ASSOCIATION OF MINING AND EXPLORATION COMPANIES

SUBMISSION TO THE POLICY TRANSITION GROUP:

- THE PROPOSED MINERALS RESOURCE RENT TAX and EXPLORATION DEVELOPMENT OPTIONS

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28 October 2010

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EXECUTIVE SUMMARY

The Association of Mining and Exploration Companies (AMEC) is the peak national representative body for mid tier / emerging and junior exploration companies throughout Australia.

For a number of important and significant reasons AMEC and its members publicly opposed the proposed Resources Super Profits Tax, and has also subsequently publicly opposed the amended proposed Minerals Resource Rent Tax (MRRT) announced by the Gillard Government on 2nd July 2010.

Despite our opposition to this proposed extra and discriminatory tax on mining, AMEC is genuinely and constructively engaging with the Government`s Policy Transition Group (PTG) and has accordingly presented a number of key observations and recommendations in response to PTG`s Issues Paper released on 1st October 2010. In doing so, however, AMEC remains opposed and extremely concerned with the possibility that the MRRT could be extended at a later date to commodities other than iron ore and coal. To avoid such an occurrence the parameters of the MRRT should be enshrined in legislation.

We have highlighted the fact that the Government`s intention of applying the MRRT homogenously across the board fails to recognise that the iron ore, and the coal sectors, are not homogenous; and that the proposed MRRT impost will have very different impacts between the major integrated producers; and mid tier / emerging producers.

In fact, the mid tier / emerging producers (which constitute the bulk of AMEC`s membership), will experience significant domestic and international competitive disadvantages against larger Australian based multi-national and multi-commodity integrated producers as a consequence of the introduction of a MRRT.

Major companies, which have locked in and largely delineated the vast majority of the Australian current iron ore resources, will have a significant advantage relative to mid tier and emerging producers in that the market value of their resources is so large as to provide them with significant MRRT tax shields. In addition they have the capacity to transfer undeducted MRRT losses from one project against MRRT liability incurred in other projects in their portfolios.

These same mid tier / emerging producers will also experience competitive neutrality implications as they are disadvantaged by a number of general and MRRT related factors that affect the overall '*per unit cost of production*' and return on investment, such as:

- Lower capacity to attract exploration and development capital,
- Higher project / entity risk profile with the result that the cost of capital is far higher,
- Lower economies of scale,
- Inability to fund or access dedicated transport and port infrastructure,
- Often single project and single commodity companies that cannot share common infrastructure among a number of projects as major integrated companies do,
- Emerging producers are exposed to double taxation if there are changes to state and territory royalties, whereas some larger developments conducted under the protective umbrella of State Agreement Acts may not be,
- Significant administration and compliance imposts for all iron ore and coal projects in Australia even for projects / entities that do not exceed the proposed $50m resource profit threshold,
- Provide more restricted career paths and find it harder and more expensive to attract and retain quality key professional personnel, and
- Uncertainty over the implementation and application of the MRRT has a disproportionate impact on those companies whose growth plans cannot be met by existing cashflows (ie all industry participants other than a few large multi-national global mining companies).

These mid tier and emerging producers have therefore become, and will continue to be collateral damage as a direct consequence of the proposed MRRT.

In order to minimize this damage AMEC considers that there are a number of major recommendations that should be implemented by the PTG, namely:

1. Increase the proposed $50 million resource profit threshold to $250 million, tax free to the minimum profit threshold, and indexed on an annual basis (Recommendations 19 to 22),
2. Implement a phased introduction of the MRRT for small companies and emerging developments (Recommendation 25),
3. Increase the uplift rate of LTBR + 7% to reflect the true cost of capital faced by industry (Recommendation 7),
4. Provide flexible valuation methodologies to reflect the varying production and operating processes within the industry (Recommendation 5),
5. Ensure that a full credit is allowed for all State and Territory royalty payments actually incurred (including those post 2nd May 2010) (Recommendation 16), and
6. Capital expenditure incurred between 2nd May 2010 and 30th June 2012 should be immediately deductible for the purpose of assessing future MRRT liabilities (Recommendation 17).

POLICIES TO PROMOTE EXPLORATION EXPENDITURE

AMEC is of the strong view that the Government should urgently implement appropriate initiatives to address market failure that has lead to declining discovery rates in Australia and ensure a level playing field for the after tax cost of exploration between those companies with revenue and those without. While correcting this imbalance, there is also an opportunity to implement policies that attract investment into Australia and to promote much needed greenfields exploration. A national exploration development program will also help address the recent damage caused to Australia`s reputation as a mining investment destination.

As previously noted by Treasury, the current treatment of tax losses puts small exploration companies at a competitive disadvantage relative to larger, more diversified companies and to business investments in other sectors.

In this regard, and subject to clarification of various design features of the model, AMEC has recommended adoption of an Exploration Tax Credit.

The issue of the declining mineral discovery rate and declining share of global exploration expenditure in Australia as well as the market failure in the exploration sector was recognised by the government that lead to its 2007 election policy position to introduce “Flow Through Shares”. This policy position was correct in 2007 and is more so today.

Moreover, AMEC considers that the recommendation should be funded from consolidated revenue and not tied to the MRRT reform process. In view of the significant wealth creation and revenue generating opportunities that the minerals exploration sector can provide, AMEC considers that it is in the **national interest** to promote future exploration activities throughout Australia.

AMEC continues to be of the view that a healthy and developing mining and exploration sector provides significant economic and social benefits to the Australian economy, communities and families, and therefore should be encouraged and promoted.

AMEC considers that the proposed MRRT does not encourage investment or development, and has directly affected and damaged Australia`s sovereign risk and reputation as a safe place in which to invest.

Over the last 6 months, 57% of funds raised in Australia for exploration are now directed overseas. This is a growing trend where the greater percentage of funds raised in Australia is diverted overseas. This does not just result in Australia`s capital being diverted overseas but also Australia`s human and intellectual capital being employed to expand the resource industries in other countries in competition and at the expense of Australia`s future industry. In the month of September 2010, over 85% of capital raised for exploration on the ASX was raised for projects outside Australia.

AMEC proposes that a broad policy framework that seeks to grow the resources industry in Australia (and the future taxation base) should be employed. This framework should seek to restore Australia`s reputation as a mining and exploration investment destination and ensure that Australia has policies in place such that the alarming trend of Australian exploration financial and human capital heading overseas can be turned around.

This should involve a combination of:

1. Increased investment in the acquisition of pre competitive data through Geoscience Australia and other state / territory bodies,
2. Investment in innovation and risk taking in exploration (including broadening R&D tax incentives),
3. Significant improvements in land access in Australia for exploration (reduced cost and time),
4. Introduction of an Exploration Tax Credit, and
5. Removal of the MRRT.

These initiatives will have the result of stimulating investment and bringing forward and increasing the level of income tax, royalties and the myriad of other taxes and charges raised by respective Federal, State and Territory Governments.

Thank you for the opportunity of providing comment on the Issues Paper.

RECOMMENDATIONS

1. The definition of 'project' for the purpose of MRRT should include within its boundaries all related exploration and mining tenements for which the owner(s) have applied for and been granted aggregation into single-project status by the relevant minister under the applicable mining act for the purpose of consolidating statutory expenditure and technical reporting commitments. Following possible mining development a project may come to include one or more mining authority/production unit on which state royalties will be levied.

2. Progressive agglomeration of various exploration and mining tenements into a single project, while subject to approval and certification by relevant state governments, should be at the request and discretion of the owner(s) of the tenements in question.

3. In essence the current mining-act-based approach to the definition of what constitutes a project has been working well for both government and industry in the past and AMEC sees no reason why it should be changed.

4. AMEC is in general agreement with placing the taxing point of iron ore at the crude, crushed and screened ore stage of the value chain. In the case of underground coal gasification projects the taxing point should be the production well head, and coal to liquids operations the taxing point should be the run of mine stock pile (ROM pad) at the conventional coal mine.

5. The value of the resource at the taxing point should be derived from the actual price of the first derivative product sold at-arms-length using either of the following two methods:

    - A "safe harbour" approach involving use of the residual price method (RPM) with the difference between the cost-plus and the net-back prices attributed, by default, 25% to activities upstream of the taxing point and 75% downstream, or

    - Taxpayers to have the option to make their MRRT returns on the basis of a different split between upstream and downstream costs, or using the net-back pricing approach.

6. Costs to be netted back should include appropriate rates of return on investments which recognise both the higher risk of junior/mid-cap and emerging producer companies and of upstream versus downstream activities.

7. In light of the Economic Regulation Authority of WA's determination of the equity risk premium for setting access charges to the TPI's Pilbara rail system of 8.0%, and in recognition that upstream activities are more risky than railing, including exploration at 15%, the Commonwealth should appoint an independent consultant to determine what an appropriate risk premium should be for the various activity components of the value chain and on this basis revise the currently proposed up-lifting rate of LTBR plus 7%.

8. The concept of "exploration and prospecting" for MRRT purposes should be the same as for subsection 40-730(4) of the *Income Tax Assessment Act 1997.*

9. In line with the proposed definition of "project" all current and historical exploration expenditures incurred prior to the decision to develop a mine both within the project boundaries and on open ground in adjoining areas of interest should be recognised and eligible for deduction.

10. Gains and losses from hedging should be included in the assessment of MRRT.

11. Recognition of the assessable revenue relating to advance sales entered into for the purpose of funding the development of a project (customer finance) should be lagged to when the relevant tonnages are actually delivered.

12. The ATO should issue clear guidelines regarding apportionment of indirect expenditures incurred by single or multiple-project iron ore and coal companies in support of their project(s).

13. Payments to Aboriginal communities within or outside the scope of native title and heritage legislation should be deductible for MRRT purposes.

14. Payments for carbon pricing should be deductible for MRRT purposes.

15. AMEC believes that no losses should be quarantined and that taxpayers should be given discretion after royalty credits as to the order in which they wish to apply other losses against profits.

16. AMEC believes that there should be full credit allowed for all State or Territory royalty payments actually incurred by a taxpayer, irrespective of whether States or Territories chose to increase their royalty rates in the future (including those post 2nd May 2010).

17. Government should be made aware of the significance of the distortions that the transitional rules regarding capital expenditure incurred between 2nd May 2010 and 30th June 2012 will generate with a view to making these expenditures immediately deductible for the purpose of assessing future MRRT liabilities.

18. MRRT losses generated by deductions attributable to the starting base should be treated as any other loss and be subject to up-lifting.

19. The minimum profit threshold should be lifted from the current $ 50 million to $ 250 million to reduce potentially significant compliance costs on the side of smaller, emerging or less profitable producers and as a benefit for a number of currently small but high-quality iron ore and coal deposits stranded for lack of access to proprietary railway networks to start initial development on a smaller scale using shared transportation facilities. This will also provide badly required working capital for development.

20. That the minimum profit threshold be based on the same measure of profit on which the MRRT is to be assessed, i.e. assessable revenue less deductible expenditure, including carried forward losses.

21. That resource profits up to the minimum profit threshold be MRRT free.

22. That the real value of the minimum profit threshold be maintained by indexing it on an annual basis.

23. That royalty credits should continue to be carried forward and up-lifted even in years when resource profits are below the minimum threshold. If necessary, in such years, the credit could be reduced by the amount of MRRT which would have been payable if the minimum profit threshold were not in force.

24. That to the degree that many projects may drift above and below the minimum threshold MRRT returns for small companies should be annual in frequency and based on 'actual' rather than 'notional' resource profits.

25. The implementation of MRRT for small companies and emerging developments should be phased in starting at a rate of 10.5 % in the first year of production and increasing by equal amounts of 2% each year to reach the full rate of 22.5% over 6 years.

26. A review similar to that conducted in 2008/09 by the Australian National Audit Office into the administration of the Petroleum Resource Rent Tax regime, should be carried out after 3 years from implementation of the MRRT to determine whether it operates in the manner in which it was intended to apply.

27. The ATO should grant a period of amnesty from interest and penalties of at least one year from the date on which the first MRRT return is due.

28. Expenditures incurred in establishing the initial stockpile should be "clawed back" and brought to account in the year in which the ore from the initial stockpile is sold.

29. Subject to clarification, the Exploration Tax Credit model should be implemented by the Federal Government as a matter of urgency, as it appears to meet all of the key strategic objectives described in Section 4.4. It should also be funded through Consolidated Revenue and not tied to the MRRT proceeds.

30. The definition of exploration expenditure should be expanded to include expenditure incurred in exploring for geothermal energy.

FORMAT OF SUBMISSION

This submission is made in response to the Issues Paper released by the Australian Government`s Policy Transition Group (PTG) released on 1st October 2010.

The submission is based upon the guidelines developed by the PTG and responds to the various issues and questions specifically raised in the Issues Paper, with relevant cross referencing of chapters and paragraph numbers where appropriate. Specific paragraph numbers from the Issues Paper have been referenced by use of the abbreviation (IP) followed by the relevant paragraph number.

