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Exploration tax incentives miss target

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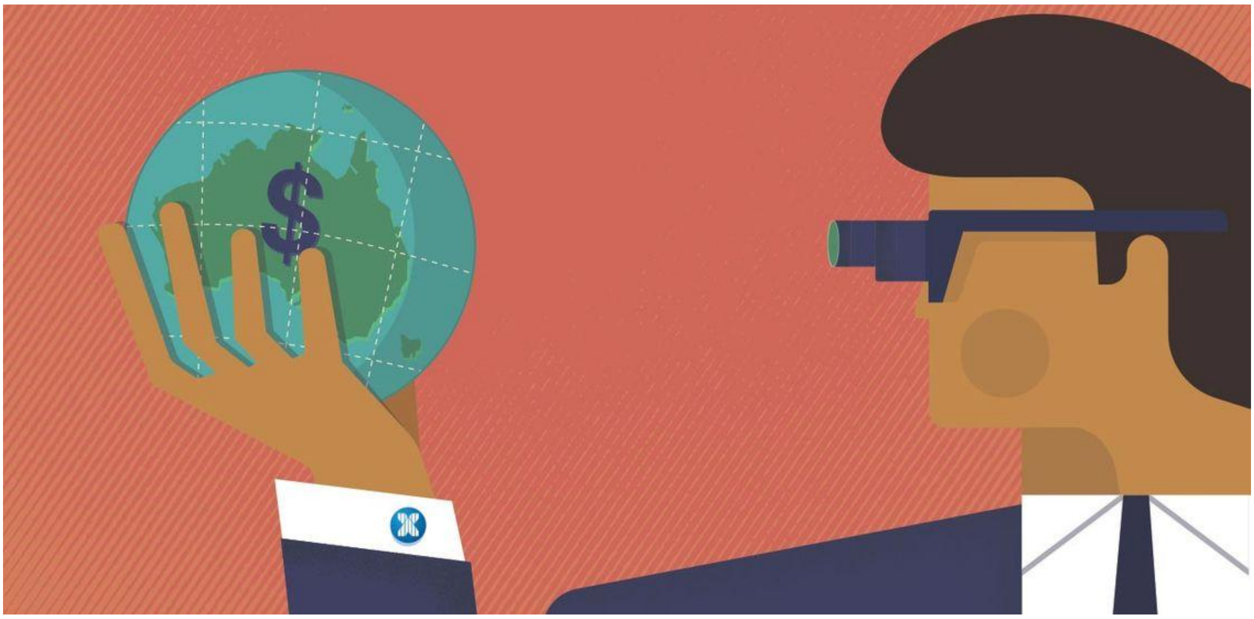

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The Australian government's new tax incentive to stimulate exploration spending shores up a political base without impacting the real constraints on higher mining output.

On March 27, 2018, the Australian parliament passed the Treasury Laws Amendment (Junior Minerals Exploration Incentive) Bill to give Australian investors a A$100 million (US$770 million) tax benefit over three years for spending more on mineral exploration.

An earlier scheme introduced in 2014 had given companies the option of passing on the value of tax losses from eligible exploration spending to shareholders.

End-of-year benefits spread over the entire shareholder base were an unexpected windfall at risk of being heavily diluted where there had been a historical legacy of large share issuance.

As investors had bought shares without being able to anticipate a benefit, the scheme offered no incentive to fund new activity.

Only 84 companies out of the hundreds eligible applied to participate in the first year, according to the Australian Taxation Office (ATO). Numbers applying halved over the next two years even as the available benefit was rising.

Over three years, a supposedly capital-starved industry applied for less than half of the financing on offer.

Industry spokespeople reacted angrily to the announcement in 2017 that the ill-targeted and little-used scheme was to end. The political pressure was felt most acutely in Western Australia where 56% of the nation's $28 billion non-petroleum exploration spend has occurred since 2004.

