
# Forest Partnership Report

### October 2018

## Hello,

Its been a busy few months since our AGM correspondence, - we've had the new government settle in and begin to bring forward some of their policies and ideology. Minister Jones has a large fund to invest in the rural economy, and the Government (read New Zealand First) are trying to stimulate the Billion Trees programme – more on this later. We've had Trump placing tariffs on China, and this is ruffling a few feathers for our log exporters. Our forest managers FMNZ have started another 5 crews in our partnership forests. We have secured another 2,000ha of greenfields (farmland) to be established into forestry for foreign owners, and as well, intend to register a PDS (Product Disclosure Document) with the Financial Market Authority, to promote and sell forestry investment in a partnership style format to retail investors – similar to a partnership prospectus.

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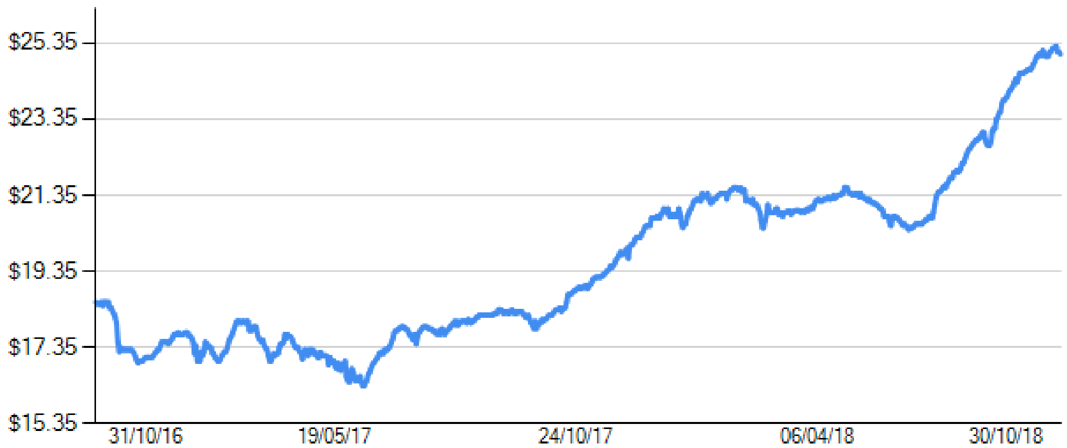
## Carbon Update

The carbon market (price of a New Zealand carbon credit) for NZU's was relatively steady at around $21 for the first part of the year. In the last couple of months the price has lifted to sit around the capped market price of $25 (in some instances it has been trading above the cap). We think that there will be continued upwards pressure in the price of Carbon moving forwards.




New Zealand Carbon Price

In August of this year Te Uru Rakau (Forestry New Zealand) and Ministry for the Environment proposed significant changes to the Emissions Trading Scheme that will be of major economic benefit to people undertaking new forest planting in New Zealand.

One of the factors which will have a major effect on forest new plantings and investment is the government proposal to move to averaging for NZU's (carbon credits). Averaging would allow a newly planted forest to progressively (as the carbon is sequestered) sell about 450 to 500 tonne of carbon per ha with a present value of around $12,500 per ha. This means at the age of about 17 to 18 years most if not all costs including land purchase and the establishment and management of the forest would have been refunded from selling NZU's. Effectively the averaging proposal means that a forest investor planting new forest on farm land can enter the forest industry for very low or zero cost. From a business perspective it is obvious there will be a significant uptake by forest investors.

**A new wooden building fitout inside a high-rise engineered timber building.**

The only obligation with this averaging proposal is that the forest must be replanted after harvest to retain the benefits of the NZU sale.

Te Uru Rakau propose that the averaging proposal will begin in 2020, but an owner may be able to opt in during 2019.

There are logical reasons for the newly proposed averaging rules

- Forests are an important part of the emissions reduction programme needed for New Zealand to meet its international commitments on CO2 emissions over the next 30 years.
- Averaging of CO2 in forests is logical because it correctly reflects the average carbon tonnage held in a range of post 1989 forests
- The averaging proposal will be much easier for government to administer than the safe carbon policy we are presently operating.
- The averaging proposals will make it much easier for government to achieve its billion trees planting programme i.e. increased new plantings are now government policy.

