

Submission to the Department of Climate Change and Energy Efficiency on the Carbon Farming Initiative

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Summary and recommendation

The natural and inevitable decline in the plantation MIS sector, with its inherent flaws, is in danger of reversal as MIS companies and middlemen making money from the schemes will use the CFI to resurrect it as an even more attractive tax minimising venture.

Although most plantation MIS companies have collapsed, some remain and tax minimising investors still subscribed \$74 million into plantation MIS in FY2010. The Australian Government retains the enabling legislation.

The details for CFI rules and integrity standards are not finalised, but it is virtually unimaginable (in the absence of substantial political engagement) that plantation MIS will not enter the CFI carbon credit market with plantation MIS companies becoming CFI project proponents, promoting and managing 'carbon sink forests' as another income stream.

Plantation MIS requires productive agricultural land to generate (at least on paper) the wood yields and therefore income to cover these high-cost tax minimisation products. The tax arrangements underpinning the schemes work as a subsidy distorting agricultural land and water use away from food production to plantations. The CFI is likely to intensify resource misallocation in Australian agriculture.

The CFI additionality test requires that there are reasonable grounds to believe that the project is unlikely to be financially viable or to occur without income from carbon credits. For plantation MIS, this provision raises important questions that require clarification.

- If plantation MIS are considered commercially unviable (as evidenced by the spate of collapses) does this mean plantation MIS could satisfy the CFI additionality standards?
- If so, does not this contradict the ATO judgement that plantation MIS are inherently commercial?
- Could a plantation MIS Responsible Entity, through the CFI, apply for carbon credits arguing that unforeseen market conditions now render the original project unviable but growing the plantations on would be viable with carbon credits?

It is recommended that:

The government prepare a consultation paper articulating MIS arrangements and CFI interactions to clarify the CFI's additionality and integrity standards for plantations.

1. Introduction

A long, convoluted and often incoherent policy process precedes the draft *Carbon Credits (Carbon Farming Initiative) Bill 2011*. The Carbon Farming Initiative (CFI) is likely to generate a new wave of agricultural land and water use distortions via a combination of government failure and market failure. In addition to rising resource use inefficiencies in Australia's agricultural sector, Australia's contribution to the global climate change challenge will be significantly less than we are capable of delivering.

Critical building blocks to support policy to engage the land use sector in the climate change challenge remain contested with unsettled conceptual and measurement tasks and inconsistencies in the treatment of different land uses and activities. This, combined with the vested interest behaviour of countries engaged in global climate change negotiations and the actions of rent seeking businesses and associated lobbyists attracted to potentially substantial new income sources, has generated a wall of complexity that makes coherent climate change policy for the land use sector probably beyond the current capacity of government. Policy makers should proceed with caution.

My aim in this submission is to communicate the potential for substantial distortions in the use of Australian agricultural land and water through the tree planting component of the CFI.

2. The Carbon Farming Initiative

The Initiative provides financial incentives for certain activities in the land use sector that remove or avoid emissions of green house gases (subject to not yet fully specified integrity standards). The sale of credits generated by eligible projects will be initially to the voluntary market in Australia and globally, and to overseas governments that have obligations under the Kyoto Protocol or companies with emissions obligations under national or regional emissions trading schemes. The actual volume of credits traded and their price will be determined by market demand and the CFI credit cost curve. In a compliance market, demand for credits will be dominated by the fossil fuel industry seeking to offset their carbon emissions, with the level of demand dependent on government emissions reduction targets. Without science-based and therefore significantly higher emission reduction targets than Australia currently subscribes, offsetting fossil fuel emissions via land based removals will stifle Australia's already weak contribution to the global climate change challenge. In a climate regime of increased variability, Australia's agricultural industry will be the loser, but compromised in its political engagement in climate change negotiations by those sectors benefiting from offsets income.

The CFI is deeply flawed. The Australian Government promoted the initiative as providing 'new economic opportunities for farmers' (Minister for Agriculture, Fisheries and Forestry & Minister for Climate Change and Energy, 2011), but this new – and in some sectors much needed – income source is dependent on continuing fossil fuel emissions. In the absence of Government establishing science-based emissions reduction targets, climate variability is set to amplify and erode food producing farm income across much of Australian agriculture.

