Woodside Submission
Exposure Draft: Tax Laws Amendment (Research and Development) Bill 2010

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1 Introduction

We refer to the Exposure Draft (ED) titled “Tax Laws Amendment (Research and Development) Bill 2010 issued by Treasury on 18 December 2009 in which feedback and comments were sought by 5 February 2010. Woodside welcomes the opportunity to participate in the consultation process.

The petroleum industry is one of the most technologically dependant and innovative industry sectors. With the increasing activity in the petroleum industry, particularly in the area of LNG, the importance of development and utilisation of technology is high as companies seek to commercialise resources in technically challenging regions.

Meeting that challenge in a sustainable manner requires smart technology, systems and people.

Woodside’s oil and gas resources are located in remote, offshore fields. They are in cyclonic environments, sea bed temperatures are very low, pipelines are long and expensive and the available landfall locations are expensive places to build large gas processing plants.

Woodside has had a history of innovation and continues to invest in research and development to ensure the company utilises the most efficient and effective exploration and production technology in its current and emerging projects.

2 About Woodside

Woodside is Australia’s leading independent oil and gas exploration, development and production company. We seek to maintain this position through the responsible delivery of outstanding economic performance, environmental excellence and social contribution.

Based in Perth, Western Australia, Woodside has major operational assets in Australia, assets in the United States and exploration interests in other parts of the world.

Woodside operates Australia’s largest resources project, the North West Shelf Venture (NWSV) Karratha Gas Plant (KGP) in Western Australian which produces more than 40% of Australia’s oil and gas. The NWSV KGP also supplies around 65% of Western Australia’s pipeline gas production and more than 80% of Australia’s liquefied natural gas (LNG) exports.

In late 2010, Woodside expects to complete construction of the Pluto LNG Project near Karratha.

Woodside has a number of proposed development projects under consideration including:

a) Browse LNG project.
b) Sunrise LNG project.
c) Pluto LNG expansion.

Woodside’s goal is to be a global leader in LNG production with global demand for LNG continuing to grow. We aim to commercialise some of Australia’s largest undeveloped gas resources through the application of leading technologies and by competing for sales agreements in the global LNG market.

3 Key Issues

In the design of the R & D tax incentive, Woodside is supportive of provisions which are simple, clear and concise. This has been somewhat lacking in the legislative provisions to date. There is a clear opportunity here to reduce the complexity of the provisions, making the provisions easier to comply with and easier to administer thereby providing taxpayers with the certainty they require in relation to their taxation obligations.

3.1 Definition of core R&D activities

The proposed section 355-25 in the ED changes the definition of core R&D activities from requiring innovation <u>or</u> high levels of technical risk to now requiring both "considerable novelty <u>and</u> high levels of technical risk".

In our view this is an unnecessary narrowing of the requirements for eligibility and creates an additional degree of uncertainty for claimants. In addition the proposed new definition now includes the concept of "considerable novelty" which is a shift from the previous concept of "innovation" which is a well understood term. The term "considerable novelty" remains undefined in the ED and therefore rather than providing clarity on what constitutes core R&D activities it will create further ambiguity in the legislation. Furthermore the shift from "innovation" to "considerable novelty" appears to move away from R&D undertaken in a business context in favour or more academic R&D activities.

In order to meet the definition of core R&D activities experimental activities must be conducted for the purpose of acquiring new knowledge or information (PKI test). The PKI test is silent on R&D conducted where information is not otherwise commercially available therefore more clarity will be needed on this matter.

<u>Recommendation</u>

1) To provide greater clarity we recommend that the definition of core R&D activities refers to the more widely understood term "innovation" rather than use the term "considerable novelty".

2) We recommend that the "or" test be reinstated rather than making it a requirement that both "innovation" and "technical risk" be present for an activity to be considered a core R&D activity.

3.2 Definition of supporting activities

The proposed section 355-35 in the ED provides that supporting R&D activities must be carried on for the dominant purpose of supporting core R&D activities. The explanatory memorandum provides that "dominant" is the prevailing or most influential purpose.

Woodside is concerned with the “dominant purpose” premise as it does not sit naturally with the way in which an efficient business operates as most activities undertaken by businesses seeking to operate efficiently will have a dual purpose. Most businesses will have an ultimate commercial objective underlying any activities undertaken. By narrowing the definition of supporting activities to require that the “dominant purpose” be to support core R&D activities is in our view an unnecessary limitation which will exclude what would otherwise be eligible activities.

