CME

4 April 2014

Manager
Not-for-Profit and Industry Tax Concessions Unit
Small Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: ExplorationIncentive@treasury.gov.au

Dear Sir/Madam

Re: Discussion Paper – Exploration Development Incentive: Policy Design

This submission is made by the Chamber of Minerals and Energy of Western Australia (CME) in response to the discussion paper on the approach to implementation of the Exploration Development Incentive by Treasury and Department of Industry on 13 March 2014.

CME has developed this submission with the assistance of member companies, including junior exploration companies, and we appreciate the opportunity to provide comment on both the technical and practical implementation aspects of the policy.

Our key recommendations throughout our submission address the specifics questions raised in the discussion paper. Our key message to ensure the tax incentive works as intended centre focus on:

- Targeting junior mineral explorers only;
- Applying the credit to all existing shareholders;
- Ensuring regulatory and compliance costs are minimised;
- Maintaining consistency amongst established definitions contained in existing legislation; and
- Continuing consultation with tax experts to ensure the modulation and credit process is appropriately consulted and designed, with a key focus on simplicity, prior to implementation.

Exploration is the lifeblood of future industry. With sensible and encouraging policy initiatives such as the Exploration Development Incentive, there are positive signs for a future pipeline of projects to underwrite the continued economic growth of Western Australia and Australia.

Thank you for the opportunity to comment on the EDI policy design. Should you wish to discuss any aspect of this submission with CME, please do not hesitate to contact Shannon Burdeu, Manager Economics and Tax on (08) 9220 8514 or s.burdeu@cmewa.com

Yours sincerely

Reg Howard-Smith
Chief Executive

CME

Exploration Development Incentive: Policy design

DISCUSSION PAPER FOR PUBLIC CONSULTATION

About CME

CME is the peak resources sector representative body in Western Australia funded by its member companies who generate 95 per cent of the value of all mineral and energy production and employ 80 per cent of the resources sector workforce in the State.

The Western Australian resources sector is diverse and complex covering exploration, processing, downstream value adding and refining of over 50 different types of mineral and energy resources.

The value of Western Australia's mineral and petroleum sector in 2013 reached a new record of $113.8 billion –15 per cent above 2012 level[1]. Western Australia accounted for $243 billion or 16 per cent of Australia's gross domestic product in 2012-13. Overall, the Western Australian resources sector accounted for approximately 11 per cent of Australian GDP[2].

Recommendations

- CME supports a no taxable income and no mining activities test to appropriately target the incentive to junior explorers (discussion paper q. 2.1)
- CME recommends consideration should be given to a cap on credits per company to further ensure the integrity of the measures (discussion paper q. 2.2)
- CME recommends the EDI apply to all shareholders for simplicity, reduction of red tape and to keep it equitable (discussion paper q.3.1)
- CME agrees with the alignment of the meaning of exploration to the ITAA definition; however CME does not support the exclusion of feasibility studies from this definition. Excluding feasibility study expenditure would be a significant step away from the intent of the EDI (discussion paper q. 4.2)
- The definition of exploration does not capture the evaluation of the economic viability of a resource. Including the widely used current definition of exploration, including feasibility studies, will allow this to occur (discussion paper q.4.3)
- CME recommends the Explanatory Memorandum to the EDI include detailed examples of 'incompletely explored' mines to ensure the intention of the wording remains broad.
- CME does not support the proposed negative limbs to any definition on greenfields due to the unintended consequence this would cause in the exclusion of genuine greenfields exploration.
- The ex-post modulation approach will work best for the implementation of the EDI to ensure companies are most easily able to comply with the process and to reduce administrative and regulatory burden. Companies will be able to provide investors with an indication of the likely value of the EDI through clear explanatory documentation (discussion paper q.5.0)
- CME considers further consultation with tax experts to ensure the simplest credit system method, without increasing compliance costs is adopted (discussion paper q. 6.1)

