The Allen Consulting Group

Financing Long Term Conservation Action

Options for outsourcing asset management and disbursement

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Report to the Commonwealth Department of the Environment and Heritage

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Executive summary

This report examines issues associated with developing a long term financing arrangement for conservation stewardship. Conservation stewardship reflects a market based approach that can reward private landholders for maintaining environmental values on their property, while promoting a culture of environmental improvement and service delivery.

Long term stewardship agreements between the Commonwealth and private landholders can be a powerful means of ensuring that the community valuation of environmental assets enters into private land use decisions.

There is a strong case for developing funding arrangements that encourage sustained effort by landholders to maintain environmental services valued by the community, underpinned by clear contractual arrangements and where appropriate by caveats on title to protect environmental assets in the event of change in ownership of the land interest. Because of the long time scales necessary to achieve meaningful environment improvement, and to avoid risks of exploitation by landholders a framework that allows a stream of payments extending over 15 to 20 years, conditional on sustained landholder environmental action is envisaged.

The corollary of long term undertakings by landholders — and their commitment to stewardship objectives — is faith by landholders that the stream of payments will continue over the long term, ie well beyond the Forward Estimates period. Landholder perceptions of a history of time limited, short term commitments by governments at all levels to natural resource management programs — of fashions and fads — discourage participation in programs of this nature. Funding arrangements that clearly insulate programs from these political vicissitudes can be psychologically important in gaining landholder commitment to conservation stewardship.

There is a clear tension between these instrument design characteristics and the natural preference for governments to avoid budget lock-in and maximise policy and political flexibility. Development of such an instrument must navigate a range of accountability and administration issues. These include:

- consistency with the Financial Management and Accountability (FMA) Act 1997;
- policies on entering long term financial commitments and capitalising those commitments;
- the ability to 'contract' with many providers for environmental service delivery, and accommodate a stream of potentially small individual payments;
- options for 'standardising' the service agreement as much as possible to reduce overheads and facilitate market development; and
- linking the payment stream to monitoring and verification functions to ensure that 'purchased' services are being delivered as specified.

Few long term funding precedents

Experience in Australia and overseas reflects growing momentum in this area, and can provide lessons for future program design initiatives. But there is currently no template for a long term, off-budget conservation payments program.

Relevant programs and initiatives examined in the course of this study include:

- Natural Heritage Trust;
- Goulburn-Broken Catchment Management Authority Bush Returns program;
- Victorian BushTender program;
- Tasmanian Private Forests Reserves Program;
- Greenhouse Gas Abatement Program;
- State government environment and conservation trusts;
- US Department of Agriculture conservation initiatives;
- New Zealand's Sustainable Management and Sustainable Farming Funds;
- the Greencover Canada Project; and
- EU Common Agricultural Policy (CAP) environmental initiatives.

However, even among these initiatives, discussions with Australian program managers revealed a common frustration, under current settings, with being unable to match the duration of agreements and milestone payments to the time horizon necessary for outcomes to be fully realised. Management of unallocated (or unpaid) program funds by government treasuries — rather than in off-budget accounts — also appears to be a common characteristic of these programs. For these programs innovation tends to be focused in service delivery and monitoring arrangements, rather than financial engineering.

Long term contracts versus 'draw down' options

The Department of Finance highlights an established policy preference for dealing with long term funding commitments through a system of pre-approvals provided by the Minister for Finance under Regulation 10 of the FMA Act. Regulation 10 approvals allow agencies subject to the FMA Act to enter into contracts that make calls on future budget appropriations. This is the most straightforward way of operationalising a long term funding program. However, funding would still be subject to future Budget processes, and the political and bureaucratic reassessment of spending priorities that that can entail.

Long term contracts supported by Regulation 10 approvals represent a promise of future payment, but fall short of a 'once and for all' draw down from the budget specifically set aside to fund the activities described. Although they may provide some rights of redress to the parties, long term contractual commitments sanctioned under Regulation 10 have not been immune from being targeted for budget savings in the past. This is an important psychological issue in securing cooperation from community groups, who often do not place a high level of trust in government commitments.

These unfunded long term commitments also represent a future liability for the Department's budget, creating lock in and reducing the options for handling any future down turn in Departmental funding.

An alternative is to capitalise and fully fund a long term income stream in a way that ensures it is not subject to cyclic budget pressures and annual appropriations in the future. This can be done within the Commonwealth account through legislation which establishes self-executing appropriations (for example the Natural Heritage Trust) and/or the establishment of a Special Account under legislation, or by the Minister for Finance under Section 20 the FMA Act, and an annotated appropriation that enables the funds to be transferred to a Special Account.

Options outside the Commonwealth account

If, however, there are good reasons (for example to secure and facilitate the participation by private philanthropy and the states), the capital fund could be established outside the Commonwealth account (ie the initial Commonwealth contribution to the fund would be fully expensed from the Commonwealth budget in the year(s) in which it was made). There are three principal alternative mechanisms to achieve this;

1. Contributions to existing (or newly negotiated) trust accounts managed by the States (for example the NSW Conservation Trust) with objectives matching those set by the Commonwealth. While detailed provisions differ, in general states require public trusts of this nature to invest in a limited range of cash and government issued securities.

2. Contributions to one or more existing private conservation trusts whose purposes match the Commonwealth's aims. The range of assets invested in by these trusts will vary according to the provisions of the establishing Trust Deed and the decisions of the Trustees. They are regulated subject to State legislation.

3. Creation by the Commonwealth (possibly in collaboration with private parties and the states) of a new Trust under State legislation with objectives, responsibilities and constraints provided for in the establishing Deed to match the Commonwealth objectives. Such a Trust could be open to contributions from the private sector and/or the States. Approval for it to be registered as a Charitable Trust for taxation purposes could be sought. The range of asset classes in which it could invest would similarly be specified in the Deed.

Options 1 and 2, while immediately available to the Commonwealth, have the disadvantage of distancing the Commonwealth not only from the financial management of the Trust accounts but more particularly from a direct relationship with the individual landholders receiving the support.

Option 3 offers the possibility of maintaining a direct relationship with the landholders while distancing the Commonwealth from the Trust's investment operations. This would be achieved by providing in the Trust's establishing deed that it could only make payments to landholders nominated by the Commonwealth, with those payments being ceased or suspended only on advice from the Commonwealth.

Under this arrangement the Commonwealth would be responsible for:

- *Policy:* which would be reflected in the terms of the Deed and the basis on which landholder participation would be sought and maintained
- *Recruitment:* of landholders in accordance with the policy (this could be outsourced to States, Catchment Management Authorities, NGO's or the private sector in whole or in part)
- *Independent Verification:* of the continuing performance by landholders of their obligations (again this could be outsourced – but preferably not to the provider of recruitment services given the potential for conflicted interests)
- *Contractual relationship with the landholder:* which would set out the obligations on each side; the Commonwealth's obligations for payments would be specified in terms of its responsibilities to advise the Trust of the landholders ongoing entitlements to payments, subject to the availability of funds in the Trust (different formulations would be possible depending on the extent to which the Commonwealth was prepared to enter into a contingent liability for payments in the event that Trust funds were insufficient. The extent and nature of the risk distribution for the Trust fund performance between the landholder and the Commonwealth is an important issue which requires careful thought).

The Trustees, in managing the Trust would be responsible for:

- *Funds Management:* which could be outsourced to a professional investment manager, subject to any requirements in relation to risk and assets specified by the Commonwealth in establishing the Trust
- *Commitments Management:* including through actuarial assessment of the stewardship obligations that the Trust was able to accept. Careful thought will need to be given to the relationship between the Commonwealth's nomination to the Trust of eligible landholders and the associated payments stream, and the duty of the Trustees not to accept obligations that they may be unable to fund.
- *Payments:* to landholders subject to advice from the Commonwealth on any changes such as suspension or cessation of landholder entitlements. Again this could be outsourced, including possibly back to the Commonwealth.

The private financial sector is rich in institutions that can provide one or more, or in some cases all, of these services. The ANZ Bank has for example, a specialist Trust management service which will provide not only advice on Trust establishment, but Trust, investment and payments management services. Governance arrangements would be critical and at the minimum would need consideration and approval by the Department of Finance. An advisory consultation with the Auditor General in that process would also be essential. Given the novel nature of the arrangements it could be appropriate to seek Cabinet approval.

Potential earnings and costs

A Trust established under normal State legislation outside the Commonwealth budget sector and coverage of the FMA Act may also be able to operate with wider discretion over investment options (ie. the type of securities in which balances are held) than normally provided under the FMA Act — depending on the terms of the Trust Deed.

Section 39 of the FMA Act highlights the tight conditions applying to investment of government funds. In addition to requirements that public money be held in government backed securities and/or bank deposits (with this term strictly defined), current interpretation of Section 39 expressly rules out investment in assets such as:

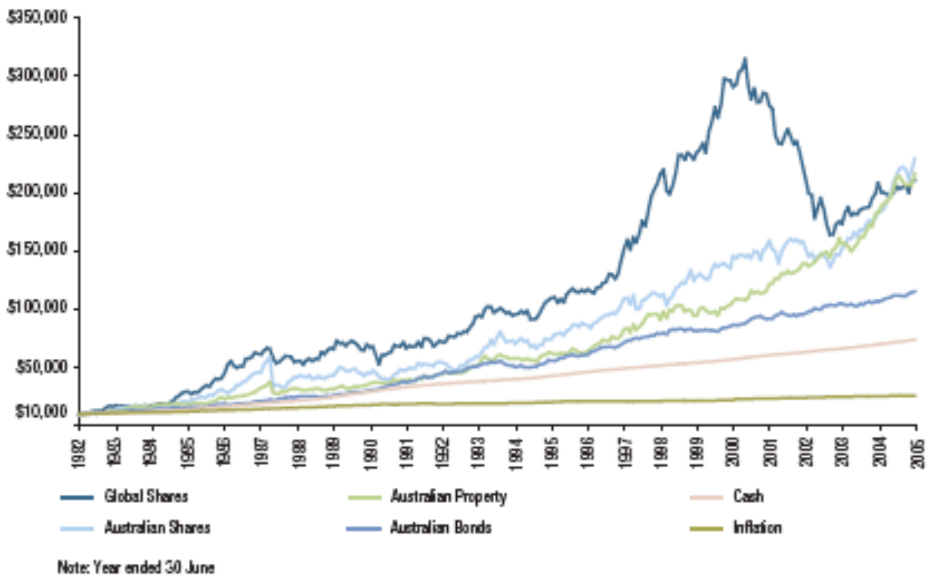
- medium term notes and fixed or floating rate notes;
- money market trusts/ cash management trusts; or
- bills of exchange.

It is up to program designers, and ultimately Ministers, to decide on the degree of investment latitude that is appropriate in pursuing a high rate of financial return on the conservation funds. High growth can drive greater conservation action, but higher returns are commonly also associated with acceptance of higher risk of default. In moving to a private Trust, which in itself is not as risk free as an on-budget arrangement, the Commonwealth would need to consider whether it was also prepared to relax the investment requirements.

Long term earning rates for different assets are illustrated in the figure below. However, as is often highlighted by investment advisers, past returns cannot be taken as a predictor of likely returns in the future.

Figure E.1

GROWTH OF A $10,000 LONG TERM INVESTMENT IN DIFFERENT ASSET CLASSES



Source: MLC (2005), Retire in Style 2004/ 05 – Strategies for Retirement, The private sector offers a range of willing fund administrators and investment options. These can drive the earnings potential of cash deposits and facilitate the selected balance of risk and return. Competition is fierce in this market, and discussions with financial institutions indicate a strong interest in operating an investment and payments program on behalf of the Commonwealth. A pilot program based around an initial deposit of $10 million and a few hundred payment recipients would be readily acceptable to fund administrators. If this were to grow to a fully fledged program of $200 million or more, there would be considerable interest (and discounting) to win this business.

In discussing the broad parameters of a potential conservation pilot program fee structures were discussed in broad terms. These, of course, vary from institution to institution and would also be linked to the specifics of the program. If the Commonwealth moved forward with the program, there would be a need to test the market through a detailed tender process. Nevertheless, fee structures associated with a pilot program are likely to be broadly in line with:

- a charge of about 0.5% to 0.6% of the annual balance for investment management and account keeping;
- payments of a few cents per electronic payment (ie to a payees account via electronic funds transfer); and
- mail out costs of around $1 per transaction (for written payment summaries).

However, this arrangement cannot provide a guaranteed payment stream for a fixed period. This is because the amount of money in the fund will be subject to variations in the earnings rate, associated with conditions in the macro-economy. Of course commitments can be managed and uncommitted reserves maintained to minimize risk, but an absolute guarantee of the period for which funds will flow is not possible. If an investment strategy of this type were to be agreed, then as a corollary either contracts with landholders would require to reflect uncertainty in term (and effectively that they were exposed to some level of investment risk) or the Commonwealth would need to accept a contingent liability to maintain payments in the event of the Trust exhausting its funds.

Guaranteeing payments (and earnings) over the long term is a risky business, and this service is the speciality of insurance companies that offer annuities.

Earnings rates on money invested in annuity products are typically much lower than other investments because the issuer must be paid to take on the risk that the initial investment plus interest will not be sufficient to fund the future stream of guaranteed payments. In the case of insufficient funds, the insurance company must fund the loss from its own capital. Annuities are typically tailored products, and their cost (best thought of as the difference in interest earnings the insurer is prepared to pay over the life of the deposit, relative to long term earnings potential available elsewhere) will vary according to expectations about the future (eg. for lifetime annuities, actuaries will base quotes on the expected lifespan of the individual seeking to buy the product).

At present, yields on fixed income annuities are currently about a percentage point (ie. 100 basis points) below those available for long term government securities. To obtain a guarantee over a future payment stream fixed in *real* terms (ie. adjusted to keep pace with changes in the general price level), an additional fee of around 300 basis points applies. In the private sector certainty comes with a significant price tag, and both program managers and payment recipients may wish to consider the merits of assuring the value of payments over a 20 year period relative to arrangements that guarantee the value of payments for (say) 10 years, but allow for variability (including the potential for higher payments) beyond that time frame, in line with investment performance.

Industry sources saw little practicality in establishing a multiplicity of small individual annuities, noting that it made little sense to incur $200 in fees (or thereabouts) to establish a $500 payment.

Recommended option: a Charitable Trust

The only option that seems to offer a prospect of simultaneously meeting all the objectives (notably long term funding of long term stewardship covenants that can be seen by landholders to be free of annual budgetary risk) and constraints (the requirement for a direct decision making role for the Commonwealth in accepting individual landholder contracts and suspending payments in the case of non-performance free of a State intermediary) is a Charitable Trust established under State legislation.

Such a vehicle could be designed to:

- maximize the future budget flexibility of the Commonwealth's environment program;
- maximize landholder confidence that funds flows will not be disrupted by future budgetary stringencies or changes in political preferences;
- maximize the scope to encourage co-investments in the program by the private sector, and possibly other governments;
- optimise the risk/return trade-off on scale of long term funding for the nominated environmental purposes and certainty of funding;
- allow for full transparency in provider choice and performance;
- minimize contingent liabilities for the Commonwealth.

Trust Deeds (to be developed by DEH in consultation with other agencies and stakeholders) would establish:

- the objectives of the Trust;
- asset classes in which it might invest;
- provide for the nomination of Trustees;
- eligibility of the Trust to receive donations from other parties; and
- nominate the terms under which it is to provide payments to landholders (and the basis for suspension of payment).

Depending on the Commonwealth's risk preference (which would in turn be reflected in the standard terms of the contracts to be negotiated with landowners), a range of asset classes could be considered to secure long term payments to landholders. Risk cannot be completely removed and attempting to minimise risk comes at some cost. It could be possible (although more costly for a pilot project) to allow an element of landholder choice with respect to the risk/return continuum by providing for an investment or annuity style product to underpin the payments stream.

An example of an approach that could strike an appropriate balance on the risk/return spectrum could entail:

- the Trust conducting a tender among financial intermediaries with a nominated credit rating for funds management through eg wholesale unit trusts (tender evaluation could be assisted by the Commonwealth);
- the chosen financial intermediary(ies) establishing an Account (eg The Conservation Stewardship Trust — Unallocated Fund) to receive the initial bulk funds from the Trust;
  - this Account would be a parcel of units within a Wholesale Fund established and managed by the intermediary under the Managed Investments Act.
  - the ownership of the Account would remain with the Trust.
- classes of assets held by the Account being determined by the Commonwealth through the Trust Deed — these could range from extremely secure, low yield assets to ones with a greater growth potential but greater risk;
- landowners nominated by the Commonwealth, become the beneficiaries of payments from individual sub-accounts (eg. Farmer Jones Fund) with personalised identifiers and a capacity to report balances as well as make payments - the balances transferred from the Unallocated account;
- payments made by the financial intermediary until otherwise advised (by the Trust on the advice of the Commonwealth).

In event of landowner default then funds could be retained in the landowner's sub-account pending resumption of services; or returned to the Unallocated Fund for reallocation if it is advised that the landowner has left the scheme.

Periodicity of payment could be agreed with the Trust (on the basis of policy guidelines set by the Commonwealth through the Trust Deed), but regularity would be important (eg monthly, quarterly, semi-annually). Payments could be agreed nominal amounts or indexed (eg to CPI), with actuarial assessment used to determine the payment amounts that the capital funds could support.

Finally, the terms of contractual arrangements with the landholders would make it quite clear that in the event of an inability of the Trust to meet ongoing payments, the landholder would be relieved of environmental stewardship obligations. By providing ongoing advice to landholders on the performance of the Trust, reassurance would be provided of the nature of the risk of such an event occurring.