The submission was drafted in consultation with AMEC members and with tax specialists from major accounting firms and other expert consultants.

1 BACKGROUND

1.1 About AMEC

The Association of Mining and Exploration Companies (AMEC) is the peak national body representing mid tier / emerging mining and junior exploration companies operating throughout Australia.

AMEC's strategic objective is to secure an environment that fosters mineral exploration and mining in Australia in an economic, socially and environmentally responsible manner.

1.2 Industry structure and operation

The general structure of the resources industry is similar in Australia and around the globe.
In Australia it is made up of approximately 2,500 companies[1] (listed and unlisted); comprising:

- A handful of major conglomerates that dominate market share;
- A relatively small number of mid-tier and emerging miners in the middle; and
- Thousands of junior exploration companies at the other end, representing a significant proportion (in numbers) of the industry.

By virtue of the nature of their business operations exploration companies do not pay Federal taxation or State / Territory based royalties until such time as they have:

- ✓ discovered an economically viable deposit;
- ✓ subsequently constructed a mine;
- ✓ commenced production;
- ✓ sold their product and
- ✓ earned income and generated a profit.

During this long gestation period, eligible exploration expenditure is carried forward in the losses incurred and only become available for income tax deductibility when assessable income is received.

It is not unusual for this "exploration to production" cycle to cover a timeframe of 7/10 years, subject to the size of the deposit; nature and complexity of the mine; extent and complexity of land access (including significant time and resources devoted to cultural heritage, native title and environmental protection and biodiversity conservation issues); approval and licensing barriers that are encountered during the whole process.

In addition, the rate of discovery is low, to such an extent that the "*probability of finding an economic deposit on any piece of ground is 1/100, whereas one that is of world class is 1/1000".*[2]

Prior to commencing exploration activities a company normally raises funding for the proposed project by way of equity financing (such as domestic or foreign investors, retail investors, superannuation funds etc). In many instances there is a mix of equity / joint ventures and, in the case of exploration success, the potential for debt financing in order to fund a project / company.

Minerals exploration is therefore considered to be a long term high risk activity, where exploration companies "*aspire*" to become successful miners after many years of activity and at significant cost – invariably many millions of dollars.

[1] Government announcement re RSPT on 2nd May 2010
[2] Gold & Minerals Gazette, August 2008 – page 4

On the rare occasion that an exploration company is able to graduate and become a mining company and start producing product for domestic and international consumption and sale, the resultant income then becomes subject to Federal income tax and State / Territory royalty processes.

1.3 Industry profile and contribution to the nation

The minerals exploration sector underpins the sustainability and growth of the mining industry, which has developed to the point that the resources industry is considered by many to be the 'engine room' of the Australian economy.

The Australian minerals industry is among the top five producers of the world`s key mineral commodities. Australia is the world`s largest exporter of black coal, iron ore, alumina, lead and zinc and the second largest exporter of uranium[3].

The importance of mining is self evident, noting that it accounts for approximately 8% of Australia`s gross domestic product (GDP) [4].

It also provides a number of other economic and social benefits, such as contributing towards:

- ✓ Approximately 50% of Australia`s exports,
- ✓ Providing jobs (approximately 160,000 in direct employment, and over 500,000 in indirect employment in hundreds of service industries),
- ✓ State / Territory and Federal Government revenue (over $21b in State/Territory and Federal taxes, including $7b in royalty payments),
- ✓ New project development,
- ✓ Rural, regional and community development,
- ✓ Public and private infrastructure (roads, railways, ports, power, accommodation),
- ✓ Education and training (including indigenous partnerships),
- ✓ Financial and other support to a large number of charitable, welfare, community and sporting organizations,
- ✓ Technology innovation,
- ✓ Research and development,
- ✓ Environmental protection and biodiversity conservation initiatives,
- ✓ Environmental research and data collection of threatened, protected and previously unidentified species of flora and fauna,
- ✓ Aboriginal cultural heritage protection, and
- ✓ Native title and cultural heritage payments to traditional owners, communities and stakeholders.

Minerals exploration and mining activities are predominantly located in regional areas throughout Australia, sometimes in very remote and harsh locations.

Although the Australian mining sector has experienced significant growth over the past 30 years, Australia still faces strong competition from other resource rich continents, such as America, Africa and Europe. However, it should be noted that most of the growth has been as a result of expanding or developing mineral discoveries made over 20 years ago.

The challenge ahead will be to ensure that Australia does not lose market share and foreign capital investment; particularly noting that there are many other competing resource rich continents in the world.

Equity capital is also known to be 'mobile' and therefore international competitiveness (combined with a stable and fair tax regime) and low sovereign risks are key investment decision determinants.

[3] Australian Parliamentary Library – The Australian Resources Sector – 23 September 2010
[4] Extracted from ABS, ABARE and DRET statistics

Competitiveness is about playing to a nation`s strengths, effectively utilizing resources, both people and natural, to maximize the returns that can be generated from those resources.[5]

As a country with a significant natural resources base (albeit a mature and declining resource base in many commodities), it is stating the obvious, but Australia is in a unique position both geologically and geographically to support the growth in Asia. [6]

This opportunity is enormous, but it is also contestable and perishable. If we do not remain competitive in supporting Asia`s growth, and continue to develop our relationship with Asian nations and businesses, then another resource rich country will take our place as has occurred in the past.[7]

[5] Australia`a competitiveness – presentation to Business Leaders dinner, by Don Argus AC 8 September 2010
[6] Ibid
[7] Ibid

2 AMEC POLICY POSITION ON THE PROPOSED MRRT REFORM MEASURES

2.1 Underpinning principles

AMEC considers that a stable public policy framework and fiscal regime must exist in the Australian economy in order to enhance the investment and decision making processes in the mining and minerals exploration industry.

In this regard, AMEC considers that there are also a number of underpinning principles that are essential components of an appropriate tax reform model, and has considered each principle in determining its position on the overall MRRT reform measures.

At the conclusion of that analysis, **AMEC continues to oppose the introduction of the proposed MRRT, on the following basis**:

A. International competitiveness

Recognising that capital is mobile and that Australia does not have a monopoly on mineral resources, it is essential that Australia has a stable, reliable, simple and competitive taxation framework to be a preferred investment destination ie the effective tax rate needs to be competitive.

(The Effective Tax Rate (ETR) for most iron ore companies is estimated to be 46%, and coal is estimated to be 43%[8].

These rates are considered to be at the 'top end' when compared to international competitors, with the ETR for iron ore in Canada (Quebec) being 40.2%, Brazil 37.8%, China 31.1%[9].

The ETR for coal in China is 25.9%, Canada (Ontario) 34.3%, Canada (Alberta) 37.4%, South Africa 43.7%[10].

The proposed MRRT has also created extreme confusion and uncertainty in overseas investment, capital markets and decision making processes, with the combined result that Australia`s international competitiveness and sovereign risk have been detrimentally affecte).

B. Competitive neutrality

The minerals sector comprises a large number of commodities, each of which has different economic, investment, production, cost, market, risk and competition characteristics.
It is imperative that these factors are considered when assessing competitive neutrality. In fact Section 2.2 of this submission highlights a number of significant factors which have competitive neutrality implications for mid tier and emerging mining companies by directly affecting their overall '*per unit cost of production*'.

(This issue is of critical importance to AMEC members and does not appear to have been considered in the Issues Paper).

C. Fairness and equity

In accordance with the Australian Constitution minerals resources are owned by the respective States / Territories, and therefore various royalty regimes have been established for payments to be made to respective State / Territory governments to compensate the community for the extraction of a non-renewable resource.

[8] KPMG Tax Reform in the Minerals Sector
[9] Ibid
[10] Ibid

(Prior to the introduction of the proposed MRRT, the mining industry already pays an effective rate of tax (including income tax <u>and</u> royalties) in the range of 34% to 50% (subject to the commodity type); whereas an average Australian company in other sectors only pays an effective rate of tax of 30%.

Disregarding the many significant and existing social and community benefits provided by industry, mining companies therefore <u>already pay</u> a real financial "premium" in excess of the average company tax rate of between 4% and 20%. The current royalty regime is considered appropriate, and provides a 'fair return' to the community for the extraction of a non-renewable resource.

The current royalty regime is considered appropriate, and provides a 'fair return' to the community for the extraction of a non-renewable resource. The iron ore and coal industries should not be discriminated against with an additional and unfair tax).

D. <u>Prospective application</u>

Investment and business case decisions are made on the basis of long term 'whole life of the exploration and mining project cycle' and therefore any tax reform program should have 'prospective application'. Investors / owners should not be taxed retrospectively on their investments.

(The proposed MRRT has prospective application).

E. <u>Valued at the point of mineral extraction</u>

Application of a tax or a royalty should be at the point of the extraction of the mineral and not on 'value added' components such as processing, transport, infrastructure, marketing.

(This important principle is being addressed in Chapter 5 of the Issues Paper).

F. <u>Efficient, simple to administer and ensures compliance</u>

A tax regime should be efficient, simple to administer and compliance easily achievable. A regime that does not meet these features will encounter significant administrative difficulties and require additional resources to be applied by industry and Government for compliance purposes.

(The proposed MRRT is considered to be inefficient, extremely complex and not simple to administer. Accordingly, compliance will be a significant issue for industry and Government with the result that there will be high administrative, compliance and resource imposts on all parties. The industry participants will need to obtain urgent advice / decisions / Taxation Rulings prior to investment and business decisions being made. The workload on industry and government will become enormous, noting the complexity of the proposed MRRT, and the general lack of available expertise to deal with queries and issues of concern. It is understood that the PTG (Perth, 7th October 2010) already acknowledges the significant administration and compliance difficulties created by the MRRT).

2.2 One size does not fit all / points of difference

It is relevant to highlight some significant key points of difference (*between large multi-national and multi-commodity Australian based companies; and mid tier / emerging Australian mining companies*) that further impacts on individual Effective Tax Rates, competitive neutrality, and that clearly "one size does not fit all" companies.

The Government`s intention of applying the MRRT homogenously across the board fails to recognise that the iron ore, and the coal sectors, are not homogenous; and that the proposed MRRT impost will have very different impacts between the major integrated producers; and mid tier / emerging producers.

In fact, the mid tier / emerging producers (which constitute the bulk of AMEC`s membership), will experience additional significant domestic and international competitive disadvantages against larger Australian based multi-national and multi-commodity integrated producers as a consequence of the introduction of a MRRT.

Major companies, which have locked in and largely delineated the vast majority of the Australian iron ore resources, will have a significant advantage relative to mid tier and emerging producers in that the market value of their resources is so large as to provide them with significant MRRT tax shields. In addition they have the capacity to transfer undeducted MRRT losses from one project against MRRT liability incurred in other projects in their portfolios.

These same mid tier / emerging producers will also experience competitive neutrality implications as they are disadvantaged by a number of general and MRRT related factors which directly affect their overall '*per unit cost of production*', such as:

- Lower capacity to attract exploration and development capital,
- Higher project / entity risk profile with the result that the cost of capital is far higher (the use of an industry average penalises those with a higher cost of capital and provides a relative advantage to those with a lower cost of capital),
- Lower economies of scale,
- Inability to fund or access dedicated transport and port infrastructure,
- Often single project and single commodity companies that cannot share common infrastructure among a number of projects as major integrated companies do,
- Emerging producers are exposed to double taxation if there are changes to state and territory royalties, whereas larger developments conducted under the protective umbrella of State Agreement Acts may not be,
- Significant administration and compliance impost even for projects / entities that do not exceed the proposed $50m resource profit threshold,
- Provide more restricted career paths and find it harder and more expensive to attract and retain quality key professional personnel, and
- Uncertainty over the implementation and application of the MRRT has a disproportionate impact on those companies whose growth plans cannot be met by existing cashflows (ie all industry participants other than a few large multi- national global mining companies).

These mid tier and emerging producers have therefore become, and will continue to be collateral damage as a direct consequence of the proposed MRRT.

Mid cap and emerging mining, and junior exploration companies have also been significantly affected as a result of the uncertainty surrounding the specific and complex design features and definitions, and still do not have a clear understanding of the proposed MRRT, particularly noting that they were excluded from the detailed discussions and underlying assumptions in late June 2010 that resulted in the 'Heads of Agreement' with the 3 large mining companies.

This has in turn significantly and detrimentally affected investment and business decision making processes to the point that many companies are understood to be having difficulty in raising equity finance in which to fund their existing or proposed new projects.

3 RESPONSE TO TECHNICAL DESIGN OF THE MRRT

3.1 Issues Paper Chapter 4 Definition of a project subject to MRRT

Issues Paper Section 4.1 Defining the boundaries of a project

Question 4.1: Which principles should determine how a project is defined?

