

Chapter 3

MIS structural issues

3.1 The inquiry canvassed a number of issues concerning the structure for agribusiness MIS in Australia, all considered against the background of the major collapses of Timbercorp and Great Southern. The committee received evidence on the following matters:

- the incentives for MIS investment and related market distortions;
- the effect of high cost structures and uncertain revenue assumptions on scheme performance;
- the ability of the MIS structure to withstand restricted access to capital and potential measures to prevent RE failure; and
- the arrangements for managing competing interests when an RE collapses.

3.2 Investor-related issues such as advice on agribusiness MIS, disclosure and other protective measures are examined in Chapter 4.

Tax incentive issues

3.3 The committee heard a number of complaints about the potentially market-distorting effects of the tax incentives available to agribusiness MIS investors. It was argued that rather than investment flowing to commercial activities on the basis of profitability, tax incentives had generated an influx of investment to agribusiness MIS that would have been directed elsewhere had they not been available. The effects of this are an inefficient use of capital and an uneven playing field for traditional agricultural enterprises competing for scarce land, water and labour resources.¹

3.4 The committee notes that much of this debate centres on the question of whether the effects of the tax incentives are justified by their policy intent of attracting capital to certain industries and regions otherwise unable to attract investment because of perceived market failure. While this debate is addressed to some extent in the discussion that follows, the committee notes that the matter is a primary focus of another committee inquiry into food production being undertaken by the Senate Select Committee on Agriculture and Related Industries.

3.5 Issues concerning the inefficient use of capital also relate directly to suggestions that MIS investment is being directed to unviable agribusiness projects,

1 Institute of Chartered Accountants in Australia, *Committee Hansard*, 15 July 2009, Canberra, p. 31

discussed further in this chapter at paragraphs 3.33 – 3.59 in the context of scheme performance.

Effect on investment decisions

3.6 From a forestry MIS perspective, tax deductibility was an important component of the 1997 forestry plantation '2020 vision' strategy, aimed at trebling Australia's plantation timber output by 2020 to meet future paper demand.² With declining government participation in the sector, MIS tax incentives have served as a popular vehicle for stimulating private investment. According to ASIC, MIS structures now account for approximately 34 per cent of total plantations in Australia.³ Rewards Group Ltd said that forestry MIS has been 'pivotal' to the success of the 2020 vision strategy.⁴

3.7 A3P and NAFI told the committee that the tax incentive available for forestry MIS is needed to ensure private investment in the industry. They argued that without allowing these deductions, private investment would be difficult to attract due to the 'market failure' associated with the 'unique nature of forestry enterprises'.⁵ Investors would be unprepared to accept the agricultural risk, delayed returns and concentrated income events that create a large tax liability at harvest:

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.⁶

3.8 Other agribusiness MIS have also been able to attract significant investment from investors obtaining allowable deductions. Rewards Group Ltd told the committee that a number of industries would not exist without the availability of the MIS structure:

Prior to the development of the managed investment scheme structure for agriculture and forestry; an export plantation pulpwood industry, an olive oil industry, an almond industry, a plantation teak industry, a plantation sandalwood industry, a plantation mahogany industry, a red grapefruit industry, a low chill stonefruit industry, a viable export mango industry, a

2 Plantations for Australia: The 2020 Vision is a strategic partnership between the Commonwealth, State and Territory Governments and the plantation timber growing and processing industries.

3 ASIC, *Submission 58*, p. 18

4 Rewards Group Ltd, *Submission 19*, p. 6

5 A3P and NAFI, *Submission 56*, p. 8

6 A3P and NAFI, *Submission 56*, p. 8

consolidated strawberry industry, and a plantation brushwood industry, did not exist.

Since the 1970's rural industries have been starved of investment. The managed investment structure has since then, facilitated the successful injection of new capital into this burgeoning component of the Australian economy.⁷

3.9 Mr Alan Jessup of lawyers Piper Alderman also stated this view. He claimed:

One of the benefits of these types of schemes, contrary to the rhetoric of local farmers who have a vested interest in keeping such schemes out of their area (their complaint being that it forces up land prices so keeping down prices enables them to purchase land at a cheaper cost), is that funds that would not otherwise be available for agricultural production in this country are made available. This creates infrastructure and jobs.⁸

3.10 Mr Eric Walters, a financial adviser, stated that the tax deductibility available to agribusiness MIS investors helps ameliorate the unique risk factors attached to agricultural pursuits.⁹

3.11 Maccacorp Ltd, the RE for a MIS in the macadamia industry, told the committee that the deductibility for MIS investment is consistent with that available to any person incurring business costs, including traditional farmers.¹⁰ Almond Investors Ltd also emphasised this point, although it should be noted that the deductions for MIS investors are larger because of the higher costs associated with that business model.¹¹ Consequently, the potential for allowable deductions to have a distorting effect on investment decisions is also increased. As referred to above, this issue is discussed further at paragraphs 3.40 – 3.48 in the context of scheme performance.

3.12 Investment underpinned by tax deductions has not been welcomed by those who believe it to have had a negative effect on rural industries. Horticulture Australia Council (HAC) told the committee that the horticulture industry welcomed corporate investment, but rejected the need for tax deductibility measures to address a market failure:

...we are unconvinced that there is any requirement for government assistance or incentives to encourage people to invest in horticultural enterprises. We believe they are a good investment in their own right.¹²

7 Rewards Group Ltd, *Submission 19*, p. 1

8 Piper Alderman, *Submission 4*, p. 1

9 Mr Eric Walters, *Submission 39*, p. 44

10 Maccacorp Ltd, *Submission 15*, p. 3

11 Almond Investors Ltd, *Submission 32*, p. 3

12 HAC, *Committee Hansard*, 15 July 2009, Canberra, p. 100

3.13 They argued that investment was not best directed when occurring under these circumstances:

...some of the investment that has been pushed in or pumped in because of that tax deductibility upfront has proved not to be necessarily very good. I think the schemes have to stand up in their own right. What is produced at the end of the day is the issue, not the tax deductibility of the upfront investment.¹³

3.14 Although HAC was unwilling to generalise about a diverse industry, they indicated that the tax breaks may have the following effects:

- creating an oversupply of certain commodities, particularly where access to overseas markets is problematic;
- increasing the cost of scarce resources such as land, water and agricultural labour; and
- transferring capital away from proven industries.¹⁴

3.15 HAC's comments about oversupply and resource allocation are discussed further at paragraphs 3.18 – 3.25. Addressing HAC's last criticism, A3P and NAFI disputed claims that investment in forestry MIS is money diverted from other more profitable agricultural activity:

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.¹⁵

3.16 However, the need to create incentives for forestry investment was queried during the inquiry. For example, Mr David Cornish suggested that there is no economic justification for the target of trebling Australia's plantation output, just a strategy to achieve an arbitrary and unnecessary goal. He commented:

...billions of dollars of tax payer money has been wasted to support a policy that has never been substantiated as being of net benefit to Australia.¹⁶

3.17 Mr Cornish also discounted the assertion that agricultural enterprises need MIS to attract capital:

13 HAC, *Committee Hansard*, 15 July 2009, Canberra, p. 100

14 HAC, *Submission 17*, p. 6; HAC, *Committee Hansard*, 15 July 2009, Canberra, p. 100

15 A3P and NAFI, *Submission 56*, p. 43

16 Mr David Cornish, *Submission 54*, p. 2

The greatest myth that is continually thrown up to support these schemes is that agriculture needs more capital. Nothing could be further from the truth. The capital market for Australian agriculture is as strong as any industry in Australia. This can be easily identified by the fact that capital assets such as land and water are highly overpriced given their earning capacity. The last thing Australia agriculture needs is increased demand for these scarce resources thereby driving the prices up further. The only place where there is a lack of capital is in the industries that cannot provide an economic return.¹⁷

Resource allocation

3.18 Resource allocation was a major concern raised during the inquiry, particularly for traditional farming enterprises. A number of submitters expressed the view that traditional farming enterprises struggled to compete for agricultural resources against tax deductible MIS. Mr Rod Davies, a soil scientist, emphasised the scale of some MIS and their resource use, comparing them with mining projects:

