Executive Summary

51A06334
27 July, 2006

The Options for Increasing Harvest Security and Investment in Private Natural (Native) Forests in Queensland

Prepared for

AgForests Queensland

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PREFACE

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SUMMARY

The AgForests project is a joint initiative of Timber Queensland and AgForce Ltd and is funded by the Commonwealth Department of Agriculture, Fisheries and Forestry. The project is designed to investigate the opportunity to develop the sustainable management of private natural (native) forests on freehold land in Queensland.

The need for this project comes from the reduction in both the volume and the security of supply of hardwood sawlogs from Queensland public natural (native) forests as the State Government is committed to ending harvesting in these forests by 2024. However, Australia currently imports around 100 000 m^3/a of hardwood sawntimber of which some could be replaced by domestic production. Hardwood demand in Queensland is also increasing and despite recent plantation development which is expected to replace the current supply from natural forests in volume terms, demand is expected to increase from the current hardwood sawntimber deficit of around 100 000 m^3/a to a requirement of around 200 000 m^3/a by 2015.

One option to meet this unmet demand is imports of hardwood from other states of Australia, but this is unlikely as these states are facing similar reductions in supply from their public forests. A second option is to import from overseas which could mean supplies are sourced from unsustainably or illegally harvested forests. Plantations are being developed in Queensland but they are relatively untested for sawlog productivity and products. In addition, not all the plantations are located in the traditional sawntimber regions which means the current social infrastructure of the industry must change. One of the simplest options would be to increase the sustainable supply of hardwood from private landowners.

Queensland has 10.2 million ha of private natural forest which is the largest area of commercial natural forest in Australia. The common species typically have high strength and durability features which are not commonly produced in plantations. The current annual harvest is estimated at 300 000 m^3 as no accurate data exists.

There is significant potential to improve the productivity of private natural forests to complement the declining supply from the Crown to meet not only the Queensland demand but demand from the rest of Australia and/or the export markets as well.

The Commonwealth Bureau of Rural Sciences (BRS) reported that in south east Queensland there is around 750 000 ha of commercial private natural forest of varying productive condition. The cost of silvicultural improvement varies but is estimated to be around $300/ha and while accurate data is again limited, productivity improvements could range from 0.5 to 1.5m^3/ha/a depending on the forest type and condition. Considering the cost of purchasing land and developing and managing a sawlog plantation over 30 years will cost around $10 000 which may produce a merchantable sawlog growth rate of 10 m^3/ha/a, then the cost of upgrading private natural forest is very competitive, particularly when considering most landowners integrate cattle production in their forests.

Improving the productivity of the private natural forest is worth pursuing for a number of reasons: it already exists and the area is significant so the establishment risk is low, the industry is familiar with the species and the markets are strong, private natural forest complements rather than displaces existing agricultural operations, they are mixed species with positive environmental potential and it represents an opportunity to increase farm incomes and the social and regional economies of Queensland.

This project has reviewed two main issues that are considered of primary importance to realise the potential of private natural forests. The first issue is the need for harvest security for landowners and investors. The second issue involves investigating the opportunity for increased investment in private natural forests by landowners and/or third party investors.

Harvest Security

Harvest security is the certainty over time for the resource owner of the right or guarantee to harvest trees in the future. Harvest security is particularly relevant to natural forestry investments as there is generally minimal activity between treatment and the return on investment at harvest and the timeframe can be significant (e.g. 10 years or more). Often this can be construed as 'no management' when in fact it is the opposite; it is a reflection of the low impact over time of forest management operations. However, the concern for resource owners is the general public interest and scrutiny of natural forest management that may generate changes to regulations which threaten harvest security, creating a disincentive to invest.

The level of harvest security in Queensland can be described in terms of a combination of clearly defined and reasonable regulatory requirements that meet community expectations, the level of discretionary intervention by various levels of government, and the degree of formal recognition of the use.

