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Research and Development Tax Incentive

The Australian Petroleum Production & Exploration Association Ltd (APPEA) is the peak national body representing the collective interests of companies engaged in petroleum exploration, development and production in Australia. The Association's membership comprises companies that account for an estimated 98 per cent of Australia's petroleum production and the vast majority of exploration. APPEA is pleased to provide the comments below in relation issues raised in the Consultation Paper titled "*The new research and development tax incentive*".

Background

From an economic perspective, the benefits associated with large scale energy projects are immense in terms of industry and regional development, employment, economic growth and the through the generation of long term revenue streams for governments (potentially many billions of dollars over the life of individual projects).

The petroleum exploration and production industry is recognised world wide as a technology leader. The sector is dependent on technical innovation for its continued existence. Without innovation, the industry would face considerable challenges, including extracting resources from technically challenging regions, maximising hydrocarbon recovery from marginal fields, reducing its overall 'carbon footprint' and developing innovative new production processes to unlock supplies of energy. Significant levels of direct funding is committed by many companies within the petroleum industry with the objective of discovering and/or supplying petroleum resources.

The industry also requires highly skilled workers with the ability to undertake a wide range of tasks, ranging from undertaking, testing, adapting and deploying research outcomes and providing technology based solutions to complex problems. Indeed, much of the research that has been adopted and refined in other sectors has been based on the ground breaking work that has been undertaken in the petroleum industry. For example, the petroleum industry's research and innovation has been fundamental to the growing scientific interest and effort in the area of carbon capture and storage.

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Innovation underpins the efficiency and growth of the sector by reducing risks associated with exploration and improving the economic viability of production processes. While some technologies (such as 3D imaging and deepwater drilling) are recognised as ground breaking in nature, on-going improvements to knowledge is critical, whether that be through incremental advancements in understandings or through the application of global solutions to the Australian environment.

Companies engaged in petroleum operations in Australia make use of the existing R&D incentive provisions. Because of the very high up-front capital costs associated with many activities in the industry, measures that assist in either reducing risk or assisting project economics (including through the use of fiscal incentives) play an important role in shaping corporate decisions in the area of R&D. Australia's isolated geographic location (together with relatively expensive input costs) further strengthens the importance of fiscal incentives, including those contained within the R&D system.

The R&D incentive has had a positive impact on the decisions of companies to both undertake research and to base the focus of their efforts in Australia. Any modifications to the regime that would act to restrict or diminish access could be expected to impact on the overall quantum of the R&D effort.

Specific Comments

APPEA would like to make the following comments in relation to the issues raised in Consultation paper.

Consistency of Application

As an overarching principle, it is important that the R&D provisions act in a way that treats similar R&D activities undertaken by different entities in a consistent manner. The nature of a company's broader operations should not be the principle determinant of eligibility – it should be the nature of the R&D that is undertaken. Specifically, the R&D incentive that applies to an activity that may be undertaken by a purely research focussed entity should not be different to the incentive that applies to an entity that undertakes the same activity as part of its wider corporate operations. An example would be R&D associated with carbon capture and storage – an entitlement to a tax benefit or incentive should apply equally to a petroleum company in the same way as it would to any other entity, including a purely research focussed entity.

Implementation

It is proposed that the new legislation will apply to both new and existing R&D activities. Significant commitments and investments have been made prior to the date of the announced changes in the 2009-10 Federal Budget. The adoption of a simple 'no worse off' test could be introduced to mitigate against adverse outcomes that could arise for activities that had been announced prior to that time.

Question 1: Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

APPEA considers that flexibility needs to be built in to the regime to allow claimants to undertake at least a portion of their activities overseas. For the petroleum industry, the ability to utilise either overseas facilities and/or specialised resources may necessitate that some activities be conducted outside Australia. The global nature of the industry will often make it essential for site specific trials or research to be physically conducted in other locations. For example, testing new reservoir interpretation technologies or data processing techniques may need to be applied to overseas geological structures to simulate or assess their impact. Similarly, the testing of production related R&D can be applied to production infrastructure that already exists in other countries, with ultimate deployment in Australia and globally.

Principle 5: The new R&D tax incentive should target R&D that:

- *is in addition to what would otherwise have occurred; and*
- *provides spillovers – benefits that are shared by other firms and the community – that are large relative to the subsidy.*

APPEA seeks confirmation that the principles outline the broad objectives of the regime, not criteria that establish eligibility. We see a key objective of the incentive being the encouragement of entities to undertake R&D and for Australia to be considered as a ‘destination of choice’ when decisions are being as to where to base R&D projects. Government should not underestimate the positive investment signal that is sent to entities through the operation of a system that incentivises activities in Australia. In this context, APPEA believes that Principle 5 should be an aspirational goal rather than an eligibility criteria in its own right.

Principle 6: 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.*

It is important that a clear distinction is made between an R&D ‘project’ and the various elements and/or activities that make up that project. APPEA recommends that decisions surrounding eligibility should be based at a project level (ie what is the general thrust of the project and does it meet the agreed criteria), rather than arbitrarily segmenting or disaggregating functions to an activity level. The adoption of the later approach would add a level of unnecessary interpretative (and administrative) complexity and potentially lead to activities that are essential elements of an eligible project being classified as ineligible.

APPEA recommends an approach whereby activities or projects are assessed in terms of needing to meet at least one of the criteria. We believe this system has worked well in the past and can continue to do so into the future.

Principle 7: Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

APPEA welcomes the suggestion that eligible entities will still be able to claim supporting (non-core) activities under the new incentive. We note however that the Government is concerned that a large percentage of some claims could be attributed

to supporting activities, at a level that is considered to be out of proportion to the broader public benefit. An example raised during discussions was the concern surrounding 'whole of mine' claims.

The retention of the 'supporting activities' provision correctly, in APPEA's view, reflects the critical role played by these activities to the overall R&D effort. It is important to understand that decisions made by some companies to locate their R&D centres in Australia was significantly influenced by the current R&D framework. The employment of highly skilled professional staff provides both direct and indirect benefits to the Australian economy. The industry would be disappointed if an arbitrary decision was made to deny eligibility of supporting activities solely for the purpose of reducing outlays under the scheme – we believe such a decision would be detrimental to the entire R&D effort in Australia. A more balanced approach would be to review the overall level of the rebate or credit if scheme funding was the key determinate.

Sole purpose test

We do not support the option of imposing a 'sole purpose' test for supporting R&D activities (such as the type proposed in the Consultation paper) that merely seeks to exclude what would otherwise be eligible activities. Such a blunt and simplistic approach fails to recognise the integrated role of many organisations and the duties undertaken by their professional staff.

We would be pleased to further discuss the issues raised above. Contact in APPEA is Noel Mullen (nmullen@appea.com.au).

Yours sincerely



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CHIEF EXECUTIVE