ZeroGen
smarter, cleaner power

26 October 2009

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

Dear Sir/madam

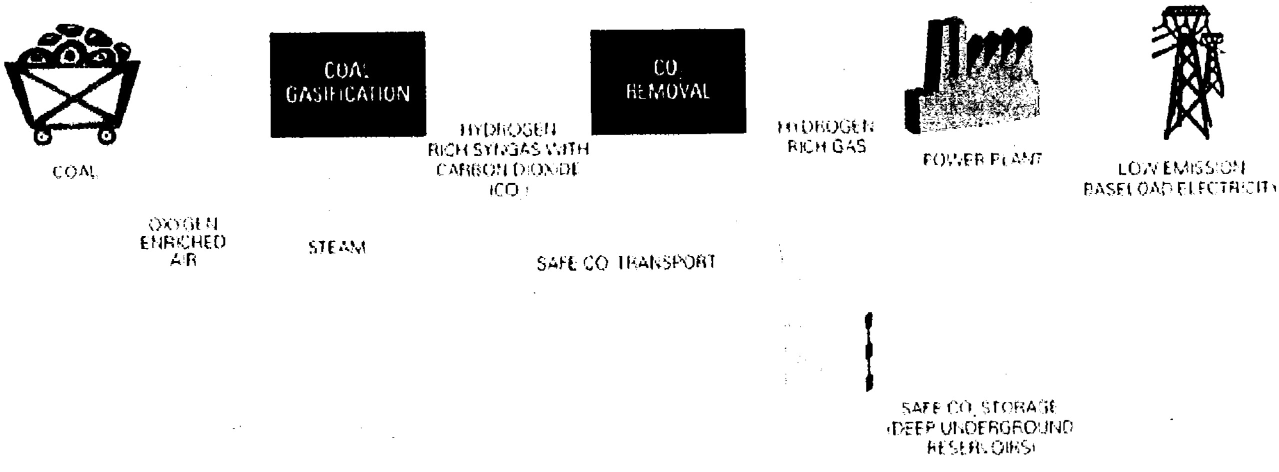
The New Research and Development Tax Incentive
Submission in response to the Consultation Paper
ZeroGen Pty Ltd (ZeroGen)

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

Background

ZeroGen was established to facilitate the accelerated development and deployment of low emission coal technologies and expects to be first in the world to construct and operate a commercial-scale 530MW (gross) Integrated Gasification Combined Cycle (IGCC) with Carbon Capture and Storage (CCS) facility for the production of low-emission baseload electricity.

ZeroGen's leading work in IGCC with CCS technology will redefine the energy landscape in Australia and around the world with smarter, cleaner power. While both are established technologies in their own right, IGCC and CCS have never before been integrated at commercial-scale for power generation. ZeroGen's world-first integration of these technologies will produce low-emission electricity by capturing and safely storing carbon dioxide (CO_2).



Through its commitment to developing a world-first low-emission technology using coal, ZeroGen is demonstrating environmental leadership on a global scale, while at the same time supporting the future of one of the world's most abundant resources.

As a result of these progressive activities, ZeroGen's research and development (R&D) has resulted in world-first technologies and significant intellectual property. ZeroGen plans to partner with companies with complementary expertise to design, construct and commission a combined IGCC and CCS facility in Australia. Access to R&D incentives will be vital to the project's viability.

ZeroGen's timeline is:

Pre-feasibility study completion	June 2010
Feasibility study completion	September 2011
Design completion	June 2013
Plant operational	late 2015

To date, ZeroGen has successfully accessed the current R&D Tax Concession program for the pre-feasibility phase and will also look to gain further benefits from the current rules throughout a significant part of the feasibility phase. The continuation of this project is dependent on accessing R&D benefits; however, we have significant concerns about our ability to access the new R&D Tax Credit incentives for key components of the R&D project going forward.

The ZeroGen Project and Policy Intent

ZeroGen welcomes the increased concessions under the proposed new R&D Tax Credit - that is, **we support Principles 2 and 3 of the Consultation Paper.**

Further, we understand the Government wants to align the benefit from its R&D Incentive program with R&D that is "genuine" from the May Budget announcement: "*Under the new Tax Credit system, eligibility criteria will be tightened to make sure that our investment is getting the best results – supporting only genuine R&D.*" The Government has also indicated in Principle 5 of the Consultation Paper that R&D should have spillovers that would be additional to what would have occurred without an incentive.

