Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Agribusiness Managed Investment Schemes

Submission

by

National Association of Forest Industries (NAFI) and Australian Plantation Products and Paper Industry Council (A3P)

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Executive Summary

The recent collapse of major agribusiness managed investment scheme companies, Timbercorp and Great Southern, is having profound, negative consequences – for investors in the projects these companies ran, for their shareholders, employees and creditors.

It is also having severe flow-on effects in the agribusiness managed investments sector as demonstrated by the decline in sales of interests in FY2009 projects.

This decline has been an unfortunate consequence for the plantation products and paper industry. As pointed out under Term of Reference 2, sudden large falls in plantings create serious and potentially costly management problems for processors in smoothing future woodflows. Retail forestry plantations have become an integral part of Australia's plantation products and paper industry, and future investment and management decisions are being made with expectations about secure future wood supplies from retail forestry plantations.

The supply of stable long-term plantation woodflows of an appropriate quality relies on having a stable and predictable policy and regulatory environment surrounding this industry. This includes appropriate tax treatment that recognises the unique long-term and large-scale nature of plantation forestry and the challenge of attracting investment.

Changes in tax arrangements have had significant impacts on the retail forestry sector in the past decade, leading to major fluctuations in tree planting. The plantation industry supports the new specific statutory deduction for retail forestry – Division 394 of the *Income Tax Assessment Act 1997* – being left in place to provide certainty for investors and companies alike.

This Inquiry is necessary in light of recent events and their consequences. The plantation products and paper industry welcomes the opportunity to contribute to the Committee's deliberations, and especially to provide information about the industry, about the retail forestry sector's role in it, and the importance of minimising the degree of 'sovereign risk' from changes in the policy and regulatory framework.

As this submission explains and demonstrates in response to each of the Inquiry's Terms of Reference, agribusiness managed investment schemes, including the retail forestry investment sector, is subject to very high levels of regulation and scrutiny, and also to penalties for regulatory breaches.

Despite this, the collapse of the two companies (**not** necessarily the projects themselves) raises questions about how effective this regulation and scrutiny has been, and whether any change is necessary.

Any shortcomings that may come to light are not related to the statutory tax arrangements for retail forestry. Indeed, one of the four integrity measures in Division 394 (*viz* the '70% DFE test') will itself contribute to higher levels of investor protection and certainty.

Two matters that have emerged already that warrant attention concern the protection of investors' interests in the event of administration or receivership – avoiding the inherent conflict of interest where a separate Responsible Entity is not appointed to act on behalf of scheme members; and protecting investors' interests in the underlying land where the manager defaults on lease payments to third party landholders.

For the most part, however, the plantation industry considers that the laws and regulations governing agribusiness managed investment schemes and the disclosure required by the promoters are robust.

If reform is considered necessary, it should be directed towards improving the level of protection of the interests of investors by improving transparency and compliance through enforcement of the existing laws administered by ASIC, and through better public information.

The plantation industry is willing to assist in this regard by enhancing the level of disclosure relating to investor interests. Specifically, this could be done by:

- disclosing how client monies subscribed to the plantation investment project are administered by the Responsible Entity in order to carry out contracted plantation services;
- disclosing the financial capacity of the plantation investment company to deal with adverse fluctuations in annual project sales; and
- disclosing more prominently the risks inherent in agricultural enterprises and investments.

The plantation industry is ready and willing to work with the Government and ASIC to ensure this enhanced disclosure is delivered via a reporting framework that is consistent with the ASX Principles of Corporate Governance.

The quantum and nature of remuneration of financial advisers is an issue for the broader financial products industry, and the question of adviser remuneration in the retail forestry sector needs to be considered in that broader context. However, the plantation industry would like to see a transparent remuneration system that encourages financial advisers to provide high quality advice that is in the best interests of their clients.

Finally, the plantation industry would support Government moves to improve the availability to the general public of socio-economic and environmental information about the plantation, wood products, and pulp and paper industry. This information should be compiled independently (e.g. by ABARE and BRS), and should include supply and demand conditions, the performance of the various industry sectors, and trends in the key financial and socio-economic indicators.

While maintaining as much flexibility as possible to accommodate the diverse structures and arrangements of retail forestry companies and their projects, the plantation forestry industry believes it can continue to work in a collaborative effort with the Government, the regulators, and the financial planning sector to continue to enhance the benefits of the industry, and the protection of retail investors, where necessary.

A collaborative effort can assist the regulators to fulfil their statutory functions efficiently, effectively and fairly; while at the same time enabling the retail forestry sector to continue to carry on its business of attracting investment to establish, manage, harvest and market the future resource.

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Introduction

This submission is made by the Australian Plantation Products and Paper Industry Council (A3P) and the National Association of Forest Industries (NAFI).

Between them, these two national organisations represent all segments of Australia's large-scale forestry, wood products and paper industries – forest management, woodchip export, sawmills, veneer mills, panel board, pulp and paper manufacturing and specialty plantation products plants.

Members of the two organisations have a particular interest in ensuring that long-term resource supplies are relatively stable, smooth and predictable, in order to maintain and expand Australia's domestic and export wood and paper industries, particularly those deriving resource from plantation timber. A number of members are also managers of forestry managed investment schemes.

Maintaining a policy and regulatory framework that recognises the increasingly important contribution that forestry managed investment schemes ('retail forestry') are making to current and future plantation resource supplies is fundamental to the industries' objectives.

This submission generally takes a broad industry-wide view in its response to the Inquiry's Terms of Reference. Other submissions from individual companies and from significant parties with specialist knowledge in the corporate regulation of managed investment schemes are providing more specific details and commentary on all or part of the regulatory framework.

Term of Reference 2: *Impact of past and present taxation treatments and rulings relating managed investment schemes* has been brought forward, because it complements the first section of the submission. That section provides a background and history, setting out the origins, expansion, role and importance of retail forestry, and the importance that appropriate tax arrangements play in facilitating large-scale private investment into timber plantations in Australia.

The remainder of the submission addresses each of the other Terms of Reference in order. It concludes in Term of Reference 12 with some suggestions for how the plantation industry can assist the Government to enhance the level of investor protection in forestry managed investment schemes while enabling that sector of the plantation industry to continue to fulfil its important role of growing Australia's future timber resource.

Background: The role and importance of managed plantation investments

Forest plantations privately funded through managed investment schemes (also known as 'retail forestry' and 'managed plantation investment') are now an integral part of Australia's wood and paper industry.

The trend towards this integration began in the mid-1990s and accelerated after the launch in 1997 of the national plantations strategy known as *Plantations for Australia: The 2020 Vision*. Managed plantation investment, having existed for decades as 'prescribed interest schemes until the *Managed Investments Act 1998*, began expanding initially to grow quality eucalypt pulpwood primarily for export, making up for the transfer of productive public native forest into conservation reserves where harvesting is prohibited.

Retail forestry investment projects have proven to be the most effective of the currently available options to attract long-term private investment in plantation forestry, using only the standard entitlement to year-of-expenditure deductibility for eligible expenditure. This contrasts with all other major plantation-growing countries, which encourage private plantation investment through the use of grants, bounties, subsidies, concessionary loans, special tax incentives and the like.

State government forest agencies, previously responsible over decades for building Australia's plantation resource with Commonwealth financial assistance, have been increasingly directing their resources to the essential task of replanting their estates following harvesting rather than to substantial further expansion of their estates. The Victorian Government has exited plantation ownership and management entirely, and other states are considering various forms of privatisation. Institutional investors, such as superannuation funds, have demonstrated their preference for buying established plantations that are generating a cashflow, rather than investing in the establishment of new 'greenfields' plantations. Many industrial wood and paper processors have divested their own captive plantation resources primarily to free up capital for investment in their manufacturing operations. Farm forestry has not yet demonstrated that it alone can grow the critical mass of resource to supply internationally competitive processing facilities.

Retail forestry investment has been steadily filling that gap.

Retail forestry projects account for around 80 percent of all new timber plantations each year, and a substantial and increasing proportion of replanting. From about 5 percent in 1997, privately funded managed plantations now account for more than a third of the total national plantation estate of 1.9 million hectares, and by the end of calendar 2009, this figure will be close to 700,000 hectares, based on private woodlot sales in retail forestry projects in the financial year 2008.

Retail forestry has so far directed over $3 billion of investment into regional areas (plantation establishment, management, harvesting, haulage, etc) and urban areas (export facilities, processing, transport etc). These plantations are providing significant employment in rural and regional Australia, particularly important at a time when Australia is facing rising levels of unemployment.

Managed plantation investments have traditionally grown native hardwoods for woodchip export and domestic pulp mills, and a much smaller area of softwood for the domestic sawn

timber and pulp and paper industries. In the past few years, the plantation investment in softwood projects has begun to increase to meet future domestic demand, as has investment in temperate and tropical native and exotic species to produce high-value cabinet timbers and specialty plantation products for domestic and export markets.

The proportion of sawlog plantations is likely to grow more rapidly now that the new tax arrangements (see below) make it permissible for investors to on-sell their woodlot interests before harvest.

The domestic and export wood processing industries in regional Australia are becoming increasingly dependent on plantations grown in managed investment projects for their consistent long-term wood supplies. This retail forestry is now creating the scale of resource to maintain future wood supply to existing domestic facilities and to underpin investment in new and upgraded facilities.

Vertical integration and more sawlogs

While Great Southern Plantations and Timbercorp focused on the growing of short-rotation hardwood pulpwood for the export woodchip market, four other major plantation investment companies – FEA, Willmott Forests, ITC and Gunns – are either already diversified companies with integrated interests along the wood growing, processing and marketing supply chain, or are increasingly specialising in growing plantations to provide the future resource for the seriously under-supplied domestic sawn timber or veneer markets. This is where future domestic supply will not be able to meet demand, in addition to the supply of resource to the woodchip market. All four have also made major investments in their own new and upgraded sawmills and veneer mills. Another rapidly growing retail forestry company – Tropical Forestry Services, growing high-value Indian sandalwood – now has a processing and distillation plant operated through its Mt Romance subsidiary in Albany.

This move towards further vertical integration of plantation investment companies into timber and plantation products companies could be expected to continue as plantation estates reach critical mass in new regions and the first plantations approach maturity.

FY2008 was the first year in which, following the Parliament's 2007 enactment of a specific statutory tax deduction for retail forestry (described in more detail under ToR 2), companies could also promote the prospect of the initial investors being able to sell their interests in the schemes before final harvest ('secondary markets'), without retrospectively losing their initial tax deductions. This greater liquidity of inherently long-term projects had the effect of making the longer-rotation sawlog and specialty timber plantations a more attractive investment than they had been.

The impact was immediate. While short-rotation pulpwood project sales remained steady or declined, FY2008 sales of sawlog and specialty projects – softwood, hardwood, sandalwood and high value cabinet timbers – all increased.

Employment and investment

Most plantation investment companies have now started harvesting their investors' early plantations, bringing more jobs and businesses into their plantation regions. Albany and surrounds in Western Australia have already experienced this revitalisation. Harvesting of retail forestry investment plantations is also being carried out in Tasmania and the Green Triangle (Vic/SA).

Hardwood plantation woodchip exports from Australia have increased from virtually zero to more than 4 million tonnes per annum in less than ten years, a substantial proportion of which has been harvested from retail forestry plantations. Regardless of the returns to individual projects or individual investors, there can be no doubt that

these plantations are generating real foreign earnings income of hundreds of millions of dollars per annum to regional areas such as south west WA, northern Tasmania and western Victoria.

Well-publicised studies by the Bureau of Rural Sciences and the Cooperative Research Centre for Forestry, based on empirical data, clearly show that employment and business opportunities expand rapidly once the plantations reach maturity, providing ongoing work in harvesting, haulage and processing.

Increasingly, the plantations funded by retail forestry are being grown with agreements already in place (or under negotiation) to sell the resultant timber products. In addition, hundreds of millions of dollars are being invested regionally in new and upgraded processing facilities that do or will utilise wood from these plantations. Examples include the upgrade to the Australian Paper pulp and paper facility at Maryvale, Victoria, and the expansion of the Visy pulp and paper mill in Tumut, NSW.

Plantation investment companies themselves are also investing in port and handling facilities, in mills for woodchips, sawn timber and related products, and in the processing of specialty plantation products to utilise the harvests from their investors' plantations. (Examples are included in Table 1.)

Table 1 below illustrates the reliance being placed by the forest industry in Australia upon wood being grown in retail forestry projects.

Company	Location	State	Investment Type	Value ($million)	Direct Employment	Indirect Employment
Gunns	Bell Bay	TAS	Pulp Mill	2000	300	1300
Protavia	Penola	SA	Pulp Mill	1600	120	300
Visy	Tumut	NSW	2nd Paper Machine & Increase Pulping Capacity	450	50	350
Aust Paper/Paperlinx	Maryvale	VIC	New/replacement Pulp Mill	258	200	520
Forest Enterprises Australia	Bell Bay	TAS	Sawmill	72	105	35
Weyerhaeuser (nowCHH)	Tumut	NSW	Sawmill Upgrade	60	30	80
Willmott Forests	Bombala	NSW	Integrated Timber Processing Facility	60	130	370
ITC/Timbercorp/Great Southern	Portland	VIC	Woodchip Export Facility	50	360	500
Midway	Myamyn	VIC	Greenfield Mill	35	40	200
WA Plant'n Resources	Bunbury	WA	Woodchip Mill	35	25	60
Ta Ann Holdings	Smithton	TAS	Plywood & Rotary Veneer Mill	32	50	150
Great Southern	Heywood	VIC	Woodchip Mill	20	25	50
Great Southern	Albany	WA	Infield Chip Receival Facility	6	18	54
McCormack Demby Timber	Morwell	VIC	Modern Scanning and Optimizing Dry Mill	3.8	n/a	n/a
McCormack Demby Timber	Morwell	VIC	Investment in Green Mill and Laminating Plant	3.5	n/a	n/a
Tropical Forestry Services	Albany	WA	Distillation Plant Upgrade	3.0	tba	tba
FEA/ITC SmartFibre	Bell Bay	TAS	Woodchip and Port Facility	n/a	3	53
Harvest and Haulage Sector	Australia Wide	ALL	New Equipment for Resource Expansion	571	n/a	n/a
Harvest and Haulage Sector	Australia Wide	ALL	Equipment Upgrade and Replacement	1938	n/a	n/a
Total				**7197.3**		

Table 1: Completed, under construction and proposed port and processing investments that will utilise wood from retail forestry plantations

Ongoing development of processing infrastructure based on resource supplied from retail forestry projects is happening. The proposed Gunns pulp mill at Longreach, Tasmania is one example of this, with further processing investment expected in other regions in the future as a critical mass

of retail forestry plantations approaches harvest age in each region – for example, northern NSW/Southern Queensland, Esperance (WA), north Queensland, and Northern Territory.

With retail forestry now becoming so embedded in the wood and paper industry production and distribution chain, the cessation of this plantation sector would have far-reaching adverse consequences.

Improving performance

Performance of some of the earlier retail forestry projects has been variable, with some early plantings resulting in poor yields. However, rapid improvements in tree genetics, site selection and silvicultural and nutrient management in later plantations has seen improved performance and higher yields.

Some early projects have actually exceeded their forecasts, not only in growth rates and harvest yields but also in financial returns to growers.

For example, one 1993 project, harvested in 2008, yielded a clearfall harvest volume of 404 tonnes per hectare, with a mean annual increment (the growth rate) of 27.6 cubic metres per hectare per year, compared to the original targets of 375 tonnes per hectare and 25 cubic metres per hectare per year; a growth rate more than 10 percent higher. Combined with the income from the thinnings harvest in 2003, the total *net* harvest proceeds (after deduction of harvest and management costs) were $16,920 per hectare (including GST) – a return of 13.3 percent per annum (pre-tax) and 7.3 percent per annum (post-tax).

