22nd December 2011

Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email: economics.sen@aph.gov.au

Dear Sir/madam

Minerals Resource Rent Tax Bill 2011 and related Bills

Attached is the submission from the Association of Mining and Exploration Companies (AMEC) on the call for submissions by the Senate Standing Committee on Economics on the Minerals Resource Rent Tax Bill and related Bills.

On behalf of the 350 member companies of AMEC I thank you for the opportunity to comment and look forward to meeting with the committee at the first opportunity.

Yours sincerely

Simon Bennison
Chief Executive Officer

Submission to

Senate Economics Committee

Minerals Resource Rent Tax Bill 2011 (MRRT) and associated Bills

December 2011

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Introduction

1. Thank you for the opportunity to provide this submission on the Minerals Resource Rent Tax Bill 2011 (MRRT) and associated bills.

2. The Association of Mining and Exploration Companies (AMEC) is the peak national industry representative body for mineral exploration and mining companies within Australia, many of which have iron ore and coal projects. AMEC has over 350 companies that are members.

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

4. It is in this context that AMEC provides the following additional comments and observations on the legislation.

Executive Summary

5. AMEC was strongly opposed to the original Resource Super Profits Tax (RSPT) announced in May 2010, including the detrimental effect the tax would have on Australia`s international competitiveness and attractiveness as a place in which to invest, and on the effect it could have on regions and communities throughout Australia. In AMEC`s view those '*national interest*' concerns still remain.

6. AMEC has also been publicly opposed to the replacement Minerals Resource Rent Tax (MRRT) announced by the Government in July 2010 as it is **unfair**, **discriminatory** and **extremely complex** tax legislation. It is also considered to be ill conceived as it was a direct result of a private and secret consultation process with three large multi-national companies and the execution of a Heads of Agreement with those companies, which formed the basis of the tax design.

7. AMEC was not consulted in any way during this private 'negotiation' process.

8. These companies had no mandate to act on behalf of the many other mining and exploration companies with projects or interests throughout Australia. These conglomerates also did not have any mandate to act in any way on behalf of AMEC or its wide membership base.

9. These companies undoubtedly negotiated the Heads of Agreement with the Government with the interest of their own shareholders in mind, and not necessarily for the benefit of the wider industry.

10. AMEC still considers that the MRRT regime is an ill conceived, punitive, discriminatory and irrefutably badly designed tax, and should be rescinded in its entirety.

11. It is not a strategic long term tax reform program.

12. Notwithstanding this, AMEC continues to constructively participate in the process, and therefore provides the following constructive and pragmatic comments on the MRRT legislation and associated bills, some of which will require consideration and subsequent amendment to the proposed legislation.

Recommendations

13. ***Design amendment 1* - That small emerging miners should be sheltered from the MRRT by the provision of a 10mtpa group production threshold as identified by the Policy Transition Group.**

14. ***Design amendment 2* - That competitive neutrality should be re-established and a level playing field created by the establishment of a benchmark rate and payment deferral arrangement.**

15. ***Design amendment 3* - That magnetite concentrate should be excluded from the provisions of the MRRT legislation.**

16. ***Design amendment 4* - That the MRRT legislation will not be extended to commodities other than iron ore and coal.**

17. ***Administrative amendment 5* - That the MRRT Profit Threshold should maintain its real value by means of annual indexation.**

18. ***Administrative amendment 6* - Removal of the restrictions to transfer allowances where the Alternative Valuation Method is elected by an emerging miner.**

19. ***Administrative amendments 7* - That if a taxpayer elects for the simplified MRRT Method then entitlements to the allowance components are allowed to be carried forward. (This proposal would enable small taxpayers the advantage of a reduced compliance burden, but without the permanent loss of the allowance components).**

    That the taxpayer be allowed to bring forward all elements of the allowance components into the later year, on the basis of what would have been allowed, had the election not have been made in prior years, and that appropriate records are maintained to support the relevant components.

20. ***Administrative amendments 8* - That the pre-mining losses provisions are amended to allow exploration expenditure incurred by an entity prior to earning an interest in the tenement to be included in an entity`s pre-mining expenditure.**

    That exploration expenditure should still qualify as pre-mining expenditure even if it does not lead to the farmee acquiring an interest, and would attach to another pre-mining project interest which relates to the same taxable resource.

