26 July 2002

The Hon Geoff Prosser MP
Chairman
Standing Committee on Industry and Resources
House of Representatives
Parliament House
CANBERRA ACT 2600

Inquiry into impediments to increasing investment in mineral and petroleum exploration in Australia

Dear Mr Prosser,

Please find attached submission of the Commonwealth Bank Group to the Committee's *Inquiry into impediments to increasing investment in mineral and petroleum exploration in Australia*.

The submission is drawn largely from our experience in the funds management business as an equity investor in the resources sector.

The Bank's contact for this submission is Mr John Cairn, Manager Government and Industry Affairs. You may contact him at the above address or on (02) 9378 3193.

Yours sincerely,

Paul W McCarthy

Submission by

Commonwealth Bank of Australia

to

House of Representatives Standing Committee on Industry and Resources Inquiry into impediments to increasing investment in mineral and petroleum exploration in Australia

July 2002

Commonwealth Bank

Executive Summary

This submission outlines aspects of the Commonwealth Bank’s knowledge and experience in the mineral and petroleum exploration industry in Australia relevant to the Committee’s terms of reference, and suggests some options for government to consider that may reduce impediments to increasing mineral and petroleum exploration investment.

The Bank and its subsidiaries include funds management, investment, finance and leasing operations that either invest, or have clients with an interest, in the mineral and petroleum exploration industry in Australia.

Australia hosts some of the best ore bodies in the world and has abundant gas resources, but lacks the competitive fiscal regime needed to attract the international capital flowing to growth areas that are very large in comparison with Australia. The remote location of resources in Australia and the lack of infrastructure also means exploration is often not economically viable. This problem is enhanced for small companies. Depreciation write-off periods and the withdrawal of accelerated depreciation make Australia unattractive, particularly for large investments with a long pay-back period.

Small energy and minerals exploration companies need to repeatedly return to the equity market to raise capital, and this dilutes existing shareholders. In the absence of interim exploration success, capital raising may also prove very difficult or impossible.

Government should give serious consideration to developing a more competitive fiscal regime in Australia. This includes reducing the 15-year depreciation limit, allowing deductions earlier in capital-intensive and long-life infrastructure projects to commercialise resources, increasing the 5 year cut-off date of past exploration costs that can be used to offset the Petroleum Resource Rent Tax, and encouraging investment in smaller companies through the use of Management Investment Schemes.

More coordination between governments, agencies and project proponents could speed up the approval process involving government regimes that cover Native Title claims and environmental approvals. This may reduce the time, costs and risk added to the exploration process by variations between the regimes.

Australia's resource endowment

Australia is largely gas prone with a low probability of finding large-scale oil. Despite the fact that Australia has abundant gas resources, current commercial reserves are likely to fall below national demand levels over the next 20 years. In addition, crude oil and condensate production is expected to fall well below projected demand.

The remote location of much of Australia’s gas resources and lack of infrastructure means that undertaking exploration for gas in these areas is often not economically viable. This problem is enhanced for small companies who experience a relatively higher cost of capital and have fewer competitive advantages in marketing their gas.

Exploration success rates, weighted by volume, have declined over the last 40 years. As a result, the major international oil companies have largely withdrawn from exploration in Australia.

The availability of cheap, abundant coal has caused gas prices and usage in Australia to remain low by international standards (gas comprises around 18% of primary energy consumption compared to around 25-40% for coal).

The expected supply/demand gap in crude oil and condensates will force Australia to increase its reliance on other sources, such as the Middle East.

In the minerals industry Australia has traditionally produced significant quantities of iron-ore, copper, nickel, zinc and gold, mainly for export. The dramatic reduction in exploration spending by the major mining companies such as BHP Billiton, Rio Tinto and WMC has resulted in a serious shortage of discoveries capable of replacing existing production levels over the next 5 to 10 years. In the case of gold and nickel, the current production levels are already in decline.

Australia hosts some of the best ore bodies in the world, such as Hammersley Iron Ore, Olympic Dam, the Bowen Basin Coal Fields and the Eastern Goldfields. Australia also has a number of key advantages in the minerals business: low political risk (once land access has been negotiated) and large areas with no conflicting land use. Australia’s challenge is to create an environment where exploration is made more attractive and effective.