Such better-performing retail forestry projects will become more common over time.

Reducing competition for land

Another trend now becoming apparent in the plantation investment sector is the increased replanting of harvested plantation land with second, or subsequent, rotation plantations. Harvesting of early retail forestry plantations is accelerating rapidly, as illustrated in Figure 1: *Woodchip production from hardwood plantations*. Consequently, each year, an increasing proportion of the retail forestry funds establishes new retail plantations on this same land. This replanting of harvested plantations is vital to the ongoing wood supply to industry.

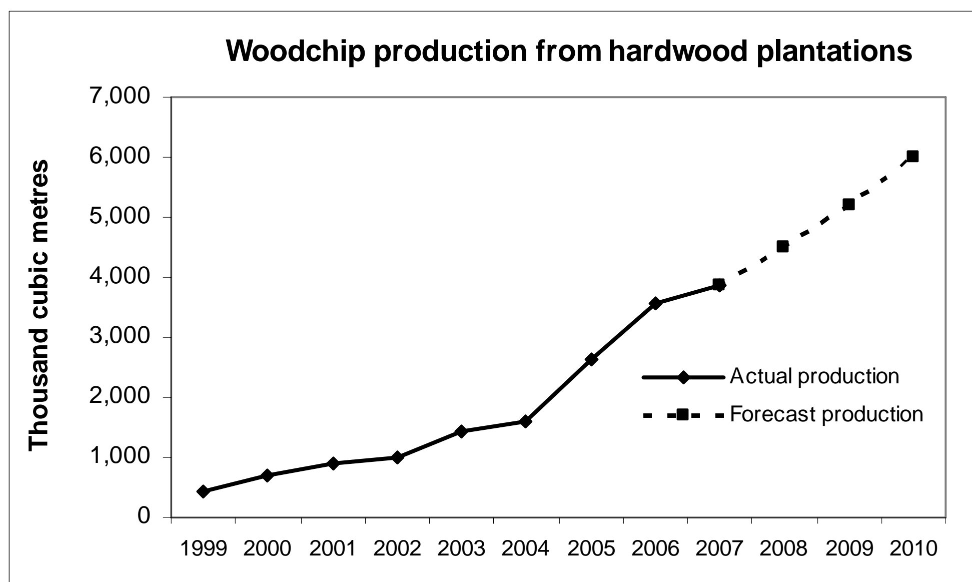

Figure 1. Source: Data to 2007 – National Plantation Inventory annual updates, Bureau of Rural Sciences. Data for 2008-2010 – derived from data in *Australia's Plantation Log Supply 2005-2049*, BRS .

Although plantations will still be competing with a range of other land uses in some regions, the overall national effect of second rotation planting on the future demand for new land is likely to be similar to the forecast for hardwood plantations in Figure 2 (without a carbon price factored in). Competition for land is a healthy part of an efficient agricultural system and ensures that there is constant re-evaluation of the appropriate use of all land.

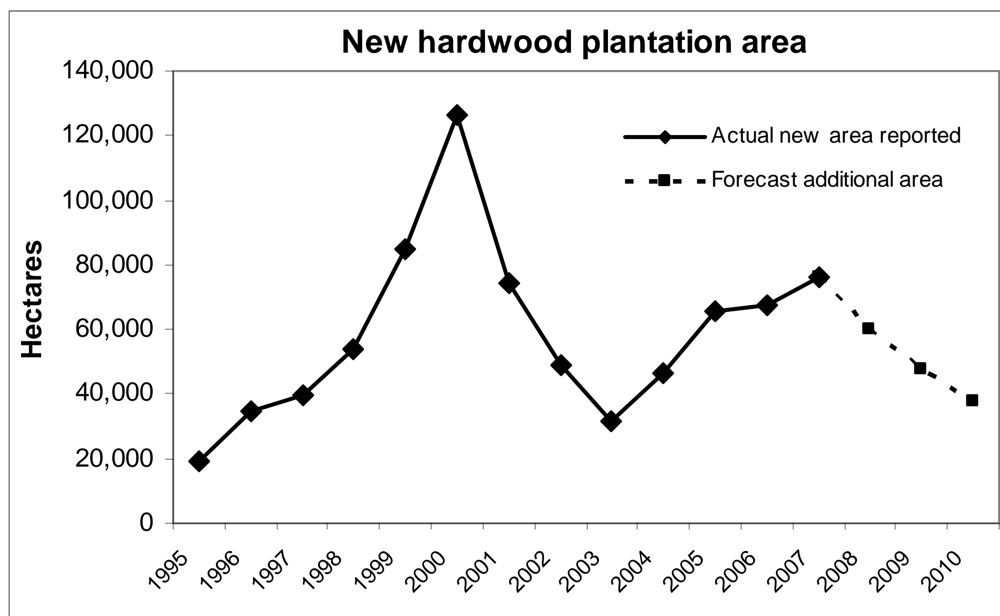

Figure 2. Source: Data to 2007 – National Plantation Inventory annual updates, Bureau of Rural Sciences. Data for 2008-2010 – derived from data in *Analysing the Economics of Forestry for Carbon Sequestration under the Carbon Pollution Reduction Scheme: ABARE*. Report to the Dept of Treasury (2008)

NOTE: This graph illustrates the trend in the demand for NEW land, not the trend in plantation establishment, which is expected to continue to oscillate around the long-term trend line of 70– 80,000 hectares per year.

Forestry and agriculture: a small part of the managed investments sector

Plantation and agricultural investments comprise only one (very small) category of many diverse investments funded under the managed investment scheme structure.

The chairman of the Australian Securities and Investments Commission (ASIC), Tony D'Aloisio, gave a summary of the managed investment scheme structure during the Senate Estimates Committee hearings on 4 June 2009. It is inserted here in full.

> "The MIS is really a generic term to describe a variety of structures for the creation and operation of collective investment schemes or projects. Basically it covers everything that involves an investor acquiring something other than a security; that is a share or debenture or an interest in a prudentially regulated entity such as a bank deposit, a superannuation interest or a life interest. The sector includes things like managed funds; public unit trusts; ASX-listed trusts; common funds; limited partnerships; investment pools and clubs; cash management trusts; property trusts; property syndicates; mortgage trusts; serviced strata schemes; agricultural schemes, including forestry, horticulture, viticulture [and others]; and alternative investment schemes such as horse racing syndicates, for example.
>
> "There are something in the order of 5,200 registered managed investment schemes in Australia..They are operated by 674 responsible entities. Statistics on total funds invested that are under management in these different types of MIS are not reliable but we estimate that it is around $350 billion. The registered MIS can be listed or unlisted. We have got something in the order of 110 listed schemes. Mostly they are invested in property or infrastructure."

Within this vast and diverse range of financial products in the managed investments sector (which in turn is but a small part of the total managed funds sector), forestry and agriculture account for something in the order of 2 percent of the total funds under management. The number of companies offering forestry projects has not exceeded sixteen in the past three years, and currently, since the demise of Timbercorp and Great Southern, and other mergers and departures, it is less than ten.

ToR 2: Impact of past and present taxation treatments and rulings relating to managed investment schemes

The tax treatment of timber plantations needs to be considered in two broad contexts:

- the market failure that confronts the attraction of large-scale private investment into long-term enterprises characterised by agricultural risk, only one to three income events over that period, and ‘period inequity’ (defined below); and
- the relationship of timber plantation enterprises to the whole upstream and downstream production and distribution chain.

This section addresses these questions as a background to summarising the impact of changes in the tax treatment of timber plantations that have taken place over the past three decades, as well as the importance of minimising the sovereign risk to the plantation industry created by periodic changes in public policy.

Tax and plantation forestry — addressing market-failure

Although plantation forestry has features not shared by annual agricultural crops (for example, flexible harvest dates, within reason), it still faces the same general agricultural risks – rainfall variability, flood, fire, pest and disease outbreaks, commodity market volatility, etc.

But attracting large-scale private investment into plantation forestry to replace what used to be financed directly through government forestry commissions faces different and peculiar challenges flowing from the unique nature of forestry enterprises and assets.

Plantation forestry is a relatively long-term enterprise, with high establishment costs, illiquid assets, very few income events, returns coming in large ‘lumps’, and a large tax liability at final harvest.

This ‘lumpy returns’ feature creates the phenomenon of **‘period inequity’**, a form of market failure that continues to bedevil private plantation enterprises. Because most of the income in large income events (commercial thinnings harvests and final clearfall harvest) is taxed at the forest grower’s highest marginal tax rate, it can be seen that, subject to the taxpayer’s individual circumstances, more income tax is likely to be paid on a plantation forestry enterprise than if the same total amount of income had been received and taxed annually – as with most livestock, cropping and horticultural enterprises.

In the face of this market failure, plantation forestry receives no subsidies or ‘special tax advantages’ not available to other primary producers. Plantation forestry accesses the same tax deductions as are available to every business in Australia – including other primary production enterprises. Under section 8-1 of the *Income Tax Assessment Act 1997* (the ‘general business deduction’ provisions), eligible non-capital expenditure is deductible against other income in the year the expenditure is incurred.

If access to this general entitlement was to be denied to plantation forestry – as nearly occurred during the Ralph Review of Business Taxation in the late 1990s – not only would

that denial discriminate against one form of enterprise that is already challenged simply by its inherent characteristics, but it would perversely create a disincentive to further such investment, as occurred in New Zealand in the mid-1980s.

The relationship of this tax treatment to retail forestry investors is explained in the next section.

Tax arrangements for forestry managed investment schemes

Retention of the general business deduction and the statutory arrangement is important for continued large-scale private plantation investment in Australia.

The Australian Government conducted an exhaustive review of plantation forestry taxation in 2005 and 2006, which culminated in its decision in December 2006 to introduce a statutory deduction for forestry managed investment schemes.

For many years before that, investors in retail forestry projects – one small category in the diverse array of pooled investments closely regulated by ASIC and the ATO – fell under the general business deduction provisions of the *ITAA 1997* (section 8-1), described above. As growers carrying on their businesses collectively through a manager, they were entitled to deduct their eligible business expenses in the year they (the growers) incurred them.

The growers had no special incentive other than this standard business deductibility. The 12-month prepayment rule (2002 to 2008) provided no extra incentive for the growers, but allowed the plantation investment companies to secure the land and nursery stock and establish the plantations in a prudent and seasonally appropriate manner.

The new statutory deduction for forestry managed investment schemes was enacted in June 2007, as a new Division 394 of the *ITAA 1997*. Although investors are no longer required to demonstrate that they are carrying on a business in order to access the deduction, the new law retains the same simple basic principles described above—year-of-expenditure deductibility for investors' contributions to the project, and a prepayment provision.

Three important integrity measures have been embodied in this new arrangement, which must be met to enable the investors to claim and retain their tax deductions.

- First (and most important to project integrity), at least 70 percent of the project expenditure over the life of the project must be 'direct forestry expenditure' (the '70% DFE test'), determined at net present value against arm's length prices.
    - DFE is defined as expenditure associated with planting, tending and harvesting of trees, plus the annual costs of the land. The legislation specifically excludes such expenses as marketing the investment, commissions, insurance, contingencies, and general business overheads.
- Second, all the trees must be established within 18 months of the end of the income year in which the investors enter the project.
    - The time limit for tree establishment is accompanied by a legislated requirement to officially notify the ATO of a failure to comply, retrospectively exposing the taxpayer to lost deductions and the company to the 'promoter penalties' legislation.
- Third, the initial investor in a forestry managed investment project must hold the woodlot interest for a minimum period of four years before trading the interest to a secondary buyer.
    - Special provisions have been legislated to prevent tax mischief.

The 'secondary markets' thus created by this third integrity measure will increase the liquidity of managed plantation investments, and will especially help the much-needed longer-rotation sawlog plantations to become a more attractive investment prospect than they have been.

It is important to note the 'tax neutrality' condition embodied in both the former 12-month prepayment rule (section 15-45 of ITAA 1997) and again in the new statutory deduction arrangements (section 15-46 of ITAA 1997). In order to maintain temporal 'tax symmetry' between public tax expenditures (deductions) and public revenues (income tax), this provision requires the plantation investment company to bring forward its own income tax liability into the same year that the investors claim their tax deductions. Additionally, the company must recognise the *gross* receipts from investors, which can only be offset by deductible expenditure that the company incurs in managing the previous years' projects. In effect, this provision imposes a tax prepayment on managers, with potentially a serious burden on cash flow.

It does, however, bring about a level of tax neutrality, such that the only cost to the public revenue of the prepayment provision is the difference between the marginal tax rates of investors and the company tax rate, a tax policy feature that is unrelated to the specific tax arrangements for retail forestry.

The Government's reason for legislating the new tax arrangement was to quarantine plantations funded through managed investment schemes from whatever might be the outcome of a test case that the Tax Commissioner was planning in 2006. On the basis of evolving case law, the Commissioner had changed his legal interpretation of the proper tax treatment of all agribusiness managed investment schemes, meaning the standard year-of-expenditure tax deductibility entitlement for the investors would no longer apply, thereby bringing an end to large-scale private plantation investment in Australia.

For good policy reasons discussed in the previous section, the Government and the Parliament were unwilling to let that happen.

The Federal Court, on 19 December 2008, found unanimously against the Tax Commissioner's new arguments. The Court confirmed that, subject to appropriate project structures and documentation, investors in agribusiness managed investment projects could indeed be carrying on a business, and thus be subject to the same tax deduction entitlements as other businesses (as described in the previous section).

It is sometimes claimed that tax deductibility for retail forestry investors leads to foregone tax revenue that the Government could spend on diverse public services and infrastructure. Such a claim is misleading, on two counts. First, if investment in retail forestry projects was denied, the investors' deductions would not suddenly become available to the Budget. Rather, most of that investment would be redirected into the much larger pool of highly tax-effective negatively-geared share and property portfolios, rather than into rural Australia to create jobs, businesses and wealth.

Second, all the funds collected from retail forestry investors quickly become taxable income in the hands of the plantation investment companies and their employees, contractors and suppliers, and the investors later pay income tax on their net income from harvest. Independent research analysts, Australian Agribusiness Group (AAG), have estimated that lifetime tax revenues to the Government from all agribusiness projects can be as much as three times higher than the initial deduction entitlements claimed by the investors.

Plantations in the production and distribution chain

Processing and value-adding in the plantation products and paper industries involves investment of tens of millions of dollars, and is not made unless the processor is confident of having access to the necessary plantation resource.

Demand for resource continues to rise in line with the increasing scale of new processing investment required to remain internationally competitive.

The domestic and export wood and paper industries seek secure supplies of harvested wood of the nominated quality and specifications, delivered in sufficiently large volumes, consistently and continuously over a long period at competitive prices. (This is one of the reasons why small, diverse and dispersed farm forestry operations continue to find it difficult to access markets for their harvested logs.)

The corollary is that these industries try to avoid sharp and substantial fluctuations and disruptions to their resource supplies. The advantage of plantation forestry is that it is possible to delay harvest for two or three years if mills are experiencing a downturn in demand and there is a 'surplus' of resource.

Wood supply disruptions present different problems, however. 'Smoothing' adjustments to compensate for such disruptions are possible, as long as the mill can find an alternative source of the appropriate resource. But these adjustments are invariably very expensive. It may mean transporting wood from a distant location, at a haulage cost of approximately 10 cents per tonne per kilometre. Transporting wood more than about 100 kilometres can become economically unattractive, and at anywhere near 300 kilometres, a big financial loss is a likely outcome.

Furthermore, if domestic wood is unavailable, the only alternative is either to limit production in that year or to purchase imported wood, contributing to Australia's current account deficit, something the Australian Government has sought to overcome by encouraging the continued development of the national plantation estate.

During the decades when state government forest agencies were the dominant plantation growers, supplemented by wood from industrial processors' own captive plantations, securing long-term access to the wood resources was simpler and more predictable.

