseas markets, there needs to be a long-term commitment to the expenditure programs.

If this approach is to be pursued, industry and the investment community need clear guidelines on the assistance being offered and the outcomes that need to be delivered for that assistance. At the present time, the industry has a very limited understanding of the outcomes being sought from each of the regional natural resource management plans and, in most cases, the regional management groups have not been willing to support commercial plantation forestry projects.

The only program that provides a partial solution to overcome these difficulties has been the Commonwealth's Greenhouse Gas Abatement Program (GGAP). Under this program, the requirements are quite clear. The Federal Government is purchasing carbon abatement for the First Commitment Period (2008-2012) and the projects must be demonstrated as being 'additional'. That is, the plantations must be established on land that would normally be regarded as sub-commercial and the payment for carbon raises the rate of return on the projects so that it is possible to achieve the hurdle rate of return sought by investors. The Government purchases the rights to these carbon credits through a payment at the time of establishment.

Industry is willing to participate in the establishment of multi-purpose plantations and supports a stronger integration of natural resource management and plantation policies. However, a greater level of engagement in the design of such programs is required in order to improve the processes for aligning the multiple objectives – environmental benefits, wood supply for industry, and reasonable rates of returns for investors. In addition, there must be a recognition that these plantations are not likely to produce the same volumes of timber as industrial plantations established through the managed investment schemes and that there must be a demonstrated commitment to maintain those programs for a sufficiently long period in order to develop a critical mass of resources.

Global support options for plantations

Wherever plantations have been established around the world on a significant scale, Governments have implemented major programs to encourage investment into those commercial tree crops. This is a reflection of the investment climate that surrounds plantation forestry. Independent of the rotation length applying to plantations or the potential returns available from the timber that is harvested, the requirement for significant up-front cash outlays to establish the plantations followed by lengthy periods before any returns are realised, presents a number of risks for investors.

The following summary outlines some of the program options introduced in countries (including Australia) that are highly reliant on plantation timber resources and in many cases, the timber-producing companies in those countries are competing with Australian companies for a share of the world's timber markets. Each of the programs have been shown to drive investment into plantation forestry and when those programs are removed, plantation investment falls away quite sharply.

Australia – Softwood Loans Agreements between the Commonwealth and the States drove plantation investment activities, primarily by Government agencies across the period of 1960-1985. While a range of 'tax efficient' investment schemes arose during the 1980s, they stimulated investment in a relatively small area of private plantation resources. Only with the advent of the short-rotation Blue gum plantations, plus the release of the government-industry strategy for plantations (*Plantations for Australia: the 2020 Vision*), the application of the 13-month prepayment rule, and the introduction of the product ruling system by the Australian Taxation Office, was there an acceleration in private plantation establishment.

The abolition of the 13-month rule and uncertainty about the investment and taxation rules applying to managed investment schemes saw the level of investment fall until the introduction of the 12-month prepayment rule in 2002. Under the 12-month prepayment rule, there is a one-year delay between the collection of immediately deductible investment funds and the establishment of new plantations. The area of new plantation establishment has been increasing since 2003.

New Zealand – the plantation programs have been quite variable over the past 45 years. Grant programs operating from 1970 and again from 1980, provided a cash grant of up to 50% of the costs of afforestation. Plantation establishment rates increased almost immediately after the programs were introduced. Even though the companies could access immediately deductibility allowances for their expenditure on plantations, once these programs finished the expansion of the plantation estate was markedly reduced.

When the immediate deductibility provisions were removed in 1987 (so that the projects were treated like capital investments), there was a further decline in the annual plantation establishment rates. A return to immediate deductibility, in combination with a range of events that provided investors with greater certainty of the taxation treatment applying to these activities, led to an increase in the plantation establishment rate from 15,000ha in 1991 to approximately 80,000ha per annum through the middle of the decade.

Chile – in 1974, the national Government passed Decree Law 701, which provided a 75% subsidy for plantation establishment and tending costs of exotic tree species, combined with tax exemptions for foreign investment. Plantation establishment rates increased from 30,000ha per annum in 1970 to 80,000ha in 1975. When this law was repealed in 1995, establishment rates fell to 5,000-6,000 hectares per annum.

United Kingdom – in the period between 1960 and the late 1980s, plantation forestry expenses were immediately deductible against other sources of income, where the top marginal tax rate was 83% between 1975-1980 and 60% until 1989. Overall, these taxation conditions supported a significant

amount of new investment into plantation forestry projects. In 1989, the Government removed the immediate deductibility provisions, although the profits on later logs sales became tax free. These changes led to an immediate reduction in plantation establishment. To retain any significant level of investment in plantations, the Government introduced a range of incentive schemes.

Brazil – the Fiscal Incentive Law (1966) was a generous incentive (establishment subsidy) program for expanding the plantation estate with fast-growing timber species. Between 1974-1982, the program supported an average increase in the plantation estate of approximately 400,000ha per annum. Due to domestic financial troubles and the mis-use of the incentive program, it was reduced in 1983. After it finished in 1988, plantation establishment rates fell sharply and have remained low ever since. **Almost twenty years later, that sudden reduction in plantation investment has led to a reduction in wood supply for the growing domestic economy. The greatest impact is in their softwood sector, where the rapidly rising log prices and the limited availability of wood have reduced the international competitiveness of at least this sector of their industry.** This is a good example of why it is essential to retain some consistency in the approaches to support plantation development (and the subsequent establishment of plantation resources).