Plantation wood growers are positioned best to take advantage of the CFI. The sector has 15 years managed investment scheme (MIS) experience (an investment vehicle that appears CFI ready with Responsible Entities becoming project proponents) and has been actively engaged

with Government over a similar period to facilitate wood into the biofuel market and carbon sink forests. The plantation sector is CFI ready, has fewer measurement difficulties than most other project types and is likely to dominate the supply of CFI credits (especially Kyoto compliant ones) when the market opens.

3. Plantation MIS

The Australian Government maintains the enabling legislation for plantation MIS arrangements: a sector saturated in corporate collapses (since 2006, Environinvest, Great Southern, Timbercorp, Forest Enterprises, Rewards Group, Willmott Forests). Economically, plantation MIS are fundamentally flawed (discussed below) with the corporate collapses predicted and commencing well before the GFC. Nevertheless, plantation MIS promoters remained active in 2010 with Macquarie Forestry offering tax minimisation products based on eucalypts for wood chips, Tropical Forestry Services (sandalwood), Elders Forestry (mixed species) and WA Blue Gum project (eucalypts for woodchips). Gunns withdrew its product. Despite the highly publicised collapses, tax minimising clients (often inappropriately termed ‘investors’) steered \$74 million into plantation MIS over FY2010 – 62% of all agricultural MIS (Australian Agribusiness Group, 2010). Macquarie Forestry is estimated to account for 70% of plantation MIS sales in FY2010.

Plantation MIS are engineered tax minimisation products that create market failures because wood market signals are largely blocked. Tax minimisation drives the money flow into plantations with clients – despite being classified as ‘carrying on a business’ – seemingly taking little if any serious independent wood market analysis. The Responsible Entity selling the tax minimising product has a reduced incentive to undertake a robust market analysis because the market risk is largely born by the client through high-cost up-front payments to the Responsible Entity (fully tax deductible) with the majority of the returns generated at project end from net harvest proceeds (whatever they might be) going to the tax minimising client.

These arrangements are made possible by an apparent anomaly in the Australian Taxation Office (ATO) treatment of plantation MIS. Tax minimisers putting money into plantation MIS are able to deduct their up-front payments against income earned elsewhere. This is only possible because they have received a dispensation from the ATO deeming their business activity to be commercially viable. In granting this dispensation, the ATO must have judged that plantation MIS are inherently commercial. Far from being an attractive investment proposition, plantation MIS are high cost with many tax minimising clients recouping an estimated 25 per cent of their up-front payments (Ajani 2010). Contrary to the ATO view or analysis, such a return is not evidence of a commercially viable business.

The arrangements enabling plantation MIS is a tax-based subsidy to forestry estimated at between \$0.9-1.2 billion per annum over the five years ending 2008 (Ajani 2010). The assistance exceeds substantially the assistance (including drought related payments) to food growers and works to distort agricultural land and water use. If the CFI is combined with plantation MIS tax engineered products, resource use distortions in the agricultural sector can be expected to escalate.

4. Macquarie Forestry

Macquarie Forestry dominated (estimated 70%) plantation MIS sales in 2010 and as such its Product Disclosure Statement is appropriate for illustrating the criticisms raised in section 3. The key variables and financial arrangements for Macquarie Forestry's 2010 product are presented in Table 1.

Table 1. The Macquarie Forestry Investment 2010

Item	Quantification	Benefit to Macquarie	Benefit to tax minimising client
Year 1: up-front payment.	\$10 208 (inc GST)	High up-front payment generates investment income from surplus funds. Macquarie receives fees and interest on loans to clients.	Up-front payment is fully tax deductible in tax year 1. Provision of loan funds from Macquarie Bank up to 100% of payment with interest cost fully tax deductible.
Year: 1 planting land arrangements.	Clients have the option to purchase units in the Macquarie Timber Land Trust 2010 (a MIS) at \$1 500/ha. Macquarie Bank finances outstanding land cost.	Macquarie receives fees and interest on loans to clients.	Clients can finance the payment via a Macquarie Bank loan. Payments and interest fully tax deductible.
Assumed plantation productivity (MAI).	22.5 m ³ /ha over 10 years.		
FOB woodchip price per bone dry tonne (bdt).	\$207.40 for 2009. No expected final price data presented but text and associated graph (Macquarie Group p. 20) suggests real prices may continue to decline at historical rate of around 1% per annum.		
Assumed woodchip sales revenue/ha.	No estimate reported.		
Plantation establishment, management and maintenance over the rotation undertaken by contracted plantation managers (Midway & McEwans).	No cost data reported.	Contract paid by Macquarie from revenue received in year 1. Surplus available for ongoing investment and income generation.	
At rotation end, harvesting, haulage, chipping and loading contracted to Midway.	No cost data reported.	Contract paid by Macquarie from revenue received in year 1. Surplus available for ongoing investment and income generation.	