This model is very little different from other long term financial arrangements that landholders are familiar with — such as superannuation and other investment programs. Further, it would not be impossible to authorise the Trust to acquire annuity style products on behalf of landholders.

Financial policy and governance

While the approach outlined above could be technically feasible, and politically attractive, it has elements that could be seen to be in conflict with the post Uhrig objective of minimizing the Commonwealth's involvement in 'GBE like' or special purpose arrangements.

There are, of course, steps short of this model that might find greater acceptance within that framework. These will no doubt emerge from the agency level and Ministerial discussions that would be necessary to advance any 'off-budget' arrangements.

Further development of the program, if it is to proceed, should involve:

- specialist legal and accounting advice on the detailed Trust Structure and associated governance arrangements;
- further investigation of land holder payment preferences (eg. fixed money amount, indexed payments, length of term, guaranteed minimum term, etc);
- financial modelling of risk/ return trade-offs and associated limitations on asset classes;
- development of landholder environmental service contracts (including appropriate terms, risk distribution and payment and suspension provisions);
- development of approaches for recruitment services (in-house, States, CMAs, NGOs or private sector eg combined rural traders) and mode (tender, nomination, application etc);
- similarly proposed arrangements for independent audit/verification of landholder performance under contracts (again in house, States, NGOs or private sector);
- careful consultations particularly with the States and stakeholders;
- development of performance assessment and reporting guidelines; and
- draft tender documents seeking bids from financial institutions for defined asset management and payment services based on a concrete proposal (eg. number of recipients, periodicity, duration, number of payments, suspension provisions, etc).

Logistic and financial design issues will need to be advanced in unison with consultations around contract development and legislative obligations.

Finally, it is worth emphasising that while the elements listed above will be important to the mechanics of a conservation stewardship funding program, performance measurement will be critical to ensuring effective outcomes. It is within the Commonwealth's power to design innovative ways of delivering funding to landholders with significant potential to generate valuable environmental outcomes. A critical challenge faces markets and policymakers in quantifying these achievements and ensuring that their value is reflected in ongoing decision making.

Chapter 1

Focus of the project

This report addresses issues and options for developing long term financing arrangements for the delivery of conservation stewardship services. Such an approach formalises the role of government as a purchaser of environmental benefits on behalf of the wider community, and opportunity for private landholders to realise a return on the environmental assets that they conserve, manage and enhance. It is a market based approach that promises to reward landholders for enhancing environmental values on their property, and shift the notion of 'improving the land' to include options beyond clearing and intensification of agriculture.

1.1 Long term funding: a market based approach

The greater use of market-based approaches in the delivery of environmental policy can help add transparency to the valuation of environmental assets and the costs of protecting them. It can also help ensure that maximum benefit is generated from environmental expenditures, while incentives for minimising the cost of administrative overheads are maintained. Stewardship agreements between the Commonwealth and private landholders can be a powerful means of ensuring that the community valuation of environmental assets enters into land use decisions by private owners.

Development of a long term funding instrument for enhanced conservation stewardship practices aligns well with a growing overseas trend toward incentive approaches, particularly in the US and EU, and some activity along these lines in State jurisdictions. Indeed, there has been considerable joint activity by Commonwealth, State and Territory jurisdictions in the administration and delivery of NRM funding at a regional level. Agricultural groups represented by the National Farmers' Federation have recently called for continuing recognition of farmers' stewardship role and establishment of a payment mechanism designed to promote it (see Box 1.1).

Timescales are an important issue in environmental improvement. There can be a significant separation of action and outcome, and sustained action and stewardship can be required to ensure that previous progress is not undone. The time frame issue has been explicitly recognised by the NRM Ministerial Council in establishing a monitoring and evaluation framework for NRM investment. The Framework notes that:

> While interventions undertaken by Government are usually structured as programs conducted over periods of between five and seven years, significant changes in the resource condition will not be measurable for periods ranging from five to fifty years. Processes to measure and report resource condition change and the performance of NRM interventions must encompass this range of time-scales.
>
> Natural Resource Management Ministerial Council, October 2002

Box 1.1

NFF'S PROPOSED NATIONAL ENVIRONMENT MANAGEMENT PROGRAM (NEMP)

As part of a 2004 Election policy package, the National Farmers' Federation (NFF) proposed development of a National Environment Management Program, comprising a a system of property-based agreements that would:

Chapter 1 identify the environmental values that require conservation, ongoing management or enhancement activities on behalf of community;

Chapter 2 clearly outline the actions and outcomes that the community is paying for from the landholder;

Chapter 3 establish management payments for the delivery of identified actions and outcomes over an agreed period of time; and

Chapter 4 minimise bureaucratic processes.

NFF sought a Federal Government commitment establish and fund this as a new 10 year rolling program, with an initial $250 million per annum for each of the first four years (to be reviewed after year 3).

Source: NFF 2004, 2004 National Farmers' Federation Election Priorities - National Environment Management Program, http://www.nff.org.au/ (accessed 25/8/05)

Finding mechanisms to support *sustained* conservation, management and enhancement of environmental assets are important to ensuring "additionality" of environmental services in market based programs. This is because there is a high risk in short term tender/auction arrangements (particularly where essentially passive conservation is required) that landholders will bid for funding to preserve biodiversity which they had no intention or incentive to remove or otherwise damage in the short term. On the completion of the program, the landholder is then free to re-examine the decision to protect these natural assets if the market incentives for more intensive or changed use have increased. In these circumstances a high proportion of program funding can result in little environmental protection additional to that which would have occurred in any case.

There is therefore a strong case for developing funding arrangements that encourage sustained effort beyond the normal forward estimate timeframe adopted by Commonwealth programs, and provides progress payments to land holders in respect of the stream of community level conservation benefits that they deliver, underpinned by clear contractual arrangements and where appropriate by caveats on title to protect environmental assets in the event of change in ownership of the land interest. This is the essence of fee for service, and sustained incentives that will encourage cultural change and revised land management practices that will continue after direct funding has ceased.

The corollary of any such long term undertakings by landholders – and their genuine commitment to the stewardship objectives – is faith by landholders that the stream of payments will indeed continue over the long term. Perceptions by landholders of a history of time limited, short term commitments by governments at all levels to natural resource management programs – of fashions and fads – discourage participation in programs of this nature. Funding arrangements that clearly insulate programs from these political vicissitudes can be psychologically important in gaining landholder commitment to conservation stewardship.

There is a clear tension between these instrument design characteristics and the natural preference for governments to avoid budget lock-in and maximise policy and political flexibility. Development of such an instrument must navigate a range of accountability and administration issues. These include:

- consistency with the Financial Management and Accountability Act 1997;
- policies on entering long term financial commitments and capitalising those commitments;
- the ability to 'contract' with many providers for environmental service delivery, and accommodate a stream of potentially small individual payments;
- options for 'standardising' the service agreement as much as possible to reduce overheads and facilitate market development; and
- linking the payment stream to monitoring and verification functions to ensure that 'purchased' services are being delivered as specified.

The latter element is vitally important and raises a spectrum of complex issues. Defining the environmental services to be delivered, and monitoring their achievement will be critical to the success and demonstrable 'value for money' of the program. Progress in this area is being made in a number of jurisdictions, and has been a key issue in the Natural Resource Management framework and operation of the Natural Heritage Trust.

However, design of the verification 'module' of the program and advice on resolving the definitional issues associated with specifying and measuring environmental performance are beyond the scope of this report. For the current project it is sufficient to recognise the importance of this function, and the need to factor it in to the payment and management arrangements that are established to finance the stream of environmental services generated.

1.2 Project aims

This analysis and advice in this report is focused on developing a robust financial structure in support of long term funding agreements with Australian landholders, overseen by the Commonwealth Department of the Environment and Heritage (DEH).

Key objectives of this report are to:

- identify financial instruments currently available that meet DEH needs in this area;
- assess the potential for changes to existing products to meet DEH needs;
- identify potential providers and administrators of such instruments;
- investigate possible models for the financial instrument;
- investigate options for managing the monitoring of compliance by landholders to the stewardship agreements; and
- identify risks to the government and the recipient of proposed funding arrangements.

The proposed long term funding arrangement would have the following characteristics:

- meet the highest public standards of efficiency and effectiveness;
- provide the Commonwealth Environment and Heritage Minister with the ability to suspend or cancel payments to a particular landholder if the terms of the stewardship agreement are breached;
- provide for the return to the Commonwealth of unallocated funds from cancelled agreements or their reinvestment in new or extended/intensified agreements;
- provide for reporting to Government on disbursements to each landholder and to the public on consolidated cash flow; and
- be simple to implement and manage over the period for which the stewardship agreement is in force — both for the Commonwealth and for the individual landholder.

1.3 Report structure

Analysis and advice on options for further development of the proposed program are set out in the following chapters of this report.

Chapter 2 provides a survey of recent experience in this area of program design and environmental services contracting, drawing on long term funding arrangements implemented in Australia and overseas. Chapter 3 examines the various functions that need to be integrated within the program and the legal and policy issues that need to be reflected in the design process.

Drawing on this discussion and advice from a range of stakeholders, Chapter 4 sets out a range of practical considerations that will influence design thinking and outcomes. Finally, Chapter 5 puts forward preferred models for further development, and recommendations for progressing program design activity.

Chapter 2

Survey of relevant programs and initiatives

The need for improved environmental management is firmly established, and a variety of jurisdictions within Australia and around the world are developing a range of approaches to achieve this.

This section provides a brief overview of conservation funding programs that could provide insights to the development pathways, options and issues that are likely to apply in the development of a long term conservation financing measure by the Commonwealth.

ACG's research has identified a number of environmental programs that exhibit some objectives and characteristics similar to those envisaged by DEH for development of a long term conservation stewardship program. These are:

- a secure government commitment to long term funding (potentially involving an off-budget funding pool) ;
- progress payments made over 15 to 20 years to fund private environmental action;
- land holders provide a stream of environmental services (ie. contract designed as a service agreement); and
- private sector management/ verification role.

A brief examination of relevant Australian and overseas programs follows.

2.1 Relevant Australian experience

Natural Heritage Trust

The Natural Heritage Trust (NHT) is jointly administered by the Australian Government Department for Agriculture, Fisheries and Forestry, and the Australian Government Department for the Environment and Heritage. The NHT was set up in 1997, and is currently funded out to 2007-08. The Australian Government finances the initiative, with AUD $3 billion available over this ten-year period.

Box 2.1

THE NATURAL HERITAGE TRUST

The NHT's objectives are:

- biodiversity conservation;
- sustainable use of natural resources; and
- community capacity building and institutional change.

The NHT is intended to invest in one or more of ten activities that are designed to meet its objectives. These activities are:

- protecting and restoring the habitat of threatened species, threatened ecological communities and migratory birds;
- reversing the long-term decline in the extent and quality of Australia's native vegetation;
- protecting and restoring significant freshwater, marine and estuarine ecosystems;
- preventing or controlling the introduction and spread of feral animals, aquatic pests, weeds and other biological threats to biodiversity;
- establishing and effectively managing a comprehensive, adequate and representative system of protected areas;
- improving the condition of natural resources that underpin the sustainability and productivity of resource based industries;
- securing access to natural resources for productive purposes;
- encouraging the development of sustainable and profitable management systems for application by landholders and other natural resource managers and users;
- providing landholders, community groups and other natural resource managers with understanding and skills to contribute to biodiversity conservation and sustainable natural resource management; and
- establishing institutional and organisational frameworks that promote conservation and ecologically sustainable use and management of natural resources.

Source: http://www.nht.gov.au/index.html, accessed on 21 September 2005.

The NHT has consolidated the 23 programs it previously used to administer through the states and territories into four: Landcare, Bushcare, Rivercare and Coastcare. However, the four programs do not represent discrete funding sources — rather, the majority of the NHT funds are apportioned to the states and territories through a system of bilateral agreements ranging from 2002-03 to 2006-07. In addition to these agreements, there are a number of funding initiatives directly administered by the NHT, at the local, regional and state level.

Individuals and local communities

The Australian Government Envirofund (see box 2.2) is the 'local action' component of the NHT. Envirofund provides grants to community groups and individuals to assist them in carrying out on-ground actions that target local problems. Most grants are up to AUD$30 000, although grants of up to AUD$50 000 are considered under special circumstances.

Box 2.2

ENVIROFUND

Envirofund is an Australian Government initiative under the NHT, funded by the Australian Government Departments for the Environment and Heritage, and Agriculture, Fisheries and Forestry.

It has approximately AUD$60 million in funding over three years, and is administered by the Department for the Environment and Heritage.

The funding resides in the NHT, which is due to lapse in 2007-08.

Projects that receive grant funding from Envirofund are expected to achieve outcomes within 12 to 18 months of commencement, and the payments are made on the basis of milestone achievements.

Source: http://www.nht.gov.au/envirofund/ and consultations with Envirofund.

Successful applicants have eighteen months to implement their proposals. As part of the funding arrangements, the program has a documented monitoring and evaluation process. There are three stages to this — a self-evaluation, a pre-project survey and the final project report. As part of the self-evaluation stage, recipients are to monitor their achievement of milestone targets set to obtain the overall objective.

Formal reporting to the Australian Government is undertaken in the form of the pre-project survey and the final project report. The final project report must establish the activities that were undertaken and the extent to which the activities led to measurable outcomes, and relevant financial details of the project.

Regions and catchments

Regional delivery is the primary focus of the NHT, and the programs under this component have the greatest amount of funding allocated to them. The NHT Regional Competitive Component delivers NHT funding at a regional or catchment level within the states and territories, in addition to the NHT funding that the states and territories themselves allocate, received via their bilateral agreements.

Under the program, funding is allocated based on an accredited, integrated natural resource management (NRM) plan and investment strategy or plan developed for the region. The funding for this initiative is a combination of NHT funding, as well as funding from the National Action Plan for Salinity and Water Quality (NAP). The regional bodies and catchment management authorities develop plans that propose and prioritise actions to address regional issues. These plans are assessed and accredited by the relevant state or territory government before the plan can be implemented.

The 'National Natural Resource Management Monitoring and Evaluation Framework' (the Framework) sets out the monitoring and evaluation guideline established by the NRM Ministerial Council. The Framework proposes a number of indicators that could be considered when measuring or reporting the performance of the project against its objectives.

While the specifics of monitoring, and reporting and performance evaluation requirements are individually determined and agreed upon for each region, the Framework establishes that all three partners (the Australian Government, the State or Territory Government and the regional body) share the responsibility of the monitoring and evaluation, as all three benefit from doing so effectively. There is also the option for project evaluations to be conducted by an independent assessor, using the information gathered by the partners.

Goulburn-Broken Catchment Management Authority

The Goulburn-Broken CMA was established in 1997. It oversees natural resource management in the catchment, which is in the Victorian span of the Murray-Darling Basin. The CMA has two main types of business, which are:

- Direct Service Delivery, involving:
  - Waterway Management (River Health);
  - Water Quality and Biodiversity Co-ordination;
  - Floodplain Management; and
  - Catchment Planning (corporate functions), and
- Partnership Business involving:
  - Sustainable Agriculture and Land Management (particularly with reference to irrigation and dryland salinity);
  - Water savings and water use efficiency;
  - Biodiversity (Including vegetation management and private forestry);
  - Landcare Support; and
  - Pest Plant and Animal Management.

These business functions are designed to achieve outcomes up to 2008-09, under the CMA's current corporate plan. In the four years to 2003-04, this CMA has received roughly AUD$80 million in government contributions, with an additional AUD$150 million expected over the next five years to 2008-09. Of this AUD$150 million, roughly AUD$71 million is anticipated as coming from the NHT and the NAP, and the rest from the State Government.

Initiatives are conducted in partnership with the local community and private landholders. The activities that are eligible for funding through the CMA's 'Environmental Management Incentives' include:

- protecting endangered remnant vegetation;
- enhancing remnant vegetation (eg. planting understorey);
- the revegetation to link existing stands of remnant vegetation;
- protecting threatened species habitat; and
- the revegetation of high priority sites for salinity (recharge and discharge areas).

The CMA also administers Waterways Grants, which provide incentives to landholders to:

- fence for grazing control;
- organise revegetation with indigenous trees, shrubs and grasses; and
- set up off-stream watering points for stock.

Farm Program

One of the CMA's partnership programs is the Farm Program (see box 2.3), which has been in place in one form or another since the early 1990s. The role of the Farm Program is aimed at implementing the Shepparton Irrigation Land and Water Management Plan, with a particular focus on private farm activities. Incentives are available for addressing the following issues:

- Whole Farm Plans — Broadacre Farms;
- Whole Farm Plans — Horticulture;
- Tile Drainage for Horticulture;
- Community Surface Water Management Systems;
- Farm Exploratory Drilling Service;
- Groundwater Pumping — Non-Horticulture and Horticulture;
- Tree Growing;
- Automatic Irrigation;
- Drainage Reuse Systems;
- Drainage Nutrient Removal;
- CMA Waterway Management; and
- Individual Property Outfall to Natural Waterways.

Box 2.3

FARM PROGRAM

The Farm Program is a joint initiative of the Goulburn-Broken CMA, and the Victorian Department of Primary Industries. The Program is funded by a number of sources across Commonwealth, State and local governments, with funding also matched by private land-owners. The main source of funding is the National Action Plan for Salinity and Water Quality (NAP).

It has approximately AUD$60 million in funding over three years, and is administered by the CMA, as well as sub-contractors to the Victorian Department of Primary Industries.