In the context of mining a 'project' is born with the granting of the first exploration tenement. The boundary of a project then continues to expand or reduce as subsequent mining tenements are added to or deleted from it or reduced in size at the request of the project owner and subject to ministerial approval, to consolidate the statutory exploration expenditure commitments and technical reporting requirements under the relevant mining act, as for instance under Section 115 A (4) of the *Mining Act 1978* of Western Australia. The ground for grouping of adjacent or closely related mineral exploration and mining tenements into a single project is on the basis of common geological characteristics and mineral exploration/mining objectives. Following the discovery of potentially economic mineralisation some of the exploration titles are converted to mining leases which following the start of production become the 'mining authorities or production unit' from which states / territory royalties are levied. This definition of what constitutes a project and related administrative systems have been working well from the point of view of both industry and government and for this reason AMEC favours its retention for the purpose of the MRRT.

The proposed definition is largely consistent with the aggregating considerations in IP 72 and 83 to 85 of the PTG's Issues Paper and provides a high degree of clarity as it concerns assessable revenue and deductible expenditure, the starting base, carried losses and royalty offsets as discussed in IP 74.

Requests for consolidation would still be initiated by the project owners subject to ministerial approval and there would be no need for intervention on the side of either the Minister for Resources and Energy or the Commissioner of Taxation as suggested in IP 73.
To the extent that the proposal combines all states / territory production licences within a project it is in some ways consistent with the first dot point in IP 75 and 76.

The notion of defining projects on the basis of the related environmental approval processes is considered impractical and generally undesirable for many of the reasons discussed in Section 4.1.2 (IP 75 to 81) of the Issues Paper.

The proposed definition of 'project' is largely consistent with that adopted for the purpose of Section 40-830 of the *Income Tax Assessment Act, 1997*, which requires that project activities be undertaken for the purpose of generating taxable income and that they must have a limited and specified life for the related assets to qualify as 'pooled project assets' thus benefiting from highly accelerated depreciation rules.

AMEC`s preferred definition is better tailored to mining projects and it includes all relevant exploration and mining tenements, rather than being limited exclusively to eligible production licences as in Section 19 of the *Petroleum Resource Rent Tax Assessment Act, 1987* , which suites off-shore petroleum projects but does not accommodate well on-shore mining.

The proposed approach would simplify recording and reporting processes, eliminate some duplications and facilitate compliance thus reducing administrative costs.

Issues Paper Section 4.2, Defining the beginning and end of a project

Question 4.2: When should a project commence, and how should this interact with the deductibility of exploration expenditure?
Question 4.3: When should a project cease, and how should this interact with the existence of prior year losses and the deductibility of closing down and rehabilitation expenditure?

As previously detailed AMEC considers that a project formally starts with the granting of the first exploration title. In this context we put forward the position that all relevant exploration expenditures incurred both within the leases and in adjacent related open ground (often referred to as the project area of influence in joint venture agreements) preceding the discovery and development of the mineralisation should fall within the MRRT. This approach is consistent with the intent of IP 89 and with the second dot point in IP 91.

AMEC refutes the assertion in IP 90 that it would be "difficult to separate past successful and unsuccessful exploration expenditure ……. from that for other minerals" given the multi-commodity nature of exploration licenses, as exploration for iron ore for example, has very specific characteristics which make it clearly identifiable. Verification by the ATO would be a simple matter of referring to the statutory annual technical and financial reports submitted by explorers to the relevant mines department in compliance with the relevant mining acts.

AMEC`s position is contrary to IP 88 and IP 92 which seek to formally commence a project at the time of issuance of a production licence or of a final investment decision.

Closing-down expenditure is an integral part of mining and as such there should be no issue relating to its eligibility. AMEC is pleased by the fact that during recent consultations (7th October 2010) with the PTG, it was given assurance in line with the third dot point in IP 94 that closing down costs will be deductible in the year in which they are incurred and that if there is no assessable resource profit in that year a credit will be applied against MRRT already paid in previous years.

Recommendations:

1. The definition of 'project' for the purpose of MRRT should include within its boundaries all related exploration and mining tenements for which the owner(s) have applied for and been granted aggregation into single-project status by the relevant minister under the applicable mining act for the purpose of consolidating statutory expenditure and technical reporting commitments. Following possible mining development a project may come to include one or more mining authority/production unit on which state royalties will be levied.
2. Progressive agglomeration of various exploration and mining tenements into a single project, while subject to approval and certification by relevant state governments, should be at the request and discretion of the owner(s) of the tenements in question.
3. In essence the current mining-act-based approach to the definition of what constitutes a project has been working well for both government and industry in the past and AMEC sees no reason why it should be changed.

3.2 Issues Paper Chapter 5 Taxable Value

Issues Paper Section 5.1 Taxing Point

Question 5.1: Is the production value chain the most appropriate way to set the taxing point in all circumstances? If so, at what point in the production process should it be set?

AMEC is in general agreement with the thrust of this section and specifically agrees with the government's intention that the 'resource profit' on which MRRT will be levied should be close to the point of extraction and

relate to the value of the mineral at the metaphorical not physical 'mine gate'. Thus only resource profits generated by upstream activities should be liable for MRRT and it is not intended that this tax should apply to value added through downstream investments and expenditures incurred in processing, transportation and port facilities.

Deeming the first saleable product in the value chain the crude iron ore after crushing and screening to a pre-processing stage, as suggested in IP 97 and 98, is generally acceptable to most AMEC members because this taxing point appears logical and unequivocally identifiable. In the case of underground coal gasification projects the taxing point should be the production well head, and coal to liquids operations the taxing point should be the run of mine stock pile (ROM pad) at the conventional coal mine.

As discussed later, a methodology, acceptable to AMEC's members, needs to be developed to derive an appropriate transfer price at the mine gate from the price of the first product(s) sold at-arms-length, most frequently that of f.o.b. sales of direct shipping ore (DSO) or magnetite concentrates.

Issues Paper Section 5.2 Valuing resource revenue

Question 5.2: What methods should be used for valuing a resource at the taxing point? Should those methods be legislated? What is the appropriate rate of return downstream of the taxing point?

The amount of crude iron ore which is actually sold at the mine gate is minimal with the bulk of the sales in fact being f.o.b. at the relevant export port. This lack of a liquid at-arms-length market, and confidentiality about relevant contract prices, means that it would be impossible to directly determine a price at the proposed taxing point. There is, therefore, a clear need to calculate a transparent, equitable, auditable and simple to administer transfer price for crude crushed and screened ores at the mine gate which relates to the price realised in the first at-arms-length sale of a derivative product to a third party.

Of the valuations methodologies listed in IP 121, the majority of AMEC's members prefers the fourth, that's to say the "residual price method" (RPM) (see IP 127) making combined use of cost-plus and net-back values.

Determination of both these values entails deduction of relevant upstream and downstream costs including an appropriate rate of return. AMEC notes the desirability for there to be safe harbour calculations for rate of return on investment (Box 5.1, p. 34). The Issues Paper does not suggest what such a rate should be other than it must reflect (Box 5.1, p. 34) "…the nature and type of risk involved at different points in the value chain…" It is an accepted fact that risk upstream, particularly in exploration and mining is much higher than downstream in processing and transportation and this should be reflected in the relevant cost of capital as discussed in detail in section 5.4. It must also be recognised that junior/mid-cap and emerging producers have a higher cost of capital and risk profile than majors.

We concur with IP127 and IP 129 about the need for an appropriate allocation of the difference between the cost-plus and the net-back prices (in effect of the economic rent generated by the project) but contend that the 50-50 split used in the context of the liquefied gas industry (IP 128) would not be appropriate for the iron ore mining industry where most of the value is added downstream of the taxing point.

AMEC suggests that a 25% - 75% for the upstream and downstream components respectively would be more appropriate for the iron ore industry and that this split should be adopted as a "default methodology" for the purpose of MRRT.

Projects which can substantiate very significant downstream transportation and processing capital investments and recurrent operating costs should be allowed by exception to submit their MRRT return using a different split based on proportional costs (which would be consistent with IP 129) rather than on profits or transactional margins (IP 130). In addition, AMEC is of the view that taxpayers should still be given the option of using the net-back pricing approach, if they wish.

The combination of the above safe harbour RPM approach with the additional flexibility would be consistent with the third dot point in IP 136. Such an approach would also assist in streamlining the administrative process and reduce compliance costs.

Issues Paper Section 5.4 Deductible expenses

Question 5.4: Are there particular expenses which should or should not be deductible under the MRRT? What practical definitions of these expenses would give certainty in the final design of the MRRT?

The MRRT design principles and IP 154 indicates that for administrative purposes the MRRT will be inspired by the provisions of the PRRT and specifically indicate that "non-deductible expenditure will be broadly consistent with PRRT".

Definition of "exploration and prospecting" - IP 159 states that "There does not appear to be a strong argument for defining exploration expenditure differently in the MRRT to the PRRT or income tax and using the same definition will reduce compliance costs".

AMEC considers that the definition of "exploration and prospecting" in subsection 40-730(4) of the Income Tax Assessment Act 1997 provides a more appropriate definition for mining companies, than that in section 37 of the Petroleum Resource Rent Tax Assessment Act 1987 which is more specific to petroleum projects.

The concept of "exploration and prospecting" in subsections 40-80 or 40-730 of the *Income Tax Assessment Act 1997* arose from the work conducted under the Tax Law Improvement Project, undertaken by Treasury and the Australian Taxation Office. In the Explanatory Memorandum to the *Income Tax Assessment Bill 1996*, being the Bill introduced into Parliament containing the first instalment of the rewritten income tax legislation, the following was stated,
"Exploration or prospecting will not be defined exhaustively but will have flexibility to take in over time comparable activities that evolve from technological and other changes.

Explanation - The existing law is inconsistent in its treatment of activities that can be regarded as exploration and prospecting. For general mining and quarrying, the term is tightly confined to certain activities and to no others. For petroleum mining, the term specifies the same kinds of activities while leaving it open for new activities to be included. In standardising this term the more flexible approach is being adopted." (Explanatory Memorandum to the *Income Tax Assessment Bill 1996*, Chapter 8)

This definition has been expressly designed to be forward looking and expansive, to apply to technological and other changes in the industry. It is considered this is more appropriate than a definition that was specifically designed for offshore petroleum projects only.
Further, the definition was specifically designed to include certain types of feasibility studies.
In the Explanatory Memorandum to the *Income Tax Assessment Bill 1996*, the following is stated, *"Exploration or prospecting will include feasibility studies into the economic viability of mining.*

Explanation - The Commissioner treats certain feasibility studies as exploration and prospecting. These are studies that evaluate the economic viability of the proposed extractive process or treatment process. Not all feasibility studies can be regarded this way. For example, feasibility studies into:

- *infrastructure costs for housing and welfare;*
- *the provision of water, light or power;*
- *the viability of facilities to transport minerals are not treated as 'exploration or prospecting' (expenditure on these activities could qualify for a deduction under another provision)"* (Explanatory Memorandum to the *Income Tax Assessment Bill 1996*, Chapter 8)

The definition is also broad in that it includes (TR 98/23) reconnaissance and regional exploration and prospecting over large areas still open for pegging before an application for any exploration or mining tenements is submitted to the relevant department of mines.
It has also been ruled (TR 98/23) that exploration may continue after a decision to mine has been taken, i.e. during the development and construction phase of a project.

Eligibility of exploration expenditures – Given the preferred definition of "project" as starting with the exploration expenditures leading to the granting of the first exploration tenement and of "exploration and prospecting" as discussed above there should be no ambiguity about the eligibility of exploration expenditures incurred both within the project boundaries and on open ground in adjoining areas of interest. Historical exploration expenditures, including but not limited to land access clearance payments prior to the granting of the first exploration title, some of which are required by law, should be recognised and eligible even though they may have been expensed in the year in which they had been incurred for income tax purposes under Section 40-730 of the *Income Tax Assessment Act 1997* by the holding corporation and therefore, no longer appear as an asset in its balance sheet. As already indicated, expenditure relating to iron ore and coal are easily identifiable and auditable.

Adequacy of the LTBR plus 7% proposed up-lifting rate -

Given the high risk of exploration and the often long pre-production periods elapsing between incurring exploration expenditure and developing a mine, the issue as to whether LTBR + 7% would be an adequate rate of up-lift for historical exploration expenditure also arises.

During the consultations of 7th October 2010 the PTG indicated that the up-lift rate of LTBR plus 7% was a weighted average between those of LTBR plus 15% and LTBR plus 5% currently applicable to exploration and general expenditure respectively under the PRRT regime.

These premia equate to uplift rates of 10.44% and 20.44% respectively, given that LTBR is currently around 5.44%.

However, the Economic Regulation Authority`s (ERA) determination of the nominal pre-tax weighted average cost of capital (WACC) for The Pilbara Infrastructure (TPI) rail networks (a subsidiary of Fortescue Metals Group) as at 30th June 2010, as required by the *Railways (Access) Code 2000* is 11.43%. The cost of equity component (Re) inherent in it assuming inflation at 2.6%, however, is 13.46%. The risk premium inherent in this discount rate is 8%. The level of risk of this operation and business (rating BBB-) is significantly lower than that of processing, mining and exploration in this order. In this light it would be realistic to expect that an appropriately higher risk premium should apply to processing, mining and exploration in this order leading to reasonable nominal costs of equity ranging between 13.5% and 15%.