[1] WA Department of Mines and Petroleum *Mineral and Petroleum Industry 2013 review,* March 2014

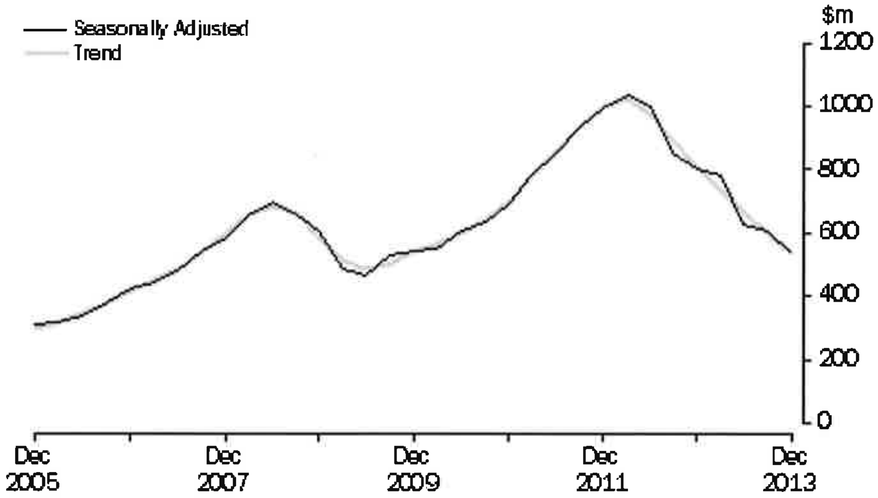
[2] WA Department of State Development *WA Economic Profile*, February 2014

Continued decline in exploration

Australia's competitiveness as an investment destination is a critical factor underpinning investor confidence that attracts capital inflows to Australia. The greater the confidence to invest in Australia, the greater will be the availability of finance and the lower the cost of finance, making projects more economically viable and internationally competitive, thereby more likely to receive positive final investment decision.

Year on year dollar expenditure on exploration in Australia has decreased dramatically since the record investment highs witnessed in 2011/12 with Australian Bureau of Statistics (ABS) December 2013 quarter data showing exploration expenditure 33.7 per cent lower from 12 months earlier at December 2012[3].

Figure 1. Mineral Exploration, Seasonally Adjusted and Trend



Quarterly results at December 2013 showed mineral exploration had fallen 12.5 per cent to $533 million for the quarter with Western Australia investment in exploration down 19.3 per cent, or $73.4 million.

Of further concern, a significant proportion of the decline in exploration activity in Australia has been in the exploration of greenfields sites. Exploration on areas of new deposits fell 27.5 per cent (or -$66.5 million) and expenditure on areas of existing deposits, brownfields, fell 6.2 per cent (or -$24.5 million)[4].

Greenfields exploration expenditure is a key indicator of future production. While no one factor on its own is conclusive; geology, commodity prices, the cost of doing business and effective pro-exploration policies in competing jurisdictions have all exacerbated the decline in Australian exploration investment.

Research by the University of Western Australia has shown that without new discoveries or mine extensions, the reserves of Australian non-bulk commodity mines would be exhausted between seven and 18 years[5]. Due to the long lead time from discovery to conversion, it is therefore necessary to ensure a continued pipeline of projects as a high priority.

Another driver of the decline in exploration expenditure is the risk and reward relationship for exploration. Greenfields exploration is inherently risky; the number of project-worthy discoveries from investigations is very low. This risk is compounded by the relatively substantial upfront sunk costs

[3] ABS statistics, 8412.0 - Mineral and Petroleum Exploration, Australia, Dec 2013

[4] ABS statistics, 8412.0 - Mineral and Petroleum Exploration, Australia, Dec 2013

[5] *Where are Australia's Mines of tomorrow?*, Pietro Guj & Richard Schodde, September 2012

associated with exploration. For the most part these funds are raised through initial public offerings as debt funding is generally not a viable option.

