INQUIRY INTO RESOURCES EXPLORATION IMPEDIMENTS.

House of Representatives Standing Committee on Industry and Resources

Submission No: 98

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David Reed

The health of Australia's vital minerals industry should not be taken for granted. The price of neglect is too dear.

It is a mistake to assume that the minerals industry is robust and self sustaining. Capital markets are not allocating sufficient capital to exploration. And profits from mining are not being fed back into exploration. As a consequence the long term stability of the industry is under threat.

In the late 1990s and early 2000s, the ability of the mining industry to sustain its activities in Australia has been steadily eroding. The evidence is in exploration spending figures, both in Australia, and abroad. An explanation can be found in share market returns from mining shares.

The availability of capital for exploration spending is driven by the perceived competitiveness of the *returns* from exploration, when compared against other available investments. Put simply, money goes where investors believe they can get the best returns.

Since 1982, the returns from mining and exploration have been worse than most other asset classes. The ASX All Mining Index, at 918 points in October 2002, is just 60% higher than it was on average in 1983. It is also 35% lower than its peak in 1987, and 10% lower than it was for most of 1994. By contrast the ASX All Industrials index is 500% higher than it was in 1983, 60% higher than the peak of 1987, and also 60% higher than 1994 levels. As an investment class, mining and exploration was deserted for greener pastures in about 1998, and has since remained out of favour.

The first reaction of mining companies around the world has been to halt new developments, shrink exploration budgets and concentrate on extracting maximum returns from existing mines and plants. The effect on output, and even ore reserves, is not immediate, as returns are squeezed from past expenditure. Consequently there is a danger that casual observation of the industry would pass it with a clean bill of health, when indeed urgent action is required.

Investors will eventually return to mining and exploration, when metal prices once again promise sufficient rewards to mining companies for finding and developing new projects. The problem is that while we wait for this market solution, the expertise and services base of the exploration sector is being dismantled. Australia became a world leader in exploration sciences and services, by virtue of the money spent in the late 1980s to mid 1990s. If this accumulated knowledge is dispersed to other industries it will be difficult to reassemble. Moreover the process of exploration and development takes up to ten years on average to bear economic fruit. Action now to reinvigorate exploration is a vital step in preparing the industry to respond to future price rises, both in terms of exploration *and* development.

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Minerals exploration needs assistance now. The core problem is the perception of poor returns from exploration, both by investors and mining companies. The solution is to directly improve returns from exploration expenditure. A flow through tax incentive is one mechanism that would fairly direct investment back into minerals exploration.

The basic principle of a flow through tax incentive is to allow companies to renounce the tax benefit accrued from mineral exploration expenditures in favour of the investor who subscribed the funds. No new tax benefit needs to be issued, and the sole cost to the government comes from the acceleration of claims on specified mineral exploration expenditure.

Flow through shares would assist junior, or non-taxpaying, mineral exploration companies, a sector that is acknowledged by investors and larger mining companies alike, as best equipped for making new discoveries.

Flow through shares have been issued since 1983 in Canada, the only other country that supports a mineral exploration sector comparable to Australia's. From 1983 to 2001, \$C9.1 billion was raised under flow through share issues, resulting directly in numerous mineral discoveries. In October 2000 the Canadian federal government extended the tax credit available for eligible exploration expenditures, in response to falling exploration levels. Flow through shares are popular and demonstrably successful in Canada, from both investor and government standpoints.

For further exploration statistics and details of flow through shares please refer to the attached submission given to the Government Members Committee 24th June 2002.

D Reed.

David John Reed

31/10/02

A PRESENTATION ON THE NEED FOR A TAX EFFECTIVE INCENTIVE FOR JUNIOR MINING COMPANIES TO STIMULATE MINERAL EXPLORATION INVESTMENT

To

The Government Members Committee on Industry, Resources and Small Business
Monday 24 June 2002

D.J.Reed

Chairman – Reed Resources Ltd
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CIBC World Markets

MINING: AUSTRALIA'S LARGEST INDUSTRY

Mineral exploration and mining contributes significantly to all aspects of the Australian economy.

