

Executive Summary

This is a submission by Macquarie Alternative Assets Management Limited (MAAML), the responsible entity for the Macquarie Forestry Investment, response to the Review of Taxation Treatment of Plantation Forestry. The submission addresses the following terms of reference:

- a. the commercial viability and current tax treatment of plantation investment; and
- b. whether the operation of the Income Tax Assessment Acts impedes investment in longer term forest rotations which produce higher value products;

In summary, it is our view that the Australian Plantation Forestry Sector has many commercial attractions and opportunities. The current tax treatment of plantation investments is no more favourable than the treatment available to other agricultural activities other than the prepayment concession. The prepayment concession is important to the plantation sector as it provides some early year cash flow to partially offset the extended delayed cash flow that these investments experience relative to other agricultural investments. In our experience there is a limited number of species, with limited application that are grown in longer rotations which represent higher value products than short rotation pulpwood. In these cases the tax system is an impediment but not a major one. The main impediment to longer rotation forestry products is the poor price performance and expectations of output.

1. Term of Reference a) The commercial viability and current tax treatment of plantation investment

Discussing the commercial viability of plantation investments requires an assessment of the commerciality of the pulpwood plantation sector as well as a review of the mechanisms which exist to ensure the commerciality of investment products that allow investors to participate in this sector.

1.1 The Commercial Viability of Investment in the Australian Plantation Sector

Plantations developed by Managed Investment Schemes are being used to grow hardwood pulpwood and used in the production of high quality paper and paper products which is a growing area of demand particularly in the Asian region. Australian foresters have developed skills and technology which enable the production of very high quality paper making fibre from Eucalyptus pulpwood grown in short rotations.

Eucalyptus globulus is the main species grown in pulpwood plantations. This is the premier pulpwood for the production of high quality printing and writing papers which make up the bulk of Australia's trade deficit in forest products. There are many features of the species which make it attractive to pulp and paper producers including fibre structure, wood density, light colour (giving bright paper with low chemical use) and the high proportion of paper making fibre per tonne of wood. The demand for this pulpwood is reflected in prices paid for the pulpwood. The pulp and paper producers are well placed to pay higher prices for the pulpwood as the paper produced by them is a highly value added product. The current prices received for pulpwood and the pricing projections, along with the relatively short (in forestry terms) investment period, make this potentially an attractive investment alternative.

The attractiveness of pulpwood production in Australia is seen by the direct involvement of Japanese and other Asian investors who have established their own plantations in Australia and who continue to look for opportunities to develop plantations in what is one of the world's best growing regions for this highly valued product.

A positive development for the hardwood pulpwood plantation sector is the number of proposed pulp plants which are being proposed for development or expansion in Australia.

Australian Paper is well advanced in its plans to redevelop its Maryvale facility with the potential for this plant to be expanded in the future. Gunns Limited is proposing a pulp producing plant in Tasmania and is in the process of developing its proposal. In addition to these proposals there are proposals for a pulp mill in Western Victoria and a pulp mill in Western Australia. None of these investments will be possible without the existence, continued development and replanting after each harvest of pulpwood plantations.

Of the above proposals the most likely developments are the Australian Paper and the Gunns mills. MAAML is completing documentation to be the provider of plantation based pulpwood to the Australian Paper operation. We understand that our ability to facilitate the reliable supply of the necessary pulpwood is critical to the decision to proceed with the approximately \$200 million mill investment. The plantations required to support the Australian Paper mill require ongoing investment of approximately \$15 million per annum. To illustrate the value add, Australian Paper estimates the wood cost makes up just 10% of the cost of their paper. By comparison, wages and salaries make up between 20% and 30% of the paper cost.

The presence of these pulp mills will create locally based demand for the pulpwood produced by the plantations which we believe is positive for the future direction of pricing. In addition the significant commitment of capital by the promoters of the proposed mills is an indication of their belief in the underlying commercial potential of the plantation sector in Australia as they will be relying on its continued presence for many years to come. These developments will provide business and employment for rural communities.

1.2 Commerciality of Forestry Management Investment Schemes

The commerciality of the Macquarie Forestry Investment is assured in the following ways:

- Design of the investment
- Independent review of the investment
- Planning group review
- ATO product rulings.