With the shift over the past decade towards greater reliance on private investor-funded plantations, different forces have come into play, which must be planned for and managed by the processing sector. Economic conditions, such as those now confronting the national and global economies, can affect the flow of investment into new and replanted plantations, with inevitable impacts on long-term wood flows. There is not much that plantation growers and processors can do to prevent such market fluctuations.

By contrast, changes in government policy and regulation are a factor that **can** be controlled. In Australia, forestry at large has been subject to 'sovereign risk' for decades. Plantation forestry is no exception. As indicated in the summary below, changes in the tax treatment of plantation forestry, and managed plantation investment in particular, have created wide fluctuations in the annual rates of plantation establishment, which processors are now having to factor into their future operations.

Avoiding adverse changes in the corporate regulatory framework for managed plantation investment and the plantation investment companies is similarly within the control of the Government.

Besides the impact on future wood flows, and thus on 'downstream' employment and contracting businesses, dramatic downturns in planned plantation establishment has immediate adverse consequences for the 'upstream' businesses, jobs and rural communities providing services to the plantation sector.

There would also be – as is currently being experienced – an immediate loss of confidence in the sector, which in turn would jeopardise the continued signing of multi-million dollar long-term supply contracts and future plans for the development of processing infrastructure, including new and upgraded chip mills, saw mills, pulp and paper mills, and port and transport infrastructure. These investments rely on steady continuity of resource to underpin the

substantial capital investment required and to avoid high cost solutions to sudden fluctuations in supply to mills.

Policy and regulatory changes can even threaten the marketability of existing plantations, if regional estates don't continue to expand to the size of the critical mass needed to supply new processing facilities.

We urge the Committee to take account of these unique features of the plantation products and paper industries when formulating its recommendations.

Impacts of changes in tax arrangements

The managed plantation investment sector has experienced six identifiable periods of change in tax arrangements over the past three decades.

Pre-1988 (introduction of general 13-month prepayment rule, May 1988)

In May 1988, the Hawke Government introduced the general 13-month prepayment rule, applying to all prepayments, including prepaid interest, insurance premiums, business expenditure and investment. The purpose was to achieve greater symmetry in the timing of tax expenditure (deductions) and tax revenue (income tax payments) by reducing the lag time to effectively two years from what could be decades.

With respect to plantations, it had previously been possible to prepay (and claim as a tax deduction) many years of lease and management expenditure for pine plantations funded through 'prescribed interest schemes'.

The decline of private investment in new pine plantations was immediate and dramatic, which many regarded as not necessarily a bad outcome. Many of these projects had not been well managed, and investors' funds in some case had been misused. However, the managed plantation investment sector inherited an unfortunate and long-lasting legacy from this period.

Within this period (1985), Treasurer John Kerin proposed the quarantining of on-farm business losses from off-farm income. Had this been successful (and it was not), it would have severely reduced non-government plantation establishment, particularly by individual private growers within the managed investment projects and on their own farms.

1988 to 11 November 1999 (sudden abolition of this rule)

The 13-month rule prevailed for eleven years, but even the two year lag in tax symmetry was considered by the Ralph Review of Business Taxation to be excessive. The draft report recommended that tax deductions for plantation establishment business expenditure should not be deducted until the year in which harvest income was received.

This would have ended almost all private plantation investment immediately, just as it had in New Zealand in the mid 1980s. The recommendation was deleted from the final Ralph report, and the entitlement to standard year-of-expenditure business deductibility remained, as it had done for many years.

The ATO general Tax Ruling TR 95/6 on primary production and forestry was finally issued, providing clarity for private growers. The *Managed Investments Act 1998* replaced the 'prescribed interest scheme' regime for pooled investments and, in the same year, the ATO commenced its new Product Rulings program, which became and remains a core and valuable element in the regulation of the managed investments sector.

The 13-month rule was abolished without warning or consultation on 11 November 1999, effectively in the middle of the annual business cycle for plantation investment companies.

The managed plantation investment sector unsuccessfully recommended delaying implementation until 1 July 2000. The 'unintended consequence' for the sector was immediate and dramatic in FY2000, with long-lasting consequences.

First, the planting deadline for new plantations funded in FY1999, scheduled for 31 July 2000, had to be brought forward to 30 June 2000.

Second, prospectuses for new projects on offer in FY2000 (for planting by 31 July 2001) had to be withdrawn and reissued with the new 30 June 2000 planting deadline. Land had to be secured, seedlings ordered and grown, and all the site preparation and tree planting had to be completed in the same financial year. None of the site preparation and planting work could be commenced until the growers had subscribed to the projects and commenced their businesses, leaving only a brief window of weeks and even days for the manager to do all the work that would normally be carried out over several months.

Third, two years plantings had to be carried out in the same year, creating a massive spike in new plantation establishment.

Community disquiet about the plantation 'explosion' became very loud and widespread.

Plantation investment companies' debt burdens, mostly for land acquisition, increased substantially.

ATO Tax Ruling TR2000/8 on investment schemes was issued, after a last minute proposal by ATO to withdraw it on the grounds that growers in forestry projects were actually passive investors contributing non-deductible capital into a trust. But ATO accepted contrary legal opinions from three leading law firms and recommenced issuing Product Rulings, after having frozen their issue for three weeks in May 2000.

The Parliament introduced GST and the non-commercial business loss provisions (Division 35 of *Income Tax Assessment Act 1997)*. Both these new tax laws added significantly to the administration and compliance burden of the plantation investment companies.

FY2001 (no prepayment rule)

The effect of removing the prepayment rule was significant. In order for growers in retail forestry projects to claim tax deductions for their business expenditure, the project manager had to complete all the contracted plantation services within the same financial year that growers commenced business and claimed their deductions. An almost impossible task.

Managers also had to gamble (and incur debt) on anticipated woodlot sales when acquiring land and when ordering tree seedlings (several months in advance).

A Senate Inquiry into mass-marketed tax-effective schemes was conducted during FY2001, which also coincided with a highly public and contentious ATO crackdown on around 50,000 investors in such schemes (from the era before the *Managed Investments Act*, the Product Rulings program, and the much-needed 'promoter penalties' legislation).

The combination of these two events with the effect of having no prepayment rule led to a dramatic (70 percent) decline in woodlot sales in FY2001.

Within two months, the Commonwealth Bank withdrew the credit facility of the largest (and listed) plantation investment company, Australian Plantation Timber, sending it into receivership, and went within a whisker of doing the same with two other leading companies. Another leading company, Yates, withdrew from the industry.

Millions of ordered but unplanted seedlings were sent to landfill, nurseries and contractors in plantation regions went bankrupt, and hundreds of families lost their jobs.

FY2002 to FY2007

FY2002 through to FY2007 was effectively a period of extended review of the tax arrangements for plantation forestry.

In October 2001, the Government decided to reintroduce a prepayment rule for managed plantation investments (the 12-month rule). This was supported by the Opposition, and was legislated in April 2002. The Opposition insisted on a sunset clause of 30 June 2006 in order to pass the legislation in the Senate.

The prepayment rule was accompanied by a unique tax symmetry section requiring the plantation investment companies to bring forward their gross receipts from growers into the same year as the growers claimed their tax deductions – achieving tax neutrality by, in effect, imposing a tax prepayment on the managers.

Over the first three years of this period, plantation investment woodlot sales and resultant plantings recovered steadily towards the long-term trendline that had prevailed before the planting spike and crash in FY2000 and FY2001.

In May 2005, the Government granted a two-year extension of the 12-month rule sunset clause until 30 June 2008, and announced a comprehensive public review of the taxation of plantation forestry, which received 67 public submissions.

In May 2006, the Government proposed the introduction of a specific deduction for managed plantation investments, featuring, *inter alia*, a 'dollar cap' on the deduction available to investors in the first year. 90 submissions commented on this proposal.

In December 2006, the Government announced a new specific statutory deduction for managed plantation investments, to take effect from 1 July 2007, one year earlier than indicated in all the consultations conducted before the decision. The statutory deduction had three integrity measures to be met in order for initial investors to claim and retain their deductions: at least 70 percent of funds paid by investors has to be used for 'direct forestry expenditure'; all the trees has to be planted within 18 months; an initial investor has to hold the interest in the retail forestry project for a minimum of four years before being able to on-sell that interest in a 'secondary market'

In February 2007, the Tax Commissioner announced his intention to issue a new tax ruling and conduct a test case on his revised interpretation of the law; *viz.* that investors in agribusiness managed investment schemes are passive investors contributing non-deductible capital to a trust. He also agreed to a 'transition year', by extending the time for the new ruling to take effect until 1 July 2008, during which time the test case was expected to be decided.

The statutory deduction was legislated (Division 394 or *ITAA 1997*, with accompanying amendments) in June 2007.

The uncertainty surrounding the entire sector during this extended period of review contributed to the variations in sales of woodlots and non-forestry offerings in FY2006 and FY2007. Forestry woodlot sales are illustrated in Figure 3.

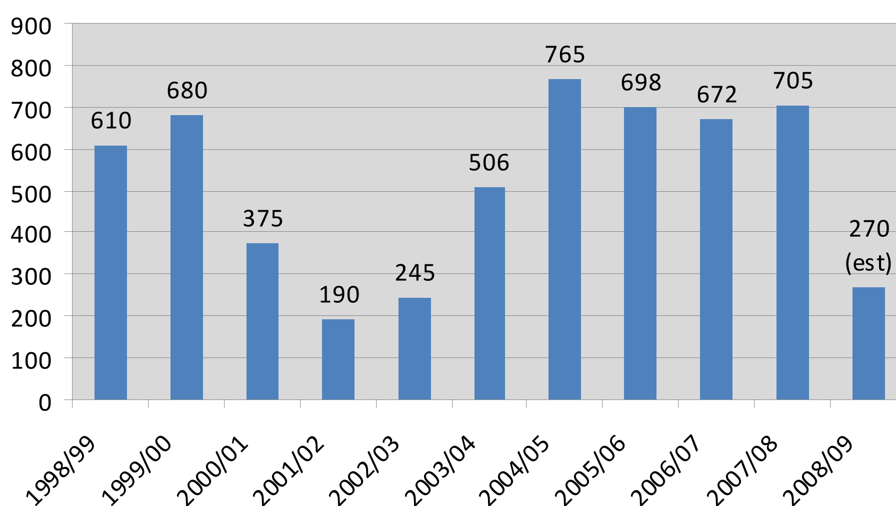

Figure 3: Retail forestry project sales ($ millions)

FY2008

No retail forestry projects were issued with the product rulings under the new Division 394 in FY2008. Managers preferred to use the still-available section 8-1 business deductibility provision during the transition year while the new law was 'bedded down' within the ATO and the plantation investment companies.

Woodlot sales remained relatively static in FY2008, but there was a dramatic upturn of investment in long-rotation sawlog plantations, this being the first year that the prospect of 'secondary markets' could be promoted as an option for greater liquidity.

The Tax Commissioner's new view of the law was issued in a new ATO Tax Ruling TR 2007/8: *Income tax: registered agricultural managed investment schemes*.

The ATO non-forestry test case was not heard within FY2008 as had been originally intended. But the non-forestry investment companies were unsuccessful in their request for an extra transition year for their projects.

The small increase in woodlot sales above FY2007 was partly due to this uncertainty surrounding the competing non-forestry projects.

Draft GST Ruling GSTR 2008/D1: *Registered agricultural managed investment schemes* was released. How GST was to be treated under the new Division 394 was linked to the outcome of the (income tax) test case, and remained a source of confusion for some time.

FY2009

No product rulings were issued for non-forestry projects until the test case was decided. The test case was heard by the full Federal Court (August 2008), which decided unanimously against the Tax Commissioner (December 2008). The Commissioner did not appeal, withdrew the Tax Ruling, and recommenced issuing Product Rulings for non-forestry projects, but too late for some non-forestry project managers to continue in the business, notably Timbercorp.

All product rulings for retail forestry projects were issued under Division 394, ensuring that 70 percent of funds received from investors would be for direct forestry expenditure.

The dramatic downturn in woodlot sales in FY2009 (see Figure 3) was not related to the tax treatment of managed plantation investments. But the uncertainty surrounding the tax treatment of non-forestry projects undoubtedly affected that sector.

Current tax arrangements

Despite the test case decision that effectively allows retail forestry to operate once again under the general business deduction entitlements (section 8-1 of *ITAA 1997*), all plantation investment companies are now operating under Division 394, and will continue to do so.

This statutory deduction provides greater certainty for retail forestry companies and investors alike, benefiting also from the integrity measures that:

- ensure that at least 70% of the funds raised will be allocated to direct forestry expenditure, and not be spent on marketing and commissions;
- ensure that all the trees will be planted within an appropriate period;
- introduce greater liquidity into retail forestry investment, thereby attracting a greater proportion of the investment pool into sawlog plantations for the under-supplied domestic market; and
- provide a large measure of neutrality in the tax system by matching tax expenditures and revenues in the same income year.

Left in place, this statutory tax deduction and its integrity measures will also contribute to achieving higher levels of investor protection and enhancing the effectiveness of the corporate regulation that is the primary focus of this Inquiry.

ToR 1: Business models and scheme structures

The structures of managed investment schemes operated by retail plantation investment companies are all broadly similar, given that they must all comply with the regulatory regimes administered by ASIC, the ATO and, for listed companies, the Australian Securities Exchange (ASX).

However, there are numerous variations to the companies' business models and to the actual investment offerings. Plantation investment companies have structured their investment offerings for efficiency, effectiveness and attractiveness in the marketplace. The key differences in offerings relate to:

- the location;
- the pricing;
- the provision of internal or external forest management;
- the growing of veneer, sawlogs, pulpwood or specialty plantation products;
- whether the offer is diversified or focused on a single species and product;
- whether annual or deferred fees are charged; and
- the way the investment funds are handled within the groups.

The most significant development in the structure of retail forestry investments has been the move away from annual fees to deferred fees, in which the lease fees and the forestry management costs are taken out of harvest sale proceeds. Early on in the offering of retail forestry investments, both structures existed and competed. By about 2004 most, but not all, companies had transferred to the single-payment deferred fee model, as financial advisers and potential investors demonstrated a preference for this payment structure.

In more recent times, some companies have formed land trusts and are offering investors units either separately or stapled to their forestry investment products. Thus some investors now not only own the trees, but also have a stake in the land on which they grow.

Key features of business models

- **Corporate structures.** Several plantation investment companies are public companies listed on the ASX, some are wholly-owned subsidiaries of listed companies, others are unlisted public companies, and a few are private companies. Some companies are fully vertically integrated forestry and forest products manufacturing groups. Others are purely forestry investment companies. Some plantation investment companies have diversified and now also offer non-forestry retail investment products.

- **Responsible Entities (REs).** Most companies use wholly-owned subsidiaries to act for their projects while others employ external groups as REs.

- **Purpose of retail forestry investment.** Managed investment schemes are a pooled investment mechanism that has been used to attract investment into plantation establishment and to finance plantation operations. When the mechanism first emerged, the majority of companies developing retail plantation projects relied on the sale of these projects as their major form of income. However, the structure of the retail forestry industry has changed over time, with the majority of companies now

vertically integrated and generating returns from forestry operations, rather than relying solely or mainly on the sale of retail forestry projects.

- **Internal management.** Some groups use a centralised management model, in which corporate functions and finances are centralised in head office and the forestry operational arms contract their services to the group and to the projects. Others hold the retail investment operations at arm’s length from the group, and seek to limit recourse to the group balance sheet. Forestry, harvesting and transport services can be provided from within the group or outsourced to an external company. Some companies have developed specialised retail investment marketing fully in-house and some have used the services of external organisations to market their offerings. Timber products are often marketed by external agencies, and in some cases by joint ventures with others in the same field.