21. ***Administrative amendments 9* - That small emerging miners (<10mtpa) are excluded from the instalment system for a minimum period of 2 years from the introduction of MRRT, or from commencing production.**

    That the lodgement date for small merging miners is extended until the end of the eighth month (28 February for a 30 June year end) to allow sufficient time for MRRT returns to be completed and lodged.

22. ***Administrative amendment 10* - That all mechanisms included in the Organisation for Economic Cooperation and Development (OECD) Transfer pricing Guidelines should be capable of being applied.**

23. ***Administrative amendment 11* - 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.

Discussion of key issues

'Points of difference' and anti-competitive issues

24. It is very apparent that despite constructive and proactive AMEC comments and recommendations in various submissions and letters there is still an apparent lack of understanding or appreciation:

- of the significant '*points of difference*' between small emerging and mature miners;
- that 'one size does not fit all';
- that there are significant anti competitive issues at the domestic and international levels; and
- that this tax is unfair.

25. Small and emerging mining companies:

- have different risk profiles;
- do not have significant cash flow levels,
- have lower economies of scale, and
- consequently higher unit-cost of production in comparison to large mature miners, making it difficult for them to compete with large mature miners in the domestic and global markets.

26. The current design of the proposed MRRT will provide mature miners with significant tax **shields** and provide additional financial advantages to large mature multi-national conglomerates.

27. Expert independent modeling (**attached**) by the University of Western Australia[1] highlights the **unfair and discriminatory** nature of the MRRT regime, and shows that there will be at least a **4% difference** in the level of **effective total taxation (including income tax, royalties and the MRRT)** between a project that was in existence before 2 May 2010 (mostly the three major iron ore and coal miners), and that applying to less advanced or new developments taking place after 1 July 2012.

28. The modeling shows that before the introduction of the MRRT the average total tax (income tax and royalties) for mining companies would have been around 38%, and post MRRT the total effective tax rate increases to over 40% and over 44% for existing and new projects respectively[2].

29. This means that under the proposed MRRT regime a small emerging miner will be paying an **additional effective tax rate of 6%,** compared to a large mature miner that will be paying an extra 2%. See Figure 1 at the end of the submission.

[1] Dr. Pietro Guj, Research Professor, Centre for Exploration Targeting, The University of Western Australia – 'Is MRRT competitively neutral?'.

[2] Evidence provided by Mr Morgan Ball, the Chief Finance Officer of BC Iron to the House of Representatives Committee on 9 November 2011 expected the company`s effective tax rate to go from roughly 39% to potentially 46% to 48% subject to commodity prices.

30. This differential, which is caused by a large tax shield provided to mature miners who are able to claim a significant deduction for the market value of their 'starting base assets', allows them to reduce their MRRT liability for the remaining life of the mine or 25 years, whichever is the lesser.

31. Small emerging miners are not able to claim such an extensive 'tax shield', and therefore their 'unit cost of production' and ultimate effective tax rate is detrimentally affected.

32. This is a significant issue in respect of competitive neutrality and equality, and is fundamental to AMEC`s continued opposition to the current design of the MRRT.

33. Unfortunately, this crucial point has not been understood or recognized by key influencers. This includes the House of Representatives Economics Committee Chair, Julie Owens MP, who incorrectly stated in the foreword to that Committee`s Report that '*emerging miners believed that they would be paying a <u>large amount of the revenue</u> under the MRRT and that large miners would pay very little, due to the larger starting base that established miners have available to them as a deduction against the MRRT.'*(emphasis added by AMEC).

34. As detailed above, due to the capacity of large mature miners to claim a larger starting base deduction, their effective tax rate will be lower than small emerging miners, who cannot claim the same level of starting base allowance. AMEC has never indicated that small emerging miners would be paying a large amount of the revenue.

35. Despite having an objective to '*identify unintended consequences'* it is also disappointing that the House of Representatives Economics Committee failed to recognize the obvious impact that the MRRT will have on Australia`s small emerging miners (as detailed above), who will be competitively disadvantaged in the domestic and international markets.

