

Exploration Development Incentive: Policy -
Design -
Consultation Process -
Feedback and Comments -
by -
Kenneth James Harvey -

Submitted to:

ExplorationIncentive@treasury.gov.au -

4 April 2014

Introduction

Thank you for the opportunity to have input into the Exploration Development Incentive (EDI; “incentive”). This is a great incentive which has long been promised and is long overdue. It provides a firm indication that the current Australian government is serious about competing, at least at the exploration level, with other governments that encourage exploration as a means of generating wealth and opportunities for the citizens of their countries. The incentive does not match the Canadian flow through share scheme at this point in time but it is a good start. I am aware and have visited some of the many substantial discoveries that have resulted from the Canadian scheme and the supportive environment that accompanies that scheme.

As a taxpayer I also find the basic approach of the EDI acceptable in that it essentially allows legitimate tax deductions to be claimed by the taxpayers providing the exploration funds at the time the exploration occurs. Most rational people will, I believe, find this acceptable and particularly so when the incentive starts producing new greenfields discoveries with all that follows from development of these discoveries. The incentive also partly addresses the issue where exploration (which is essentially research) is, somewhat artificially, specifically excluded from the R&D definition, and therefore does not qualify for the favourable R&D tax treatment.

While the consultation paper is specifically directed to the EDI, I make additional suggestions that, in my opinion, would significantly improve the returns from the EDI. Inclusion and consideration of these additional suggestions is therefore warranted on this basis. I am confident that they will assist in making the EDI a very successful incentive.

My Background

As it may have some relevance to the substance of my submission I briefly provide a short summary of my background.

I have forty-five years experience in mineral exploration largely in Australia including extensive field work, supervision of exploration programs, exploration management, consultant to the exploration industry, managing director of a junior explorer and currently a director and part time consultant.

My children and their partners and offspring all depend either directly or indirectly on the mining industry, and therefore in the longer term on the exploration industry.

My Views

The mineral exploration industry is of fundamental importance to the mining industry and therefore to the future of most Australians. There is little doubt that the mining and exploration industry has suffered because of the strong expression of competing

views by minority groups who are largely unaware that they have prospered because of it.

The industry was appreciated by previous generations with mineral exploration (and mining) up until about the 1970-1980s being considered a legitimate and important activity and it was therefore allowed ready access to land which was essential for it to be undertaken efficiently and effectively.

In Queensland, for example, at that time, applications for exploration tenements were only a few pages requiring only the relevant information, granting times for tenements were only a few months, costs were modest, access to the land was straight forward with advice to landholders done verbally and the mining acts and regulations were concise practical documents which were easily interpretable and usable. Access to crown land was even available via a miners right without an exploration tenement. Many discoveries were made which added to the wealth of all Australians.

Since about the 1980s, the community's and politician's understanding of the fundamental importance of mineral exploration to Australia has declined. This has particularly been the case since the early 1990s. Despite its current importance, mineral exploration is now relegated to last place in the priority list of land uses under the so called multiple land use policy that is supposed to apply. It ranks below native title, the environment, heritage, landholders and the general public's access to land.

In Queensland, for example, ready access to land for exploration is no longer available. The process is expensive, time consuming and bureaucratic. Applications for exploration tenements reflect government's penchant for collecting irrelevant information or information that is readily available elsewhere, costs are high, granting times are very long and grants require the issuing of 'environmental authorities' which in most cases are essentially meaningless bit of paper but which require additional payments. Native title significantly adds to delays and costs. Large areas are now off-limits for exploration. Signed agreements are now required with landholders before drilling can be undertaken. Transfer duty is payable on dealings on exploration tenements. Tenement transfers can take extended periods. The mining act and regulations are apparently some 3000 pages and well beyond the capability of any explorer to fully understand and the explorer is also subject to a number of other acts that add to the burden of understanding the legislative environment. I could go on. It is a dismal scene and the discovery rate reflects this dismal scene.