The multi layered protections provided by the above ensure that the commerciality of the investment product is tested at a number of levels to provide investors with appropriate levels of protection. This high degree of scrutiny should also provide the review with comfort that investments that make it to market are tested for commerciality by a range of parties who are experienced, independent and regulated by ASIC under the Corporations Act.

a) Investment design

A number of measures are in place to ensure investors receive a commercial return from the growing of pulpwood under the Macquarie Forestry Investment. In selecting land for the plantations, there are stringent land selection protocols which must be complied with to ensure that the land selected is likely to meet growth rate forecasts. An independent forester, URS Forestry, reviews selections of land prior to acquisition by Macquarie to ensure compliance with the land selection protocols. Jaakko Pöyry Consulting is engaged to provide an independent market review to monitor the market for the pulpwood to provide confidence that there will be a market for the pulpwood produced at the end of the growing period and to give a view of the likely pulpwood price. The pulpwood from the Macquarie Forestry Investment is subject to an off-take agreement with Midway Pty Ltd. The combination of these factors allows Macquarie to conclude that investors should receive a commercial rate of return from the investment.

b) Independent review of the investment

Macquarie engages independent researchers to review the investment. These researchers form a view as to whether to recommend the Macquarie Forestry Investment. In doing so, they have access to all of the information necessary to form an opinion on the returns from the investment including the independent market reports, independent forester's opinions and other project agreements. These independent reviewers are regulated by ASIC.

c) Planning Group Review

Once independent research is carried out, the investment is submitted to a further level of scrutiny by the in-house researchers at the various planning groups who decide whether to include the investment on the list of products which its planners can recommend to their clients. Once the product is recommended to the financial planners, the financial planners themselves have to form a view as to the commerciality of the investment. The financial planning industry is closely regulated by ASIC, meaning that planners must be diligent in recommending a product to their clients.

d) ATO Ruling

In providing a product ruling for the investments, the ATO must form a view on non-commercial business losses. All of the relevant information such as market reports, forester's reports and project agreements are made available to the ATO to allow them to make the ruling and the ATO has concluded that there is an objective expectation that the project will produce a taxation profit.

1.3 The Current Tax Treatment of Plantation Investment.

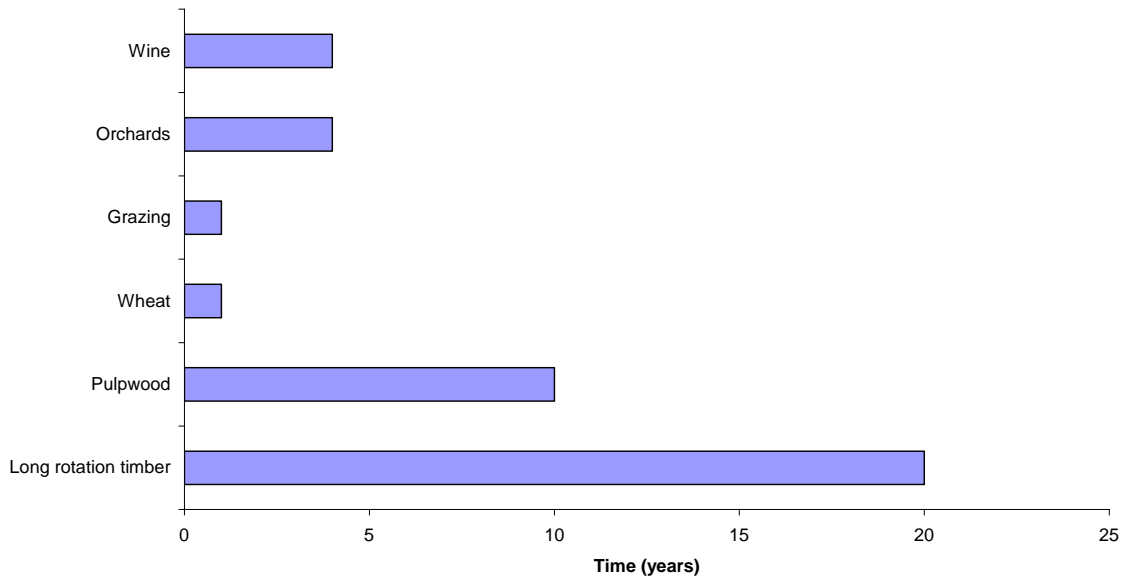
Forestry is a form of agricultural investment. Aside from the prepayment rule, forestry does not receive any preferential treatment over other agricultural enterprises. The table below outlines the tax treatment of forestry and other forms of agriculture and demonstrates that forestry receives similar tax treatment to other forms of agriculture.