The following scenarios are presented in increasing order of harvest security:

1. *Not a legal use* – e.g. a conservation reserve.
2. *A legal use with highly restrictive regulation* or significant opportunity for government intervention and limited formal recognition of the use – e.g. forestry would require an impact assessment to be undertaken with formal public review and subject to challenge.
3. A *legal use with limited opportunity for government intervention* – e.g. current situation with self-assessable code in remnant vegetation, no further regulation permitted by Local Government, and some limited recognition of the use through a Forestry PMAV.
4. A *legal use with formal recognition* – e.g. a reasonable State code with no further regulation by Local Government, combined with the establishment of something like a 'Category F' on a PMAV that acknowledges the legitimate use for forestry, although no specific detail of compensation if the rights are withdrawn or significantly affected (i.e. similar to Category X for non-remnant vegetation).

5. A *legal use with formal recognition and compensation* should the right be withdrawn or significantly affected.

The opportunity to improve the current security by developing a formal government recognition of the right to harvest the forest crop (ideally with compensation if it is prevented); or probably with lesser effectiveness, by improving the evidence of the use through forest management plans, records of use, or formal documentation (such as long term sale agreements) demonstrating future intent is considered important.

Numerous risks exist for harvest security but the main ones are considered to be:

- Legislative changes
- A change in regulation such as a change to the Code, or
- A change in the interpretation of the law/Code by third parties such as local government.

In Queensland the above risks relate predominantly to state government regulation of forestry operations. While these risks are not unique to forestry they tend to be more prominent because the time between investment and return is considerably longer than traditional agricultural activities. Resource owners will be reluctant to invest in forest improvement if they suspect they will be prevented from harvesting.

In relation to local government regulation there is, in fact, a considerable degree of harvest security embedded in the current regulation of forestry. The Integrated Planning Act (IPA) exempts legally established forest practices from further regulation by local government. This means that if there is an established use for forestry (which is the norm in most productive forests), and provided there is not a material change in the intensity of use, then local government is unable to require any further approval or impose further regulation on forest practices.

In addition, State Government regulation under the *Vegetation Management Act 1999* (Qld) (VMA) provides an exemption for forest practices from requiring a development approval, provided operations comply with the code applying to a native practice on freehold land (the Code). The requirement to notify prior to conducting a forest practice also delivers a degree of security, as it provides some documented evidence that the land is to be used for forestry.

In addition to this, forest areas that are not mapped as ‘remnant’ can be ‘locked in’ as Category X, thereby securing landholders’ rights to future management of these areas and limiting their future regulation.

An option for strengthening harvest security includes gaining formal recognition of forestry as an ‘as of right use’ by defining forest practice areas as Category F on a property map of assessable vegetation (PMAV). This would not be dissimilar to the ‘Private Timber Reserves’ (PTRs) in Tasmania where the State Government offers enhanced protection for forest management by allowing landholders to register their private forests in these reserves. This limits any regulation of these areas from local government control, and their establishment via a State Government mechanism implies a degree of support at the State level. However, even with this

level of direct recognition of harvest rights, there are examples of local government controlling forest use by regulating road use by timber trucks.

Further security would be gained by seeking compensation from the Queensland Government if they subsequently remove harvest rights on freehold land where a legally complying forest practice is operating and significant investment in time and development expense has been undertaken. Although difficult to implement, it would send a very strong positive signal to investors and potentially develop Queensland private natural forests into a world class example of sustainable forest management with strong environmental, social and economic outcomes and potentially make the State the largest producer of hardwood sawlogs in Australia.

In summary, although currently there is a reasonable level of harvest security, there are still concerns this will change due to government policy and legislative uncertainty. These risks apply to any industry. However the period of investment (time between cost and returns) is of particular concern in the forest industry. Improving harvest security with designated Category F areas on a PMAV with compensation for loss of harvest rights would send a positive investment signal to landowners and investors, and also has the potential to benefit the state of Queensland. If the Queensland Government wants to gain triple bottom line (environmental, social and economic) outcomes for rural Queensland then it must provide security for each element, and harvest security is an integral element of economic and social returns from private natural forest.

Improving Supply Security

Coupled with harvest security is the importance of supply security for industry. Traditionally, industry has received strong supply security from the Crown via long term harvest contracts but these will cease in 2024. Harvest arrangements on private land have varied from verbal ‘one off’ arrangements to more formal five year contracts and in some cases 20 year access rights. Formal contractual sale agreements for harvesting are widespread in the industry. The need for formal long term arrangements was discussed at the Gayndah workshop but landowners indicated that harvest security, return on investment and improved resource data were higher priorities. However, in order to give certainty to both the landowner and industry, and develop private natural forests as a long term reliable source of wood supply, a more structured process is needed.

