



Cement Australia Pty Limited

ABN 75 104 053 474

Queensland Office

40 McDougall Street, Milton, QLD 4064

PO Box 1328, Milton, QLD 4064

Tel: 07 3335 3000 Fax: 07 3335 3222

www.cemaust.com.au

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General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

rdtaxcredit@treasury.gov.au

Consultation Paper: The New Research and Development Tax Incentive

Cement Australia is pleased to have the opportunity to provide comment on the Consultation Paper entitled the New Research and Development Tax Incentive ('the Consultation Paper').

Cement Australia is the leading integrated manufacturer of cementitious products in Australia. The company holds 47% of the Australian market, and is an acknowledged leader in the national industry while retaining an international shareholding providing leading global support on the full range of related technical, environmental and sustainability issues confronting the industry.

Cement Australia has the commitment and capacity to drive worthwhile outcomes in cement manufacture and materials, critical outcomes for ensuring that Australia has access to high quality materials able to provide a sustainable built environment.

Our strong links with global cement players provides us with real benefits including:

- global benchmarking of our operations;
- access to the developments in cement processing technology; and
- links to the World Business Council for Sustainable Development through our parent Holcim - one of the founding members of the Cement Sector Initiative - which provides, amongst a half a dozen sustainability initiatives, an international focus on greenhouse issues, emissions reporting, and resource sustainability.

Cement Australia has an annual turnover of \$990 million, through 4.2 million tonnes of cement sales, as well as sales of lime products, fly ash and slag, on an asset base of \$1 billion. We employ a fleet of transport assets and some 1,500 employees.

Cement Australia recycles over 1 million tonnes of fly ash, and over 100,000 tonnes of blast furnace slag each year, making us one of Australia's largest recyclers.

Cement Australia has been a pioneer in developing an active alternative fuels and raw materials business, based largely out of Victoria and which utilises a spectrum of industry by-

products that exhibit either calorific value or material replacement value. These alternative fuels and raw materials are used as partial replacements for our traditional fuels and raw materials.

As a result of these progressive activities, Cement Australia's research and development ('R&D') expenditure has addressed a broad range of activities from cement processing technologies through to resource conservation and new-generation, sustainable materials.

Technology development and the cement industry

The Cement Industry Action Agenda; a joint industry/government initiative was published in mid-2006 and identified a number of barriers to technology development in the Australian cement industry. The following relevant observations were made:

- From page 10:

Given expectations of technology adoption under its BAU scenario, and assuming that forecasts of production and uptake of substitute fuels and materials eventuate, the industry believes that it can maintain a continued improvement in its energy efficiency, with consequent reductions in greenhouse gas emissions. However, moves to technological improvements beyond BAU currently face regulatory barriers and inconsistent approaches across States and Territories. In addition, large capital investment and risk hurdles exist which could be assisted through access to existing government programs. (Commonwealth of Australia, 2006, 'Punching Above Its Weight', p.10)

- from page 27:

Over the past 15 years the Australian cement industry has invested over \$1 billion in new and emerging process and product technologies to ensure that it remains competitive and sustainable in a rapidly expanding global market. Initiatives that have improved the energy efficiency and greenhouse gas abatement capabilities of Australian cement plants include:

- *reducing emissions from the cement-manufacturing process, including greenhouse gases, landfill, dust and nitrogen oxides;*
- *increasing efficiency in manufacturing—requiring less power and fuel;*
- *creating superior construction materials for a wider range of uses; and*
- *improving the durability of concrete through cement quality.*

(Commonwealth of Australia, 2006, 'Punching Above Its Weight', p.27)

- from page 28:

The key hurdles to address to facilitate this technological transformation are:

- *lack of capitalisation and insufficient risk-return trade-off;*
- *inadequate government incentives for medium sized industries, such as cement, to engage in transformational research and development activities; (Commonwealth of Australia, 2006, 'Punching Above Its Weight', p.28)*

- and from page 29:

The Australian cement industry is very successful at developing and implementing small and incremental technological improvements, resulting in significant improvements in its energy efficiency and greenhouse emissions performance.

The increased use of new technologies that employ new processes and alternative resources requires on-site development and compatibility testing. This involves substantial capital outlays and risks to plant production and infrastructure. For example, to trial a new process the plant must shut down normal production. Due to the continuous production cycle of Australian cement plants, a shutdown automatically results in lost product and revenue that cannot be recovered.