- **Forestry operations.** Most companies use internal subsidiaries to manage their forest plantations but, as noted above, many specific operations are outsourced to contractors. Retail investment-financed plantations operated by vertically integrated companies have product off-take agreements in place. Some companies use external operating groups. Some have in place from the outset off-take agreements with customers. Some companies have internal R&D groups to assist in plant breeding and pest control. Others have interests in outside agencies for this purpose. Export woodchip companies have developed their own port facilities, either alone or in consortiums. Sawlog and veneer producers have invested in mills to process their products.

- **Tree species and investment terms.** The term of investments depends on the species of trees being planted and the products being produced. Most eucalypt pulpwood plantation projects are for 10-13 years, and radiata pine integrated sawlog and pulpwood for up to 25 years. Sandalwood, teak and mahogany plantation projects can be for 15 to 20 years. Most of the pulpwood plantations will be harvested at term; others offer investors commercial harvesting via thinnings at intervals during the life of the project.

- **Locations.** Some companies are focused on developing their plantations in traditional, key locations, such as the Green Triangle of Victoria-South Australia, Tasmania and the Great Southern region of Western Australia. Others have sought out suitable land in non-traditional plantation regions across Australia to suit the species they are planting. Plantations can therefore be found in many regions across all states, from Tasmania to the Tiwi Islands, from south-west WA to the Ord River and northern Queensland, and in south-eastern Victoria and NSW. Climate, soil and infrastructure are key considerations in finding potential plantation sites. Land prices and availability are key factors in investment viability.

- **Investment financing.** A number of companies offer investors leveraging through internally sourced loans for various terms at commercial rates. Others offer to facilitate loans through external financiers.

- **Fees and commissions.** Most companies charge an application fee upon investment, without further payment until harvest. Fees for plantation management and timber marketing are taken out of the harvest proceeds (net of harvest costs) at rates that are stated at the outset of the project. All companies pay commissions to the distributors of their retail investment offerings. These distributors are generally independent licensed dealer groups and their financial planners, who must disclose these commissions in a Statement of Advice (SOA) they must prepare for all investors.

- **Insurance.** In the majority of cases, insurance for the retail forestry project is optional. However, some companies do stipulate compulsory insurance. Most companies will facilitate external insurance cover at commercial rates.

- **Other variations.** A small number of companies have begun offering investors an option to sell back to the project manager all or part of their interests in the plantation, in line with the secondary market provisions of Division 394 of *ITAA 1997*. Some companies are offering investors all or a share of any proceeds that might arise from carbon credits.

ToR 3: Any conflicts of interest for the board members and other directors

Directors of plantation companies that operate retail forestry projects are subject to the same body of law that governs all public companies. In addition, the company must comply with the relevant provisions of the *Corporations Act 2001* that specifically govern managed investment schemes, including the requirement to ensure the company complies with the conditions of its Australian Financial Services Licence (AFSL), issued and overseen by ASIC. Specific obligations are set out in ASIC's Regulatory Guide (RG) 181, *Licensing: Managing conflicts of interest*.

Retail forestry investment companies also develop and comply with their own internal policies and guidelines covering corporate governance, conflicts of interest and related party transactions.

Compliance committees are required to be formed to ensure ongoing compliance with the Scheme Constitution and Compliance Plan. These committees comprise a majority of independent members, except when the board itself is comprised of a majority of independent directors.

There would appear to be no compelling reason why potential conflicts of interest for directors of plantation investment companies should be identified and resolved in a way other than in accordance with the statutory and common law duties and obligations of company directors in any corporate structure, plus any specific obligations applying to holders of AFSLs.

ToR 4: Commissions, fees and other remuneration paid to marketers, distributors, related entities and sellers of MIS to investors (including accountants and financial advisers)

It is important to note that marketing costs and commissions are explicitly excluded from the definition of 'direct forestry expenditure' under the '70% DFE test', which is a core integrity measure in the Division 394 statutory tax deduction for plantation managed investment schemes described under ToR 2. These costs are paid from the plantation investment manager's own funds, in contrast with, say, superannuation products, where commissions are paid directly from the investor's funds.

Interests in retail forestry projects are not usually offered directly to potential investors by the scheme promoters, but through independent, licensed financial planners and, in some cases, accountants. The financial planners operate either as 'boutiques', holding their own AFSL, or as authorised representatives within larger dealer groups, operating under the dealer group's AFSL. The size of a dealer group can be substantial, some having hundreds of authorised financial planners. Where accountants don't hold an AFSL, they have in some cases acted as agents of the promoter, operating under the promoter's AFSL.

The planners provide advice to potential investors, recommending investment products from among those included on the dealer group's Approved Product List (APL) for that year. Planners are required to apply the principle of 'know your client, know your product', and thereby to recommend investments (if any) that match the client's needs and risk profile.

As with any other investment product, licensed advisers must provide a Statement of Advice (SOA) to their clients, as set out in ASIC RG 168, *Disclosure: Product Disclosure Statements (and other disclosure obligations).* The importance of this is further highlighted under ToR 7.

Being accepted on the APLs of dealer groups is a critical step in the marketing process for plantation investment companies, who strive to be on as many APLs as possible. Inclusion on APLs comes after the dealer groups have assessed the ratings given by independent research houses or, in some cases, conducted their own research. The most highly rated projects on offer can be 'approved products' on 50 or more APLs of licensed dealer groups.

Scheme promoters generally employ or engage marketing and sales teams which deal directly with the independent dealer groups and their financial planners, and others. The activities of the marketing and sales teams include holding direct bilateral discussions with dealer groups and planners, as well as organising exhibitions and marketing and training presentations and similar events for dealer groups.

As is common across all industries, promoters have a marketing budget, which covers all the usual activities common to the marketing of any product or service including advertising; publications and related promotional material; sponsorship; attendance and displays at conferences, seminars and exhibitions; salaries and bonuses to the marketing and sales personnel, whether employed or contracted; and commissions paid to licensed dealer groups and other distribution agents.

The most commonly used means of remunerating dealer groups and other distribution agents recommending the projects has traditionally been through the direct payment of commissions. Some dealer groups have also sought additional payments in the form of

sponsorships, access to conferences, or as part of ‘assistance with marketing expenditure’ and ‘strategic partner contributions’: an arrangement that affords provision of promoter product shelf space and/or access to advisors within the dealer group.

The SOA that a financial adviser prepares for a retail client must include information about “any remuneration or other benefit that a service provider or an associate may receive in connection with the advice that could influence the service provider”.

Improving the quality and reliability of financial advice

The payment of commissions to financial planners and accountants has attracted substantial criticism in recent years, not the least being from within the financial planning sector itself. Financial planners have been conducting a robust public debate over the relative merits of commissions and fee-for-service payments.

The timing and quantum of the commission can vary and the commission may be ‘rebatable’, in part or in full, to the investor. For example, a commission can be paid in full at the time of the woodlot sale being completed, or in part at that time followed by a trailing commission over the life of the project or a nominated period within the project life. For some time, it has been most common for commissions on the sale of interests in plantation investment projects to be paid in full at the time of sale, consistent with the single-payment deferred-fee model demanded by the market (described under ToR 1).

This has contributed to the frequently repeated assertion that commissions in the retail forestry investment sector are excessive. However, closer examination reveals that the total quantum of such a commission is frequently the same as, or similar to, the total quantum of a commission paid on a ‘time-of-sale plus trailing’ basis, which is the most common practice in the managed funds and other investment sectors.

In the past three years, some plantation investment companies have commenced offering trailing commissions as opposed to ‘up-front’ commissions. This has, in part, come at the request of some dealer groups. However, attracting private investment into long-term primary production enterprises such as plantation forestry is always a challenge, and is conducted within a highly competitive marketplace. This involves competition not only among the range of plantation investment projects on offer but also within the far larger and more diverse tax-effective investments and managed funds market.

The scale and scope of managed investment schemes in Australia was discussed earlier in this submission. However, this is not the only segment of the financial product industry which pays commissions to investors. For example, other ‘tax-effective’ financial products besides managed investment schemes that pay commissions, mostly as trailing commission, include:

- margin loans;
- superannuation; and
- insurance (including life insurance and income protection).

It is possible to ‘churn’ insurance, managed funds and superannuation providers and underlying investments within superannuation. These can be turned over a number of times through the equivalent life-span of a forestry investment, and this will result in multiple up-front commission payments well in excess of what retail forestry commissions will amount to.

In this highly competitive investment market, it is not entirely or even necessarily within the promoters’ control to determine how the financial planners will be remunerated, nor the scale of commissions that will be paid. In other words, the market can be described as a sellers’ market, with financial planners/advisers being the sellers of the service.

Following the collapse of agribusiness managers Timbercorp and Great Southern (NOT the collapse of the retail forestry projects themselves – an important distinction), the public discussion about the established and possible practices in the arenas of marketing, sales and financial advice has intensified significantly. The central themes in this discussion is the demand for a greater level of transparency in the provision financial advice, and for more effective separation of financial advice from the sale of interests in managed investment schemes to remove potential conflicts of interest that are not always apparent to a potential investor.

Both the Investment and Financial Services Association (IFSA) and the Financial Planning Association (FPA) have recently made public statements with regards to commissions and the restoration of confidence in the quality and objectivity of financial advice. In addition, Senator Nick Sherry, in his former role as Minister for Superannuation and Corporate Law, and ASIC Chairman Tony D'Aloisio have recently made public statements about the possible need for regulatory reforms in the provision of financial advice.

The plantation investment sector welcomes these discussions as indicating the potential for improvement. The industry does not believe that payment of commissions is inherently unworkable. It may be possible to find ways to improve the use of the commissions model with respect to such factors as disclosure and transparency, and quantum and timing, while recognising that commissions may still be the most cost-effective method of selling certain financial products.

In that context – recognising that this is an arena far wider than simply the sale of interests in agribusiness managed investment schemes – the plantation investment sector is willing to participate constructively in any discussions with the Government, the corporate regulator and the financial planning sector that may lead to a greater transparency and objectivity in the provision of financial advice and greater investor confidence in that advice across the whole financial products industry.

ToR 5: The accuracy of the promotional material for MIS, particularly information relating to claimed benefits and returns (including carbon offsets)

This response should be considered in conjunction with the responses to **ToR 7:** ***The level of consumer education and understanding of these schemes***, and **ToR 10:** ***The projected returns and supporting information, including assumptions on product price and demand***. They provide additional details and explanation of the diverse sources of information available to investors in the retail forestry market

Promotional materials

The development of material used to promote retail forestry investment projects follows a strictly regulated process with high standards of verification, disclosure, compliance, and sign-off.

The most important document is the **Product Disclosure Statement (PDS).** All the requirements for preparing and issuing a PDS are covered in the *Corporations Act 2001* (Division 2) and a number of ASIC Regulatory Guides and other public documents, particularly RG 168: *Disclosure: Product Disclosure Statements (and other disclosure obligations),* RG 53: *The use of past performance in promotional material*, RG 170: *Prosepctive financial information*, and Information Release IR 04-71: *ASIC issues guidance on PDS disclosure.*

A number of requirements are of particular relevance to this ToR. These include, *inter alia,* that the PDS must:

- contain all the information that investors would reasonably require in order to make an informed assessment;
- be worded and presented in a clear, concise and effective manner;
- not contain statements that are misleading or deceptive.

All material information to be published in the PDS must be verified through a due diligence process, and the substantiation, assumptions and sources kept on record. This procedure is overseen variously by a due diligence committee and/or a compliance officer, and signed off at the most senior level. Most plantation investment companies also secure external legal counsel that the presentation of the information in the PDS is accurate and complies with the relevant laws and regulatory guidelines.

ASIC conducts periodic reviews of promotional material and the due diligence records, and can issue stop orders, injunctions and enforceable undertakings if the PDS and accompanying advertising material is found to be defective.

To further underpin the accuracy that a plantation investment company must meet in its PDS and accompanying brochures and advertising, promoters utilise diverse information sources. These include: contributions from independent forestry experts and forestry/timber market consultants; information from previous and ongoing projects of relevance and other established plantations in the regions of relevance; and market trends and projections from independent industry analysts.

Reports by independent experts are subject to ASIC guidelines set out in RG 111: *Content of expert reports*, and RG 112: *Independence of experts*.

While promotional material aims to be as accurate as possible at the time of publication, any material inaccuracies or misconceptions are able to be continually addressed over the lifetime of the projects, with continuing updates and communications from the investment managers. These include revised yield estimates and revised management plans as necessary.

Past performance and forecasts

The growth or yields from **previous retail forestry projects** is disclosed in a number of ways. First, the PDS, and in most cases later Supplementary PDSs, provide information on past projects. The PDS also includes a report from an independent forestry expert on a range of likely production and product outcomes for average plantations in the regions where the projects will be established. Independent research houses prepare reports on actual inventory or measurement data, plus actual harvest results for past projects, which are available directly from the company or via the licensed financial advisers.

Companies provide information on earlier projects in several ways. Some companies have disclosure of the production to date of some of their earlier projects as a separate item on their websites. This may be in the form of average production to that point of time, not final full-rotation production. Most companies provide productivity information in their annual Independent Forester Reports or Grower reports to investors for each of their projects, once the plantations have reached an age and size where meaningful measurements can be made. In addition, some companies provide information on yields in their newsletters to shareholders and investors, as well as updates on harvest progress..

Reliance on performance of earlier projects is subject to ASIC guidelines, set out in RG 53: *The use of past performance in promotional material.*

The amount of detailed information that is available from plantation investment companies contrasts with that available from most other managers of forest resources in Australia, including publicly owned plantations. More information is publicly available about the production from retail forestry projects than other plantation resources, with the individual reports making it possible for advisers and investors to make direct comparisons.

As explained in detail under ToR 10, ASIC's Regulatory Guide RG 170 effectively prevents the incorporation of yield and returns **forecasts** in promotional material. To compensate for this exclusion, plantation investment companies supplement their own promotional material with investment evaluations prepared by independent research and ratings analysts, who determine forecast yields and returns based on their own market and product analysis, independent of the company.

Plantation managers make every effort to achieve maximum returns for investors. The managers' in-house or contracted forestry experts utilise advanced silvicultural science to generate their forest management programs, irrespective of forecasts. Management techniques such as basal thinning, fertiliser application, pruning, etc. aim to ensure that plantations result in optimal growth and return under the relevant conditions.

ToR 6: The range of individuals and organisations involved in the schemes, including the holders of the relevant Australian Financial Services Licence

This submission assumes that "involved in the schemes" means the individuals and organisations having some responsibility for the development and implementation of the scheme. This would include those involved in such activities as:

- designing and developing;
- assessing and giving expert opinions;
- promoting and marketing;
- financing;
- insuring;
- recommending and selling; and
- implementing the schemes (i.e. carrying out the contracted services.).

But it does not include investors, shareholders (unless they have another role, such as director), or service providers and suppliers operating completely at arm's length.

This ToR 6 should be considered together with ToR 1, recognising the link between the business structure of the scheme and the number and diversity of the people and organisations 'involved' in it.

Examples of the individuals and organisations who carry out functions in the broad categories listed above include:

- the parent company and all its related entities, such as the landholding, financing, and operational management companies;
- directors and office-holders of those companies;
- compliance committee or board members, including independent committee/board members;
- the providers of independent expert opinion – such as the independent forester, independent accountant, independent legal advisers, harvesting and forest product market consultants;
- external finance providers and plantation insurance providers;
- research analysts and ratings agencies;
- dealer groups and financial planners, particularly where they advocate a product as well simply providing investment advice to clients;
- accountants where they act as agents; and
- employees and contractors who carry out all the operations to implement the project.

