SUBMISSION TO FEDERAL INQUIRY INTO

EXPLORATION IMPEDIMENTS

Submission lodged by John Richard Langford, Partner,

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I make this submission in my capacity as a partner of Deloitte Touche Tohmatsu, responsible for Deloitte Corporate Finance in Western Australia. In this capacity I have been involved in assisting companies raise capital for exploration purposes for the past 18 years.

In addition, I have experience over 15 years as a director of publicly listed entities, experiencing the practical issues associated with accessing investment funds for exploration.

In the submission I will confine my comments to specific issues:

1. Accessing capital.
2. Contribution of exploration to regional Australia.
3. Natural relationship between explorers and producers.
4. Feasibility Studies.
5. Effect of native title legislation.
6. Effect of foreign owned companies on exploration.

1. Accessing Capital

The economic benefit derived from a successful resources industry is well documented and I do not propose to provide any analysis in this submission. I am sure that many of the industry representative groups will more than adequately cover the economic contribution provided by a robust exploration industry.

Australia is currently experiencing the adverse impact of a prolonged period where exploration has been unfunded and new resource developments are lacking despite robust commodity prices. [It is not a factor as to whether commodity prices are subsidized by a low Australia dollar. The reality is that profits are determined by reference to revenue received in Australian currency and if there is an economic benefit from mining, economically the country should be ensuring that development is occurring.]

Exploration by nature needs to be anticyclic to the commodity price cycle.
The risk profile of exploration requires enormous effort to be put into general exploration before success is achieved in identifying an economic deposit. The time taken to implement a feasibility study, the process of sourcing capital then the developing of the project means that there is little rationale in focussing exploration efforts during a commodity boom as the resultant exploration successes will more than likely allow exploitation when the commodity cycle has moved to a downward momentum adversely effecting the economics of the project, the ability to hedge for price protection and possibly the ability to finance the project developments. Exploration must be ongoing so that the country has a regular flow of new resource project developments. Exploration success and

regular project development further enhances the focus of the investors on the industry and their confidence in supporting the industry.

Exploration is undertaken by two sectors; producers who are seeking to replenish resources mined or develop new provinces and the smaller explorers who tend to focus on the grass roots exploration. It is these smaller explorers who arguably have achieved most success in developing new resource provinces in Australia. Companies such as Sons of Gwalia, Gascoyne Gold, Aurion Gold (predecessor firms), the Gutnik group of companies all had their gestation period as junior explorers relying on support from the investment community for funding. Even WMC had a history as a junior company that developed on exploration success achieved in a period where developing new frontiers were encouraged through active encouragement and incentivisation by Governments to develop new projects.

The smaller explorers are totally reliant on ongoing support from the investment community who are prepared to invest a portion of their equity investment at the high-risk end of the equities market. These investments are generally short term and the investment terms are at a discount to the market price for the equity but they do allow the explorers to access capital. These investors are driven by market sentiment. Investors who support investing in exploration companies are not generally driven by the desire to seek new frontiers, but see an investment in a resources stock as a means to possibly make a quick profit. These investors generally understand the risk of exploration and treat the investment with a high-risk high return yield expectation. In many cases, this sector of the investment community is the only source of capital for an exploration company.

If commodity prices are low, generally these investors are able to access an alternative investment that offers them the same profile as they can access in strong commodity booms and the resources industry loses access to this capital. The most recent example was the recent technology boom where all of the high-risk investment funds were diverted. Access to capital for exploration funds completely dried up and most exploration companies were forced to move from a focus on resources to participation in the technology sector as they could not access funds for exploration and a total change in direction was the only value that could be derived for shareholders.