The Australian taxation system provides further limits to exploration investment in Australia as it does not allow for immediate utilisation of sunk costs or losses – unlike the Canadian policy of allowing 'flow through' tax deductions of greenfields exploration costs.

From 2002 to 2012 Canada's share of global exploration has increased from 14 per cent to 18 per cent; Australia's proportion of global exploration investment has decreased from 21 per cent to 12 per cent over the same time period[6]. The Australian Bureau of Agricultural and Resource Economics has in the past estimated that the lack of an incentive scheme such as Canada's represents a competitive penalty of 7-8 per cent[7].

Exploration and development capital is mobile and we operate in a world where different countries are actively competing for this capital using fiscal and various tax incentives. This type of disincentive is simply not sustainable.

CME position and the Exploration Development Incentive

CME has long advocated for an exploration credit scheme to reverse the trend of decreasing exploration expenditure. CME welcomes the Australian Government's proposed Exploration Development Incentive (EDI) as it will encourage investment and stimulate growth to further add to the pipeline of future resources projects.

In November 2008, CME in conjunction with the Association of Mining and Exploration Companies (AMEC), Minerals Council of Australia (MCA) and other state bodies developed a proposal for a national flow-through shares (FTS) scheme. In 2010 this was again revisited with a joint response submission accompanied with modelling on the Australian government's Policy Transition Group's issues paper on exploration policy, jointly developed with representation of peak bodies from all Australian states. This was further developed and explored with AMEC releasing further modelling to support development of a Mineral Exploration Tax Credit (METC) policy.

CME supports the main objective of the government's proposed EDI to encourage exploration in the small and mid-tier sectors. Proper design of the policy is imperative to ensure that it functions in a way to achieve the desired impacts.

CME has contributed to and endorses the MCA submission to the discussion paper. CME urges government to pursue a policy design which is easy to administer and provides for straightforward compliance obligations to create the most effective incentive for small and mid-tier explorers. The following comments on the design specifics address this ambition.

Policy design specifics

How to target junior explorers

CME considers a 'no taxable income test' to be an appropriate criteria in the determination of which junior explorers should have access to the incentive. This test should be considered from a corporate consolidated group perspective, where the group as a whole must be in a tax loss position for the EDI to be passed through to shareholders. This mechanism is an integrity measure that will assist to ensure the EDI is targeted at junior explorers only and can not be circumvented by larger owners.

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6 *Where are Australia's Mines of tomorrow?*, Pietro Guj & Richard Schodde, September 2012
7 Australian Bureau of Agriculture and Resource Economics, Tax incentive options for junior explorers, May 2003, p 31. (formerly under ABARE now Bureau of Resources and Energy Economics)

CME agrees with the need to include a 'no mining activities' provision to target junior explorers. This clause will help prevent unintended consequences of credit availability being reduced for exploration expenditure where genuine costs of a loss-making entity are being incurred, which may have income from other sources, such as interest.

The appropriateness of a 'no mining activities test' criteria is dependent upon what activities are included within this definition. Activities conducted by a junior explorer inclusive of those endeavouring to determine the existence, location, extent, quality, economic and feasibility studies of a discovery should be included as deductible as there are important steps for explorers in the process of evaluation prior to sale of an asset, to establish a fair price.

Attempts to limit and re-define mining can be fraught. CME recommends the current definition of 'mining operations' as included in section 40-370 of the *Income Tax Assessment Act 1997* (ITAA) should be used. This definition is clear, understood by industry and will meet the policy aims of limiting the EDI to junior and mid-tier explorers.

CME supports a no taxable income and no mining activities test to appropriately target the incentive to junior explorers.

An additional mechanism to ensure the credit is more specifically targeted would be a process for capping the total credit amount to be passed on per company, or corporate group. An annual limit or cap could be applied on the EDI to be claimed per company or corporate group. This, along with the restrictions of 'no taxable income' and 'no mining activities' tests, would ensure the EDI is available for junior explorers only.