There is no doubt that the proposed all-encompassing up-lift rate of LTBR plus 7% as proposed for the MRRT is clearly inadequate.

On this basis, given that a risk premium of 15%, ie a current rate of 20.44%, is considered appropriate by the Commonwealth for petroleum exploration, there is ample justification for the Commonwealth to engage an independent consultant to determine what an appropriate cost of equity should be for the various activity components of the mining to port value chain. It is AMEC's expectation that the risk premium for processing and mining will prove higher than that for railing (8.0 %) probably by several percentages. As a consequence the uplifting rate for general expenditure should be of the order of LTBR plus a minimum of 8% or more. This rate (currently 13.44% or more) would then be weighted in with that for exploration (currently 20.44%) in determining an appropriate weighted average uplift rate for application in the MRRT context. This is expected to be well above LTBR plus 7%.

Hedging gains and losses - IP 166 to 168 debate to whether gains and losses from hedging could be excluded from the MRRT or whether both should be included. IP 168 concludes with the statement: *"Where a sale*

would occur regardless of whether the expenditure relating to the hedging arrangement had been incurred, the expenditure or loss could not be said to relate to a particular sale".

AMEC considers that gains and losses from hedging should be included in MRRT and that the concluding statement in paragraph 168 is needlessly restrictive.
Under Australian Accounting Standards AASB *Financial Instruments: Measurement and Recognition*, paragraph 88(a) requires all hedges that qualify for hedge accounting to document the hedge relationship and the entity's risk management objective and strategy for undertaking the hedge. It is necessary for the following to be identified; the hedge instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedge instrument's effectiveness in offsetting the exposure.

This thorough documentation has been effectively incorporated into the *Income Tax Assessment Act 1997* under the taxation of financial arrangement rules, at section 230-355 of the *Income Tax Assessment Act 1997.*

AMEC considers that this documentation can be used to identify whether the hedge relates to sales or not.

It is uncommon for hedges to be structured on the basis that sales cannot occur unless the hedge is in place. It is usual for hedges to be structured to close out early should entities so require.

Issues Paper Section 5.4.5 Excluded expenditures

IP 181 summarises the type of expenditures which are currently ineligible under the PRRT regime and should also apply to the MRRT. These include financing costs, payments to acquire an interest in a mining license, payments of indirect administrative or accounting costs and payments of private override royalties. These exclusions create in AMEC's view significant problems in the following areas:

- **Project funding by advance sale contracts** - A financing issue, requiring clarification is the treatment of advance sale contracts entered into for the purpose of funding a mine development. It would be considered unfair if this type of consumer finance were to engender assessment of an MRRT liability in years preceding the start of production when the project cash flows are negative. It would appear fair for recognition of the assessable revenue relating to these advance sales to be lagged to when the relevant tonnages are actually delivered.
- **Indirect expenditure** – For companies with single or multiple Australian iron ore and coal projects, a majority of head office costs relate to support of the project(s) and should be attributable to the project(s) and be deductible for MRRT purposes (IP 191). AMEC identifies a need for clear guidelines regarding apportionment of indirect expenditures as otherwise there will be considerable uncertainty as to deductibility of this type of expenditure.
- **Payments to Aboriginal communities** – IP 202 to 209 deal with the circumstances in which native title and heritage related costs may be deductible for MRRT.
  AMEC considers that all native title and heritage related costs should be deductible for MRRT purposes.
- **Payments for carbon pricing –** payments for carbon pricing should be deductible expenses.

In C*ape Flattery Silica Mines Pty Limited v. F.C. of T.* 97 ATC 4,552 the Federal Court confirmed in the circumstances of that case, the compensation payments made to an indigenous council were not in compensation for damages but rather were payments in the nature of rent, being compensation payments for the deprivation of possession of land. Further, a bursary paid to the council was held to be a deductible business expenses. Lastly, the legal fees paid by the taxpayer for negotiations with the council and for the application for renewal of the mining lease were equally deductible.

In one sense it could be said in line with IP 203 that all of the costs were connected to accessing the land to enable production.

It should also be noted that Aboriginal communities are not the legal owners of the resources and therefore payments to them cannot be construed as override royalties or rent-sharing mechanisms. The argument that if

they were they should not be deductible because the Aboriginal communities will not be liable for MRRT (PI 204) is fallacious. The fact that Aboriginal communities are exempt from income tax does not imply that they should also be free of any MRRT liability.

Not allowing mining companies to deduct these payments amounts to an economically inefficient tax being imposed on a true cost of production which is contrary to the principles of the MRRT.

In the meantime, AMEC is aware that the Federal Government is currently undertaking a review of the tax treatment of native title payments and will be making a separate submission to that specific review.
For all these reasons, AMEC recommends that all native title and heritage related costs should be treated as deductible for MRRT purposes.

Recommendations:

4. AMEC is in general agreement with placing the taxing point of iron ore at the crude, crushed and screened ore stage of the value chain. In the case of underground coal gasification projects the taxing point should be the production well head, and coal to liquids operations the taxing point should be the run of mine stock pile (ROM pad) at the conventional coal mine.
5. The value of the resource at the taxing point should be derived from the actual price of the first derivative product sold at-arms-length using either of the following two methods:

- A "safe harbour" approach involving use of the residual price method (RPM) with the difference between the cost-plus and the net-back prices attributed, by default, 25% to activities upstream of the taxing point and 75% downstream, or
- Taxpayers to have the option to make their MRRT returns on the basis of a different split between upstream and downstream costs, or using the net-back pricing approach.

6. Costs to be netted back should include appropriate rates of return on investments which recognise both the higher risk of junior/mid-cap and emerging producer companies and of upstream versus downstream activities.
7. In light of the Economic Regulation Authority of WA's determination of the equity risk premium for setting access charges to the TPI's Pilbara rail system of 8.0%, and in recognition that upstream activities are more risky than railing, including exploration at 15%, the Commonwealth should appoint an independent consultant to determine what an appropriate risk premium should be for the various activity components of the value chain and on this basis revise the currently proposed up-lifting rate of LTBR plus 7%.
8. The concept of "exploration and prospecting" for MRRT purposes should be the same as for subsection 40-730(4) of the *Income Tax Assessment Act 1997.*
9. In line with the proposed definition of "project" all current and historical exploration expenditures incurred prior to the decision to develop a mine both within the project boundaries and on open ground in adjoining areas of interest should be recognised and eligible for deduction.
10. Gains and losses from hedging should be included in the assessment of MRRT.
11. Recognition of the assessable revenue relating to advance sales entered into for the purpose of funding the development of a project (customer finance) should be lagged to when the relevant tonnages are actually delivered.
12. The ATO should issue clear guidelines regarding apportionment of indirect expenditures incurred by single or multiple-project iron ore and coal companies in support of their project(s).
13. Payments to Aboriginal communities within or outside the scope of native title and heritage legislation should be deductible for MRRT purposes.
14. Payments for carbon pricing should be deductible for MRRT purposes.

3.3 Issues Paper Chapter 6 Treatment of Losses and Royalties

Issues Paper Section 6.5 Deduction (loss) ordering rules

Question 6.1: Should losses be transferrable beyond the entity owning a project? If so, is there a case for extending transferability beyond a wholly owned group?
Question 6.2: Should MRRT losses be required to be transferred or should this be at the choice of the taxpayer? If the latter, what is the supporting rationale given the arguments in favour of requiring transfer?
Question 6.3: Are there circumstances where transferability of losses from an acquired project should be allowed?
Question 6.4: How should deduction (loss) ordering rules be applied to give effect to the quarantining of some types of deduction and non-refundability of losses?

AMEC concurs with IP 214 which makes the case for allowing transfer of MRRT losses from an entity to offset MRRT profits of a related, not necessarily fully-owned entity, because this would be in line with corporate income tax practices and would avoid any bias that might otherwise arise concerning the choice of corporate structure.

AMEC does not agree with the notion presented in IP 222 that losses that are attached to a project interest should not be transferrable in the hands of the acquiring entity and that they should be quarantined. The reason is that this would represent a disincentive to acquire and revitalise projects that may have been unsuccessful under the previous ownership but that may have the potential to make future significant economic contributions. The other reason is the inconsistency between the proposed approach and the transferability of losses under the Income Tax Assessment Act.

IP 226 states that "*…existence of quarantined and transferable losses means that there will need to be a defined order in which deduction and losses are applied against profits."*

AMEC does not agree with the notion of quarantining losses and of giving priority to transferable losses as it may mean that quarantined losses may never be recovered and recommends that royalty credits should be deducted first after which the taxpayer should have discretion as to their ordering.

Issues Paper Section 6.6 Royalty credits

The design principles provided by the PTG on 2nd July 2010 state that *"**All** state and territory royalties will be creditable…"* but IP 229 states that *"State and Territory royalties will be creditable **at least up to the amount imposed at the time of the announcement, including scheduled increases and appropriate indexation**"*. The PTG has later clarified on 7th October 2010 that the term 'up to the amount' can be interpreted to also mean 'up to the rates of royalty' imposed.

AMEC believes that there should be a full credit allowed for any State of Territory royalty payments incurred by a taxpayer irrespective of whether states or territories chose to increase their royalty rates in the future (including those post 2nd May 2010).

This issue is beyond the control of industry and should not be penalised accordingly.
At IP14, the PTG has stated that one of its guiding principles or objectives is that the MRRT should be broadly neutral. Not allowing full credit for State and Territory royalties is distortionary and will not result in neutrality.

The fourth bullet point at IP 35 states that royalties of this nature are viewed as another way of taxing the resource, *"... and so are credited against the liability for MRRT/PRRT to avoid double taxation."*.

Not allowing a full credit will in fact lead to double taxation if states and territories increase their royalties and AMEC believes this should be prevented from occurring.

In addition as different states and territories will increase their royalties rates to different extents and at different times the amount of mineral taxation (i.e. MRRT plus uncompensated for royalties) will be different in different states and territories which would be inequitable and inconsistent with the basic principles of a nation-wide MRRT system.

Furthermore if states and territories increase their royalties only the junior / mid-cap and emerging mines developed under the mining act will be subject to double taxation, while the royalty increases may not apply to major producers because they are protected by their developments having been under State Agreement Acts which cannot be changed without mutual consent. This is discriminatory, inequitable and unacceptable.

Capping of future royalty credits means that with time the amount of credits could lag well behind the royalties actually paid by companies resulting not only in double taxation but also complicating the administrative effort and compliance costs for both companies and government.

Recommendations:

15. AMEC believes that no losses should be quarantined and that taxpayers should be given discretion after royalty credits as to the order in which they wish to apply other losses against profits.
16. AMEC believes that there should be full credit allowed for all State or Territory royalty payments actually incurred by a taxpayer, irrespective of whether States or Territories chose to increase their royalty rates in the future (including those post 2nd May 2010).

3.4 Issues Paper Chapter 7 Starting Base

Issues Paper - Terms of reference

IP 230 "… recognises that the decisions to invest in existing projects preceded the announcement……Entities will have a choice in the way they value the starting base for their projects. The can use either..."*:*

- The book value (excluding the value of the resource) up-lifted at the long-term bond rate (LTBR) plus 7% and fully depreciated on an accelerated basis over a five-year life; or
- The market value (as at 1st May 2010) with no up-lifting and depreciated over the life of the project to a maximum life of 25 years.

Issues paper Section 7.2 New capital expenditure incurred prior to 1 July 2012

Question 7.3: How significant are the potential distortions to investment behaviour in the lead up to 1 July 2012?

IP 236 states that capital expenditure incurred between 2nd May 2010 and 30th June 2012 will be added to the starting base of a project. Under the book value approach, it can be up-lifted by the LTBR + 7% and depreciated on an accelerated basis over 5 years (i.e. 36% in year 1, 24% in year 2, 15% in years 3 and 4 and 10% in year 5). If the market value base is selected, it will be depreciated over the life of the project to a maximum of 25 years and up-lifting will not apply.

Potentially severe counter-productive effects will occur because if capital expenditure is incurred over the period 2nd May 2010 and 30th June 2012 it will, in the absence of a policy change, be added to the starting base and depreciated over a relatively long period of time, whereas, if expenditure were to be deferred to beyond 1st July 2012, it would become immediately expendable.

This is of particular concern to some of AMEC's members who have already committed to significant investments in this period which are incapable of being deferred to 1st July 2012 or beyond without incurring severe penalties and commercial setbacks.

AMEC recommends that, where a company incurs capital expenditure in the period 1st May 2010 till 30th June 2012, the relevant expenditures should become eligible for immediate deduction.