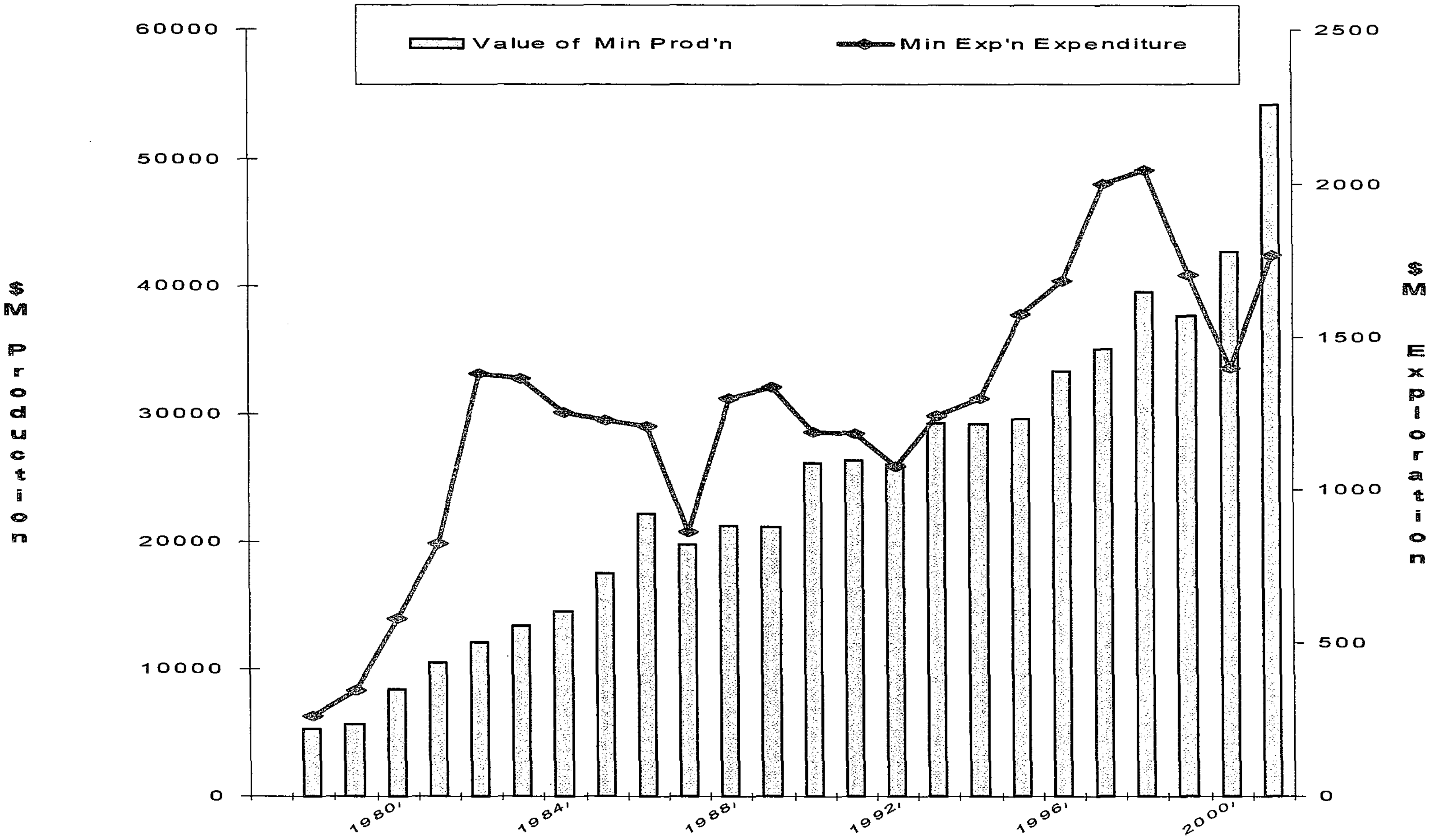
In the last three decades the gross value of minerals produced has increased from $5b in 1977-78 to $54b in 2001.

