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

By e-mail: rdtaxcredit@treasury.gov.au

Dear Sir / Madam

New R&D Tax Credit - Exposure Draft Legislation

This letter is in response to the exposure draft legislation jointly released by the Treasurer and Minister for Innovation, Industry, Science and Research on 18 December 2009, regarding the proposed replacement of the existing research and development (R&D) tax concession by a new R&D tax incentive from 1 July 2010.

Summary

BlueScope Steel has serious concerns regarding the exposure draft legislation in its current form, and believes that the underlying objectives behind the R&D tax credit changes will not be achieved with this draft legislation.

Comments on the proposed R&D tax incentive

Based on the joint Media Release of 18 December 2009, we understand the objectives of the new R&D Tax Credit reform are to deliver a more generous, more predictable, and less complex tax incentive. The new R&D Tax Credit is intended to:

- cut red tape and provide better incentives to help boost the competitiveness of the Australian economy;
- lift Australia's innovation capacity and performance;
- boost investment in research and development, supporting jobs and strengthening Australian companies as they continue to seize new opportunities; and
- allow companies to invest with certainty knowing they can claim a tax offset of at least 40 per cent of their expenditure on R&D activities.

BlueScope Steel believes that the new R&D Tax Credit will be far less generous, far less predictable and more complex than the current R&D incentive. We believe that the new R&D Tax Credit measures, as proposed, will:

- create uncertainty as to the likely eligibility of an R&D Tax Credit claim at the time of making the R&D investment;
- be more administratively complex than the current R&D incentive by requiring increased record keeping; and
- be likely to reduce the level of innovative activity and R&D investment by BlueScope Steel, particularly in relation to the development phase of R&D projects, with consequential impacts on the level of investment for the research phase.

Certainty

One aspect of the present system that works well for our business is that there is certainty concerning the extent of the available tax relief at the time the decision is made to undertake a research project. This aids in the planning and design of the project because the budget impact is known in advance. The new R&D Tax Credit system does not encourage our business to maintain current levels of expenditure on fundamental research because a tax incentive only applies to failed projects. In effect, success is not rewarded but there is relief provided for a small proportion of expenditure on failed outcomes. In truly innovative research, it is extremely difficult to predict which projects will be successful and which will fail. In practice, we take a portfolio approach to research, which means that we work on a range of technologies and options, with the portfolio of projects covering a spectrum of low through to high probability of success. There is an expectation that some projects will fail but that the cost of failed projects will be more than offset by the value of successful projects. The existing system is very beneficial in supporting a portfolio approach to research because the degree of support is not linked to success or failure, which are inherently unknown at the time a financial commitment is made.

Complexity

The new system requires more extensive record keeping, and makes a distinction regarding the various project costs in a way that is not consistent with the logical execution of a research project. Our research is typically dynamic in nature: it is understood that when there is a problem to solve because progress is being impeded, the appropriate resources are made available to the project team regardless of whether they might be arbitrarily defined as core or supporting. For example, the project team may need extensive analytical support, which is best provided by a laboratory that also conducts routine testing. The requirement to capture and segregate costs according to a new set of definitions will inevitably impose an additional administrative burden on researchers who should be concentrating on carrying out the research activities.

Incentive to invest in development phase

BlueScope Steel Research has a demonstrated track record of developing new to the world technologies, and commercialising them. A recent example is the CASTRIP® process for continuously casting liquid steel directly into 1.5mm thick strip. The process provides significant energy savings, lowers steel manufacturing cost, and reduces the economic scale at which flat steel production can be undertaken. It was jointly developed by BlueScope Steel and our partners from a laboratory concept into a full scale production process, with two commercial facilities currently operating in the United States. The technology is genuinely a world first, and is underpinned by approximately 800 international patents. In order to achieve this outcome, which was supported by the current R&D tax deduction system, it has taken twenty years of development effort, and the investment of hundreds of millions of dollars by the partners. Our experience from this type of project is that the cost and attendant risk increase by an order of magnitude each time the process is scaled up. For example the capital cost for pilot stage was in the millions, the capital investment for development stage required tens of millions, and for commercial stage the cost was well in excess of one hundred million dollars. Operating cost expenditure escalates with scale-up in a similar way. Our view is that the most difficult and costly stage of an innovation that results in actual commercial outcomes is the scale-up, which occurs as part of the development phase of R&D. In our business, which relies on capital intensive manufacturing processes, the development phase of an R&D project is particularly costly. Any change to the system that results in greater financial support for the research phase of a project and less support for the development phase is a significant disincentive to undertake high risk innovation in a capital intensive industry such as ours.

