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19 May 2010

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Australia
economics.sen@aph.gov.au

Dear Mr Hawkins

Please find attached a submission to the Senate Standing Committee on Economics Inquiry into the Tax Laws Amendment (Research and Development) Bill 2010 and Income Tax Rates Amendment (Research and Development) Bill 2010.

Caltex would be pleased to discuss the submission with the Committee.

Yours sincerely

Frank Topham
Manager Government Affairs & Media

**Caltex Australia Limited submission to
Senate Standing Committee on Economics**

Inquiry into the

**Tax Laws Amendment (Research and Development)
Bill 2010 and**

**Income Tax Rates Amendment (Research and
Development) Bill 2010**

19 May 2010

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Senate Standing Committee on Economics Inquiry into the Tax Laws Amendment (Research and Development) Bill 2010 and Income Tax Rates Amendment (Research and Development) Bill 2010

1. Summary

Caltex Australia Limited welcomes the opportunity to make a submission to the inquiry.

Caltex is a refiner and marketer of petroleum products in Australia, with operations in all states and territories. Caltex has a long history of investment in R&D, with average expenditure of \$15 million a year. We believe the current drafting of the legislation could leave a substantial amount of our R&D expenditure ineligible for the tax credit.

Caltex has provided submissions to the Treasury at the discussion paper, exposure draft and second exposure draft stages of the proposed legislative changes. While this consultation has been welcome, it has been inadequate to properly assess and debate the implications of such a major and complex change to legislation. We believe the eligibility rules are flawed and the implementation timetable is unreasonable.

Caltex acknowledges the importance of R&D in facilitating growth in the economy and supporting the development of a skilled workforce, with the goal of building a smarter Australia. However, we do not accept that changes intended to support SMEs must come at the expense of larger enterprises that play a major role in Australian manufacturing.

Established Australian manufacturers face strong overseas competition. In order to remain viable, ongoing R&D into product and process improvements is essential. We are concerned the new rules will unduly restrict legitimate R&D expenditure and erode the competitiveness of Australian manufacturing.

The proposed provisions significantly narrow the range of eligible activities and shift the focus from incentivising R&D which supports existing commercial activities towards pure research, laboratory-style activities. Caltex advocates changes to the new core R&D activities definition and supporting R&D activities definition in the legislation, to ensure that the crucial R&D which it undertakes continues to receive tax benefits. While we accept that support should apply to "genuine R&D, not routine business activities", we are most concerned that the definitions will adversely affect genuine R&D that is related to improving existing business activities.

Caltex proposes amendment of the core and supporting R&D activities definitions by adopting the OECD definition for R&D and removing the dominant purpose test for supporting activities so that all activities meeting the OECD definition would qualify.

Even if Caltex's amendments are accepted, we believe that implementation of the new rules should be delayed for at least 12 months, to allow businesses to develop an understanding of the definitions and develop plans and procedures to enable legitimate claims to be made. All businesses will require expert internal and external advice to ensure compliance with the legislation and SMEs will be at a greater disadvantage than larger companies. Implementation by 1 July 2010 is impractical.

We understand that Treasury has undertaken modelling of the impact of the new legislation but this has not been released. Given the serious adverse impact we believe the changes could have on existing manufacturing industry, this modelling should be released for examination and debate by Parliament and stakeholders.

2. Caltex's business and the role of R&D

2.1 Business outline

Caltex is a refiner and marketer of petroleum products in Australia, with operations in all states and territories, with about 3,900 employees. It supplies over one third of wholesale

transport fuels (petrol, diesel and jet fuel) supplied nationally. It has a branded retail petrol market share of about 16 per cent nationally (excluding Woolworths co-branded sites).

Caltex accounts for almost a third of Australia's oil refining capacity. It owns and operates two of Australia's seven operating oil refineries – at Kurnell in Sydney and Lytton in Brisbane. Between them, the Caltex refineries have the capacity to process 244,000 barrels (about 39 million litres) of crude oil per day.

Caltex produces mostly high-value transport fuels which contribute to the growth of the economy and provide significant employment. The two refineries directly employ almost 900 Caltex workers and around 550 contractors. These numbers can escalate when there is major maintenance and project work, growing by a further 1,200 workers to bring the total number employed to over 2,600.