CME recommends consideration should be given to a cap on credits per company to further ensure the integrity of the measures.

All shares or new shares

CME supports the restriction of access to the EDI to all Australian tax-paying shareholders of Australian resident companies active in Australian exploration. This is consistent with access to the Research and Development (R&D) tax concessions available to junior explorers and with Australia's franking tax credit system more generally.

Providing credit access to all Australian shareholders is important. If the EDI is restricted to only new Australian shareholders this would be a significant administrative burden on companies. Red tape and complex regulatory compliance requirements are a major problem for all resources companies and can be compounded at the small and mid-cap level or for explorers where operations are often very lean with few staff attending to the day to day running of the organisation.

Given the target of this incentive are small explorers, it is important to note there may not be the sufficient skill and capacity to appropriately administer complex and varied incentives, effectively defeating the purpose of the incentive.

CME supports the proposal that the EDI take up be voluntary. Exploration companies should be able to choose to retain their exploration deductions for their own future use if they wish to, or be able to pass on directly to shareholders.

CME recommends the EDI apply to all shareholders for simplicity, reduction of red tape and to keep it equitable.

Exploration expenditure

CME agrees that the use of section 40-730(4)(a)(i) of the ITAA is the most appropriate way of determining a definition for exploration or prospecting. We do not however, consider the included definition of 'exploration or prospecting' should be excluded from this under section 40-730(4)(c).

The removal of feasibility studies from the definition of exploration will be inconsistent with the current application of the ITAA and will significantly limit the availability of the credit. CME does not support any attempts to limit the definition of exploration, particularly so as to exclude feasibility studies. Activities aimed at determining the commerciality and technical economics of a project are vital to a project's success.

An ore body that is highly complex to extract could cost a prospective purchaser significantly more during the production stage; feasibility studies will enable project proponents and investors to appropriately evaluate the options available to it. Feasibility expenditure is critical to determine if activities are viable to proceed to development and limiting the EDI to exclude feasibility studies and associated activities, will lessen the impact of the EDI.

We note the definition given to 'minerals' for the purpose of the EDI will specifically exclude 'petroleum' as defined in section 40-730(4)(b) of the ITAA. While petroleum exploration is outside the scope of the current EDI, CME recommends including petroleum interests in the EDI scheme in the future continue. This will also ensure consistency with the current definition of minerals as it is applied in tax law.

Greenfields

As there is no defined or technical meaning for 'greenfields' exploration activities, attempts to define such have often referred to spatial distance from historical or operating mines. 'Grassroots' on the other hand is used to refer more to exploration techniques. The discussion paper refers to grassroots exploration activities as the 'generative and early stage exploration for new mineral deposits'.

The definition of greenfields exploration provided in the discussion paper extends to "*exploration of unexplored or incompletely explored areas directed at discovering new resources*".

The use of the phrasing 'incompletely explored' in the definition is quite vague and could have various meanings. CME would seek to apply a broad understanding of this phrase to include specific activities which will assist to determine the existence, location, extent, grade, size, commerciality and quality of a resource.

The meaning of 'incompletely explored' should also include previously explored but not mined, or completely mined, sites. This inclusion in the definition of 'incompletely explored' is paramount as it is not uncommon for tenements that have been explored to no success to be re-explored and result in significant finds. This is irrespective of whether the exploration activities are undertaken with either a mining or exploration lease.

CME recommends that the definition of greenfields exploration extends to mining leases as well as to exploration licences. It is not uncommon for explorers to undertake greenfields exploration to re-evaluate the geology of a mining lease using improved technology or to target different minerals. Excluding greenfields exploration on mining leases would effectively mean this search of genuinely new discoveries was not supported by the EDI.

As technology becomes more sophisticated and plays a greater role in discoveries it is commonplace for previously uneconomical or incompletely evaluated deposits to be revisited. This is more so the case when commodity prices are high.