...Timbercorp are only one of the companies undertaking these schemes but ... their schemes, their olive and almond schemes, total 16,000 hectares and Timbercorp claim these developments are worth around \$250 million. These schemes are developed around the Murray and are dependent on irrigation, with water requirements of approximately 160,000 megalitres.¹⁸

3.19 The National Farmers Federation (NFF) expressed concern about the effect of MIS capital access distorting emerging water markets:

The capacity for the schemes to manipulate a developing market is likely to significantly undermine the Governments' intended policy outcomes for the water trading market. There are also a range of considerations relating to the physical limitations of river systems to deliver the required increased water demand, including a move from the fringe irrigation periods (i.e. autumn and spring) to a concentration to the summer period (and particularly the peak period of January).¹⁹

3.20 Sunraysia Irrigators Council claimed that Timbercorp had pushed up the price of temporary water considerably, causing 'financial distress for many genuine irrigators along the Murray'.²⁰ They added:

To show good faith, any large scale horticultural development should be required to purchase the full amount water required before the development can take place. Timbercorp has been able to plant many thousands of hectares of almonds, knowing that it would never be able to buy sufficient water to enable the projects to reach maturity. If these projects are allowed

17 Mr David Cornish, *Submission 54*, p. 2

18 Mr Rod Davies, *Committee Hansard*, 15 July 2009, Canberra, p. 53

19 NFF, *Submission 22*, p. 4

20 Sunraysia Irrigators Council, *Submission 33*, p. 6

to proceed, they will be in the market for water, either permanent high security water, or temporary water, year by year. The schemes will be competing with the Federal Government if they buy permanent water, and other irrigators if they buy temporary water.²¹

3.21 A number of submissions to the inquiry also stated that land prices were being artificially inflated by the tax driven capital flowing into MIS, to the detriment of more traditional enterprises.²² For instance, the Institute of Chartered Accountants in Australia (the Institute) stated:

In many areas of Australia managed investment schemes have resulted in the increase in land prices to the detriment of local farmers who are unable to justify prices offered for land by MIS promoters. The agribusiness managed investment schemes introduce a class of investors who have access to tax-deductible capital sources while traditional rural producers competing against them for productive rural land do not. As a result the market is distorted by a group of participants whose investment drivers are not risk based returns relevant to the particular asset class of the investment but the prospect of substantially deferring taxable income.²³

3.22 The Institute of Foresters of Australia (IFA) described the following mixed effects:

MIS companies often do not have sufficient land under ownership or lease when they publish their PDS. Therefore, if the PDS is fully subscribed there is a rush to secure the necessary land to establish the area of plantations bought by the investors. This has led to the choice of buying marginal properties at inflated prices or very high lease payments. There have been positive and negative effects in rural Australia. High demand for marginal cropping or grazing land has allowed some farmers to exit their land at a good price and “retire with dignity”.

In other instances the purchase of land by MIS companies at higher than expected market prices has restricted ability of local farmers to compete and thereby expand their own farming enterprises.²⁴

3.23 A3P and NAFI responded to land price concerns by claiming that many factors had contributed to land price rises:

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

21 Sunraysia Irrigators Council, *Submission 33*, pp 7-8

22 See for example Kelly Ag Services, *Submission 1*, p. 5; NFF, *Submission 22*, p. 4; Australian Sugar Milling Council, *Submission 27*, p. 5; VFF, *Submission 28*, p. 5, NSWFF, *Submission 52*, p. 8

23 Institute of Chartered Accountants in Australia, *Submission 36*, p. 2

24 IFA, *Submission 42*, pp 10-11

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.²⁵

Oversupply

3.24 The disruption to local industries caused by MIS generating oversupply was also raised with the committee, a matter which is also discussed later in the context of scheme performance and revenue assumptions at paragraphs 3.49 – 3.59. The Victorian Farmers Federation argued that traditional growers are more exposed to the consequences of oversupply:

One of the most significant impacts for the farming community that non-forestry MIS have on commodity markets is that of oversupply. Non-forestry MIS have the capacity to dramatically increase production of the commodities they manage...

Any increase in supply when it is driven by tax purposes rather than market fundamentals, has the potential to lead to oversupply impacting on the returns of not only MIS investors but other operators who have established business without the same tax advantages. This would be financially devastating for farmers, but as investors in MIS are likely to have these types of investments as a part of a port folio and have other incomes streams as their main source of funds they are not impacted to the same degree as traditional farm investors.²⁶

3.25 In particular, there was strong criticism of MIS driving increased wine grape plantings during a period of oversupply. Wine Grape Growers Australia (WGGA) informed the committee that a doubling of Australia's vineyard areas since 1995 had created a chronic oversupply requiring 'an adjustment in vineyard area of as much as 20 per cent to bring supply and demand back into balance'.²⁷ The consequence has been that many growers are receiving prices from wineries below the cost of production, a situation unlikely to improve in the medium to long term without structural adjustment.²⁸ While WGGA indicated that most MIS vineyard operators had ceased new plantings, they noted that further projects are proposed and remain possible. There is a perception among growers of wineries encouraging MIS growth to reduce their own costs, knowing that such investment is not entirely profit driven.²⁹

25 A3P and NAFI, *Submission 56*, p. 41

26 VFF, *Submission 28*, p. 5

27 WGGA, *Submission 44*, p. 1

28 WGGA, *Submission 44*, p. 2

29 WGGA, *Submission 44*, p. 3

Suggested reform

3.26 The Institute suggested a loss quarantining mechanism to limit the distortionary effects of the present deductibility arrangements. They proposed that up-front deductions for agribusiness MIS investment only be permitted to be offset against future taxable income from the same MIS.³⁰ CPA Australia did not support this suggestion, though. They indicated that it would threaten the viability of the forestry industry, as investors would not be prepared to wait until income from harvest before being allowed to claim deductions.³¹

3.27 Mr Kerin Smart proposed that tax deductions only be allowed to the extent of the real commercial cost of running the relevant project.³²

3.28 Maccacorp Ltd recommended that non-forestry MIS be confined to export-oriented or import replacement crops, which would alleviate the problem of MIS producing a domestic glut to the detriment of local producers.³³ WGGGA recommended a moratorium on further ATO product rulings until agribusiness MIS until the current parliamentary and government reviews of the sector are completed.³⁴ Failing this, they called for the removal of tax deductions for investment in vineyard MIS.³⁵

3.29 The Australian Sugar Milling Council called for a restriction on plantation forestry being established on prime agricultural land, subject to an assessment of its broader effects on the local community. Using a Tasmanian example, their submission notes that this is a planning matter under state legislation.³⁶ Canegrowers Australia made a similar proposal:

...a full review of the economic, environmental and social impacts of diversion of significant areas of agricultural land into forestry be required before access is available to taxation concessions for the proposed activity.³⁷

3.30 The Victorian Farmers Federation queried the need for tax incentives for non-forestry MIS entirely:

The original purpose of MIS was to enhance regional wealth creation by increasing plantation resources. As almost 50 per cent of MIS is now

30 Institute of Chartered Accountants in Australia, *Submission 36*, p. 5

31 CPA Australia, *Committee Hansard*, 15 July 2009, Canberra, p. 34

32 Mr Kerin Smart, *Submission 60*, p. 2

33 Maccacorp Ltd, *Submission 15*, p. 11

34 WGGGA, *Submission 44*, p. 5

35 WGGGA, *Submission 44*, p. 6

36 Australian Sugar Milling Council, *Submission 27*, pp 5-6

37 Canegrowers Australia, *Submission 23*, p. 3

accounted for by non-forestry projects, it is time to question whether this indirect form of support continues to effectively deliver targeted assistance to an area of perceived market failure.³⁸

3.31 Delegate Station Pastoral Company advocated the UK model, where forestry planting and establishment costs are subsidised and tax advantages given to value adding processing.³⁹

3.32 The committee makes comment on these proposals later in the chapter (paragraph 3.122 onwards).

Scheme performance

3.33 An important issue the committee has considered is the performance of particular schemes and the effect this has on the viability of the Responsible Entities behind them. From the alternative perspective, the committee examines any effect of the RE structure on the viability of the schemes in the later part of this chapter, beginning at paragraph 3.60.