MINING: AUSTRALIA'S ENGINE ROOM

In 2001, Australia produced:-

Coal	$ 12.4b	- World's biggest exporter
Oil	$ 6 b	
Gold	$ 6 b	- World's 3rd biggest exporter
Iron Ore	$ 5.8 b	- World's biggest exporter
Wheat	$ 4.2 b	
Alumina	$ 4.2 b	
Aluminium	$ 4.1 b	- World's 3rd biggest exporter
Wool	$ 3.9 b	
Dairy	$ 2.4 b	
Nickel	$ 2 b	
Copper	$ 2 b	
Wine	$ 2 b	

Figure 1: Value of Australian Mineral and Energy Production and Exploration Expenditure (1977-78 to 2000-01)



Over the last five years, Australia as a whole has generated $175b in mineral and energy production and $9b in mineral and energy exploration expenditure.

Source: Australian Mineral Statistics

CIBC World Markets

MINING: AUSTRALIA'S ENGINE ROOM

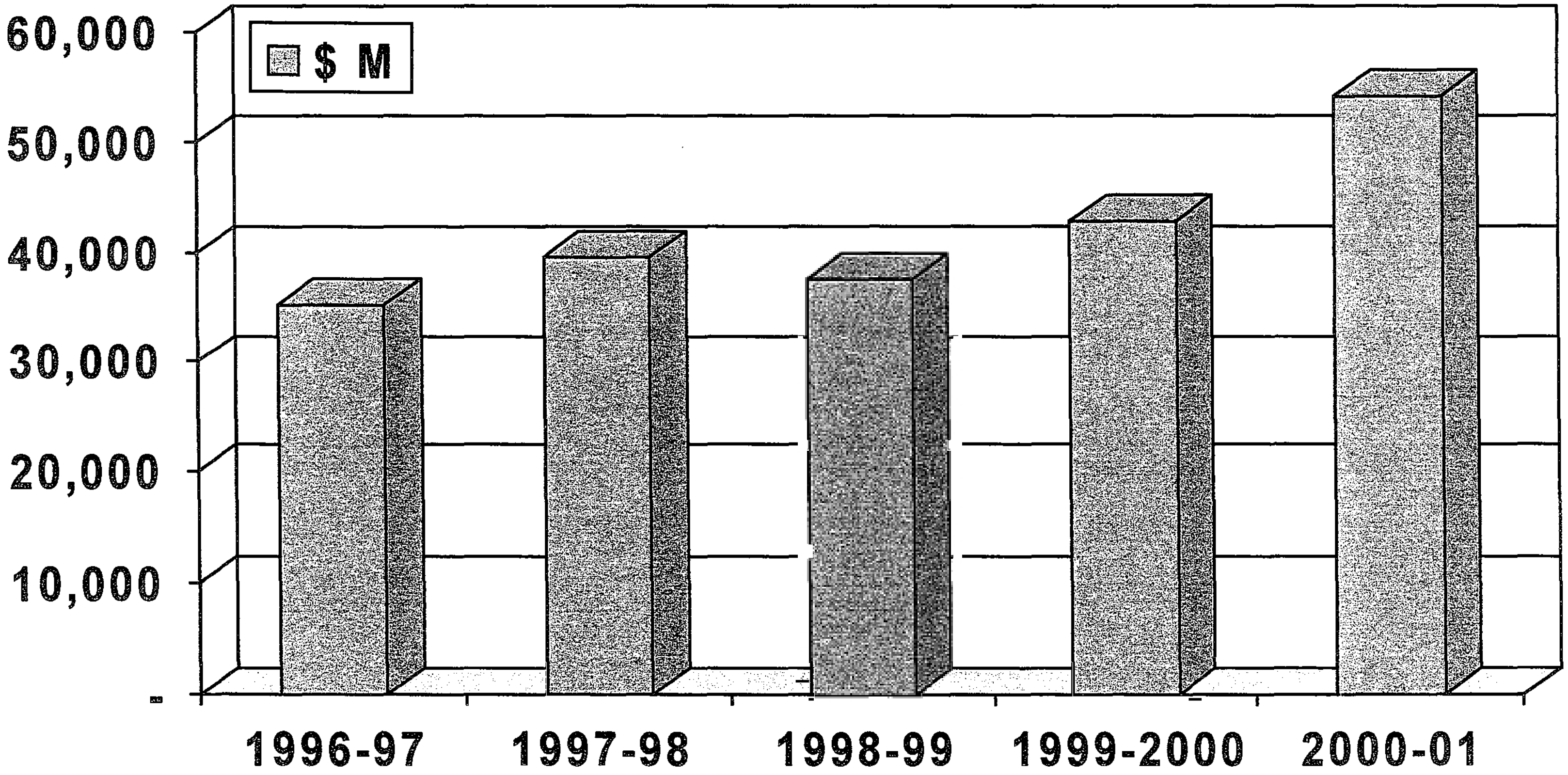
The Mining Sector accounts for 4.4% of Australia's GDP exceeding Agriculture at 3.5%.

