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Tax White Paper Submission

Strategic National Interest Investments - Tax treatment at point of commercialisation

With notable exceptions, Australia's performance in translating innovative and potentially valuable scientific knowledge, R&D and advanced technology into commercialised business activity is poor. Outcomes range from loss of key innovators overseas, transfer of ownership or control of intellectual property to foreign companies, through to the building of projects at overseas locations using Australian equity and debt, due to more competitive and strategically focussed environments for capital investment existing in those locations. In many cases the loss to Australia is not just the loss of the investment in an individual project but loss of opportunities for multiple projects and for the development of downstream industries.

This submission proposes that government recognises within tax law a class of high potential Strategic National Interest Investments (SNII) that, at the point of initial commercial scale investment and subject to certain tests, can qualify for supportive tax treatment. The proposed tax treatment recognises the higher than business-as-usual risk associated with commercialisation investments and the proposed tests ensure that no tax-payer funds are spent in supporting what must be economically viable, private sector investments.

Proposed tests are directed at confirming that the advanced technology and project contains Strategic National Interest Investment value and that in the absence of access to the supporting tax treatment, private sector investment will not proceed.

The aim of the proposal is to help ensure that high potential Australian innovation, which has often received tax-payer support during the R&D phases of development, is afforded every opportunity to attract commercialisation investment in Australia and to achieve that without any form of tax-payer subsidy.

A Definition for Strategic National Interest Investment

A suitable definition for SNII is intended to be completely open in terms of industry sectors and the types of technological advances that could qualify as being of strategic national significance. A particular investment might hold strategic value because of effects on economic development, enhancement of critical Australian exports, through being a component of critical infrastructure or improvement of capabilities related to national security. The proposed definition for SNII is that the technology and associated project meet the following criteria:

- The investment is a private sector investment, and
- The advanced technology and project are the first of its kind to be operated at commercial scale, and
- There are multiple projects of its type available in Australia once commercial operation is proven successful in the first instance or where multiple initial commercialisation projects can start in parallel, and / or
- The availability of the product or output of the project enables the creation of downstream industry investment opportunities in Australia that may service domestic or export markets, and
- Without access to the proposed commercialisation tax regime private sector investment will not occur

How SNII Value Arises

SNII value exists where the initial proof of the economic viability of an advanced technology leads to additional projects of the same type using the same technology. In general the potential for multiple projects will be clear when the output of the project is used by a particular industrial scale customer and there are a number of identifiable similar customers in the industry. A hypothetical example is where the advanced technology has application in the mining of iron ore and there are a significant number of iron ore miners in Australia. If the economic and competitive effect of the technology was significant all or most iron ore miners would adopt its use as state-of-the-art creating not only multiple projects for the technology but a more competitive iron ore industry in Australia.

SNII value can also exist where the initial commercial scale project using the advanced technology allows creation of downstream industrial activity. Following on the iron ore example, application of the advanced technology might not only have economic benefits in reduced cost in mining but might also enable downstream processing of iron ore fines into higher value pelletized iron ore or direct reduced iron for export markets.

Hypothetical examples above are indicative of technology impacts in one particular industry, being iron ore mining and processing. Application of the proposed SNII tax regime however is framed to be applicable to any industry sector. Examples could emerge in communications technology, medical technology, advanced manufacturing, defence applications and many others.

A recent example where Australia lost the opportunity for establishment of a new, export focussed, high intrinsic value industry is in the mining and production of rare earth minerals and potentially rare earth metals (REM). Rare earth metals are critical materials in the production of high efficiency, low weight magnets that find use in motors for everything from hard disc drives, to car windscreen washer pumps, to the large electrical generators in wind power facilities. REMs are central to many of the technological advances in electrical power generation that increase energy efficiency and reduce carbon emissions across a wide range of applications.

In this approximately \$1 billion project, where the original intent was to mine ore, process the ore into a concentrate at the mine site (physical separation of the RE minerals) and to process the concentrate at a coastal processing plant (chemical extraction of the REMs), all within Western Australia. The project was not able to be funded in Australia other than with China backed capital, which was rejected by the FIRB. Finally the project was built with the mine / concentrator necessarily in Australia and the chemical treatment plant in Malaysia. The value of the mine / concentrator capital cost was around \$200 million and the chemical treatment plant investment in Malaysia was \$800 million. Malaysia now exports those products into world markets; reaps the benefits of jobs, tax revenue and multiplier effects; has captured 90% of the value add in processing within its GDP; has the opportunity to open up a new industry in production of REMs and mother alloys used in sophisticated manufactures and perhaps even manufacture of the end use products. None of that will come back to Australia other than in the expensive imports that we need, for example, in increasing energy efficiency and reducing carbon emissions. And the equity supporting that investment was raised on the ASX, the debt obligations held by the Australian company and the commercial risk taken by many Australian shareholders.

Any proper strategic analysis of the long term value of that project, the opportunities that could flow from it and the potential long term value to the Australian economy would have led to state and

federal governments doing much more to ensure that the value was not lost and that the investment remained in Australia.

The SNII Test

In order to access the commercialisation support tax regime, proponents of advanced technology based commercial scale projects where the investment represents the first demonstration of commercial viability, would be asked to identify and quantify the flow-on benefits from the initial project. That is, the existence of multiple projects within Australia, and / or the enabling of downstream industries or manufacturing in Australia based on the products of the project being invested.

Assessment of the proponent's view of flow-on benefits and verification of the likely value of benefits would likely be undertaken by Industry and Science departmental advisors with support commissioned from one of the major management consultant companies that has the most relevant industry experience. Such companies include, PwC, KPMG, Accenture, E&Y and others amongst their peers. In this way a level of independent advice would be available to government. Alternately there might be resources within existing government policy support structures that could be prioritised to carry out this function.

