



Maximising Value of Returned Crown Forest Licensed Land

Prepared by
Ian Dickson
Burleigh Evatt

June 2010

Purpose

The Crown Forestry Rental Trust (the Trust) has commissioned this advice for claimants whose settlement redress includes Crown land subject to a Crown Forest Licence (CFL). While the transfer of CFL land fulfils Treaty settlement objectives, the resulting land ownership fragmentation has the potential to undermine the viability of forestry operations. The current land occupier undertaking forestry operations has continued land use rights until the harvest of the standing crop (or the expiry of 35 years) which means that land returns piecemeal to claimant land owners. This advice outlines options to maintain and increase commercial value from the ongoing management of returned CFL land.

Readers who wish to read a fuller discussion of models for collective management where there are multiple owners of CFL land should refer to the technical paper "*Models for Collective Forest Management: Working towards a Limited Partnership*" (May 2010) which is available on the Trust's website.

This paper is a summary of the options for managing resumed CFL land.

Background

The Trust was set up under the Crown Forest Assets Act 1989 (Act). This Act provided for the:

- Establishment of the Trust.
- Continued management of the Crown's forest assets while protecting the claims of Māori under the Treaty of Waitangi Act 1975.
- Sale of Crown Forestry licences (CFLs) for continued forestry operations but prevented the Crown from selling the land itself until the Waitangi Tribunal determined future land ownership.
- Transfer of land subject to CFL's to Māori ownership and payment of compensation in the case of successful claims under that Act.

The Trust receives and invests rental income from the CFLs and uses the interest earned to assist claimants with claims before the Waitangi Tribunal involving CFL land. The Trust provides assistance to claimants to prepare, present and negotiate claims which involve, or could involve, Crown forest licensed lands before the Waitangi Tribunal or through the direct negotiations process managed by the Office of Treaty Settlements.

The CFL's separated land ownership from the right to occupy and use the land for commercial forestry purposes, i.e. growing timber. Termination arrangements protect the licensee in the event of a successful land claim.

On transfer of land ownership from the Crown to Māori in fulfilment of a settlement, a termination notice is given to the licensee. During the next 35 years, occupancy progressively returns to the Māori claimant as timber is harvested. The licensee may not replant harvested areas and improvement to the land transfers to the successful claimant is at no cost.

Rentals accumulated by the Trust from the CFLs are paid to the successful claimant and the claimant continues to receive rental income from the licensee until the end of the lease period upon harvest of the standing crop. The CFL provides for revaluation of land and review of rental rates at specified dates.

Maximising the Value of Returned Crown Forest Licensed Land

There were clear expectations amongst the parties to the 1989 Crown Forests Agreement that settlement of the CFL lands would occur quickly. In any event, it was twenty years before significant progress was recently made with settlements that transferred more than 50 percent of all CFL lands out of Crown ownership and the termination of the CFL's was triggered.

The transfer of CFL land ownership fulfilled Treaty Settlement objectives but has resulted in land ownership fragmentation that has the potential to undermine the commercial viability of forestry operations.

The issue is further compounded for landowners in that the termination arrangements for CFLs may take up to 35 years to be completed and at a rate as low as some 4 percent of land returned per annum as standing crops are cleared by the licensee. This exacerbates the effect of ownership fragmentation through the slow trickle back of land in parcels that may be too small realistically to manage as stand-alone forestry blocks.

Landowners may face a long wait before a critical mass of land is in their hands. This in turn impacts on optimising value creation from the returned lands. The only available option in such circumstances may be to continue for another rotation (or indeed in perpetuity) as a passive landlord. The time limits for reforestation set by the New Zealand Emissions Trading Scheme are a further consideration that narrows the choices available to owners of CFL land classed as pre-1990 Forestry Land under the Emissions Trading Scheme.