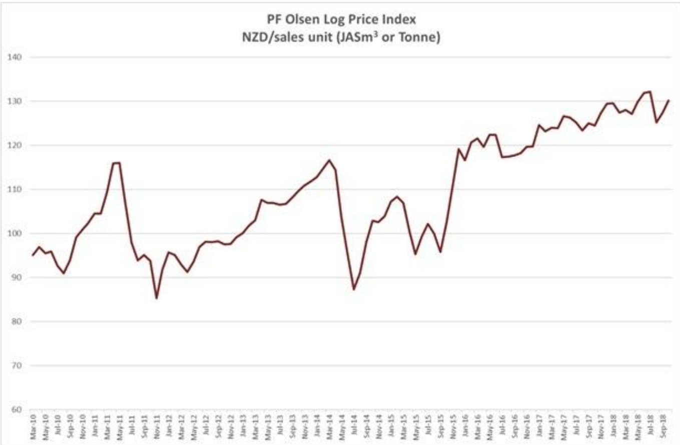
We have researched the probability of this averaging proposal being confirmed by Government. Senior officials have told us that the averaging proposal is highly likely to happen.

Read more about the proposals here https://www.mpi.govt.nz/news-and-resources/consultations/a-better-ets-for-forestry

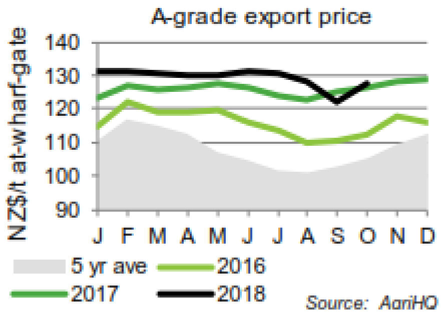
## Log Markets

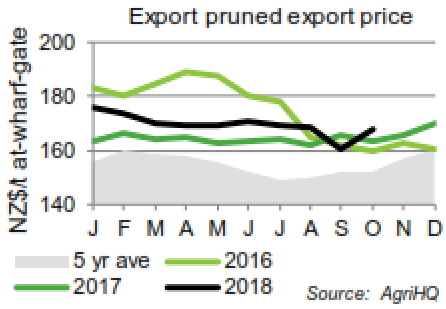
With 8 of our forests now harvesting and 9 more to start in 2019 it's pleasing to see the continued upward trend of log prices.

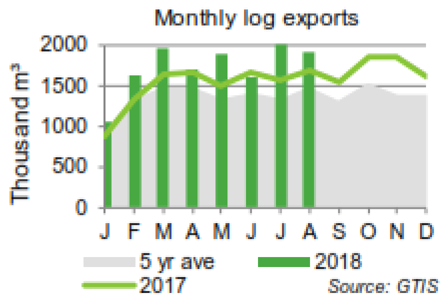
The PF Olsen Log Price index is at $130 per tonne for October. This is $4 above the two year average, $6 above the three year average and $15 higher than the five year average.




This Index is based on prices weighted in proportions that represent a broad average of log grades produced from a typical pruned forest with an approximate mix of 40% domestic and 60% export supply.





The October report from Summit Forests sums up the export market well:

*As it is now the busy season in China & there is a limited supply of North American Logs, port inventory has begun to decrease, and the domestic price of logs has begun to increase. The demand for pruned logs remains limited as the US trade war continues to affect wooden furniture exports.*

*Currently there is a 10% tariff on wood products exported to the US from China. This came into effect on the 24th of September. At present this increase can be absorbed between the buyer & seller. However, this tariff might lift to 25% in January 2019, having a major impact on profitability for those manufacturers.*

*Overall the demand in China for radiata pine is still good, particularly for construction.*

*AWG (At Wharf Gate) Forecast*
*We anticipate CFR (Cost & Freight) levels to increase slowly towards the end of the year. Watch closely the balance between forecast moves downwards in FX, creeping freight rates & small step-ups in CFR. The result is likely to be strengthening AWG prices.*

## Insurance

The insurance cover has been renewed for the current tree crop. Once again, the per unit rate has not changed however the total sum insured has increased, so we are seeing an increase in our premiums. We have kept firefighting cover because the new FENZ levy still has some uncertainty around it. As more of our forests begin harvesting, we have added a small amount of infrastructure cover to the policy. If an event in our forest caused damage to a culvert or harvest roading infrastructure, this would now be covered.