Caltex's capital expenditure over the next three years (our budget period) will be \$300-325 million pa plus significant expenditure for major scheduled maintenance.

2.2 The role of R&D in oil refining

In Caltex's view, reliable, affordable and secure energy supplies are critical to Australia's continuing economic prosperity. Australia's refineries were built in the 1950s and 1960s but have been extensively upgraded since then. For example, about \$500 million was spent to meet tougher fuel quality standards in 2006 and \$320 million was spent recently to increase diesel production capability to meet market growth.

Australia's refineries are fully exposed to import competition, and market conditions following the global financial crisis remain difficult, with global refining capacity in excess of demand, depressing profitability. Competitive pressures and regulatory changes have resulted in Australian refinery rationalisation in recent years.

Australia currently imports over a third of its petroleum product requirements, and this proportion is likely to grow, as petroleum product demand is increasing but there is limited scope to increase refining capacity. Oil refining is a crucial link in the supply chain and relying on overseas refineries for our petroleum products would expose all industries and private consumers to unnecessary risk.

Large modern Asian refineries have economies of scale that mean lower unit costs than Australian refineries. Staying competitive requires strenuous efforts by Australian refiners to improve efficiency and cut costs and ongoing R&D plays an essential role in achieving this objective.

We believe the government should reconsider the value of innovation in existing manufacturing processes when assessing changes to R&D assistance in Australia. While the government has promoted the changed scheme as a way to incentivise small and medium enterprises, we believe the contributions that larger corporations make are being undermined through reduced eligibility for the tax credit. While greater support to SME R&D should provide long term benefits to Australia, the benefits from R&D by existing manufacturing are more immediate and substantial.

We understand that Treasury has undertaken modelling of the impact of the new legislation but this has not been released. Given the serious adverse impact we believe the changes could have on existing manufacturing industry, this modelling should be released for examination and debate Parliament and stakeholders. If modelling has not been undertaken or is inadequate, consideration should be given to appropriate modelling being undertaken.

3. Recommended changes to the legislation

3.1 Outline

Caltex proposes the following changes to the legislation:

- Delay the implementation of the legislation until 1 July 2011 or later
- Amend both the core and supporting R&D activities definitions (as below)

1. Adopt the OECD definition for R&D in place of the proposed definition:

- Creative work undertaken on a systematic basis in order to increase the stock of knowledge, including the stock of knowledge of man, culture and society; and
- The use of this stock of knowledge to devise new applications

2. Remove the dominant purpose test for supporting activities so that all activities meeting the above definition would qualify.

3.2 Delay the legislation

The legislation was introduced to Parliament on 13 May 2010, the Senate Economics Committee must report by 16 June 2010 and the start date for the legislation is 1 July 2010. This timeframe is unreasonable and impractical.

Caltex agrees with the consensus among industry and tax agencies that the amended R&D scheme is a dramatic and complex change from the previous scheme. In order to understand and apply these changes, the industry will need time to consult on the legal implications to ensure compliance, and individual companies will need to develop and implement new internal mechanisms to administer the scheme.

The definitional changes are complex and will require alterations or additions to compliance procedures and even to the research processes to ensure that qualifying R&D that should be eligible, is in fact eligible. While this poses challenges for corporations like Caltex, the difficulties will be even greater for small and medium enterprises who may not have access to timely and costly advice due to lack of internal resources or external auditors. The haste to implement the scheme could in fact disadvantage the SMEs that it is intended to assist.

Caltex recommends that implementation of the new scheme be delayed until 1 July 2011 or later.

3.3 Amend the core R&D activities definition

The Government's AusIndustry website explains that under the proposed legislation, R&D entities will need to show that activities that are systematic and investigative, and involve both considerable levels of novelty and high levels of technical risk. Under the current R&D Tax Concession, R&D activities need to be systematic, investigative and experimental, but only need to involve either innovation (novelty) or high levels of technical risk.

As summarised by PricewaterhouseCoopers (PwC), a new definition of "core R&D activities" has been included in the bill, which does not refer to existing terms such as 'innovation', 'novelty' or 'technical risk'. Under the new definition, 'core R&D activities' in broad terms as defined in the bill:

- must be 'experimental activities whose outcome cannot be known or determined in advance'
- are to be determined by 'applying a systematic progression of work that is based on principles of established science', and
- are conducted for the purpose of generating new knowledge.

