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Overseas Investment Act Reforms
The Treasury
PO Box 3724
Wellington 6140
New Zealand

By email: overseasinvestment@treasury.govt.nz

Overseas Investments in Forestry

This submission is made by the Guardians of New Zealand Superannuation (**Guardians, we, our**) as manager and administrator of the New Zealand Superannuation Fund (**Fund**) in response to Treasury's consultation regarding a proposal to extend the scope of the Overseas Investment Act 2005 (the **Act**) to include forestry cutting rights. We welcome the early engagement and opportunity to submit on this proposal.

The Fund

The Fund was established by the New Zealand Government in 2001 to help pre-fund the future cost of universal superannuation. As at 31 December 2017 the Fund was worth \$38 billion. A long-term, growth-oriented investor, the Fund has a diversified investment portfolio that is invested globally and locally across a wide range of asset classes.

The Guardians has operational independence from the Government and is required by legislation to manage the Fund on a prudent, commercial basis, in a manner consistent with:

- Best practice portfolio management
- Maximising return without undue risk to the Fund as a whole; and
- Avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

The Fund has returned 10.5% p.a. since investing began in 2003.

Our involvement in New Zealand forestry

The Fund's single largest investment is Kaingaroa Timberlands in the central North Island. The Fund's original stake in the forest was purchased from the Harvard Management Company, the endowment fund of Harvard University, in 2006. We have since increased the Fund's investment in Kaingaroa to 42%.

The Fund's investment partners in Kaingaroa include Canadian PSP Investments (55.5%) and Kakano Investments (2.5%), a collective of iwi groups which also part-owns the underlying land.

Covering around 178,000 hectares of planted forest, Kaingaroa is widely recognised as one of the world's premier softwood plantations and is a major supplier of logs to the domestic and export markets. The forest is managed by Timberlands Ltd, which is wholly owned by the Kaingaroa partnership, to Forest Stewardship Council certification standard.

Less than 1% of Kaingaroa comprises freehold title – the balance is forestry cutting rights (forestry rights and Crown forestry licences).

Because of its relatively low levels of correlation to other investments, timber is a useful way of diversifying the Fund's portfolio. Furthermore, as a long-term, relatively illiquid asset, timber is not suitable for all investors and we expect to be compensated for the illiquidity through a return premium over time.

As at 30 June 2016, the most recent publicly disclosed figure, the Fund's investment in Kaingaroa Timberlands was valued at approximately \$1.5 billion. It comprises approximately 4% of the overall Fund.

We do not support including cutting rights in the Act

Deterring overseas investment harms the forestry sector

The forestry sector is capital intensive, and, due to New Zealand's small domestic capital markets, it is critically dependent on overseas investment.

Planting and managing forests requires significant capital investment and, because forests take decades to mature for harvesting, investments in forestry are ideally suited to long-term sovereign or institutional investors with patient capital.

We believe that there is a material risk that creating additional barriers to overseas investment in forestry will undermine the future success of the New Zealand plantation forest industry. The potential consequences include:

- a decline in plantation forestry and the downstream processing industry, with corresponding reductions in export receipts and jobs (with a particular impact in the regions);
- less productive utilisation of land, as a consequence of changes in land use, or forgone opportunities to plant forests;
- increasing the challenge in meeting New Zealand's climate change obligations through reduced prospects of attracting the further capital needed to develop new forests or re-plant existing ones;
- creating additional impediments to the Government's commitment to plant one billion trees; and
- an impact on iwi, many of whom are significant holders of land subject to some form of cutting right.

Conversely, we would expect that regulatory changes that encourage additional foreign capital to be deployed in forestry would have a positive impact in these areas. We have made some suggestions on this below.

By way of context, cutting rights account for a very significant proportion of New Zealand's total forest estate. The precise figure is hard to determine, but we estimate it is in the order of 30%. We also believe that cutting rights will continue to be an important mechanism in attracting the further capital required to expand the estate.

Extending the Act to include cutting rights would mean that investors would be required to meet the public benefit test in section 16 of the Act. Investment to support planting of a new forest, or re-planting of an existing forest, would likely meet this test in many circumstances.

However, pursuant to the Act's 'counterfactual' test for public benefits, a subsequent transfer of cutting rights to an overseas person would require that person to show that the transfer would result in an additional incremental benefit to New Zealand as a result of the transfer. In many cases (particularly in well managed, mid-rotation forests) this is an insurmountable hurdle, as there is little that subsequent acquirers can commit to do in order to add additional benefits.

So, extending the Act to cutting rights would in our view impair the liquidity (and therefore value) of existing forests subject to cutting rights.

The constraint on liquidity would also deter potential investors (both domestic and overseas) from investing in planting or re-planting forest assets. This is because even long term investors need the certainty of knowing that they can exit their investment at full value – potentially prior to the plantation maturing. If this option is rendered unavailable/uncertain, then investors will be less attracted to New Zealand plantation forestry as an investment, as compared to other jurisdictions where there is greater certainty around liquidity options.

Including cutting rights in the Act will adversely affect the value of forestry assets held by New Zealand investors

While the valuation impact on plantation forests is difficult to predict with any certainty, it could be significant, taking into account the total amounts invested across the New Zealand forest estate and the sector's dependence on foreign capital.

To illustrate, the valuation of the Fund's approximately \$1.5b stake in Kaingaroa assumes that the Fund can achieve a fair value price for the asset. Creating an impediment to our ability to sell the asset by restricting the pool of potential buyers would have a material impact on the value of the investment. To give a sense of magnitude, a discount of around 10% would equate to an impact of approximately \$150 million dollars.