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## National Environmental Standards

The National Environmental Standards for Plantation Forestry (NES-PF) came into force on 1 May.

The NES-PF is a set of nationally applied rules and conditions for plantation forestry that was developed to better protect the environment while also increasing operational certainty for foresters. The NES-PF was designed to provide rule consistency for forestry across the county.

The Tolaga Bay floods in June brought with them large amounts of logging slash from recently harvested forests in the hills above. Mindful of this, our forest managers (FMNZ) will review their harvest plans for harvesting on steep slope forests. They have amended the harvest plan at one of our harvesting forests to address environmental issues and mitigate, as best they can, any such movement of slash and soil occurring. They have decided to spread the harvest for that forest over a longer term to avoid harvesting some of the steep slopes near the river in the winter months.

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## 2019 Forest Visits and Meetings

Please note the dates for the 2019 forest visits and meetings are available on our website.

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## Power Corridors

In my end of year partnership report I discussed that the Unison lines company are seeking to recover the cost of repairing damage to their lines from trees that blew over in a wind event. Our public liability policy covers these events. Our trees are planted outside of the legal easement required for power corridors and we have repeatedly said we will remove any trees they would like to identify outside of this corridor provided we are compensated. Unison do not want to settle the case and we are proceeding to trial in May 2019. This will be a significant case and the Forest Owners association are supporting us with the trial as any decisions made here may set a precedent for the forestry sector. In some of our forests it could result in the loss of significant areas. On behalf of the partnerships we have engaged the services of a lawyer with significant experience in this area to ensure the best possible outcome in the trial. (Note – the cost of the trial is being met by the insurance company, we have engaged independent legal services to oversee some aspects)

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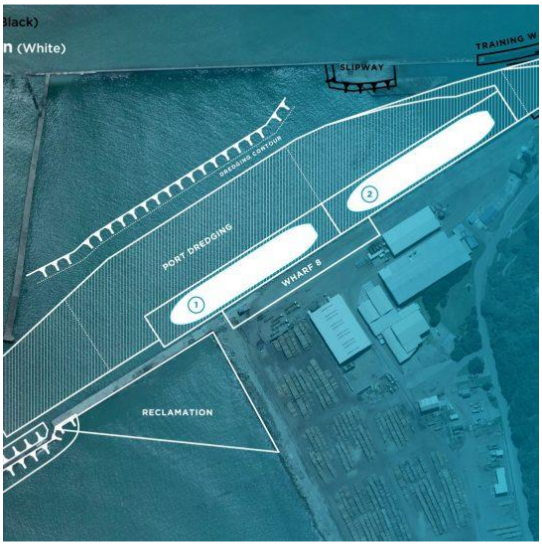
## Gisborne and Napier Ports




One of the significant projects for the regions that Minister Jones is funding from the regional growth fund is the Twin berthing (two ships) of logging ships in the Gisborne port. This involves an extension of the current wharf to facilitate the loading of two ships at the same time which will increase capacity from approximately 3millon tonnes to 5 million tonnes on completion. The development is welcomed by the forestry sector and the region who benefit significantly from the upgrade. You can find out more at [www.twinberth.nz](http://www.twinberth.nz)

Napier Port on the other hand, as a multi-use port, needs to keep developing and innovating to keep up with the supply of logs.  Twice now we have seen increased freight costs being incurred by our forests due to delays with scaling and unloading at the port. Every time a cruise ship visits the Hawkes Bay, logging ships are required to stop loading logs and leave the port for the duration of the cruise ships stay before returning to the dock to continue loading – as you can imagine this is highly inefficient. Although it is the exporters job to liaise with the port, I am taking an active role on behalf of our forests, as any delays ultimately cost us as forest owners.