There appears to be a view in governments, since explorers are obviously wealthy, that the relegation to bottom place on land access, the high-level of bureaucracy and costs and the legislative burden is justifiable and sustainable. This is not the case. The major companies no longer carry out the large exploration programs in Australia

that they previously did and now largely explore in other countries. Their exploration in Australia is principally around existing mines or resources and they now do far less greenfields exploration where the new discoveries are made. Junior explorers attempt to fill the resulting gap in greenfields exploration but find they are unable to achieve an acceptable discovery rate because funds are difficult to raise and numerous demanding expensive non-productive activities take precedence over activities which are essential for discovery.

With the very poor discovery rate it is difficult to attract investors to junior explorers active in Australia. At the current (risk averse) time and the penchant for returns in the short term, prospective investors in junior explorers have largely shifted their attention to companies that explore overseas or put their efforts into acquiring existing resources that may be able to be exploited or perhaps sold to other parties. Many junior companies are therefore being forced away from exploration just to survive. The result is that there will be a further decrease in greenfields exploration expenditure and a further decline in the discovery rate.

There is little doubt that the EDI should help to reverse some of the decline in the discovery rate by increasing the level of greenfields exploration. However successfully restoring the level and effectiveness of greenfield exploration to the point where it will replace the resources currently being mined is going to require a determined effort to also address the problems, outlined above, which are the major cause of the poor discovery rate. The problems have existed for considerable time and, because of the long time between the commencement of exploration and the commencement of mining, the current situation is best described as dire.

Take the example of northwest Queensland base metal province where the likely situation is as follows:

- ❖ Closure of the Century mine in 2015 with the loss of 500,000 tonnes of zinc + lead + silver (>\$1B) and the loss of jobs and income to the state and Australian businesses
- ❖ Closure of the Mount Isa underground copper mine in approximately 2021 with the loss of 200,000 tonnes of copper (>\$1.5B) and loss of jobs and income for the state and Australian businesses
- ❖ Closure of Mt Isa copper smelter ~ 2016 and the loss of jobs etc. (and closure of the Townsville copper refinery - more jobs lost etc)
- ❖ Closure of the Ernest Henry and Cannington mines at some stage (dates uncertain) with further loss of production and jobs etc
- ❖ Considerable uncertainty on development of the Dugald River zinc-lead mine and the Mount Isa open pit copper mine with probable loss of potential future job creation
- ❖ Grossly inadequate exploration to replace resources and therefore a substantial decline in mining in the area at a time when Australia has a substantial deficit and a growing debt.

The potential for replacement of these resources in northwest Queensland through exploration is high. Northwest Queensland is one of the world's great mineral provinces. The major discoveries at Century, Cannington and Ernest Henry in the latter part of the 1900s indicate clearly that modern exploration will find new deposits. A considerable proportion of the prospective area in northwest Queensland is the covered area surrounding the historically explored outcropping area and discoveries are almost certain to occur in this area. Exploration under cover is not easy and it requires a long term supportive environment. However this exploration is being severely impacted by the problems mentioned above and it certainly does not have a supportive environment. For example, a large area between Mount Isa and Century with excellent potential for discovery of copper, zinc and lead resources is not available for exploration and mining because of the Gregory wild rivers high-preservation area despite the fact that there is no justification for including much of this area in the high-preservation category. There was no consultation about declaration of the area with those affected and no opportunity for boundaries to be modified to leave prospective areas available for exploration. Promises to revoke the wild rivers areas and replace by more appropriate declarations that allow development by the LNP government have not been fulfilled. It is no wonder that there is currently an exodus of explorers from northwest Queensland.

It may well be asked why I have raised these other issues when the purpose of the submission is to have input into the EDI. My purpose is to make it abundantly clear that the EDI will have limited impact on improving the discovery rate unless it is accompanied by other reforms. If the EDI is accompanied by the many other reforms required to address the problems outlined, it will have a major impact on the discovery rate and the EDI will be viewed as a success. The EDI with the necessary reforms will ensure the continuity of mining in many areas of Australia despite a predictable dip in mining production in the shorter term.

The EDI

It is my view that the EDI must be seen to provide value from both the explorer's and taxpayer's points of view and that it also provides maximum returns to taxpayers for the investment made. My comments above on the need for reforms in other areas have been made as these reforms are essential if taxpayers are to get maximum returns from the investment.

