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Dear Dr Preston

As Chair of the Australian and New Zealand Minerals and Energy Council (ANZMEC), I take this opportunity, on behalf of my State and Territory Ministerial colleagues, to raise a number of issues arising from the Review's discussion paper *A Platform for Consultation.* ANZMEC represents the mines and energy Ministers of all the States and Territories, the Commonwealth and New Zealand. ANZMEC's mission is to promote the welfare and progressive development of the Australian resources sector.

ANZMEC supports taxation reform which offers the prospect of improved competitiveness and national economic growth. We welcome proposed reforms that have sought to address taxes on business inputs. We also welcome the Review's recognition of anomalies in current tax law, for example blackholes expenditures.

However we are concerned that the requirement upon the Review to develop options for business tax reform that are revenue neutral has led to the development of options which could have significant adverse implications for the resources sector. It is our view that in considering the revenue neutrality constraint, the Review should take the widest possible interpretation.

Our principal concerns relate to the possible loss of accelerated depreciation provisions and changes to the immediate deductibility of exploration expenditure from any income. These are two of the most significant provisions available to the resources sector. It is our view that these provisions are not considered to be concessionary. They serve to correct existing distortions arising from problems embedded in the taxation structure and market failure related to inherent high risk. We are particularly concerned that these issues not be seen as only impacting on projects which might be commercially 'borderline'. It needs to be recognised that:

- marginal projects can have significant regional and national economic impacts, and
- the competitive nature of the global market for mining capital means that negative impacts at the margin could deter investment in significant projects.

There are a number of further issues associated with the Review of Business Taxation, which have implications for the resources sector. These include:

- The possible loss of the 125% deduction for R&D expenditure which would impact on the sector's ability to innovate. Innovation has enabled the sector to compete on world markets, improve environmental management and to further expand the range of services it provides.
- Proposals for the tax treatment of distributions of company income have implications for our attractiveness to foreign investors and for Australian companies operating offshore.
- Proposals for the taxation of financial arrangements should take account of the needs of the legitimate, non-speculative hedging operations which are a long standing and normal feature of mining operations.

Further discussion of these issues is attached.

The resources sector is a key driver of the Australian economy. It contributes directly nearly 8% of GDP and 36% of total exports of goods and services (the largest single export sector of the economy) and together with its downstream industries, over a quarter of total new capital expenditure. It also spends some $2 billion annually on exploration for minerals and petroleum.

Furthermore regional development in remote areas of the country has been largely attributable to the resources sector. The development of ports, railways and townships in remote Australia is a direct result of resource development. This has brought with it enhanced social infrastructure such as health, education and communications that have significant flow-on benefits to communities in regional areas. The extent and nature of this sector's contribution to the nation was recognised in the Commonwealth Government's *Minerals & Petroleum Resources Policy Statement, February 1998*.

The prospect of a fiscal regime which disadvantages the resources sector in the hope of compensatory investment in other sectors needs to be carefully considered as do the implications of a tax regime which could further penalise Australians living in remote and regional areas in exchange for hoped-for urban employment. The degree to which investment is inefficiently allocated to the resources sector due to the current fiscal regime is by no means clear. Compensatory investment in other sectors of the Australian economy may not occur and instead funds may be relocated offshore.

The resources sector's success is in part due to Australia's fiscal environment. This has ensured Australia's ongoing attractiveness as a destination for investment. It has also ensured a high level of technical innovation and technology transfer which has produced a number of benefits. It has enabled the resources sector to raise its level of productivity in order to compete successfully in global markets and meet the challenge of decreasing real commodity prices. It has enabled Australian industry to meet our ever more stringent environmental aspirations while remaining competitive. It has fostered a range of world's best practice services associated directly or indirectly with the resources sector both at home and for export.

The skills, experience and technology developed in Australia's resources sector provide a foundation for knowledge-based industries in other sectors of the economy. While the growing contribution of other sectors to the nation's economic base is welcome, Australia will rely substantially on the resources sector for the foreseeable future and growth and innovation in resources will be to the benefit of the secondary and tertiary industries and services.

Australia's resources sector currently faces a number of hurdles - depressed markets, competition for sales and investment and restrictions upon land access. Decisions made on tax reform will determine the extent to which it can maintain or increase its share of new global investment. The highly mobile and competitive nature of investment in the resources sector requires that Australia develop a more competitive fiscal regime.