3.34 A3P and NAFI told the committee that it is necessary to distinguish between individual agribusiness schemes and the companies that manage them as part of a broader commercial enterprise:

We might look at an individual forestry project and say: ‘Yep, that looks like a pretty good project. It’s being grown on appropriate land, it uses appropriate species, there’s a good growth rate, it’s near the port, it’s near the processing facility. That’s a good project.’ It may or may not make a return at whatever rate, depending on how much was paid to establish it et cetera. But some of the companies have a much broader range of factors affecting their profitability. For example, Timbercorp and Great Southern were involved in a number of projects—not just in forestry. They were involved in a whole range of horticultural projects. Of course their job was really managing the projects and marketing the projects, not necessarily the fundamentals of any one particular forestry project.⁴⁰

3.35 This view was supported by IFA:

Those IFA members with knowledge of the two companies under administration have advised that in their opinion the collapses are a result of a wide range of factors more attributed to those companies’ management structures, debt levels and earlier decisions to diversify away from forestry and into other agricultural enterprises. These factors were common to those

38 VFF, *Submission 28*, p. 6. The committee notes that while the proportion of non-forestry MIS projects is nearly 50 per cent, as a proportion of total investment that figure is less (see paragraph 2.51).

39 Delegate Station Pastoral Company, *Submission 50*, p. 9

40 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, pp 67-68; AAG, *Submission 43*, p. 5

entities now in voluntary administration or liquidation. The yield information from respective plantations and standard of forest practice has not had a direct impact on the collapse of these companies. IFA recognises that the plantations have generally been established using standard industry practices and that a large and valuable wood resource has been created by the companies that have recently collapsed. There are many other companies operating forestry MIS schemes which are operating successfully and continue to attract investment funds.⁴¹

3.36 Forestry consultant Mr David Wettenhall also suggested that poor management was the problem, not the nature of the enterprise itself:

I do not believe that the crops are the problem. There are many private growers who are growing forests profitably. But a major part of the problem is that the revenues do not justify the expenses involved in some—but not all—of the managed investments schemes. The excessive costs seem to be overspending on some forestry expenses and administration and marketing expenses, resulting in poor returns to the investors.⁴²

3.37 There were also a number of comments cautioning against premature judgment of the industry generally. Rewards Group Ltd suggested that the industry was not mature enough to make a judgment about the overall performance of the schemes, while Mr Eric Walters, a financial adviser, stated that some early schemes had performed well.⁴³ IFA told the committee that 'most early [forestry] schemes did not achieve projected growth rates, but in most cases the stumpages paid to investors exceeded projected stumpage rates'.⁴⁴ They also noted that 'normal market fluctuations' would significantly affect performance.⁴⁵

3.38 However, other contributors claimed that many of the schemes are inherently unprofitable, having been established on the basis of inefficiently directed capital, high costs, flawed assumptions and a lack of scientific rigour. According to the NFF, this is reflected in poor performance in the overall MIS sector, measured by the discrepancy between 'realistic or actual rates of return versus projected rates'.⁴⁶

3.39 Delegate Station Pastoral Company also refuted the distinction between the corporate entities and the schemes:

At present grower investors of failed MIS companies think they are ok because their products (trees, almonds, etc) are remain in the ground. It seems that many of these grower investors still don't get it. The notion that

41 IFA, *Submission 42*, p. 9

42 Mr David Wettenhall, *Committee Hansard*, 15 July 2009, Canberra, p. 84

43 Rewards Group Ltd, *Submission 19*, p. 6; Mr Eric Walters, *Submission 33*, p. 10

44 IFA, *Submission 42*, p. 7

45 IFA, *Submission 42*, p. 7

46 NFF, *Submission 22*, pp 4-5

once a new responsible entity takes over, all the schemes will return a profit is incorrect. These investors can't change the fact that they have paid far too much to invest in forestry and agricultural schemes where solid markets may not exist.⁴⁷

Cost issues

3.40 There was particular concern that the high cost nature of agribusiness MIS is unprofitable, despite the preparedness of investors to finance them for perceived tax benefits. The Institute's submission to the inquiry suggested that rational investment criteria could be discarded in favour of short term tax benefits, although 'tax attributes should never serve as a sole or primary driver of investment decision-making'.⁴⁸

3.41 The NFF also expressed concern about the basis for MIS investment:

...decisions to invest in MIS are largely based on the tax deductibility of the investment, rather than driven by long-term profitability. As a result, MIS have traditionally been primarily focused on industries with a high proportion of up-front expenses, with little regard given to the output returns generated.⁴⁹

3.42 Macadamia nut producers Maccacorp Ltd argued that the non-forestry MIS structure benefited from economies of scale, even though regulatory compliance costs are higher than traditional, smaller enterprises:

Production per employees is usually higher with an MIS compared to privately owned farms. In addition, the increased equipment available to an MIS is a reflection of the higher investment in MIS managed properties.

Non Forestry MIS projects encounter the same challenges as traditional operations in respect to site selection, establishment, access to water and maintenance of the property and equipment. The advantage that an MIS has over smaller traditional operators is the economies of scale that allow for the engagement of professional services to provide for example, worlds best practice irrigation design, soil analysis and fertiliser programs, pest monitoring and other services.⁵⁰

3.43 The committee received evidence describing a forestry MIS business model that cost investors considerably more than other business structures to grow forestry plantations. A3P and NAFI informed the committee the cost of establishing a forestry plantation is around \$1500 per hectare, to engage a professional forester would cost \$5000 per hectare and the cost of investing in a forestry MIS project ranges between \$6000-9000 per hectare.⁵¹ Despite this variance, they argued that some of the

47 Delegate Station Pastoral Company, *Submission 50*, p. 8

48 Institute of Chartered Accountants in Australia, *Submission 36*, p. 4

49 NFF, *Submission 22*, p. 3; see also NSWFF, *Submission 52*, pp 5-6

50 Maccacorp Ltd, *Submission 15*, p. 8

51 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 80

additional cost of forestry MIS is offset by the bargaining power pooled schemes can use when negotiating processing contracts. They also commented that research houses had assessed there to be a return for investors at those levels.⁵²

3.44 Dr Judith Ajani described the forestry MIS model as 'a very high cost business draining the public purse'. She claimed:

MIS eucalypt pulpwood growers invest 4.5 times more than non-MIS growers to do the same job of planting and managing trees over the rotation...⁵³

3.45 Delegate Station Pastoral Company highlighted the potential costs of indirect activity:

No genuine business can afford to have the leaks that a MIS has and remain competitive in the world market. With advisers/brokers taking 10%, promoters taking 30-40%, there is not much chance of making a return, when at least half of your money never hits the ground.⁵⁴

3.46 They claimed that the 70 per cent DFE rule is ineffective to prevent this because it can be 'made up some time at the end of the growing period'.⁵⁵

3.47 In the non-forestry MIS sector, WGGA claimed that exorbitant cost structures had driven investment:

WGGA is aware of a number of Vineyard MIS that have charged investors double and sometimes treble the reasonable establishment costs for vineyards in that production zone, even after taking into account the legal and advisory costs of establishing and marketing the MIS. It is apparent that investors have been more attracted to the tax deductions available through payment of such large sums in the initial years of the investment than pursuing alternative direct investments in vineyard developments not structured as MIS at significantly lower establishment costs.⁵⁶

3.48 Sunraysia Irrigators Council raised similar concerns about Timbercorp almond schemes:

It seemed that investors were paying a significant premium to participate in such schemes, especially when the only asset they owned was the crop on the trees. It appeared that the MIS was using investor money as cheap finance to set up these schemes and then run them for a fee for the life of the project (25 years), avoiding the risk of the uncertainty in the crop – the

52 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 81

53 Dr Judith Ajani, *Submission 9*, pp 2-3

54 Delegate Station Pastoral Company, *Submission 50*, p. 4; see also NSWFF, *Submission 52*, p. 5

55 Delegate Station Pastoral Company, *Submission 50*, p. 4

56 WGGA, *Submission 44*, p. 5

investor took all the risk – and then ending up with a significant asset at the conclusion of the project.