This process may involve the recording of relevant supply data such as availability, location, quality and species by an independent organisation such as AgForests. A previous review of forest owner organisations by AgForests[1] suggested that for this type of service to be successful it requires cooperation, ownership by industry and growers and promotion of the service to the whole industry.

[1] Jaakko Pöyry Consulting (April 2005), *Review of Forest Owner Organisations.*

For the processing industry to continue to invest in mill development and value adding on the basis of supply from private natural forests, they will need to know the following:

- Volumes available over time from private natural forests by recognised quality classes
- Some guarantee of future harvest access and a predictable pricing formula.

For landowners to be interested in investing and potentially locking in their resource to a processor, they will need to have confidence in and/or know:

- The processor's capacity to meet their contractual obligations.
- Some agreement on the timing of harvest.
- A predictable pricing formula that delivers market returns.
- A reliable and accountable harvesting process.

Options for improving supply security include long term contracts, supply pooling, independent wood agents, formation of a supplier group and forward selling under an options contract. Long term contracts are logistically difficult from an industry perspective and landowners do not seem keen to sign up for them. Supply pooling involves a central register, possibly internet based, that could be facilitated by AgForests which illustrates forests for sale and expressions of interest to purchase from industry. Independent wood agents are essentially the same as livestock agents and forward selling under an options contract would be an add-on to supply pooling but would require better resource data to allow industry to buy wood in advance of their needs.

Attracting Landowner Investment

There are significant areas of forest on freehold land in Queensland and while data on the condition of the resource is limited, preliminary information suggests that while forest quality varies it could be improved with management. Supply could be developed to the extent that it could more than compensate for the loss of volume historically supplied from the Crown forests.

The majority of landowners manage their forests in conjunction with beef cattle production and as such if the commercial value of the forest can be improved then the total returns of the farm should also be improved.

If landowners are prepared to invest in the sustainable management of their forests by implementing silvicultural treatment programmes (anticipated to cost between $200 to $400/ha) then it is not unreasonable to expect higher production of quality logs which should not only attract a higher return as they meet Queensland's growing demand for hardwood but also improve their land value.

Many landowners are unaware of the investment potential of their natural forest and there is a lack of comprehensive extension advice with supporting demonstration trials for landowners to appreciate how they can improve the productivity of their private natural forests and the overall income on their properties. Even if landowners are aware of the treatment that is needed there is

also a shortage of skilled contractors that can provide silvicultural improvement services.

Harvest arrangements between landowners and industry have varied from long to short term, from formal to ad hoc. The Gayndah workshop indicated that the priority for landowners was harvest security and forest improvement rather than a need for long term supply arrangements. Possibly this is due to a belief that the market will resolve these supply requirements and most landowners do not have long term supply arrangements for their other agricultural products.

Historically, prices for private wood have been low and in comparison to other agricultural commodities the market is not particularly transparent. This has created limited incentive for landowners to actively manage their forests. Recent significant price increases have improved the returns to landowners and this has changed the financial viability of investment in forest management.

Taxation treatment of private natural forests appears to be a disincentive to sustainable forest management which is a concern as a forest practice must be part of an 'ongoing forestry business' to achieve the exemption under the VMA. In the event that a property was purchased before the introduction of capital gains tax (CGT) in September 1985, then the income from forest harvesting can be treated as a sale of capital and therefore is not subject to income tax. However, if the landowner is conducting an ongoing forestry business, then the forest most likely becomes trading stock and subject to income tax. This will be a disincentive to investing in the forest. It is however understood that this issue is under review by the Federal Government and in particular the profit a prendre issue.

There are various existing incentive schemes and assistance programmes already available in Queensland (and in other States) that could be used as models for Government assistance to landowners in order to further encourage investment in sustainable management of their forests. In the event that landowners are interested in investing in sustainable forest management but are constrained by a lack of funds to make the investment, then the PIPES scheme administered by the Queensland Rural Adjustment Authority allows for investment in forestry, although the timeframe for repayments is not ideally matched to forestry investments.