> **Behind the new policy is a questionable assumption that the forces constraining exploration are financially surmountable**

The current Liberal-led Australian government, with the smallest possible majority in the House of Representatives, holds 11 out of the 16 seats from Western Australia where the party was routed at state-level elections in 2017.

With such political considerations in mind, new exploration incentives were tweaked to take account of the evident shortcomings in the earlier scheme.

Now, investors will know before they put up risk capital whether companies are participating and the size of the expected benefit. Companies must apply to the ATO, before they spend, for an allocation of credits they can attach to only newly-subscribed shares.

In a novel and potentially controversial role, ATO staff will have to validate the bona fides of exploration companies to be dealt with on a 'first come-first served' basis.

To avoid companies locking in a disproportionate share of credits, no single entity will be granted more than 5% of the available benefit in any one year.

On paper, these arrangements provide an incentive to invest where none existed before. By excluding pre-existing share holdings, the benefit will also be more tightly targeted and correspondingly more meaningful.

As always with government interventions to redirect capital, unintended consequences abound. Existing shareholders, for example, will be given an incentive to quit their holdings in favour of taking up new and theoretically more valuable shares. There will be some tendency for markets to be more than usually depressed around the timing of a placement as this manoeuvring occurs.

The policy is an example of governments wanting to do something but baulking at the most logical policy alternative. With $100 million to spend, the government could choose a dozen exploration projects. Over three years, each could be given every chance of success with an extra $8 million rather than spreading the money so widely that it is at risk of losing its effectiveness.

Behind the new policy is a questionable assumption that the forces constraining exploration are financially surmountable.

Between 2012 and 2017, annual spending on Australian exploration fell by $4.7 billion, according to data published by the Australian Bureau of Statistics in March. Of that decline, $2.8 billion was within the petroleum industry. The value of offshore petroleum exploration declined $2.2 billion. Spending on onshore exploration dropped $0.6 billion.

Petroleum is excluded from the scheme and, in any event, several states have limited or even banned onshore oil and gas exploration.

Of the remaining $1.9 billion, $1.5 billion came from lowered interest in iron ore, coal and uranium. Stalled Chinese steel production and overt government hostility toward uranium and coal make short-term tax incentives a wholly ineffective way to rekindle exploration efforts in these areas.

A further $352 million of the fall in exploration spending between 2012 and 2017 was on base metals where a cyclical recovery is already underway. Base metal exploration spending in 2017 was 63% higher than in 2016. Spending on gold exploration has already recovered fully from a 50% fall.

Expenditure, as a guidepost to exploration activity, may also offer an incomplete picture. The number of metres drilled in 2017 was only 19% lower than in 2012 after having risen 41% since 2015 as explorers have extracted better value from their spending.

The new tax scheme comes into force as the government searches desperately for ways to stimulate regional development. Again, the pressures are political with the junior partner in the national coalition government holding a disproportionate number of seats in northern Queensland where constraints on mine development and mineral processing are aggravating already high unemployment.

On March 28, the minister for resources announced that he had established the 'Resources 2030 Taskforce': a committee of eight policymakers, industry personnel and other stakeholders, including the mayor of Mt Isa, which was given six months to come up with a thoroughgoing policy redesign for the industry.

Hopefully, in addressing the industry's growth potential, the Resources 2030 Taskforce will eschew the view, contained in many government statements, that mineral discovery is synonymous with development, higher output and employment.

Beyond gold and iron ore, Western Australia can already point to as yet undeveloped world class mineral discoveries involving zinc, nickel, lithium, vanadium, cobalt, rare earth elements, potash, phosphate, bauxite and high-purity alumina. The challenge is moving to the next stage.

The spinoff benefits from mine development sought by governments too frequently depend on underfunded businesses run by sometimes inexperienced executives whose progress is in the hands of far larger global corporations.

As the industry's prior responses have shown, tax incentives for exploration are probably an insignificant piece of the development puzzle.

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