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## Log Scaling

As with the port, we are seeing hold ups with the scaling sheds measuring our logs before they are delivered. As some of our harvesting forests know, this has directly resulted in increased transport costs. Last month I was in Napier when there were 25 logging trucks waiting on the road to be scaled. We are developing a site in Napier with Weigh Solutions and are in discussion with the log scaler to implement a system that will give priority to our logs.

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## Tax on Harvest Income

We're frequently surprised at the lack of understanding around tax on your harvest income. In a few instances we have heard of investors paying too much tax by not spreading income or reviewing the ownership structure of their partnership interests. We strongly recommend that you take specific forest accounting advice.

Jeff Whitlock, the forest Partnerships Accountant, is an expert in forestry accounting and tax filing and acts for many of our clients.  Jeff can be contacted at (06) 346 7070

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## Secondary Market

There has been very little activity this year with Partnership Interests generally being taken up by partners in the pre-emptive rights phase of a sale. This has seen very few offerings come onto the secondary market outside the individual partnership. The most common reason for selling seems to be for those who want an injection of cash for retirement or helping children into a home. We are bringing a new property to market with early income from the sale of Carbon – see below. We do have shares for sale in the dairy farms in Southland, please contact the office to find out more.

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## New Investment Opportunity

As discussed above we are working hard to bring a new Greenfields Forest Partnership to market. The Government is committed to getting new plantings underway to meet our emissions targets and is incentivising new greenfields planting. The 374 hectare property is located just 34km from Gisborne Port and neighbours our Chatswood and Heywood Forest –planted in 2000 and both exhibiting excellent growth.

Karaka Station with Chatswood and Heywood in the background.

The current Emissions Trading Scheme is under review, proposing more 'liability free' units are available to a forest owner. These units when sold can cover most of the cost of establishing and managing the forest through to harvest. Current projections for private forest investments (we are already planting an additional 2,000ha next winter) show most investor money returned by year 16, and IRRs of above 6.5%. The forests are still grown to harvest logs, with the bonus of early income from carbon.

Under the Financial Markets Conduct Act, there are new disclosure requirements, and a PDS (Product Disclosure Statement) which replaces an older style 'prospectus' governs how financial products are created, promoted and sold. We are working the documentation.

To register your interest and receive priority information please call or email Richard or Grant.

Regards

Roger Dickie

Will Dickie

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# TOTARA VALLEY

## Forest Partnership

Forest Managers Report October 2018

### Climate Change and Plantation Forestry

A recent paper produced by Scion Research in association with Manaaki Whenua Landcare Research has looked at the likely effects of climate change on plantation forestry in New Zealand.

The major finding is that the effects of increasing levels of carbon dioxide in the atmosphere will promote increased growth rates of trees and carbon sequestration. This potentially could increase the productivity of radiata pine 10% by 2040 and 20% by 2090. Trees will be taller and slimmer however, will also be more exposed to risk from wind and fire.

The greatest threat to our forest estate is from wind damage and the risk can be reduced by modifying forest management practices to include timely thinning and earlier harvest. Genetic improvement of treestocks and changing silvicultural practices should also help support earlier harvest.

It is also likely that fire risk days are likely to increase – the average fire season will increase by around 70% by 2040 and 80% by 2090. The most fire prone areas will remain as Gisborne, Marlborough and Canterbury, with increasing risk areas being identified as Wellington and coastal Otago.

### A Forest Policy for New Zealand

The NZFOA identified the need in 2013 to develop a forest policy for New Zealand. This was in response to acknowledgement that forest ownership in New Zealand had changed significantly from a single government department formerly owning around 50% of the forestry asset, to including overseas owners who may have little commitment to this country or the health of the wider domestic forestry sector.