The management structure was also convoluted in that Timbercorp were the scheme promoter, Timbercorp Securities were the responsible entity and Select Harvest was the orchard manager. Proceeds from the eventual crop would have to wash down through these layers of management before the investor would see a return.⁵⁷

Revenue assumptions

3.49 Dr Ajani claimed that the inflated costs in the MIS structure are accompanied by similarly inflated predictions about price and yield; risks borne by scheme members:

Yet MIS growers—informed by the projections presented in prospectus documents—expect rates of return ranging between 6.5% to 11.0% (Lonsec Agribusiness Research 2001). On paper, the cost chasm between MIS operations and actual industry standards has been reconciled using highly optimistic assumptions on wood yields and stumpage prices. In the case of wood yields: in the vicinity of 60% higher than industry actuals. In the case of stumpage prices: in the vicinity of between 93% to 820% higher than industry actuals ...⁵⁸

3.50 There were conflicting views on the effect of maturing MIS plantation supply and predicted global demand on woodchip prices. On one hand, Dr Judith Ajani claimed that forestry MIS have 'driven a hardwood chip glut', forcing prices lower in an industry dominated by publicly subsidised native forest product.⁵⁹ She also questioned predicted global shortages of paper and wood products.⁶⁰ A3P and NAFI disagreed with this view, saying that demand for plantation products is reflected in the steady price of woodchips in comparison with falling prices for other commodities.⁶¹

3.51 With regard to non-forestry MIS, Sustainable Agricultural Communities Australia suggested that the establishment of schemes producing a commodity already in oversupply, such as wine grapes, demonstrated that REs are often motivated by the profit they can make from an increasing investor base, rather than from the enterprise itself.⁶² WGGGA highlighted the limited likelihood of new wine grape projects returning a profit in an environment of chronic oversupply and water shortages.⁶³

57 Sunraysia Irrigators Council, *Submission 33*, p. 2

58 Dr Judith Ajani, *Submission 9*, p. 3

59 Dr Judith Ajani, *Submission 9*, p. 4

60 Dr Judith Ajani, *Submission 9*, p. 6

61 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 79

62 Sustainable Agricultural Communities Australia, *Submission 13*, p. 3

63 WGGGA, *Submission 44*, p. 1

3.52 The approach to establishing new schemes to meet investor demand also came under scrutiny. IFA commented that:

MIS companies often do not have sufficient land under ownership or lease when they publish their PDS. Therefore, if the PDS is fully subscribed there is a rush to secure the necessary land to establish the area of plantations bought by the investors.⁶⁴

3.53 Aside from potentially distorting land prices, as discussed above at paragraphs 3.21 – 3.23, there is a risk that inappropriate projects will be established on unsuitable sites by REs trying to sell more MIS product. Mr Davies suggested that underperforming Timbercorp olive and almond groves in Western Victoria are likely due to inappropriate site selection and irrigation design stemming from poor soil surveying.⁶⁵ Referring to yields well below original expectations, he told the committee that required surveying qualifications are insufficient given the magnitude of the projects:

A surveyor who surveyed some of the ground that Timbercorp has developed could have had as little as five days instruction before being accredited to do one of those surveys for an agricultural scheme worth \$250 million—each of these is worth about \$25 million. If a survey is undertaken by a person with five days experience, it is an unreasonable expectation that that soil information will be of a quality suitable enough to make that sort of financial decision.⁶⁶

3.54 While Mr Davies did not directly attribute the underperformance of yield to poor soil assessment, he said that: 'the elements are there for that type of mistake to be made'.⁶⁷

3.55 Dr McKenzie provided the committee with an example of a failed paulownias project near Forbes in Western NSW, where a soil scientist's qualified opinion that the project would fail on the land selected was dispensed with in favour of a more optimistic assessment. The crop failed and the company managing the project went into receivership. He suggested that the involvement of a qualified soil scientist at the early stages may have prevented this failed decision.⁶⁸ Dr McKenzie recommended that commercial soil surveyors be required by law to hold professional accreditation.⁶⁹

64 IFA, *Submission 42*, p. 10

65 Mr Rod Davies, *Committee Hansard*, 15 July 2009, Canberra, p. 53

66 Mr Rod Davies, *Committee Hansard*, 15 July 2009, Canberra, p. 59

67 Mr Rod Davies, *Committee Hansard*, 15 July 2009, Canberra, p. 59

68 Dr David McKenzie, *Committee Hansard*, 15 July 2009, Canberra, p. 55

69 Dr David McKenzie, *Submission 7*, p. 3; see also Dr Geoff Kew, *Submission 57*, pp. 2-4. Dr Kew agreed with Mr McKenzie's concerns about training but raised a number of criticisms about Mr McKenzie's claims (submission 7) about methodology. This debate is not examined in this report.

3.56 Other evidence to the committee also suggested that some operators 'shop' for expert opinion to confirm the likely success of their proposed project. Mr Davies indicated that this is often related to the requirement to complete a source survey to obtain an irrigation licence. He suggested that requiring surveyors to be part of a professional association would protect them from pressure to produce favourable reports lest another opinion be purchased.⁷⁰ This matter is further discussed in the next chapter at 4.40 – 4.46 in the context of disclosure material for investors.

3.57 From a forestry perspective, Mr Wettenhall suggested that independent foresters be required to report to the RE's compliance committee, an entity 'at arm's length from the success of the project'.⁷¹

3.58 Mr Alan Jessup of lawyers Piper Alderman claimed that the timing of investors' deductions in relation to the provider's return of income had 'encouraged bad agricultural practice' that include planting horticultural crops in June.⁷² Canegrowers Australia noted a similar experience in Queensland:

...one outcome of the perverse incentives available to MIS promoters has been land management practices that appear to have been geared to obtaining a tax advantage rather than good agriculture. For example, in 2007 and 2008, considerable areas were cultivated just before the wet season in the Ingham area, apparently to allow planting before the end of the financial year. As any local farmer would have predicted, when the seasonal monsoon arrived thousands of tonnes of topsoil, that would have been safe under current cane farming systems, were eroded away to form plumes of sediment in local streams and the Great Barrier Reef lagoon. The schemes' land management practices have been described as appalling.

Since the promoting companies passed into administration, this land is now effectively unmanaged. There is no control of noxious weeds on these properties and they can serve as a haven for feral animals, particularly wild pigs. Without maintenance, further soil erosion is inevitable. Cane growers are heartbroken to see this good land go to waste and are concerned that rehabilitation to profitable and appropriate farming enterprises will be costly and difficult.⁷³

3.59 IFA expressed concern that some hardwood plantation schemes are 'using investor funds to conduct broad scale experiments for plantation suitability'; while some tropical forestry schemes were dependent on 'uncertain markets'.⁷⁴ These views are mentioned further in Chapter 4 (at paragraph 4.46) in the context of disclosure issues.

70 Mr Rod Davies, *Committee Hansard*, 15 July 2009, Canberra, p. 61

71 Mr David Wettenhall, *Committee Hansard*, 15 July 2009, Canberra, p. 87

72 Piper Alderman, *Submission 4*, pp 5-6

73 Canegrowers Australia, *Submission 23*, p. 2

74 IFA, *Submission 42*, p. 9

Agribusiness MIS structural issues

3.60 Related to the issue of whether individual schemes are commercially viable is the considerable debate about the REs behind them, and whether the business models they use are inherently flawed. In particular, some witnesses and submitters suggested that the high cost model is driven by the requirement to sell more MIS to maintain the viability of existing schemes and the RE itself.

3.61 The committee heard that a discussion of the circumstances contributing to the recent collapses of Timbercorp and Great Southern is necessary before structural deficiencies of the MIS model can be ascribed. Some contributors concluded that those companies were victims of external factors that have similarly affected other non-MIS enterprises, while others argued that the agribusiness MIS sector has significant problems with REs using a business model that depends on continuing strong sales to be viable.

3.62 Further on, at paragraphs 3.85 – 3.98, the committee examines suggestions for identifying and limiting agribusiness MIS that are not sufficiently well capitalised to sustain their existence without input from new MIS sales.

Contributing events

3.63 Aside from any structural deficiencies that may have existed, the committee heard that failed agribusiness MIS companies faced a number of challenging events in the period before their collapse. These included the credit crisis and economic downturn, drought, superannuation incentives and tax uncertainty following the ATO's revised ruling.