Item	Tree Farming	Other Forms Of Agriculture
Planting costs	Deductible	Deductible
Preparation costs and cultivation costs	Deductible	Deductible
Management costs	Deductible	Deductible
Interest costs	Deductible	Deductible
Maintenance Costs	Deductible	Deductible
Harvest Revenues	Immediately Assessable	Assessable subject to the availability of averaging provisions
Diesel	Rebate Available	Rebate available

The prepayment concession contained in section 82KZMG of the Tax Act is the one concession that is afforded to the plantation sector that is not extended to other areas of agriculture.

We believe that the prepayment rule does not give the timber industry a large advantage over other agricultural sectors. The chart below illustrates the time between the first expenditure and the first receipt of income by various agricultural and horticultural activities. The time lag between the first outlay of expenditure in establishment of the plantation and the first receipt of proceeds is significantly greater in the forestry sector than in other agricultural or horticultural activities. Allowing a prepayment of expenditure is a small concession to investors in the timber industry which provides some levelling of the playing field in the minds of investors.

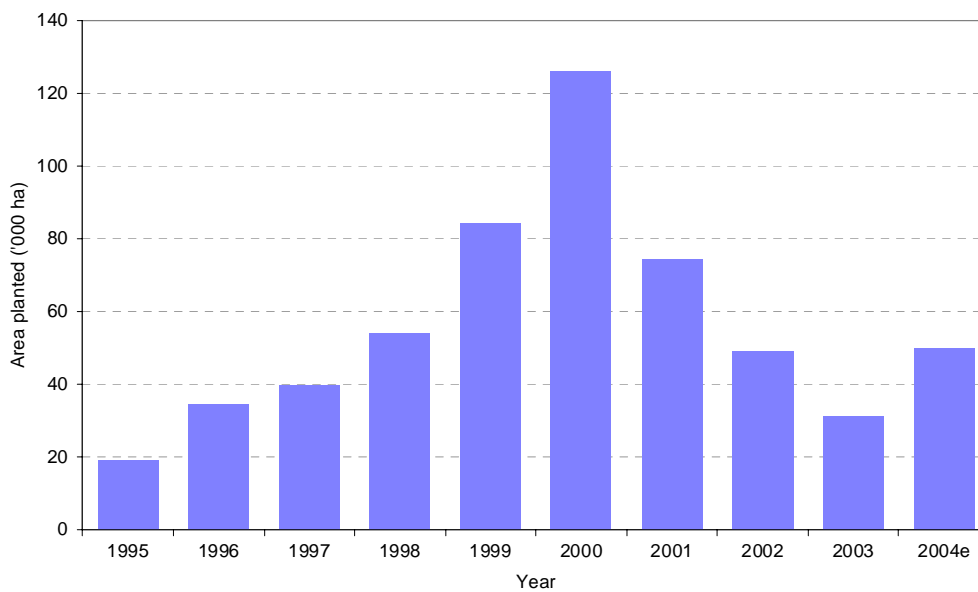
Time between first expenditure and first economic cash flow



The importance of the prepayment in the minds of the investors in overcoming the time lag otherwise associated with forestry investment is also reflected by being the other significant factor in the reduction in planting rates experienced in the period immediately following the abolition of the ability to claim a prepaid deduction in 2000. The reductions in plantation establishment rates following 2000 are evidenced in the chart below.

The prepayment rule encourages the investment of smaller investors. In the absence of the prepayment, the cashflow profile would only be attractive to large corporate investors who can afford to have a long term horizon. This is likely to be foreign paper producers. The prepayment concession therefore encourages average the Australian investor and keeps the value generated by the plantations in Australia.

Australian Hardwood Plantation Establishment Rates



Source: Jaakko Pöyry Hardwood Woodchip Market Review

The establishment activities for plantations located in the southern regions of Western Australia, South Australia and Victoria occur across a period of 12 months beginning with land selection followed by ripping and mounding in summer, weed control in autumn and planting in winter. Concurrent with the land preparation, seed must be acquired, germinated and grown in nurseries and delivered to the plantation site, a process which takes most of the year prior to planting. The process of land selection and assessment in many cases is completed prior to 30 June, being one of the significant steps in the establishment of a plantation. The germination of the seedlings and the cultivation and planting of the land is undertaken following 30 June in line with the seasonal requirements of the trees. It is not possible to undertake these practices in advance of this and remain within prudent silvicultural practice.