Structure of the industry and role of small companies

Along with the withdrawal from exploration of major companies, the scope of the industry has shifted from a small number of large fields to a large number of small fields. The major companies consider these fields too small to impact their bottom line, and therefore have little interest in this type of exploration. The low number of mid-sized companies means that the government will need to stimulate smaller companies to fill the gap.

Most major miners now rely on junior explorers to discover new projects, and plan to acquire the best of these. Unfortunately, whilst it is true that small companies often explore in a more capital-efficient manner than a major company, the very small amounts of capital severely limit their effectiveness. As a result, on a global scale, there is a dire shortage of world class greenfields projects.

The mining industry, at times, has been inclined to lock up large tracts of land under exploration licence without actively exploring. The obligation to relinquish within a certain period or to apply for a mining/petroleum development licence has been shown to be a good discipline (eg Santos' discoveries within the Cooper Basin).

Impediments to accessing capital, particularly by small companies

Australia is not attractive for international petroleum investment. Our fiscal terms rank at around 90 out of 162 fiscal regimes offered internationally (Source: IHS Energy Group). Exploration spending has been increasingly rationed by the major companies following the “mega-mergers” of the last few years. The main international growth area for exploration spending is the deepwater belts in the Gulf of Mexico, West Africa and Brazil, where the size of the targets is very large in comparison with Australia. This exploration is primarily for oil.

Depreciation write-off periods and the withdrawal of accelerated depreciation make Australia unattractive in the competition for capital, particularly for large investments with a long pay-back period. A more competitive fiscal regime is needed so that:

- Australia can develop its resources in the globally competitive market. For example LNG in Australia has a 15-year depreciation limit, but competitors such as Oman and Qatar are about a third of that time.

- Australia can develop the required capital-intensive and long-life infrastructure required to commercialise stranded resources. For example, a major project may take 3-4 years to construct, but deductions cannot be claimed until equipment is ready for start-up.

- International players will be attracted to the higher risk/reward exploration plays. Petroleum Resource Rent Tax is the secondary tax that applies to most offshore areas in Australia. The favourable uplift of past exploration costs that can be used to offset the tax has a 5 year cut-off date. This rate should be increased to recognise the greater risks associated with deepwater exploration for large targets.

It is difficult for pure exploration companies in both energy and minerals to raise much-needed capital on an ongoing basis. They need to repeatedly go back to the equity market, and this dilutes existing shareholders. In the absence of interim exploration success, further capital raising may prove impossible.

Management Investment Schemes (MIS) may be a way of encouraging investment in smaller companies. For example Sunshine Gas has a proposal before the tax office for approval. Money that individual investors place into the MIS is spent on a specific exploration program in a specific area. Individual investors may be able to claim a 50% tax deduction for monies contributed to the program.

Flow through share schemes aimed at making exploration tax deductible have had a positive effect on the Canadian energy and mining industry. Australia does not offer tax deductions to investors for the cost of share placements taken up in exploration companies. These schemes allow for investors to use the tax deductions from exploration activity to offset their other assessable income. This recognises the long time and uncertainty as to whether exploration will give rise to profitable mining operations. As most discoveries now tend to be under cover, and therefore harder to find, this type of scheme would assist investors to accept the risk profile of exploration investments.

A Case Study: US Tax Incentives for non-conventional gas

Coal Bed Methane (CBM) production is at an embryonic stage in Australia where there is potential to develop significant production associated with large coal resources.

In the United States, CBM was successfully encouraged through a tax credit scheme. Companies involved in production of unconventional gas between 1 Jan 1980 to 31 December 1992 earned tax credits on production through to 31 December 2002. Although the initial CBM drilling enthusiasm subsided with the end of the tax credit drilling window, a small number of producers continued to explore for non-conventional gas; refining completion techniques, initiating new pipelines and making the plays more economically viable.

In 1999 CBM contributed around 6% of gas production and 7% of gas reserves in the Lower 48 states. Prior to the introduction of tax credits in 1988, there was no commercially viable production of CBM.