Small and emerging miner issues

36. The Government has unsuccessfully attempted to provide some recognition to Small Miners through Division 45 (Low Profit Offsets) and Division 200 (the Simplified MRRT Method).

37. However, industry believes the low profit offset threshold offers very little protection as the Government`s Policy Transition Group (PTG) had set out to do. The MRRT profit threshold (possibly to be increased from $50m to $75m as a result of a proposed amendment passed through the House of Representatives), based on discussions with AMEC members, does not provide sufficient protection to a small merging miner, and does not address the uncertainty, nor the inequities and identified discrimination between small emerging miners and large mature miners, caused by the significant difference in '**effective tax rates'**.

38. The original $50m MRRT profit threshold was an arbitrary amount without any foundation that resulted from private negotiations between the Government and three large miners.

39. The original $50m MRRT profit threshold (**not be confused with normal company profit**) provides very little shielding in comparison to the large miners, (through the 'starting base allowance') and does not address the inequities identified by the University of Western Australia.

40. The $50m MRRT profit threshold (<u>and</u> the proposed amended threshold of $75m) is a very low return on the significant levels of capital invested upstream (exploring, developing and

extracting) of the MRRT taxing point (mine gate), and takes no account of the subsequent investment downstream (crushing, blending, transporting, loading, infrastructure).

41. The $50m MRRT profit threshold (and the amended $75m threshold) is also subject to variances in commodity prices and exchange rates, and does not take account the non renewable aspect of the resource.

42. The Government has also proposed a Simplified MRRT concept which is intended to provide small taxpayers with the opportunity of reducing their record keeping compliance burden. In practice, new and emerging companies have indicated that they will not adopt the Simplified Method and still maintain full MRRT records to determine whether they are below the threshold and in the event of a future merger or acquisition. The proposed simplified method will therefore have limited practical benefit to small emerging miners. They will also **lose any rights to carry forward allowances (deductions) should they choose this method**.

43. The Government has also proposed an Alternative Valuation Method (AVM) as a short cut method to allow emerging miners (<10mtpa) a simpler method to work out the mining revenue attributable to their resources at the taxing point. However, where an emerging miner elects to use the AVM for a particular year this precludes them from transferring certain allowances and also combining interests in later years. As a consequence, companies have slammed this aspect of the tax design as there will be limited benefit.

44. The permanent extinguishment of all allowances is considered to be extremely unfair and discriminatory and should be removed from the legislation. Industry believes that without the ability to include the use of allowances, both the Simplified MMRT Method and the Alternative Valuation Method have limited attraction particularly when giving consideration to a merger or being acquired at a future date.

45. Given the failure of these aspects of the legislation to provide the appropriate benefits to smaller emerging miners, AMEC members have recently pursued a more pragmatic and effective approach as described in the following recommended design and administrative amendments below.

Design and administrative amendments

Design amendment 1 – Group production tonnage threshold

46. The Government`s Policy Transition Group has previously attempted to recognise some of the issues facing small miners, and in it`s December 2010 Report[3] to Government recommended the concept of a '**safe harbour of 10mtpa'**. Although this was in relation to alternative valuation methods (Division 175 of the current Bill refers), the 'safe harbour' concept of 10mtpa per se has considerable merit to be used as a threshold on which to '*trigger'* the MRRT.

47. Industry is of the view that adoption of such a 'safe harbour' in relation to **tonnage** is more realistic and has the capacity to provide a **more equitable shield for new and small emerging miners**. It will also provide an opportunity for these new and emerging miners to direct their derived cash flow back into their business and associated infrastructure in order that they can

[3] PTG Report Dec 2010, page 38 and recommendation 21

increase production to 10mtpa, and beyond. This will lead to an increased income tax, royalty and MRRT revenue stream.

48. AMEC considers that such a tonnage threshold shield is more equitable on which to 'trigger' the MRRT, apply an economic rent and recognise the 'non renewable' nature of the resource (Division 1 of the Bill).