The investment community has been reluctant to redivert significant funds to exploration subsequent to the technology boom finishing despite a more robust gold price etc. This is probably due to the investment community understanding the time factor between initial exploration and development. It is also possibly due to most of the major gold producers in Australia being acquired by International mining houses, taking an investment focus in Australian mining opportunities by Australians away from the resources sector. There are also other opportunities for investors seeking volatility in equities to drive potential premium profits but at the premium part of the investment market that allow the traditional exploration investors the ability to “have a punt on the market” but also protect their risk.
ie. The larger companies now have a share price volatility that has not been present in previous markets.

There will be numerous submissions to this inquiry encouraging the Federal Government to look to providing tax relief to investors of exploration through flow through deduction incentives such as is operating in Canada. I will not reiterate the mechanics of a flow through share, as I am sure industry groups will adequately cover this. I have mentioned earlier in this submission that the profile of investors for explorers are those who take a short term approach to investment and whose investment decisions are influenced by market sentiment. I have also covered the fact that it is a necessity that exploration occurs anticyclic to the commodity price and therefore anticyclic to investor sentiment. If an incentive is not provided to investors to invest funds with explorers during these periods, the investment funds will be diverted as occurred during the technology boom to opportunities that the investment sentiment supports. Again we will be in a position that the country currently finds itself in where there is little resource development as a result of a dormant exploration industry.

There has been a number of concerns expressed with respect to whether providing tax relief will be cost neutral to the government or whether exploration funds will be spent as intended on exploration or whether there will be an industry created around potential taxation rorts as has been suggested with other tax products. I suggest that there has been considerable evidence that providing the legislation is properly thought through that the gross economic benefit from any industry that develops with the assistance of tax relief far outweighs the cost from those who misuse the incentive.

Providing the funds invested are actual funds and not artificial and providing the use of the funds is regulated, tax incentivisation will provide a stimulus for economic activity. The reality of the much-publicised tax schemes that have attracted adverse reaction relate to artificial financing such as non-recourse loans that grossed up the tax deductibility. Legislation can be appropriately drafted to ensure that funds are used for the purpose intended by the tax incentives.

A strong example of where tax incentives were effectively used to stimulate a vibrant industry was in the 1980's where the Australian film industry was financed largely on the back of tax deductibility in excess of 100%. Many good films, writers, producers and actors were provided an opportunity to develop during this period and there was excellent investor support as well as strong economic benefit from the use of the funds developing this industry.

Given the state of the exploration industry and lack of funding as well as the economic benefits that have historically been derived from and active exploration industry, I submit that it is appropriate for the government to look at urgent and significant investor stimuli to encourage funding for the resources industry.

I am a firm believer that while the flow through schemes have merit, the exploration industry is in dire requirement of funding and it does not appear that in the foreseeable future that there will be a substantial flow of funds to support the industry. The industry needs a major boost to encourage investors to divert part of their investment funds towards exploration and in the short term and for a short period there is a major requirement for leadership to be shown to government in this regard. This is not suggesting

direct subsidisation as this does not encourage focus or efficiency. I do however suggest that there is a strong argument that for a finite period of say three years that taxation incentives of say 150% deduction for funds invested directly into exploration are applied as a stimulus for the exploration industry. Legislation could obviously contain restriction as to the use of funds raised under these incentives as well as provisions that post expenditure reporting could be a condition to verify satisfaction of the expenditure requirements. It would be practical for a statement of expenditure to be lodged with the Australian Taxation office with the companies tax return with a sign off from the companies auditor that they have reviewed the expenditure. The benefits of this incentive will be similar to the film industry, it will provide an incentive for investors to support an industry in anticyclic periods as well as providing much needed economic activity for regional areas that rely on exploration for survival. This would provide significant incentive for the industry as well as provide time to properly assess and legislate a flow through share concept if appropriate. The rationale for the interim but finite period of the tax deductibility is that the industry needs urgent funding. This is not ground breaking. The government has used similar incentives to effectively encourage investment in the research and development in Australia.

The industry has an additional hurdle it must overcome that has not been present in the past. There is a lot of current publicity surrounding the number of new exploration floats that are currently proposed.

The reality is that few of these have underwriters that in the past have provided surety of funding.