The policy would be a negotiated agreement among stakeholders and adopted by government to create a common vision for all forests in New Zealand and to identify the actions required to achieve the vision.

A draft policy has now been completed and a full copy of the document can be found at: https://www.nzif.org.nz/assets/Uploads/New-Zealand-Forest-Policy-28-June-18.pdf

It is good to see the back of winter and we look forward to the summer where hopefully our forests can dry out and we can catch up with our scheduled work such as tracking and weed and pest control. The past months have again seen a continuation of unpredictable weather patterns. We are getting more rainfall in shorter bursts and dealing with the associated repercussions.

The Tolaga Bay deluge in early June is a well publicised example of these weather events. It was a very localised event where as much as 60mms of rain an hour fell over the weekend in the worst affected areas. The ensuing floods mobilised harvest debris which inundated downstream residents, farmers, landowners and beaches with tonnes of debris.

Flood debris at Tolaga, June 2018

The forest companies in the area have put considerable resource into clearing up as much of the forest debris as possible however, the event has signalled to the industry the need to improve forest engineering and harvest management ensuring the impacts of such events are minimised. There is little we can do to control the weather but forest management practices can be changed to help de-risk high intensity rain events.

The NES-PF (National Environmental Standards for Plantation Forestry) came into force on 1st May, 2018 and the Tolaga event certainly justified the introduction of the NES. The new standards mean that all local authorities will need to control plantation forestry activities in a more consistent manner and provides a “licence to operate” for the forestry sector by allowing most day to day activities to occur as permitted activities, albeit subject to compliance with quite strict permitted activity conditions.

Land is now classified into four categories of erosion susceptibility depending on the erosion risk, green, yellow, orange and red. Forest activities are then broken down to seven subparts, afforestation, pruning and thinning to waste, earthworks, harvesting, forestry quarrying, river crossings and mechanical land preparation. The control on plantation forestry activities increases as the erosion risk increases. Forestry activities may be permitted, controlled or restricted discretionary depending upon the forestry activity, land category and slope.

While the forest industry and councils are getting to grips with the changes brought about by the NES, we can already see some of the benefits which will lead to all foresters making better land use choices which will help mitigate environmental effects.

## Forest Health

The health of Totara Valley Forest is in excellent condition overall.

RNC is a continuing presence in the forest however, it is not widespread nor as prevalent as it was last winter.

## Fences/Forest Security

Security is good as our pest control operator lives nearby and regularly visits the forest to check his mustelid traps and keeps an eye out for any unauthorised access.

## Carbon Sales

No NZUs have been sold over the past six months.

The NZU holding as at the end of August was 78,094 units. 17,126 of these units are liability free, 240 units are pre 1990 and 60,728 units which do carry liability. This is an increase of 20,421 units which have been allocated following lodgement of the mandatory emissions return earlier in the year.

Raupunga washout on Napier/Wairoa line

## Napier/Wairoa Rail

The commitment of $5 million from the Regional Development/Provincial Growth Fund to the Napier/Wairoa rail has been a positive boost towards getting the line reopened. We have been seeing good progress made with replacement of sleepers, vegetation being cut back and drains and culverts restored to operational condition.

The plans to start railing logs from early December received a bit of a setback following a period of very heavy rain in early September. This caused a large washout north of Raupunga that left several metres of railway line suspended in mid air.

Due to the extent of the slip and the complexities involved with repairing the damage it looks likely the opening of the rail service will be delayed for at least six months. Commencement date now looks like mid to late 2019. Kiwirail plan to rebuild the embankment to reinstate the rail line rather than relocate the section of line. This will involve removing a significant volume of slip residue and then backfilling however, they are initially working through the specifics such as consents, community and iwi liaison, design and the associated construction programme.

Kiwirail, Hawkes Bay Regional Council and Port of Napier remain committed to the project and once the line is re-opened, are still planning on initially running four trains a week. This will ramp up to a daily service mid 2020 when the "wall of wood" comes on stream. This depends on whether the rail service gets support from the forest industry. The combination of rising diesel costs and a shortage of truck drivers and rigs helps make the rail a more viable and economic option.