Hence, the industry generates substantial positive economic activity in terms of direct and downstream employment opportunities, investment and export income and is one of the country's major export earners.

80,000 persons are directly employed by the Australian minerals and energy industry. For every person employed in the industry another 3 to 4 jobs are created elsewhere in the Australian economy.

Figure 2: Value of Australian Mineral and Energy Exports - 1996-97 to 2000-01

The value of mineral and energy exports has more than doubled since 1987-88, rising in 2000-01 to a record $54 b.



Source: Australian Mineral Statistics

CIBC World Markets

MINING: AUSTRALIA'S ENGINE ROOM

Mineral and energy exports currently represent 46% of Australia's merchandise exports and 36% of total exports.

A recent survey by the Minerals Council of Australia showed that the industry paid $2.7b in total direct taxes and $460m in indirect taxes to State and Federal governments in 2000/01.

Many regional centres and remote towns are heavily dependent on the mining industry. A large proportion of the public and private infrastructure in remote areas was built and in some cases maintained by the industry.

MINERAL EXPLORATION: AN INDUSTRY IN CRISIS

Exploration expenditure (excluding petroleum),fell from the 1996/97 year to the 2001/02 year, down from $1148m to $640m.

1996/97	$ 1,148 m
1997/98	$ 1,069 m
1998/99	$ 838 m
1999/00	$ 676 m
2000/01	$ 683 m
2001/02	$ 640 m

This means that since the high in 1996/97 of $1148m, Australia's private expenditure on mineral exploration (excluding petroleum) has fallen a staggering **44%** or the equivalent of **$ 508m**.

MINERAL EXPLORATION: A WORLDWIDE CRISIS

Exploration Expenditure Globally at 9 year low

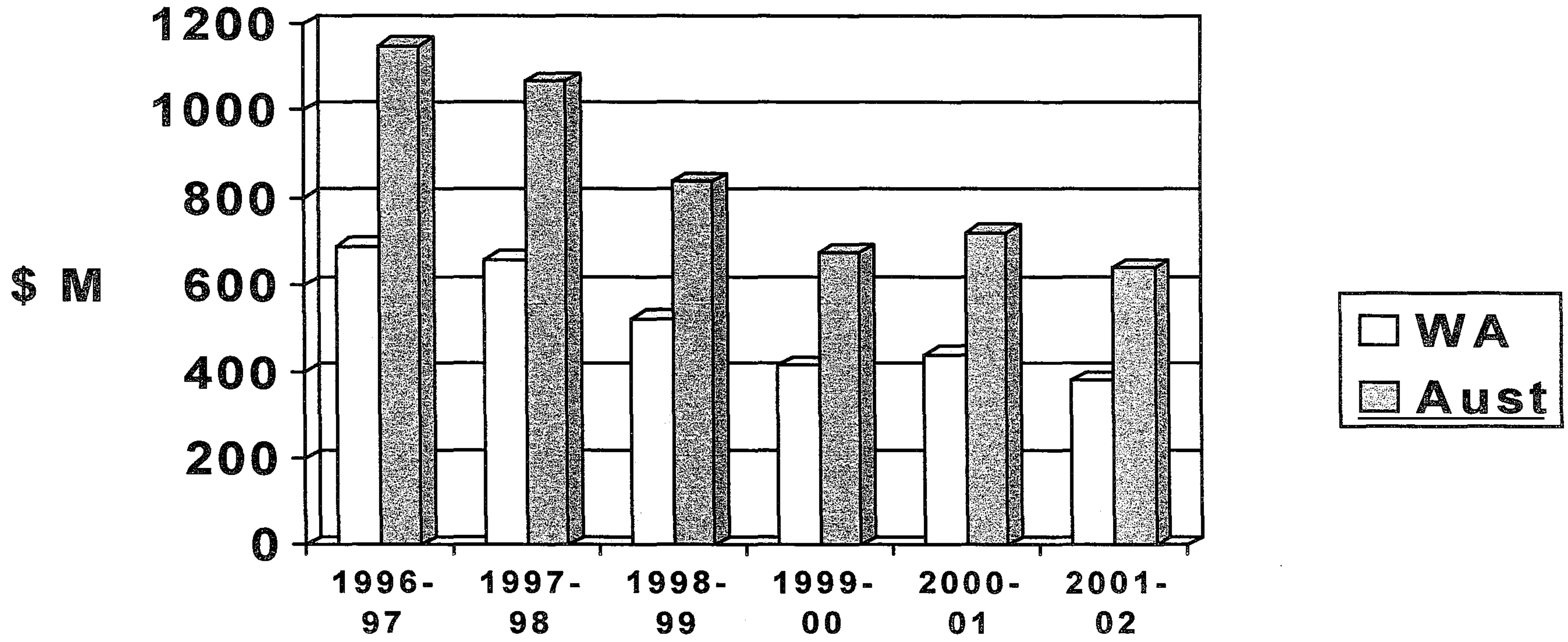
1997	-	US$ 5 b
1998	-	US$ 3.8 b
1999	-	US$ 2.2 b