The funding for the program resides within the CMA's budget, and the number and value of grants funded in a given year depend on the amount of funding the CMA is able to appropriate.

Projects are funded for a maximum of two years, and monitoring, evaluation and verification is conducted by the program administration before any funding is payed out.

Source: Consultations with Farm Program administrators.

While projects are funded for a maximum of two years, the close working partnership between CMA and farmers has generated a lot of goodwill. As a result, the initiatives that have attracted funding so far have been voluntarily maintained at the end of the two-year funding period, and in some cases, even after the property changes hands.

Bush Returns

A more recent initiative is the Bush Returns program (see box 2.4), which the CMA administers as one of a suite of similar programs funded by the Victorian Departments of Environment and Sustainability, and of Primary Industries (discussed in the next section under BushTender). Bush Returns is a pilot program aimed at achieving large-scale increases in native-vegetation on private land. Under the program, private landholders are able to bid for payment to manage regeneration on parts of their property, over a period of five or ten years.

Box 2.4

BUSH RETURNS

The Bush Returns is a joint initiative of the Goulburn-Broken CMA, and the Victorian Department of Sustainability and Environment. The primary source of funding for Bush Returns is the National Action Plan for Salinity and Water Quality (NAP).

Bush Returns had AUD$200 000 in its initial phase, and not all of this funding was committed. The program is now in its second phase with an allocation of $650 000.

The funding for the program resides with the CMA, in a separate account to the rest of the CMA's funds. There are plans underway to store the funds in a trust in order to guarantee funding commitments — this will depend on how successful the pilot stages are, and whether or not the program becomes an ongoing one.

The program is administered by the CMA, and projects are intended to be funded for a maximum of ten years.

Projects are funded for a maximum of two years, and monitoring, evaluation and verification is conducted by the program administration before any funding is payed out.

Source: Consultations with Bush Returns administrators.

Southern Victoria BushTender

BushTender is a relatively recent, market-based approach to achieving ecological outcomes in Victoria.

> [It] is an auction-based approach to improving management of native vegetation on private land. Under this system, landholders competitively tender for contracts to improve their native vegetation. Successful bids are those that offer the best value for money, with successful landholders receiving periodic payments for their management actions under agreements signed with DSE. These actions are based on management commitments over and above those required by current obligations and legislation.[1]

Program funding is sourced from Victoria's Departments of Primary Industries (DPI) and of Sustainability and Environment (DSE). The specifics of the delivery of each project vary according to which catchment they apply to, and from where the funding is sourced.

[1] http://www.dse.vic.gov.au/dse/nrence.nsf/LinkView/15F9D8C40FE51BE64A256A72007E12DC8062D358172E420C4A256DEA0012F71C, accessed on 16 August 2005.

Current projects include:

- North Central River Tender (North Central CMA);
- EcoTender (North Central and Goulburn-Broken CMAs);
- Southern Victoria BushTender (see box 2.5);
- Plains Tender (Corangamite CMA);
- North East RiverTender (North East CMA); and
- Bush Returns (Goulburn-Broken CMA).

The suite of projects is based largely on the success of two completed pilot projects — in North-East and North-Central Victoria in 2001-02, and in Gippsland in 2002-03. Under these trials, approximately 4800 hectares of native vegetation is under management, with initiatives implemented by the landholders and AUD$1.2 million has been allocated for payments to landholders over five years. Some of the initiatives implemented by landholders (e.g., fencing, or alternative grazing arrangements) must be continued for six or ten years — continuing after the funding ceases.

Box 2.5

SOUTHERN VICTORIA BUSH TENDER

Bush Tender is a joint initiative of the Victorian Departments of Sustainability and Environment, and of Primary Industries. The primary source of funding for Bush Tender is from the Department of Sustainability and Environment.

Bush Tender has a funding allocation of AUD$500 000, which will reside in the Department of Sustainability and Environment's budget. Once funding is committed to a project, it can be paid out over the longer term from the Department's budget.

The Department of Sustainability and Environment directly administers the program, and successful projects are funded for up to five years. Funded initiatives are required to be maintained for an additional five years after funding ceases.

The Department requires funding recipients to submit annual reports of progress towards targets. In addition, the Department will also monitor a number of agreements in each year, to check the veracity of reports.

Source: http://www.dse.vic.gov.au/, accessed on 16 August 2005.

Greenhouse Gas Abatement Program (GGAP)

The Greenhouse Gas Abatement Program (GGAP, see box 2.6) is an Australian Government initiative that provides financial incentives to individual firms to reduce net greenhouse gas emissions between 2008 and 2012 — either through the reduction of greenhouse gas emissions directly, or through contributions to carbon sink enhancement.

The Program is in its third round of funding, having allocated about AUD$145 million to 15 projects established in the first and second rounds. Together, these projects are expected to reduce net greenhouse gas emissions by 27 million tonnes between 2008 and 2012. Long term funding commitments and milestone payments are involved.

Box 2.6

GREENHOUSE GAS ABATEMENT PROGRAM

The Greenhouse Gas Abatement Program (GGAP) is an Australian Government initiative, funded by the Department for the Environment and Heritage, and administered by the Australian Greenhouse Office.

The Program originally had a funding allocation of AUD$400 million, although this amount has been revised down since its inception in 1999. While the funding must be appropriated annually from the Department of the Environment and Heritage's budget, once funds are committed to a project, payments to successful funding recipients are guaranteed.

Successful projects are funded — on average — for between five and seven years, and the program will lapse in 2012.

Monitoring and evaluation is managed through reports provided by funding recipients, and audits undertaken by the Australian Greenhouse Office.

Source: http://www.greenhouse.gov.au/ggap/, accessed on 21 September 2005.

- The Australian Greenhouse Office administers the Program, which is a joint initiative of the Australian Government Department of the Environment and Heritage and the Australian Government Department of Industry, Tourism and Resources.

The specifics of GGAP agreements vary from firm to firm, depending on the activity undertaken, and the intended implementation timeframe. Generally, the agreement will require performance milestones — in addition to actual greenhouse gas emission abatement — be met by the firm, and funding is linked to the achievement of these milestones.

Participating firms are also expected to conduct their own monitoring and evaluation, and provide progress reports to the Australian Government. In addition to the submission of regular progress reports — which provide information on the achievement of outcomes and milestones, and the way in which the government funding is spent — projects are also subject to checks by the Australian Greenhouse Office. The purpose of these checks is to either conduct a financial audit of the use of government funding, or to independently verify the achievement of the outcomes or milestones reported by the participating firms.

Tasmanian Private Forest Reserves Program (PFRP)

The Tasmanian Private Forest Reserves Program was set up in 1997, with the aim of facilitating nature conservation on private land. This will have a specific focus on threatened and priority habitats and ecosystems. The PFRP will meet this objective by securing conservation areas on private land in perpetuity. Landowners still have rights to access the land for purposes such as grazing, eco-tourism, or domestic firewood collection.

There are three ways in which a landowner may participate in the program, where available payment options include:

- an up-front payment and regular management payments are available if a covenant is placed on the land title and the forest is managed in accordance with a Management Agreement;

- regular management payments are available, but no up-front payment, if no covenant is placed on the land title, but the forest is to be managed for conservation in accordance with a Management Agreement; or
- if the landowner is not interested in either a covenant or a management agreement, purchase will be considered only for forests of the highest conservation significance.

There is a five-stage process to reach an agreement. Generally, landowners are invited to approach the PFRP, but in some cases the PFRP will approach landowners about the forest on their lands. Secondly, a Conservation Officer from the Department of Primary Industries, Water and Environment will arrange a meeting to inspect the land and discuss the PFRP. Thirdly, an independent Science Advisory Group makes a recommendation about whether or not a particular area of forest should be included. If it is recommended for inclusion, then the Department appoints a negotiator to develop a property proposal and payment plan with the landowner. Finally, an Advisory Committee considers property proposals and agreements, and recommends them to the Minister for approval.

Box 2.7

TASMANIAN PRIVATE FOREST RESERVES PROGRAM

The PFRP is a Tasmanian initiative, administered by the Tasmanian Department of Primary Industries, Water and Environment.

The primary source of funding is through the Regional Forest Agreements.

The PFRP has a funding allocation of AUD$3 million, which is managed by the Department. The aim of the PFRP is to secure conservation values in perpetuity, so there is no finite project life.

The Department will conduct monitoring, evaluation and reporting to the Australian Government, using targets developed for communities, bioregions and the state as a whole. In addition, the Department will also monitor a number of agreements in each year, to check the veracity of reports.

Source: The National Action Plan on Salinity and Water Quality 2002, *Investigating New Approaches: A review of Natural Resource Management Pilots and Programs in Australia that Use Market-based Instruments*, Canberra, pp. 45-6.

Currently, there are 203 successfully completed negotiations, with 32 399 ha of forest secured. A further 213 properties are undergoing negotiations for inclusion in the PFRP.[2]

State government Trust arrangements

Australian governments have also sought to promote environmental action and covenant arrangements though the establishment of environmental trusts — sometimes established with independent boards operating at arms length from government process. Key examples include the:

Nature Conservation Trust of NSW;

NSW Environmental Trust; and

Victorian Trust for Nature.

[2] http://www.privaterfa.tas.gov.au/progress/index.html, accessed on 11 November 2005.

Nature Conservation Trust of New South Wales

The Nature Conservation Trust of New South Wales was established by the Nature Conservation Act 2001, to act as relatively autonomous conservation funding mechanism. The Trust legislation was developed on the initiative of the World Wide Fund for Nature (WWF) and the NSW Farmer's Association.

The Trust has 10 Board members who are responsible to the NSW Minister for the Environment for the management and direction of Trust activities.

The two primary goals of the Trust are to establish a widely accepted covenanting program and to operate a Revolving Fund whose objective is the purchase, covenanting and on-selling of private land with significant conservation values. A bid to operate such a fund was developed by a consortium prior to the establishment of the Trust. This consortium included the Foundation for National Parks and Wildlife, the Nature Conservation Council, Greening Australia, the Department of Land and Water Conservation and the NSW National Parks and Wildlife Service. As a result the NSW Government, through the Native Vegetation Management Fund, committed $1 million to the Revolving Fund. These funds were matched with $1 million from the Commonwealth Government through the Natural Heritage Trust.

NSW Environmental Trust

The Environmental Trust is an independent statutory body established by the NSW government to support exceptional environmental projects that do not receive funds from the usual government sources. It is administered by the Department of Environment and Conservation.

The Trust was established under the Environmental Trust Act 1998, to make and supervise the expenditure of grants with the following aims:

- encourage and support restoration and rehabilitation projects
- promote research into environmental problems of any kind
- promote environmental education in both the public and private sectors
- fund the acquisition of land for the national parks estate.

It is backed by a standing (and indexed) annual appropriation of over $15 million per annum. Cash balances are maintained, with interest paid, by the NSW Treasury Corporation.

Trust for Nature (Victoria)

Trust for Nature was formerly known (prior to 1995) as The Victorian Conservation Trust, and was established as a body corporate by the Victorian Conservation Trust Act in 1972. It come into being as a means by which people could bequeath land or money for conservation and for the purchase of Victoria's threatened, privately owned bush.

In 1978 the Act was amended to allow land owners to voluntarily place Conservation Covenants on their land, permanently protecting significant areas of natural bushland. In 1989 the Revolving Fund was added — a mechanism which allows Trust for Nature to acquire noteworthy bushland and sell it again in covenanted form.

2.2 Relevant overseas programs

United States of America

The USA's Department of Agriculture (USDA) supports a number of environmental stewardship programs in the USA, administered by either the Natural Resources Conservation Service (NRCS), or the Farm Service Agency (FSA). All of the programs are voluntary, and land managers are provided with assistance, information and incentives to participate.

Where financial incentives are provided, almost all of the government contributions are funded by the USDA's Commodity Credit Corporation, which is a government owned and operated entity. Current programs that are administered by the NRCS or the FSA, and that are funded by the CCC include the:

- Wetlands Reserve Program;
- Wildlife Habitat Incentives Program; and
- Conservation Reserve Program.

The Wetlands Reserve Program is administered by the NRCS and funded by the CCC. Its objective is to restore wetlands, and participating landowners can agree to conservation easements (similar to a land title covenant — see Box 2.8) of either permanent or 30-year duration, or can enter restoration cost-share agreements where no easement is involved. The landowner receives payment up to the agricultural value of the land and 100 percent of the restoration costs for restoring the wetland.[3]

Box 2.8

PARTICIPANT RESPONSIBILITIES AND RIGHTS UNDER AN EASEMENT OPTION

When a landowner enrols in one of the WRP easement options, the landowner is selling a real property interest to the United States. The landowner retains ownership and responsibility for the land, including any property taxes. The landowner controls access to the land; has the right to hunt and fish and pursue other undeveloped recreational uses; and may sell or lease land enrolled in the program. The landowner is responsible for noxious weeds and invasive species control and emergency control of pests as required by all Federal, State, and local laws. Participating landowners may request other uses, such as haying, grazing, or harvesting timber under certain conditions. Requests are approved if NRCS determines that the activity further enhances or protects the purposes for which the easement was acquired. Requests for compatible uses may be made throughout the life of the easement or agreement.

Source: http://www.nrcs.usda.gov/programs/wrp/, accessed on 21 September 2005.

The cost of an average project is approximately USD$250 000, and there are currently 7831 projects enrolled in the program, covering 1.5 million acres. The Secretary of Agriculture is able to enrol up to 250 000 additional acres into the program annually.

There are three enrolment options under the program, varying by length of participation, and the amount of funding provided by the CCC.

[3] http://www.nrcs.usda.gov/programs/programs_faq.html accessed on 16 September 2005.

- *Permanent easement* — easement payments for this option equal the lowest of three amounts: the agricultural value of the land, an established payment cap, or an amount offered by the landowner. In addition to paying for the easement, the U.S. Department of Agriculture (USDA) pays 100 percent of the costs of restoring the wetland.
- *30-year easement* — easement payments through this option are 75 percent of what would be paid for a permanent easement. USDA also pays up to 75 percent of restoration costs.
- *Restoration cost-share agreement* — this is an agreement (generally for a minimum of 10 years) to re-establish degraded or lost wetland functions and values. USDA pays up to 75 percent of the cost of the restoration activity. This enrolment option does not place an easement on the property.

Wildlife Habitat Incentives Program

The Wildlife Habitat Incentives Program is administered by the NRCS, and funded by the CCC. It provides financial incentives to develop habitat for fish and wildlife on private lands. Participants agree to implement a wildlife habitat development plan and USDA agrees to provide cost-share assistance for the initial implementation of wildlife habitat development practices. [4] Currently, there are approximately 14 700 participating landowners, who have enrolled more than 2.3 million acres under the program.

The Program provides cost-share payments to landowners under agreements that span five to ten years, determined by the sorts of practices installed. There is also an option to enter into a fifteen-year agreement, in order to provide a higher level of cost-share assistance for participants who wish to provide a higher level of service, and up to 15 per cent pf the funding available under the Program is reserved for the fifteen-year agreements.

Conservation Reserve Program

The Conservation Reserve Program is administered by the FSA, and funded by the CCC. The objectives of the Program are to reduce soil erosion, protect the nation's ability to produce food and fiber, reduce sedimentation in streams and lakes, improve water quality, establish wildlife habitat, and enhance forest and wetland resources. It also encourages farmers to convert highly erode-able cropland or other environmentally sensitive acreage to vegetative cover, such as tame or native grasses, wildlife plantings, trees, filterstrips, or riparian buffers. Farmers receive an annual rental payment for the term of the multi-year contract. [5]

Participating farmers receive annual cost-share payments that are valued at up to 50 per cent of the costs they incur in establishing approved conservation practices on their land. Under the Program, participants have the option of agreements spanning either ten or fifteen years. In the twenty-ninth — and latest — sign-up in 2004, the Program enrolled approximately 19 700 of the 26 000 applications received, bringing 1.2 million acres under management. The cost share payments for the financial years 2201 to 2004 are USD$1.8 billion on average per year.

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[4] http://www.nrcs.usda.gov/programs/programs_faq.html accessed on 16 September 2005.

[5] http://www.nrcs.usda.gov/programs/programs_faq.html accessed on 16 September 2005.

Canada

Greencover Canada Project — Land Conversion

The Greencover Canada Project is a five-year project with a funding allocation of CAD$110 million, administered by Agriculture and Agri-Food Canada. The aim of the initiative is to assist producers improve their management practices, specifically in the areas of:

- land conversion — converting environmentally sensitive land to perennial cover (see box 2.9);
- technical assistance — helping producers adopt beneficial management practices (BMPs) (see box 2.10); and
- shelterbelts — planting trees on agricultural land.

The land-conversion project provides participants with financial incentives and advice for planting approved vegetation on land that is identified as environmentally sensitive. Successful recipients of the funding incentives are required to agree to ten-year land use agreements.

Box 2.9

LAND CONVERSION

In order to participate in the land Conversion Program:

- applicants must be registered landowners (indicated on Certificates of Title or Deed). Renters or leaseholders are not eligible for financial assistance through Greencover Land Conversion;
- the proposed land must be eligible for conversion — based on land quality, Canada Land Inventory class, land use and an assessment of environmental sensitivity; and
- applicants must agree to seed their land with approved perennial plants and enter into a 10-year contribution and land use agreement.

Successful applicants are then eligible for payments based on the following schedule:

- $20 per acre for seeding or planting tame forage or trees, OR, $75 per acre for native species. Accepting a seeding payment represents a commitment by the applicant to enter into a contribution and land use agreement; and
- $25 per acre following the establishment and inspection of perennial cover, and the signing of a 10-year contribution and land use agreement. This payment will be adjusted to account for any seeding overpayment.