As part of the above assessment the commercialisation status of the technology would include determination that there are no examples of the technology already operating on a commercial basis, including outside of Australia. If such examples do exist and the already proven technology is accessible, e.g. via license, then the technology and associated project would not qualify for the supporting commercialisation tax regime. A competitive advance arising from development of the technology is an essential pre-requisite for access to the support. It is then less likely that competing technologies represent a threat to commercial viability.

Commercial Viability Test

Verification of the commercial viability of the proposed advanced technology project would focus on two areas;

- Verification that the technology is ready for commercialisation, and
- That the economics for the project show positive return on investment for the project owners but not sufficiently positive to commit private sector investment

Verification that the technology is developed to the extent necessary to undertake commercialisation at normal first-of-its-kind risk would be determined through established, standardised Technology Readiness Level (TRL) evaluation procedures.

Proponents' own economic evaluation and related cost estimation and project execution plans for the project would form the basis of the assessment of economic viability. This documentation can be independently reviewed to ensure that the basis for a proponent's economic evaluation is sound and benchmarked against relevant industry data. Independent Project Analysis Inc. is one such service provider that is highly respected in the resources and process industries. Assessments can be made of the quality and reliability of the project documentation and planning, and factors such as inclusion of appropriate capital cost contingencies covering cost and schedule risks in project implementation.

Financial outcomes in terms of expected rate of return on investment could be assessed by one of the management consulting organisation such as PwC and others, as suggested for review of project flow-on benefits. Project ROI estimates would be compared to industry benchmarks and also to investor expectations in various market sectors. Expected returns for the project investment being in the range of expectations for the targeted investor group, except for ROI reduction through assessed risk premium attaching to a first-of-kind investment, would provide supporting evidence as to reasons why the proponent is not able to secure commitments from major investment groups that would allow the project to proceed.

If the project as proposed has an estimated investment return higher than that expected by target investor groups, it would be disqualified from receiving support. The intent in this submission is that only private sector investments can access support and only to the minimum level needed to achieve investment in the SNII project and to do this without cost to the tax-payer.

The Proposed Supporting Tax Regime

SNII support proposed comprises:

- A first operating year Investment Allowance, and
- A Tax Holiday period in the range 3 – 7 years, and
- Accelerated Depreciation

If this submission is taken up consideration could then be given to whether the three factors above are nominated and fixed for any project or whether there is reason to adjust the factors to suit individual projects. The value of the latter is that it allows on the minimum necessary support level to be provided. It also allows discretion useful in cases where downstream values are particularly high and increased support is assessed to be warranted.

Use of these levers can have the effect of increasing ROI outcomes by a few percent only; an increase of 3-5% would be possible. This may, however, make the difference between the project achieving a commercialising investment and not.

A proposed project that has a negative ROI cannot be converted to an investable proposition. Proposals showing negative returns in either a proponent's submission or by adjustment after independent review would be disqualified from receiving support.

No Tax-payer Subsidy

The intent of this submission is to put forward a means by which investments based on advanced technologies are able to access support for the initial commercialisation projects if necessary to realise investment without involving tax-payer funds. Any project seeking to access the SNII scheme can only do so if the project is a private sector investment and one that shows positive return on investment but insufficient return to meet investor expectations, including the risk premium normally associated with first-of-kind commercialisation projects. This means there are two possible outcomes for such a project. First, that in the absence of access to the SNII support the project will not proceed. For the tax-payer this means a zero cost and zero benefit outcome. As a result there is no issue around foregone tax revenue.

If access to the support is granted the project will proceed and, as far as tax-payer funds are concerned, tax revenue can only flow to treasury; there no flow of tax-payer funds to the project at

any time. Nor is there any form of government co-investment or loan guarantee or any other tax-payer funding or risk taking involved. If the project investment proceeds and fails commercially private investors bear the totality of the loss.

The only costs that can be incurred by government in relation to the project are costs directly associated with assessing a proponent's request for access to the SNII support scheme. However these costs are not additional government expenditures. They are a matter of policy priority and SNII administration costs may be offset by reduced expenditure of tax-payer funds in related investment support programs that are deemed by government to be less valuable to the national interest.

An approved SNII project will generate tax revenue from:

- Personal income and company taxes arising from engineering and construction activities including personal income tax from project proponent's staff and company tax paid by Australian equipment suppliers to the project
- Multiplier effects associated with servicing of indirect business activity associated with major investment projects
- Personal income and company taxes from post-construction operation of the project through project staff salaries and the company tax paid by project service providers
- Company tax paid by the project owners once the tax holiday period has elapsed
- Tax revenue from industry multiplier effects in the region of the project

Provided the market for the project's products is real, even in the event of complete commercial failure of the project, with initial investors bearing the loss, the capital asset remains. There are many instances where such assets are purchased by subsequent investors at a price that allows profitable operations to be achieved. So even in this event the SNII downstream industry and tax revenue values are not lost.

Competitive Environment for Capital Investment

Many, if not all, of Australia's regional competitors for investment capital use the investment allowance, tax holiday and accelerated depreciation levers to attract projects. Investment incentives are not limited to just these benefits; tax-payer subsidies and co-investment occur and the incentives are open to any type of project that contributes to economic development. Competing schemes are not limited to advanced technology or to initial commercialisation projects.

Australia needs to be smart about how it develops opportunities to take a leading role in the Asia Pacific region. We need to be fostering developments that open new export markets, enhance the value of existing exports and help solve environmental problems associated with the utilisation of our energy and energy intensive mineral exports. We need to be engaged with China, Japan and the US, and very soon India, in solving problems and creating opportunities based on the needs in our growing regional markets. Hopefully this submission adds something useful to that endeavour.

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