Issues Paper Section 7.4 Market value approach

Question 7.1: Which assets should be included in the starting base?
Question 7.2: Which valuation methods will provide an appropriate assessment of market value? Should any methods be prescribed or proscribed? Are there ways to provide greater certainty as to how market valuation should be conducted?
Question 7.4: What adjustments to book value (if any) are necessary to fairly recognise the value of existing project assets?
Question 7.5: What rules should govern starting base elections?

AMEC considers that in most instances a market value starting base may only be derived by subtracting from the discounted cash flow (DCF) NPV of the integrated project (at 1st May 2010) the market value (at 1st May 2010) of all downstream and ineligible assets. Because of the need to maintain the integrated project capacity, these values should represent the "depreciated replacement cost" of the assets like with like or their "modern equivalent asset" (MEA) if a possible modern substitute would cost 25% more or less than the technology currently in use. This difference represents the value of the project to the taxing point and is made up of the market value of the mining assets and the value of the resource. Additional adequate value should be added to this NPV in instances where the project features significant as yet insufficiently delineated resources not included in the JORC-compliant resources used in the evaluation model. This approach is consistent with IP248.

Project values are in turn very sensitive to key input parameters such as iron ore and coal prices, exchange rates and inflation forecasts and to the rate of discount used.

Consistency will also be sought in terms of a common criterion for setting the equity discount rate of each company by recommending the use of the capital asset pricing model (CAPM), with reference to the *beta* index of the company owning the project and to the long-term average risk premium of the market portfolio. Alternatively if the risk characteristics of the project under consideration are very different from that of the holding company then a commensurate risk premium may be added to the LTBR to determine an appropriate rate of discount.

While not seeking for this methodology to be mandatory (second dot point of IP 251), AMEC would like to receive a general endorsement by the PTG of its general acceptability or even preference among the array of various valuation methodologies that different companies may consider in establishing their starting base values.

Issues Paper Section 7.6, Treatment of starting base and starting base losses

Question 7.6: Which, if any, starting base losses should be quarantined? Does transferability of starting base losses give an entity a competitive advantage for new project acquisitions? Should losses from a starting base assessed using the market value method be uplifted?
Question 7.7: What principles should determine whether a project interest has been sold, rather than a project asset? What rules are required to govern changes in project assets?

The terms of reference do not specify (IP 266) that MRRT losses generated by deductions attributable to the starting base should not be up-lifted, even though undepreciated amounts relating to the starting base are specifically excluded from up-lifting.

AMEC's recommendation is that MRRT losses generated by deductions attributable to the starting base are to be treated as any other loss and be subject to up-lifting.

Recommendations:

17. Government should be made aware of the significance of the distortions that the transitional rules regarding capital expenditure incurred between 2nd May 2010 and 30th June 2012 will generate with a view to making these expenditures immediately deductible for the purpose of assessing future MRRT liabilities.
18. MRRT losses generated by deductions attributable to the starting base should be treated as any other loss and be subject to up-lifting.

3.5 Issues Paper Chapter 8 $ 50 million threshold

Issues Paper Section 8.1 Addressing the costs of compliance for small miners

Question 8.1: How significant are compliance costs likely to be for smaller miners? Is there an alternative approach that would reduce compliance costs for small miners?

Very high compliance cost, together with considerations of government revenue stability, is one of the main reasons why resource rent taxation models have not been used in any country for the purpose of levying mineral royalties, with its application limited to large and very profitable petroleum projects. It could be argued that compliance costs besides being significant are also largely fixed in nature. While they would represent a small proportion of the cash flows of the major iron ore and coal operations in Australia, which have recently become comparable to those of some of the offshore petroleum operations, and can be easily be borne by them, it may in fact prove prohibitive for smaller and less profitable projects with annual resource profits of less than say $ 250 million.

This problem compounds on a large number of disabilities suffered by small and emerging producers compared to large integrated companies. These include:

- reduced capacity to attract exploration and development capital,
- lower economies of scale,
- inability to fund dedicated transport and port infrastructure,
- a lower degree of certainty in future state royalties compared to larger established operations originally developed under the protective umbrella of State Agreement Acts, etc.
- Significant compliance and administrative impost

In this light and keeping in mind that, for example; at current prices, $ 50 million represents the resource profit of an operation producing around 1 to 1.5 Mt of iron ore p.a., it may be argued that the minimum profit threshold as it stands is grossly inadequate and that it should be significantly lifted to at least $ 250 million and that its real value be maintained by annual indexation.

Issues Paper Section 8.2 Annual application of the threshold profits test

IP 276 indicates that the measure of resource profit on which the profitability test is based would be one based on assessable revenue minus eligible expenditure, but excluding starting base and carried forward losses. AMEC cannot see any rationale why the profit base on which the MRRT is to be assessed should be different from that for the determination of whether the minimum profit threshold has been exceeded.

On this basis AMEC recommends that the minimum profit threshold should include deduction of starting base and carried forward losses.

Issues Paper Section 8.3 Applying the threshold at an aggregated entity level

Question 8.2: Which aggregation test is most appropriate for the $50 million threshold?

IP 272 interprets the term 'taxpayer' as meaning the entity that owns one or more iron ore and coal projects in its portfolio. This interpretation is critical in that it makes the difference as to whether the provision is designed to shelter individual small projects from the impact of the MRRT, as opposed to small or unprofitable multi-project entities.

While there are many different grouping tests in the *Income Tax Assessment Act 1997,* such as those relating to small business in Subdivision 328-C, all rely on assessing the degree of connection or affiliation among the various taxable units, none of which is straightforward and easy to administer and may lead to the selection of dysfunctional ownership structures. Presumably the criteria for aggregation of resource profits for the purpose of testing whether an entity has exceeded the minimum profit threshold or not, should be a mirror image of those used to determine the scope for eligibility to transfer losses.

Accordingly, it would be advantageous to industry if the minimum profit threshold were to be applied on an individual project basis.

Issues Paper Section 8.4 Addressing the distortionary effect of the threshold

Question 8.3: Is there a less distortive way to apply the threshold for entities with resource profits below $50 million per annum?

As the design policy currently stands (IP 283), the marginal increase in MRRT liability when crossing the $ 50 million profit threshold is sudden as the quantum of MRRT payable goes from $ 0 for a resource profit of $49.9 million to $11.27 million less royalty credits and other losses for a profit of $ 50.1 million. Clearly this is not acceptable.

The simplest and fairest way to overcome this inequity and to eliminate unnecessary and very costly compliance complexity is to make resource profits up to the threshold tax free with MRRT being levied only on profits in excess of the minimum threshold.

Issues Paper Section 8.5 Interaction between the threshold and royalties

Question 8.4: How should royalties be treated when an entity has accessed the $50 million threshold?

Similarly for simplicity sake and to reduce compliance costs, AMEC agrees with IP 286 which suggests that annual royalty credits should be computed, carried forward and uplifted whether MRRT is payable or not in any year. It also agrees with IP 287 suggesting that the royalty credits in years when the profit of a project is below the minimum threshold should be reduced by the amount of MRRT that would have been payable if the minimum profit threshold were not part of the MRRT policy.

3.6 Other matters not raised in the Issues Paper

The case for annual MRRT returns

It is possible that many smaller iron ore developments may, in response to the high rate of volatility in exchange rates and iron ore prices, end up switching on and off the MRRT fiscal regime, which it can be assumed will add to the already cumbersome level of compliance cost. To the extent that a producer may not know until late in the year whether it will exceed the minimum profit threshold it is recommended that the MRRT return be annual and based on 'actual' resource profits, rather than as for the PRRT, which has no minimum profit threshold, quarterly and based on 'notional' profits followed by annual reconciliations.

Recommendations:

19. The minimum profit threshold should be lifted from the current $ 50 million to $ 250 million to reduce potentially significant compliance costs on the side of smaller, emerging or less profitable producers and as a benefit for a number of currently small but high-quality iron ore and coal deposits stranded for lack of access to proprietary railway networks to start initial development on a smaller scale using shared transportation facilities. This will also provide badly required working capital for development.
20. That the minimum profit threshold be based on the same measure of profit on which the MRRT is to be assessed, i.e. assessable revenue less deductible expenditure, including carried forward losses.
21. That resource profits up to the minimum profit threshold be MRRT free.
22. That the real value of the minimum profit threshold be maintained by indexing it on an annual basis.
23. That royalty credits should continue to be carried forward and up-lifted even in years when resource profits are below the minimum threshold. If necessary, in such years, the credit could be reduced by the amount of MRRT which would have been payable if the minimum profit threshold were not in force.
24. That to the degree that many projects may drift above and below the minimum threshold MRRT returns for small companies should be annual in frequency and based on 'actual' rather than 'notional' resource profits.

The case for a phased introduction of MRRT for new developments

AMEC recommends that to lessen the initial impact of the MRRT on its smaller members the MRRT rate of 22.5% (net of the extraction allowance) should be phased in over a number of years. Modelling indicates that, disregarding significant increases in compliance costs, the objective of economic efficiency would have been achieved on a 'revenue neutral basis' with an MRRT (net of extraction allowance) of around 10.5% to 11.5%. The balance of 12% to 22.5%, essentially increases the amount of tax levied from industry. This represents a significant and sudden shock, which may be capable of being absorbed by very large and profitable current operators, but places smaller and emerging producers in the process of raising funds for new developments under considerable stress.

In an attempt to alleviate the smaller companies' and particularly emerging developers' financial distress, AMEC recommends that the implementation of MRRT for small companies and emerging developments should be phased in starting at a rate of say 10.5 % in the first year of production and increasing by equal amounts of 2% each year to reach the full rate of 22.5% over 6 years.

Recommendation:

25. The implementation of MRRT for small companies and emerging developments should be phased in starting at a rate of 10.5 % in the first year of production and increasing by equal amounts of 2% each year to reach the full rate of 22.5% over 6 years.

The need for an initial amnesty and for a future review of the MRRT

AMEC is concerned that the MRRT may result in unintended consequences and recommends that 3 years after introduction of the MRRT regime, a review be carried out by an independent body, of the efficiency and effectiveness of the regime and whether it is imposing undue hardship on taxpaying companies.

During 2008/2009, the Australian National Audit Office conducted a study into the administration of the Petroleum Resource Rent Tax regime and made a number of findings in its report about shortcomings that should be addressed by the Australian Taxation Office.

In addition, given its complexity small companies may find complying with the administrative requirements of MRRT quite hard at least until appropriate systems are developed, installed and tested. As a consequence it would not be surprising if a number of unintentional mistakes and misunderstandings will occur in the early stages of enforcement. It would therefore be fair for the ATO to grant a period of amnesty from interest and penalties of at least one year from the date on which the first MRRT return is due.

Recommendations:

26. A review similar to that conducted in 2008/09 by the Australian National Audit Office into the administration of the Petroleum Resource Rent Tax regime, should be carried out after 3 years from implementation of the MRRT to determine whether it operates in the manner in which it was intended to apply.
27. The ATO should grant a period of amnesty from interest and penalties of at least one year from the date on which the first MRRT return is due.

Taxing of iron ore sales from initial stockpiles

AMEC is concerned that in the early stages of operations, sales are sourced from stockpiles established through significant expenditures incurred in previous periods.

The sale from stockpiles creates assessable revenue without any counter balancing expenditure in the period. This would clearly be unfair.

As a result, AMEC recommends that the expenditure incurred in establishing the initial stockpiles should be "clawed back" and brought to account in the year in which the ore from the initial stockpile is sold.

Recommendation:

28. Expenditures incurred in establishing the initial stockpile should be "clawed back" and brought to account in the year in which the ore from the initial stockpile is sold.

Magnetite concentrate

Some AMEC members, who are prospective producers of magnetite concentrate, feel that they would be at a disadvantage under the proposed MRRT given the very low iron grades of their resources and the extremely high levels of investment and risks inherent in separating their iron bearing materials.

4 RESPONSE TO POLICIES TO PROMOTE EXPLORATION EXPENDITURE

4.1 Introduction

AMEC and its members welcome the opportunity to consider "the best way to promote future exploration and ensure a pipeline of resource projects for future generations; and that it is to cover all resource exploration activities in Australia"[11].