Source: http://www.agr.gc.ca/env/greencover-verdir/faq_conv_e.phtml, accessed on 15 September 2005.

The Watershed Evaluation of BMPs (WEBs) is the Greencover Canada initiative aimed at assisting farmers find out about and adopt beneficial management practices to, among other things, protect habitat and retain water quality. The WEBs initiative has a funding allocation of CAD$5.65 million from the Government of Canada, as well as CAD$1.25 million from Ducks Unlimited Canada — a conservation group. The initiative aims to fund studies on micro-watershed sites (approximately 300 hectares in size) that attempt to quantify the relative environmental and economic effects of selected beneficial management practices.

In addition to the research and development of beneficial management practices, the technical assistance component of the Greencover Canada Program also provides funding incentives for the implementation of these practices. The provincial governments of Canada administer the provision of incentives to farmers, and as a result, the delivery of the program varies between the provinces.

Box 2.10

TECHNICAL ASSISTANCE COMPONENT AS ADMINISTERED IN SASKATCHEWAN

There have been two calls for proposals in Saskatchewan. In the first call for proposals, 12 of 33 proposals were approved at a total value of CAD$1.4 million, and in the second, 12 of 15 proposals were approved at a total value of CAD$670 000. While the projects approved so far have been multi-year projects, the next call for projects will approve a total of CAD$500 000 for one-year projects.

There are no matching funding requirements, and the provincial government is prepared to approve 100 per cent of all eligible expenses, however payments are made upon the completion of the project, or a phase of the project, and the size of the payment may be reduced due to whether or not funds can be appropriated in that financial year, and whether or not departmental funding levels are altered by Parliament.

Source: http://www.agr.gc.ca/env/greencover-verdir/sk_ta_e.phtml, accessed on 15 September 2005.

The Shelterbelt Enhancement Program (SEP) is a CAD$4 million Government of Canada initiative, aimed at reducing greenhouse gases.

> Shelterbelts…can be planted to establish habitat for wildlife, increase biodiversity, protect waterways and, in some cases, provide alternate income from tree products. Shelterbelts have also been recognized for their carbon sequestration potential and as a means of reducing fossil fuel consumption when farm buildings are sheltered.[6]

Unlike the other two programs, the SEP does not provide financial incentives. Rather, it provides successful applicants with the necessary plants and plastic mulch required to construct shelterbelts.

European Union

European Union's 'Common Agricultural Policy'

The European Union's 'Common Agricultural Policy' (CAP) deals with the integration of environmental concerns into the CAP rules, as well as with the development of agricultural practices preserving the environment and safeguarding the countryside. A reform to the CAP in 2000 (specifically to the 'Horizontal Regulation') requires that Member States undertake appropriate environmental measures in relation to the use of agricultural land, and to agricultural production when providing support to farmers.

Under the reform, when granting direct aid, Member States can take account of environmental issues by making the grant of aid subject to:

- agri-environmental undertakings;
- general mandatory environmental requirements; or

[6] http://www.agr.gc.ca/pfra/climate/shbenhpfaq_e.htm, accessed on 15 September 2005.

- specific environmental requirements constituting a condition for direct payments.[7]

From 2005 onward, farmers that receive direct payments will be subject to 'compulsory cross compliance', requiring that they observe a minimum level of environmental standard in exchange for the full granting of direct payments. At the same time, if a community its farmers to achieve a higher standard than the minimum, this higher standard should be purchased using 'agri-environmental measures'.

Agri-environmental schemes have been used in the European Union since the 1980s. Under the reforms to the CAP, the schemes are obligatory for Member States, but voluntary for farmers. 'Farmers who commit themselves, for a five-year minimum period, to adopt environmentally-friendly farming techniques that go beyond usual good farming practice, receive in return payments that compensate for additional costs and loss of income that arise as a result of altered farming practices. Examples of commitments covered by national/regional agri-environmental schemes are:

- environmentally favourable extensification of farming;
- management of low-intensity pasture systems;
- integrated farm management and organic agriculture;
- preservation of landscape and historical features, such as hedgerows, ditches and woods; and
- conservation of high value habitats and their associated biodiversity.[8]

An example of one of the programs offered by a Member Country, under the CAP, is the United Kingdom's 'Environmental Stewardship' program. This is a relatively recent initiative, replacing the Environmentally Sensitive Areas Scheme that was in place from 1987 to 2005. The Department for Environment, Food and Rural Affairs administers the Program, with the aim of providing funding to land managers in England that deliver effective environmental management on their land. The Program's direct objectives are to:

- conserve wildlife (biodiversity);
- maintain and enhance landscape quality and character;
- protect the historic environment and natural resources;
- promote public access and understanding of the countryside; and
- protect natural resources.

By achieving the direct objectives, the Program will also indirectly achieve its objectives for genetic conservation and flood management. There are three categories of Environmental Stewardship — Entry Level Stewardship (ELS), Organic Entry Level Stewardship (OELS) and Higher Level Stewardship (HLS). These are described further in boxes 2.11, 2.12 and 2.13.

7 http://europa.eu.int/scadplus/leg/en/lvb/l60025.htm, accessed on 14 September 2005.

8 http://europa.eu.int/comm/agriculture/envir/index_en.htm, accessed on 14 September 2005.

Box 2.11

ENTRY LEVEL STEWARDSHIP

- Participants are eligible for a payment of £30 per hectare per year for the land that they enter into the scheme.
- Payment is linked to the achievement of a 30 point target per hectare. Participants can choose from over 50 simple management options, each of which is worth a certain number of points. There are options to suit most farm types.
- Provided that participants agree to deliver options that meet their 'points target', and to meet the scheme conditions, they will be automatically accepted into the scheme.
- The program is delivered at a regional level, through the Rural Development Service's Business Delivery Centres.
- Agreements last five years, and payments are automatic with no claims required until the fifth year.

Source: http://www.defra.gov.uk/erdp/pdfs/es/es-promotional-booklet.pdf, accessed on 14 September 2005.

Entry Level Stewardship is 'is a "whole farm" scheme open to all farmers and land managers who farm their land conventionally. Acceptance will be guaranteed provided [they] can meet the scheme requirements.'[9]

Box 2.12

ORGANIC ENTRY LEVEL STEWARDSHIP

OELS is much the same as ELS, but with the following differences.

- Participants are eligible for a payment of £60 per hectare per year for all the organic land they enter into the scheme.
- Payment is linked to the achievement of a 60 point target per hectare. Participants are automatically awarded 30 points per hectare to reflect the inherent environmental benefits delivered through organic farming. The remaining 30 points will be made up from a range of management options similar to the ones available under the ELS.
- Some of the options available under ELS are not available on organically managed land as they are inappropriate for organic systems (e.g. conservation headlands). The organic land that participants want to put into OELS must be registered as 'fully organic' or 'in conversion to organic farming' with an Organic Inspection Body before an application is made. Copies of current, valid, certificates of registration and accompanying schedules must be submitted with an application.
- Aid for converting conventionally farmed improved land and established top-fruit orchards (planted with pears, plums, cherries and apples, excluding cider apples) is also available as a top-up to OELS payments. Payment rates are £175 per hectare per year for 2 years for improved land and £600 per hectare per year for 3 years for established top fruit orchards. To qualify, the land must not previously have been converted to full organic production, it must be registered as 'in conversion to organic farming' with an Organic Inspection Body and be in its first year of conversion before an application is made.

Source: http://www.defra.gov.uk/erdp/pdfs/es/es-promotional-booklet.pdf, accessed on 14 September 2005.

[9] http://www.defra.gov.uk/erdp/schemes/es/default.htm, accessed on 14 September 2005.

Organic Entry Level Stewardship is 'a "whole farm" scheme similar to ELS, open to farmers who manage all or part of their land organically and who are not receiving aid under the Organic Aid Scheme or the Organic Farming Scheme.' [10]Higher Level Stewardship is 'is designed to build on ELS and OELS to form a comprehensive agreement that achieves a wide range of environmental benefits across the whole farm. HLS concentrates on the more complex types of management where land managers need advice and support and where agreements will be tailored to local circumstances.'[11]

Box 2.13

HIGHER LEVEL STEWARDSHIP

- The payments are linked to the management options chosen. In all but a few specified situations, applicants to the HLS must also apply for, or already be in, either ELS or OELS.
- HLS applicants are required to prepare a Farm Environment Plan (FEP) to identify the important environmental features on their farm and their current condition. The FEP is submitted with their application and they will receive a payment (of not less than £395) for completing it, based on the area of their farm.
- There is a wide-ranging and comprehensive list of land management options linked to specific environmental features. The information in the FEP is used as a guide to help select the options most appropriate to each farm.
- Payments are available for a wide range of capital works, which may be claimed at any time after completion of the work.
- Entry into the scheme is discretionary; applications will go through an assessment procedure that will take into account how the application meets the environmental priorities identified in a participant's local HLS 'targeting statement'.
- The final agreement will be developed in discussion with an Rural Development Services adviser. Agreements will last normally 10 years with a 5-year break clause.
- Successful applicants will receive a payment every six months, equivalent to half their annual management payment for that year. Unlike under the ELS and OELS, they will however need to complete a claim to enable payment of the second half of the payment for that year.
- 'Indicators of success' will be agreed with participants (e.g. particular species of birds to be present by year three) to give them a good idea of what should be achieved on the ground and by when. During the lifetime of their agreement, participants will be given feedback on how successful their management is at achieving its aims.

Source: http://www.defra.gov.uk/erdp/pdfs/es/es-promotional-booklet.pdf, accessed on 14 September 2005.

New Zealand

Sustainable Management Fund

New Zealand's Ministry for the Environment administers the Sustainable Management Fund (SMF). The SMF's objectives are 'to make a positive difference to the environment by funding projects:

- that fit under one of the five topic areas:
  - freshwater management initiatives;

[10] http://www.defra.gov.uk/erdp/schemes/es/default.htm, accessed on 14 September 2005.

[11] http://www.defra.gov.uk/erdp/schemes/es/default.htm, accessed on 14 September 2005.

  - 'adopt a' schemes (for example, adopt a stream, a beach, a reserve, and so on, for restoration or maintenance);
  - urban sustainability;
  - waste minimisation and resource recovery;
  - practical action to address climate change;
- that strengthen partnerships between the community, industry, iwi and local government; and
- that can demonstrate buy-in and support from stakeholders'.

Sustainable Farming Fund

A similar program is the Sustainable Farming Fund (SFF), which is administered by New Zealand's Ministry of Agriculture and Forestry, with the objective of supporting projects that will contribute to improving the financial and environmental performance of the land-based productive sectors.

> The SFF aims to help the land based sectors solve problems and take up opportunities to overcome barriers to economic, social and environmental viability. It will do this by bringing together "communities of interest". These are groups of people drawn together by a shared problem and/or opportunity in the sustainable use of resources.[12]

To achieve its objectives, the SFF provides for a range of activities, including the identification of barriers to and options for improved land use and management. Projects run from between one and three years, and the maximum funding for projects is NZD$200 000 per project per year.

2.3 Key observations

There are several programs — in Australia, and around the world — that have payments to landholders, long-term agreements, and the monitoring and evaluation of services provided. Only a handful of programs have all these characteristics, and off-budget management of government funding appears to be rare (even in the case of the Natural Heritage Trust, monies are moved from the Commonwealth budget into State government control). NSW Trust arrangements also appear to be based on cash balances managed by the NSW Treasury Corporation.

A number of programs have significance for this study including:

- Goulburn-Broken CMA's Bush Returns program;
- Victorian Department of Sustainability and Environment's BushTender program; and
- UK Environmental Stewardship Program.

These provide progress payments for environmental action and extend over several years. However, even these do not exhibit the long term contractual arrangements and performance monitoring envisaged by DEH for this project.

[12] http://www.maf.govt.nz/sff/criteria/index.htm, accessed on 15 September 2005.

Consultations with managers of some of the Australian programs revealed a shared frustration at the fact that the length of agreements could not be matched to the amount of time it took for outcomes to be realised. Management of unallocated (or unpaid) program funds by government treasuries also appears to be a common characteristic of these programs.

Innovation in these programs tends to be focused in service delivery and monitoring arrangements, rather than financial engineering. Asset management has not tended to be out-sourced. Even in the case of the NHT funding to catchment management authorities, draw down from State government budgets tends to be made on an annual basis in respect of approved longer term action plans.

Chapter 3

Framework and threshold design issues

A stewardship program that established a payment system for delivery of a stream of 'environmental services' would incorporate a number of key operational elements. These would be integrated to ensure the streamlined and effective management of the Commonwealth's financial contribution to the program, and the delivery of a high value stream of on-land outcomes. Various design combinations and choices are relevant to attempting to maximise the environmental return on the funds invested.

Key functions for the program in support of the ongoing provision by landowners of environmental services would include:

1. policy framework (including the scope and nature of services to be provided, the nature of obligations to be assumed by participants and the legal framework for enforcing those obligations);
2. selection of participants;
3. funding
4. financial asset management;
5. payments;
6. monitoring and verification;
7. suspension or removal of participants failing to provide the agreed environmental services.

These functions would need to be planned for and linked together in a way that addressed operational risks and supported the overall effectiveness of the program. Issues associated with each of these elements are discussed briefly below.

This report focuses on the financial elements (ie. modules 3,4,5 and 7 - funding, asset management and provision of payments, including their suspension). However, in bringing all the elements together it is important to understand the role and options available for the suite of functions. A holistic approach such as this will help ensure that the design process focused on financial aspects is fully informed of, and can accommodate, potential design outcomes for downstream elements.

3.1 Issues in developing program elements

Funding

The program, as currently envisaged, would be driven by Commonwealth funding. However, it is feasible that if successful, other sources of finance could be available. Potential co-contributors could be drawn from State and Territory governments, environmental groups (and private individuals) and business organizations.

The latter group might have an interest in contributing to such a program in a benevolent capacity or — depending on eligibility arrangements in certain jurisdictions — as part of environmental 'offsets' arrangements. Offset arrangements are being developed and implemented in a number of Australian States (eg. Western Australia and NSW) and are also feasible under the Commonwealth Environmental Protection and Biodiversity Conservation Act (EPBC) 1997. A number of private trusts have been established to fund conservation activities and have been accorded charitable status under the Tax Act. Examples include the:

- R E Ross Trust;
- ANZ Foundation;
- Myer Foundation;
- Trust for Nature Foundation; and
- Environmental Trust (administered by the NSW Department of Environment and Conservation).

A Trust Fund established by the Commonwealth could receive similar status which would encourage private contributions to the program.

Given that the program is essentially a delivery mechanism for achieving objectives already defined under the EPBC and other relevant Acts, it would be feasible for Commonwealth funding already appropriated for the purpose of environmental and biodiversity enhancement on private lands to be used to fund this program. Of course, any additional funding beyond existing appropriations and forward estimates would need to be sought via the new policy process.

Management of financial assets

Compliance with the Commonwealth Financial Management and Accountability (FMA) Act 1997 is a fundamental requirement for the program. As highlighted in the preamble to the Act:

> The main purpose of this Act is to provide a framework for the proper management of public money and public property. …. Broadly, those terms refer to money or property that is owned or held by the Commonwealth, including money or property held on trust. This Act contains rules about how public money and property are to be dealt with. Many of the detailed rules are in Finance Minister's Orders made under section 63 and regulations made under section 65.
>
> Financial Management and Accountability Act 1997, page iii (amendments and compilation as at 2 March 2005)

The Act covers a range of issues including the collection and custody of public money, borrowing and investment provisions, the accounting framework underpinning the Consolidated Revenue Fund and reporting and audit requirements.

Importantly, a threshold issue for development of this program is the scope to deliver the program effectively from within the standard Commonwealth budget framework.[13]

[13] There are echoes of this approach — particularly with respect to the proliferation and complexity of governance arrangements for statutory authorities in the Uhrig Review, and government's response to it. See Uhrig, J. (2003) Review of the Corporate Governance of Statutory Authorities and Office Holders, Commonwealth of Australia, Canberra

The Department of Finance advises that it is feasible, with the approval of the Minister for Finance, to enter into long term funding agreements with land holders. Such agreements would not need to approved on a case by case basis but could be approved at a ‘program’ level, with senior officials exercising the Minister’s delegation to commit the Commonwealth (and future budgets) to such contracts. As stipulated in section 44 of the FMA Act, it is the responsibility of agency chief executives to apply these delegated powers and responsibilities in line with relevant regulations, special instructions, Finance Minister’s Orders or other legal requirements — and with the aim of promoting the …. *efficient, effective and ethical use* … of Commonwealth resources.

The scope and provisions for Commonwealth officials to make funding commitments that are not covered by existing budget appropriations are covered in Regulation 10 of the FMA Act. The operation of FMA Regulation 10 (and related Regulations 9,12 and 13) is covered in detail in Finance Circular 2004/10 (see Box 3.1). Importantly, the Finance Circular makes it clear that, in the absence of specific Regulation 10 approval or other legislative provisions, agencies should not make commitments to pay funds out of future budgets. This is explicitly linked to the goal of retaining budget flexibility and avoiding ‘lock-in’ of future expenditures.

Box 3.1

FMA REGULATION 10: COMMITMENTS BEYOND BUDGET APPROPRIATIONS

FMA Regulation 10 authorisation is required for approvers of spending proposals where the total amount of public money that may become payable under the spending proposal cannot be funded from within sufficient uncommitted appropriations.