In the absence of a prepayment concession, promoters of plantations in southern Australia can only compete with other projects by incurring these expenses in advance of raising the funds so that the preparation is well advanced and allows for all the activity to be completed by 30 June. This would increase the risk of not raising the funds to cover the expenses which would put the promoter at risk of insolvency. When the prepayment rule was last removed in 2000, one of the major companies in the industry, Australian Plantation Timber went into administration and a number of other leading companies in the industry experienced financial difficulty. The uncertainty caused by the failure of a major player reduces investor confidence in the industry and discourages future investment in the industry. This is reflected in the chart above by the fall in plantation establishment rates following the removal of the prepayment in 2000. In addition to this there is significant uncertainty as to whether preparation costs incurred in advance of the planting would remain deductible as they may be classified as a capital expense which would not be deductible. This would exacerbate the disadvantage against plantation forestry and would act to further reduce its attraction in the eyes of investors.

2. Term of Reference b) Whether the operation of the Income Tax Assessment Acts impedes investment in longer term forest rotations which produce higher value products

We believe that short term pulpwood rotation is generally a higher value added product than longer term rotation timbers. Macquarie Alternative Assets Management Limited entered the pulpwood investment business in 2003. At that time we reviewed a number of alternatives before settling on pulpwood as our initial project. Some of the alternatives involved longer-term rotation plantation for the supply of construction grade timbers. We could not make a viable investment case for the greenfield establishment of longer rotation plantations, although we believe that mature long term forest rotation plantations can provide attractive investment returns. Our decision to proceed with short rotation pulpwood seems to have been justified with price increases in the period from 2003 keeping pace with inflation whilst the prices for logs grown in longer term plantations continuing to decline in real terms.

It is the lack of return potential for most long term forest rotations that in our opinion is the major impediment to investment in those areas. It is only where the longer term forest rotation is based on higher valued products such as flooring and furniture grade timbers that we believe there is the potential to develop a genuine investment product.

Investment in greenfield plantations is mainly centred on retail investors who have participated through Managed Investment Schemes. Wholesale investors have not in general participated in this area of forestry. In general wholesale investors prefer mature forests which will generate regular cash flows from harvesting on a year-to-year basis. This cash flow provides them with the opportunity to introduce debt funding to enhance the returns to their investors. Newly established plantations do not produce the type of cash flows that are required for wholesale investors largely explaining their absence from this form of investment.

Retail investors do not share the same investment horizon as a wholesale investor and as such are not attracted to investment terms in excess of 25 years without significant cash flows

during that period. We have tried in the past to develop a scheme where the investment term could be broken down into two periods of 12 years or so. This would involve the initial investors being in a position to earn income from the sale of the plantation as standing timber at say year 12. The incoming party who could be either a retail investor (as the remaining term is now only 12 years or so) or a wholesale investor (who seeks out mature plantations) who would not seek a deduction for their investment but record it as a capital cost. Whilst the ATO were helpful in considering the proposal they noted that it was difficult to consider within the terms of the current practice and policy in relation to plantations. The underlying project did not proceed and we did not continue in the development of the concept.

We believe that a one off ability to trade in a plantation interest which was delayed for at least 10 years would assist in the development of longer term rotation forestry. This will only see significant investment if the underlying economics of the project are sound which we believe is limited to higher valued forestry product.