Under the existing Act, the terms "novelty" or "technical risk" grant eligibility to both forms of R&D – commercial and laboratory. The additional complexity introduced by changing the definition entirely and using the term "new knowledge" shifts the focus to the laboratory style research.

Commercial R&D is essential to the ongoing viability and strength of Australia's manufacturing industries, and withdrawing support for these could impact innovation that increases the ability to compete against overseas manufacturers.

Caltex undertakes commercial scale R&D activities to help maintain the viability of its refineries in an entirely trade-exposed industry. Caltex needs to continuously evolve and innovate processes employed to remain efficient and competitive. As many of these activities are unlikely to be eligible under the “new knowledge” definition, due to their relevance to existing processes and systems, this R&D will no longer be incentivised by the tax credit.

The new definition of core R&D requires taxpayers to seek new, previously unknown or undiscovered information and carry out scientific experimentation to uncover that new knowledge. Claimants such as Caltex will need to prove in a retrospective assessment that the knowledge did not exist anywhere else, which will create additional administrative and operational burdens. This creates an innovation system which does not encourage industry to pursue innovation and development of processes and products.

3.4 Amend the supporting R&D activities definition

The new legislation has redefined supporting R&D activities as those that are directly related to core R&D activities and undertaken for the dominant purpose of supporting the core R&D activity. As outlined above, Caltex believes that much of its R&D will be ineligible under the core R&D activities definition and is likely to fall into the non-supporting category, impacting its eligibility to claim the tax credit.

The dominant purpose test, which must be applied to all supporting activities, means that supporting and non-supporting activities are split and treated differently. The dominant purpose test is also another example of a new definition which will be open to administrative or legal interpretation.

Caltex completes testing, analysis and implementation of its R&D activities on existing production processes concurrent with its day to day business. Caltex’s R&D is undertaken in this manner due to both the inability to dedicate refinery processes to R&D and due to the strong R&D outcomes achieved by utilising real conditions. It is not practical operationally and financially to conduct separate R&D experiments on a refinery yet the R&D conducted during ongoing production is genuine. The complexity of R&D projects undertaken and the need to do so within normal operating processes would make splitting out the costs of R&D between supporting and non-supporting activities very difficult. It would also require Caltex to divert resources to administration and compliance, rather than R&D activities.

By redefining supporting activities as proposed, incentives for R&D will move away from industrial R&D programs to laboratory-style programs. Caltex’s industrial R&D occurs on a commercial scale, with improvements to processes and outputs trialled in live conditions rather than laboratory or theoretical conditions.

3.5 Case studies

Case study #1

Crude oils have varying qualities that affect their price because some quality characteristics make the crudes more difficult to process. While the impacts of processing may be generally known from published research, the exact impact on Caltex’s refineries is not known as all refineries are unique in design and operation. Therefore R&D must be undertaken to determine the impact on our specific equipment and what process changes must be made at what cost, in order to calculate whether purchase of the particular crude oil is justified.

Under the proposed rules any expenditure incurred on such an investigation will be significantly impacted. First, the expenditure may not be considered to be generating new knowledge under the new definition, whereas it would be both novel and involve technical risk under the existing legislative definition. Second, even if it were generating new knowledge, most of the costs would be incurred in a production environment and hence would not satisfy the definition of supporting activities, since running the crude through the refining process may not be the dominant purpose of incurring that expense.

Case study #2

Another example involves investigation of reduced production rates associated with a new diesel hydrotreater (a process unit used to reduce the sulfur content of diesel). Designed production rates had not been achieved and further reduction rates were experienced with continued use of the new unit. Significant shutdowns, examination of the unit, development of potential solutions and trialling of the solutions were required to solve the technical issues.

Hydrotreater technology is reasonably well known so such R&D activity might not be eligible under the proposed rules as no "new knowledge" would be created for hydrotreaters generally, even though new knowledge would be created in the context of Caltex's unique refinery operation. However, such new knowledge is critical for Caltex to maximise the efficiency of the new equipment. Further, the associated supporting activities would most likely not be eligible under the new rules, as they were not incurred for the dominant purpose of conducting the research but were conducted as part of the production process.