Types of appropriations — Appropriations are classified for reporting and other purposes as either administered or departmental. Departmental appropriations are controlled by Agencies and used in producing their outputs. Administered appropriations are those that the Agency does not control directly but, rather, are controlled by the Government and managed or overseen by Agencies on behalf of Government. Further information on the distinction between administered and departmental appropriations is available in the Financial Management and Accountability Orders (Financial Statements for reporting periods ending on or after 30 June 200x).

Forward estimates are not appropriations — As noted in paragraph 8 above, when assessing whether FMA Regulation 10 authorisation is required, regard can only be had to appropriations that exist or are before Parliament. This may require consideration of the annual Appropriation Acts (and proposed appropriations in Bills before Parliament), the effect of any net appropriation agreements under section 31 of the FMA Act and special appropriations generally, including Special Accounts under the FMA Act (as discussed more fully in paragraphs 57-59 below). Regard cannot be had to forward estimates, however, as these are not appropriations but merely estimates of future expenditure that might be made from a future appropriation. On the other hand, forward estimates are relevant when considering a spending proposal under the Delegation.

Authorisation is not an appropriation — An authorisation under Regulation 10 does not itself create any appropriation or guarantee of future funding.

Source: DoFA 2002, Using the Financial Management and Accountability Regulation 10 Delegation, Finance Circular 2004/10, Department of Finance and Administration, s.43 – 46.

With Regulation 10 approvals in place Commonwealth agencies can enter long funding commitments with service providers and other parties. However, from an agency perspective this implies an implicit risk that any future need for budget stringency will result in a squeeze on other 'discretionary' areas of program funding. This approach implies the primacy of fiscal priorities over micro-economic opportunities for gains in welfare and economic efficiency. For clients too — even those holding long term contracts — the prospect of changing Commonwealth attitudes to budget priorities and micro-economic objectives can be destabilising.

The overt budget flexibility demanded by government can easily undermine the confidence landholders place in long term contracts with the Commonwealth government. Despite the legal protections, it is not hard to envisage landholders having residual concerns about making a contract with a body with the power to make and amend the law, and an explicit reluctance to set aside the funding described in the contract.

Even given the high standing of the Commonwealth in terms of credit worthiness, low sovereign risk and reputation as a model litigant it is entirely feasible that, in the mind of the landholder, an agreement to future payments (even one made by the Commonwealth) might not provide the same level of assurance as an arrangement where those monies were reserved for future disbursement at the time the agreement is made.[14]

This is not to suggest that governments could or should run their entire budgets this way. Economic growth will tend to mean greater funds availability in the future, and few would recommend the level of budgetary and policy lock-in implied by extending long term legislated appropriations, or similar guarantees of future funding for all programs with long term objectives.

However, it does highlight that in certain circumstances Regulation 10 payment approvals can be "psychologically" imperfect substitutes for advance draw down arrangements, and these circumstances (and the nature of the stakeholders and funding involved) need to be considered on a case by case basis. As noted above perceptions by landholders of a history of time limited, short term commitments by governments at all levels to natural resource management programs – of fashions and fads – discourage participation in programs of this nature. Funding arrangements that clearly insulate programs from these political vicissitudes can be psychologically important in gaining landholder commitment to conservation stewardship.

It is also feasible that government may see merit in setting aside funding for forward commitments at times of economic buoyancy, rather than authorising a call on future budgets (via Regulation 10) and uncertain cash flow. This could actually enhance future budget flexibility, in a world where government was indeed looking to honour its prior payment commitments. This is a particularly relevant consideration from the viewpoint of those responsible for managing the Commonwealth's environmental programs.

[14] ACG understands that there are examples of Commonwealth revisions to long term funding commitments subject to Regulation 10 approvals. Once such example involved changes to matching grant arrangements under the Renewable Energy Equity Fund (REEF).

These issues point to the potential for off budget management of program funds. As identified in the previous chapter, there does not appear to be strong precedents for this approach. Advance funding of long term environmental action at a Commonwealth level, in those cases where it has occurred, has tended to involve the establishment of trust accounts managed by the States with payments from these to statutory bodies (ie. catchment management authorities) with subsequent disbursement to private entities. And government treasuries manage the funds in government hands.

Nevertheless, it is theoretically possible to develop a Commonwealth program of long term conservation finance and environmental service delivery that was fully funded from a single year's appropriation (or a 4 year program commitment).

The FMA Act explicitly provides the Finance Minister (and the Treasurer) with the power to make 'investments' in private banking institutions (see Box 3.2). Further, Finance Circular 2003/08 describes the redefinition of publicly held Trust Accounts to Special Public Money (SPM) Accounts and exempt SPM accounts that may be held off-budget (see Appendix B).

Specifically, '<u>Special</u> Public Money' is defined (at section 16 of the FMA Act) as:

> '… public money that is not held on account of the Commonwealth or for the use or benefit of the Commonwealth.'

It can cover a range of transactions and circumstances where the Commonwealth holds money on behalf of third parties, or for a specifically agreed purpose. Deposits in Trust accounts (where the Commonwealth is the Trustee) are a subset of SPM — with Trust accounts being subject to Trust law. ANAO Audit Report 18 notes that a 'trust' will typically have the following characteristics:

- a Trust Deed, specifying the trustee, beneficiaries, property and terms of the Trust;
- transfer of <u>ownership</u> of the money or property to the Trust (not just custodianship);
- as requirement to keep the money/property separate from other money; and
- a requirement to hold and apply the money solely for the benefit of an entity other than the Commonwealth;
- the arrangement is intended to be legally binding.[15]

It is possible for funds to be expended from budget appropriations to a Trust (established on the basis of Trust Deeds established by the Commonwealth or an existing private trust) that in turn would manage the funds and allocate fund income in a manner consistent with its objectives (the ATSIC Land Trust and associated regional charitable trusts are worth exploring as precedents in this regard).

[15] Australian National Audit Office (2002), *Management of Trust Monies,* Audit Report No. 18, Appendix 3.

In cases where the Commonwealth (ie. Departments or prescribed agencies) was the custodian or trustee of money transferred to these accounts, the balances would be classified as Special Public Money, and the investment requirements of the FMA Act would apply. Under normal circumstances the SPM accounts established (including trust accounts) would be deposited with the Reserve Bank as part of the Official Public Account — and held in line with normal prudential investment practices (this is the effect of Finance Minister Special Instruction notified by Finance Circular 2003/10 of 31 October 2003).

However, if the SPM is held under a Trust Deed that specifically requires it to be held separately from other money, it would not be subject to this 'sweeping' arrangement. This is an exempt SPM Account. Such an account may also be able to operate with wider discretion over investment options than normally provided under the FMA Act — depending on the terms of the Trust Deed.

However, there is no precedent for the Commonwealth establishing an SPM — the essence of an SPM Account is that it is non-Commonwealth money (examples of SPMs include bequests for enhancements to a public asset (such as a memorial, or money held by the Commonwealth whose ownership is yet to be legally established). There could be extreme sensitivities around the Commonwealth establishing an SPM Account for the purpose, or with the effect of, holding what was primarily Commonwealth money.

The implications of Section 39 of the FMA Act involving the 'investment' of public money are discussed in Finance Circular 2005/11. It highlights the tight conditions that apply under the FMA Act. In addition to requirements that public money be held in government backed securities and/or bank deposits (with this term strictly defined), current interpretation of Section 39 expressly rules out investment in assets such as:

- medium term notes and fixed or floating rate notes;
- money market trusts/ cash management trusts; or
- bills of exchange (that do not comply with FMA Regulation 22).

DoFA, Finance Circular 2005/11, Department of Finance and Administration (para 6)

With these stipulations in mind, and provided requirements for *efficient, effective and ethical* use of Commonwealth resources are met — and risks are appropriately identified and managed, program managers might entertain options for early draw down of available funds, with private sector involvement in custodianship, asset management and payment disbursement.

Development of this option would require exploration of the:

- form that the relationship between the funds provider and funds manager might take (eg. the Commonwealth would not be depositing funds for investment purposes, but having them held in trust or managed to support payment commitments — possibly through a Charitable Trust arrangement);
- cost effectiveness of different options with respect to fee structures;
- acceptable levels of risk and return in terms of generating and 'guaranteeing' future payments; and

- implications of possible future growth in the scope, size and number of suppliers to the program.

Box 3.2

INVESTMENT OF PUBLIC MONEY: SECTION 39 OF THE FMA ACT

(1) The Finance Minister may invest public money in any authorised investment.

(2) For the purpose of managing the public debt of the Commonwealth, the Treasurer may invest public money in any authorised investment.

(3) An investment of public money under this section must not be inconsistent with the terms of any trust that applies to the money concerned.

Clause (4) ………investments from a Special Account – expenses ….

Clause (5) ………investments from a Special Account – proceeds ….

(6) At any time before an investment matures, the Finance Minister or Treasurer, as the case requires, may authorise the re-investment of the proceeds upon maturity in an authorised investment with the same entity.

Note: The proceeds of investment of the original investment will not become public money when the investment matures because the proceeds will not be received by or on behalf of the Commonwealth.

(7) The corporation established by section 62B of the Audit Act 1901 is continued in existence for the purposes of this section with the name “The Minister for Finance of the Commonwealth”. Investments by the Finance Minister under this section must be made in that corporate name.

Clause (8) …. relevance to section 8 of the Loan Consolidation and Investment Reserve Act 1955 …..

(9) The CRF is appropriated as necessary for the purposes of this section.

(10) In this section authorised investment means:

(a) in relation to the Finance Minister—any of the following investments:

(i) securities of the Commonwealth or of a State or Territory;

(ii) securities guaranteed by the Commonwealth, a State or a Territory;

(iii) a deposit with a bank, including a deposit evidenced by a certificate of deposit;

(iv) any other form of investment prescribed by the regulations; and

(b) in relation to the Treasurer—any of the following investments:

sub-clauses (i) – (iv) …. describing investments relevant to managing the public debt …..

(v) any other form of investment prescribed by the regulations.

Source: Excerpts from s.39 of the Financial Management and Accountability Act 1997

Payment system

Payments from the ‘funding account’ need to be made on a periodic basis to landholders. This function is separate to funds management – although it is feasible that one organisation might be the most cost effective solution to the provision of these services.

The cost of delivering this function (and associated issues for coordination and communication with other program delivery functions) can be influenced by:

- number of payment recipients;
- payment frequency;
- timing of payments;
- ‘standardisation’ of payment amounts to a recipient;

- whether payment is established on a 'default' or individually sanctioned basis;
- the process for stopping or suspending payments.

Monitoring and verification

Monitoring and verification of delivery of environmental services is a critical and challenging component of the program. While upstream elements involve the administration and distribution of funding, monitoring elements ensure the delivery of serves and outcomes targeted by the program. Funds management is a well practiced activity offering considerable market depth and a proven track record. On the other hand, defining, measuring and reporting on flows of environmental services (or even the activities that are the precursors to those services) is still in development. Yet these activities are crucial to ensuring that public funds (and any other contributions) are well spent, and successfully driving the environmental outcomes that fundamentally reflected in the program objectives.

Drawing knowledge and experience in this area will be critical to the success of the program. That experience is being built up across a range of State-based programs, and in a variety of overseas jurisdictions. The mechanisms and analytical frameworks employed will prove valuable lessons. However, these will also need to be adjusted to reflect expert judgement and advice on minimum expectations, and definitions at the farm level, of the threshold that separates environmental responsibility – that society might reasonably expect of land holders — from enhanced performance — that would justify a payment.

These activities are also linked, in a mechanical way, to consideration of finance requirements. Arrangements for payment of monitoring and verification services must be taken into account in designing the program. Like the funding itself, there may be a need for arrangements (and funds) for audit functions to outlive the initial appropriation for the program. This would require a set-aside amount for verification funding. Alternatively, DEH may be prepared to carry this obligation, and direct (and pay for) verification activities on a year-on-year basis.

The arrangement settled on in the final design would need to be reflected in both the funding and contractual arrangements developed by DEH. Relevant issues will include:

- fee structure (eg. co-payment, fixed fee);
- intensity of audit/ verification proposed (eg. cost per audit);
- reporting structure and authority regarding payment suspension or continuation (eg. advice to DEH, instructions to payer institution, etc).

Service provision

Landholders are the funding recipients and service providers within the program. They are recruited and drawn into long term contracts with the Commonwealth (or the relevant body with ultimate responsibility for the fund and the payments it delivers).

Recruitment and assessment of the value of services that could be delivered, in addition to assessment of what is actually being delivered (as discussed above), are complex exercises that would need careful analysis and planning in further development stages of the program.

Nevertheless it is apparent at the outset that the recruitment and monitoring/ audit functions of the program should be vested in separate entities in order to avoid conflict of interest issues. Other contract and design elements would need to cover issues including:

- size and frequency of payments;
- on-site access for performance of the verification function;
- options and implications for suspension of payments (back-payment or catch–up arrangements could add significant complexity and inflate asset administration costs;
- arrangements for withdrawal from the program;
- triggers for suspension or termination of the contract (eg. drought or bushfire resulting in the destruction of environmental or biodiversity value) — and implications for the funding stream.

3.2 Implications

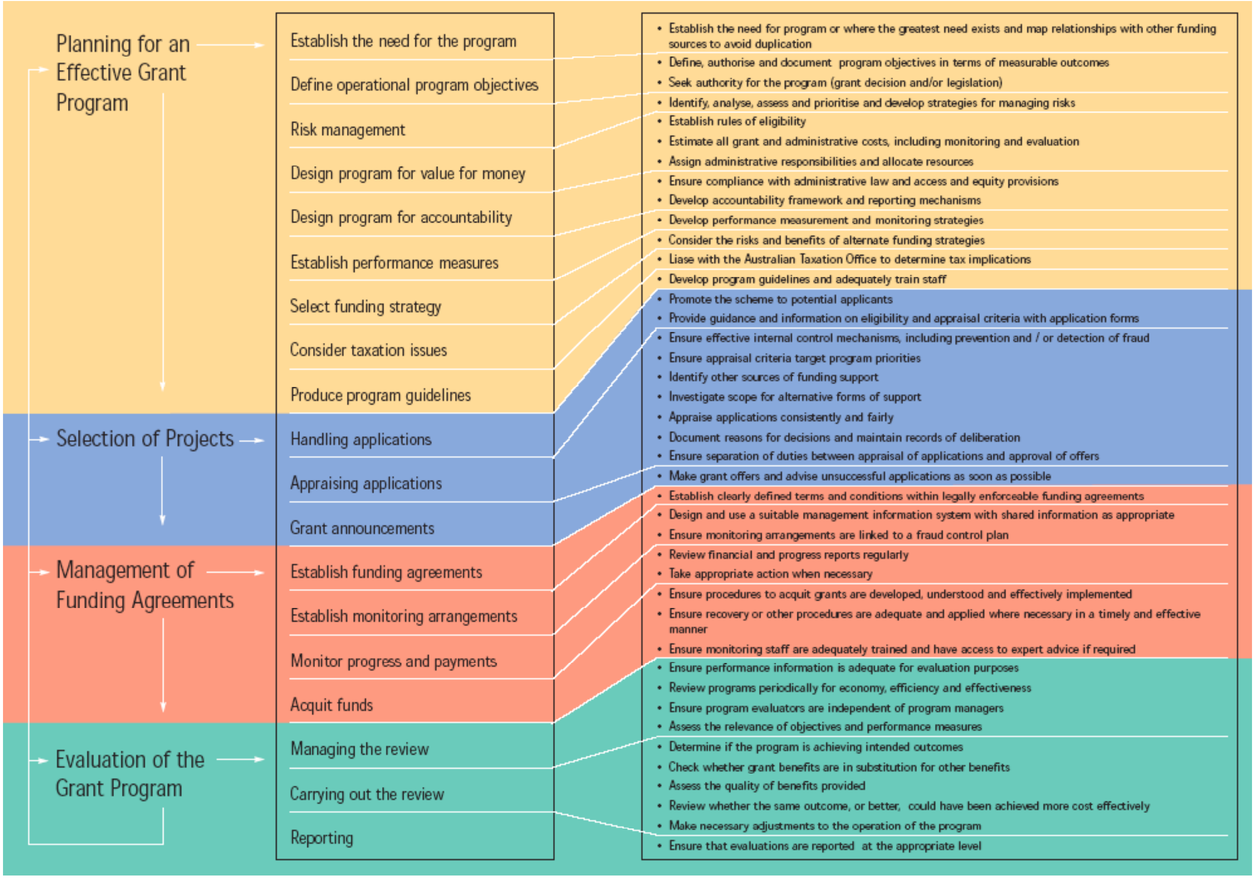
These elements need to be integrated into a robust package that delivers on objectives, provides value for money and complies with legislation and government policy. Development of this program must build on past experience in this area, and the expertise that exists and is being built up around each of the different facets of the program. The challenge is to link an innovative funding arrangement, that cuts across DoFA preferences for a year-by-year approach to budget planning and appropriations that provides government with flexibility to revise past plans as emerging circumstances dictate, with a market approach to environmental services that requires the description, valuation and measurement of factors that are often qualitative and contextual. Stringent requirements on Commonwealth 'investments' (as opposed to Budget outlays) must also be navigated.

At a program level, the Australian National Audit Office (ANAO) emphasises the need to identify and address the risks that are inherent in a funding program. Lessons from past ANAO experience have been drawn together into 'Best Practice' guides. These provide a starting point for considering further design issues and identifying and covering potential difficulties before they occur. A summary table from the ANAO Best Practice Guide on grants is reproduced below in Figure 3.1.