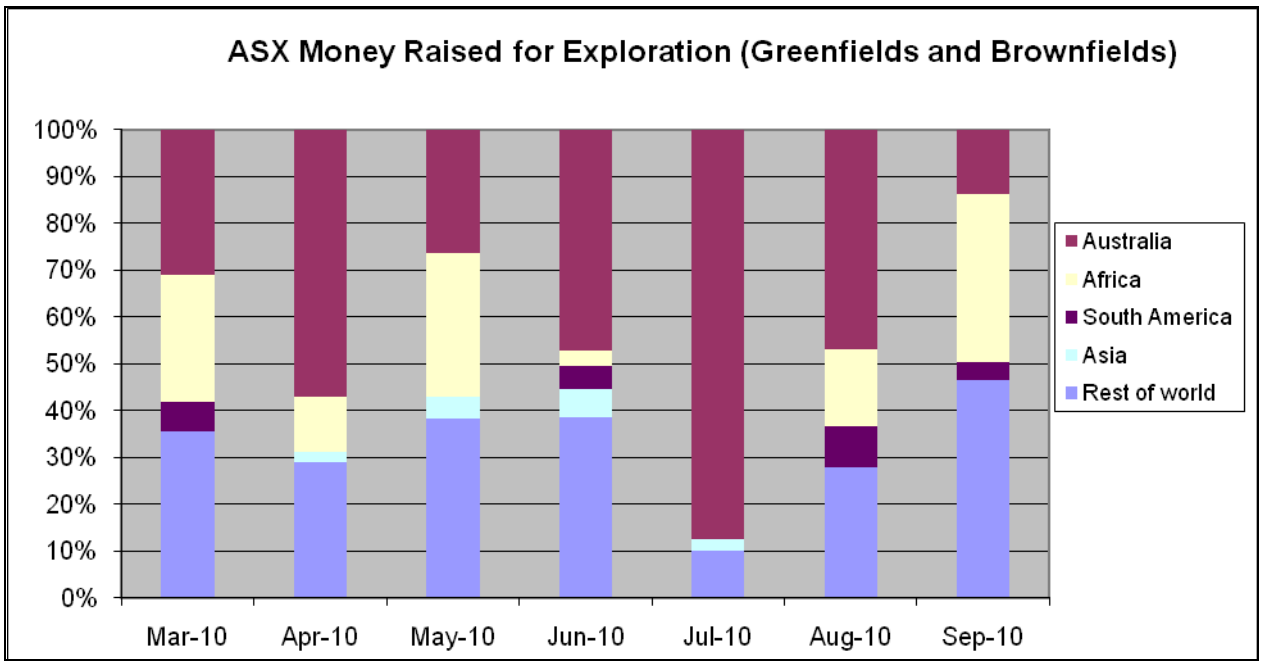
As determined by the Australian Institute of Geoscientists, AMEC notes that there has been a decline in success rates and in the average size and quality of deposits discovered (IP 414).

AMEC notes that the Issues Paper suggests that the decline could be a reflection of a mature environment, with very few major near surface mineral deposits remaining (IP 414), and that new 'buried' deposits involve a lower chance of discovery and a higher cost of extraction (Prosser Inquiry 2003). The perception that minerals exploration in Australia is mature is false. This ignores the fact that much of the nation remains largely under explored. The majority of Australia`s land mass has extensive weathering and widespread cover that masks the subsurface which remains highly prospective for the discovery of new, high quality mineral deposits. The challenge for the nation is to effectively explore this under cover environment to provide new, large, high quality mineral deposits to sustain our minerals industry and associated government revenue into the future. The nation should be focusing its efforts on the discovery of new Tier 1 mineral assets and not relying on the exploitation of lower quality deposits found in historical exploration campaigns to maintain our future prosperity.

IP 414 further states that the globalization of mineral exploration, combined with greater perceived prospectivity elsewhere, may have led to Australian and other entities diverting funds overseas. AMEC observes that Australia has one of the most comprehensive, complex and time consuming processes for access to exploration ground. This process stymies and delays the crucial high risk early stage exploration efforts.

Currently on average over 57% of funds raised in Australia for exploration are now directed overseas. This is a growing trend where the greater percentage of funds raised in Australia is diverted overseas. This does not just result in Australia`s capital being diverted overseas but also Australia`s human and intellectual capital being employed to expand the resource industries in other countries in competition and at the expense of Australia`s future industry. In the month of September 2010 alone, 85% of the capital raised for exploration on the ASX was raised for projects outside Australia – refer the table below:

[11] IP Terms of Reference page 105



Source: Intierra October 2010

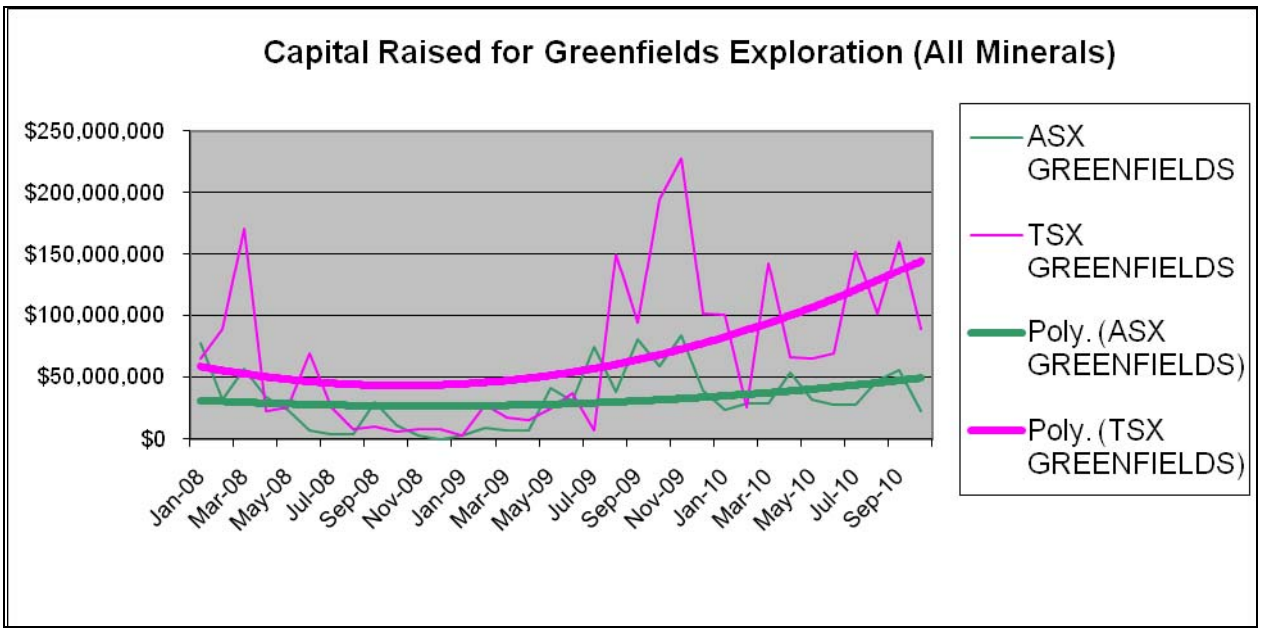
AMEC further notes that most of Australia`s mineral production is from deposits found 20 or more years ago (IP 415).

Although mineral exploration expenditure has increased over the past few years (IP 419), AMEC considers that these statistics do not reflect the significant increase in the cost of exploration (including regulatory, environmental, native title and cultural heritage expenses and associated approvals), and agrees with the suggestion in IP 421 that a better measure of activity is by 'metres drilled', which clearly indicates a reduction since 2007 (IP Figure 14.1).

IP 422 also indicates that the metres drilled data contained in Figure 14.2 shows an increased focus on brownfield exploration, rather than greenfields exploration, which is of significant concern.

The increase in the level of mineral exploration expenditure and metres drilled since 2000 in Australia has also been insufficient to keep pace with other more proactive competing nations (such as Canada).

These assumptions appear to have been confirmed by the following graph that indicates capital raisings in Australia for greenfields exploration has remained fairly static over the past two years; whereas by comparison Canada has shown a significant increase in greenfields exploration.



Source: Intierra October 2010

According to this year`s *RESOURCESTOCKS* magazine World Risk Survey, Australia has fallen 23 places down the ladder of desirable mining locations to finish one place below Bolivia and one spot above Cambodia.[12]

Canada was once again ranked the most attractive investment destination.

According to Resource Stocks, "Australia`s plunge from an international rank of 3 to 26 is considered to be a reflection of Federal Government policy concerning exploration".[13]

These trends are alarming, and of extreme concern and reinforce the fact that Australia`s reputation as an attractive destination for investment has been severely tarnished, and that remedial action should be taken by the Federal Government.

4.2 Issues Paper Chapter 14 Policies to Promote Exploration Expenditure

Q 14.1 Is exploration expenditure subject to a market failure that warrants intervention by the Australian Government? If so, is this market failure specific to any particular sectors or types of exploration?

The following key extracts are taken from an authoritative Paper titled "*Market failure in the Australian Mineral Exploration Industry: The Case for Fiscal Incentives"* (Cairns, Hronsky and Schodde) which clearly reinforce the need and rationale for Government intervention due to market failure:

a) "*Given the limited funding resources of most junior companies short term positive results are therefore usually only achieved in mature areas with known mineralization. In most cases, such areas of known mineralization are only likely to be available to a junior company if they are also considered by the industry to be relatively poor quality and/or already largely depleted. Therefore, the ultimate net result in terms of minerals discovery tends to be relatively small, incremental new deposits at best and sub economic resources at worst.*

[12] Mining.News 18 August 2010
[13] Media Release by Resource stocks

b) *A consequence of the short term focus of the capital markets, and the increasingly large role that they are playing in funding Australian mineral exploration, is that mineral exploration investment is being allocated into less productive opportunities than might otherwise be the case. New greenfields discoveries are in the best long term interests of all stakeholder groups; shareholders in junior companies; shareholders on major companies; the Australian nation and the global customers for Australia`s mineral products. However, the current incentive structure for minerals exploration* ***discourages investment in the type of opportunities most important for long term, sustainable wealth creation; greenfields exploration. This is a classic case of "market failure" where market forces result in an inefficient allocation of resources.***

c) *The current fiscal structure actually discriminates against investment in exploration by companies that do not have producing mines. No tax concession is available to investors unless the company actually develops a producing mine, providing a cash flow against which accrued exploration investment can be amortised. However, mineral exploration, and in particular greenfields mineral exploration, is a high risk business with less than one in a hundred projects going on to be a significant mine.* ***Therefore, the overwhelming majority of exploration expenditure by the junior sector does not attract any tax concession****.*

d) *The long term sustainability of the Australian base and precious metal mining industry (a critical sector in the Australian economy) is under threat because of a lack of significant greenfields discoveries in the last two decades. This lack of greenfields success relates to a decline in levels of investment in greenfields exploration in Australia.*

e) *In turn,* ***this decline in investment relates to the short term imperatives of the capital market which has become a much more important factor in Australian exploration funding during the last decade. It is argued that this short term focus of capital markets and the behaviour it drives in both major and junior mining companies constitutes an example of market failure****, where market forces are resulting in an allocation of resources that is not consistent with long term wealth creation, both for shareholders and the nation.*

f) ***It is one of the important roles of government to mitigate the effect of market failure when this impacts on areas of critical national significance*** *(such as the Australian mining industry). An opportunity exists for the government to encourage investment in greenfields exploration through the introduction of appropriate targeted fiscal incentives.*

g) *A significant contributing factor to the decline in greenfields discovery over recent years is a 'market failure' whereby the incentive structure currently in place for investment in the mining industry actively* ***discourages investment in greenfields exploration****. This largely relates to the disconnect between the very short term focus of the risk capital market compared to the longer term gestation period required for well conceived greenfields exploration programs.*

h) *The Australian government has the opportunity to mitigate this market failure through the introduction of appropriately structured fiscal incentives that provide more incentive for the risk capital market to support greenfields exploration. Such fiscal incentives specifically targeting greenfields exploration have already been introduced with great success in Canada, and Quebec in particular*".

In summary, **AMEC considers that the short term focus of the capital market is severely discouraged from investing in greenfields exploration** in view of the significant **high front end cost and associated risk profile** that applies to mineral and geothermal exploration activities.

As described by Messrs Cairns, Hronsky and Schodde above, AMEC is also of the view that there is evidence of market failure in minerals and geothermal exploration activities.

In view of the significant wealth creation and revenue generating opportunities that the minerals exploration sector can provide, AMEC considers that it is in **the national interest** to promote future exploration activities throughout Australia.

AMEC further considers that any innovative programs (including those provided as an inducement to potential investors) are an **"investment in Australia`s future"**, without which the likelihood of successful discoveries will be severely diminished in the short and medium term.

The crucial role that equity funding plays in this process should be emphasised as it is the "**life blood**" of the junior exploration sector, without which, exploration and subsequent discoveries (and government revenue streams) would not occur at a pace fast enough to meet growing demand for commodities. If Australia is unable to meet that demand in the short term other resource rich continents will take competitive advantage at a considerable and long lasting 'opportunity cost' to Australia.

AMEC therefore proposes that a broad policy framework that seeks to grow the resources industry in Australia (and the future resource base) should be employed. This framework should seek to restore Australia`s reputation as a mining and exploration investment destination and ensure that Australia has policies in place such that the alarming trend of Australian exploration financial and human capital heading overseas can be turned around.

This should involve a combination of:

1. Increased investment in the acquisition of pre competitive data through Geoscience Australia and other state / territory bodies,
2. Investment in innovation and risk taking in exploration (including broadening R&D tax incentives),
3. Significant improvements in land access in Australia for exploration (reduced cost and time),
4. Introduction of an Exploration Tax Credit, and
5. Removal of the MRRT.