Attracting Third Party Investment

Many landowners do not have the time, management experience or the cash flow to invest in improving their forest and so would potentially welcome the opportunity to have a third party investor undertake this improvement work for them on a joint venture basis or by selling the investment outright. A third party investor may be a bank, specialist timber investor or a processor such as a sawmiller.

In order to attract third party investment from either the local processing industry or from investors such as Timber Investment Management Organisations (TIMOs), superannuation funds or investment managers, a number of criteria within the industry need to be met:

- Comprehensive data on the resource to quantify the investment over time

- An understanding that a return can be made over a 10 to 15 year period
- Whether the processing industry has scale, depth and stability
- An attractive future demand for both the log and end products
- A transparent market price for forest products e.g. reported in a similar fashion to other agricultural commodities
- Identification of political and environmental risks and their manageability
- Currency risk is important for international investors
- Will there be buyers for their investment at the end of their investment period?

This information will be crucial to the investor at the outset to ascertain whether the investment is a viable economic investment with a return to its investors that meets or exceeds its return thresholds.

Investors such as the specialist TIMOs which include companies such as the Hancock Timber Resource Group and GMO are very familiar with investment structures that legally split the land from the trees, so they will not necessarily be looking to acquire both. The Queensland legal system can accommodate separate ownership of the land and the trees through registered profit a prendre/ natural forest product agreements.

A profit a prendre does not give the holder exclusive possession of the land but it does give the holder exclusive rights to the land where the trees are located so only one profit in respect of the tree itself. It is possible to have separate profits (natural resource product agreements) for the tree itself and the carbon sequestered in the tree. It is also possible for the landowner and the resource owner to share the land with stock being grazed in the forest when appropriate.

There are many different ways of structuring the arrangements between the landowner and the investor, most of which will be familiar to the TIMO's from their experiences elsewhere in Australia (such as Hancock in Victoria and GMO in Tasmania) and overseas. Such arrangements may result in an outright purchase of the trees (including all future trees and future growth in the trees) together with rights of access to the land for harvest. Such a payment may be coupled with an annual licence fee or rental. Alternatively, the parties may negotiate a part payment upfront together with a further payment on harvest linked to the volume of wood harvested and the price paid by the market for the wood. There are many different variations to be negotiated between the parties and this will really depend on the circumstances of each party and the outcome they wish to achieve.

For the TIMOs, scale of the forest is important as it is unlikely that a TIMO will invest in a small scale forest unless they can easily add to its investments. For instance in North America, "The Forestland Group" [www.forestlandgroup.com] has investments in over 700 000 ha and is generally only interested in natural forest blocks of 800 ha or more. TIMO's also tend to invest by themselves rather than joint ventures although there are some exceptions.

However if the private natural forest industry in Queensland can meet the criteria outlined above then it is highly likely that this resource would be attractive to third party investors.

Recommendations

The process of developing this report and the outcomes of the two Workshops (Appendix 1 and 2) served to highlight key investment constraints and the options for increasing investment in private natural forests. The key recommendations are as follows (more detail can be found in section 7.0 of the report):

1. Raise the profile and awareness of the opportunity to invest in private natural forests among landowners, industry and government by the development of extension services, demonstration sites and a pilot project.

2. Foster access to and training for reliable silvicultural treatment contractors that understand how to optimise forest productivity (and grazing). This is currently a major difficulty, particularly for larger properties.

3. Improve the taxation treatment of private natural forests in particular the conflict between sustainable forest management and income and capital treatments.

4. Strengthen harvest security by addition of a category F to the PMAV and lobby for compensation if harvest rights are lost within this category.

5. Assist the development of supply security through cost efficient harvesting, possibly with a supply pooling arrangement, and the development of options contracts to assist with the forward purchase of timber by industry.

6. Develop a greater awareness of government support schemes and grants to assist with investment in and improvement of private natural forests.

7. Foster alliances with key conservation groups such as WWF with a view to certification.

8. Improving the resource information, harvest security, taxation treatment, industry stability, and developing transparent log and end product market information will increase the attractiveness of the private natural resource for third party investors.