Notably, the insights provided by this project into the options and pathways for developing funding and payment arrangements, and integrating these with other elements in the function chain, forms part of this risk analysis and is integral to 'best practice' evaluation and design.

Figure 3.1

ANAO ADVICE ON BEST PRACTICE DESIGN FOR GRANTS PROGRAMS



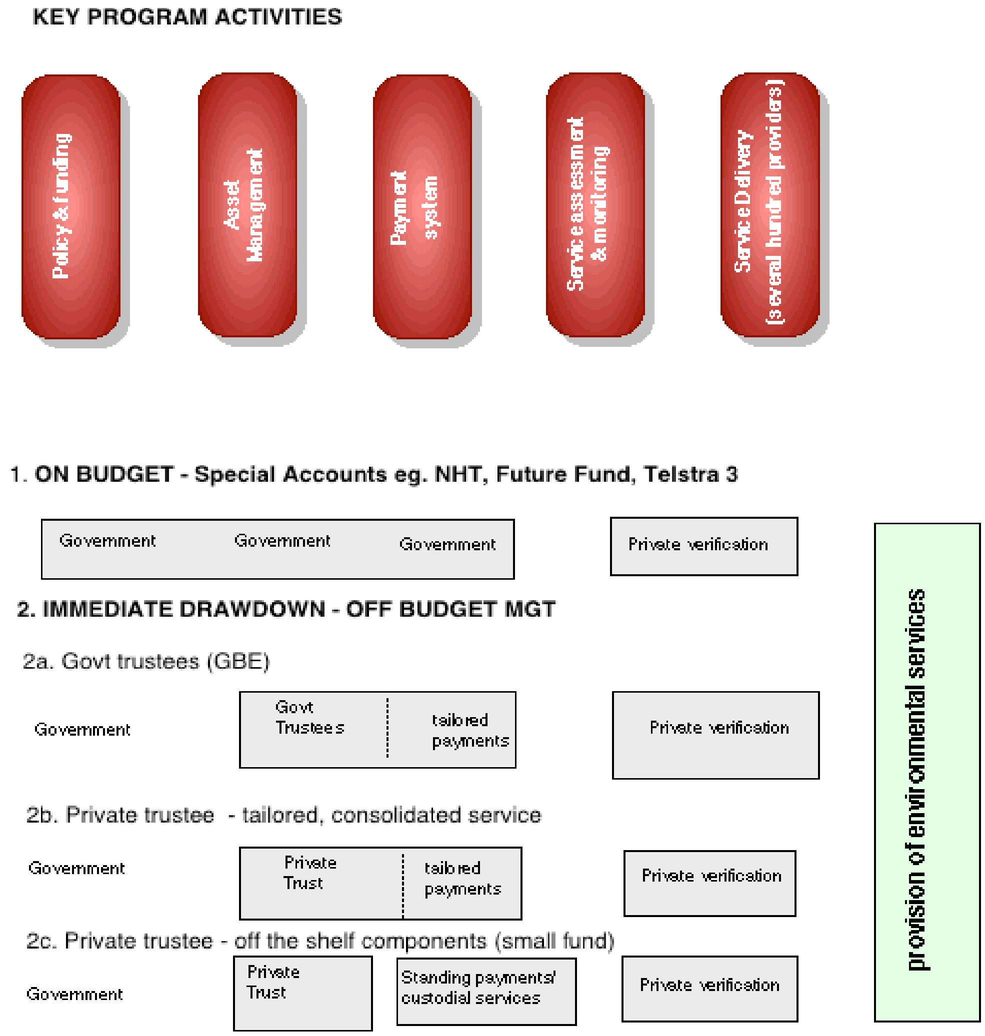
Source: ANAO 2002, Administration of Grants — Best Practice Guide, Australian National Audit Office

Consideration of the various functional elements of the program suggests some broad options for program design. A key part of bringing the program together is to explore options with a view to feasibility and cost. Over-engineered arrangements may prove too costly to administer (depending on the core pool of funds available) while legal and policy requirements on government expenditures, together with the need to assess and demonstrate outcomes, may rule out the simplest options or those that might satisfy a private organisation with identical objectives. Similarly, economies of scale and specialisation might mean that overall costs could be minimised by vesting certain functions in a single entity, or that costs are most likely to be minimised by coordinating the skills and networks offered by a range of providers.

The possible functions and relationships that might be established to support the program are represented in Figure 3.2.

Figure 3.2

PROGRAM ELEMENTS AND DESIGN OPTIONS



Source: ACG analysis

These options were explored in consultation with a range of government officials and representatives from financial institutions. A discussion of the key conclusions and implications drawn from those discussions follows.

Chapter 4

Practical options for design and implementation

The Allen Consulting Group has explored the feasibility and merits of alternative program financing models with government agencies and Australian financial institutions. Key areas of investigation have been the:

- interest and capacity of institutions to provide the required financial management and payment services;
- most cost effective form of these arrangements — including the nature of the financial instrument and contractual arrangements that could best support program objectives; and
- capacity for streamlining financial management, payment and monitoring/ verification functions.

A discussion of these issues, together with consideration of tax issues, is provided in the following sections.

4.1 Scope for private sector involvement

Discussions with private financial institutions suggest a significant degree of interest and capacity to undertake the financial management and payment functions of the program. As might be expected, this interest is broadly proportional to the amount of funding likely to be associated with the program. Nevertheless, a cross section of large and small institutions was consulted and all would be willing to offer their services to the Commonwealth in a financial management role. Similarly, as was consistently observed, the need to manage accounts (including small ones) and make regular payments to identified parties from those accounts is also a standard requirement and core competency.

A range of pre-existing and well established services is currently provided by financial institutions, and Commonwealth agencies would be welcomed as new clients. However, significant funding would need to be in prospect to induce institutions to develop new products or services. Also for a 'margin business' such as a bank (whose primary source of income derives from the difference between borrowing and lending rates) larger deposit amounts allow more lucrative lending opportunities and economies of scale to be accessed — which can result in lower account keeping charges (or higher interest earnings).

The responsiveness of institutions to the program needs of the Commonwealth will vary, and would need to be tested via further consultation and tendering processes. However, as a general indicator larger financial institutions are more likely to offer negotiated fee and margin arrangements on a deposit base in excess of $100 -$200 million. Below this threshold, clients would be offered 'standard' fees and products.

As indicated by Table 4.1, there is a large range and number of financial institutions operating in Australia. These operate, with some cross over, in various segments of the market and have different specialisations. This can be relevant to future consultations on instrument design.

Further, the size and credit worthiness of institutions will also be a fundamental issue in assessing the riskiness of one institution relative to another. The supervisory role of institutions such as APRA and ASIC does not amount to a guarantee of future solvency or asset protection. The assessment of ratings agencies such as Moodys or Standard and Poor's can be important to judgements about the credit risk associated with different institutions that might be entrusted with public money.

Table 4.1

OVERVIEW OF AUSTRALIAN FINANCIAL SECTOR (AS AT DECEMBER 2003)

Institution	Regulating body	No. of active Groups [a]	Total assets ($billion)
Banks	APRA	53	1 164 [b]
Building societies	APRA	14	14
Credit Unions	APRA	180	30
Money market corporations (merchant banks)	ASIC [c]	37 [d]	80
Finance companies (incl. general financiers and pastoral finance companies)	ASIC [c]	83 [d]	90
Securitisers		64	118
Life insurance companies	APRA [e]	32	185 [f]
Superannuation and approved deposit funds (ADFs)	APRA	11 041 [g]	337
Management companies (public unit trusts)	ASIC [c]		
Trustee companies (common funds)	State and Territory authorities		
Friendly societies	APRA	34	6 [h]
General insurance companies	APRA [e]	79	73

(a) Subsidiaries of an institution undertaking the same activity are treated as part of a single group. (b). Refers only to the Australian banking operations and does not include assets of banks' overseas branches or domestic and foreign non-bank subsidiaries. Banks' global consolidated group assets (for all locally incorporated and foreign bank branches) at December 2003 were $1 301 billion. (c) The Australian Securities and Investments Commission (ASIC) does not conduct prudential supervision of these institutions, but does regulate certain aspects of their operations (e.g. compliance with the fundraising and securities licensing provisions of the Corporations Law). (d) Groups with total assets below $50 million are not included. (e) State Government owned insurance offices are not covered by Commonwealth legislation, nor supervised by the Australian Prudential Regulation Authority (APRA). (f) Figure relates to total assets backing Australian policyholder liabilities. (g) Includes assets in life office statutory funds, but excludes pooled superannuation trusts, non-regulated public sector funds and self-managed superannuation funds (which have less than five members); self-managed funds are regulated by the Australian Tax Office. Total superannuation assets were estimated to be around $565 billion as at December 2003. (h) Figure relates to total benefit fund and management fund assets.

Source: Reserve Bank of Australia 2005, http://www.rba.gov.au/FinancialSystemStability/FinancialInstitutionsInAustralia/the_main_types_of_financial_institutions_in_aus.html

A key area of differentiation relates to the willingness and ability of different institutions to guarantee a future income stream — or stream of payments from the funds under management.

All institutions will accept new clients and their deposits, but attitudes differ toward accepting the risk that variations in earning rates (ie. the interest that can be earned on the deposit over time) may not be sufficient to cover the stream of payments that have been committed to in the future. Estimating this risk and the premium that the institution should seek for accepting it (when it 'guarantees' a stream of future payments linked to a current deposit) is an actuarial calculation.

Banks offer a high degree of security for deposits, target low risk investment opportunities and, on instruction, will make regular payments from deposits held. On the other hand, life companies and other insurers deal in actuarial risk and are in the business of estimating expected future income and payment streams. A range of other institutions (such as superannuation and investment companies) provide services in the market by investing in portfolios of bonds and other tradable securities (with different risk-return exposures) on behalf of small investors.

Notably, advice from one financial institution consulted in the course of this study confirms that, in line with the discussion of FMA Act requirements, the Commonwealth Department of Finance and Administration requires that public money kept in trust with private institutions be held in the form of cash or government bonds. This narrows investment options (and risk-return choices) if 'ownership' of the funds is to be vested in the Commonwealth.

These stipulations need not apply to outlays (ie. contributions) to a special purpose fund whose environmental objectives qualified it as a Charitable Trust. Such a vehicle could also readily be designed to accept funding from non-government sources.

4.2 Form of the financial instrument

The appropriate form of the financial instrument will depend on the payment characteristics it must support, and costs of provision. It would be feasible to deposit the funds in an account — established as a Trust Fund (these can take a variety of forms, which can be important to their tax treatment and also their classification for Budget purposes) — or use them for the purchase of an annuity-like instrument.

At the simplest level, it is feasible to think of an account established and held in the form of cash – and therefore accumulating no interest — that is drawn down over time to provide a stream of regular payments. In this simple model (where no fees apply) an amount of $10 million could fund annual payments of $500,000 per year for 20 years, after which the funding pool would be exhausted.

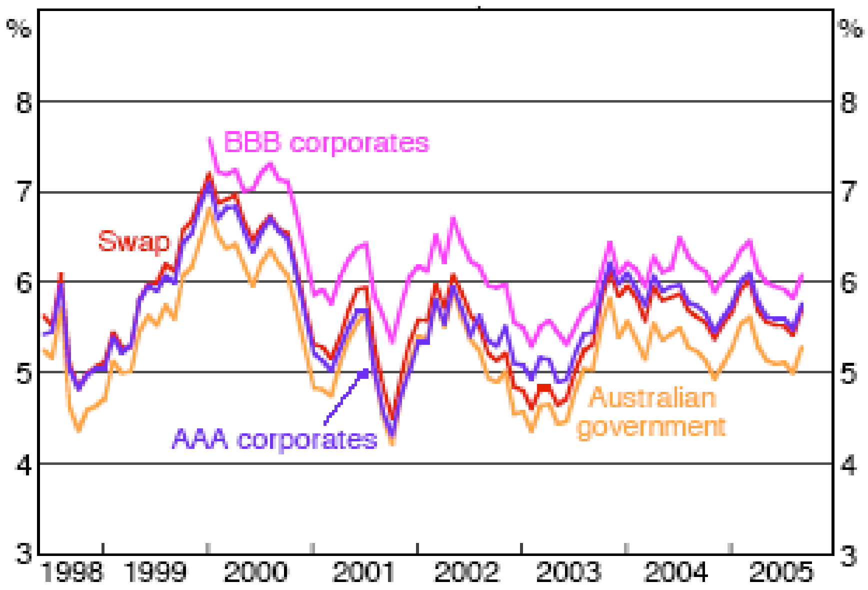
But, of course, it is feasible to extract greater benefit from the funding pool by allowing it to attract interest, dividends and capital growth. Reinvestment of income earnings allows the pool to grow in nominal terms. This helps to maintain the purchasing power of the funds over time (ie. positive real earnings allow the funds to grow faster than price rises (inflation) in the general economy), and buy more environmental services with the initial outlay.

On the other hand, allowing the funding pool to grow can introduce uncertainties about the rate of growth (including the risk of negative growth), and the amount that will be available for disbursement over the long term. The total can be expected (in the statistical sense), but not guaranteed, to be greater than that originally deposited — but how much greater can be difficult to determine in advance. And there is a risk of negative returns —through erosion of the real value of the funds (an interest rate versus inflation rate issue) and even the erosion of nominal values if the funds are held as equity investments. Uncertainty over future growth rates is known as interest rate risk, and uncertainty over what a dollar buys in the future is inflation risk.

These risks can be managed — and greater certainty provided — through selection of 'guaranteed' investments. Government bonds provide a stream of defined payments over a defined period. These offer a secure fixed interest rate investment that provide a high degree of certainty over total earnings. Figure 4.1 highlights the movement of government bond rates in the period since 1998, and by implication, the challenge facing an investor in determining (or predicting) total earnings available over an extended period. The figure also indicates how higher rates of return are available from riskier assets (such as bonds issued by AAA or BBB rated companies; the 'swap rate' is the fixed interest rate traders will pay/ accept to receive a floating money-market rate.)

Figure 4.1

AUSTRALIAN CORPORATE 3 YEAR BOND YIELDS (MONTHLY DATA)

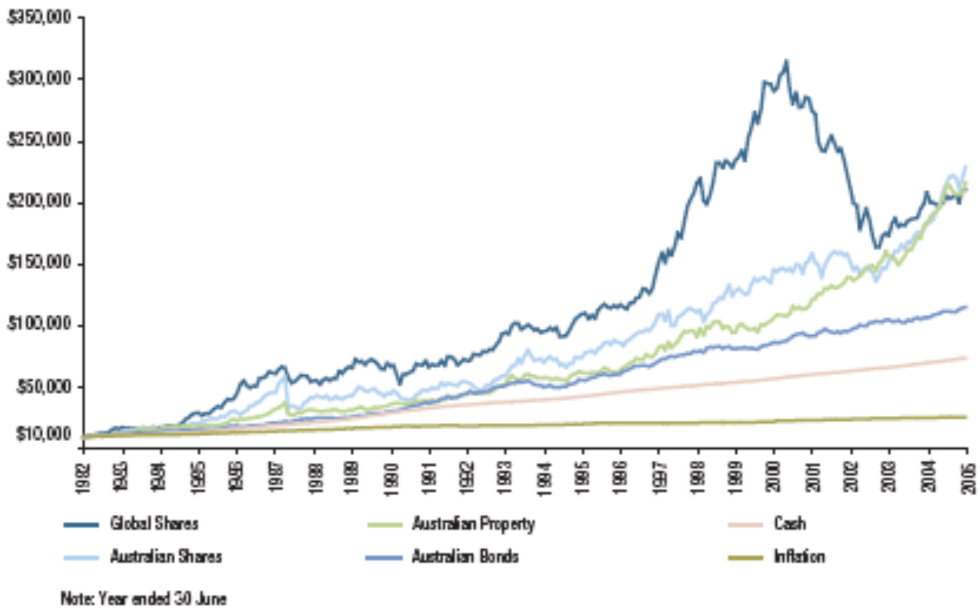


Source: Reserve Bank of Australia (2005), Chart Pack, Interest Rates – Australia, http://www.rba.gov.au/ChartPack/index.html

Figure 4.2 further highlights the historical relationship between risk and return. Not only can returns on 'guaranteed' securities fluctuate over time, but investors also face decisions about the degree of risk they are prepared to accept. Higher risks (and returns) typify the equities market, where investors become owners of assets, rather than lenders on 'fixed interest rate' terms, and thereby accept the possibility of losing all or part of the funds.

Figure 4.2

GROWTH OF A $10,000 LONG TERM INVESTMENT IN DIFFERENT ASSET CLASSES



Source: MLC (2005), Retire in Style 2004/ 05 – Strategies for Retirement,

These factors can make it difficult to determine the full amount available for disbursement from a fund. Because funding is not being 'parked' in an account, but is growing and periodically being drawn down to make payments, there will always be a need to liquidate and rollover part of the investment. Even with the 'risk free' asset provided by government bonds, these typically are offered with maturities of 1, 3, 5 and 10 years (Treasury has occasionally released 13 year bonds, and indexed bonds, into the market).

Significant costs can be associated with delivering long term 'certainty' over a future payment stream.

As mentioned previously, life insurance companies specialise in providing investments that deliver a fixed (nominal or real) payment stream over a defined period. These investment products are annuities.

A range of annuity products are available within the Australian marketplace — these tend to be tailored to individual needs. Key variables are the size of payments required, the payment frequency and the duration. The requirements of the program envisaged by DEH readily lend themselves to development of an annuity:

- payments are likely to be uniform (and fixed in nominal terms);

- they are regularly spaced; and
- the contract term (ie. duration of payments) is known in advance.