Net harvest revenue	No estimated net harvest revenue data presented.	Macquarie Bank minimises its exposure to risk of unfavourable market and low plantation productivity. High up-front payment enables Macquarie's low 11.45% share of net harvest proceeds (comprising maintenance & management fees and deferred rent as detailed in next two items).	Receives 88.55% of net harvest revenue as taxable income.
Maintenance and management fees (5.5% (inc GST) of net harvest proceeds).		Fees paid to Macquarie.	Fees are tax deductible.
Deferred rent (4.95% (inc GST) of net harvest proceeds).		Fees paid to Macquarie with equal amount of deferred rent paid to the Land Trust Responsible Entity.	Payment is tax deductible.

Source: Macquarie Group, 2010.

As investments, plantation MIS are high cost products (for evidence, see Ajani 2010). The Parliamentary Joint Committee on Corporations and Financial Services (2009, pp. 45-6) commented on agribusiness MIS:

'... , 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. While investor focus is on minimising tax, rather than investing in the most profitable venture, this directs capital away from profitable uses and disadvantages traditional farming enterprises by increasing natural resource costs and encouraging oversupply.'

High-cost up-front products provide increased opportunities for middlemen providing them guaranteed income hooks via fees and contracts. Ultimately, the Australian public, farming communities and tax minimising clients pick up the bill. Wood processors are also damaged with their wood supply shifted to a high-cost and high-risk wood growing regime disconnected from market signals.

Nearly every aspect contributing to the client return is heavily inflated in the PDS. For example, plantation growth rates are assumed to be 22.5 m³/ha however, in late 2008 there was increasing evidence, including some published information, that much of the earlier plantings are not achieving anything close to these growth rates. Indeed, pre-inventory data collected by one firm suggests that the average MAI at age 10 is more like 14.5 m³/ha/yr (a 40% reduction on earlier expectations).

Similarly, in respect of stumpage rates: the price paid to 'growers' for standing trees before harvest. (Plantation MIS Responsible Entities call tax minimising clients 'growers'.) The return they receive at harvest time is effectively for stumpage and so the market reality of

stumpage price statements in Product Disclosure Statements is crucial for sound investment decision making.

In the expert report accompanying Macquarie Forestry's product disclosure statement, Poyry Management Consulting calculated a chiplog stumpage price of \$49.65/m³ and a harvest residual stumpage price of \$29.57/m³ (Macquarie Group 2010, appendix A). These assumptions, while helping to make the financial product look better on paper, bear no relation to actual returns being achieved by growers nor prices being paid by buyers of plantation wood in Australia at present.

For example, Gunns' pulpmill would be rendered commercially unviable even with the 'cheaper' harvest residual stumpage cost of \$29.57/m³. The chiplog stumpage price of \$49.65/m³ is around two to three times higher than softwood plantation chiplog stumpages for wood also supplying paper and wood based panels producers.¹ It is also many times higher – even allowing for quality differences – than competing native forest wood (We should acknowledge that most native forest wood is sold by state forest agencies that at best barely break even.)

5. Market analysis

The wood market analysis presented in plantation MIS product disclosure statements has been poor (see Ajani 2009 Appendix A for a detailed examination). The normal commercial incentive to undertake rigorous market analysis is dampened under plantation MIS arrangements because Responsible Entities receive their major income flow up-front. Indeed, Responsible Entities have a short-term commercial interest in biasing upwards their wood market assessments to maximise up-front funds input.

Macquarie Forestry's 2010 product disclosure statement (Macquarie Group 2010) presents six pages of wood market analysis that contain words of caution about predicting market conditions on nearly every page. It also notes that the trend decline in real (inflation adjusted) native forest hardwood chip prices is a relevant guide for 2010 clients. However, substantial information, that I argue is crucial for sound (hardwood chip) plantation investment decision making, is not presented. This information concerns three areas:

- a. Macquarie Forestry states that the level of paper consumption is dependent on GDP and population. It does not refer to increasing wood saving practices, notably paper recycling and investing in higher pulp yielding pulp mills, both of which dampen the demand for wood to make paper. Macquarie Forestry's clients are selling into the wood (not the paper) market and resource saving technology enables paper consumption to continue growing at significantly higher rates than that for wood. Data limitations abound, but FAO data reveal that pulp made from wood used in global paper production grew by 1% per annum since 1990, meaning that growth in actual wood input is likely to be less than 1% per annum because of increasing pulping efficiencies (Ajani 2011).