ZeroGen's R&D project is a world first. There are many innovative and technically risky aspects to the project – there is no doubt that the ZeroGen project involves "genuine" R&D. The spillovers created by the project will include long-term environmental and economic benefits, as one of the promising solutions to climate change. R&D incentives are key for the viability of the project and without access to the R&D Tax Credit, the project is unlikely to proceed.

As such, we see our project as being closely aligned with the profile of project to which the Government is trying to channel additional assistance. We believe our project should be strongly supported from these changes to the R&D Tax Incentives program; otherwise we would have to question whether the new measures achieve the Government's aforementioned policy intent.

ZeroGen's concerns in relation to the Consultation Paper's proposals

The National Innovation Review stated: "*Appropriate measures (should) be taken to heavily constrain 'whole of mine' and similar claims against the existing R&D Tax Concession program or proposed Tax Credit program.*" The Consultation Paper proposes how to limit these claims "where there is not a strong rationale for public support". However, in the proposed measures to deliver these limitations, there is a real risk the Government will adversely affect highly innovative and technically risky R&D projects, such as our world-first technology development.

Specifically, our concerns relate to the proposal to limit supporting activities. That is, **we strongly reject Principle 7.**

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

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

Under the new R&D Tax Incentive program, ZeroGen's R&D project will involve the critical phases of design, construction and commissioning and we are concerned that these activities will not receive the appropriate benefits from the new program. For ZeroGen, supporting activities are significant and a valid component of the R&D program. In particular, given the scale of the equipment involved, trial and pilot activities will become an essential component of core R&D activities in the commissioning phase. The conduct 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 the successful world-first integration of IGCC and CCS. If trial and pilot activities attracted less R&D support, this would have a major impact on our ability to undertake core R&D and would be detrimental to the viability of the project.

Additionally, It is clear that the Government wants to reduce the compliance and administration burden on companies through its submission in the Consultation Paper under Principle 4. However, we note that all of the options proposed for supporting activities require the segregation of all R&D activities into core and supporting. This inevitably will create an unnecessary administration burden on companies and will inappropriately direct resources away from the R&D project itself.

We will now highlight our opinion on specifically why each of the five options presented in limiting supporting activities will have adverse affects to ZeroGen's ability to access the incentive for critical parts of the project.

Option (a): Capped as a proportion to core R&D

It is immediately evident that a fair and equitable cap on R&D expenditure would never be achieved with this option, given the vast differences in industries that will participate in this program. For ZeroGen, significant trialling work and initial pre-feasibility work will need to be conducted to continue the core R&D activities and prove the technology. It is envisaged that significant expenditure will need to be spent on these activities and this option would severely impact the benefits received, which will inturn detrimentally affect the core R&D activities. If this option were chosen, the world-first technology that would greatly benefit the entire Australian community would be at risk of not proceeding without the appropriate R&D incentives. This option would be at odds with the intention of the R&D Tax Incentive program (being *"more effective in delivering support for business R&D"* under point 8 of the Consultation Paper) and would have adverse affects on our world-first R&D project.

In addition, it would not be possible to forecast the expected R&D Tax Credit benefit until a review of expenditure is undertaken at the completion of the R&D project. It will lead to adjustments having to be undertaken each year to ensure the correct ratio is calculated. Further adjustments may then be needed at project completion adding to the administration burden for the claimants. Again, we believe this is contrary to the policy intent highlighted under Principle 4 of the Consultation Paper.

Option (b): Sole purpose test

Moving to a 'sole purpose' test has the potential to eliminate almost all non-core R&D activities (including all R&D-related trials) from being eligible R&D activities, as very few activities are undertaken for the one purpose. While our project is a world first, we are concerned that the R&D benefits in the commissioning phase of the project would be severely restricted and inturn would limit ZeroGen's ability to invest in core R&D activities should this option be chosen. For the reasons already listed, supporting R&D activities are an integral part of most core R&D programs. 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. Through the conduct of trialling in our R&D project, we will gain significant new knowledge that will foster on-going innovation and core R&D activities. Without these trialling activities and also R&D incentives from these activities, our R&D project will be materially impaired. Under this proposal, no or few of these activities that provide vital support to core R&D would be eligible under this proposal, and this would have a substantial negative impact on promoting R&D within the business.