An example of indicative monthly payments available over time from an initial \$100,000 capital investment, drawn down to zero (under different nominal interest rates), is provided in Table 4.1. Note that the actual payments that an institution would be willing to guarantee over a defined term will depend on assessment of future risk — and could well vary from company to company because these assessments and attitudes to risk will differ.

Table 4.1

MONTHLY PAYMENTS ON A \$100,000 ANNUITY, DURATION VS INTEREST RATE

	3%	4%	5%	6%	7%
1 Year	\$8,468	\$8,512	\$8,556	\$8,599	\$8,643
2 Year	\$4,296	\$4,339	\$4,382	\$4,425	\$4,468
3 Year	\$2,906	\$2,949	\$2,992	\$3,035	\$3,078
5 Year	\$1,795	\$1,838	\$1,882	\$1,926	\$1,970
10 Year	\$964	\$1,009	\$1,055	\$1,102	\$1,150
15 Year	\$689	\$736	\$785	\$835	\$887
20 Year	\$553	\$602	\$654	\$707	\$762

Source: CommInsure (2005), Lifestream Guaranteed Income – A Guide to Immediate Annuities, Commonwealth Banking Corporation

For this reason, annuities tend to be a 'tailored' product that offer lower interest rate earnings because of the need to compensate the issuer for the risks involved in offering a guaranteed future income stream. Standard fixed term annuities must compensate issuers for accepting the interest rate risk. Indexed annuities (offering inflation-protected income) are more expensive (ie. offer a lower real rate of return on the initial deposit) because these require that the issuer be or paid an additional amount to accept the inflation risk as well.

A comparison of annuity offerings can be obtained from a variety of investment advisors and actuarial companies. This service is usually provided on a fee paying basis. Individual providers of annuity products structure these to client needs and vary quotations to reflect up to date interest rates and forward expectations. For this reason, it can be difficult to find published quotations on the actual costs of 'off the shelf' products. Nevertheless, some advisers collect this information — stipulating that it not be reproduced for commercial purposes. One such example can be found at: www.sharesmag.com.au/allsites/annuities/annuities.xls.

This provides a comparison of different annuity products offered by Australian institutions. It shows yields offered on annuities of different duration, and differences between fixed monthly payment and indexed payment income streams. In respect of costs associated with an indexed annuity product, relative yields suggest that (as at August 2005) institutions would typically offer a 20 year fixed payment annuity (based on an initial deposit of \$100,000) earning an interest rate of between 3.5 to 4.5 per cent per annum.

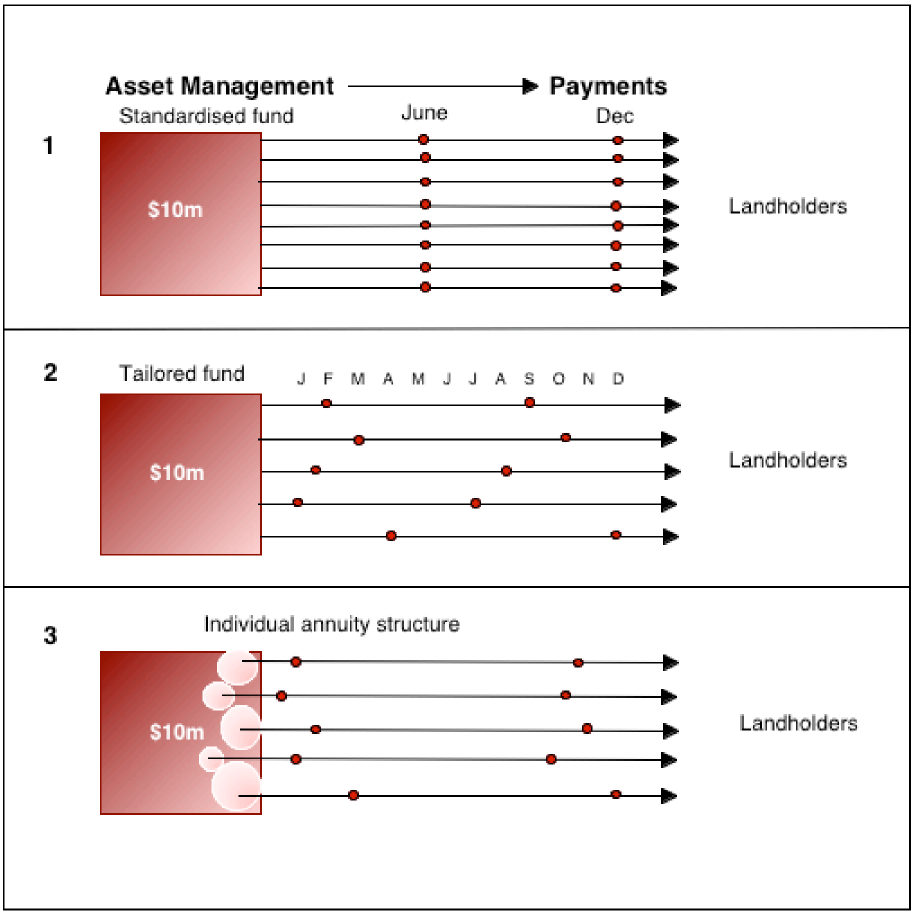
By comparison, an equivalent investment (ie. $100,000, being drawn down to a zero balance through equal payments over 20 years) for which monthly payments were CPI –indexed (ie. increased in line with inflation) offered a yield in the range 0.95 to 1.3 per cent per annum. The difference in yields reflects the added 'fee' associated with securing a long term, inflation protected income stream.

In theory, an annuity could be purchased by the Commonwealth to fund the payment stream agreed in each individual conservation stewardship contract. Such an arrangement could reflect the unique characteristics of the contract such as commencement date of payments, payment frequency and duration. However, this approach, resulting in a program fund made up of a pool of individually tailored annuities, could involve significant fees and be administratively cumbersome. It would also entail a piecemeal draw down of funds allocated in the budget as a series of annuities were bought to underpin newly signed contracts.

While income payments are guaranteed under annuities for the term of the annuity, in the event of early termination of the annuity the capital value of the remaining funds (the commutation value of the future income stream) is a function of prevailing market interest rates – in general, the higher the market rates at the time of commutation relative to when the annuity was acquired, the lower the remaining capital value of the annuity. In this sense the owner of the annuity is still exposed to risk in addition to inflation risk. This is particularly relevant in the event of the termination of an annuity because the annuant had failed to meet the terms of a conservation stewardship agreement.

Some broad models for structuring payments under the program are depicted in Figure 4.3. These begin with a very simple payment structure where payments from the account (or a single payment distributed across a number of recipients) are made at a fixed frequency. The second model depicts a trust account arrangement where payment cycles are individually tailored, and the third illustrates an annuity structure where each individual payment stream is capitalised and funded via an annuity.

Figure 4.3
STYLISED OUTSOURCED ACCOUNT AND PAYMENT MODELS



As noted earlier, tailored payments are part of core business for banks and other financial institutions. Options 2 and 3 represent the main thematic choices — although variations on these themes are also possible. Again, the larger the funding pool, the greater the interest of institutions in the development of innovative (and elaborate) new solutions.

Consultations highlighted a willingness to consider a range of management strategies to reduce the risk of disruptions to a nominated income stream over the medium term. These included agreements on asset classes to underpin the income, the withholding of an 'unallocated' reserve in the investment fund to be committed only as certainty that funds flow over the nominated period would be achieved and so on.

The fees for providing this 'account keeping' service are typically in the order of 0.5% to 0.6% of the balance, and costs for making payments amount to 2 cents per electronic fund transfer (though these can run higher). Mail out costs are typically around $1 per transaction. Of course interest earnings on balances would depend on the types of assets and securities invested in. Yields on long term government securities are currently around 5.4 per cent per annum.

However, risk management via investment in capital secure assets, falls well short of the income 'guarantees' offered by life companies. But obtaining these guarantees can be expensive. As indicated above, yields on fixed income annuities are currently about a percentage point (ie. 100 basis points) below those available for long term government securities — and this gap will change depending on expectations of future market conditions. To obtain a guarantee over a future payment stream fixed in *real* terms (ie. adjusted to keep pace with changes in the general price level), an additional fee of around 300 basis points currently applies.

The costs of establishing an annuity (often in the range of $100-$200) also militates against this option for establishing a modest payment stream.

Risks can also be managed by the nature of contracts developed within the program. In turn this will depend on the extent to which the Commonwealth is prepared to incur contingent liabilities to guarantee an income stream over a nominated period so long as the landholder is meeting his/her obligations. Alternatives include provisions that, while providing a high level of certainty, do not give absolute guarantees, but provide instead for a release of landholder obligations in the event that funding falls short of expectations. The levels of risk for the landholder need not be any higher than those that they would willingly embrace to acquire typical superannuation products.

If the program was designed to allow flexibility in investment choice, the Department might also consider ethical investment choices that targeted assets that promised to deliver an appropriate rate of return, in addition to supporting investment in activities with desirable social and environmental spin-offs.

A range of further design issues was discussed with finance industry representatives related to operating costs, structure of payments and other program characteristics. These issues and insights are summarised in Table 4.2. Costs are indicative and would need to be tested on a tender basis. However, the overall picture suggests a solid capability for the finance sector to handle the requirements of the program (including a capacity to suspend payments on instruction, if environmental services are not delivered).

A key issue is the price (in terms of fees, potential interest earnings and loss of flexibility) that government is prepared to pay to 'guarantee' the entirety of a future income stream, and the premium that landholders would put on the stability of income (particularly in outyears) relative to the prospect of greater funds availability.

Table 4.2

KEY DESIGN CONSIDERATIONS FOR OUTSOURCED ASSET MANAGEMENT

Activity variables	Vehicle/ design requirements	Cost/ interest implications
Funding	< $100m	Use standardised products & fees
	$100m+ program	Scope for negotiation & fee discount
Asset structure		
single fund	Establish Trust Fund (or a Charitable Trust if option of acquiring securities other than govt bonds or bank bills is required)	Low cost – no guarantees on outyear payme stream Typical funds mgt margin: 0.5- 0.6 basis points (ie. fee is 0.5- 0.6% of balance pa — offset by interest earnings)
'stacked' annuities	Purchase tailored annuity	Higher cost – conservative investment profile guaranteed payment stream. Tend to be structured around large deposits (eg. $100k)
Payments		
equal	Easily accommodated by all instrument	Low cost – for Trust account equal to a few cents per EFT payment, $1 per mailed statement
Varied amount	Easier for Trust Account	
indexed	Standard offering for an annuity	Significant additional cost (acceptance of interest rate and inflation risk)
Duration		
up to 20 years	Trusts and annuities can readily accommodate	
over 20 years	Trust accounts more feasible	Few prepared to guarantee fixed payment over this period – annuities expensive
Number of recipients		
small number	Not a significant design issue	Payments are core business – transaction fees apply
up to 1000	ditto	ditto
Periodicity		
regular but individual	Readily accommodated	
special pay'ts available	Feasible with Trust Account	High cost annuity option
Suspension of payments		
standing payments	Readily accommodated	Least cost approach
approved payments	Inconsistent with annuity structure	High costs and administratively burdensome

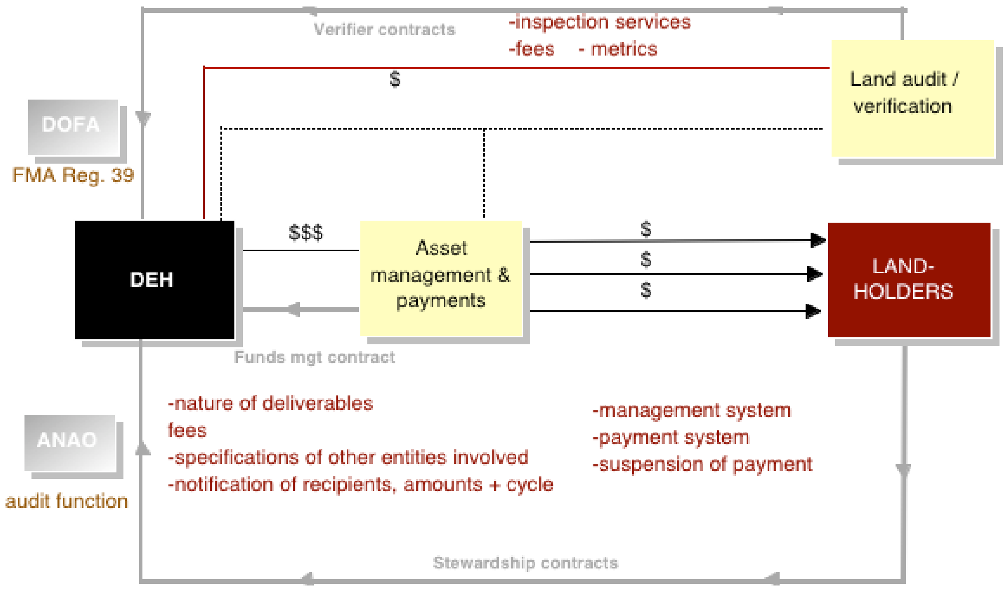
4.3 Streamlining options

Analysis of options suggests a model where asset management and payment functions are handled by a single entity (selected by tender on the basis of cost, credit-worthiness and payment services provided — recall that if the funding is provided as an 'investment' only banks can be considered under the FMA Act). Similarly, the verification function — and the right to issue instructions to suspend payments — should be handled in a contract between the Commonwealth and the verifying agents.

Figure 4.4 depicts an idealised scheme of payment and contractual arrangements (including key content issues) likely to result in a robust and streamlined system. This outline represents a framework for more detailed design work, and consideration of practical constraints and development options in the following chapter.

Importantly, contract relationships should closely specify the nature of services to be delivered, fees, treatment of contingencies and access arrangements and entitlements for third parties (eg. ANAO and verifiers).

Figure 4.4
ROBUST PAYMENT AND CONTRACT RELATIONSHIPS BETWEEN PARTIES



4.4 Tax issues

Consultations highlight that the tax treatment of the fund and payments from it should be carefully though through as an element of design.

It is relatively clear that payments established as a fee for delivery of environmental services would be viewed as income for taxation purposes. As such these payments would be subject to Goods and Services Tax (see Box 4.1 below relating to the treatment of grants), but would also be eligible for payment into Farm Deposit Accounts, as offered by a number of financial institutions — though minimum deposit and balance conditions (eg. $1,000) are generally applied by institutions.

Box 4.1

GST TREATMENT OF GOVERNMENT GRANTS AND PAYMENTS

The GST treatment of a grant needs to be determined on a case by case basis and agencies should seek advice if they are uncertain. However, it is generally the case that, when a grant is paid to an organisation for a specific purpose or with binding conditions, GST is payable if the recipient of the grant is registered for GST. The recipient must give the agency a valid tax invoice or in particular circumstances the grant-giving agency can issue a Recipient Created Tax Invoice (RCTI).

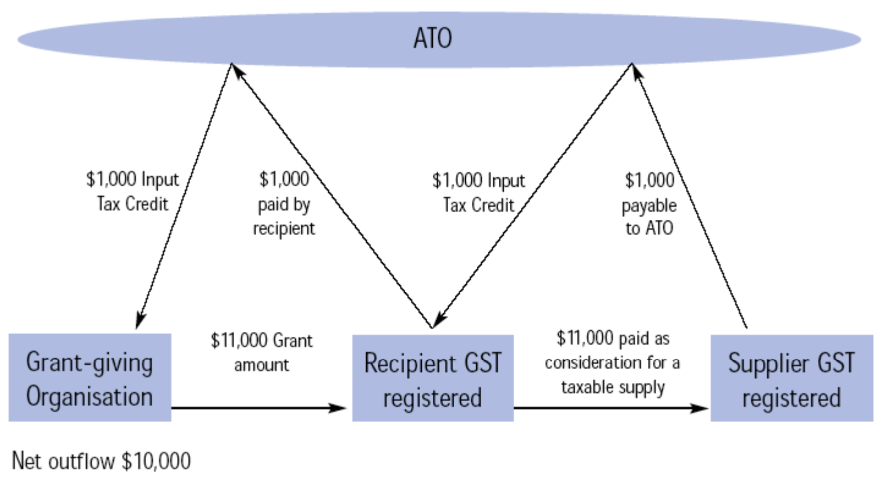
For a grant-giving agency to issue a RCTI, the recipient and supplier must satisfy particular requirements. The Commissioner of Taxation has issued a Public Ruling (GSTR 2000/10 Goods and services tax: recipient created tax invoice) that only certain classes of entities may issue RCTI. One of the eligible classes are 'government related entities'.

Paragraph 13 of GSTR 2000/10 lists the requirements that must be satisfied by the recipient and suppler. Among these are:

- the supplier and the recipient must be registered for GST when the invoice is issued and a RCTI must show the Australian Business Number (ABN) of the supplier;
- the recipient must issue the original or a copy of the RCTI to the supplier within 28 days of the making, or determining the value, of the taxable supply and must retain the original or a copy;
- the recipient and the supplier must have a written agreement specifying the supplies to which it relates, that is current and effective when the RCTI is issued.

Failure to satisfy all of the requirements will mean that an invoice issue by the recipient will not be treated as being a tax invoice. If the requirements for RCTI are not satisfied, it is the recipient and not the government agency that is liable to pay the GST. The recipient must pay 1/11th of the grant amount to the ATO — the grant-giving agency would then be entitled to an input tax credit (ITC) equal to 1/11th of the grant amount. See the figure below.

