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19 December 2006

Science and Innovation Study
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Sir/Madam

Cochlear Limited Submission – Public Support for Science and Innovation Productivity Commission Issues Paper

We are writing to you concerning the draft Productivity Commission Report released on 2nd November 2006 and specifically the draft finding 9 relating to the Research & Development (R&D) Tax Concession in the report.

Cochlear acknowledges the intent of the paper is to enhance productivity of R&D, but we have concerns regarding certain aspects of the paper.

In particular, Cochlear is concerned at the Commission's recommendation in relation to the base 125% R&D tax concession.

Abolition of the base 125% R&D tax concession would, in our view be a backward step and would have a deleterious influence on our ongoing R&D investment in Australia. Accordingly, Cochlear strongly recommends that the Commission rescinds its recommendation to abolish the base 125% R&D tax concession.

Basis of Cochlear's Response to the Paper

1. Long term nature of R&D

Cochlear Limited has a long history in carrying out high-tech cutting edge research in Australia. Our research projects are not merely so-called "new-to-Business" product development, but are often regarded as "new-to-the-world".

These projects commonly have a long development life cycle (often the process is in excess of ten years). Cochlear's experience is that spending patterns do not always show linear growth year on year as your report suggests. Therefore, an incremental approach of tax concession does not always fit within our R&D framework in practice. For example, expenditure may actually reduce in a period when analysis of initial results occurs and then ramp up again. In these periods, no concession would be available.

Certainty of funding over these extended periods is critical to the success of a long term project. A threat to this funding can result in reduced spending on projects as was Cochlear's experience when the concession was reduced to 125% from 150%.

2. ***Breakthrough technology is risky: Government partnership***

Cochlear has created a new industry over the last 20 years and nowadays, cochlear implantation is performed in over one thousand clinics globally. There is no comparable industry and so all research is by definition world-first rather than incremental.

Cochlear relies on the government for support in offsetting some risk through the provision of the base 125% R&D concession. The government's support has enabled peripheral, higher risk projects to be tackled. These projects have in Cochlear's experience, had the highest returns, but there have by definition been failures along the way. Government support is critical to the continuation of these projects.

The benefits from the commercial exploitation of our high risk R&D projects are clear. They have significantly contributed to increased revenue and profitability and improved our product and processes. As a result, additional tax revenue has been generated from both federal and state governments and the flow-on impact of the additional investment into the Australian economy has been significant.

Cochlear has accessed the R&D tax concession since its inception and it forms an integral part of our ongoing business operations in assisting us to embark on projects where the inherent risks would have otherwise precluded the sanctioning of the project.

3. ***Power of science to our economy and the general community are often underestimated.***

As detailed previously the R&D tax concession has been pivotal in enabling Cochlear to develop significant capabilities in Australia to invent and produce a world-class product.

Given Cochlear's understanding of the government's strong endorsement of the R&D tax concession in its "Backing Australia's Ability: Building our Future Through Science and Innovation" packages, Cochlear has been encouraged to continue investing in R&D in Australia. The location of our manufacturing facility which employs over 500 people in Australia has been strongly motivated by co-locating the R&D staff with manufacturing to assist with the transfer of technology to commercial process. There is therefore a broader implication to encouraging R&D activity to remain in Australia.

4. Creating a culture of R&D

A critical element in encouraging R&D in Australia is to have a culture which supports risk taking in research programmes. The removal of the 125% R&D tax concession would have a detrimental impact on the research culture in Australia as it would further limit the ability of organisations to engage in the higher risk peripheral projects. It would also send a strong negative signal to researchers on the Australian government's commitment to R&D.

Cochlear's experience when the 150% R&D tax concession was reduced was that it was the peripheral projects that were lost, together with a setback to the culture that encouraged thought and ambition in these areas.

5. Retention of Australian research skills

As a corollary to the above point, a key element to retaining Australian research is to maintain a vibrant environment in which Australian educated researchers can be motivated and developed.

Cochlear and other innovative companies play a critical role both in employment and providing development opportunities for these researchers. The abolition of government partnering through the removal of the 125% R&D tax concession in this area would have a negative impact on our ability to continue expanding this aspect.

6. Difficulties of tying R&D expenditure to sales revenue

On a practical matter, Cochlear is alarmed at the suggestion in the paper that R&D spend to sales revenue be reviewed as a potential criteria for eligibility for the R&D tax concession.

The real market for most innovative products is not Australia, but export. By nature, these revenues are in foreign exchange. The USD/AUD FX rate can move up to 20% in a year – other currencies also fluctuate considerably. This results in significant movements in AUD reported revenue while the R&D expenditure is (hopefully) locally based and in AUD. The link is therefore inappropriate.

At Cochlear, 97% of revenue is denominated in foreign currency while 75% of our research expenditure is in local AUD.

A more effective measurement of R&D growth is the real increase in R&D expenditure.

7. *International competition*

Cochlear is aware of countries, including the UK and some in the Asia Pacific region, proactively increasing their R&D incentives in recent years.

Due to the global presence of our company, we are constantly being invited to join R&D projects closer to our customer locations overseas.

The R&D tax concession has been a key factor for retaining R&D in Australia. Any weakening of these arrangements, for example by eliminating the 125% R&D tax element, would not be helpful to further decisions to invest in Australian R&D.

Please do not hesitate to contact me if you wish to discuss any of these points further.

Yours sincerely

N Mitchell

NEVILLE MITCHELL
Chief Financial Officer &
Company Secretary

COCHLEAR LIMITED

PROFILE

- Top 100 ASX listed medical device company focusing on research, development, manufacturing and distribution of implantable hearing devices including cochlear implants and Baha.
- International market leader with approximately 65 – 70% global market share in cochlear implants.
- Total sales revenue in financial year 2005/2006 of AUD 452 million with over 97% of sales revenue being in foreign currency.
- Over AUD 56 million spent on R&D in financial year 2005/2006 with nearly AUD 42 million (75% of spending) spend in Australia.
- Cochlear Limited employs more than 1,400 employees worldwide, of which more than 900 are based in Australia.
- Cochlear Limited employs more than 200 scientists and engineers engaged in R&D in Australia.