The incentive will provide maximum returns to taxpayers and be seen to provide value if it produces new discoveries and thereby substantially improves the discovery rate. New discoveries will either prevent the closure of existing mines or lead to the development of new ones. A properly designed and implemented incentive is necessary to achieve discovery.

I now return to the EDI discussion document and make the following comments and suggestions on the various issues raised.

HOW TO TARGET JUNIOR MINERALS EXPLORERS?

The “no taxable income test”, the “no mining activities test”, the restriction to widely-held listed Australian resident companies and the application of a “related party” test all appear to be sensible to ensure that the EDI correctly targets greenfields exploration. Care would need to be exercised that the “no mining activities test” does not exclude companies that are undertaking pre-resource bulk sampling.

WHICH INVESTORS WILL BE ABLE TO RECEIVE EXPLORATION TAX CREDITS?

Limiting the EDI to new investors to maximise investment in junior explorers is attractive as it will encourage investors to start investing again and will result in new investors entering the scene. This would require companies to list a new class of shares on the stock exchange for this purpose. It could not be done otherwise.

The problems will include:

- there will be more administration and costs associated with this – these need to be minimised,
- existing shareholders will strongly object and may sell out of the stock particularly if new fund raising is not offered to all shareholders,
- a fair method of dealing with expenditure of funds that the company already holds, particularly if they are being spent on the same project areas as EDI funds, will be required. In most cases these funds are not significant.

Limiting the incentive to new shareholders may therefore be difficult without careful consideration of existing shareholders and existing funds. Opening up new ‘qualifying’ raisings to all shareholders will mainly solve the problem. Offering existing shareholders the right to participate by limiting the EDI to funds raised by new Share Purchase Plans or Rights Issues (where all shareholders can participate), however, is not practical as, in the current environment, these typically don’t raise sufficient funds. The alternative of being able to invite existing shareholders to invest on the same terms as new placement shareholders (without all the limitations, documentation, cost and bureaucracy of SPPs and Rights Issues) would solve this problem and, at the same time, also address a problem that some shareholders have with placements. Amendments of legislation and regulations to allow this to occur would be required .

HOW WILL ‘ELIGIBLE EXPENDITURE’ AND ‘GREENFIELDS’ BE DEFINED?

Both the terms ‘eligible expenditure’ and ‘greenfields’ are well understood by the industry but require clear definitions. Eligible or allowable expenditure is regularly addressed in joint venture agreements and one of these definitions could readily be adapted as required. I would suggest that eligible expenditure includes:

- ❖ valid greenfields exploration direct costs as indicated by tax invoices and does not include head office, corporate or capital raising costs
- ❖ valid exploration direct costs include costs associated with operations at the field site where the exploration is being conducted including but not limited to geological, geochemical, geophysical, native title and heritage studies, payments to landholders, native title parties and governments relating to the tenements on which the exploration is conducted, drilling and associated activities including geological and geophysical logging, assaying, clearance and rehabilitation of drilling sites, reporting, safety, accommodation, vehicle and equipment hire and costs, consumables and travel to and from the site of those completing the exploration (there are more complete lists if required).
- ❖ a fixed overheads charge of 8% of the direct valid exploration costs to reflect the need for administration and management of the exploration activity

Eligible expenditure should exclude exploration for coal, petroleum and industrial minerals.

'Greenfields' is a term that is well understood in the exploration industry. Greenfields is exploration for new resources in areas away from existing mining or resources, it can best be defined in terms of what it excludes as well as what it includes. A definition appropriate for the EDI is:

Greenfields exploration includes:

- ❖ eligible expenditure on exploration that is primarily carried out to discover new or to add to inferred mineral resources. It does not include exploration expenditure to raise the status of mineral resources above the inferred category as determined in accordance with the 2004 or 2012 JORC code.

Greenfields exploration excludes:

- ❖ exploration on mining tenements or blocks of contiguous mining tenements containing indicated or measured mineral resources or mineral reserves reported in accordance with the 2004 or 2012 JORC code,
- ❖ exploration on mining tenements or blocks of contiguous mining tenements where mining is currently being undertaken, where there are plans for mining or that have been mined within the last 5 years,
- ❖ exploration on exploration tenements less than 5km from the limits of indicated or measured mineral resources or mineral reserves reported in accordance with the 2004 or 2012 JORC code,
- ❖ exploration on exploration tenements less than 5km from the boundary of mining tenements over an area where mining is currently being undertaken, where there are plans for mining or that have been mined within the last 5 years.