Examples of the employee/contractor category above include:

- professional foresters and forestry technical officers;
- agronomists and soil scientists;
- land assessment officers and valuers;

- earthmoving contractors and road-builders
- fencing contractors;
- plant nurseries;
- spraying and fertiliser contractors and crews;
- tree-planting crews;
- harvesting contractors and crews; and
- haulage contractors and crews.

Extending the definition more widely would incorporate the many people involved in the processing, marketing and distribution of the timber products grown by these projects.

AFSLs are necessary to carry out a number of these functions, such as the RE (whether internal to the plantation investment company or externally engaged), and the dealer groups and financial planners.

The purpose of this general discussion above is to illustrate that there is a chain of creation and distribution of managed investment schemes, including agribusiness. This chain has a number of core entities but is otherwise variable from one company to the next, depending on the way each company chooses to structure its operations. It also indicates the scope and scale of the professional and skilled labour force, usually locally engaged, that is required to manage even one plantation investment project, let alone a dozen.

ToR 7: The level of consumer education and understanding of these schemes

Managed investment schemes appear to receive more public and regulatory attention than any other investment medium, except the share market. The intricacies and value of managed investment schemes are dissected and publicised widely by proponents and critics alike. There have been four Parliamentary inquiries into aspects of managed investment schemes, and numerous court cases, including one test case. The 2007 legislation that made the tax arrangements for retail forestry investment statutory was preceded by a long period of Government inquiry and public debate, and was issued to a further round of discussion.

There is no shortage of advice available in the market place. ASIC and the ATO publish consumer advice, and potential investors have easy access to licensed financial planners and investment advisers, regulatory agencies, investment analysts, accountants, lawyers and media commentators.

However, as with any product, it is not possible for the provider of that product to force the consumers to make themselves fully aware of and to fully understand all the information available about the product.

For some years, Australian Forest Growers (AFG), the national association representing private forestry, published two documents to assist investor understanding of retail forestry projects – the *AFG Disclosure Code for Afforestation Investments*, and its companion *Short Guided to Afforestation Investment*. The investors' guide was distributed widely through the plantation investment companies and dealer networks. The investors' guide set out, under eight categories, all the questions potential investors should ask when assessing and comparing retail forestry projects on offer. AFG has indicated that it would be prepared to consider republishing the investors' guide.

Key consumer educational sources

- **Product Disclosure Statements (PDS) and any Supplementary PDS:** Sets down in detail what the retail forestry project is about, investor entitlements, fees, commissions, and supporting documents such as independent assessments and expert reports. The content is governed by the *Corporations Act 2001* and ASIC Regulatory Guide (RG) 168 and other RGs, described earlier under ToR 5. ASIC does not approve either the projects or the PDSs, but has the power to review them and take action if a PDS is defective.

- **ASIC:** Devotes whole sections of its FIDO* consumer protection website to managed investment and tax schemes, as well as publishing printed material. The risks are spelt out in the plain language. PDSs are all required to carry a consumer advisory warning which directs investors to ASIC for advice. FIDO is linked to the ATO site. [*FIDO = Financial Information Delivered Online]

- **ATO:** The ATO Product Ruling issued for a specific retail forestry project provides a biding commitment on the Tax Commissioer about the tax treatment of an investment in the project. Every product ruling contains a very prominent disclaimer that the ruling is not an endorsement of the product or its commercial viability. Many other tax rulings are very informative for the interested reader. ATO regularly publishes material that warns about and explains aggressive tax planning and tax 'scams' to beware of.

- **Company newsletters, websites and reports/updates:** Plantation investment companies, whether listed or not, provide substantial amounts of information, on the their websites and in printed material, about themselves, their projects, their finances and management, and their operations, products and markets.

- **Independent forester's reports:** Each retail forestry investment project is obliged to prepare regular (in most cases annually) reports on the performance of the plantations comprising the project. These reports are made available to project investors, but are also sometimes put on the company's website.

- **Financial planners and other investment advisers:** This is the group of people that has the most contact with potential and ongoing investors in retail forestry projects, and thus in the best position to judge the level of understanding their clients have of the investment products on offer.

  Financial planners and other financial products advisers are required to operate under their own or someone else's Australian Financial Services Licence (AFSL), and they must also be trained to give financial advice (ASIC Regulatory Guide RG 146: *Licensing: Training of financial products advisers*). They also may receive training about specific investment products, such as retail forestry projects.

  As well as having access to all the promotional material (see ToR 5) about various investments, and the ratings reports from the independent research houses, financial advisers are required to produce a Financial Services Guide (FSG) and a Statement of Advice (SOA) for their clients.

  They must apply the principle of 'know your product, know your client'. Their clients (the retail investors) are required to sign the SOA declaration that they have read and understood the promotional material and all the risks and implications of the investment.

- **Independent research houses:** A number of specialist analysts in the retail managed investment field conduct research on the retail offerings, as well as a range of analysts in broking houses that follow various companies in the sector. Their reports are available to potential investors, usually through the financial advisers, as an independent source of educative material to halpe investor understanding of the sector and the investment projects.

- **Media:** Many aspects of tax-effective managed investment schemes is routinely inspected by a wide range of newspapers, magazines, newsletters, radio and TV programs and internet blogs. Regulatory affairs and court action are covered comprehensively, as are assessments of the worth of schemes, the effects of managed investment schemes on various sectors, the commissions paid, and the personalities.

The level of information available to both the prospective as well as the current investor is extensive. However, regardless of how much information is available, there is no guarantee that it will be consumed, understood and acted upon. Merely providing more information will not necessarily address this limitation.

The financial advisers are in the best position, and indeed have a statutory responsibility, to assess a particular client's understanding of an investment before recommending that product to that client.

ToR 8: The performance of the schemes

Retail forest investment schemes can be assessed on their performance against forest policy objectives, broader government policy objectives and in relation to their performance against other land use investments, such as agriculture.

Forest policy objectives

As part of the development of the Regional Forest Agreements (RFAs), Australia's timber industry lost access to over 11 million hectares of native forests to conservation reserves. The Government developed the *Plantations for Australia: The 2020 Vision* strategy, in conjunction with industry and State and Territory Governments, as a means of assisting the industry and timber communities to adjust to this significant loss of resource and to facilitate the continued development of Australia's plantation-based industry. The overarching principle of the Plantations 2020 Vision is to enhance 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.

Retail forest projects have been successful in attracting private sector investment into forestry plantations and meeting the objectives of the Vision 2020. Retail forestry projects have added around 700,000 hectares to the national plantation estate, in addition to the re-establishment of many second rotation plantations.

Many of the plantations established by early retail forestry projects are now in the harvesting phase, providing opportunities to access export wood markets as well domestic value-adding (See Table 1 for infrastructure and processing investments related to plantation resource based on retail forestry projects). This phase of plantation development will bring thousands of direct and indirect jobs and substantial income to rural and regional communities.

Regional development objectives

Investment in rural and regional Australia is essential in building strong and robust regional economies. Retail forestry projects have delivered much needed investment and have established a high-value, sustainable wood resource, jobs and essential support industries. These projects have assisted in meeting key objectives in Government regional development policy, including diversifying the economic and employment base in these areas.

The environment and natural resource management

The Australian Government has a key objective of promoting the sustainable use and management of natural resources, including land, water, forests and vegetation. It is recognised by scientists that many of Australia's natural resource problems have been exacerbated by clearing of trees from for agriculture and urban development. Trees create a natural filter for the environment, resulting in improved soil, water and air quality, as well as helping to address salinity problems. Many scientists are also exploring the potential link between tree cover and increased rainfall. Australia's plantation resource has assisted the Government's objectives in relation to natural resource management by placing more trees into our landscape. Research by the Bureau of Rural Sciences has shown that the level of plantation development in many catchments is far below the level where they would have any significant impact on water availability for downstream consumptive use such as irrigation and town water supplies.

Climate Change

Adjusting Australia's economy to a low emissions trajectory path is a major policy objective of the Government. Since signing the Kyoto Protocol in 2007, Australia has been subject to its requirements of maintaining emissions at no more than eight percent above 1990 levels over the period 2008–2012. As the majority of retail forestry projects have been established since 1990 on cleared agricultural lands, they are classified as 'Kyoto forests' and can contribute toward Australia meeting its emissions target. The Government has estimated that the 'Kyoto forest' resource, again largely made up of retail forestry projects, will contribute 21 million tonnes or 4 percent in emissions reductions. The industry estimates that this contribution could be significantly larger in the future, provided that stable policy settings are maintained for the retail forestry sector.

The Government has included this plantation expansion in its calculation of Australia's greenhouse gas emissions. However, carbon sequestered after 1 July 2010 will be eligible to create credits for the owner if the Carbon Pollution Reduction Scheme (CPRS) is implemented as proposed.

Performance of the plantation sector

From the 1960s to the 1980s, Australia's plantation estate expanded at a relatively steady rate, with around 90 percent of establishment carried out by State Government agencies largely supported by Commonwealth loans to State Governments through the *Softwood Agreement Acts* (SAA) of the 1960s and 1970s.

During this time it is acknowledged that the understanding of all aspects of softwood plantation establishment, management and harvesting increased dramatically, as a result of substantial research and development, with, on average, the latter plantations providing superior returns in comparison to earlier plantations. This experience was repeated in the hardwood plantations that followed.

The long-standing tax deductibility available to plantation forestry provided an investment environment that enabled retail forestry projects to attract much-needed private investment into the plantation sector. With this significant shift towards private investment, the nature of plantation management evolved rapidly. In the past decade, plantation development has been dominated by Australian hardwood species such as *Eucalyptus globulus* (Tasmanian Bluegum) – a species that had not previously been subjected to long-term genetic improvement in Australia.

As with the government softwood plantation resource, techniques and knowledge for establishing hardwood plantations have improved rapidly. However, as noted earlier in this submission, some of the early plantations did not perform as well as predicted or as well as later plantations, and a number of early projects fell short of projected growth rates and returns. This largely related to issues of site selection and the effect of drought on plantation growth rates.

However, improvements in silvicultural practices and all aspects of plantation management including site selection, establishment and harvesting, have resulted in improved performance and superior returns in later plantations.

The production of timber in plantations is a commercial activity subject to a number of risks. It is not possible to make conclusive statements about the performance of all companies' projects or individual plantations that make up the entire retail forestry sector. Individual companies are responsible for providing information about the actual performance of their projects.

However, according to the Australian Bureau of Agricultural and Resource Economics, the average growth rates in Australia are comparable with the highest average growth rates of

plantation regions in other parts of the world (Table 2). This, coupled with the stable economic and political climate, makes Australia highly suitable for the establishment of plantations for the domestic processing or the export of industrial plantation products industries.

	Species	Indicative range of mean annual increments m3/ha/yr
Africa	*Acacia spp*	9 - 26
	Eucalyptus grandis	16 - 24
	Pinus elliottii	12 - 15
	Pinus patula	12 - 15
Asia	*Acacia spp*	8 - 30
	Eucalptus spp	11 - 25
Europe and former Soviet Union	*Picea spp*	1 - 6
	Pinus sylvestris	3 - 8
North and Central America	*Picea spp*	2 - 6
	Pinus spp	7
	Pseudotsuga spp	2 - 12
Oceania, including Australia	*Eucalptus nitens*	14 - 32
	Pinus radiata	12 - 26
	Pinus caribaea	13 - 26
	Eucalyptus globulus	15 - 38
	Acacia mangium	20 - 60
	Swietenia macrophylla	7 - 10
South America	*Pinus spp*	10 - 25
	Eucalyptus spp	15 - 30

Table 2: Mean annual increments of selected plantation species, by region (Source: Global Outlook for Plantation Database)

Comparison of plantation performance with other land uses

As with any land use activity, there is the risk of natural events such as drought, pests and disease and natural variation in site productivity that impact on performance. The exposure of agricultural and forestry activities to natural risks differentiates these activities from other investments, such as investments in rental properties or government securities (e.g. 10-Year Treasury Bonds), which have a different and often lower risk profile.

Retail forestry project managers undertake comprehensive assessments of plantation sites, climate and other risk factors to minimise the potential effect on project performance and investor returns. This involves the project manager engaging forestry experts to undertake a range of activities, which may include:

- site inspection, survey and assessment;
- soil testing;
- implementing codes of practice;
- plantation design and layout;
- quality control of seedlings in the nursery;

- site preparation including deep ripping and weed control;
- supervision and quality control of planting and post planting activities;
- periodic measurement and reporting of growth performance throughout the rotation; and
- adjustments to management regimes, such as additional fertilisation application, to maintain project performance.

A key indicator used by economists and financial analysts to determine investment or project performance is the internal rate of return (IRR) (determined as the discount rate that brings the future stream of project costs and revenues to zero).

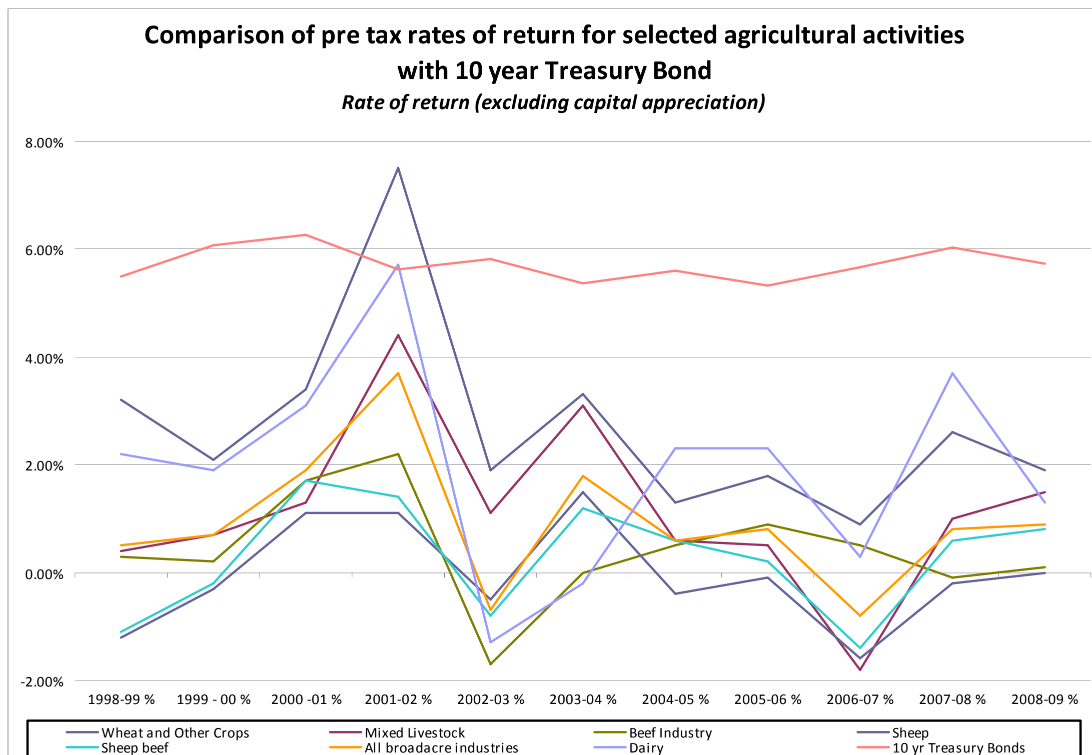

Figure 4: Average rates of return (excluding capital appreciation) for agricultural industries compared with 10 yr Treasury Bonds (Sources: ABARE Australian Farm Surveys (1998/99 – 2008/09); Treasury)

Analysts often benchmark IRRs from particular activities with activities that are subject to a similar risk profile; for this reason forestry is benchmarked with agriculture. Forestry and agriculture are subject to the same natural variability and climatic risks and exposure to international market forces.

The difficulty with a direct comparison with agricultural activities is that many retail forestry projects are yet to reach harvest stage and thus a representative sample of retail forestry projects, sufficient to create a statistically robust ‘industry average’, is unavailable. Although estimates of returns from retail forestry projects have been compiled by independent research houses, these are predicted and not actual returns, and hence not appropriate for comparison with actual returns from agricultural activities. While these estimates predict that, on average, retail forestry projects are likely to provide returns between 8 and 12 percent before tax, it should be noted that some IRRs for individual projects and activities may not fall within this range.