Many companies utilising vehicle and equipment finance have an annual turnover of less than $40m. The large capital cost of equipment and equipment finance rentals in mineral and petroleum exploration can be an impediment to smaller companies.

Some worthwhile options that would provide an incentive for such companies to invest in equipment for this purpose could be an investment allowance of the capital cost, or the ability for companies to accelerate the depreciation on the asset.

Access to land including Native Title and Cultural Heritage issues

Native Title claims have resulted in lengthy delays in gaining access for exploration and, in some cases, prevented the commencement of exploration or adequate testing prior to the expiry of the permit. This has the greatest effect upon minerals companies exploring in the Northern Territory, Western Australia and Queensland.

Whilst Native Title impacts on permitting for mining operations rather than exploration, in most cases the nexus is strong. Most exploration companies have a limited capital base and the "cash burn" over a period of as little as 12 months can trigger loss of good staff and investor confidence.

Annual work programs require approval of the Land Councils in conjunction with the traditional owners. Sometimes access is delayed for more than a full field season.

Such delays greatly reduce a small company's ability to raise further funds from relatively impatient equity markets. Often rent has to be paid, even though access is not granted. The longer the delays, the more of the funds earmarked for exploration are actually spent on overheads and legal fees.

Government policy could support efficient Native Title negotiations after the issuing of licenses by developing mechanisms for consultation on Native Title. One suggestion would be for access to be granted for minimal disturbance exploration in less sensitive areas, with heritage surveys to be completed for more intensive exploration. This could apply to areas that have been used extensively for grazing that are already in a degraded state.

Environmental and other approval processes

The most cited issues with environmental approval are a lack of a coordinated approach nationally, too many government entities to deal with and a slow turnaround time for government approvals. These problems add time and cost to the exploration process, particularly for smaller companies.

In some states, such as New South Wales, the environmental bond is a significant impediment for the smaller explorers.

More coordination between governments, agencies and project proponents would speed up the approval process.

Government could provide information packages accompanying acreage releases that are comprehensive and include all relevant information available on Native Title, environment and cultural heritage relevant to the acreage being released.

Environmental risks (indemnity, third party and public liability insurance) to the Bank or its subsidiaries as an owner of plant and equipment are of concern in a leasing arrangement. The Bank, as a direct creditor, would also be less likely to trade a small business on in the event of an insolvency due to the environmental/heritage risks and frequent exposure to remote locations.

Public provision of geoscientific data

The provision by public agencies of aeromagnetic surveys is a desirable activity. This activity is expensive and its undertaking by public agencies allows for companies to individually assess and interpret the signature, as the threshold to what constitutes an economic area can vary significantly.

Conclusion

Australia has a number of key advantages in the minerals industry, such as low political risk and large areas with no conflicting land use.

However, the major companies consider Australia's fields too small to impact their bottom line. The importance of stimulating small companies to fill the gap left by the withdrawal of major companies, and the need to increase the limited number of mid-sized companies in exploration, is not reflected in current government policies.

Exploration investment is flowing to international growth areas where the size of the targets is very large in comparison with Australia, such as in the Gulf of Mexico, West Africa and Brazil. Australia lacks the competitive fiscal regime needed to attract this international investment. Depreciation write-off periods and the withdrawal of accelerated depreciation make Australia unattractive, particularly for large investments with a long pay-back period.

Capital raising for small energy and minerals exploration companies may prove very difficult due to the need to repeatedly return to the equity market, and dilute existing shareholders. In the absence of interim exploration success, further capital raising may prove impossible.

Flow through share schemes aimed at making exploration tax deductible have had a positive effect on the Canadian energy and mining industry, and may suit the Australian industry. Such schemes recognise the long time and uncertainty as to whether exploration will give rise to profitable mining operations.

US tax incentives for non-conventional gas exploration and development was successfully encouraged through a tax credit scheme.

Lengthy delays and variations between the government regimes covering Native Title claims and environmental approvals add time, costs and risk to the exploration process. More coordination between governments, agencies and project proponents could speed up the approval process.