World Bank states reduction due to Global economic slowdown and cyclical downturn, reduction by larger companies highlight's the need to provide funds for Junior Exploration companies.

World Bank injected in excess of US$300 million into exploration programmes in developing countries, proof of the flow-on economic benefits from exploration expenditure.

Source: World Bank

Figure 3 – Mineral and Energy Exploration Expenditure 1996-97 to 2001-02.



Source: ABS Catalogue 8412.

AN INDUSTRY IN CRISIS: Brain Drain

55% fewer geoscientists working in 2001 than at end of 1996.

The Unemployment rate of 14% masks a much higher rate of underemployment of the 20% of geoscientists who describe themselves as self-employed contractors and consultants. Many talented geologists have moved overseas in order to remain employed.

The mineral exploration sector in Australia has undergone massive structural change. The pool of geoscientists drained as many have abandoned their profession, forced to obtain gainful employment in other industries and not being replaced by younger trained geoscientists.

Currently some 37% of Australian geoscientists currently employed do not feel that their positions are secure.

52% of geoscientists are employed in Mineral Exploration.

60% of world's mining software comes from Australia world $1 billion p.a.

Source: Australian Institute of Geoscientists.

FUTURE IMPLICATIONS

The level of exploration expenditure is a crucial indicator of the future of the mining industry. It has a direct correlation with the value of mineral production and thus the net worth of the mining industry to the Australian economy.