The commercial justification for investment in new technology must compete with existing technologies both in terms of costs and retrofitting the existing plant....

The cement industry has made limited use of government assistance, either because associated administrative burdens significantly reduce the real benefits to an applicant or because eligibility criteria limit its access to existing government schemes. (Commonwealth of Australia, 2006, 'Punching Above Its Weight', p.29)

By way of a summary; the following aspects of the industry impact on our ability to engage in R&D activities, and in particular highlight the importance of an accessible effectual R&D incentive program:

- Being a relatively small, domestic player, the cement industry has traditionally been a technology taker, relying largely on R&D occurring in the northern hemisphere;
- The rapid globalisation of the industry and increasing pressure to maintain our competitiveness have been significant drivers for innovation and R&D;
- The capital and energy intensive nature of the industry mean that, wherever possible, R&D trial activities must be coordinated with plant shutdowns and/or, where possible, with actual production periods.

We do not believe that these aspects should be penalised through any changes to the R&D incentive structure.

Specific Comments in relation to the Consultation Paper

The Definition of Core R&D Activities (Principle 6)

Principle 6 of the consultation paper proposes the following:

Eligible R&D activity will be defined as systematic, investigative and experimental activity that:

- (a) involves both innovation **and** high levels of technical risk; and*
- (b) is for the purpose of producing new knowledge or improvements.*

For R&D activities to be eligible under the current regime, they must contain 'innovation' or 'high levels of technical risk'. Inserting the word 'and' raises a concern as to the implications of moving away from a now well-established working definition of R&D that significantly raises the bar in relation to determining eligible activities.

It is Cement Australia's concern that some R&D projects that involve technical risk alone may now have less chance of being undertaken (or be undertaken at a slower rate) if the benefit offered from the R&D tax concession is removed. It is our experience that 'technically risky projects' in and of themselves are equally valid sources of new knowledge and improved processes for Cement Australia and, often, for industry generally.

If the definition test were to change to an 'and' test it will also become necessary to obtain greater clarification as to the precise definition of what 'innovation' is; and what 'high levels of technical risk' means.

Supporting R&D (Principle 7)

Principle 7 of the consultation paper states:

Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

The consultation paper provides some suggestions as to the new limitations the Government is considering, i.e. whether supporting R&D activities should:

- a) be capped as a proportion of expenditure on core R&D and, if so, what would the appropriate proportion should be?
- b) only eligible where they are for the sole purpose of supporting core R&D activities;
- c) exclude production activities or dual role activities;

- d) only be eligible on a net expenditure basis; or
- e) attract a lower rate of assistance than core R&D and, if so, what would the appropriate rate be?

R&D trial and pilot activities are a highly important aspect in getting new and improved technologies and developments from R&D activities to market. It is fundamental that any R&D activities have a commercial goal in mind. It is one thing to develop new or improved technologies, but it is another to be able to commercialise these technologies. Crucial to this process are R&D trial and pilot activities. In other words without them the benefits to Cement Australia, the Australian cement industry generally, and additional spill-over benefits to both suppliers and customers are likely to be seriously impaired. It is for this significant reason that R&D trial and pilot activities should be seen for what they are, crucial to any Australian R&D activity. The concept of something being "supporting" to a "core" activity should not be seen as "second rate".

Given the aspects of cement manufacturing identified earlier, for Cement Australia, supporting activities are an even more significant and valid component of R&D activities. In particular, given the scale of the manufacturing equipment involved, trial and pilot activities become an essential component of core R&D activities. The undertaking of trial and pilot activities is critical to minimise the risk of adverse impact to major plant and equipment on which the company relies for production and cash flow. If trial and pilot activities attracted less R&D incentive support, this would have a major impact on our ability to undertake core R&D.

Any curtailment of R&D incentive funding means that Cement Australia will have a reduced capability to fund innovation and thus to maintain the advantages of being 'technically' at the forefront of an internationally competitive market. Such curtailment would also risk Cement Australia falling behind its competitors, underperformance of its plant and inability to meet its customer demands.