In addition, we believe that substituting 'predominantly' for 'sole' would not solve the problems with this option as it would again be a subjective test that would increase the complexity of administration for claimants (again, against the policy intent as described under Principle 4).

Option (c): Exclusion of production or dual purpose activities

In similarity to option (b), it is our view that this would severely limit the genuine R&D activities that we are undertaking. In order for our world-first R&D project to succeed, we will need to conduct significant production trials in our power plant. We do not believe that we should be disincentivised to test our world-first technology in real-life circumstances (ie production). This option is severely industry targeted and will adversely affect continued business innovation where trialling is a necessary and integral part of the R&D process.

Option (d): Net expenditure

In our view, this option is impractical and unworkable. This option will pose a lack of certainty to claimants, given that the outcome of R&D is, by its nature unpredictable, and therefore to suggest that only 'net' R&D expenditure be eligible makes the R&D incentive impossible to predict in advance, rendering it irrelevant in business investment decisions. The policy intent is for businesses to invest in innovation (as seen in Senator Kim Carr's May budget announcement) and this option will merely add minor benefits should an R&D activity result in a net loss. This option also presents measurement issues as companies will be unable to gain certainty on R&D benefits until well after the conduct of the related activities and this will threaten the viability of our project.

This uncertainty defeats two stated design principles. Firstly, because the benefit is so uncertain it will not motivate companies to make additional investment in R&D (as clearly desired by the Government under point 8 of the Consultation Paper). Secondly, the numerous calculation methodology complexities are not in accordance with the proposals of the Government to create a more streamlined incentive (as stated under Principle 4 of the Consultation Paper).

Option (e): Lower rate of assistance

In our view, this option would also be impractical due to the onerous and unnecessary burden requiring companies to separately identify and cost core and supporting activities.

This option would adversely impact the world-first R&D project that we are conducting. As stated above, the greatest impact will be seen in the necessary trialling and commissioning phases. It is our view, that this option will reduce the incentives for companies to conduct these necessary activities and inturn reduce the number of spillover benefits. Companies should be incentivised to test their hypotheses and determine a viable solution that will benefit the broader Australian community and economy. A lower rate of benefit will merely limit the incentives in conducting these activities, dramatically affect core R&D activities and reduce spillover benefits.

We accept that some tightening of the current definition may be necessary to deliver increased concessional rates. Importantly, the Consultation Paper does not demonstrate what further funding (in addition to that provided by the abolition of the 175% Premium Concession) if any, is required to fund these changes. However, ***if*** some tightening of the definition is required, our preference is that the definition of core R&D be limited (per Principle

6) rather than limitations to supporting activities. Due to the world-first nature of our project, we see this having limited impact on the eligibility of our project, which we believe is the right outcome and indicative policy is achieving its intent.

The limitation achieved by requiring core activities to be both innovative and have high levels of technical risk, will have an implicit limitation on what activities are then supportive of these activities. No specific limitation to supporting activities is required.

In addition, it is our view that the retention of the current meanings of innovation and high levels of technical risk is highly desirable. Given the significant case law along with Innovation Australia and ATO guidance that has been well adopted by ZeroGen, retaining the current meanings will provide much needed certainty moving into the new program.

Conclusion

ZeroGen welcomes the new R&D Tax Credit system and supports the targeted objectives of providing a new system which is less complex and more predictable.

However, we strongly urge the Government and Treasury to reconsider its proposal to change the R&D definition, especially to supporting activities, as this will not drive companies to continue business innovation that benefits the broader Australian community. Further, these proposed changes will have unanticipated detrimental impact on exactly the type of R&D the Government is trying to further support.

The R&D Tax Incentive plays an important role in the chain of commercially driven R&D in Australia for both large and small companies. It is critical that the new R&D Tax Credit system is a certain, predictable and simple way for decision makers to invest in their technological future. We encourage the Government and Treasury to take on board all the feedback it receives in relation to the Consultation Paper and create a new R&D Tax Credit that supports R&D in Australia for decades to come.

ZeroGen maintains a vision of being the first in the world to construct and operate a commercial-scale IGCC with CCS facility for the production of low-emission baseload electricity. The project needs ongoing access to the R&D Incentive Program for its future viability.

Thank you again for the opportunity to provide comment on this Consultation Paper.

Yours faithfully

Chris Fellows
Director Finance
ZeroGen Pty Ltd