The log trains from Wairoa have been in gestation for a long time now and it seems we are going to have to wait a bit longer before we finally get to see a load of logs heading into Napier Port on the rail.

## NZU Price

During August, the NZU price moved to $25.05 which is not only a record high for the market but also above the $25 price cap.

The $25 option cannot be availed of unless an emissions return is filed and units are required to be surrendered. Emitters are not required to file emissions returns until next year. The view is that by then, it is likely the government will have increased the price cap. In the meantime, the carbon market seems to have stalled with little liquidity. This is unlikely to change until there is an adjustment to the cap.

## Weed & Pest

The main weed at Totara Valley is a wall of blackberry. Generally as the canopy closes over in the forest the lack of light diminishes the presence of this weed. This does not seem to be the case here and there is blackberry along all of the track edges.

We are also seeing an increasing amount of Japanese honeysuckle in the native around the forest and it is only a matter of time before it spreads into the forest.

We have made allowance in the budget to carry out weed control in November.

There is currently no sign of pest damage in the forest. There are plenty of goats present however they are helping keep the blackberry at bay.

## Tracks/Access

Due to the very wet winter experienced in Hawkes Bay, the tracks are very slippery but generally in reasonable order and all of the tracks are currently accessible. The slip at the main entrance to Totara Valley, across the bridge, continues to erode away and will soon become impassable. We plan to attend to this when the tracking maintenance is carried out.

Tracking maintenance is budgeted for October however we will wait until things dry out a bit before getting the maintenance programme underway.

We made allowance in the budget for the maintenance and weight certification of the bridge and will attend to this over the next couple of months.

Fire dam

## Emissions Trading Scheme

On 21st September, submissions to the government closed on an Improved Framework for the Emissions Trading Scheme (ETS) and a Better ETS for Forestry. The proposals in the consultation documents were discussed during a number of stakeholder meetings held around the country by Ministry for the Environment (Mfe) and Te Uru Rakau (MPI). The meetings were held in two parts to cover each consultation document.

The first set of improvements to the ETS propose to strengthen the ETS framework so that it is a credible and well functioning scheme that will help New Zealand meet climate change targets. The proposals included:

- Introducing an auction system for New Zealand Units (NZUs) while recognising that a secondary market already exists. It is anticipated all NZ ETR account holders are able to participate in these auctions.
- The government intends to replace the price ceiling which is currently the $25 fixed price option with a cost containment reserve. This is a type of price ceiling which is incorporated into the auction mechanism whereby the units held in reserve are auctioned once a trigger price is reached.
- While the fixed price option of $25 will remain in place until at least 2020, the government is considering making changes to the price level prior to 2020 as the current price level may not be appropriate for that period of time. This would help keep prices in line with international markets and maintain market stability.
- The government is looking to limit the number of international units a participant is able to use if the scheme reopens to international carbon markets. Any international units would need to meet high standards of “environmental integrity” to maintain the integrity and stability of the ETS.
- How to phase down industrial unit allocations to Emissions Intensive Trade Exposed emitters. The proposal suggests a reduction of 1% to 3% per annum.
- Whether market governance and information provision requires improvement or regulation,
- Seeking feedback on the improvement of an ETS compliance regime and the introduction of strict liability infringement offences for lower level non-compliance.

The second set of consultation documents related to forestry and the changes proposed were to reduce complexity and other barriers to forestry owners participating in the ETS.

Possibly the most significant proposal for forestry is a change from the present carbon accounting approach to “averaging” which is hoped will encourage new afforestation. This would enable participants to earn NZUs for carbon growth up to the long term average storage volume of their forest and once they reached the average, can earn no more NZUs nor would they be required to surrender NZUs at harvest.

This means forest owners are able to sell more NZUs without incurring surrender liabilities. This will increase the financial return for land which is afforested. Averaging would also reduce the complexity of ETS as at harvest no surrender calculations would be required and there would be a reduced need for ongoing reporting and monitoring. The introduction of averaging will undoubtedly stimulate afforestation, particularly in association with an increasing NZU price.