¹ For comprehensive Australian stumpage prices see Private Forests Tasmania (2004). Prices are for 2002 but unlikely to have changed significantly in real terms over the past eight years.

- b. Macquarie Forestry's arguably loosely worded statement that:

'Harvest volumes from plantations are expected to progressively replace much of the native forest-sourced fibre currently used by the Japanese market. It is anticipated that the Australian woodchip producers, such as investors in the Macquarie Forestry Investment 2010 remain in a position to provide a replacement for the native forest sourced wood previously used to satisfy demand for wood and paper products.'

could reasonably be interpreted to mean that the Japanese woodchip market for 2010 clients (i.e. in 2020-2021) will still be open to native forest substitution. The evidence is to the contrary. Over FY2009, Australia exported an estimated 3.7 million tonnes of hardwood plantation chips and an estimated 4.4 million tonnes of native forest hardwood chips (using ABARE 2010 with data amended for wood losses and unit conversions). Most (81%) was exported to Japan. Australia's hardwood plantation chiplog supply over 2010-14 is projected at 13.8 million m³ per annum (1 m³ is roughly equivalent to one green tonne) (National Plantation Inventory 2007, p. 8). The Japanese paper industry is already well advanced in its shift to the more attractive plantation resource, a structural change that is expected to be finished well before Macquarie Forestry's 2010 wood comes onto the market.

- c. Macquarie Forestry highlights China as an emerging market opportunity without mention of China's substantial work to avoid pressuring global wood resources. China has so far avoided driving up wood prices through resource saving technology (notably paper recycling and investment in high yielding pulp mills), plantation establishment for paper production and pre-emptive price negotiations. Despite China's average 9% per annum growth in paper consumption over the 27 years ending 2007, growth in global wood consumption has remained constrained and export prices for wood have not escalated (Ajani 2011).

6. MIS and the CFI

Although most plantation MIS companies have collapsed, some remain and tax minimising investors still subscribed \$74 million into plantation MIS in FY2010. The Australian Government retains the enabling legislation. This is the context for appraising the CFI. The details for the rules, arrangements and integrity standards are not finalised, but it is virtually unimaginable that plantation MIS will not be incorporated, in the absence of substantial political engagement to oppose such an outcome. Possible arrangements include:

- a. Plantation MIS Responsible Entities becoming CFI project proponents, promoting and managing 'carbon sink forests' as another income stream. Plantation MIS requires productive agricultural land to generate (at least on paper) the wood yields and therefore income to cover these high-cost tax minimisation products (for example Macquarie Forestry 2010 p. 22 states its 2010 planting will be undertaken on dairy farms, grazing properties and existing commercial plantation land). The tax arrangements underpinning the schemes work as a subsidy distorting agricultural land and water use away from food production to plantations. The CFI is likely to intensify resource misallocation in Australian agriculture.

- b. Broadening plantation MIS to include biofuels and other biomass feedstocks. This would link the already economically flawed plantation MIS arrangements with the arrangements aimed at meeting government renewable energy targets (Australian and overseas). Policy implementation in Australia is via traded renewable energy certificates (RECs) which generate an income stream in addition to the actual energy product. Governments (Australian and overseas) have deemed wood-based energy renewable and therefore eligible for RECs. This is heavily contested in the case of native forest wood and questioned in the case of plantation wood. In addition, for both wood sources, Australia ignores the CO₂ emissions from burning wood for power production, arguing that regrowing 'forests' will (eventually) remove the emissions. Such a ruling enables wood-based energy products to be carbon cost free in any carbon pricing arrangement, although emissions occur and take decades for removal.

CFI projects will be required to meet additionality standards: the test being that there are reasonable grounds to believe that the project is unlikely to be financially viable or to occur without carbon credits income. This provision raises important questions that require clarification:

- If plantation MIS are considered commercially unviable (as evidenced by the spate of collapses) does this mean plantation MIS could satisfy the CFI additionality standards?
- If so, does not this contradict the ATO judgement that plantation MIS are inherently commercial?
- Could a plantation MIS Responsible Entity, through the CFI, apply for carbon credits arguing that unforeseen market conditions now render the original project unviable but growing the plantations on would be viable with carbon credits?

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