In preparing its final report, we urge the Review to take into account the particular characteristics of the resources sector, its operating environment and to undertake a rigorous assessment in order to ensure that options for business tax reform will enhance the international competitiveness of the resources sector to the benefit of all Australians

Yours sincerely

COLIN J. BARNETT
ANZMEC CHAIR

15 April 1999

ACCELERATED DEPRECIATION - COMPANY TAX TRADE-OFF

Introduction

A possible outcome of the Business Tax Review is the removal of accelerated depreciation in exchange, among other tax expenditures, for a 30% company tax rate. A policy decision implementing this trade-off carries with it the risk that investment in large resource sector projects in Australia would be considerably less than it would otherwise be. An assessment of that risk is crucial and is the subject of this short paper.

Current depreciation provisions allow accelerated write-off of plant (for example, plant with an effective life of between 13 and 30 years can be written off over 8 years). Site preparation and employee infrastructure can be written off under the Mining provision of the Act over 10 years or the life of the project, whichever is the less. Complete removal of accelerated depreciation would mean that capital items would be amortised over the full life expectancy of the item, which for major items would be the life of the project.

In the resource sector, accelerated depreciation benefits capital intensive projects with lives significantly greater than 10 years. The provisions allow greater depreciation to be taken in the early life of an asset, permitting larger tax deductions in the early years compared to other types of depreciation provisions. The resulting increased after-tax rate of return on projects (compared to projects which face an expected life depreciation regime) can be crucial to the development of a large marginal capital intensive resource project which would be associated with significant regional and national economic impacts. In this context the Business Tax Review recognises that externalities represent one of the rationales for accelerated depreciation.

The proposed changes to accelerated depreciation will fundamentally alter the mix of incentives toward investment in relatively short-lived assets, and away from capital intensive longer-term assets which may have significant positive externalities for the community.

An example of long life resource projects where accelerated depreciation provisions can make a difference include $8 to 10 billion LNG developments. These projects have the potential to contribute significantly to national economic well-being. A study has shown that, in a typical year of the production phase of the North West Shelf Gas project, for example, the project increased Australian exports by 3.5%, real Gross Domestic Product (GDP) by 1.24% and employment by 80,000 jobs.

At a State level, the mining industry has been found to have an output multiplier of 2, an income multiplier of 3 and an employment multiplier of around 4. The income and employment multipliers for mineral processing are even higher at around 3.5 and 4.5 respectively. These are amongst the highest of all industry sectors and almost twice the average. A recent example is the $1.64 billlion Olympic Dam expansion in South Australia. It is expected to increase Gross State Product (GSP) by 0.4%.

The expansion of mining and mineral processing has been a major factor in population growth, employment levels and economic growth. The mining and mineral processing industries are important generators of business for other sectors of the economy and are among the best economy-wide creators of employment and personal income. Major beneficiaries of these gains have been small to medium size enterprises.

Against these benefits it needs to be recognised that by reducing the effective tax rate faced by long life, large capital intensive projects, the accelerated depreciation provisions can act to allocate

investment away from other enterprises. The possibility of such outcomes needs to be assessed against the real possibility that Australia will forfeit investments of national significance which will flow to overseas alternatives. As the Business Tax Review's second paper states the judgement on this issue is a difficult one.

Analysis

An international study assessing the competitiveness of Australia's fiscal arrangements applying to offshore petroleum production (PRRT and company tax) found that the biggest element of tax impacting on moderately profitable and marginal fields was the depreciation provisions under company tax (Aberdeen University Petroleum & Economic Consultants, 1998). Their modelling showed that current depreciation provisions make the tax provisions regressive, that is, the larger the capital cost the greater the real tax take. Some argue that the availability of immediate deductions of interest costs associated with debt financing acts to remove or reduce the regressive outcomes of the depreciation provisions. This does not provide grounds for removal of accelerated depreciation as financing and investment allocation decisions are related but not the same with the former driven by risk/reward and liquidity considerations.

The above finding is supported by a paper commissioned by the petroleum industry peak body, APPEA ("Impact of Changes to Company Tax on Investment in Petroleum Exploration and Development", ACIL, December 1998). The paper notes that the bias against capital in the current arrangements arises because depreciation provisions are based on historic rather than real replacement cost. As a result operating costs which are expended in the year they are incurred have a higher net present value than an equivalent expenditure on plant and equipment.