Figure 4 graphs actual IRRs for a range of agricultural activities over the past 10 years with the average rate of return from 10-Year Treasury Bonds over the same period. On average, IRRs for agricultural activities have been less than the return on 10-Year Treasury Bonds with many activities registering negative IRRs in some years. While the drought has largely been

responsible, the general trend of declining IRRs for agriculture is also a result of declines in terms of trade in the industry (Productivity Commission, 2005, Trends in Australian Agriculture, Research Paper, Canberra).

Final product prices and agricultural and plantation activities

A key determinant of final returns to forestry and agricultural activities is final product price. Fluctuations in final product prices can influence the IRRs of investments over time. Figure 5 shows the indexed prices of selected major agricultural products in Australia. The fluctuating nature of these commodity prices over time has contributed to the highly fluctuating returns (IRRs) from agricultural activities over the past decade (see Figure 4 above).

In comparison, Figure 6 shows the indexed prices of selected forest products in Australia. In contrast to agricultural products, these prices have remained relatively stable over the last decade and in nominal terms have been increasing over time, reflecting the strong fundamental demand for Australia's forest products. This provides stability to the industry; attracting investment and maximising returns for investors.

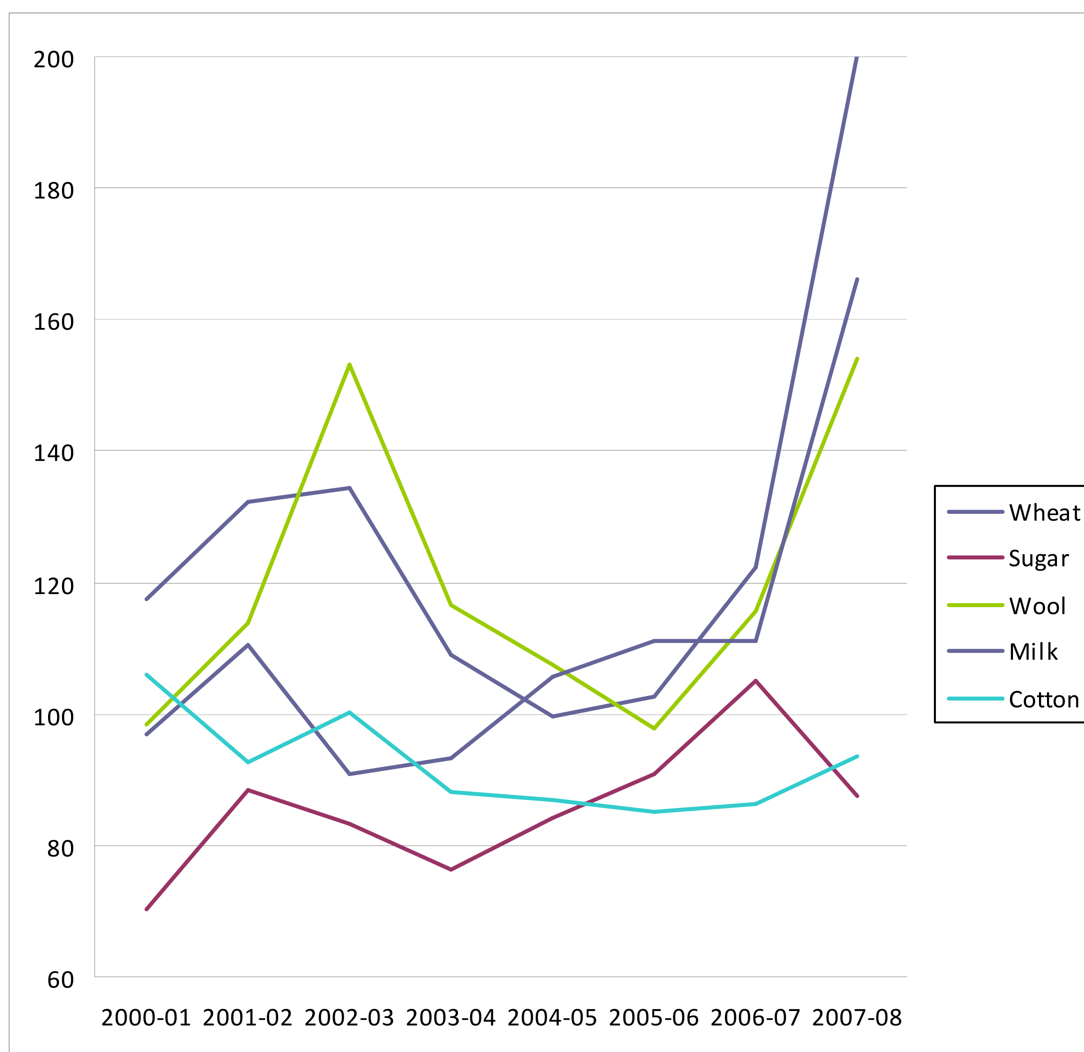

Figure 5: Indexed prices of selected Australian agricultural products (Source: ABARE 2008, Australian Commodity Statistics 2008, Canberra.)

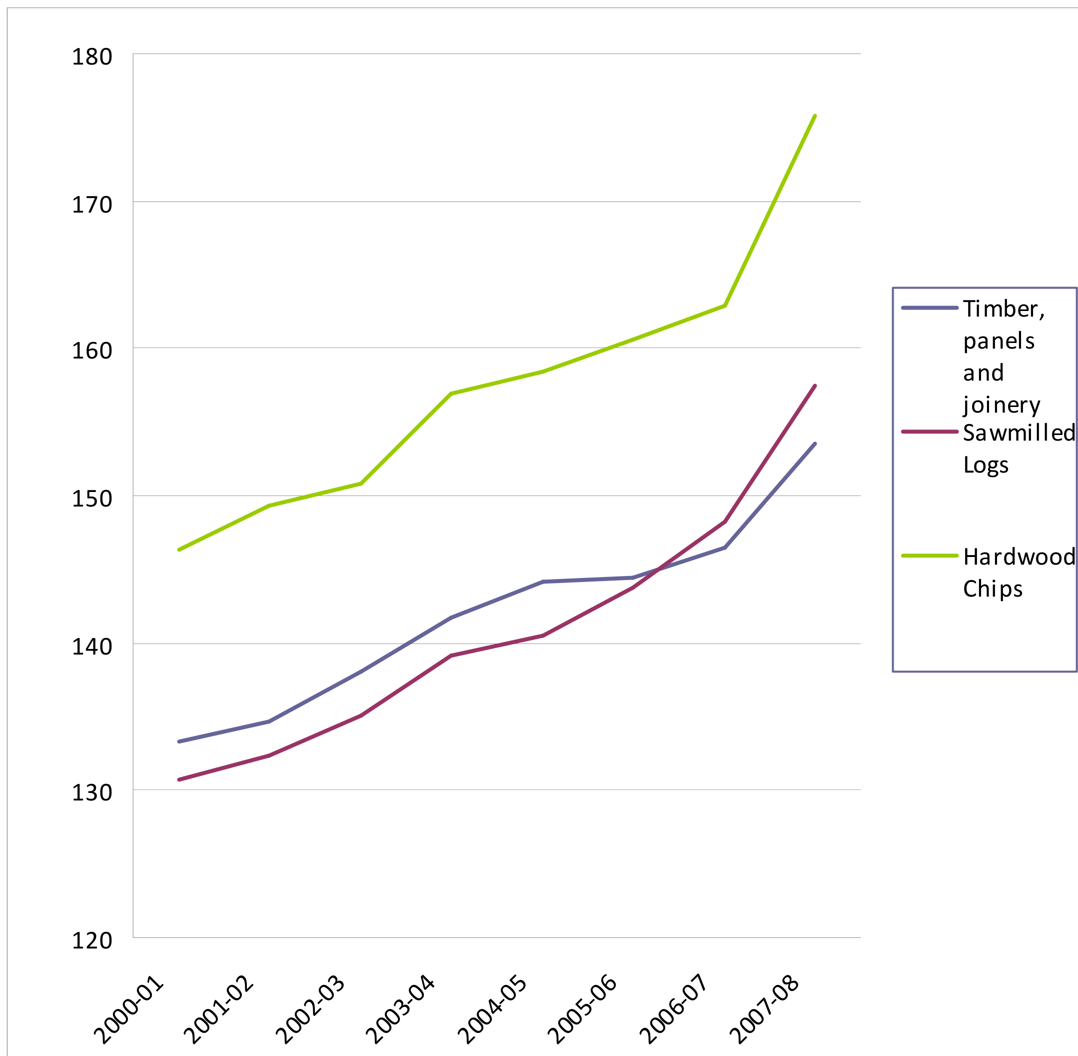

Figure 6: Indexed prices of selected Australian forest products (Source: ABARE 2008, Australian Commodity Statistics 2008, Canberra.)

This stability in end-product price is further evidenced by ITC Limited's announcement of 30 June 2009, reporting the conclusion of negotiations for the second-half 2009 benchmark price for Australian plantation-grown bluegum woodchip for export to Japan. The existing price of $207.40 free on board (FOB) per bone dry metric tonne was maintained (ITC Limited, 30 June 2009, Press Release: *ITC Secures Maintenance of Benchmark Price for Australian Plantation Grade Woodchip*, Melbourne.)

ITC Limited's CEO, Mr Vince Erasmus, said that the maintenance of the price was an, "extremely positive outcome given global economic conditions." He went on to note that, "Australian certified plantation grown woodchip is a valued commodity in our major export markets."

This stability in end-product price provides strong foundations for the plantation investment industry. It suggest that there will be continuing strong growth in this industry, benefiting investors, shareholders, the timber industry and the greater Australian economy.

ToR 9: The factors underlying the recent scheme collapses

The factors underlying the recent collapses of Timbercorp and Great Southern will be debated and analysed for some time to come. However, most analysts agree that the collapse of these companies resulted from a combination of events rather than one specific factor. Appointed administrators for Timbercorp stated that in their opinion, Timbercorp was caught in a ‘perfect storm’. It is not the role of this submission to represent these companies on this issue. Rather, this response to ToR 9 aims to highlight some of the factors that have been identified by analysts as contributing to the collapse of the companies.

The failure of the two companies has had and will have profound, painful and far-reaching consequences. However, it is imperative that the Committee recognise that it is the companies that have ‘collapsed’, NOT the managed investment schemes that the companies managed.

The agricultural (non-forestry) MIS test case

As described under ToR 2, the Tax Commissioner announced in February 2007 that he would cease issuing product rulings for agricultural (non-forestry) MIS projects from 1 July 2007, stating that in his opinion the investors in the projects were not carrying on a business and hence were not eligible to receive business deductions associated with the projects. The Commissioner later extended the date to 1 July 2008, so that, in conjunction with industry, a test case could be developed to test his new interpretation of the law.

However, the test case was not heard until August 2008 and not decided until December 2008. During that part of FY2009, the companies operating agricultural (non-forestry) MIS projects could not market their projects. The Federal Court found in favour of the industry and the ATO recommence issuing product rulings for FY2009 projects. However, the loss of half a year in marketing agricultural (non-forestry) projects had a critical and adverse impact on the cash flow of companies such as Timbercorp and Great Southern, two companies that would have been offering a large and diverse range of agricultural (non-forestry) retail investment projects to the market.

The ‘Global Financial Crisis’

The global economy has experienced the worst financial crisis since the Great Depression. This has had significant consequences for all companies in the Australian economy, including retail managed investment companies.The fall in the share market has resulted in a significant reduction in the value of many publicly listed companies (Figure 7), and financial institutions have severely tightened the availability of both equity and debt capital. This has left companies with short-term debt refinancing needs at a serious disadvantage; and the slowing of economic activity has reduced land values and commodity prices. The decline in asset values and access to short-term debt refinancing meant that Timbercorp and Great Southern were unable to sell assets to pay down their debt.

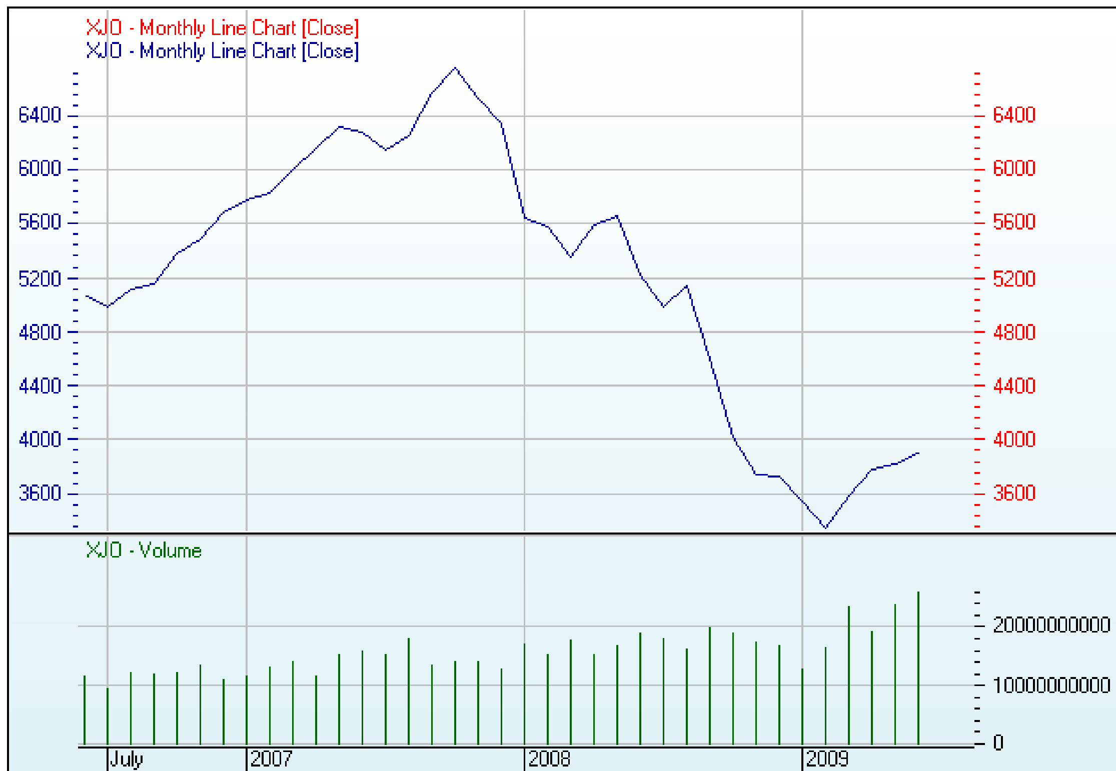

Figure 7: Australian share market response to the Global Financial Crisis (Source: ASX)

Long term drought and climatic instability

The majority of Australia's agricultural land has been subject to the worst drought in living memory which has had a significant effect on a wide range of agricultural returns. Timbercorp and Great Southern had considerable exposure to the agricultural sector during the drought, resulting in less than predicted returns to many of their agricultural projects. The drought has resulted in reduced growth rates in timber plantations and in some instances will have led to the need for replanting or infill planting of plantations where the survival rate of initial plantings has been below the required level.

In the vast majority of situations, timber plantations are not irrigated. However, the impact of the drought has been far greater in the irrigated agriculture/horticulture sector where additional and more expensive water has had to be purchased just to ensure the survival of crops.

ToR 10: The projected returns and supporting information, including assumptions on product price and demand

Plantation investment companies rely on diverse sources of information in choosing the plantation yields and product prices on which they will base the projected returns for their projects. These sources include their own in-house research of others' plantation data, their own site productivity assessments, direct advice from their expert consultants (e.g. in forestry management and wood product markets) and other research from specialist analysts.