Mines change ownership and the demand for different commodities also changes over time. When assets would otherwise have remained stranded, companies which take the risk and substantial costs incurred to explore these assets should be able to access the EDI as they are generating new mineral discoveries. Again, this would be the case irrespective of whether a mining or exploration lease was granted. Some detailed examples in the EDI's explanatory memorandum to this effect would be useful to provide clarity, where it is deemed a definition is necessary.

CME agrees with the alignment of the meaning of exploration to the ITAA definition; however CME does not support the exclusion of feasibility studies from this definition. Excluding feasibility study expenditure would be a significant step away from the intent of the EDI.

The definition of exploration does not capture the evaluation of the economic viability of a resource. Including the widely used current definition of exploration, including feasibility studies, will allow this to occur.

CME recommends the Explanatory Memorandum to the EDI include detailed examples of 'incompletely explored' mines to ensure the intention of the wording remains broad.

CME does not support proposed negative limbs of the definition of greenfields which limit the EDI to 'a mine that has come into production or to a potential or actual extension of a mine' or 'inferred mineral resource' under the Joint ore Reserves Committee (JORC) code, to ensure brownfields exploration is not captured in the definition.

Mines previously in production may have been mothballed or put into care and maintenance. Again when ownership or economic conditions change, the asset may again become viable and further exploration of the incompletely explored site is required.

Furthermore, 'inferred reserves' listed under the JORC code are very broad and encompassing. Excluding under these terms has the potential to unintentionally limit the credit availability to otherwise greenfields exploration due to previous, limited geological information.

While CME considers a definition for 'greenfields' is not necessary, where a definition is included is must remain simple, practical and not have the consequence of excluding genuine greenfields exploration expenditure from the EDI.

CME does not support the proposed negative limbs to any definition on greenfields due to the unintended consequence this would cause in the exclusion of genuine greenfields exploration.

Modulation process

In most tax policy design processes, there will be a trade-off between desirable policy outcomes. In the case of determining modulation and allocation of the EDI, the competing interests are of investor certainty and administrative and regulatory burden.

CME recommends the EDI applies ex-post modulation methodology for the return of tax deductions for shareholders. While it would provide limited certainty for investors, the ex-post methodology would minimise reporting requirements and maximise the credits paid. Simplicity and removal of duplicative processes must be a key priority in all government guides to regulation.

A way to provide further certainty to investors would be to bring forward the proposed timing for the cut-off date for companies to notify the ATO of their eligible loss. Early timing will assist companies to be able to provide genuine and timely notification to shareholders and potential investors.

The proposed ex-ante methodology would impose an unworkable regulatory and duplicative process which potentially many small and mid-cap explorers may not have the capacity to be able to administer. While providing greater investor certainty, this is outweighed by the required trade-off of simplicity in the modulation method.

The ex-post modulation approach will work best for the implementation of the EDI to ensure companies are most easily able to comply with the process and to reduce administrative and

regulatory burden. Companies will be able to provide investors with an indication of the likely value of the EDI through clear explanatory documentation.

How the exploration credit system will work

CME does not recommend there should be any requirements for companies to have entries on the explorer's imputation accounts. The methodology suggested in the discussion paper appears unnecessary when the implementation of the EDI has the ability to be less administratively burdensome. Making adjustments to the imputation account will create additional compliance for the explorer as many junior explorers, in not paying tax or dividends, would not have the need to maintain an account. There could also likely be issues with tainting the share capital account which could dilute the impact of the credit.

CME considers further consultation with tax experts to ensure the simplest credit system method, without increasing compliance costs is adopted.

CME endorses recommendations in Appendix 2 of AMEC's submission to the discussion paper. The example proposed by AMEC will preserve the integrity of the cost base without diluting the upfront value of the EDI. Both of these outcomes are desired in optimal design of the exploration credit system.

Detailed examples in the EDI's Explanatory Memorandum, such as those prepared by AMEC, will assist in companies' application of this process.