Removal of the accelerated depreciation provisions amplifies this regressive outcome. It makes projects with lives of around 15 years or more, with marginal to moderate profitability, and high upfront capital costs relatively worse off than under the present arrangements. Analysis of the effects of removal of accelerated depreciation accompanied by a reduction in the company tax rate to 30% on a representative sample of projects (a proposed LNG project; a proposed gas pipe line, an iron ore mining and steel project; and a base metals project) shows a consistent pattern: each project would experience a 3% to 7% decrease in internal rate of return. These outcomes clearly indicate that major projects of strategic significance could be prevented from going ahead in Australia.

The November 1998 Review of Business Taxation discussion paper states that Australia must ensure its international taxation arrangements attract desirable inbound investment and further the competitiveness of the economy generally. As such, there is an argument for allowing accelerated depreciation for strategically important investments on the grounds that they would not otherwise occur without an incentive (especially important for mobile investments), they generate spillover benefits and tax revenue, and they further the competitiveness of the economy generally.

Eliminating accelerated depreciation from capital intensive projects to bring them in line with investment in intellectual property and service sector investments would not necessarily lead to a compensatory increase in investment in other sectors. Instead, it may lead to a lowering of investment in Australia, in favour of other countries offering more attractive fiscal terms for similar large scale commodity based industries. The Business Taxation Review's second paper acknowledges that accelerated depreciation is a feature of many overseas tax systems and that other countries offer incentives to attract particular projects.

Conclusions

Those resource projects involving large capital expenditures, and long operating lives (around 15 years or more), and with marginal to moderate profitability, are more sensitive to the depreciation rate than to changes in company tax rates. This is explained primarily by the timing impact on the cash flows. The complete removal of accelerated depreciation and the introduction of a 30% company tax rate will make such resource projects relatively worse off than under present arrangements.

Accelerated depreciation removes an impediment to investment in capital intensive, long life projects with national significance for the balance of trade and regional development. In the absence of accelerated depreciation these investments could shift to offshore locations with detrimental consequences for regional development. Projects involving energy production and distribution that act as fundamental drivers for other strategic developments, such as smelters, refineries and petrochemical plants, could be prevented from proceeding.

IMMEDIATE DEDUCTIBILITY OF EXPLORATION EXPENDITURE AGAINST COMPANY TAX

ANZMEC would like to state its unreserved support for the retention of this allowance.

Immediate deductibility of exploration expenses ranks with accelerated depreciation as one of the two most significant mining allowances. Exploration is an unavoidable pre-requisite to carrying on a mining activity and an expense unique to the resources sector.

Its origin derives from the peculiar characteristics of exploration activity, particularly the very low success rate of exploration. It has been variously estimated for mineral exploration that the chances of a commercial discovery range between 1:100 to as little as 1:1 000. Despite substantial improvements in exploration technology over the years, there is no evidence that the level of risk has declined. Risk remains an inherent part of mineral and petroleum resource activity where even successful exploration is accompanied by the expectation that returns could be substantially delayed.

The Review has not publicly canvassed any options for changing the current arrangements allowing immediate deductibility of expenditure for mining and petroleum exploration against any income. This does not however, discount the possibility that it may be traded-off along with other expenditures for a lower company tax rate. Among the options that may be suggested are that there be provision for separate treatment of successful and unsuccessful exploration, that immediate deductibility be limited to mining income, or that all exploration costs be treated as capital and amortised.

If exploration expensing is not permitted, then the low probability of success in exploration may impede the needed levels of investment. Immediate deductibility of exploration expenditure is an attempt to correct the non-neutral implications of corporate income tax on the expected rate of return to exploration compared to other activities. In this context, The Industry Commission Report No.7, 1991 *Mining and Minerals Processing in Australia*, supports the retention of immediate deductibility on the grounds that "although immediate deductibility of expenditure may contain an element of assistance, this is the least distorting tax treatment in terms of efficient allocation of resources."

For some specialist exploration companies who derive their income from the sale of mining rights, exploration expenditure is a legitimate revenue expense. For others, where exploration proves unsuccessful (there being no income against which to write off) and where companies cannot pass on losses under group transfer provisions, there may effectively be no assistance from immediate deductibility. Limiting deductibility to mining income would increase the risk that exploration losses will never be recovered.

The *Full Report* of the Taxation Review Committee (Asprey, 1975) argued that in broad terms, the removal of immediate deductibility would shift investment away from exploration to other, lower risk, activities and more specifically, would direct exploration away from geologically poorly understood areas towards areas of known mineral prospectivity. Many potentially valuable regions would remain under-explored leading to a misallocation of Australia's resources. These conclusions are supported by a recent study by ACIL Economics, "Impact of Changes to Company tax on Investment in Petroleum Exploration and Development" commissioned by the Association of Petroleum Production and Exploration Association (APPEA). ACIL found that if petroleum exploration costs were to be capitalised over the economic life of a project, it would significantly raise the after tax cost of exploration programs. The ACIL report also argued that the impact of removal of full immediate deductibility would be greatest on areas with a low probability of success, frontier areas where Australia's largest future discoveries are likely to be made.