At best many brokers are operating on a best endeavours basis and may act as a sponsoring broker, taking fees but no risk. My understanding discussing this with brokers who have been active in the market is that there is a lot of product around and the investors are being extremely selective in where they are investing their funds. While there is a lot of activity in seeking funds, this does not, and at the moment is not, converting to successful equity raising and therefore enhanced exploration activity.

2. Contribution of exploration to regional Australia

Traditionally strong economic regional contributors to Australia such as Kalgoorlie etc rely heavily on exploration activity to generate revenues to provide the economic activity required to sustain regional towns that are essential in Australia. Mining operations provide strong economic value but the exploration industry provides the balance of the economic equation that allows communities such as Kalgoorlie to develop as a strong infrastructure region with significant local investment by local business people.

Kalgoorlie is a good example of a town that has developed a robust business community that has reinvested in the region to provide strong infrastructure facilities not only for industry but also the residents. These communities require regular economic activity to allow the investment activity to occur and to provide financiers confidence to provide finance for these infrastructure assets. It was not until the late 1980's that external financiers were prepared to offer communities with a credit rating that allowed external finance to be accessed by investors seeking to develop substantial investments in communities such as Kalgoorlie.

The investors and financiers have had in the past four years a period where the value of and return from their investments diminished significantly and I would suggest confidence in future significant investments has been eroded. It took a long time for these communities to establish a history that supported the view that the regional communities were not subject to severe cyclic fluctuations that make investment into these communities questionable. There was a strong period of around 18 years where the resource communities benefited from combined exploration and development activity and investor confidence in these regions was high. This confidence has ceased and there is neither strong exploration nor resultant new development. It is a necessity for governments to provide strong leadership and provide initiatives to stimulate activities in these regional centres.

3. Natural relationship between explorers and producers

While exploration is not exclusively based around gold, it is this metal that traditionally has provided momentum for broader investment in exploration. It is also a commodity that continues to have emotional support from traditional investors for the exploration industry.

The fact that major gold producers have in the past two years largely been acquired by international mining houses has resulted in Australian investors diverting funds that were previously allocated to the local resources sector to alternative investment sectors further restricting available funds for exploration.

Junior explorers are conditioned to operate under tight monetary constraints and as such are recognised as being efficient in undertaking exploration and using funds with a conscious end result as distinct from operating under a significant budget where results are expected but the cost effectiveness not necessarily measured or challenged. The junior explorers can operate an exploration budget from several hundred thousand dollars to a few million and retain focus. They are adept at staging exploration and stage-funding efforts so that they can achieve success based funding. This ensures that all exploration is focussed and all funds are strategically spent giving shareholders the opportunity to maximise value. If the exploration efforts are not successful, generally funding from juniors is ceased quickly and the focus is changed to another target. This again is a safety valve that ensures exploration focus is not only efficient but also broad.

There is a natural evolutionary relationship that occurs between junior explorers and major mining houses. If a junior discovers a resource that is sufficiently large that it naturally is the domain of a major mining house three options can occur:

a) if the junior can find funding it can develop into a significant producer and there are a number of strong examples such as Sons of Gwalia;
b) if funding cannot be found the asset can be sold to a major allowing the resource to be developed and providing funds for the junior to get back to exploration: or
c) the junior can be acquired through takeover by the major allowing the major access to the resource and realising value, often at a premium, for shareholders of the junior. Often this premium is more cost effective for a producer than funding an exploration programme. In other words, it may well be a cost effective mechanism for major companies and a strong impetus for the exploration industry if incentives could be provided to major producers to effectively subcontract out the exploration process to junior public companies or the focussed explorers.