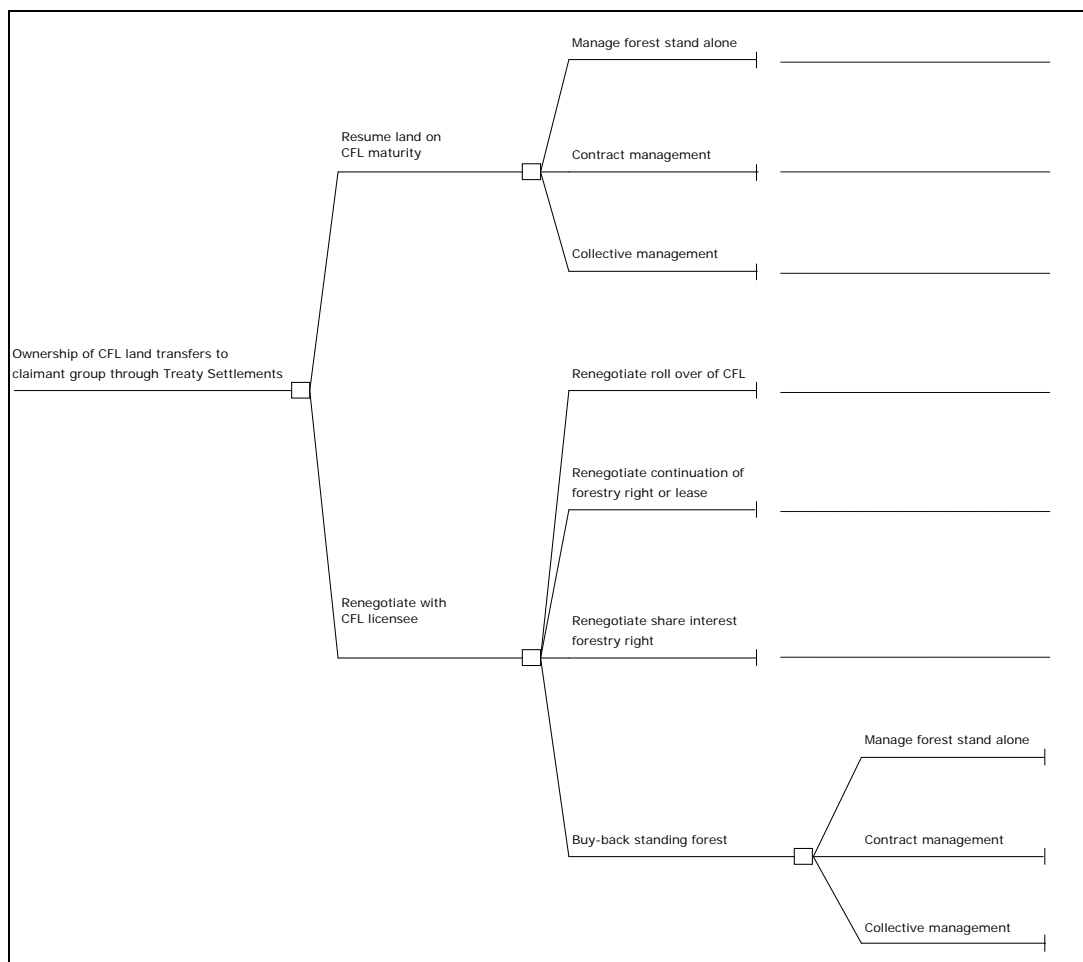
Until the land is cleared the landowner is locked into a leaseholder role receiving the licence fee (rent on the land's unimproved value at fairly low rates). In the meantime the trickle back of returned land is too small to be economically managed on a standalone basis.

This land ownership fragmentation would matter little if the continued pattern of occupation and land use remained as it is by a continuation of long-term lease arrangements akin to the CFL. There would be some duplication of administrative costs and, at times when the licence fee for use of the land was reviewed, this cost would increase. While there might be some loss of value, this could be avoided in large part by means of simple cooperation and agreement among landowners to share information, services and costs.

However the objective for claimant groups is to build an economic base around land returned in Treaty Settlements to support tribal infrastructure and employment opportunities. Achieving these aspirations requires a greater involvement in the cycle of planting, tending, harvesting and marketing of forest products than has formerly been the case. By implication this also involves investing in the crop of trees, infrastructure, equipment, market relationships and related and supporting businesses. All of these activities must be funded by the landowner and/or its commercial partners.