## Wairoa District Council Rates – Increased Roading Rate Differential

In July 2018, the Wairoa District Council (WDC) resolved to set the rural roading rate for forestry land greater than 100 hectares at 5.29. The current differential is 1.54. The effect of this is to more than double the rates – 219%. For the forests under our management in Wairoa District, some 9,500 stocked hectares, the quantum of the increase is approximately $170,000 which is a significant sum.

The rationale behind the increase is to reallocate the cost of the rural roading so that the forestry sector will bear 43% of the cost of maintaining these roads. This does not mean that there will be more spent on rural roads, just a change as to where the funds come from. The questions as to the future roadworthiness and ability of these roads to cope with harvest traffic remain unaddressed.

Foresters, Hawkes Bay Forest Group (HBFG) and N Z Forest Owners Association (NZFOA) all submitted against this increase however, it was implemented regardless. The industry have been seeking to engage with the Wairoa District Council over roading costs and while all agree forestry should bear their fair share of roading costs, the implementation of the differential, without engagement with the sector can hardly be described as correct process on the part of WDC.

NZFOA sought legal advice on the remedies available to challenge WDC's decision and the opinion concluded there were grounds to judicially review WDC's decision on the basis their consultation process was flawed. Given the litigation costs involved and assuming the Court found WDC's decision was invalid, it is likely WDC would be required to make a fresh decision after following the correct due process. Their decision would probably remain the same, that is to apply the roading rate differential of 5 to forestry land over 100 hectares.

The industry continues to push for engagement with WDC. Although we doubt there will be a change to the rating differential, at least in the short term, such engagement would give an opportunity to challenge some of the WDC assumptions the decision making was based upon with a view to seeking a more equitable solution.

This is not solely an issue in the Wairoa District. With the 1990's forest plantings reaching maturity, the funding of rural roading is an issue right around the country. WDC have dealt with the matter using a very blunt instrument, we hope this is not an example followed by too many other territorial authorities.

## Emissions Trading Scheme Continued

Some of the other forestry proposals are:

- Consideration of how to recognise storage of carbon in harvested wood products (HWP). Under the Paris Agreement, from 2021 the carbon stored in wood products will need to be included in New Zealand's carbon accounting. This provides an opportunity to allow the domestic ETS to recognise HWP also which will enable more NZUs to be allocated, on top of the averaging limit.

- There are several operational improvements to the ETS including matters such as extending the pre 1990 ability to offset to post 89 forests, allowing landowners to retain ETS participation when a forestry right is granted, a simpler process to reconfigure CAA boundaries etc.

- To replace the Permanent Forest Sink Initiative with a new Permanent Forests category. This would make it simpler for landowners to access a potential revenue stream from the sale of NZUs, make the administration of permanent forests simpler and increase the area of permanent forest registered in the ETS.

There are some very positive changes amongst the proposals however, we will now need to wait until next year before the results of the consultation are known and the changes are implemented.

## Biosecurity Forestry Levy

Potentially the greatest threat to the forest industry is a biosecurity incursion which given the prevalence of radiata pine plantation forests, could very quickly devastate the industry. The ability to quickly manage such an event relies on government and industry collaboration.

NZFOA have recently consulted their members on the establishment of a biosecurity levy. The proposal is 1 to 4c per seedling/cutting and of 10 to 26c per tonne on harvested wood products. The imposition of these levies would provide around $10m per annum to manage a biosecurity incursion.

The levy is to initially be set at zero until a biosecurity incursion occurs, at which point the forest industry response will be initially funded from borrowing from commercial entities. The levy under the Biosecurity Act would be collateral for the debt and funds collected would be used to service any debt. The levy would be paid to NZFOA as trustee for the industry.

While we hope there is never a need to collect the levy, the mycoplasma bovis outbreak in New Zealand has demonstrated that as an industry we need to be prepared for such events. It is therefore sensible to put a mechanism in place to enable us to quickly deal with any biosecurity threat.

Steve Bell
Forest Manager