Incentive to invest in research phase

The proposed change to the system will have an immediate impact on our research program because of the change in emphasis explained above. As an example, we are currently considering whether to make a significant investment in a research consortium consisting of two Victorian universities, CSIRO, and several other industry partners. The project is designed to progress a ground breaking renewable energy technology from laboratory to pilot scale, and will run for three years. If success were achieved after three years then we would look to scale-up the process technology to development scale as a precursor to making a commercial product. It is anticipated that the number and nature of the problems that will need to be solved during the pilot phase will be just as challenging as those encountered during the initial laboratory phase. There will be an equal reliance on fundamental science and knowledge, but the costs will be an order of magnitude greater. Consequently, we believe that lack of support for the development phase of R&D projects will act as a disincentive for commercialisation of research outcomes and therefore also create a disincentive to undertake the initial research phase.

In relation to the more detailed aspects of the exposure draft legislation, BlueScope Steel supports the positions explained in the submission made by Michael Johnson & Associates on 5 February 2010 regarding the new R&D tax incentive. We also note that Michael Johnson & Associates, at Section 3 (page 8) of their submission, have estimated that the new R&D Tax Credit measures will be far from revenue neutral, delivering around 20 – 30% of current government support levels for R&D activities. This view is consistent with the likely impact of the new measures on BlueScope Steel as outlined above.

Conclusion

BlueScope Steel supports the proposition to implement a simplified tax credit, and understand that the changes are designed to be revenue neutral in order to maintain the current level of support for R&D. However, the Bill fails to meet the stated objective of 'boosting investment in research and development, supporting jobs and strengthening Australian companies as they continue to seize new opportunities during the economic recovery'.¹ The proposed new rules do not encourage our business to maintain the current levels of investment on fundamental research because the tax incentive only applies to failed projects. In our business, which relies on capital intensive manufacturing processes, the development phase of an R&D project is particularly costly. The proposed rules disproportionately disadvantage R&D that must be done using existing processes and production facilities. We are constantly seeking improvements in our production processes to boost our competitiveness, reduce carbon, water and other environmental impacts. These activities would be similarly discouraged.

We believe that the proposed measures will not deliver a more generous, more predictable, and less complex tax incentive.

Thank you for the opportunity to make a submission. For further information regarding our submission please do not hesitate to contact me on (02) 4252 3175 or David.Varcoe@bluescopesteel.com

Yours sincerely



David Varcoe
GENERAL MANAGER PRODUCT R&D

¹ Joint Media Release with The Hon Wayne Swan Treasurer of the Commonwealth of Australia and Senator The Hon Kim Carr Minister for Innovation, Industry, Science and Research – New R&D Tax Credit – Exposure Draft Legislation. Media Release of 18/12/2009 No. 124.

About BlueScope Steel

BlueScope Steel is an Australian listed company (ASX: BSL), and the leading producer and supplier of flat steel products in the Australian market. BlueScope Steel produces steel products, including slab, hot rolled coil, cold rolled coil, plate and value-added metallic coated and painted steel products for use in the building and construction (commercial, residential and engineering/infrastructure), automotive and manufacturing industries.

BlueScope's Australian iron and steelmaking facility is located at Port Kembla (NSW), while a rolling, coating and painting plant operates at Western Port (Vic), along with metal coating and painting plants at Springhill (NSW) and painting plants at Erskine Park (NSW) and Acacia Ridge (Qld). The company operates 38 BlueScope Lysaght building products manufacturing plants. It also distributes both long and flat steel products through 82 distribution outlets and 4 sheet metal supplies outlets, and has 16 BlueScope Water sites in Australia.

The Port Kembla Steelworks is an internationally competitive integrated steel plant, with an annual production capacity of approximately 5.3 million tonnes.