In 1997 Exploration Drilling totalled 4.2 million metres

In 2001 Exploration Drilling totalled 0.8 million metres

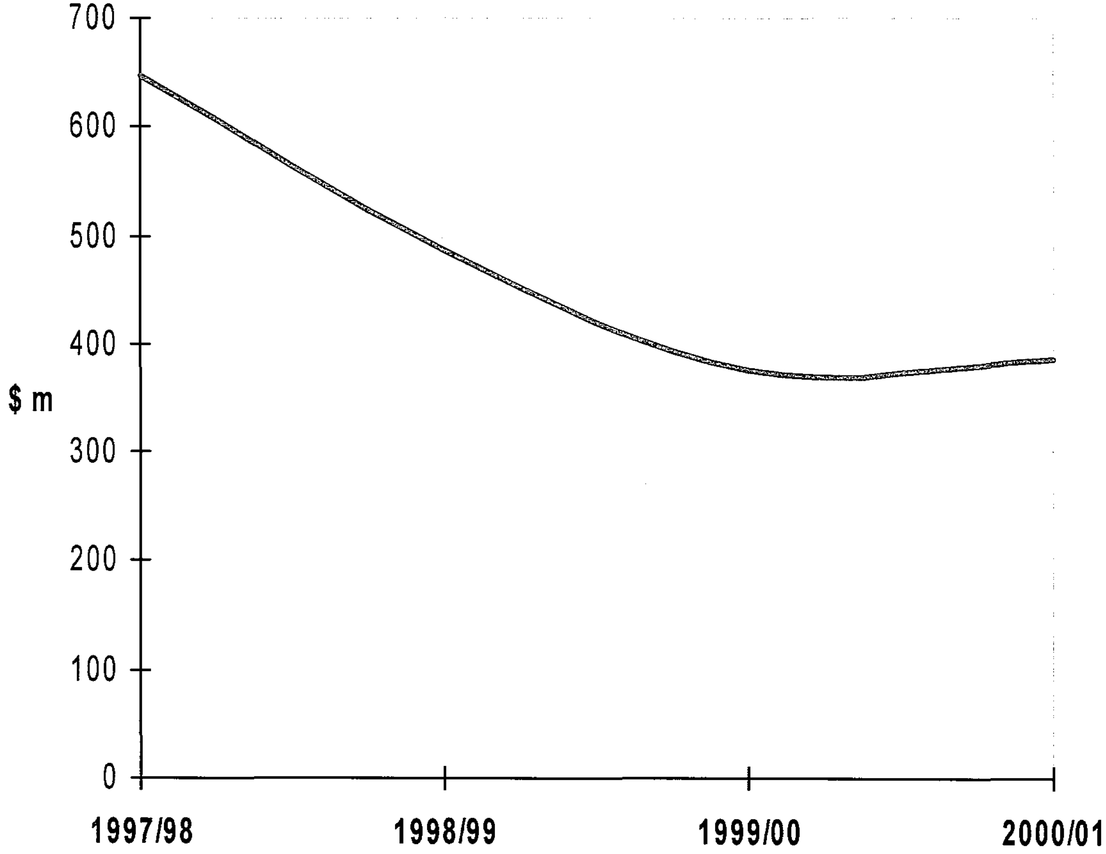
It follows that if one wants to predict the industry's future, what is happening with exploration expenditures <u>now</u> is a good place to start.

EXAMPLE : GOLD EXPLORATION

Gold, a mineral important to WA, has been particularly hard hit.

Gold Exploration Expenditure

1997/98	$ 648 m
1998/99	$ 486 m
1999/00	$ 375 m
2000/01	$ 385 m



Source: Australian Mineral Statistics

EFFECT ON GOLD PRODUCTION

Gold Production is at a 7 year low.

Quarterly Gold Production to 31 March 2002 was 65.7 tonnes the lowest quarter since 1995 and down 4.5% on the Dec 2001 quarter.

Only 20% of Worldwide Gold Production each year is being replaced by discoveries.

Australia-wide Gold Mines are being exhausted, examples are Kidston and Mt.Leyshon.

Fewer new discoveries are being made, due to lower exploration expenditure.

RESPONSIBILITY FALLS ON JUNIORS

Finally, a trend has developed in the industry over the past several years where national and multi-national companies have down-sized their mineral exploration departments, making large numbers of staff redundant.

At the same time these companies have begun to strike deals with smaller purely exploration companies and the result is that in many cases these small companies are now effectively acting as the exploration arm of the bigger companies.

PROGNOSIS

What is clearly needed is a circuit breaking initiative to help produce a sustainable upward trend in exploration expenditure while maintaining the essential dynamic fuelled by competition and a will to grow.

The initiative must be commercially driven, tax effective and sufficiently attractive to achieve a reversal in current trends.

CANADIAN FLOW-THROUGH SHARE SCHEME

Basic concept of flow-through is that a person (the "subscriber") subscribes for shares of a corporation and the corporation uses the subscription proceeds to incur certain resource expenditures. The incurred expenses will then be renounced to the relevant investor and will be treated as if they had been incurred by the subscriber for the purposes of the Income Tax Act.

KICKSTARTING EXPLORATION IN CANADA

Canadian Domestic exploration levels are currently at very low levels as senior companies increasingly spend their exploration dollars overseas and junior companies find it difficult to raise financing for their activities. In its brief to the 1999 Mines Ministers' Conference, the PDAC urged the Federal Government to reintroduce a Mineral Exploration Depletion Allowance (MEDA) to make follow-through shares more attractive to investors. Restoring the highly successful program, which ran in this country during the mid-1980's, would relieve the current crisis in exploration levels and in future ore sustainability. The PDAC is calling for a MEDA premium of between 33 1/3 per cent and 50 per cent initially, followed by a gradual reduction when recovery in the industry starts to take hold. Follow-through shares were instrumental in the discovery of diamonds in the Northwest Territories, the Loouvicourt base metal mine in Quebec, and two high-grade precious and base metal mines - Eskay Creek in British Columbia and Lindsley in Ontario.