The issue of land fragmentation and drip feed of terminating leases is a major impediment to creating value. This paper explores the options that claimants have for maintaining or increasing value of their forestry enterprise as lands are returned in Treaty Settlements. These options are illustrated in Figure 1 below and discussed in the text following.

Figure 1: Options for Managing Resumed Crown Forest Licensed Land



Resumption of Control upon Termination of CFL Licences

The default situation is that land use rights of existing licensees terminate upon harvesting of the standing crop, or 35 years after a termination notice is given, whichever comes first. Land owners gain progressive control over the land use rights as small land parcels. The land owners face two options:

- **Standalone Operation.** The landowner resumes ongoing use of their land as licences terminate and they manage their forestry interests as standalone operations. Some land owners may prefer non-commercial land use in specific circumstances such as allowing the land to revert to native forest. It will however be more likely that the land owner plans some continued commercial use of the land such as forestry, or non-forestry (e.g. conversion of suitable land for dairy farming, exploitation of geothermal resources for electricity generation or horticulture etc). If the continued land use is non-forestry then the landowner will need to factor in the costs of the Emissions Trading Scheme following a change of land use.

The progressive return of fragmented land produces inefficiencies as it is difficult, time consuming and expensive for landowners to independently manage relatively small amounts of land for optimal benefit. The costs of replanting, tending and harvesting of small blocks of land may arguably approximate the value of the resulting crop and given the inherent risky nature of forestry may result in value loss. Accumulated rentals received following the transfer of the ownership of the CFL land and the ongoing (and decreasing) rental income will not cover the cost of replanting and ongoing silviculture work to achieve the highest value pruned plantations.

Small landowners may struggle to attract external funding from co-investors to finance the ongoing standalone operations. Bank borrowing to fund forestry planting is not an option because of the negative cash flows associated with forestry up until the year of actual harvest.

- **Contract Management.** The landowner resumes ongoing land use of their land as licences terminate and finances the forestry crop but contracts out management of the planting, tending and harvesting of the crop to a third party. This option may allow a cost effective management arrangement to be put in place covering multiple parcels of contiguous and non-contiguous land. It relies on a simple contractual relationship, and will strengthen the potential market returns in the event that a critical mass of forest land under contract management can be created. Costs are shared and administrative costs are minimised. The land owner should have lower costs than managing the land on a standalone basis, but will incur a management fee. A contract manager should be able to negotiate better terms with the forest owner than the land owner would be able to alone. Obtaining external funding to finance the combined forestry operations under the auspices of the contract manager should be easier so long as sufficient-sized forested areas can be achieved. Because of their scale of operations, contract managers can be expected to have access to sources of funding for subsequent rotations. Management fees will be a continuing cost which should be offset by costs savings. The landowner will assume risk on returns from the harvested timber.

- **Collective Management.** The landowner joins with other landowners in the same or adjoining forests and enters a joint venture for the collective management of their land. This collective management arrangement comes into effect as CFL licences terminate upon the harvest of the standing crop of trees. Collective management includes the costs of planting, tending and harvesting including the management of the forestry operation. Collective management of forestry interests can achieve scale economies through sharing of costs together with improved coordination and management, resulting in higher returns as well as sustaining a local workforce. It is estimated that some 30,000 hectares of total forestland is required to be economical and a complex although manageable governance arrangement is required which is further discussed below.

Renegotiation of Current Licenses

The CFL land use rights of existing licensees provide for the owner of the trees to have a limited interest in the land until the harvest of the standing tree crop. Once the licence terminates, the full rights of enjoyment of the land revert to the landowner.

Given that this progressively happens over 35 years it may be in both parties' interests in certain circumstances for the current licence arrangement to be renegotiated when the claimant completes the Treaty Settlement. The landowner may want to overcome the problem of land use being gradually returned as standing crops are harvested. In some circumstances it may become uneconomical for the licensee to continue to tend and harvest increasingly less trees as standing crops mature, are harvested, and land returns to the landowner.