As many activities undertaken by a business will have both a commercial and R&D purpose, requiring the “dominant purpose” to be in support of the core R&D activity will significantly increase the level of uncertainty surrounding whether or not an activity is an eligible supporting R&D activity. In addition to the increased level of uncertainty, the “dominant purpose” test will also impose an additional compliance burden on businesses as documentation will need to be maintained to evidence the dominant purpose of the activity being undertaken.

The proposed section 355-35 seeks to further limit supporting activities by excluding expenditure from being considered supporting R&D activities. The current law only excludes activities from being core R&D activities but allows expenditure to be claimed where there is a strong nexus to core R&D activities. Extending the list of excluded activities to supporting R&D activities will significantly reduce activities which would otherwise be eligible for the R&D tax offset. Furthermore by specifically excluding such activities as trial runs and pre-production activities, the proposed legislation will create possible contention as to the extent an activity is a pre-production activity versus an experimental activity, or a trial run versus proving a hypothesis.

<u>Recommendation</u>

1) **In order to reduce uncertainty surrounding whether or not an activity is a supporting R&D activity we recommend that the “dominant purpose” test be replaced with “a purpose” test consistent with the current R&D legislation.**

2) **We recommend that the list of excluded activities set out in the proposed section 355-35 applies only to core R&D activities and not supporting activities.**

3.3 Augmented feedstock rules

Proposed subdivision 355-G in the ED sets out new feedstock rules referred to as “augmented feedstock rules” in the explanatory memorandum. These new rules appear to extend the previous feedstock rules to all cases where R&D activities produce direct output. Based on the current provisions only the cost of materials processed as part of the output of an R&D process is clawed back.

Under the proposed new “augmented feedstock rules” the feedstock output is defined very broadly and refers to any output (other than new knowledge or information) produced by the R&D activities (core R&D and supporting R&D activities) and all costs incurred that directly relate to the production of feedstock output will need to be clawed back.

Based on the current drafting of subdivision 355-G there appears to be little guidance on what comprises expenditure directly related to the production of feedstock output, however conceptual design is specifically excluded.

The feedstock amount that can be claimed for R&D is the difference between the feedstock output's value and the feedstock output's cost. The feedstock output's value is determined based on its market value at the time of its production, however it may be difficult to determine the market value of the output at the time of production.

Recommendation

1) To provide greater clarity in relation to what comprises expenditure directly related to the production of feedstock output we recommend that the list of expenditure that is excluded from the feedstock rule be expanded to include expenditure such as:
- **Salary expenditure**
- **Overhead expenditure**
- **Feasibility costs**
- **Consumables**
- **Commissioning**

2) To provide greater clarity in determining the feedstock output value we recommend that rather than using market value as the measure, emphasis should be put on consideration received for the feedstock output where transactions are at arm's length.

3.4 Removal of core technology

The proposed section 355-220 in the ED specifically excludes core technology expenditure from being notionally deducted in determining the R&D tax offset. Under the current R&D rules core technology expenditure is deductible at a rate of 100%.

Recommendation

We recommend that consistent with the current treatment and existing legislative intent core technology should be deductible at a rate of 100%.

4 Conclusion

Woodside is concerned about revenue neutrality. Based on our understanding of the proposed measures the new rules are far more restrictive than the existing rules and therefore significantly reduce an organisation's ability to claim R&D. This assertion is based on the following proposed amendments contained in the ED:

- The narrowing of the definition of core R&D activities requiring activities to contain both "considerable novelty" and high levels of technical risk will significantly reduce the amount of core R&D that can be claimed.
- Narrowing supporting R&D activities that can be claimed by requiring the activities be undertaken for the dominant purpose of supporting the core R&D activity will limit the extent of supporting activities that can be claimed.
- Extending the application of excluded activities to supporting R&D activities will significantly reduce the amount of expenditure which would otherwise be claimable as R&D.

- Expansion of the feedstock rules which may potentially limit expenditure incurred during the testing and trial R&D phase of a project.

Whilst Woodside is supportive of a tax incentive regime which provides increased clarity and certainty for taxpayers it is important to ensure that the scope of the incentive properly encourages the development in Australia of internationally competitive, innovative industries.

We wish to highlight that Australian oil and gas development is challenging with high risks and costs associated with stepping outside of established norms. The R&D tax incentive plays an important role in the oil and gas industry by encouraging innovation and accelerating its pace, especially in the deployment phase. There are many examples of early adopters suffering disappointing results which has made companies continue with conventional practices. As a result technology adoption is slow in comparison to other industries, often taking many years between release of innovations and its widespread adoption.

We trust the comments made in this submission assist the Government in its deliberations and would be pleased to discuss the comments in this submission further if required.

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