Uruguay – Forestry Law No. 15.939 was passed in 1990, outlining a program of credits and fiscal incentives to promote investment in plantation forestry. The program included a 50% subsidy for the estimated planting costs of reforestation, exemptions from land taxes, and low interest rate loans to cover the costs of establishment. Establishment rates fell away during the Argentinian-Uruguayan financial crisis around 2000 and earlier this year, the national Government removed the plantation investment subsidies.

Argentina – Forestry law Nbr. 25.080 was introduced at the end of 1998 to encourage the establishment of new plantations. Grants are paid to cover part of the establishment costs. In general, the grants are 80% of the plantation establishment costs for areas less than 300ha and 20% of the establishment costs for areas greater than 300ha. Additional benefits provided under the forestry law include accelerated depreciation allowances on capital equipment used for timber milling. Although the plantation establishment rate increased after the forestry law was introduced, the collapse of the Argentinean economy and lengthy delays in the payment of the grants led to a significant loss of confidence in the plantation sector.

Indonesia – a re-afforestation levy of approximately \$20 per cubic metre on harvested native forest timber was used to finance that country's plantation establishment program. These funds were used to provide an interest-free loan worth 32.5% of the cost of plantation establishment and management. It was combined with Government financing for 14% of the plantation costs (in return for the Government having 14% equity in the resources) and the companies providing 21% of the costs. Commercial loans were taken out to fund the remainder of the total plantation costs.

China – a major program is in place to raise the total area of forest coverage through the establishment of plantations and limiting the access to native forests. The plantation activities are supported by low-cost seedlings, land grants, grants to growers, and concessionary loans (through the Development Bank and the Agriculture Bank).

India – social forestry programs were used to support the expansion of plantations. With these donor programs finishing in the early 1990s, plantation investment has been assisted through the provision of grants to growers, land grants, the provision of seedlings, and concessionary loans.

Malaysia – tax incentives alone did not act as the catalyst for new plantation investment. As a result the establishment rate for new plantations has remained relatively low.

United States – high timber prices, technological advances and favourable tax policies were responsible for the increase in private investment in plantations between 1945 and 1976. During that

time, 11.7 million hectares of the current total of 16.2 million hectares of plantations were established. Between 1977 and 1997, there was a more conservative rate of plantation growth.

European Union – the EU has had a significant plantation subsidisation program in place since 1979. In 1992, Regulation 2080/92 was introduced, with a budgeted cost of approximately of \$1.5bn to refund a significant proportion of the plantation establishment and management costs. In areas where the per capita GDP is less than 75% of the EU average, the maximum refund rate is three-quarters of the plantation costs. In all other areas, up to half of the plantation costs may be refunded.

Regulation 2080/92 sets out the maximum payments to plantation growers and is a mandatory requirement in each of the EU member countries. Maximum payments are approximately \$3,200, \$4,000 and \$6,250 per ha for the establishment of short rotation tree crops, conifers and hardwood plantations, respectively. Annual maintenance costs of between \$150-\$500 per hectare are provided together with income compensation to farmers of more than \$600 (per hectare per year for 20 years), a woodland improvement payment, payments for forest roads, and contributions towards firebreaks and dams are all available to plantation growers.

As a result of these programs, private plantation establishment has increased and there is a declining interest in short-rotation plantation (where there are no maintenance or income support programs for trees grown under rotations of 16 years or less). One of the primary motivating forces behind the program is to retire land from agricultural production. **It is important to note that the Regulation provides an excessive emphasis on establishing new tree farms, rather than encouraging good (and improved silviculture) in existing plantations.**

There are many interesting outcomes from the introduction of Regulation 2080/92. For example, in Ireland some 75% of the agricultural land converted to plantations with the aid of the subsidies has been sold off to other investors

From a whole range of countries, there is considerable evidence to demonstrate plantation expansion will only proceed on a scale that can supply a critical mass of resources where there are long-term programs of government incentives or beneficial taxation arrangements. As a result, all of our international competitors are reliant on these support programs to build their forest industries. The loss of these favourable treatments led to an almost immediate loss in private sector investment in plantation forestry and the potential introduction of other programs to help retain their competitiveness.

Of all the incentives that have been investigated, not one has emerged as being definitely perverse (FAO, 2004). The impacts of these plantation programs have varied considerably, depending on when they are used during the development of a country's plantation estate. However, the greatest gains arise when the policies create a favourable and attractive investment climate that reduces the risks of investment and is designed to remove the structural impediments to investment (FAO, 2004).

Bibliography

Note: the information contained in this attachment represents a summary of material provided in a consultants report prepared for NAFI by Jaakko Poyry and Dana Limited, supplemented with details from the following FAO report:

FAO (2004). *What does it take? The role of incentives in forest plantation development in Asia and the Pacific*. Executive Summary (RAP Publication 2004/28). Asia-Pacific Forestry Commission, Food and Agriculture Organisation of the United Nations. Edited by Thomas Enters, Patrick B. Durst, Chris Brown, Jim Carle and Philip McKenzie.