Source: CIBC World Markets from Canadian Newspaper Article 1999

PURPOSE OF FLOW-THROUGH SHARES

There is no statement of general policy intent relating to flow-through shares in federal budget documents. However, government policy statements in respect of tax-based incentives (eg earned depletion) and direct grants (eg Canadian Exploration Incentive Program grants) indicate that flow-through shares are used to support economic and social policy by:

- Encouraging additional exploration and development in Canada.
- Promoting equity investments in mining and petroleum companies; and
- Assisting junior (typically non-taxpaying) exploration companies whose access to internal sources of financing (I.e. cash flow) may be limited.

Since flow-through shares allow investors to access income tax deductions for exploration and development more quickly that the companies which issue them, they result in a tax cost to government. The net federal tax cost of exploration financed by flow-through shares is estimated at $563 million for the period 1987 to 1991; it fell each year from $283 million in 1987 to $14 million in 1991.

CANADIAN FLOW-THROUGH FUNDS RAISED

	Mining CEE	Oil & Gas CEE	All CEE
		(c$ millions)	
1983	40	-	40
1984	180	-	180
1985	340	-	340
1986	840	-	840
1987	1260	240	1500
1988	900	120	1020
1989	320	120	440
1990	200	140	340
1991	100	100	200
1992	100	100	200
1993	75	208	283
1994	81	224	305
1995	72	199	271
1996	260	468	728
1997	293	620	913
1998	116	548	664
1999	116	451	567
2000	110	-	
2001	160	108	268
TOTAL 1983-2001	5,562	3,539	9,101
First 10 years (1983-92)	4,280	820	5,100

Notes:

1.Funds raised estimates based on CEE (Canadian Exploration Expense) renumciated by mining and oil & gas exploration companies to Department of Finance, Canada.

2. Data for 1992 unavailable/assumed to be comparable to 1991 (slow year).

3. 1993-95 data showed no breakdown between oil & gas and mining; assumed 26% mining per 1996-1999 breakdown.

Sources:

- "Evaluation Report 1994" Department of Finance, Canada, for years 1983-91.
- Discussions with Department of Finance, Canada for years 1993-99.

"SUPER" FLOW-THROUGH SHARES

In October 2000, the Canadian federal government introduced a 15% non-refundable tax credit. The credit is in addition to the existing 100% deduction of eligible exploration expenditures from the federal portion of one's taxes. To distinguish it from the fully deductible regular flow-through, investors are calling this new credit-enhanced version "super" flow-through

<u>Ontario</u>
In May, Ontario proposed a 30% bonus tax deduction

<u>Quebec</u>
Extended the maximum 175% deduction of certain qualifying expenses in certain locations for provincial tax purposes

<u>Yukon</u>
Announced it will increase refundable tax credit to companies from 22% to 25% of eligible mineral exploration expenditures

EFFECTS OF FLOW-THROUGH SHARE SCHEME

Flow-through shares:

Raised equity-based financing primarily for mining and petroleum exploration, especially gold exploration.

Accounted for a large share of all funding for mining exploration (averaging 60% for the period 1987 to 1991)

Resulted in significant spending on mining exploration from C$110m in 2000 to C$160m in 2001 due to additional benefits of "Super" flow-through incentives.

Benefited the economics of Alberta, British Columbia, Ontario and Quebec; and

Benefited non-taxpaying junior exploration companies.

EXECUTIVE SUMMARY

Australia relies on mining industry more than any other.

Minerals and energy are Australia's biggest exports.

Exploration has lead-lag correlation to Production levels.

Exploration levels indicate future of the mining industry.

Exploration levels are at crisis point, if neglected condition could become permanent, crippling the net worth of the industry and its contribution to the nation.

Need to reverse current trend with commercially driven, tax effective initiative, proven internationally in Canada, another mineral powerhouse.

Flow-through shares could be the answer.