3. Other Comments

3.1 Benefits of Plantation Forestry

We believe that the investments made in the short rotation pulpwood sector deliver a number of benefits as set out below.

a) The opportunity for further value adding in the form of pulp and paper mills

Pulpwood plantations are providing the first essential link in the development of an extensive value chain here in Australia which will mean greater investment and employment in the longer term. This investment and the jobs created are primarily in rural and regional centres. All of the proposals set out earlier in this submission represent the opportunity to add significant value to the pulpwood and to capture within Australia some of the economic potential from the product. It is important to note that all the main proposals are being promoted in regional areas by Australian owned companies listed on Australian share markets which further ensures that the value will be captured for the benefit of Australians. None of these proposals would be possible without the significant plantation resource which has been built up over the past 15 years. More importantly none of these proposals will proceed unless the promoters of the projects are comfortable that they will have a continuing source of timber as feedstock for the mills.

b) Other Opportunities to Add Value

We see parallels between the early radiata pine plantations which were initially grown to meet a shortage of naturally occurring softwoods in Australia. The logs were originally used for packaging and, over time, research and development has resulted in radiata pine being the premium framing and construction timber in Australia and New Zealand. Similar research and development is currently being undertaken in Australia to investigate the use of some of the short rotation pulpwood plantation logs to produce sawn timber. Unless there is ongoing investment in Eucalyptus plantations, this development will not occur.

c) A sustainable alternative to native forest logging which provides other environmental benefits

Plantations provide a wide range of environmental benefits such as dry land and in-stream salinity control, carbon sequestration, control of soil and soil nutrient losses. Plantations also provide a means of achieving the Federal and State Government policy of trebling Australia's plantation base by 2020. Hardwood plantations will reduce the reliance on native forests, the traditional source of pulpwood.

d) Direct new investment in rural and regional Australia providing current and future employment opportunities

The development of the pulpwood plantation estate has resulted in the creation of many small and medium sized businesses to provide the services which are required to establish, maintain and harvest the trees. These businesses are owned by people who live in the regions where the plantations are established, they employ locals and use services provided by other local businesses. In some areas the plantation industry is the major employer of people and an essential contributor to the local economy. In the future, jobs will be created in the harvesting and processing of the pulpwood.

Many of these areas struggled prior to the commencement of plantation development as the traditional agricultural commodities produced by farms failed to generate the returns that justified investment on a scale approaching that which has been committed to by the plantation sector. Data from the Green Triangle region indicate that agriculture uses 10 times as much land as the forestry and forest products industry but the gross value of production is only 1.3 times as much. In the Murrumbidgee Valley, plantations occupy just under 1.4% of the land area but contribute just over 20% of the economic activity.¹

3.2 Profitability of Managed Investment Schemes

We understand that there is a perception that the profits made by promoters of plantation forestry investments are excessive. This, it is said, results in uncommercial investments and much of the benefit of the prepayment concession being captured by the promoter.

We believe that profits made by promoters are reasonable having regard for the risks borne in the offering of the product; the level of compliance costs required by ASIC to protect investors' interests and the high distribution costs. The profitability levels are disclosed to the ATO in the product ruling process and the profit to the promoter is limited by the need to provide a competitive return to investors.

Promoters of forestry products need to earn an acceptable level of profit having regard to the costs that the promoter incurs and risks that the promoter takes. For example, Macquarie guarantees that a certain survival rate of the plantation and if the rate is not achieved, Macquarie must replant the trees at its own expense. This can double the cost of seeds and labour in the planting process. The promoter is also exposed to a risk that the costs of plantation establishment and the on going maintenance exceed forecasts due to increases in labour and other costs. The promoter has exposure to these risks after it has set the price of the investment and any additional costs will be paid out of the profit margin. Large costs are incurred in the setting up of the scheme and preparation of offering documents, which exposes the promoter to a risk of not recovering the set up costs.

There are other costs outside of the cost of establishing the plantations that are incurred by the product promoter. As retail forestry investments are an alternative unlisted asset and sold through the diverse financial planning network, the costs of distribution are quite high and commissions need to be paid to financial planners. These costs currently run at 10% for commissions with additional amounts being required to promote an asset class that is not well understood by the investment community. Compliance with ASIC regulations imposes a significant cost and has required Macquarie to have in-house legal and compliance functions. There are also significant administrative costs in investor management and reporting.

Macquarie's profit margin is disclosed to the ATO in the product ruling application. We will continue to make the ATO aware of the profit that we make out of the product as a step in the process of obtaining a ruling for the product.

Finally, the profit margin to the promoter directly affects the price at which the product is sold, which in turn affects the return to the investor and therefore the demand for the product. These market forces ensure that the level of profit is reasonable and acceptable to the investor.

¹ Pratt Water, 2004, "The Business of Saving Water"; and RRDB, 2004, "Profile of the Value of the Timber Industry in the South West Slopes Region of NSW."