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FLOW-THROUGH SHARES

Financing tomorrow's resource prosperity

→ ***What are Flow-Through Shares?***

A Flow-Through Share scheme would enable the transfer of tax deductions of individual small exploration companies to individual investors. Flow-Through Shares offer an opportunity to generate a sustainable level of exploration investment in Australia, returning activity to historical levels.

The basis for a Flow-Through Share is that an individual invests in an exploration company's shares and the company uses the proceeds for exploration expenditures. As many exploration companies are not generating revenues, some expenses "flow-through" to the investor who can then access income tax deductions.

→ ***Why is mineral exploration so important?***

Exploration expenditure is a crucial indicator of the future performance of the mining industry. Australia's mining industry is the backbone of the Australian economy¹. Over the past five years, Australia has generated \$175b in mineral and energy production and the value of mineral exports has more than doubled rising to over \$89b in 2005-06, an 18 per cent increase on the previous year.

The problem is that Australia is living on mineral discoveries made fifteen or more years ago. Australia was once a world leader in mineral exploration. However, Australia's share of the global exploration budget has plummeted from 15.5 per cent in 2003 to 11 per cent in 2006². There are now 55 per cent fewer geoscientists working in the industry today than there were eight years ago. Many talented geologists have moved overseas³. In 1997, exploration drilling in Australia totaled almost thirteen million metres, then fell to as low as 4.5 million metres and last year recovered to 7.6 million metres⁴.

→ ***Why is there market failure?***

The funds raised in the Australian market for exploration by listing remains at record low levels. This is a result of market failure caused by the "crowding out" of exploration by other less-risky investment opportunities, including residential property, film, tree plantations and vineyards.

While established mining companies do invest in exploration, they are largely focussed on brownfield sites; proving up reserves and optimising mine plans. Past greenfield exploration has been most successful when undertaken by nimble specialist small exploration companies who can manage the high risks of this speculative activity. While established mining companies are building formal links with exploration companies to encourage their activities, the reality is that Queensland's exploration activity is only just recovering from an all-time low.

¹ See AusIMM http://www.ausimm.com.au/main/policy/docs/min_ind_pins_hopes_canadian.pdf

² Metals Economics Group. Special report on world exploration trends for the PDAC International Convention 2007 http://www.metalseconomics.com/intelligence_special_reports.html

³ See AMEC http://www1.amec.org.au/pages/policies_taxation.asp

⁴ ABS 8412.0 Mineral and Petroleum Exploration, Australia, March 2007 Table 2 Mineral Exploration (Other than for petroleum)

There are other special factors that argue for a measure of assistance to the exploration sector, including its contribution to regional development, the significance of regional development to indigenous communities and the fact that native title and heritage issues impose a particular burden on junior exploration companies.

A research report by the Australian Bureau of Agricultural and Resource Economics (ABARE) in 2003 noted that that Australia had around 400 junior exploration companies, of who 70% have a market capitalisation of under \$10 million. Despite their small size, ABARE found that these companies were responsible for around 30% of Australia's exploration expenditure and around fifty percent of gold and base metal discoveries⁵.

→ **What are the benefits?**

A Flow-Through Share scheme, similar to the scheme operating in Canada, would enable the transfer of tax deductions of individual exploration companies to individual investors. The tax losses involved are not large, but the initiative would effectively address the "crowding out" effects of Government policies and programs designed to assist aspects of the small venture capital market, unsuited to junior explorers. Estimates prepared to date suggest such a scheme would cost \$250 million over four years⁵. However, similar arrangements in Canada are credited with a substantial boost to minerals exploration in Canada.

Data from the Australian Stock Exchange (ASX) clearly indicates that IPOs (Initial Public Offerings) and secondary raisings of capital of mining companies are increasingly migrating to Canada⁶. Since Canada introduced a Flow-Through Share scheme there has been an exponential growth in Canada's equity financing, and it has become the world's leading market for raising equity capital for mining. Once this critical mass develops, the ASX suggests it results in an 'un-level playing field' between Canada's capital market and Australia's. Consequently, buyers and sellers flock to the market which offers greater scale, higher liquidity and lower cost of capital; and the whole process is a self-reinforcing cycle. Once entrenched it is very difficult to reverse.

→ **Are Flow-Through Shares a bit left-field?**

The Canadians introduced a scheme in 2000, and based on the success of stimulating exploration investment, renewed the scheme in 2006. The original proposal for Australia was suggested by the House of Representatives (Prosser) Inquiry in September 2003⁷. The subsequent development of the Minerals Exploration Action Agenda as a joint industry-Government initiative also recognized the benefits of the scheme July 2004⁸. The Australian Stock Exchange has publicly endorsed the proposal⁹. QRC understands that a proposal to introduce Flow-Through Shares was (unsuccessfully) considered as part of the 2006/07 Federal Budget.

Flow-Through Shares are an effective policy instrument which is broadly supported across Australia's financial and exploration sectors. The cost of the scheme is contained and provides targeted benefits to redress a market failure specific to junior exploration companies.

→ **For more information**

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⁵ ABARE research report - *Tax incentive options for junior exploration companies*

<http://abareonlineshop.com/product.asp?prodid=12498>

⁶ MCA Pre-Budget Submission – page 27 http://www.minerals.org.au/data/assets/pdf_file/18816/FINAL_Pre-Budget_sub.pdf

⁷ See Minerals Council of Australia Press release

http://www.minerals.org.au/corporate/whats_new/decisive_action_required_to_boost_exploration_investment

⁸ Department of Industry <http://www.industry.gov.au/content/itinternet/cmscontent.cfm?objectID=D7C1D25A-65BF-4956-BA9CF3F4C477D200>

⁹ ASX 2005 Speech http://www.asx.com.au/about/pdf/asx_speech_exploration_mining_oct05.pdf