3.64 There was some evidence that the effect of uncertainty about the deductibility of MIS investment was significant. Mr Alan Jessup of lawyers Piper Alderman claimed that it was an unnecessary contributing factor:

...the taking of a position contrary to law had the effect of creating uncertainty leading to a fall off in investment activity. As a result cash flows of existing operators was adversely affected for a period of time which has contributed to the current circumstances.⁷⁵

3.65 A3P and NAFI speculated that the increase in forestry MIS sales in 2007-08 was due to uncertainty about non-forestry MIS.⁷⁶ They added:

The dramatic downturn in woodlot sales in FY2009 ... 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.⁷⁷

75 Piper Alderman, *Submission 4*, p. 5; see also Mrs Glen See, *Submission 11*, p. 4

76 A3P and NAFI, *Submission 56*, p. 15

77 A3P and NAFI, *Submission 56*, p. 15

3.66 Others disagreed with this view. For instance, Mr Wettenhall was of the opinion that changes making superannuation a more attractive investment had been a major contributor to declining agribusiness MIS sales.⁷⁸

3.67 Rewards Group Ltd suggested that the ATO's revised ruling 'created high levels of uncertainty' and reduced income flows. However, difficulties in refinancing and raising new equity, along with sub prime investor loans, were also key factors.⁷⁹ Maccacorp Ltd also nominated drought and excessive leverage during a market downturn as critical issues.⁸⁰

3.68 Indeed, a more common view is that the uncertainty relating to allowable deductions was just one of a number of contributing factors. NAFI and A3P told the committee that the ATO's decision, combined with the drought and credit crisis, meant that Timbercorp and Great Southern had been 'caught up in a perfect storm'.⁸¹ They said that the inability of Timbercorp and Great Southern to obtain short-term debt re-financing, in conjunction with declining asset values, is considered to have been a significant factor.⁸²

3.69 AAG highlighted the confluence of problems affecting Timbercorp and Great Southern: rapid expansion and increased debt followed by sustained drought, tax uncertainty and banks reassessing risk in an environment declining asset values. They concluded:

When the companies were unable to sell sufficient assets, the banks moved to protect their interests. The rest is history.⁸³

3.70 McMahon Clarke Legal held the same view:

...the environment in which the collapses have occurred cannot be discounted—significant drought, high debt levels, tightening credit, declining asset values and commodity price falls at a time when companies were endeavouring to restructure their businesses and reduce debt had an undoubted impact on their financial deterioration.⁸⁴

3.71 Rewards Group Ltd denied that the recent collapses demonstrate that there is a 'fundamental problem' with the MIS structure:

78 Mr David Wettenhall, *Submission 35*, p. 1

79 Rewards Group Ltd, *Submission 19*, p. 7

80 Maccacorp Ltd, *Submission 15*, p. 8

81 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 64

82 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 79; A3P and NAFI, *Submission 56*, p. 35

83 AAG, *Submission 43*, p. 6

84 McMahon Clarke Legal, *Submission 24*, pp 2-3

The primary reason for the collapse of these two organisations was debt structuring in the parent company.

Both companies overpaid for assets and granted loans to investors that were non conforming (sub prime). Any company in any sector is doomed to fail using this business acumen. There are thousands of companies around the globe that have ceased to exist in the last 12 months due to similar business models.⁸⁵

3.72 These submitters maintained the view that the collapses were due to 'a combination of events', rather than 'an inherent flaw in the MIS model'.⁸⁶

3.73 However, other evidence the committee received argued that these factors did in fact expose structural deficiencies inherent in the MIS business model. For instance, Trustee Corporations Association defined these events as 'the first serious stress test of the new MIS regime', which demonstrated structural flaws.⁸⁷ Mr David Cornish also argued that the global financial crisis could not be blamed for deeper structural deficiencies:

...the structure of these schemes and the activities they are involved in means that an investor is highly unlikely to ever receive a consummate return for the risk they take even given the tax benefit of the schemes. After a time the investor will wake up to this fact and will no longer invest in the scheme. No new investors means no cash flow for the promoter and so the schemes fail. This is a systemic structural problem and will continue to happen GFC or no GFC.⁸⁸

MIS structural deficiencies

3.74 The potential dependence on new MIS sales for the viability of existing projects and the corporate entity itself was a matter of particular concern through the inquiry. The discussion concentrated on the cash flow of agribusiness MIS, particularly the problems associated with investors paying fees upfront and at harvest, rather than annually. The committee was informed that forestry MIS typically use a model where upfront fees are charged and annual costs deferred until harvest and met out of the RE's own assets. Alternately, non-forestry MIS more commonly use a recurring annual fee model because of regular income from harvests.

3.75 A3P and NAFI informed the committee that investors had shied away from forestry MIS charging annual fees:

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

85 Rewards Group Ltd, *Submission 19*, p. 3

86 Willmot Forests Ltd, *Submission 45*, p. 4

87 Trustee Corporations Association, *Submission 25*, p. 2

88 Mr David Cornish, *Submission 54*, p. 3

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.⁸⁹

3.76 McMahon Clarke Legal commented that the deferred fee model suited financial planners 'because they could legitimately advise their clients that it was effectively a "set and forget" investment'.⁹⁰

3.77 Forest Enterprises Australia informed the committee that they had moved from a recurrent fee model to a deferred fee model 'to stay competitive in the financial services market and to keep pace with apparent investor preferences'. However, they preferred the former:

...on a cash flow-basis from a manager's perspective being able to match operational forestry expenditure with recurrent fee income is a much more logical approach. ...

Our view is that deferred fee model is sub-optimal and puts significant pressures on managers who do not have diversified revenue streams.⁹¹

3.78 While acknowledging the commercial drivers for the single up-front payment, Mr Wettenhall suggested that it was unsuitable for forestry MIS:

...the single upfront payment does not reflect the cash flow of forestry and it is therefore somewhat artificial. Forestry is characterised by a large upfront investment and then annual expenses maintaining the plantation. I am uncomfortable with that structure. Back in the 1990s and the early part of this decade, there were schemes ... whereby you put in an upfront payment to cover the establishment of the trees and then annual payments to cover the rent and maintenance of the trees. That reflected much better the cash flow of forestry and avoided the circumstances that we see now, where the cookie jar is empty and there are still some maintenance and rental liabilities to be met.⁹²

3.79 Piper Alderman concurred:

[The] ability to collect fees in advance ... encourages a type of Ponzi scheme where this years fees are being used to pay last year's expenses.⁹³

3.80 The problem for companies that rely on new MIS sales to support existing schemes is that, as a consequence of these sales, new financial obligations accrue.

89 A3P and NAFI, *Submission 56*, p. 16

90 McMahon Clarke Legal, *Submission 24*, p. 5; see also AAG, *Submission 43*, p. 3

91 Forest Enterprises Australia, *Submission 46*, p. 5

92 Mr David Wettenhall, *Committee Hansard*, 15 July 2009, Canberra, p. 88

93 Piper Alderman, *Submission 4*, p. 3

Macquarie Agricultural Funds Management explained that some companies had become caught in a cycle of sales dependency:

...as companies become successful, as they sell more and more product, they need to acquire more assets. They need to buy the land in which to plant the trees, they need to establish the almond orchards or the horticultural assets and they need to buy water. This creates financial obligations on the company to pull together capital assets.⁹⁴

3.81 While well capitalised companies (including those with a self-funded structure where investors purchase the land) can meet their obligations, Macquarie suggested that others were left in a precarious position:

...the companies that have failed have been in neither of those categories and we think that that has caused difficulty because the companies need to always be looking for fresh equity and fresh debt. We have just been through a very buoyant time in debt and equity markets and during this period companies in this sector, and indeed lots of companies, could attract debt and equity. Sadly, as the debt and equity markets dried up, the companies' capacity to fund these assets became more and more difficult. The equity markets were the first markets to become problematic. When the debt markets closed down as well, that was when the companies became stressed and unable to continue to operate.⁹⁵

3.82 MacMahon Clarke Legal considered that market forces would steer a return to forestry MIS using recurring fee model schemes, rather than deferring fees until harvest.⁹⁶

3.83 Willmot Forests Ltd acknowledged that 'the business model of these companies relied too heavily on annual future sales revenue', though they suggested that the tax uncertainty, credit and drought were extenuating circumstances.⁹⁷ Statistics ASIC provided to the committee indicated that 'MIS sales formed the primary source of revenues and cash flows' for Great Southern and Timbercorp's businesses.⁹⁸ They described the common practice where investor fees are 'diverted into the general working capital of the parent entity', instead of being quarantined for the purpose of meeting the project's future obligations.⁹⁹

94 Macquarie Agricultural Funds Management, *Committee Hansard*, 15 July 2009, Canberra, pp 92-93

95 Macquarie Agricultural Funds Management, *Committee Hansard*, 15 July 2009, Canberra, p. 93

96 MacMahon Clarke Legal, *Submission 24*, p. 5; see also AAG, *Submission 43*, p. 3

97 Willmot Forests Ltd, *Submission 45*, p. 5

98 Application fees accounted for 76 per cent of Great Southern's revenue and 87 per cent of Timbercorp's revenue in 2008. See ASIC, *Submission 58*, p. 23.