4.3 Issues Paper Chapter 14.2 Existing policies to promote exploration

Q 14.2 Is there a case for the Australian Government extending or adjusting existing policies to better promote exploration or adopting additional policy option(s) to promote future exploration? What costs and benefits would such policy option(s) have?

AMEC and its members consider that there is a case for the Australian Government to continue, and increase existing exploration development programs.

4.3.1 Geoscience Australia

In response to IP 439 to 446, AMEC considers that Australia`s reputation for the provision of high quality pre-competitive geoscience products and services used by industry to make mineral discoveries is due partly to the significant role played by Geoscience Australia (GA) and the various State and Territory based geological surveys.

AMEC understands that these various services are the subject of ongoing review by respective governments, including a current formal Review of GA`s programs and funding arrangements.

AMEC has contributed to that review and has indicated support for the programs and services currently provided by GA, particularly in view of the excellent geoscientific data and information produced on a large regional scale basis; as well as filling the gaps in national geological data. The government is significantly under

investing in the acquisition of pre-competitive geoscientific data. There has been a significant growth in tax revenue at state / territory and federal levels from the resources industry, however only a small fraction is being reinvested in the acquisition of pre-competitive geoscientific data to allow explorers to provide the mineral discoveries that will underpin government revenue for future generations.

AMEC has expressed concern with the possibility of any funding cut to GA, and in fact has indicated that additional and ongoing funding should be provided as GA appears to be constrained in its abilities to provide additional and essential pre-competitive geoscientific data.

AMEC has further noted the decline in greenfields exploration and success rates, and how it is becoming harder to find mineral deposits at or near surface (IP 414). The sub surface work undertaken by GA is therefore becoming increasingly important to industry. It is also relevant to note historically that major companies had the resources to complete broad regional surveys at the early stages of their exploration. Smaller companies have largely relied on government surveys and mapping to assist with early stage targeting and project generation. In a market that is focussed on drill results it is virtually impossible for junior explorers to raise funds to complete regional data acquisition.

As noted in the Issues Paper, greenfields exploration is increasingly being conducted by junior explorers. As such they have a distinct and important role in maintaining the long term pipeline of future resource projects (IP 430). This move towards reliance on junior companies to complete greenfields exploration in Australia has not coincided with a commensurate increase in the acquisition of pre-competitive geoscientific data by Government. To improve Australia`s discovery rates into the future this under investment needs to be addressed.

AMEC therefore considers that access to comprehensive and up to date pre-competitive geoscientifc information is essential in encouraging mineral exploration activity within Australia and that additional and ongoing funding should be provided to Geoscience Australia.

4.3.2 Research and development

AMEC supports any strategy that promotes business innovation and attracts investment in research and development initiatives that stimulate economic growth. AMEC has therefore been supportive of the Federal Government's Research and Development tax concession scheme (IP 482 to 485).

AMEC notes the Government`s recent review of the national innovation policy and supports the Government`s overarching policy in respect of the new tax credit program. However, in order to ensure that the Government`s policy is effectively implemented, AMEC considers that there are a number of required changes to the detail of the new proposed R&D legislation. AMEC further notes that the new program should not be introduced until such time as to allow further stakeholder consultation and fine tuning (such as modifying the qualifying criteria, in order that exploration activities can meet 'the dominant purpose test' under the R&D legislation) to occur on technical aspects of the legislation, which do not appear to properly recognize and reward the genuine R&D activities undertaken by junior and mid-sized exploration and mining companies.

There is also a strong view that the provisions contained in the proposed legislation will put downward pressure on R&D activities as the net tax benefit for businesses in Australia will decrease.

These concerns need to be addressed as a matter of priority.

4.4 Issues Paper Chapter 14.4 Policy options to promote future exploration

AMEC and its members consider that the following **strategic objectives** should be met by the recommended policy option:

1. **Remedying market failure;**
2. **Promoting investment in junior exploration companies;**
3. **Promoting exploration expenditure by junior exploration companies in Australia; and**
4. **Addressing tax asymmetries.**

It is also anticipated that the adopted policy option would minimize:

a) administrative costs for companies, regulators and investors;
b) differences between shareholders' tax compliance costs;
c) risks for investors and regulators; and
d) distortions for investment decisions by companies.

The policy options described in the Issues Paper have therefore been assessed against these strategic objectives:

4.4.1 Issues Paper Chapter 14.3.1 Exploration refundable tax offset (ERTO)

The exploration refundable tax offset (ERTO) as detailed in IP 460 to 468 appears to be similar to the Resource Exploration Rebate (RER) proposed under the Resource Super Profit Tax measures (RSPT).

Accordingly, and based on certain commentary over recent months there has been a perception that the junior minerals exploration sector did not support the Resource Exploration Rebate (RER) as proposed under the previous Resource Super Profits Tax (RSPT) reform measures.

These perceptions are incorrect as AMEC did not oppose the Resource Exploration Rebate.

AMEC`s publicly available Policy Statement on the Government`s response to the Henry Tax Review states, inter alia:

> "*Members have welcomed the concept of a Resource Exploration Rebate (RER) as a possible means of increasing exploration expenditure. However, a RER is not acceptable if it is coupled with the introduction of a RSPT.*
> *AMEC has long advocated a Flow Through Shares (FTS) / Exploration Tax Credit (ETC) scheme as a priority policy initiative and believes this is a more beneficial mechanism in attracting exploration investment and would increase exploration expenditure in Australia."*

The AMEC Policy Statement has since been reinforced on several occasions with the Prime Minister, senior Ministers and government officials.

AMEC was therefore extremely disappointed to note in Prime Minister Gillard`s announcement of 2nd July 2010 that "*The resource exploration rebate will not be pursued".*

AMEC considers that the ERTO described in the Issues Paper will increase exploration expenditure however it does not appear to specifically address the other strategic objectives described in Section 4.4; namely, remedying market failure, promoting investment in junior exploration companies, or addressing tax asymmetries.

4.4.2 Issues Paper Chapter 14.3.2 Exploration tax credit (ETC) - (AMEC Preferred Option)

In November 2008, a joint industry submission was presented to the Federal Government on a proposal to introduce a Flow Through Shares / Exploration Tax Credit (ETC) scheme in order to promote exploration in Australia. That submission was subsequently referred to the Henry Tax Review, and apparently not supported by Government.

In hindsight, it may have been more prudent for industry to not have used any reference to the "Flow Through Shares" terminology in that submission, as the November 2008 model was a hybrid of a Flow Through Shares model, Australia`s franking system, and an exploration tax credit concept.

AMEC still considers that the November 2008 ETC model (incorporating the franking system) provides a number of significant benefits, as follows:

1. It is well understood by investors and relevant stakeholders,
2. It is embedded in taxation law,
3. It has a proven track record having operated successfully in Australia for 20+ years,
4. It is simple and workable,
5. Administrative and management costs are minimized for companies, regulators and investors,
6. Tax compliance costs are minimized as existing franking style systems are already in place,
7. Risk for investors and regulators is minimized, and
8. Compliance and audit processes already exist, are well established, easily managed and policed.

AMEC notes that no reference has been made in the Issues Paper (IP 14.3.2) to a proposed 'uplift in the credit', as detailed in Clause 3.2.18 of the original November 2008 joint industry submission.
That Clause stated "*A 25% to 75% uplift in the credit, consistent with the R&D uplift obtained by Australian innovation companies, should be applicable to the ETC system. This would reflect the high front end risk, and significant long term future dividends payable to all Australians that flow from mineral exploration, which are comparable to those relating to R&D investment.*"

The 25% uplift factor is included in the calculation example provided below, and is an essential component of the November 2008 model as it provides a clear benefit to the investor and recognises the high front end risk of exploration.

This issue is a significant point of differentiation and requires clarification.

Subject to this issue being clarified, the following **Exploration Tax Credit model** (based on the November 2008 model) would meet all of the strategic objectives listed in Section 4.4 of this submission:

4.4.2.1 Eligibility:

1. An exploration franking / tax credit will be allowed to Australian resident shareholders of Australian companies, only in respect of eligible exploration expenditure incurred by those companies in Australia,

2. A 'no taxable income' test will ensure that the Program is only available to junior explorers,

3. The franking credit will apply to all exploration expenditure in Australia incurred after the date of commencement of the Program,

4. All taxpayers would be entitled to the franking credit (currently based on the 30% company tax rate), regardless of their own marginal tax rate – including superannuation funds with a 15% tax rate and individuals on low or nil tax rates. Taxpayers unable to use the franking credit against their tax liability would be entitled to a refund, on the same basis as other franking credits are refundable,

5. The Program is voluntary, noting that exploration companies can already retain their exploration deductions for their own future use if they wished to do so for strategic reasons. An appropriate declaration would need to be made to the capital market prior to the issue of any such share,

4.4.2.2 Mechanism:

6. Participating companies will be able to claim 'eligible exploration expenditure' using existing income tax law definitions,

7. The eligible company will identify the proposed franking credit through a special 'share class'. In the case of new capital raisings, it may be possible for a company to direct the franking credits to the new shareholders rather than all existing shareholders, via the use of different share classes,

8. The existing franking credit mechanism would be utilised to provide a credit to eligible shareholders,

9. The franking credit could be available to all shareholders for a discrete capital raising for eligible expenditure (such a credit could be transferred if the share is sold),

10. The franking credit would be available to all shareholders on the register on the day that the credit was 'declared',

11. Shareholders who sell out early (for example, short term IPO speculators) will not receive the franking credit until the 'declaration date',

12. The franking credit will be available at the prevailing company tax rate (currently 30%),

13. No time limits should apply on the use of the franking credit,

14. Eligible companies will have flexibility in the timing of passing on the credit, using a franking-account-like mechanism. Any shareholder on the register at the company's declared record date for distribution of the franking credit would receive it,

15. Consistent with the uplift factor in research and development programs, a 25% - 75% uplift in the credit would be available (such an uplift would reflect the high front end risk, and significant long term future dividends payable to all Australians that flow from mineral exploration, which are comparable to those relating to R&D investment),

4.4.2.3 Compliance:

16. All relevant terms are defined under current tax law, and would be adopted unchanged for this Program,

17. A number of well tested and existing Australian tax compliance mechanisms would operate to ensure that there was no double deduction of exploration expenditure either by the company, or for shareholder capital gains tax purposes,

18. All anti-avoidance provisions existing in the franking law would also apply to the Program, such as the anti-streaming rules, and the 45 day rule. A simple amendment would ensure that these provisions were mirrored in this Program,

19. A company (or corporate group) would not be permitted to choose to pay tax itself and instead use its exploration expenditure to distribute franking credits to shareholders. If the company has net taxable income after all expenses and prior year losses have been deducted, it would be required to use its

own exploration expenditure to reduce its taxable income to $nil. This provision is made as a further integrity measure in ensuring that the Program is contained to junior explorers,

20. The taxable income test would be considered from a corporate consolidated group perspective. Where companies have elected to be a consolidated group for tax purposes, the group as a whole must be in tax losses for any franking credits to be passed to shareholders,

21. In the event that a company distributes a franking credit, and it is later determined that its expenditure does not meet the eligible exploration definitions, this should be dealt with at the *corporate* level rather than at the shareholder level,

22. Appropriate penalty provisions should apply for any non compliance,

4.4.2.4 Implementation and review:

23. Specific details of the Program will be determined in consultation with peak representative bodies, such as AMEC, MCA, AusIMM. (If required, AMEC would be pleased to facilitate this process, and /or participate in a joint industry / government agency implementation working group).

4.4.2.5 Simple example of the calculation methodology:

Discrete capital raisings through an IPO of $10m (50,000,000 shares @ 20 cents)

Eligible exploration expenditure of $7.5m – available for tax credit purposes
Company tax rate of 30%
Uplift factor of 25%

Calculation:
$7.5m x 30% x 125% = $2,812,500 available for tax credit purposes to 50,000,000 shareholders = $0.05625 cents per share (representing 28.125% per share).
NOTE: The credit is deferred and only becomes available once the expenditure has been incurred, the credit 'declared', and the tax return lodged.

4.4.2.6 Cost v benefit analysis:

Following the November 2008 submission, Synergies Economic Consulting prepared a robust cost benefit analysis in May 2009, and identified that the costs of the proposed ETC scheme were far outweighed by the significant social and economic benefits.

The Report indicated the immediate implementation of an ETC scheme for Australian junior exploration companies would result in **increased exploration expenditure up to around 30 per cent.**

Coupled with high labour intensities, few impediments and significant spare capacity in exploration and supporting industries, the report concluded that an Australian ETC would deliver a significant boost to the domestic economy.

The analysis specifically concluded that the immediate implementation of an ETC scheme would be a very worthwhile measure, delivering significant short term socio-economic benefits across Australia at an estimated cost to government of **approximately $130m per year.**

Over a four year period, the report concluded that a FTS / ETC scheme could generate immediate **socio-economic benefits** across Australia of:

- **4,196 new jobs,**
- **$114.4m in additional Gross Domestic Product,**

- **$191.2m in additional real private consumption,**
- **$965.1m in additional real investment.**

It is noted that the analysis did not attempt to quantify **the substantial 'flow-on' of economic benefits** beyond the initial four year period, particularly when more exploration is translated into more discoveries, and in turn, new mines and increased minerals production.