This could be affected by allowing producers a tax incentive for direct investment into exploration vehicles to fund exploration programmes. This could be in the form of flow through shares as has been previously proposed by industry representative bodies. This would be almost nil cost to the

government as the majors would be entitled to a tax deduction for exploration expenses incurred in any case so an investment through shares would create no advantage for the producer but would provide funding for the explorer. There is actually a potential net tax gain as a disposal of the shares would result in a taxable input for the public company when they sell the shares where the current situation is that the current tax deductibility generally does not allow any sale mechanism or rebate of sunk costs. The purpose of this incentive is to provide incentive for producers to invest in exploration through subscribing for shares in juniors.

It could be argued that a mechanism for a strategic relationship between producers and explorers already exists via joint venture relationships. The difficulty with this is that equity in a project is split and the economic hurdles for a project in a joint venture are likely to be dictated by the major under a joint venture relationship. The difficulty with joint ventures is that once the financier (in most cases the senior mining company) ceases to see economic benefit in a project, the exploration ceases. A junior will be able to see economic benefit in smaller projects and as has been proven many times has not only developed these smaller projects for strong economic benefit to the broader economy but also in many cases these projects have developed into longer term, significant resource regions. The financier or producer has the option of retaining the investment as a shareholder, increasing their investment through additional injection of equity, project acquisition etc or disposing of their investment via a sale of shares depending on success of the exploration. A sale of shares would recoup to the producer who funded the exploration via an equity injection some of the "sunk exploration money" and provide a taxable input so that there is not a net tax cost to this initiative.

4. Feasibility Studies

The exploration industry requires funding not just for exploring and proving new resources but also for the preparation of a bankable feasibility study. This is an additional hurdle that the exploration industry tends to face. It is also a stage where explorers tend to face difficulty in accessing funds as the expenditure does not have the speculative upside for the traditional investors of say funding a drilling campaign where the investors generally believe that drilling may provide some speculative movement on the shares. I have addressed the short-term focus of the traditional investor earlier in the submission. The feasibility study by its nature does not provide this perceived return potential for the high-risk profile investor. The process is generally a half way house between exploration and production and companies do not undertake corporate promotion that is appealing to investors during a feasibility study.

External financiers correctly require a robust feasibility endorsed by external consultants before they will provide funding to allow project development funding to be accessed. Again is a hurdle particularly junior resource companies face when attempting to develop a resource project.

It would be beneficial if there could be a tax relief provided to providers of capital to fund feasibility studies, as this remains a high-risk section of any development stage.

In most cases a feasibility study does not allow deductions to be achieved, as is the case with research and development provisions of the taxation act. Providing tax deductibility for feasibility studies as well as exploration will provide some taxation cost, however this will be substantially compensated for via taxes both federal and state when projects are developed. The general economic benefit of project development also justifies tax relief to provide an incentive to fund project initiation.

Tax incentives similar to those offered under research and development provisions of the income tax act would be appropriate. There are substantial similarities and risk profiles between a mining feasibility and research and development activities.

5. Effect of Native Title Legislation

Providing incentives for investors to fund exploration is only one barrier to exploration activity that needs to be addressed. A major prohibition to exploration, if funding is available, is access to land.

I do not believe that any explorer thinks that native title legislation will be repealed. There must however, be a process that allows responsible exploration to occur on prospective land. It does not make sense for any of the stakeholders from the traditional owners to the explorers for the current bottleneck in process to occur. The current process is not working and no one apart from external advisers are benefiting financially or socially from the native title process and exploration activity is further hindered even if the broader exploration funding issue can be resolved.

The concept of ensuring adequate compensation being paid for land access must also be defined to ensure that any compensation paid is distributed for the benefit of the indigenous community supposedly affected and if possible used to ensure that there are measurable outcomes that provide sustainable benefit for the traditional owners. While this may appear to be politically incorrect, I would contend that if compensation funds were diverted into community or educational benefits so that the stakeholders paying compensation could see an economic benefit, a far more conciliatory approach would be taken to the whole negotiation process.

This approach is not so different than the process where explorers pay pastoralists compensation. Generally this will be in the form of services where fencing, dams or other infrastructure. Where a pastoralist is able to provide services to an exploration programme such as land clearing, this is also generally negotiated. Both parties are mindful of their responsibility and a commercial approach works allowing all parties to benefit from economic activity.

