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Submission on New R&D Tax Incentive

OneSteel

OneSteel Ltd ("OneSteel") welcomes the opportunity to make this submission in response to the released exposure draft legislation Tax Laws Amendment (Research and Development) Bill 2010 ("the draft legislation").

Summary Of Submission

OneSteel submits that the draft legislation should be reconsidered as it would take away the R&D program support currently provided for manufacturers, amongst others, and is likely to result in a dramatic drop in their participation in the program. Manufacturers generally conduct their research and development in their manufacturing facilities concurrent with commercial operations. Development of commercially successful products or processes is not supported by the draft legislation.

OneSteel's position is to maintain the current definition of R&D and adopt the new R&D tax credit. Onesteel supports the removal of the 175% incremental claim.

In 2009, OneSteel conducted 123 eligible R&D projects with an R&D spend of over \$200m. R&D program support is currently a key consideration in the approval and timing of R&D projects. Based on the draft legislation it is unlikely that many of these projects would benefit from the R&D program. Indeed, the likely drop of support would be so severe as to bring into question whether OneSteel remained active in the program at all.

This drop of support would occur at a number of levels. The dramatic narrowing of the eligibility definition to an "AND" requirement for innovation and risk will result in a significant proportion of projects being ineligible. Of those that are eligible the augmented feedstock rule will result in little actual R&D program support being derived, as much of the R&D conducted by OneSteel is production based experimentation of either products or processes that results in saleable product. From that, the small portion of eligible activities that results in actual R&D support is then subject to increased administrative uncertainty in the application of new definition requirements for core and support: with support needing a dominant purpose which is likely to be highly contentious for R&D conducted in a live manufacturing process.

The draft legislation does not provide an Impact Financial Statement to support the proposition that the proposed R&D program is revenue neutral. In the absence of government modelling, Onesteel submits that with the severe curtailing of eligibility

due to the R&D definition restrictions and the augmented feedstock rules, the draft legislation is not revenue neutral.

Background on OneSteel's R&D Activities

OneSteel is a vertically integrated mining, scrap recycling, steel manufacturing and metal products distribution company with annual revenues of over \$7 billion. OneSteel employs more than 10,000 people in Australia.

OneSteel has always been an active participant in R&D. In order to compete domestically and internationally, OneSteel is continually investing in new plant, new products and in programs of continuous improvement to manufacturing efficiency. As a manufacturer, production R&D is critical and is the main focus of support currently provided by the existing R&D scheme.

Since 2000, OneSteel's R&D program has seen the development of many new and improved products and processes, including:

- Following the closure of steelmaking operations at Newcastle in the late 1990s a billet casting plant was installed at the Whyalla Steelworks to extend the range of products produced from a slab, structural and rail steel maker to include the feed material for the rolling mills in Newcastle. These included many different high-grade steels for local manufacturers whose products would otherwise have been imported.
- Environmental projects such as the elimination of coal tar contamination from fence posts on farms, the treatment and handling of waste materials to be suitable for reuse and the continuing reduction of dioxin emissions to world's best practice levels.
- The design and installation of a new type of heavy mining rope plant in Australia allowing OneSteel to continue to be a world leader in this specialist market.
- Ongoing development of grinding media for the world's resources industries which is another specialist market in which we are a world leader.
- New products such as the LiteSteel Beam which is expanding into the US and other international markets.
- Development of new mining techniques for iron ore.
- The extension of the life of Whyalla Steelworks with a major program to convert from hematite to magnetite as the source material for operations and at the same time to reduce significantly the impact of operations on the ambient dust levels in Whyalla. This program has also had major regional economic impact and secured the future of operations to at least 2027.

These developments have allowed OneSteel to continue to be a large scale Australian manufacturer. We supply many other manufacturers with products as well as delivering to the infrastructure, construction, mining and agricultural industries. Many of our plants and distribution centres are located in regional Australia. To maintain this type of domestic business, OneSteel has utilised the R&D tax concession.

The R&D tax concession is factored into project evaluations and, as such, contributes directly to the assessment of the viability of projects and acts as a variable in the decision as to whether to fund the developments.

THE DRAFT LEGISLATION

The draft legislation provides the removal of the current incremental (175%) claim and replacing the standard 125% support with an increased base rate at two levels with SMEs provided a greater level of support than larger claimants.

OneSteel broadly agrees with these aspects of the draft legislation.

However, the mechanics of the proposed R&D program severely limit its availability to Australian manufacturing businesses which, it is submitted, generally conduct research and development activities in tandem with commercial production activities. Up to 75% of OneSteel's R&D is production based. The draft legislation appears predicated on a notion that production based R&D is not "genuine R&D" deserving of R&D program support.

R&D Definition

OneSteel does not support a change to the definition of eligible R&D activities. The current definition has gained broad support and understanding over a long period of time and allows for a broad based R&D program.