HOW WILL THE MODULATION PROCESS WORK?

This is the area where the incentive may not achieve its aims if the design is botched. There are a number of very important issues that impact on the 'modulation process' including:

- While the EDI is a great incentive, the funds allocated to the incentive are inadequate to provide significant incentive to all greenfields explorers and therefore a decision on whether some explorers will receive the incentive or all explorers will receive some incentive is required. I prefer the latter.
- The EDI will only be truly effective at increasing the investment in greenfields exploration if investors can claim the tax deduction in the year in which the investment is made. A possible tax deduction at some time in the future has limited appeal to today's investor. There is also the difficult question whether the tax deduction would transfer on the sale of the shares which 'qualified' and how this would be done.
- To be able to raise funds on the basis of the EDI junior explorers need to know that they can offer prospective investors access to a tax deduction. Eligibility for a deduction is therefore required before the investment is made not decided at a later date.

These considerations require that the 'moderation process' be moved to the front of the process not at some later time. Application for EDI 'status' therefore need to be submitted and appraised before or at the very beginning of the financial year in which it will be available and decisions on success or otherwise made almost immediately following application. A successful application will then allow junior explorers to fully utilise the tax deductibility of the investment to raise funds. It should also allow the modest cap of the available deduction to be managed and it should also ensure that the expenditure is being directed to greenfields exploration.

The various state government schemes that assist explorers drill holes on greenfields projects operate on a similar basis (eg The CDI in Queensland). They are similarly impacted by a limited amount of funding and a need to ensure that the funds are applied to real greenfields projects.

The principal problem with such an approach is that some explorers may make submissions for expensive programs with the hope of raising substantial funds. If these companies are successful, it could leave some companies without access to the incentive and without the ability to attracting funding given that they are competing against companies that are offering a tax deduction. Therefore the amount allocated to any company should be capped and it should not be transferable to the following year (but can be reapplied for in that year).

Under such an approach to moderation, it would be vitally important that the federal government NOT take on the role of adjudicator of the merits or otherwise of greenfields exploration programs. It should merely decide if the programs are greenfields exploration and whether the companies qualify. The ideal application

form for EDI 'status' should be brief and contain a limited number of inputs such as company name, information on whether the company and the exploration expenditure complies, commodities, tenement/s, location and proposed raising amount and tax deduction sought. Unlike the state government's committees assessing greenfields drilling programs the government's assessing committee should not be comprised of exploration specialists.

Other Associated Issues

The incentive is to assure the discovery of new mineral deposits but, given the long permitting times for new plants and the difficulty of raising funding for these as well as the argument for maximising the returns from existing plants, it seems likely that some ore from new discoveries is likely to be processed in existing plants. This alone should not disqualify exploration from being considered as greenfields exploration. It is still reasonable for new resources that are close to existing mines or identified resources or reserves to be considered as brownfield exploration and therefore not to qualify for the incentive.

The presence of inferred mineral resources should not be used to rule out greenfields exploration at a prospect. Under the JORC code inferred resources cannot be converted to reserves and they do not allow the inference that mining will be carried out. They have a very low status. Many junior explorers make inferred resource estimates for internal purposes of better managing exploration as well as providing information to investors at the early stages of exploration. If the presence of inferred resources were to be used to deny access to the EDI, junior companies would be under pressure to cease announcing inferred resource estimates – a backward step if the purpose of the incentive is to increase greenfields exploration.

It is important that the EDI doesn't significantly add to the already substantial burden that all companies carry at the present time due largely to requirements of ASIC, ASX, ATO, mines departments and others. The legislative environment already impacts substantially on discovery. It doesn't need to be increased.

Ideally the incentive would be available to all greenfields mineral explorers so that the 'moderation' was minimised for the government and the greenfields explorer. While this is not possible in the current fiscal environment, it should be a future aim of the federal government to extend the EDI to all greenfields exploration. With the appropriate reforms to the issues raised above, a more expanded EDI would guarantee that Australia prospers well into the next generation as it has in the past.