The treatment of exploration costs for tax purposes impacts on the investor's estimate of expected project value prior to the exploration stage and, to a lesser extent, at the development stage, when carried forward exploration expenditures act to reduce the tax liability.

Australia's treatment of exploration expenditure is consistent at present with the majority of large resource-based economies which allow exploration expenditure to be deducted as incurred. However, the competition for mining investment has increased significantly as other highly prospective nations are actively developing their resources sectors as other risk factors decline eg political, sovereign risk. The loss of immediate deductibility would increase the effective tax rate on resource development with a consequent adverse impact on the competitiveness of the Australian resources sector.

Conclusion

The Review of Business Taxation in its report *A Strong Foundation* concluded that the taxation of inbound and outbound investment and other cross-border business activities should be consistent with Australia's national interests, including its competitiveness. Maintenance of the immediate deductibility of exploration expenditure would contribute to our efforts to attract desirable inbound investment to help maintain economic activity in remote areas, and further the competitiveness of the economy generally.

The current arrangements covering immediate deductibility should be maintained to reflect the peculiar characteristics of exploration activity, particularly the high risk and low levels of success. Under the possible options canvassed, the low probability of successful commercial development suggests that there is either little prospect of meaningful savings to tax revenue but at the risk of adding significantly to complexity. While the current arrangements may contain an element of assistance they have been found to be the least distorting tax treatment in terms of efficient allocation of resources.

FURTHER BUSINESS TAX ISSUES WITH IMPLICATIONS FOR THE RESOURCES SECTOR

125% R & D Concession

The maintenance of the 125% R & D concession is necessary to assist the Australian mining and mineral processing industries remain competitive in a global market where incremental gains through continual advancement in exploration, mining and processing technology are critical in maintaining a competitive edge. A study by Coopers and Lybrand in 1995 - *Business Expenditure on R &* D [1] found that the minerals industry expended a "high amount on R & D" and that it performed "better than manufacturing in general on a range of performance indicators."

R&D incentives are also a key to the maintenance of Australia's position as a leader in the services and technology industries serving the resources sector. It is within these industries that Australia's competitive edge and potential for increased servicing of the rest of the world's resource companies lies. There has been significant growth in these small to medium enterprises as large resource companies outsource and resort to core business. Fundamental to these companies is the ability to access incentives for R&D.

A study by the former Bureau of Industry Economics [2] found that the concession was warranted on grounds of knowledge spillovers (know-how that links from innovating firms), downstream spillovers (savings to Australian using industries and customers which do not directly recompense the innovator) and general community spillovers (mainly in the form of environmental quality, and public health and safety). Moreover, while critical research projects will be carried out as necessary by industry, there is a certain proportion of research and development which is discretionary. The ability to write-off R & D expenditure on prototype, pilot plants and research facilities is a significant benefit in capital intensive mining projects, by reducing risk.

It is also surprising that R&D incentives might be considered for review given the findings of the recent *Mortimer Review of Industry and the Government's Investing for Growth plan* which stated that "The R&D tax concession is a central element of the Government's strategy to encourage stronger private sector R&D" [3].

Conclusion

The minerals and energy industry is highly capital intensive. It is also globally oriented and faces a highly competitive international environment in the sale of its products. Its ability to continue to be at the leading edge of technology and product innovation is critical to its long term survival in the international arena.

Loss of the 125% R&D tax concession would have a detrimental effect on the industry's ability to continue to operate at best practice internationally. Moreover, the spillover effects of discretionary research previously done in the industry in Australia would be lost if loss of the concession forced that research overseas.

The former Industry Commission and the Bureau of Industry Economics (BIE) [2] both concluded that removal of the tax concession for R&D would lead to a reduction in GDP.

[1] Coopers and Lybrand 1995, Scoreboard '95: Business Expenditure on Research and Development, Industry Research and Development Board, Canberra.
[2] Bureau of Industry Economics (BIE) August 1993, Productivity Commission (formerly the Industry Commission), 15 May 1995.
[3] Investing for Growth, The Howard Government's Plan for Australian Industry, December 1997, page 32.