99 ASIC, *Submission 58*, p. 23

3.84 ASIC distinguished between a problematic business model requiring additional sales for a 'substantial part' of their working capital, and an illegal ponzi scheme. ASIC commented that ponzi schemes have no meaningful economic enterprise underpinning the investment, whereas agribusiness MIS investors purchase an interest that entitles them to a share of profit from a specific agricultural project. However, ASIC also made the following comment:

Agribusiness MIS operators have been criticised for adopting business models which rely on receipts from application fees for revenue ... this business model may be unstable if the flow of new MIS sales is interrupted.¹⁰⁰

Investment safety regulation

3.85 A number of submitters recommended that the financial capacity of agribusiness MIS to meet their operational requirements be subject to closer regulation. Prudential regulation is currently limited to entities 'where the systemic risks and the intensity of the financial promises, and hence the risk of market failure, are greatest'.¹⁰¹ These include authorised deposit-taking institutions, insurers and superannuation funds, but not managed investment schemes.

3.86 ASIC told the committee that certain financial requirements are imposed on REs as AFS licensees:

As AFS Licensees, REs are required to meet base level financial requirements set out in RG 166. These require the RE to have:

- (a) positive net assets and be solvent;
- (b) sufficient cash resources to cover 3 months expenses with cover for contingencies; and
- (c) maintained audit compliance.

REs must also maintain minimum net tangible assets of \$5 million unless the RE uses a custodian. If a custodian is used, the RE must maintain 0.5% of assets of the registered schemes it operates with a minimum requirement of \$50,000 and a maximum requirement of \$5 million.¹⁰²

3.87 McMahon Clarke Legal described agribusiness MIS as 'one of the most highly regulated sectors in the Australian managed fund market'.¹⁰³ They added that ASIC could provide further guidance to make the existing regulatory regime more effective:

Whilst the collapses of Timbercorp and Great Southern have been profound and far reaching, this submission cautions against reactive regulation and law reform. It is our view the laws governing agribusiness MIS are already

100 ASIC, *Submission 58*, p. 25

101 ASIC, *Submission 58*, p. 14

102 ASIC, *Submission 58*, pp. 6-7

103 McMahon Clarke Legal, *Submission 24*, p. 2

robust enough. It is compliance with, or enforcement of, those laws which needs to be the focus of attention.

There is an opportunity for ASIC to revisit its regulatory guides, or issue new guidance, on minimum requirements it expects to be observed by responsible entities in scheme establishment, promotion and operation in order to comply with those laws. There is also no doubt it is also incumbent on the industry to ensure and promote the highest level of compliance with the laws as they stand.¹⁰⁴

3.88 Commenting on the distinction between ASIC's oversight role and APRA's responsibility for prudentially regulation, ASIC noted:

There is probably an issue emerging as to whether on the setting in relation to that, when you look at some of the failures that have occurred in recent times, there needs to be some discussion. The committee might want to think about whether the prudential requirement settings are currently set correctly.¹⁰⁵

3.89 Macquarie Agricultural Funds Management recommended that MIS providers should be required to demonstrate to ASIC that they are sufficiently capitalised to meet the financial commitments that flow from new and existing MIS sales. They wrote:

This may be achieved by making the annual certification to the regulator as a condition of the [AFSL]. Providers should be required to certify that all future financial obligations of intended (new) and existing agricultural schemes have been appropriately considered and provisioned for, and that in meeting these financial obligations they are not wholly reliant on future or expected income that will be derived from additional agricultural MIS sales.¹⁰⁶

3.90 To prevent potentially unprofitable schemes being established, WGGA recommended that schemes using a high cost model, benchmarked as such against real commercial costs, be prevented from obtaining an ATO product ruling in the first place.¹⁰⁷ Mr Kerin Smart agreed, suggesting that the ATO has been in error by issuing a product ruling for these schemes:

In my view, most of the losses incurred over the last 8-9 years would not have happened if ASIC had enforced Section 1013E and the ATO had

104 McMahan Clarke Legal, *Submission 24*, p. 10

105 ASIC, *Committee Hansard*, 15 July 2009, Canberra, p. 109

106 Macquarie Agricultural Funds Management, *Submission 48*, p. 8

107 WGGA, *Submission 44*, p. 6

restricted deductions in the Product Rulings issued to the real commercial cost of the projects involved.¹⁰⁸

3.91 Maccacorp Ltd suggested that annual management fees be tied to scheme profit to combat the potential agency problem of RE directors benefiting from selling more, rather than profitable, schemes.¹⁰⁹

3.92 Trustee Corporations Association argued that the RE minimum net tangible assets and insurance requirement of \$5 million (each) is too low given the amount of investor funds under management. They also recommended that the compliance committee be removed and providing the compliance plan auditor with a greater oversight role.¹¹⁰

3.93 Forestry consultant Mr David Wettenhall said that upfront payments 'should be set aside for future management expenses', with the funding levels to be held based on the assessment of an independent forester.¹¹¹ Piper Alderman recommended that fees paid for the provision of services over three months in advance be held on trust by a custodian.¹¹²

3.94 AAG was of the opinion that the market may dictate a shift towards this type of practice:

Without legislation, it is possible that market forces could see changes to best practice scheme documentation for the handling of grower funds. Money could be set aside for future management operations and lease obligations in separate trust accounts. The active participation of the Compliance Committee could be used to periodically review the adequacy of account balances against forecast expenses for the life of the schemes. As Compliance Committees are already in place under existing ASIC licensing requirements for all Responsible Entities, they could be used to sign off on when funds can be released following the achievement of set milestones (e.g. planting of trees).

As long as grower funds are held separate to company assets and remained the sole property of an individual scheme, in any event of corporate insolvency this would allow for a much easier replacement/transition of the Responsible Entity.¹¹³

108 Mr Kerin Smart, *Submission 60*, p. 3. Section 1013E of the Corporations Act relates to the requirement for a PDS to contain information that could reasonably be expected to have a material influence on a decision to invest.

109 Maccacorp Ltd, *Submission 15*, p. 11

110 Trustee Corporations Association, *Submission 25*, pp 3-4

111 Mr David Wettenhall, *Committee Hansard*, 15 July 2009, Canberra, p. 84 and 86

112 Piper Alderman, *Submission 4*, p. 3

113 AAG, *Submission 43*, p. 3

3.95 McMahaon Clarke Legal disputed the need to mandate that funds raised for a particular scheme should be held as working capital for that project alone:

In the case of group companies, funds paid as application money or ongoing fees may have been released into the consolidated revenue of the corporate group and then ‘drip fed’ back to the responsible entity and its related parties (which were often subcontractors for a scheme) as and when required. From a legal perspective, it is our view a responsible entity is perfectly entitled to use fees paid to it as it sees fit—once fees are paid and properly applied under the management agreements, the fees become the responsible entity’s asset. This is not to say the responsible entity’s contractual and fiduciary obligations are limited in any way whatsoever.¹¹⁴

3.96 TFS Corporations Ltd also rejected this proposal:

...due to the long duration of the agricultural projects performed by the MIS schemes it would be an inefficient allocation of capital to contribute to reserves for all future expenses. For this reason annual expenses ought to be commercially realistic and the MIS parent company needs to ensure it has sufficient funding to meet its future obligations where the annual fees are deferred.¹¹⁵

3.97 They contended that the efficient operation of the market should drive prudent business practices:

...nothing in the MIS business model prevents the efficient operation of the market and that unsustainable MIS businesses will and should fail. It is expected that there may be further corporate failures in the MIS industry as investor funds and capital is allocated away to more appropriate investments.¹¹⁶

3.98 The committee comments on these suggestions below at paragraph 3.132.

RE collapse

3.99 The committee also received evidence about the problems associated with managing competing interests following the collapse of an RE. Of particular concern was the conflict of interest for insolvency practitioners and protecting growers' interest in the land. The committee also discussed the options available for growers in the failed Timbercorp and Great Southern schemes.