Operating within the biophysical environment and within commodity markets means there will always be ranges of values within which the final harvest yields and financial returns will fall.

This submission cannot comment on specific decisions of individual plantation investment companies, as the industry associations are not privy to the companies' commercial considerations.

However, it is important that the Inquiry has a broader understanding of the regulatory constraints on publishing projected returns and the processes the plantation investment companies engage in to satisfy themselves that the decisions they make are reasonable and within acceptable ranges.

Regulatory constraints on publishing projected returns

In September 2002, ASIC released its Policy Statement PS170: *Prospective financial information*, (known since July 2007 as Regulatory Guide RG170). RG170 provides guidance on ASIC's approach to the use of prospective financial information (including financial forecasts and projections) in PDSs and other disclosure documents. The guide covers when prospective financial information can or should be disclosed; what constitutes reasonable grounds (assumptions) for stating prospective financial information; how prospective financial information should be disclosed; and what information should be disclosed by a product issuer in the absence of prospective financial information.

At that time, ASIC's motivation for the guide had been to minimise the chances of a recurrence of the failures of a number of 'dot.com' companies, with their reliance on blue-sky financial projections. The central threshold theme in the guide is that forward looking statements about financial information beyond a period of two years can only be included in an offer document if they are based on "reasonable assumptions".

The plantation forestry industry took a very active role in ASIC's consultation on the draft guide. The industry argued unsuccessfully that the two-year limit on such estimates is neither appropriate nor justified for forestry projects, and that the plantation forestry industry could demonstrate reasonable grounds for its assumptions behind its forward-looking statements well beyond the time limit. (A copy of the industry submission to ASIC can be made available to the Committee).

Although substantial changes were made before the final RG170 was issued, the basic premise in the draft remained. Attempts to secure greater clarity about what ASIC would accept as 'reasonable grounds' were unsuccessful.

Taken literally, RG170 does not prevent the use of long-range forecasts in offer documents. However, the plantation investment companies were left with a very real fear that ASIC would issue commercially disastrous Interim Stop Orders (ISOs) on any PDSs that contained long-range forecast returns expected from their plantation projects, with the consequence that retail forestry PDSs no longer contain prospective returns.

The information presented tends to be limited to historical trends and values, assumptions on which future returns might be based, and possible scenarios. Companies rely on the independent research houses to conduct their own analysis and derive indicative forecasts of yields and returns to include their ratings reports.

Plantation investment companies′ in-house knowledge

Long-range forecasts are a central element of product development and project management for the plantation management company.

All major plantation forest projects have long-term financial projections embodied in their management plans, regardless of whether they are managed by government forestry services, corporate-industrial plantation growers/processors, managed investment plantation growers and their managers, or individual private forest growers. All these managers and investors accept that there are inherent risks in long rotation, illiquid forestry investment. If such risks had not been accepted in the past, there would have been no private forestry investment in Australia in the twentieth century.

As noted elsewhere in this submission, plantation investment companies operate in a business environment highly regulated by relevant federal laws. But regardless of the business structure, **the practice of plantation forestry is similar to that under other management regimes.**

Plantation forestry is regulated by relevant land-use laws and regulations and codes of forest practice, and is carried out by qualified and experienced forest managers. It relies upon established forestry science, and continually adopts results from new research on site selection, site preparation, genetic improvement, fertiliser response, pest control, thinning and pruning regimes, growth monitoring techniques, and so on. Plantation forestry is carried out in accordance with forest management plans that include growth rates, yields and cash-flow projections based on decades of experience with various species in different regions; and is carried out with acceptance of the risks inherent in any enterprise that relies upon the biophysical environment and domestic and international commodity markets, and especially one with a long lead-time.

In addition to these forest management factors, plantation investment companies include the following considerations in their project planning.

- Timber supply can be ascertained further into the future than any other commodity or asset class.
- Timber is one of the most stably priced of all commodities.
- Leading forestry consultants can make reasonable assumptions about domestic and international forest products markets.
- Forest products companies rely upon a reasonable view of long-term resource supply.
- Forest growers rely upon a reasonable view of future markets.
- Average inflation rate over the rotation provides a reasonable basis for future costs.
- Exchange rate movements have little correlation with timber prices.

In assessing future trends in supply and demand, in prices, production costs and returns on investment, plantation investment companies don't rely only on independent industry experts and consultants. Plantation investment companies spend substantial time and resources

conducting their own direct research, meeting with potential suppliers, purchasers and even competitors in domestic and international markets.

The product development process

It may be instructive also to summarise the process that plantation investment companies follow in the development of their PDSs. As described under ToR 5, in developing their products, companies are bound by the relevant sections of the *Corporations Act* and ASIC Regulatory Guides, especially RG170 (see above) and RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*, and in particular the requirement not to publish statements about future matters or past performance that are misleading or deceptive.

The many steps in the product development process can be grouped into the following categories fairly common among companies:

- Document development
    - Structure, content, drafting, forms, due diligence, board approvals, design, printing, etc.
- Legals
    - Scheme constitution, compliance plan, agreements (lease, management, loan, custodian), etc.
- Independent experts
    - Forestry, markets, tax, accounting
- Product ruling application
    - ATO checklist, drafting, lodging, responding to formal questions, redrafting, etc.
- Registrations
    - Scheme (Australian Registered Scheme Number), constitution, compliance plan, and ‘in-use’ notice for the product ruling
- Independent research reports
    - Not part of PDS development, but usually sought at the same time.

Technically, most of these steps, individually, can be completed in from one to four weeks per step. Furthermore, several steps in different categories can be conducted concurrently, both in-house and through the professional advisers. But there are critical ‘sign-off’ stages which cannot be by-passed or side-stepped. And some stages are known to take months. The ATO product ruling process, for example, takes a minimum of 70 to 90 days from the date of lodging a completed application, accompanied by the PDS; this period can be extended many more weeks if ATO requires changes or additional information.

Overall, assuming that there is a level of consistency with the previous year’s scheme structure, companies rarely allow less than six months to be ready to release a new offer document.

The legal and regulatory requirements on the companies are substantial, subject to random audit by the regulators, with serious commercial consequences for uncorrected breaches.

Furthermore, the ‘promoter penalties’ provisions in the *Tax Administration Act 1953*, legislated in 2006, have added an additional deterrent to companies not complying with their legal and regulatory obligations.

ToR 11: The impact on other related markets

Retail forestry projects have been directing significant investment into rural and regional Australia for over a decade. Because of the duration and size of the investment, there is no doubt that retail forestry projects have had a positive influence on the markets for factors of production in many rural and regional communities.

Reasonably recent data is presented below with respect to the impact of retail forestry investment on regional economies; land-use change; rural land values; land purchase statistics; population, employment and services; water; and capital markets.

Retail forestry investment is now woven into the regional economic fabric

A modelling study by Econtech, conducted as part of the industry submission to the Commonwealth forestry taxation review in 2006, provides an insight into the economic relationship between forestry, the regional community and the broader economy. The study determined the economic consequences of terminating the 12-month prepayment rule that was in place between FY2002 and FY2008.

The dramatic reduction in retail forestry investment offerings that would result from there being no prepayment rule was estimated to result in the following impacts:

- 35% decrease in the annual production of the plantation industry;
- $1.2 billion reduction in the industry's gross value of production;
- declines in the exchange rate, GDP and housing construction;
- an increase in imports of $523 million per annum (25%);
- substitution away from domestically produced wood and paper products, towards imported wood and paper products;
- a fall in employment of around 35% within the plantation industry (predominantly in regional communities, as illustrated in Table 3);
- movement of resources out of the main plantation timber-dependent regions such as Northern Tasmania and Lower Western WA and into mining-dependent regions such as the Northern Territory;
- a halt to most of the $7 billion of planned industry investment in value-adding; and
- potential to reduce the ability of the plantation industry to reach the critical mass required to sustain harvesting and processing facilities in each region over the long term.

Region	Job Losses
Southern and Eastern South Australia (Mount Gambier)	1600
Barwon-Western (Southwest Victoria)	1100
South Eastern NSW (Eden-Bombala, Tumut)	1100
Northern Tasmania (Northeast Tasmania)	900
Goulburn-Ovens-Murray (Myrtleford-Albury)	1300
Inland Northern and Central NSW (Oberon)	1400
Lower Western WA (Albany)	1900
Wide Bay-Burnett (Gympie)	700

Table 3: Long-term regional employment impact of removing the 12-month prepayment rule

The report concluded that it is essential to have a stable investment regime for new plantations to address the changing nature of Australia's wood resource base. This will encourage investment on the scale required to build the plantation timber resources required by industry (Econtech, 2006)

Land-use change

Broadacre cropping, farm consolidation and other factors, not plantations, have been the main drivers of land-use change in many rural regions of Australia in the past decade.

Between 1994 and 2004, the total area of land used for cropping and grazing fell by 29 million hectares, compared with an increase in the area of plantations of less than 0.7 million ha (2 percent) while cropping specialists doubled (from 10 to 20 percent of total agriculture). Total number of dairy farms fell 27 percent, but dairy cow numbers rose 14 percent.

Land degradation, urban development and rural residential development are having a far greater impact on land use change than plantation expansion. Although timber plantations are very obvious and do change the appearance of local landscapes, the total amount of rural land being planted is very small.

In the five regions that in 2000 accounted for about 70 percent of total plantations as well as having major timber processing industries, no more than 6 percent of the land was under plantations. Even in Local Government Areas with the highest concentrations of plantations, maximums of 5 to 20 percent of agricultural land is used for plantations (Great Southern WA).

Rural land values

Recent research by Australian Agribusiness Group (AAG) into the effects of retail managed investments on land values concluded that retail managed investment projects have not been the major driver of rural property prices. Using statistics from the Valuer-General Victoria, AAG compared rises in values for specific areas in the state. It contrasted areas where there was a strong level of retail managed investment purchases with areas that had few or no retail managed investment purchases. AAG concluded that land prices in retail managed investment activity areas did not go up any differently to other areas (*Financial Review* – Matthew Cranston P47, 29/6/09).

Rising values of rural land have been driven by a combination of factors that include low interest rates, high commodity prices, strong international demand for Australian farm products, rationalisation in the rural sector with farm amalgamations, competition for farms from overseas buyer, and multiple changes in land use.

Plantations are only one of several competing land uses putting upward pressure on rural land prices in recent years. Plantation companies buying properties have been welcomed by retiring farmers, many having had their properties on the market for some years.

Other strong competitors for land include: broadacre cropping (a major land-use change); dairying and beef cattle expansion; intensive agriculture; farm consolidation; rural subdivision and lifestyle farms (especially in popular 'sea-change' and 'tree change' regions, such as Denmark, WA. and Oberon, NSW); and urban encroachment (such as in Wynyard, Tas).

In 2005, BRS confirmed that WA's Great Southern region saw a steeper increase in land prices since 2002 in non-plantation regions because farmers had experienced "a couple of good seasons".

Nationally, average prices of broadacre farms sold in Australia rose by 34 percent in 2004-05, following an average increase of 19 percent in 2003-04 (Elders Rural Property Index). At that time, plantation investment companies had purchased around 3 percent of the total of around

10,000 broadacre properties sold in each of the previous four years. It is simply not possible that 3 percent of sales could drive a 34 percent increase in land values.

A rural property forum convened by National Australia Bank Agribusiness presented comparative land values and capital growth in eleven NSW regions from 1978 to 2006. Most notably, "values for most classes of property are shown as having at least doubled since 2002, and in some cases (like Mudgee) nearly trebling or even quadrupling (Yass)," (*The Land,* 22/6/06). Plantations are not being established or expanded in either of the Mudgee or Yass districts.

Dairy farms

According to Elders (December 2005), several dairy farms in Tasmania were purchased in 2005 by forestry companies at prices of $3,000 to $6,500 per hectare, while interstate and international dairy farmers had pushed the price for established dairies in prime areas up to $14,000 per hectare.

According to the Commonwealth Bank (Stephen Rafferty, 15 Dec 2005), dairy farmers seeking to expand their holdings in western Victoria had met stiff competition from overseas farming interests – particularly from NZ (where dairy land was about $25,000 per hectare), but also from Holland, England, Germany, Switzerland and Canada. At least 100 overseas families had invested in SW Victorian dairy farms since 1996.

In March 2006, 164 dairy properties were advertised for sale in Victoria, at an average asking price of $11,500 per hectare. Advertised prices for dairy farms currently on the market in SW Victoria range from $12,000 to $15,000 per hectare.

These prices were almost double what plantation investment companies could afford to pay for land. It is illustrative that the three plantation investment companies that had been purchasing such land in Corangamite and Colac Otway Shires in SW Victoria were no longer actively seeking land in that region, and had made no purchases since mid-2005.

Thus, although blue gum plantations had been established on those properties over the succeeding 12 months, the plantation investment companies had not been a force in the market for at least a year, yet were still being blamed for forcing up the price of rural land.

Land purchase statistics

As at mid 2006, plantation investment companies had purchased only several hundred of the thousands of properties inspected over the previous five years. Averaged over the total estates of the major companies, 12 to 35 percent of all properties inspected were purchased. The average was less than 20 percent.

Many a property is offered to a retail forest project manager but not inspected, because the manager already knows the property to be unsuitable (e.g. too far from existing or future processing or port facilities, or fails an initial desk-top analysis). However, for properties that have been inspected, the main reasons for not purchasing, in order of importance, are

- property was too expensive (in one-to-one sales);
- percentage of net plantable area was too small (a sub-set of 'too expensive');
- soils were unsuitable;
- company was the losing bidder at auction or tender, mostly to farmers;
- vendor was not serious, and withdrew once commitment was required; and
- property was too controversial (e.g. near a town or a tourist feature).

Contrary to some local stories, the majority of houses on farms purchased or leased by retail forestry companies remain occupied, being let to company employees, contractors, or external tenants (including the previous owners, in some cases).

Population, employment and services

Independent studies by the BRS of socio-economic impacts showed that, except in isolated cases, plantation expansion did not cause decline in rural populations or services. Contrary to some popular misconceptions, the studies showed that plantations tend to slow or reverse rural decline, by attracting more working-age families, creating new jobs and businesses, providing off-farm work opportunities, and increasing the demand that justifies maintaining and improving community services.

For example, in Bombala (NSW), the hospital was upgraded and the Westpac bank re-opened full-time after six years at three days a week, because of the expansion of the plantation industry.

Plantation forestry is more labour-intensive than local agriculture, providing 2.5 jobs for every 1000 ha of plantation, compared with 1.8 jobs per 1000 ha used by other agriculture (CIE, 2005).

Plantations have a multiplier of ~2.5 (i.e. an extra 1.5 indirect jobs for every direct job); milling operations have a multiplier of >3 (i.e. an extra 2 indirect jobs for every direct job in the mill).

Water

Plantations, like all forms of agricultural crops, intercept and use water. Trees have a longer growing season, more foliage and deeper roots than pasture or crops, and plantations can improve water quality, and assist in reversing salinity and erosion.

No irrigation is used in mainstream plantation forestry. Instead, plantation managers mostly utilise cleared land in higher rainfall areas. The effect on streamflow of converting agricultural land to timber plantation is related to the catchment area affected. In smaller catchments, it is difficult to detect an impact when less than 20 percent of the catchment is planted. In major plantation regions, plantations occupy between 1 and 6 percent of large catchments.

Some plantations in some parts of some catchments in some soil and rainfall conditions have the potential to reduce environmental flows.

The retail forestry sector strongly supports and contributes to research that will enable plantations to be more strategically located in different catchments, in the context of the impacts of all land uses on water yield and quality.