Substantial compensation should be deferred to provide for any compensation to be payable out of production from economic resources. It is difficult enough to fund exploration than to have a significant portion of a budget to be diverted to land access compensation, particularly when there is a significant economic risk associated with defining an economic resource. Practically the use of funds for compensation is a further disincentive for investors to fund exploration for junior explorers as the investors expect the funds to be used to seek an economic resource and not to be significantly applied to non-exploration costs.

If significant compensation needs to be paid under native title regulations, consideration must be given to the imposts already associated with mineral development such as state royalties. It makes sense that if a project is generating State royalties that the State should bear some of the impost of providing compensation. Resource projects are by nature high risk, capital intensive and often do not provide a return that adequately compensates the risk and capital investment when compared to other investment returns available to investors. Adding a further impost does not assist in attracting investors to support the industry.

The industry is seen as an inefficient manager of investment funds. This is partly due to the fact that the industry is capital intensive, generally has high operating costs and has a non-regenerative product requiring successful exploration to provide a sustainable future. It is this rationale that is often used by investors when they justify not investing in the resources industry. This exploration is of course high cost and high risk. Balancing this, is the fact the industry by nature has to develop assets in remote regions providing employment opportunities and infrastructure in regions that have significant potential to assist the indigenous communities adding further rationale for moneys to be focussed on productive development rather than early compensation.

Most other industries are able provide a sustainable future through accessing raw materials or replanting crops etc. These industries are also able to benefit from economies of scale etc. The resources industry is restricted in accessing these economies through a finite asset life, which restrict the ability in many cases, to increase production capacity etc due to an inability to generate a commercial return from the capital investment.

The resources industry is not one that can absorb significant additional costs such as inappropriate compensation. While it can generate substantial economic benefit to the broader community, largely due to the fact as an industry that it is a significant consumer industry in terms of people, assets and consumer products and this drives the economic activity, it cannot continue to absorb imposts such as large compensation claims. The Governments, both Federal and State must accept some of the responsibility for funding land access or at least creating a legal framework that provides compensation to be paid only based on economic success from resource development.

6. Effect of Foreign Owned Companies on Exploration

A factor that requires consideration from the recent acquisition of most of the major gold producers in Australia by international mining houses is the fact that these companies have paid a premium to access the Australian assets. Notwithstanding the fact that part of this premium has been funded by a low Australian dollar and part of the consideration has been funded by scrip, a return on these investments will be expected in the short term by shareholders of these international mining companies.

There will be pressure to return a significant portion of profits as dividends to justify the cost of the investment. It is likely that exploration efforts by these companies will be restricted to regional focus of enhancing lifespan of existing production facilities and a focus will not be made on grassroots exploration outside of the companies immediate asset locations.

It is reasonable to suggest that these companies will continue in Australia but that this investment will be focussed on asset development rather than exploration. As such the Australian owned companies will retain the responsibility for exploration and industry development. At least in the next few years while the foreign owned companies get an acceptable return from their current investment.

This emphasises the necessity for a robust exploration industry in Australia and provides a priority for the government to provide significant support for the industry in making it an attractive industry for investors to invest when it is sensible for the industry to access the investment funds rather than relying on external sentiment. Government should be also taking an active role in ensuring that the industry can operate by ensuring proper access to land etc.

It is not opportunistic for the exploration industry to seek robust input from governments to provide stimulus to create investment activity. It is imperative that incentives be driven to "kick start" activity that historically has proven the ability to provide a multiple pay back to the economy. This is an urgent matter and not one that should be driven by next year's budgetary

process. The resources industry has a track record of persistence and success. Access to funding will drive employment, project development and sustainable economic activity and I would urge a bipartisan approach to urgently resolving a proactive approach to assisting the resources and particularly the exploration industry into activity.

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