Potential RE conflicts

3.100 One issue of concern is the conflict between an insolvency practitioner's obligation to act in the interest of scheme members and any competing obligation to

114 McMahaon Clarke Legal, *Submission 24*, pp 3-4

115 TFS Corporations Ltd, *Submission 30*, p. 8

116 TFS Corporations Ltd, *Submission 30*, p. 10

creditors and shareholders. ASIC indicated that RE directors may face certain conflicts of interest in discharging their duties, including:

- a personal interest in a related entity such as the landholder or operational service provider;
- the inherent conflict between their duty under section 181 of the Corporations Act to act in the best interests of the corporate entity, and their section 601FD duty to act in the best interests of scheme members (the latter must take precedence); and
- conflicts where a director holds common directorships between the RE and related entities.¹¹⁷

3.101 In the event of the RE for an agribusiness MIS going into administration, ASIC explained that the insolvency practitioner (administrator, receiver or liquidator) is considered to be an officer of the RE under the Corporations Act and therefore subject to the same duties.¹¹⁸ That is, they must place the interests of scheme members ahead of the corporate entity, including creditors.

3.102 Where the RE is insolvent, external administrators have to manage the competing claims of two groups:

1. secured creditors, who may want projects terminated and the land over which they have security sold; and
2. investors, who want the projects to continue to be managed and harvested.

3.103 While an administrator, receiver or liquidator is bound to act in the best interests of members (growers), ASIC acknowledged the concerns about this arrangement:

...in practice, particularly for receivers and liquidators, difficulties may arise in managing the tension between their obligations to growers and their obligations to the RE's creditors. In recent failures in the sector, it is apparent that (whatever the legal position) the fact that there is no person in there charged solely with representing their interests has undermined growers' confidence in the capacity of the existing insolvency laws to protect their position.¹¹⁹

3.104 There has been significant controversy over the role of the RE as an appointed insolvency practitioner following the collapse of Timbercorp. A group of investors in Timbercorp's olive and almond growing schemes opposed KordaMentha's application

117 ASIC, *Submission 58*, pp 27-28

118 ASIC, *Submission 58*, p. 29

119 ASIC, *Submission 58*, p. 29

to have the schemes wound up and the proceeds distributed, seeking to have temporary REs appointed to the schemes to reassess their continuing viability on behalf of growers. At the time of writing, the winding up application has been adjourned to allow growers to vote on the options before them.¹²⁰

3.105 Lawyers Piper Alderman observed that the current arrangements are unsuitable:

Clearly a responsible entity should not continue to be a responsible entity if it is externally administered. This is because of the inherent conflict of interest of an administrator or liquidator which has to act in the interests of creditors when there is an overriding duty to also act in the best interests of members.¹²¹

3.106 They recommended the following amendment be made to the Corporations Act:

If a responsible entity of a registered scheme becomes externally administered under Chapter 5.3A or a liquidator is appointed to the responsible entity then ASIC must apply to the Court for the appointment of a temporary responsible entity by the Court pursuant to section 601FP of the Corporations Act 2001.¹²²

3.107 This proposal was supported by McMahon Clarke Legal:

...the interests of investors are best preserved and enhanced by having a temporary responsible entity with experience and expertise in running agribusiness MIS being appointed as soon as possible.¹²³

3.108 To overcome the problem of potential temporary REs being unable to operate that particular scheme under their licence conditions, Piper Alderman included the following recommendation:

Notwithstanding the aforesaid provisions, an entity which holds an Australian financial services licence which authorises it to operate a managed investment scheme of any kind may be appointed by the Court ... as a temporary responsible entity.¹²⁴

3.109 According to Piper Alderman, the current provisions of the Corporations Act providing that ASIC 'may' apply to the Court for the appointment of a temporary RE

120 Nickless, R. 'Timbercorp investors granted a reprieve', *Australian Financial Review*, 21 July, 2009, p. 9

121 Piper Alderman, *Submission 4*, pp 3-4; see also Australian Forest Growers, *Submission 53*, p. 2; and FPA, *Submission 40*, p. 5

122 Piper Alderman, *Submission 4*, p. 4

123 McMahon Clarke Legal, *Submission 24*, p. 6

124 Piper Alderman, *Submission 4*, p. 4

had led to ASIC being 'particularly inactive in acting to protect members'.¹²⁵ Mr Michael Butler also criticised ASIC for being 'reluctant' to appoint a temporary RE. He claimed that the current insolvency practitioner for Timbercorp has inflated the price required to harvest the 2009 crop to benefit the RE, rather than growers.¹²⁶

3.110 A3P and NAFI also called on ASIC to facilitate the appointment of a separate RE to 'overcome this inherent conflict of interest'.¹²⁷

Protecting investors' land interests

3.111 In light of potential ambiguity about members' interests following the collapse of the RE, some submitters highlighted the importance of investors maintaining a right to access the land projects use for the life of that project. There was particular concern about the potential for leases to be terminated and land to be sold free from the lease encumbrance if rent is not paid on time, due to the RE's financial difficulties.¹²⁸ ASIC indicated that growers' ownership rights are 'not always clear as a matter of law' when schemes are wound up.¹²⁹

3.112 IFA suggested that scheme offers should only be made where access for the life of the project is assured:

...it is problematic that MIS investors are vulnerable in situations whereby their investment (eg in trees) is jeopardized if the security over the owner or lender associated with the land upon which the trees are grown does not match the duration of the MIS investment. MIS companies should only be able to offer schemes, where they can clearly demonstrate they have guaranteed access to the land upon which the trees are to be planted for the entire duration of the scheme.¹³⁰

3.113 Mr Alan Jessup of lawyers Piper Alderman recommended an amendment to the Corporations Act to prevent liquidators selling the land in conflict with the interests of growers. Specifically, he suggested that the land be held by a custodian on trust for the growers, and that this arrangement only be terminated where the court determines it is just and equitable to do so.¹³¹ This proposal was supported by McMahon Clarke Legal and A3P and NAFI.¹³²

125 Piper Alderman, *Submission 4*, p. 5

126 Mr Michael Butler, *Submission 14*, p. 2

127 A3P and NAFI, *Submission 56*, p. 45

128 See for example A3P and NAFI, *Submission 56*, p. 45 and McMahon Clark Legal, *Submission 24*, p. 6

129 ASIC, *Submission 58*, p. 25

130 IFA, *Submission 42*, pp 9-10

131 Piper Alderman, *Submission 4*, p. 2

132 McMahon Clark Legal, *Submission 24*, p. 6; A3P and NAFI, *Submission 56*, p. 45

3.114 Macquarie Agricultural Funds Management recommended that sale and leaseback arrangements be subject to the pre-existing rights of investors.¹³³ Macquarie also suggested that the best way to protect investors' rights in the land is to require the provider to have sufficient funds set aside to meet land costs for the life of the project, or be adequately capitalised to buy the land outright.¹³⁴

3.115 McMahan Clarke Legal proposed that disclosure be improved (see also paragraphs 4.28 – 4.53):

...greater disclosure on land and water rights is required, including details about ownership, whether those assets are encumbered, the risks associated with the form of ownership and the encumbrances and other related matters.¹³⁵

Post collapse scheme management

3.116 The collapse of an RE necessitates the appointment of temporary REs to continue running the schemes on behalf of growers, generally under circumstances where they are considered profitable despite any requirement to recapitalise them. If such an entity (or entities) cannot be found, the schemes are wound up and proceeds from the sale of the assets are distributed amongst growers.¹³⁶

3.117 A3P and NAFI expressed the view that forestry plantations established under Great Southern and Timbercorp would derive returns:

...we are confident that in some way the vast majority of these trees will continue to be managed. We do not know exactly how that is going to unfold, but there are companies who are looking at the opportunities in relation to that resource. There is a significant resource there—as you say, hundreds of thousands of hectares with trees growing on it. What we have to get to is who will ultimately own that [and] how they will go about harvesting it...¹³⁷

3.118 They added: 'we hope that, whatever happens, it happens quickly'.¹³⁸ The committee notes that Timbercorp forestry MIS growers have since agreed for the schemes' assets to be sold.