The requirement for both innovation AND high levels of technical risk for core R&D will foreseeably result in R&D program support for development activities decreasing. Indeed, the draft legislation is highly skewed towards research at the expense of development. For a manufacturer, development activities include a whole range of their own technical risks and process innovations that are required for successful production and end game commercialisation of *per se* innovative products and processes.

Onesteel submits that developmental activities are an equal part of the R&D equation, and that there are spillover effects and positive outcomes in the Australian economy.

Recently, our electric arc furnace mills in Sydney and Melbourne conducted world leading research and development activities into pioneering technology that allows polymer technology (use of waste plastic and car tyres etc) to be used in steel making. This R&D was undertaken in collaboration with the University of NSW and Professor Veena Sahajwalla and included considerable development work. The use of polymers means that power and chemical consumption in the steel making process has been reduced. This project was the focus of an article in the QANTAS In Flight Magazine November 2009. This technology has been patented to be licensed and marketed overseas.

It is highly likely that this project would not be eligible under the draft legislation because it contained considerable development work and so may not satisfy the AND requirement. Alternatively as it was done in a live manufacturing environment there is a question whether the activities would be considered support R&D and if so be able to satisfy the dominant purpose requirement.

The requirement for supporting R&D activities to have the dominant purpose of supporting core R&D activities is disadvantageous for manufacturers. It is submitted that experimentation on real production equipment is generally the only option. Access to pilot plant or a laboratory environment is in many cases inappropriate. In the case of OneSteel there is no better way to do experiments than in a live process: eg operating furnace or bar mills. Our earlier example of Professor Sahajwalla's experiments could never have been achieved in a laboratory or a pilot plant.

On top of the dominant purpose test being impractical, there are no criteria on how to identify the dominant purpose.

If the R&D program is seeking to support genuine R&D that can result in spillover benefits then there is no plausible reason to reduce the support for development and focus attention on research alone. Mature industries and or businesses will by their very nature conduct considerable development activities as they seek to become more efficient and thus competitive. Such businesses will obtain little support from the proposed R&D program. The current R&D program has maintained manufacturing developmental activities in Australia. There is a risk that these activities will be done in countries that encourage these activities.

The draft legislation requires a split between what is core R&D and what is supporting R&D. In a practical setting, this is hard to distinguish. Onesteel operates on a continuous process basis for its steelmaking operations. Each individual experiment has a different split between

what is core and what is supporting depending on its focus. There will be many grey areas. Also, over time what is core R&D and what is supporting R&D changes as experiments progress. This will add to the complication of the registration process and with the risk of rejection it does not encourage participation in the R&D program.

Feedstock Rule

The proposed augmented feedstock rule's commercial return clawback effectively removes R&D support for successfully developed products and processes: effectively only providing support for failed activities. OneSteel does not support this. As a manufacturer with large scale assets, OneSteel generally conducts its R&D in its production facilities and those activities generally result in saleable product. The commercial return clawback will therefore disadvantage OneSteel and other manufacturers who use production facilities for R&D activities. Further, this proposal undervalues the importance of process R&D. The competitiveness of Australia's manufacturers is in part driven by their production efficiencies and striving for better production techniques is a constant challenge.

Administrative Uncertainty

OneSteel submits that the draft legislation increases the program's complexity and will lead to administrative uncertainty. The proposals to differentiate between core and support and to establish dominant purpose for support activities will, as noted, be sources of that uncertainty. Against this, it is a major concern that the draft legislation allows for registrations to be rejected purely on the content of the submitted form. The registration process has been made more complicated and companies are running the risk of rejection every time they submit their R&D. This is not a very encouraging environment to operate in. To allow for a registration to be rejected without a proper review mechanism puts effective discretionary power into the hands of the administrator and puts more pressure on companies to spend increased administration time adding extra detail to the registration in order to prevent ad-hoc rejection.

Conclusion

OneSteel appreciates the opportunity to make this submission in response to the draft legislation. We fully support Senator Carr's intention to provide a better targeted, more generous, more predictable and less complex R&D tax incentive. We also appreciate the Minister's resolve that, to the extent the draft legislation is not delivering this intent, it will be changed. We submit that the draft legislation will require change to meet the Minister's objective.

OneSteel is particularly concerned with the effective exclusion of successful production based R&D and believes it would have an adverse impact on Australian manufacturers, large and small. Support for production based R&D is not a general subsidy for innovation. This type of R&D faces all the challenges of technical risk, innovation and potential financial failure.

We are fully available to participate in any consultative processes that occur following the submission closing date of 5 February 2010 and would welcome the opportunity. If you have any queries or require elaboration on any aspect of this submission, please call Steve Ashe, General Manager Investor Relations and External Affairs on (02) 9239 6616, or Damien Baxter, Group Tax Manager on (03) 9673 0419 or me on (02) 9239 6661.

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