Normally, approximately half of BlueScope Steel's annual Australian production is sold domestically and the balance in the export market. The company's Australian exports were valued at some \$2.3 billion (approximately 2.5 million tonnes) in the 2007/08 financial year. While rankings vary year-by-year, steel products are generally amongst Australia's top twenty goods exports by value. Key export destinations for BlueScope include the United States, South Korea, Thailand and Indonesia, and to a lesser extent Europe, Africa and the Caribbean.

BlueScope Steel has established a substantial international footprint including an integrated steelworks in New Zealand, a flat products steel-mill joint venture in the United States (Delta, Ohio), and metal coating and painting facilities in China, Vietnam, Indonesia, Thailand and Malaysia. Building products manufacturing plants are located throughout the Asia-Pacific region, and the company is a leading manufacturer of steel pre-engineered buildings in the USA and China. In 2008, BlueScope Steel acquired the IMSA steel businesses in North America.

BlueScope has an Australian based direct workforce of about 9,000 employees, with a further 9,000 worldwide.

Research & development by BlueScope Steel

Innovation is key to the continued growth of BlueScope Steel's premium, differentiated product portfolio. Innovation underpins our competitive edge as being a leading supplier of quality branded building and construction products to markets in Australia, New Zealand, South East Asia and the USA.

The company's research and development activities fall into two main categories: improved or new product properties; and new applications for our products. Improved product properties increase the product performance experienced by the customer. For example, improving the durability of paint systems so that COLORBOND® steel stays brighter for longer and colours do not fade, and searching for ways to increase the corrosion resistance of the protective ZINCALUME® steel metal coating. This improves product performance and allows product warranties to be extended, delivering benefits for our customers. The overarching goal is to find improvements that simultaneously improve 'performance', reduce costs, and promote sustainability, typically by using less raw materials and energy in manufacturing.

In terms of new applications, we look for new ways of using steel to promote efficiency, cost reduction, and utility in design. Two current examples are a steel reinforced concrete slab wall that greatly decreases construction time; and a building integrated solar cell that is laminated directly onto COLORBOND® steel roofing. Both of these are presently under development and not yet commercialised. It is anticipated that significant further research and development will be required as part of the prototyping and scale-up of these technologies. The

scale-up phase is where the greatest financial risk to the developer occurs because it will typically require substantial capital investment in plant and equipment that may be completely unique to the development.

BlueScope Steel's innovation activities have resulted in world leading market share achievements for steel in building and construction applications. For example, nearly fifty percent of all new residential buildings in Australia have a steel roof; this compares to ~1% in the USA. We also enjoy very high rates of adoption of steel in house frames. In Asia, we have developed a 'clean' COLORBOND® steel that addresses the widespread problem of tropical discolouration (building exteriors become 'dirty' over time). This product is a market leader. BlueScope is responsible for worldwide licensing of GALVALUME® steel technology, which has now been adopted by forty other steel producers. Over the last 40 years our company has developed a reputation in the steel industry for continuous innovation of steel coatings, underpinned by a commitment to investment in fundamental research and development.

BlueScope has also led the world in the development and adoption of new and improved coating manufacturing technology, with the primary aim of reducing production costs and energy consumption. Normally the application of the metal coating layer for corrosion protection, and the paint layer for decoration and colour, are done on two separate processing lines. We have recently implemented a new paint curing technology – near infrared (NIR) – to replace conventional convection ovens. This allows for reduced energy consumption, a simpler process route, and avoidance of significant capital cost because the paint coats can be applied directly after metal coating, on the same process line. Although this innovation has subsequently proven to be viable, significant capital cost and risk was involved in the development of the process from pilot to industrial scale.

We have approximately 300 technical staff whose principal role is to carry out research and development activities. Approximately 150 technical personnel are located in our corporate R&D laboratories in Port Kembla, which are equipped with state-of-the-art technology for analysis, measurement, simulation and characterisation of our products. We are fortunate to have more than 40 PhD qualified staff members, which enables us to conduct fundamental research within the corporate R&D environment, as well as supervising work carried out in collaboration with universities and research institutions. Each year we spend over \$3 million on collaborative R&D projects with Australian universities. This includes sponsorship of undergraduate students through scholarships, Australian Research Council (ARC) projects, and direct support for the BlueScope Steel Metallurgy Centre at University of Wollongong. We also indirectly support a number of universities in NSW through employment of cadets that we require to undertake undergraduate degree courses.