Treatment of Blackhole Expenditures

The proposals canvassed in ***A Platform for Consultation*** have been welcomed by the resources sector and are supported by ANZMEC as they will enhance the Australian resource sector's competitive position while recognising anomalies in current taxation law.

Clearly, as a matter of principle, expenditures undertaken for genuine business purposes should be recognised for tax purposes.

Consistent with the approach throughout this response, it is considered that Australia's tax system must be competitive with the tax regimes of our major competitors for investment [1]. It is therefore argued that the inclusion of blackhole expenditures for deductibility, be done in a manner that is consistent (and attractive) when compared with the regimes offered by Australia's competitors.

Research by the Minerals Council of Australia revealed that the majority of these expenditures are generally deductible, either outright or over time, in most other tax regimes surveyed. Further, it was estimated that the total value of non-deductible expenditure is around $98 million annually. If a 36% company tax rate is assumed, then the cost to revenue of allowing deductibility of such expenditures is around $35 million.

The proposed treatment of expenditures canvassed in the Ralph Review are consistent with the approach adopted in competing nations and recognise the genuine need for the resources sector to undertake these expenditures in order to generate income. Further, the Review recognises that certain tax deductions (e.g. wind up and closure costs) may be worthless in the case of stand alone companies. In such cases, there is an argument for a limited form of loss carry back to ensure an appropriate recognition against income. This is essential for smaller resource companies. It should also be noted that costs associated with dealings under the *Native Title Act 1993*, which currently fall within blackholes, will become an increasing burden to the resources sector. The proposed tax treatment of compensation payments made by companies in particular requires urgent clarification.

[1] Countries considered to be our major competitors include Chile, Argentina, Indonesia, South Africa, Brazil, Canada and the United States.

Tax Treatment of Financial Arrangements

Financial arrangements are a critical means by which resource companies underpin mining project development and day to day operations by hedging the risks exposures they face in financial and commodity markets. These arrangements are not speculative in nature, but are a risk management strategy to ensure the viability of the company both in the short and long term.

This is particularly important given the current downward trend in commodity prices and in some cases, companies have been able to insulate themselves somewhat from adverse market conditions.

Any proposal for the taxation of unrealised gains from financial arrangements will be distortionary to a company's investment and financial decision making. At present, financial gains arising from the closure of financial arrangements are taxed at the point of realisation once those gains enter the revenue account of the company. The net position of the financial

arrangement is highly variable over the life of the arrangement and may not reflect the end position. This means that taxing the financial arrangement prior to the point of its realisation may result in tax being paid on an arrangement that eventually has a negative value, even though at the point of taxation it may have a positive (though unrealised) value.

In developing anti-avoidance provisions in the treatment of financial arrangements, the commercial reality facing mineral and petroleum producers should be recognised. Legitimate hedging operations should not be penalised, nor should there be any disincentive to engage in such operations, such as complex and/or costly administration requirements. There needs to be flexibility in the treatment of such arrangements to ensure that legitimate, long-term arrangements, that are important in the day-to day running of an operation, are not penalised.

Deferred Company Tax

ANZMEC notes that the Review has developed further options on entity taxation to those proposed in the *A New Tax System* document. There is some concern that the original proposals would have had a number of adverse impacts including the raising of the effective tax rate on distributions of tax-preferred income to overseas shareholders, implications under tax agreements and impacts on companies' abilities to maintain an acceptable level of dividend distributions. These concerns may have negative effects on Australia's attractiveness as a destination for foreign investment. ANZMEC supports proposals which would have the effect of facilitating or at the very least not adversely affecting the prospects for foreign investment in Australian mining enterprises.

Treatment of Overburden Expenditures

The Review canvasses as an option the treatment of expenses associated with stripping/overburden removal as a capital expense which would be depreciated across a project’s life. Under the current regime some expenses associated with stripping/overburden removal are treated as being immediately deductible.

ANZMEC supports the existing tax treatment for expenditure incurred in the removal of overburden.

The Australian Taxation Office (ATO) has extensively examined this issue and has accepted that costs incurred in the removal of overburden are revenue expenses. It considers the removal of overburden as part of the method of extraction - an expense incurred as part of the operating process. The ATO considers that removal of overburden "does not add to the capital value of a mine in the same way as a vertical shaft adds value to an underground mine". It also states that "being part of the extractive process, the purpose of overburden removal is to reduce the capital value of the mine. A mine being a wasting asset is reduced in value every time valuable ore is extracted."