In relation to Option a): implementing a cap proportion to core R&D expenditure is not considered appropriate as it will require increased administration associated with segregating core and supporting activities and then calculating the portion that is able to be claimed.

Additionally, it would be inequitable to introduce a standard proportion (i.e. a cap %) to cover all claimants as the nature of core R&D activities in each industry may be such that the associated costs are not on par with the costs of supporting R&D activities. For the cement industry, this is the case where supporting activities/expenditure, very often focused around kiln running costs, are by their nature significantly high when compared to the cost of core R&D activities, the latter which often comprise high proportions of personnel design time/costs.

If this option were to be adopted, Cement Australia would consider that an appropriate proportion of core activities to supporting activities would be 1:10.

In relation to Option b): moving to a sole purpose test has the potential to eliminate all R&D-related trials from being classified as 'eligible R&D activities'. This would have the impact of severely restricting Cement Australia's ability to invest in core R&D activities. For the reasons already listed, supporting R&D activities are an integral part of all core R&D programs able to be undertaken. While it is true that, as a matter of common business sense, trials may be undertaken for R&D purposes while still maintaining some revenue-creating production, there are still significant levels of risk associated with most trial or other supporting activities. Production efficiency and plant throughput are likely to be impacted, and risks to plant and equipment may exist. To encourage the undertaking of only R&D-dedicated supporting activities, is neither practical nor equitable in such a highly plant-oriented industry environment, where much of the testing of its R&D 'hypotheses' must necessarily be fitted within real-time, machine production cycles. Under this proposal none or few of these activities that provide vital support to core R&D would be eligible, resulting in a substantial negative impact on promoting R&D within the business.

In relation to Option c): the discussions above relating to options a) and b) also apply to Option c).

In relation to Option d): As per Option c), however, of particular relevance is the fact that, due to Cement Australia operating on a profit-driven business model, it will always be the case that, in the medium-to-long-term, our revenue from operations will exceed our costs (including R&D expenditure) therefore, conceptually, as all expenditure is 'recouped' either directly or indirectly, there might never be any 'net expenditure' that would be eligible.

In relation to Option e): while we do not advocate any change to the current definition and interpretation of 'Supporting R&D Activities', for the purpose of this submission and assuming a change were imminent, this would be Cement Australia's preferred option, as we believe that this option provides recognition of the importance of supporting R&D activities, while still acknowledging there may not be the same level of spill-over benefit/s associated with these types of activities as compared to core R&D activities. This option would also have the benefit of minimising ambiguity associated with a change in the definition of a supporting activity (i.e. it will still be for 'a' purpose). We would recommend having the rate of assistance for supporting activities reduced to that which is available under the current regime, i.e. 7.5c for every dollar of R&D expenditure as opposed to 10c for every dollar.

Software Development Activities (Question 6)

Question 6 of the consultation paper acknowledges that the current treatment of software development activities is complex, requiring that software be sold to two or more non-associates to obtain eligibility.

Cement Australia agrees with this position and believes that the current treatment is nonsensical. Cement Australia undertakes numerous software projects that contain innovation

and high levels of technical risk, and therein deliver significant benefits both to its own business, and to its business associates. Such projects are, in fact, vital 'enablers' of more efficient and novel utilisation of knowledge, technical solutions and other equally important informational facets of the business across our many operations.

Cement Australia believes that the current definition could be improved by retaining the multiple-sale requirement, but additionally allowing some concession for in-house software development on a similar basis to that used within the New Zealand regime, i.e. by providing a cap for in-house software development projects. In New Zealand this cap is set at an equivalent of \$3 million in-house software expenditure per year per claimant.

Cement Australia maintains a vision of being the leading cement manufacturer in Australia. It is proud of its resourcing of R&D and the many technological and innovation gains that have been achieved. We are also cognisant that much of these gains would, and in the future can only have been achieved through Government support for R&D. We are very concerned that if any one of the proposed changes are made (and particularly the change proposed for the core definition), coupled with whatever option is invoked in relation to supporting activities and the loss of the 175% deduction rate; that collectively this has the potential for significant impact, the non-achievement of revenue neutrality and the net erosion of support for business R&D.

Thank you again for the opportunity to provide comment on this Consultation Paper. Any questions may be directed to the undersigned.

Yours faithfully



Alexandra Carlyle
Group Tax Manager