133 Macquarie Agricultural Funds Management, *Committee Hansard*, 15 July 2009, Canberra, pp 94-95

134 Macquarie Agricultural Funds Management, *Submission 48*, p. 9

135 McMahan Clark Legal, *Submission 24*, p. 5. This is further discussed in Chapter 4.

136 Where growers obtained finance to make their investment, the payments owing could exceed the returns from the winding up.

137 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 77

138 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, p. 78

3.119 When queried about the likely returns to investors in the event of the forestry plantations being sold, A3P and NAFI indicated that it may exceed the \$1500 per hectare cost of establishing them:

It depends very much on the state of the individual plantation resource you are talking about. If these are trees that are about to be harvested next week, they will obviously be of a much higher value than trees planted last year. So the timber value has to be taken into account. In some cases that might be very small, if it is a tiny area of plantation way out in Woop Woop and the trees have not been growing well. If it is a fantastic plantation very close to other areas that are currently being harvested, it will have a much higher value. So there is a huge range, and it is very difficult for us to generalise.¹³⁹

3.120 AAG suggested that the upfront fee model could make finding a replacement RE difficult:

The upfront model has inherent difficulties in the event of corporate parent insolvency where a replacement Responsible Entity is effectively being asked to manage the schemes until harvest without any income. This can present a significant road block in the appointment of a new responsible entity.¹⁴⁰

3.121 Mr David Wettenhall told the committee that, in the short term, the collapses had disrupted the cash flows of many contractors and caused 'particular financial hardship'.¹⁴¹

Committee view

Tax deductibility

3.122 The committee is concerned about the potential for the tax deductibility for non-forestry agribusiness MIS to unfairly distort capital markets to the detriment of other rural enterprises. However, the committee considers that, on balance, the tax deduction for non-forestry MIS under the general business deductions rule is not unreasonable where there is a clear focus on scheme profitability, rather than exploiting tax breaks. The deductibility arrangements for MIS investment are consistent with that available to any person incurring business costs, now that the courts have determined that such investment is a business expense. However, there is currently potential for MIS to use unprofitable high cost structures to provide greater tax deductibility to investors, while directing a proportion of this tax-related investment to related entities charging above commercial rates for project services. Where investor focus is on minimising tax, rather than investing in the most profitable

139 A3P and NAFI, *Committee Hansard*, 15 July 2009, Canberra, pp 80-81

140 AAG, *Submission 43*, p. 3

141 Mr David Wettenhall, *Committee Hansard*, 15 July 2009, Canberra, p. 85

venture, this directs capital away from profitable uses and disadvantages traditional farming enterprises by increasing natural resource costs and encouraging oversupply.

3.123 The committee notes that the collapse of Timbercorp and Great Southern has undoubtedly focussed investors' attention on the importance of investing in commercially viable MIS. Such sentiment should temper the distortions evident when tax incentives cloud judgment about the viability of some projects. The committee also believes that the Institute's suggestion, where deductions for MIS investment are only permitted to be offset against future taxable income from the same MIS, has some merit in addressing the worst distortions caused by the current arrangements. The committee therefore recommends that the government consider this condition on deductibility for non-forestry agribusiness MIS claimed under the general business deduction provisions of section 8-1 of the ITAA 1997.

Recommendation 1

3.124 That the government considers investigating and modelling the effects of amending the ITAA 1997 to ensure that tax deductions for non-forestry agribusiness MIS investment under the general business deduction provisions of the ITAA 1997 only be permitted to be offset against future taxable income from the same MIS.

3.125 There are more pressing arguments for tax deductibility for investment in forestry MIS as provided for under Division 394 of the ITAA. The committee understands that the long lead time and one-off character of forestry income events discourage investment in the industry. Although the committee recognises that there is a vigorous debate over whether the goal of trebling Australia's plantation output by 2020 has a sound economic basis, the inherent disincentives to invest in forestry warrant the retention of the existing arrangements. The committee notes that the recent failures of Timbercorp and Great Southern will focus future investors' attention on MIS profitability, negating the worst effects of indiscriminate capital investment.

3.126 The committee also recognises that there are concerns about the likely effectiveness of the 70 per cent DFE rule to ensure that forestry MIS do not adopt uncompetitive business models with significant expenditure being directed outside forestry. However, the new arrangements are relatively new and should be given the opportunity to work. The committee is of the view that the government should continue to monitor the effectiveness of Division 394's integrity measures closely against industry practice and amend them if required.

MIS structural issues

3.127 The committee heard legitimate concerns that high cost MIS business models, encouraged by tax deductibility, cannot generate profit for investors and necessitate inflated revenue assumptions to attract investment to projects. There were also a number of witnesses and submitters who contended that the Responsible Entities operating the schemes are inherently of questionable viability when placed under stress. While it is not possible to generalise across the entire agribusiness MIS sector,

the MIS model does potentially encourage Responsible Entities to develop business models with a ponzi-like character if external factors such as access to credit and drought intervene, necessitating extra MIS sales to inject working capital into existing schemes. Cash flow problems associated with external events have been exacerbated by up-front fee models deemed necessary to sell forestry MIS in the market. These deficiencies have been exposed by the collapse of Timbercorp and Great Southern.

3.128 A number of factors could work to mitigate these concerns. Firstly, the committee again notes that the market will undoubtedly be more careful about agribusiness MIS projects for some time, especially schemes that cost significantly more per hectare for investors than the commercial cost of the activity. Secondly, the integrity measures included in the Division 394 arrangements for forestry MIS should be given an opportunity to work, in particular the 70 per cent direct forestry requirement designed to prevent excessive capital being siphoned off in management fees and administration. Fourthly, the market's preference for up-front payment schedules may be revised following the recent business failures, and investors are likely to increasingly demand that their funds be held solely for the purpose of operating the scheme for which they were raised.

3.129 Despite this, there is still a strong argument for some sort of prudential oversight of agribusiness MIS schemes to help prevent failures of the sort seen most recently. MIS providers should be required to demonstrate that they have sufficient working capital to meet the financial commitments they incur from existing schemes and new MIS sales, without being dependent on further, additional new sales for their viability. As this issue is relevant to product safety issues explored in the committee's report on financial products and services, the committee will reserve any recommended legislative changes until then.

Post-collapse issues

3.130 The committee acknowledges that the Corporations Act clearly states that insolvency practitioners, as officers of the RE, are required to act in the best interests of members. However, committee members are concerned about the way conflicting obligations to members and the corporate entity and its related entities are managed in practice, which generates an understandable lack of trust in the current arrangements amongst growers. The committee therefore recommends that the government amend the Corporations Act to require ASIC to appoint a temporary Responsible Entity when a registered managed investment scheme becomes externally administered or a liquidator is appointed.

Recommendation 2

3.131 That the government amend the Corporations Act to require ASIC to appoint a temporary Responsible Entity when a registered managed investment scheme becomes externally administered or a liquidator is appointed.

3.132 Finally, the committee is of the opinion that the problem of land interests after a collapse is best addressed by ensuring that schemes are adequately capitalised to

meet their land cost obligations for the life of the project in the first place. Land owners are entitled to terminate lease arrangements when rent is not paid. However, there are obvious conflicts of interest when the land is owned by a related entity. In this regard, the committee has concluded that the proposal for land to be held by a custodian on trust for the growers is worthy of consideration. The committee anticipates that the market may dictate a shift in this direction, rather than regulation being necessary in this area.