In this regard, compared with other industries often promoted as vehicles for generating increased economic activity, 'mining exploration' ranks #1 in terms of value adding and #3 behind 'residential construction' and 'financial services' in terms of employment generation.[14]

Recommendation:

29. Subject to clarification, the Exploration Tax Credit model should be implemented by the Federal Government as a matter of urgency, as it appears to meet all of the key strategic objectives described in Section 4.4. It should also be funded through Consolidated Revenue and not tied to the MRRT proceeds.

4.4.3 Issues Paper Chapter 14.3.3 Flow Through Shares (FTS) scheme

AMEC notes the apparent significant success of the Flow Through Shares (FTS) scheme that has operated in Canada since 2000 (as described in IP 474 to 481).

During the intervening period Canada has increased its share of global exploration expenditure and Australia has experienced a significant reduction, to the point that Australia has fallen from 1st to 5th place in the world`s top regions for mineral exploration investment. Canada has remained in 1st position. Of further concern, is that Australia has remained in 5th place for six years in a row[15].

The success of the FTS scheme appears to have been the main reason for Canada`s ability to maintain top position.

AMEC further notes that the Canadian FTS scheme has been consistently reviewed and extended at the national and provincial levels.

Based on an analysis of the FTS scheme described in IP 474 to 481, the main points of difference between the Exploration Tax Credit model described in 4.4.2 above are that the FTS scheme:

- provides investors with a benefit at their marginal rate of tax, whereas the ETC provides the benefit at the current company tax rate;
- the FTS scheme requires eligible exploration to be incurred and renounced within 24 months; whereas the ETC model does not stipulate a time limit on the use of the tax credit; and
- the Canadian FTS model provides a tax refund upfront, and prior to the exploration expenditure to encourage investment; whereas the ETC could be delayed for up to 18 months after the exploration expenditure has occurred.

AMEC is not aware of any specific problems with the current Canadian FTS scheme, other than apparent compliance issues that occurred when the scheme first commenced.

Based on the following comment from Thomas W. King – Partner Tax, KPMG, Canada, they have apparently now been overcome:

[14] http://www.amec.org.au/media/docs/Communique_Final_Flow_Through_Shares_Scheme_May_2009.pdf
[15] Metals Exploration Group – Exploration trends

"*With respect to the flow-through share program it a widely accepted program within both the federal and provincial governments. Investors receive not only tax deductions, the expenditures renounced also qualify for federal and in some case provincial investment tax credits. While there have been problems in the past with the program (expenditures on non-qualifying Canadian exploration expenses ("CEE")) the exceptions are rare. The reason they are rare is quite simple. Under a flow-through share agreement the corporation indemnifies the investor for any taxes they may incur if the proceeds of the share subscription are not spent on qualifying CEE. However the real reason there are so few exceptions is that a junior resource company relies totally on its ability to raise funds in the equity market (banks don't lend to juniors). Failure to fulfill the conditions of a flow-through share agreement will result in significant problems in attracting future investors.*"

AMEC has long advocated a FTS scheme and would welcome any such policy initiative (as detailed in IP 14.3.3) as it would also address all of the strategic objectives listed at 4.4 above.

4.4.4 Other matters not raised in the Issues Paper

Geothermal energy
Under the previously announced (2nd May 2010) Resource Exploration Rebate it was proposed that the definition of exploration expenditure should be expanded to include expenditure incurred in exploring for geothermal energy. It appears that concept may have been overlooked in the Issues Paper.

Recommendation:

30. The definition of exploration expenditure should be expanded to include expenditure incurred in exploring for geothermal energy.

Managed investment schemes
AMEC understands that Treasury has concerns that there may be some similarity between the ETC and FTS models described in the Issues Paper, and Managed Investment Schemes.

The Australian Securities and Investment Commission (ASIC) website states, *"managed investment schemes are also known as 'managed funds', 'pooled investments' or 'collective investments', which cover a wide variety of instruments; including cash management trusts, property trusts, some film schemes, timeshare schemes, or some mortgage schemes".*

The ASIC website also provides examples of the types of investments that are NOT managed investment schemes, and lists examples as "*regulated superannuation funds, approved deposit funds, debentures issued by a body corporate, and direct purchases of shares or other equities."*

The ETC and FTS models described in the Issues Paper involve the 'direct purchase of shares' and therefore cannot be considered to be 'Managed Investment Schemes'.

It is further noted that the AMEC preferred ETC option has strong compliance features and will not be the subject of the same compliance issues that have been experienced by some managed investment schemes.

An additional fundamental difference is that the ETC model requires that eligible expenditure be undertaken prior to the deferred exploration tax credit being issued; whereas managed investment schemes provide an 'upfront tax benefit'.

Further consultation on exploration development initiatives
AMEC notes the intention of the PTG to hold a specific industry consultation session on 19th November 2010 in Melbourne and reserves the right to provide any additional supporting information or comments to the PTG after that date.

APPENDIX 1

AMEC – FULL MEMBERS

A1 Minerals Limited
ABM Resources NL
ABRA Mining Limited
Adamus Resources Limited
Alchemy Resources Limited
Alkane Resources Ltd
Anglo American Exploration Pty Ltd
Apex Minerals NL
Aphrodite Gold Limited
API Management Pty Ltd (on behalf of APIJV)
Apollo Minerals Limited
Aragon Resources Limited
Areva NC Australia
Argent Minerals
Artemis Resources Limited
Ashburton Minerals Limited
Astro Resources NL
Atlantic Gold NL
Atlas Iron Limited
Aurora Minerals Ltd
Aurox Resources Limited
Australian Mines Limited
Auzex Resources Limited
Azumah Resources Limited
Bandanna Energy Limited
Bass Metals Limited
Bauxite Resources Limited
BC Iron Limited
Beadell Resources Limited
Blackham Resources Limited
Breakaway Resources
Brockman Resources Limited
Cameco Australia Pty Ltd
Catalpa Resources Ltd
Cauldron Energy
Cazaly Resources Ltd
Cloncurry Metals Limited
Comet Resources Limited
Cortona Resources Limited
Corvette Resources
Crescent Gold Ltd
Cullen Resources Limited
De Grey Mining Ltd
Doray Minerals Limited
Dragon Energy Limited
Eagle Eye Metals Limited
East Coast Minerals NL
Eleckra Mines Limited
Emergent Resources Limited
Emu Nickel NL
Encounter Resources Ltd
Endocoal Limited
Eneabba Gas Limited
Energia Minerals
Energy and Minerals Australia Limited
Enterprise Metals Limited
Exco Resources Limited
Extension Hill Pty Ltd
Fairstar Resources Limited
Ferrowest Limited
Flinders Mines Limited
Focus Minerals Limited
Fortescue Metals Group Limited
Frontier Resources Limited
FYI Resources Ltd
Galaxy Resources Ltd
Gascoyne Resources Limited
Gindalbie Metals Ltd
Giralia Resources NL
Golden West Resources Ltd
Green Rock Energy Ltd
Gunson Resources Ltd
Hampton Hill Mining NL
Hancock Prospecting Pty Ltd
Hannans Reward Ltd
Heron Resources Ltd
Image Resources NL
Impact Minerals Limited
IMX Resources NL
Independence Group NL
Integra Mining Limited
Iron Ore Holdings Ltd
Iron Road Limited
Ironbark Zinc Limited
Ironclad Mining
Jindalee Resources Ltd
Kagara Limited
Kimberley Mining Company

AMEC – FULL MEMBERS, continued

Krucible Metals Limited
Lonrho Mining Ltd
Macarthur Minerals Limited
Magnetic Resources NL
Manhattan Corporation Limited
Mantle Mining Corporation Limited
Marenica Energy Limited
Mark Creasy Group
Matsa Resources
Mega Uranium Ltd
Meteoric Resources NL
Midas Resources Limited
Minara Resources Limited
Mincor Resources NL
Mindax Limited
Minemakers Limited
Mineral Deposits Limited
Moly Mines Limited
Montezuma Mining Company Limited
Mount Gibson Iron Limited
Mount Magnet South NL
Murchison Metals Limited
Mutiny Gold Limited
Navigator Resources Limited
Northern Uranium Limited
Northwest Resources Limited
Paladin Energy Ltd
Panoramic Resources Ltd
Peak Resources Ltd
Pioneer Resources Limited
Platinum Australia Limited
Polaris Metals NL
Poseidon Nickel Limited
Prairie Downs Metals Limited
Ramelius Resources Limited
Red River Resources Limited
Reed Resources
Regis Resources NL
Republic Gold Ltd
Resource Mining Corporation Limited
Rex Minerals Ltd
Rey Resources Limited
Robust Resources Limited
Rubianna Resources Limited
Sandfire Resources NL
Saracen Mineral Holdings Limited
Shaw River Resources Limited
Silver Lake Resources Ltd
Silver Swan Group Limited
Southern Cross Goldfields
Syndicated Metals Limited
Talisman Mining Limited
Teck Australia Pty Ltd
Terrain Minerals Limited
Thundelarra Exploration Limited
TNG Limited
TPL Corporation Limited
Trafford Resources Limited
Traka Resources Limited
Troy Resources NL
Uranex NL
Venture Minerals Limited
VentureX Resources Ltd
Venus Metals Limited
Western Areas NL
Westgold Resources Limited
White Rock Minerals Limited
Zinc Company Australia Limited

AMEC – ASSOCIATE MEMBERS

Adele Millard Consultancy
AGF Charter Finance Pty Ltd
AGR Matthey
Alliance Contracting Pty Ltd
Allion Legal
ALS Laboratory Group
Anwyl Consulting
APEX Geoscience Ltd
Aquaterra Consulting Pty Ltd
Aspermont Ltd
Australian Drilling Industry Association
Australian Prospectors and Miners Hall of Fame
Australian Securities Exchange - Perth
Austwide Mining Title Management Pty Ltd
Beilby Corporation Pty Ltd
Blakiston & Crabb
Boardroomradio.com
Boart Longyear (Australia) Pty Ltd
Boyer Exploration & Resource Management Pty Ltd
Choice One
Clayton Utz
Coffey International
Complispace Pty Ltd
Constructive Recruitment
Corrs Chambers Westgarth
Cosol
Cube Consulting
Dalcassian Consulting Pty Ltd
Deloitte Touche Tohmatsu
Digirock Pty Ltd
DLA Phillips Fox
Dow Corning
Downing Teal Pty Ltd
Emerson Stewart Group Limited
Enhance Corporate Pty Ltd
Environment Land Heritage
Environmental Resources Management
Ernst & Young
Forge Creative
Freehills
Fyson & Associates
Genalysis Laboratory Services Pty Ltd
Genserve Australia
Geomole Pty Ltd
Haines Surveys Pty Ltd
Helmsec Global Capital Limited
Hetherington Exploration & Mining Title Services
Hubo Investment Co Pty Ltd
Hunt & Humphry
IMAN International
Independent Investment Research Pty Ltd
Indirect Tax Consulting Pty Ltd
Industrial Safe Pty Ltd
Inspectorate Australia
Intierra Limited
iQuest Consulting
Jackson McDonald
Jinji Australia Pty Ltd
Kasa Consulting
Kellie Hill Consulting
Kenex Pty Ltd
KPMG
Landoptions
Linc
Macquarie Bank Limited
Maxwell GeoServices
McKenzie Moncrieff Lawyers
McMahon Mining Title Services Pty Ltd
McMullan Nolan Surveyors
MHR Surveyors
Minter Ellison
MKT - Taxation Advisors
Morris Corporation WA
Multipro IT
Newexco Services Pty Ltd
Newsat Limited
Nomad Modular Building Pty Ltd
Norman Disney & Young
Optica Solutions Pty Ltd
Pennock Executive Recruiting
Perenia Carbon
PKF Chartered Accountants
Polycom Australia Pty Ltd
Preston Consulting
Price Sierakowski
PricewaterhouseCoopers
Professional Public Relations (WA)
Proteus EPCM Engineers
Quantam Analytical Services
Resource Information Unit

AMEC – ASSOCIATE MEMBERS, continued

R-Group International
Sanderson Drilling
SAS Telecom
SBD Drilling Pty Ltd
Snowden Group
Southern Cross Surveys
Specialised Broking Services
Strathearn Insurance Brokers
Telstra Business Centre - Central Perth
Tetra Tech - Mining & Minerals
The AusIMM
The CEO Institute
Thrifty Car Rentals WA
UTS Aeroquest
UWA - Energy Minerals Initiative
WA Surface Mining
Wallis Drilling Pty Ltd
Wanati Pty Ltd
Westrac Pty Ltd
Williams & Hughes
Wright Prospecting Pty Ltd
X-Pert Group (Australia)