There may be four alternative arrangements worth exploring by landowners and licensees in these specific circumstances:

- **Roll Over of Existing Arrangements.** A new lease or licence arrangement (e.g. a forestry right) is entered after harvest of the standing crop allowing the existing or a new licensee to continue to plant and harvest another one or more crop cycles. This option represents the least risk to landowners. However, it does not allow value creation from the forest lands returned in Treaty Settlements. Landowners continue to receive modest rental incomes from their lands without the responsibility and risk of managing the ongoing land use.
- **Renegotiated licence arrangements.** In this situation the landowner and the licensee negotiate different arrangements relating to the licensee's continued occupation of the land and a replanting right. The matters which may be renegotiated include the rent-setting and adjustment mechanism, whether the landowner gains a share of the value of timber at harvest (stumpage), and alternative termination arrangements including different terms.
- **Shared interest forestry right.** In this situation an agreement is reached for the landowner to share in the proceeds of the harvest (stumpage) in exchange for lower rental payments from the licensee. The landowner potentially earns a greater return upon harvest of the standing crop but accepts increased risk associated with the ultimate timber value when harvested.

- **Buy Back of forestry rights.** The landowner buys back the balance of the land use rights from the licensee including the market value of the standing crop. The landowner has the three potential options for management of the crop which are discussed in the previous section. The landowner can manage the forestry as a standalone operation, contract management to a third party or manage collectively with other landowner's lands.

The Benefits of Collective Management

Collective management is one means of mitigating the problem of fragmentation for landowners that want to be active in the ongoing management of forests growing on their land. However, it is important not to overstate the commercial case for collective management. In large part the costs of planting and tending trees are variable and not fixed costs. The scope for driving a market advantage that will reflect a true price premium is quite limited. At the harvest stage there are cost differences that relate to the scale, ease of harvest and volumes of timber transported. Small differences in market prices for otherwise similar timber can be observed that relate to the size of offerings.

One of the main benefits is reduced administrative costs through joint management of forestry blocks. The case for joint management improves if forestry blocks are contiguous and under a single forest management regime.

Analysis has demonstrated that collective management will increase landowner value but will not be overwhelming unless parcels of forestry land totalling at least 30,000 hectares can be aggregated.

The advantages of collective management are as follows:

- During the termination phase of CFLs collective action will enable landowners acting as joint venture partners to share and reduce costs of administration and replanting.
- Collective action will increase commercial bargaining power with suppliers, customers, co-investors and other forest owners or landowners.
- For subsequent rotations, collective action will enable landowners to participate as co-investors in forestry and earn a share of potential returns (as well as the risks associated with the investment) currently accruing to the CFL licensees.
- Collective action will enable the landowner partners to assemble a critical mass of forestlands so that they are able to justify commercially a collectively owned forest management company undertaking forestry management on their land.
- Collective action will increase the standing of the landowner partners with central and regional government agencies and enhance their ability to have a say on policies of importance to them.

Structural Options

There are a number of potential organisational forms available for collective management. Landowners become partners in a joint venture that would assume responsibility for forest land management and timber growing activities on that land. An incorporated joint venture provides legal protection for the joint venture and for the contributing landowners' other non-forestry assets in the form of limited liability. The landowners retain ownership of land and contribute the rights to use that land for commercial forestry purposes as partners to the joint venture.

The key principles underpinning such a joint venture are as follows:

- All forestry rights in relation to land owned by the landowner partners are covered by the joint venture.
- A minimum commitment of 35 years related to one crop cycle mirroring the CFLs.
- The shareholding interest of each landowning partner reflects the value of the land use rights contributed.
- The arrangements must cater for the gradual return of land as existing CFL licence agreements expire at the end of the current crop cycles.
- The arrangements should cater for the possibility of merging with other forestry interests to create a larger collective partnership.
- Legal structures should be transparent, simple and readily understood and recognisable by potential co-investors.

There are a number of potential organisational structures available for the joint venture including a limited liability company registered under the Companies Act (1993) or a Partnership Organisation registered under the Partnership Act (1908).