Capital market

Retail forestry investment constitutes a very minor part of the greater investment market. Any view that retail investments in forestry or non-forestry divert available funds away from other productive investment in rural and regional Australia is incorrect. Retail investment forest growers are not generally focused on the flow-on socio-economic consequences (such as regional employment) of their investments. Rather they are motivated by traditional financial growth incentives. The capital that retail forestry projects attract would otherwise be invested in other investment markets such as the share or property markets and may not necessarily result in increased economic activity in rural and regional Australia.

The retail forestry investment model provides a comparative incentive for investment in regional Australia; in areas that would benefit from investment and associated increased economic activity but would otherwise not attract significant investment at all. Retail forestry investment does not ‘crowd out’ investment in rural and regional Australia, because without retail forestry, rural and regional Australia would not be able to attract a similar level of investment.

ToR 12: The need for any legislative or regulatory changes

Retail managed investment projects are highly scrutinised and regulated. The regulatory framework includes:

- laws and regulations administered by ASIC and ATO;
- ASX requirements for listed companies;
- planning and environmental regulations and other state and local government controls over forestry operations;
- industry self-regulation, through various voluntary codes and charters; and
- other codes and quality control measures (e.g. environmental management and forest certification).

The diverse federal corporate and tax laws and regulations applying to managed investment schemes, particularly those covering licensing, scheme registration, disclosure, compliance, enforcement, training and investor protection, are referred to in other parts of this submission.

The following comments are made against that background.

Division 394 and the '70% DFE test' tighten the regulatory regime

Of particular importance is the specific statutory tax deduction for plantation investment, recently enacted (June 2007) in Division 394 of the *ITAA*.

Although described earlier under ToR 2, Division 394 warrants further consideration here.

This division contains three additional measures designed to strengthen the integrity and transparency of forestry projects carried out under these provisions.

Most significant is the so-called '70% DFE test'. When applying for a product ruling, the plantation investment forestry manager must demonstrate to the Tax Office that 70 percent of the investors' funds over the life of the project will be used for direct forestry expenditure – i.e. activities directly related to establishing, managing and harvesting the plantations, plus the annual costs of land. These costs are calculated at net present value using arm's length prices.

The '70% DFE test' specifically excludes the manager's expenditures on marketing the projects and paying commissions to financial planners, and on insurance, financing, contingency funds, general business overheads and other similar costs.

This integrity measure with respect to plantation forestry investment tax arrangements addresses one of the concerns raised in many of the 157 submissions to the previous Government's 18-month review of the taxation of plantation forestry in 2005 and 2006.

Although legislated to take effect from 1 July 2007, the new regime was given a transition year to enable the companies and the ATO to adapt. All retail forestry projects continued to operate under the previous regime for one more year.

FY2009 was the first year in which Division 394 and the '70% DFE test' was applied to all plantation investment projects. While it is too soon to evaluate its impact properly, especially with so many other factors affecting the industry, it is expected that this integrity measure alone will address a number of the perceived problems that are the subject of this inquiry.

It is critical that this provision be left in place – to provide a stable and predictable tax arrangement necessary for retail forestry to fulfil its role in Australia's plantation products and paper industry, and to be given time for its regulatory effectiveness to be demonstrated.

Other possible regulatory reform

The recent collapse of Timbercorp and Great Southern may bring to light some shortcomings in the regulatory system with respect to the ability of ASIC to fulfil its priority function, to "assist and protect retail investors and consumers in the financial economy".

As mentioned above, any shortcomings are not related to the statutory tax arrangements, which have been recognised by Parliament as necessary to accommodate the long-term large-scale nature of plantation forestry investment and thereby to enable the continued investment that will allow these projects to grow the future resource on which Australia's plantation products and paper industry depends.

The plantation forestry industry wishes to work constructively with the Government, the primary corporate regulator and the financial planning sector to improve the regulatory framework and the transparency of the marketing and the financial advice. The purpose of such collaboration is twofold:

- assisting the regulators to fulfil their statutory functions efficiently, effectively and fairly; while at the same time
- enabling the retail forestry sector to continue to carry on its business of attracting investment to establish, manage, harvest and market the future resource.

As detailed under ToR 1, while there are core features common among plantation investment companies, the precise business structures and arrangements of the companies and their projects is sufficiently diverse as to warrant maintaining as much flexibility as possible, consistent with the pursuit and achievement of these two parallel objectives.

One notable shortcoming that has emerged from the placement of Timbercorp and Great Southern into administration is the inherent conflict of interest between the administrators' legal obligation – as the default RE of a scheme – to act in the best interests of the scheme members, and the administrator's other obligations to related parties in the group and to secured creditors and shareholders.

The plantation industry has not been alone in advocating that ASIC should act or support others' actions to appoint a separate RE for the schemes in question to overcome this inherent conflict of interest. A3P wrote to ASIC on this subject on 28 May 2009. (See **Attachment A**)

Another issue that may warrant reform concerns the ongoing protection of the investor's interest in the underlying land in the case where that land is not owned by the managed investment company, but leased from a third party landholder, requiring ongoing lease payments to be made even though the company may be financially unable to maintain payments.

Recommendations put forward in the submission by Piper Alderman Lawyers are worthy of serious consideration.

For the most part, the laws and regulations governing managed investment schemes and the disclosure required by the promoters are robust. If reform is considered necessary, it should be directed primarily towards improving the level of protection of the interests of investors by improving transparency and compliance through enforcement of the existing laws.

The plantation industry is willing to assist ASIC in this regard by enhancing the level of **disclosure relating to investor interests**. Specifically, this could be done by:

- disclosing how client monies subscribed to the plantation investment project are administered by the RE in order to carry out contracted plantation services;
- disclosing the financial capacity of the plantation investment company to deal with adverse fluctuations in annual project sales; and
- disclosing more prominently the risks inherent in agricultural enterprises and investments.

The plantation industry is ready and willing to work with the Government and ASIC to ensure the above enhanced disclosure is delivered via a **reporting framework** that is consistent with the ASX Principles of Corporate Governance.

The quantum and nature of remuneration of financial advisers is an issue for the broader financial products industry, and the question of adviser remuneration in the retail forestry sector needs to be considered in that broader context. However, the plantation industry would like to see a **transparent remuneration system** that encourages financial advisers to provide high quality advice that is in the best interests of their clients.

Finally, the plantation industry would support Government moves to improve the availability to the general public of **socio-economic and environmental information** about the plantation, wood products and pulp and paper industry. This information should be compiled independently (e.g. by ABARE and BRS), and should include supply and demand conditions, the performance of the various industry sectors, and trends in the key financial and socio-economic indicators.

The plantation industry believes it can continue to work in a collaborative effort with Government, the regulators and the financial planning sector to continue to enhance the benefits of the industry, and the protection of retail investors, where necessary.

28 May 2009

Mr Greg Medcraft
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Attention: Mr Rupert Smoker

Cc: Senator The Hon Nick Sherry
The Hon Chris Bowen MP
The Hon Tony Burke MP

Dear Mr Medcraft

Timbercorp and Great Southern Managers – Appointment of alternative Responsible Entities

I write on behalf of the Australian Plantation Products and Paper Industry Council (A3P) seeking ASIC's agreement to act urgently to ensure the appointment of one or more alternative Responsible Entities to represent – separately from creditors and shareholders – the interests of investors in forestry and agricultural projects managed by Timbercorp and Great Southern Managers – now in voluntary administration and receivership respectively.

A3P is the national industry association representing the interests of all segments of the plantation-based wood products and paper manufacturing industry. A3P members employ more than 13,500 people in plantation management, sawmills, panel board, and paper manufacturing and specialty plantation products plants, mainly in rural and regional areas. Each year, A3P members create and sell products worth more than $4 billion, and produce more than 12 million cubic metres of logs, 3 million cubic metres of sawn timber, and more than 2 million tonnes of paper.

A3P members have a particular interest in ensuring that long-term resource supplies are relatively stable, smooth and predictable, in order to maintain and expand Australia's plantation-based wood and paper products industries.

This objective could be severely undermined if the Timbercorp and Great Southern managed investment schemes – both forestry and non-forestry – were to be prematurely wound up to the total detriment of the participating growers, thereby creating even greater uncertainty about all managed investment schemes. A3P's focus is on the wood and paper industries – and therefore in the forestry managed investment schemes growing plantation resources for the domestic and export markets. It is imperative that the risk of 'collateral damage' to such forestry schemes in the current circumstance be minimised to the greatest extent possible under the law.

This submission is in two parts:

- the rapidly increasing importance to the plantation products and paper industries of private plantation investment through managed investment schemes; and

- the imperative to ensure that scheme members' interests are fully and fairly represented throughout the current unfortunate process.

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The role and importance of MIS plantation forestry

MIS plantations are now an integral part of Australia's wood and paper industry.

Managed investment schemes have proven to be the most effective way to attract long-term private investment in plantation forestry, without the need for special incentives used in other countries or for other sectors.

State government forest agencies, previously responsible over decades for building Australia's plantation resource with Commonwealth financial assistance, have been increasingly directing their resources to replanting rather than expanding their estates. Institutional investors, such as superannuation funds, have demonstrated their preference for buying established plantations, rather than investing in their own new plantations. Industrial wood and paper processors have divested their own captive plantation resources and are not replanting. And farm forestry has not yet demonstrated that it alone can grow the critical mass of resource to supply internationally competitive processing facilities.

MIS forestry has been steadily filling that gap. So embedded has MIS forestry become that it is now raising funds to enable one State forest agency and one corporate plantation manager to replant and manage their next rotations. More such arrangements can be expected.

MIS forestry projects account for around 80% of all new timber plantations each year, and a substantial and increasing proportion of replanting. From about 5% in 1997, MIS-funded plantations now account for more than a third of the total national plantation estate of 1.9 million hectares.

MIS plantations have so far directed over $3billion of investment into regional areas (plantation establishment, management, harvesting, haulage, etc) and urban areas (export facilities, processing, transport etc). These plantations are providing significant employment in rural and regional Australia, particularly important at a time when Australia is facing rising levels of unemployment.

The domestic and export processing industries in regional Australia are thus becoming increasingly dependent on MIS plantations for their consistent long-term wood supplies. MIS plantations are now creating the scale of resource to maintain future wood supply to existing domestic facilities and to underpin investment in new and upgraded facilities.

While the two companies in difficulty focused on growing short-rotation hardwood pulpwood for the export woodchip market, four other major MIS forestry companies – FEA, Willmott Forests, ITC and Gunns – are exclusively or increasingly growing plantations to provide the future resource for the seriously under-supplied domestic sawlog market. All four have also made major investments in their own new and upgraded sawmills and veneer mills. Another rapidly growing MIS company – Tropical Forestry Services, growing high-value Indian sandalwood – now has a processing and distillation plant operated through its Mt Romance subsidiary. This move to becoming vertically integrated timber and plantation products companies could be expected to continue as plantation estates reach critical mass in new regions and the first plantations approach maturity.

Evidence of the cause of this change in the proportion of the total MIS forestry pool comes from the composition of woodlot sales in FY 2008. That was the first year in which, following the Parliament's 2007 enactment of a specific statutory tax deduction for MIS forestry, companies could also promote the prospect of the initial investors' being able to sell their interests in the schemes before final harvest ('secondary markets'), without retrospectively losing their initial tax deductions. This greater liquidity of inherently long-term projects had the effect of making the longer-rotation sawlog and specialty plantations a more attractive investment than they had historically been.

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The impact was immediate. While short-rotation pulpwood project sales remained steady or declined, FY 2008 sales of sawlog and specialty projects – softwood, hardwood, sandalwood and high value cabinet timbers – all increased. Indeed, two companies – Willmott Forests and FEA – experienced dramatic upturns, doubling their sales levels of the previous few years.

Against this background and these exciting and long-awaited trends, actions or omissions by the industry regulators that had the effect of undermining the MIS forestry sector would have adverse consequences much worse, farther reaching and longer lasting than might at first be imagined. The chances of that happening in the current circumstances must be minimised to the greatest extent possible.

Maximising the protection of investors' interests

As administrator and receiver respectively of Timbercorp and Great Southern, KordaMentha and McGrathNicol have taken over the role and duties, *pro tem*, of responsible entity (RE) of the respective schemes.

Part 5C.2 of the *Corporations Act 2001* prescribes, *inter alia*, the duties of the RE, the circumstances in which the RE may be changed, the removal of an RE by the members of the scheme, applications to the Court, duties of a temporary RE, and the consequences of changing the RE.

I do not need to repeat or debate the contents of the relevant legislation with the regulator that administers that legislation. Nor am I qualified to do so. The purpose of this submission is to highlight and comment on the matter that A3P believes is inherently unfair to the members of the schemes – a matter that I am aware has been raised with great concern by many other qualified and interested parties.

That matter is the inherent conflict of interest within the respective administrator/receiver, and the preferred solution to that conflict so that the scheme members are not inevitably disadvantaged with respect to the creditors and shareholders to whom the administrator/receiver also has particular obligations.

The legislation would appear to leave the impression that, regardless of the other duties of an administrator or receiver, that party must nevertheless also fulfil all the statutory obligations of a responsible entity when the party is acting in that role. Of particular relevance is the obligation (sub-section 601FD(1)(c) for the RE to "act in the best interests of the members", supported by the contravention provision of sub-section 601FD(3). Consequentially, there would appear to be an expectation that any potential conflict could be resolved so as to not disadvantage the scheme members.

While this may be possible in theory, common sense and observation of the liquidation of Westpoint Management Limited make it impossible to avoid concluding that such an outcome could not (indeed cannot) truly be achieved in practice.

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Even with the threat of litigation against an administrator/receiver in the event of contravening this statutory obligation, any such litigation would be after the fact. This would be too late to avoid or to provide appropriate reparation for the unnecessary losses to members if any of the schemes in question were to be wound up prematurely before all possible solutions "in the best interests of members" had been exhausted.

I hesitate to imagine that the administrator or receiver in each case would not first exhaust all possible solutions. But by the same token, it is also hard to imagine the biggest secured creditors willingly accepting the news that their interests were subordinate to the interests of the scheme members. Hence the inherent conflict, regardless of the legislation.

I appreciate that there are several factors to take into account when considering the appointment of a temporary RE, as ASIC's website indicates in ***Information for Timbercorp Growers***. They are very important factors, without doubt, and scheme members may not welcome the answers. But it appears that at the moment, these factors are being considered within an environment of an inherent practical conflict of interest.

I also note that ASIC's advice omits to say that, after three months, if the majority of scheme members have not voted to approve the replacement RE, the temporary RE also has the legislated option (sub-section 601FQ(2) to apply for an extension of time, rather than for the scheme to be wound up. This is an unfortunate omission from advice to scheme members in these highly charged circumstances.

An alternative to ASIC's appointing a temporary RE could be an application to the Court by scheme members, who, it appears, could recommend a permanent replacement RE. If this option were to be pursued, I would hope that the administrator or receiver would not oppose it, and further, I would trust that ASIC would use whatever influence it had to ensure the success of such an application.

Finally

In describing its role, ASIC states that its first priority is to "assist and protect retail investors and consumers in the financial economy".

Allowing the current inherent practical conflict of interest to persist any longer, potentially to the greater detriment of the retail investors in the Timbercorp and Great Southern schemes, would appear to be at odds with that priority.

A3P's particular interest in this unfortunate matter is the maintenance of a secure long-term flow of plantation resource into Australia's regionally-based wood and paper products industries. As I have explained above, this resource is increasingly being grown by forestry managed investment schemes. Thus it is most crucial to minimise avoidable threats to that source of private investment.

I urge you to consider this additional factor in making your decisions.

At A3P, the best direct contact is Alan Cummine, Manager Plantation Investment and our MIS specialist. Alan can be reached on 0407 488 927 and alan.cummine@a3p.asn.au.

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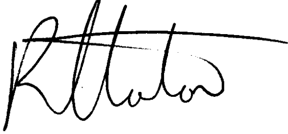
Yours sincerely



Richard Stanton
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