We also note that iwi are significant holders of forestry land and related assets, and that the characteristics of much of this land mean that forestry is its optimal use. We would anticipate that a legislative restriction on overseas investment in cutting rights could adversely affect the cutting right rental income paid to iwi and potentially the value of the underlying land.

In our experience, iwi and other forest land owners often do not have readily available capital to deploy to planting/maintaining forests to maturity at scale, so work in partnership with other capital providers to obtain a return from their land by granting cutting rights.

We would also encourage Treasury to consider the possible consequences that the proposed change could have to replanting by offshore investors and the imposition of considerable liabilities associated with deforestation under the Emissions Trading Scheme that typically sit with the land owner. It is our view that some land owners will be left in a situation where they cannot issue a forestry right enabling a forest investor to replant, and do not have the capital resource to replant themselves.

Cutting rights are not interests in land that should be subject to the Act

Cutting rights are a form of *profits à prendre* (i.e. a right to take – in this case, trees - from the land) and therefore expressly exempted from the Act.¹ We consider the exclusion is good policy.

As has been recognised by officials and Parliament in earlier iterations of the Act, in substance cutting rights do not confer an interest in land, but rather in the trees. Unlike the interests in land regulated by the Act, cutting rights typically do not endure beyond the harvesting of the trees and, unlike a lease, they

¹ Section 3 Forestry Rights Registration Act 1983 and section 6(1) Overseas Investment Act 2005.

do not confer exclusive possession of the underlying land.² It is therefore unnecessary, we believe, to subject cutting rights to the same type of constraints that apply to interests in land.

Extending the Act to cutting rights would create a conceptual inconsistency in the legislation, in that acquisitions of cutting rights will require consent, but other forms of *profit à prendre* and other comparable rights to enter onto land for defined purposes will not.

While many of the large forest estates include freehold and/or leasehold interests (so are already subject to “sensitive land” clearance processes), the proposed amendment still adversely affects such estates in that there is a significant loss of flexibility for foreign investors. For example, investors may seek to grow the forest estate by entering into cutting rights with adjoining land owners for either existing or new plantings, which could require consent under the proposed amendment.

Finally, it is not entirely clear to us what the underlying policy rationale is for extending the Act to cutting rights. A cutting right is a narrow form of interest, and as outlined above we believe the proposal will discourage quality foreign investment in New Zealand forestry assets, leading to reduced new planting and re-planting and therefore ultimately logs available for domestic processing and carbon sequestration.

Assessment of mitigation options proposed by Treasury

We support the Government’s focus on enhancing the plantation forestry sector and downstream processing industry without interfering with the ability of plantation owners to receive full market value for their product.

Treasury’s consultation paper proposes several options aimed at achieving a more streamlined and efficient overseas investment regime for forestry interests, on the assumption that cutting rights are brought within the scope of the Act.

While we do not agree that forestry cutting rights should be included in the Act, we support initiatives to streamline the overseas investment regime for forestry generally (reducing its cost, complexity and uncertainty), given the need for foreign capital outlined above.

We set out our observations on those options below, and encourage Treasury to pursue them.

Simplified test for assessing benefits of forestry investment

As noted above, we consider that the current counterfactual test that applies under section 16 of the Act is not well suited to forestry. As explained above, forestry is effectively a passive form of investment, and in the context of well-managed, mid rotation or mature forests there is often little that foreign investors can point to that would result in an incremental benefit in terms of the criteria set out in section 17 of the Act.

We suggest that any public interest test for forestry investments should therefore:

- recognise the contribution that overseas investment makes to the expansion of the forestry sector, re-planting of existing forests, and the realisation of the value of New Zealand forestry assets in international markets; and
- permit consent in circumstances where the proposed overseas buyer is at least able to preserve the public benefit accruing from the initial/previous investment in the trees.

² Under section 2A(4) Forestry Rights Registration Act 1983, “No right created under this section [which deals with the creation of forestry rights] is capable of conferring a right to exclusive possession of the land”. In this sense, cutting rights are more similar to other contractual rights (such as a non-exclusive licence to enter premises) which do not require consent under the Act. A similar position applies for Crown forestry licences under section 16 of the Crown Forest Assets Act 1989.

Exception for screening of transactions between two overseas persons

An exception for screening of transactions between two overseas persons would not allow New Zealand owners of forests to sell to overseas buyers. This would put New Zealand investors in forestry assets in a worse position than overseas owners. We believe it is preferable to permit foreign investment where the purchaser at least maintains the current benefits accruing under the existing owner (regardless of whether the owner is an overseas person).

Exception for transactions less than \$100 million

Were Government to proceed with the proposed expansion of the Act, rather than an exemption below a financial threshold, we would recommend a threshold based on the area of land to which the cutting rights apply. Generally speaking, forests under 1,000 hectares are not considered 'large.' We would therefore propose:

- an exception for acquisitions of cutting rights relating to areas of land under 1,000 hectares;
- exceptions for transactions pursuant to which crown forestry licences expire and cutting rights are granted in their place; and
- a process for granting a standing consent to permit overseas buyers who meet the investor test in the Act to engage in a programme of acquisitions up to a threshold; for example, 5000 hectares over a five year period.

This standing consent process would give foreign investors greater certainty that they can deploy a meaningful level of capital, and that there is liquidity in the forestry sector. It is similar to the "exemption certificate" regime administered by FIRB in Australia, and can be subject to appropriate conditions to ensure that New Zealand's interest are protected.

We would be happy to discuss any aspects of this submission with you. Please note that we will make the submission available on our website.



Neil Woods
Portfolio Manager
Guardians of New Zealand Superannuation

Chairman
Kaingaroa Timberlands