One organisational structure offering merit to Māori forest landowners is a Limited Partnership registered under the Limited Partnerships Act (2008). The advantages of this structure include:

- A legal structure that relates closely to the roles and responsibilities within the joint venture.
- The joint venture partners become Limited Partners in a Limited Partnership.
- The Limited Partners contribute the land use rights and capital for replanting.
- The Act provides for the appointment of a General Partner which is the legal entity responsible for managing the day to day affairs of the joint venture.
- The structure is tax transparent with income and expenses flowing through to partners in relation to their partnership interest, i.e. there are no additional tax considerations beyond the separate tax status of the partners.
- The structure is very lightly regulated allowing self regulation.

- The structure is familiar to potential co-investors in subsequent forestry rotations.
- A relatively simple Limited Partnership Agreement is required making the limited partnership quite straightforward to implement.

Landowners need to agree what land is committed to the joint venture on entering the Limited Partnership. The commitment relates to the land use rights whilst the land ownership remains unchanged with the Partners. Initially the forest land will be subject to the existing CFL in respect of which termination notice will have been given. The joint venture takes over the management of the CFL and pays each Partner the licence fee (rent) less small handling fees. When the land is cleared the right to use the land for replanting will transfer to the joint venture for a minimum period of 35 years, unless the terms of the CFL have been renegotiated between landowner and licensee.

Shares in the joint venture (termed Partnership Interests in the Limited Partnership) must be allocated according to the value of the contributed land use rights as the land becomes available to the joint venture. The relative value will recognise the area and quality of forestland committed to the Limited Partnership.

The process for withdrawing land from the Limited Partnership follows the same core requirements as the CFL:

- The landowner gives notice to the Limited Partnership.
- The land is returned once the standing crop has been harvested but no later than 35 years after notice.
- The terminating Partner relinquishes its Partnership Interests at the fair value which is defined as the Limited Partners share of net assets.

Memorandum of Understanding

Landowners considering a joint venture to manage collectively forestry lands may wish to consider signing a non binding Memorandum of Understanding (MoU). A MoU can be a useful mechanism for the potential partners to the joint venture to agree the intended scope including issues that need to be negotiated and agreed in a binding joint venture, e.g. Limited Partnership.

Issues that would typically be included in the MoU cover:

- Parties to the Joint Venture;
- Reason for formation of a Joint Venture;
- Key Principles underpinning the structure of the Joint Venture;
- Purposes of the Joint Venture;
- Issues to be agreed in the negotiation of the Joint Venture including;
 - Structure of the Joint Venture (e.g. a Limited Partnership),

- Shareholding (or Partnership) including the mechanism for allocating shares, determining value and restrictions on trading shares (or Partnership Interests),
 - Working capital requirements and circumstances for calls on subsequent capital,
 - Arrangements for distribution of income from the Joint Venture to partners,
 - Licensing arrangements for the forestland being contributed or withdrawn by each partner as well as possible future merging of interests with other owners of forestlands,
 - Arrangements for the management of forestry operations,
 - Governance and administration arrangements including Joint Venture policies,
 - Termination provisions of Joint Venture.
- Timeline for negotiating and establishing the Joint Venture.

Conclusion

A claimant whose settlement redress includes Crown land subject to CFLs includes termination arrangements that protect the land use rights of commercial forestry operations being undertaken on the land. Upon transfer of land ownership from the Crown to Māori in fulfilment of a settlement, a termination notice is given to the licensee. During the next 35 years, occupancy progressively returns to the Māori landowner as the standing crop is harvested unless the terms of the CFLs are renegotiated between the respective parties.

The landowner must determine future land use and arrangements for the management of these activities. Owners have a number of options available as the current CFLs terminate.

The option which arguably offers the greatest possibility to maintain or increase value of the forestry business for landowners is the collective management of ongoing commercial land use activities as a joint venture with other landowners structured as a Limited Partnership. This allows the landowners to pool land allowing sharing of forestry management costs as well as maximising value creation from the economic activities being undertaken on the land.

A non-binding MoU is a useful mechanism for prospective joint venture partners to formalise and guide the negotiation of the joint venture for collective management of forestry management.