Market outlook for plantation products

While plantations cover some 113 million hectares, or some 16% of the forest area across the Asia-Pacific region, there are vast areas of those plantation resources that are of very poor quality (FAO, 2004). Some have never actually been established and there are significant areas that have died because of mismanagement or some other disaster.

Between 1990 and 2000, over 34 million hectares of plantations were established in the region, adding to the 27 million hectares of plantations established in the 1980s. With these additional plantations, the major plantation growers of China (47m ha), India (33m ha), Japan (11m ha), Indonesia (10m ha) and Thailand (5m ha), account for 91% of these regional resources.

Numerous questions exist over whether additional plantation resources should be planted in the Asia-Pacific region and the capacity for those resources to meet the future market demands for timber. If the area of plantations does not increase, the growth in output from existing plantation resources (as harvesting begins later this decade) will fall well below the market demands (FAO, 2004).

One option is for the Asia-Pacific plantation area to increase by 1.2m ha per annum. Such a small increase in additional plantation supplies would require that native forest timber harvesting to remain at its current levels. It is known that this rate of native forest harvesting is not sustainable.

An alternative scenario is for the regional plantation resource to expand by approximately 4.7 million hectares per annum. Other factors will most likely prevent this from happening, most notably the community concerns surrounding the conversion of agricultural land to plantations.

As a consequence, it is predicted that plantations will supply a high proportion of the raw materials for the fibre-based industries and sawn products that are sold in the commodity markets (such as house framing) (FAO, 2004). Natural forests will continue to supply the high-quality hardwood timber products. The key feature of this analysis is that additional timber resources will be required from plantations, independent of which countries end up growing those extra resources.

Australia has an opportunity to participate in the expansion of the forestry and timber industry throughout the Asia-Pacific region over the coming decades. For our own needs, Australia currently produces around 16 million cubic metres of timber from plantations (ABARE, 2005). However, based on our existing levels of consumption and imports, approximately 26 million cubic metres of wood and a substantial amount of new investment in timber processing is required, just to meet our own domestic timber needs.

The claims of wood gluts and an excessive area of short-rotation hardwood plantations being established in Australia fail to take into account the major driving forces within the timber markets of the Asia-Pacific region. These market forces and market dynamics apply to each segment of the industry. As a clear example though, the market dynamics for hardwood pulpwood in the Asia-Pacific region have been known for some time (Baker and Evans, 2002). These resources will be used to manufacture high-quality printing and writing papers.

Around the world, there has been an accelerating growth in paper consumption since the second World War. Paper consumption alone is growing at around 5% per annum in the Asia-Pacific region. In per capita terms, the consumption of paper and board during the 1990s doubled in countries such as China and Malaysia. Across a longer time frame, the per capita consumption of paper in Japan has increased from less than 20kg per person per year in 1953 to 250kg per person per year in 2000.

To put these rising demands for paper and paperboard products into perspective, the per capita consumption in 1999 was 347kg, 239kg and 184kg per person in the USA, Japan and Australia,

respectively. At the same time, the per capita consumption in many developing countries was quite small, such as in Indonesia (15kg/person/per annum), India (4kg), China (28kg) and Brazil (39kg).

In the 20 years from 1980 to 2000, the total consumption of paper and paperboard in Asia rose from 30 to 90 million tonnes per annum. On an annual basis, the increase in consumption of paper and paperboard is equivalent to the output from commissioning one additional world-scale pulp and paper mill each and every year.

As a result of this growing consumption, it has been estimated that the deficit in wood fibre trade for Asia will exceed 50 million tonnes per annum by 2015. These resources could be supplied from a number of countries, including Australia. Australia has a number of comparative advantages that are not matched by other timber supplying countries. Even when presented with the constant changing dynamics of the timber markets, Australia's comparative advantages have allowed us to remain a dominant market supplier. These advantages include the short shipping time from Australia to destinations in Asia, relative to the US, Southern America and South Africa.

When compared on the basis of the delivered price of wood fibre or the costs for a given pulp yield, Australia has until recently, been one of the lowest (if not the lowest) cost wood supplier for the international paper markets. The appreciation of the Australian dollar has eroded some of these economic advantages, which will place some considerable pressure on the higher-cost wood producers in the short to medium term.

Australia's ability to supply wood from sustainably managed forests, to produce high quality resources, and to supply those timber resources over very long periods of time are the highly attractive features of the plantation timber-growing sector. Contrary to the many uninformed claims about the forest industry and the long term trends for products sold into the export markets, there are many important contributing factors to consider, especially for the plantation timber resources.

In recent times, the significant shift from native forest to plantation resources has allowed plantation growers to obtain a premium on their products, over the price paid for native forest resources. The primary reason for these premiums is the higher pulp yields from wood fibres derived from plantations.

It is these complex set of factors that determine the commercial viability of Australia's plantation timber suppliers, particularly those growers who will be selling their timber products to overseas markets.

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