Figure 4 – Cash flows – Recipient GST registered



Source: ANAO 2002, Administration of Grants — Best Practice Guide, Australian National Audit Office, p.34.

Importantly, the tax treatment of interest earnings on funds held in Trust can be affected by whether the Trust is owned by the Commonwealth, or if not, whether charitable status is secured for the fund.

Chapter 5

Preferred structures and next steps

It is clear from this report that there is a considerable range of options for securing a long term income stream to underpin long term conservation arrangements. Each of these has strengths and disadvantages. In proposing a preferred model, it is therefore important to consider key objectives.

The aims underpinning consideration of approach are:

- maximizing the future budget flexibility of the Commonwealth's environment program;
- maximizing landholder confidence that funds flows will not be disrupted by future budgetary stringencies or changes in political preferences;
- maximizing the scope to encourage co-investments in the program by the private sector, and possibly other governments;
- optimising the risk/return trade-off on scale of long term funding for the nominated environmental purposes and certainty of funding;
- allowing for full transparency in provider choice and performance; and
- minimizing contingent liabilities for the Commonwealth.

The Department of Finance highlights an established policy preference for dealing with long term funding commitments through a system of pre-approvals provided by the Minister for Finance under Regulation 10 of the FMA Act. Regulation 10 approvals allow agencies subject to the FMA Act to enter into contracts that make calls on future budget appropriations. This is the most straightforward way of operationalising a long term funding, but this funding would still be subject to future Budget processes, and the political and bureaucratic reassessment of spending priorities that that can entail.

Unfunded long term commitments also represent a future liability for the Department's budget, creating lock in and reducing the options for handling any future reduction in Departmental funding.

An alternative is to capitalise and fully fund a long term income stream in a way that ensures it is not subject to cyclic budget pressures and annual appropriations in the future. This can be done within the Commonwealth account through legislation which establishes self-executing appropriations (for example the Natural Heritage Trust) and/or the establishment of a Special Account under legislation, or by the Minister for Finance under Section 20 the FMA Act, and an annotated appropriation that enables the funds to be transferred to a Special Account.

However, the capital fund could be established outside the Commonwealth account (ie the initial Commonwealth contribution to the fund would be fully expensed from the Commonwealth budget in the year(s) in which it was made).

There are three principal alternative mechanisms to achieve this:

1. Contributions to existing (or newly negotiated) trust accounts managed by the States (for example the NSW Conservation Trust) with objectives matching those set by the Commonwealth. While detailed provisions differ, in general states require public trusts of this nature to invest in a limited range of cash and government issued securities.

2. Contributions to one or more existing private conservation trusts whose purposes match the Commonwealth's aims. The range of assets invested in by these trusts will vary according to the provisions of the establishing Trust Deed and the decisions of the Trustees. They are regulated subject to State legislation.

3. Creation by the Commonwealth (possibly in collaboration with private parties and the states) of a new Trust under State legislation with objectives, responsibilities and constraints provided for in the establishing Deed to match the Commonwealth objectives. Such a Trust could be open to contributions from the private sector and/or the States. Approval for it to be registered as a Charitable Trust for taxation purposes could be sought. The range of asset classes in which it could invest would similarly be specified in the Deed.

Options 1 and 2, while immediately available to the Commonwealth, have the disadvantage of distancing the Commonwealth not only from the financial management of the Trust accounts but more particularly from a direct relationship with the individual landholders receiving the support.

Option 3 offers the possibility of maintaining a direct relationship with the landholders while distancing the Commonwealth from the Trust's investment operations.

5.1 Preferred model: Charitable Trust

The option that offers the best prospect of simultaneously meeting DEH's design objectives (notably long term funding of long term stewardship covenants that can be seen by landholders to be free of annual budgetary risk) and constraints (the requirement for a direct decision making role for the Commonwealth in accepting individual landholder contracts and suspending payments in the case of non-performance free of a State intermediary) is a Charitable Trust established under State legislation.

This would require DEH to develop a Trust Deed (in consultation with other agencies and stakeholders) that would establish:

- the objectives of the Trust;
- asset classes in which it might invest;
- provide for the nomination of Trustees;
- eligibility of the Trust to receive donations from other parties; and
- nominate the terms under which it is to provide payments to landholders (and the basis for suspension of payment).

Under this arrangement the Commonwealth would be responsible for:

- *Policy:* which would be reflected in the terms of the Deed and the basis on which landholder participation would be sought and maintained;
- *Recruitment:* of landholders in accordance with the policy (this could be outsourced to States, Catchment Management Authorities, NGO's or the private sector in whole or in part);
- *Independent Verification:* of the continuing performance by landholders of their obligations (again this could be outsourced — but preferably not to the provider of recruitment services given the potential for conflicted interests);
- *Contractual relationship with the landholder:* which would set out the obligations on each side; the Commonwealth's obligations for payments would be specified in terms of its responsibilities to advise the Trust of the landholders ongoing entitlements to payments, subject to the availability of funds in the Trust (different formulations would be possible depending on the extent to which the Commonwealth was prepared to enter into a contingent liability for payments in the event that Trust funds were insufficient. The extent and nature of the risk distribution for the Trust fund performance between the landholder and the Commonwealth is an important issue which requires careful thought).

The Trustees, in managing the Trust would be responsible for:

- *Funds Management:* which could be outsourced to a professional investment manager, subject to any requirements in relation to risk and assets specified by the Commonwealth in establishing the Trust
- *Commitments Management:* including through actuarial assessment of the stewardship obligations that the Trust was able to accept. Careful thought will need to be given to the relationship between the Commonwealth's nomination to the Trust of eligible landholders and the associated payments stream, and the duty of the Trustees not to accept obligations that they may be unable to fund.
- *Payments:* to landholders subject to advice from the Commonwealth on any changes such as suspension or cessation of landholder entitlements. Again this could be outsourced, including possibly back to the Commonwealth.

The private financial sector is rich in institutions that can provide one or more, or in some cases all, of these services. The ANZ Bank has for example, a specialist Trust management service which will provide not only advice on Trust establishment, but Trust, investment and payments management services.

Governance arrangements would be critical and at the minimum would need consideration and approval by the Department of Finance. An advisory consultation with the Auditor General in that process would also be essential. Given the novel nature of the arrangements it could be appropriate to seek Cabinet approval.

Funds management and payments

Depending on the Commonwealth's risk preference (which would in turn be reflected in the standard terms of the contracts to be negotiated with landowners), a range of asset classes could be considered to secure long term payments to landholders. Risk cannot be completely removed and attempting to minimise risk comes at some cost. It could be possible (although more costly for a pilot project) to allow an element of landholder choice with respect to the risk/return continuum by providing for an investment or annuity style product to underpin the payments stream. Risk is also associated with the possibility of default by the institution holding the assets.

An approach that could strike an appropriate balance on the risk/return spectrum could entail:

- the Trust conducting a tender among financial intermediaries with a nominated credit rating for funds management through eg wholesale unit trusts (tender evaluation could be assisted by the Commonwealth);
- the chosen financial intermediary(ies) establishing an Account (eg The Conservation Stewardship Trust – Unallocated Fund) to receive the initial bulk funds from the Trust;
  - this Account would be a parcel of units within a Wholesale Fund established and managed by the intermediary under the Managed Investments Act.
  - the ownership of the Account would remain with the Trust.
- classes of assets held by the Account being determined by the Commonwealth through the Trust Deed — these could range from extremely secure, low yield assets to ones with a greater growth potential but greater risk;
- landowners nominated by the Commonwealth, become the beneficiaries of payments from individual sub-accounts (eg. Farmer Jones Fund) with personalised identifiers and a capacity to report balances as well as make payments - the balances transferred from the Unallocated account;
- payments made by the financial intermediary until otherwise advised (by the Trust on the advice of the Commonwealth).

In event of landowner default then funds could be retained in the landowner's sub-account pending resumption of services; or returned to the Unallocated Fund for reallocation if it is advised that the landowner has left the scheme.

Periodicity of payment could be agreed with the Trust (on the basis of policy guidelines set by the Commonwealth through the Trust Deed), but regularity would be important (eg monthly, quarterly, semi-annually). Payments could be agreed nominal amounts or indexed (eg to CPI), with actuarial assessment used to determine the payment amounts that the capital funds could support.

Finally, the terms of contractual arrangements with the landholders would make it quite clear that in the event of an inability of the Trust to meet ongoing payments, the landholder would be relieved of environmental stewardship obligations. By providing ongoing advice to landholders on the performance of the Trust, reassurance would be provided of the nature of the risk of such an event occurring.

Periodic reviews would apply. The risk of "running out" of funds before the nominated time period of the program would be managed by requiring the intermediary to maintain a reserve in the Unallocated Fund which would only be released over time if it became apparent that the scheme would safely meet its objectives. If it became apparent that funds surplus to the requirements had been created, then fresh stewardship agreements or variations to existing agreements to intensify or extend the period of stewardship services that could be entered into.

The financial intermediary would be required to provide comprehensive reporting on the performance of the Fund.

Finally, the terms of contractual arrangements with the landholders would make it quite clear that in the event of an inability of the Trust to meet ongoing payments, the landholder would be relieved of environmental stewardship obligations. By providing ongoing advice to landholders of the performance of the Trust, reassurance would be provided of the nature of the risk of such an event occurring.

As noted above, this is very little different from risks faced day to day by landholders in other long term financial arrangements including in relation to superannuation and other investment programs. As also noted, it would not be impossible to authorise the Trust to acquire annuity style products on behalf of landholders (with some discount to payments provided) if they wished to consider a lower risk/more secure payment option.

Verifier reporting arrangements

It is important that suspension of payments to a participating landowner be on a default basis — ie payments will occur regularly at a nominated interval unless otherwise advised by the Commonwealth. This both secures Commonwealth control over the program (including political responsibility for stopping any payments) and relieves the Fund Trustees and the funds and payment manager they choose (or chosen for them by the Commonwealth) from the obligation to make judgments about the commencement, suspension, cessation or transfer of payments. Legal advice will be required to confirm that this can be secured consistent with the direct contractual relationship being between the Trust and the landholder. It is also likely to result in a lower account management fees.

This places responsibility for suspending payment on the Commonwealth, and establishes a structure whereby the verifier or verifiers of on-farm conservation activity report to the Commonwealth, rather than the Trustee or financial institution managing the assets. This streamlines reporting, simplifies the task falling on the asset manager and allows the Environment Minister and Department to monitor program performance and take decisions on suspension of payments, in consultation with the Trustee.

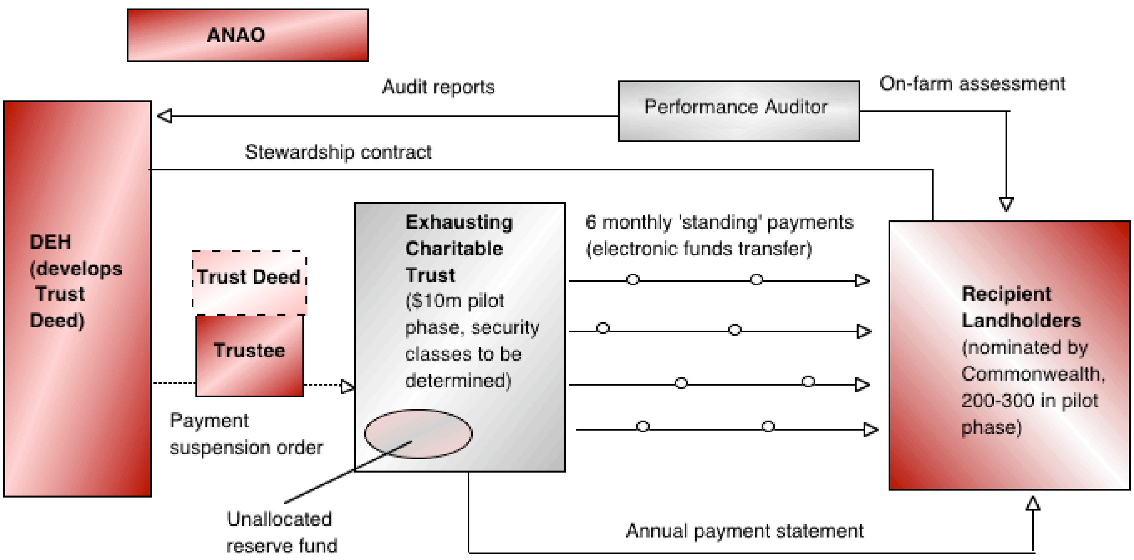
5.2 Further development needs

Each step that is taken in this process to increase the flexibility of the Commonwealth's environmental management agency could be seen as increasing the risk of setting precedents that would be unacceptable from the viewpoint of the Commonwealth's overall financial management and accountability arrangements. While the approach outlined above could be technically feasible, and politically attractive, it has elements that could be seen to be in conflict with the post Uhrig objective of minimizing the Commonwealth's involvement in 'GBE like' or special purpose arrangements.

There are, of course, steps short of this model that might find greater acceptance within that framework. These will no doubt emerge from the agency level and Ministerial discussions that would be necessary to advance any 'off-budget' arrangement.

Nevertheless, industry level discussions and the desirability of building a streamlined and effective program for funding long term conservation action (and achieving solid growth in the funds allocated for this purpose) point to the broad structure depicted in Figure 5.1.

Figure 5.1
PROPOSED REPORTING, ASSET MANAGEMENT AND PAYMENT STRUCTURE



Further development of the program, if the Department wishes to proceed, should involve:

- specialist legal and accounting advice on the detailed Trust Structure and associated governance arrangements;
- further investigation of land holder payment preferences (eg. fixed money amount, indexed payments, length of term, guaranteed minimum term, etc);

- financial modelling of risk/ return trade-offs and associated limitations on asset classes;
- development of landholder environmental service contracts (including appropriate terms, risk distribution and payment and suspension provisions);
- development of approaches for recruitment services (in-house, States, CMAs, NGOs or private sector eg combined rural traders) and mode (tender, nomination, application etc);
- similarly proposed arrangements for independent audit/verification of landholder performance under contracts (again in-house, States, NGOs or private sector);
- careful consultations particularly with the States and stakeholders;
- development of performance assessment and reporting guidelines; and
- draft tender documents seeking bids from financial institutions for defined asset management and payment services based on a concrete proposal (eg. number of recipients, periodicity, duration, number of payments, suspension provisions, etc).

Logistic and financial design issues will need to be advanced in unison with consultation on contract development and legislative obligations. The ability to describe, monitor, value and compare potential and achieved conservation outcomes will be a critical step in the successful development of this program.

Appendix B
Special Public Money (SPM) Accounts

Australian Government
Department of Finance and Administration

Finance Circular
No. 2003/08

To All FMA Act Agencies

Bank Accounts: Removal of Trust Accounts and Creation of Special Public Money (SPM) Accounts

Purpose

This Finance circular advises Australian Government entities, which are subject to the *Financial Management and Accountability Act 1997* (FMA Act) of a change in the concept and use of the term "trust account" and "exempt trust account" in the financial framework.

Key Points

1. The Finance Minister has signed new delegations that change the concept and use of the term "trust account" and "exempt trust account", as bank accounts that Agencies can operate. Effective from 15 October 2003, these accounts will be replaced with "SPM accounts" and "exempt SPM accounts" respectively, which are defined as follows:

   SPM account means an official bank account, designated as an SPM account by the Chief Executive of the Agency or his or her delegate, that is established for the receipt, custody, payment or transmission of public money held by the Commonwealth as special public money and is not designated as an exempt SPM account by the Chief Executive of the Agency or his or her delegate.

   exempt SPM account means an official bank account, designated as an exempt SPM account by the Chief Executive of the Agency or his or her delegate, that is established for the receipt, custody, payment or transmission of public money held by the Commonwealth as special public money and for which the Commonwealth:

   (a) is required to operate a bank account separate from other public money held by the Agency's transactional banker; and

   (b) is required to retain the balance of the account outside the Commonwealth's Official Public Account Group; and

   (c) may be required to invest the balance of the account outside the Commonwealth's Official Public Account Group.

   Note: For exempt SPM accounts that require moneys to be invested, investment powers will need to be sought from the Finance Minister under s39 of the Act.

2. SPM is defined under section 16 of the FMA Act as "public money that is not held on account of the Commonwealth or for the use or benefit of the Commonwealth".

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3. Trust Money, or more precisely, money that is subject to Trust Law, is a subset of SPM. The Australian Government holds a range of SPM, some that is subject to Trust Law and some that is not. By shifting the focus from Trust Money to SPM, the new delegations bring the banking terminology into closer alignment with the FMA Act.

4. These changes to the financial framework clarify that all SPM needs to be managed by Agencies in accordance with the requirements of the FMA Act. Agencies with SPM that is subject to Trust Law will need to take into consideration not only the requirements of the FMA Act but also any additional requirements imposed by Trust Law.

5. When dealing with moneys that are subject to Trust Law, Agencies need to ensure that the requirements of trust deeds do not conflict with the requirements of the FMA Act. Where potential conflicts arise, Finance should be consulted before the Agency accepts the role of trustee.

Action Required

6. The amendment delegations have effect from 15 October 2003. Agencies should notify their transactional banker of the SPM account and exempt SPM account terminology and have the changes ready to be actioned as of 15 October 2003.

Contacts

7. Further guidance regarding the banking of SPM can be found in the *Agency Banking Framework Guidance Manual* which is located at: http://www.finance.gov.au/finframework/banking.html

8. If you have any queries, please contact the Banking Team within Financial Management Group on (02) 6215 3810 or at Banking@finance.gov.au

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10 October 2003