49. Based on industry estimates the proposed amended $75m per annum MRRT profit threshold equates to a very small mining operation producing approximately **1 to 5mtpa** of iron ore (subject to the nature and extent of the mining operation and their cost structure).

50. Following consultation with industry and expert accountants / consultants, a group production of **10 million tonnes of iron ore or coal in the MRRT year** would be an equitable shield and provides a more acceptable differentiation between a **'new and emerging miner'** and a more **'advanced mature miner'**.

51. It is proposed that the amended $75m MRRT profit threshold should be retained in the Bill (Division 45), and a minor amendment made to Section 4 of each of the Rating Bills, whereby an 'emerging miner factor' of 75% is provided where group production of the taxable resource for the miner for an MRRT year is less than 10 million tonnes. It is anticipated that such an amendment would be close to revenue neutral.

52. Such a threshold would also significantly reduce compliance and administration costs for industry and government, and remove much of the business uncertainty surrounding small and emerging miners and their investors.

Recommendation:

53. ***That small emerging miners should be sheltered from the MRRT by the provision of a 10mtpa group production threshold as identified by the Policy Transition Group.***

Design amendment 2 – MRRT benchmark rate

54. In a further attempt to address some of the identified discrimination and inequities within the proposed MRRT legislation and create a more even playing field between large mature miners and small emerging miners it is proposed that the Bill be amended as follows:

- MRRT only becomes liable to be paid in the year the first mature miner becomes liable for payment of MRRT. (This should be separately calculated; on the one hand a calculation for coal and the other, for iron ore). In this context mature miner is proposed to be a miner whose group production of taxable resources exceeds 40million tonnes in an MRRT year, and
- The rate of MRRT payable by taxpayers should not exceed a "benchmark rate" calculated by reference to the highest "mature miner" MRRT Liability for the MRRT year by applying an agreed formula in relation to each class of taxable resource (either coal or iron ore).

Recommendation:

55. ***That competitive neutrality should be re-established and a level playing field created by the establishment of a benchmark rate and payment arrangement consistent with that of mature miners.***

Design amendment 3 - Exclude magnetite concentrate from the MRRT legislation

56. The proposed MRRT legislation makes no recognition of the significant differences between magnetite iron ore and hematite iron ore. Unlike hematite which is the main constituent of 'Direct Shipping Ore', magnetite iron ore requires significant processing and specialised infrastructure and considerable additional investment in order that the Fe content of the product is concentrated to an acceptable and marketable level.

57. Without such 'value adding' the crude magnetite ore would have no commercial value as there are no ready markets for it.

58. An appropriate amendment excluding magnetite concentrate from the MRRT legislation is therefore considered appropriate.

Recommendation:

59. ***That magnetite concentrate should be excluded from the provisions of the MRRT legislation.***

Design amendment 4 - Range of commodities covered by the MRRT legislation

60. AMEC members remain concerned that the scope of the MRRT could be widened to commodities other than iron ore and coal, despite the Government`s stated intention not to do so.

61. Such a commitment should therefore be enshrined in the MRRT legislation to ensure that does not eventuate.

Recommendation:

62. ***That the MRRT legislation will not be extended to commodities other than iron ore and coal.***

Administrative amendment 5 - indexation of the MRRT Profit Threshold

63. In order to maintain the real value of the minimum MRRT profit threshold it should be indexed on an annual basis in accordance with the Australian Consumer Price Index. This is despite the fact that the PTG has suggested that automatic indexation of thresholds is not a feature of the Australian income tax system and that it could be included as part of the budget process[4].

64. The absence of any indexation would result in 'bracket creep', with the present value of the proposed threshold being diminished over time.

Recommendation:

65. ***That the MRRT Profit Threshold should maintain its real value by means of annual indexation.***

Administrative amendment 6 - Alternative Valuation Method

66. The Alternative Valuation Method (AVM) has been introduced as a short cut method to allow emerging miners (<10mtpa) a simpler method to work out the mining revenue attributable to their resources at the taxing point. However, where an emerging miner elects to use the AVM for a particular year this precludes them from transferring certain allowances and also combining interests in later years.

[4] PTG Report, page 77.

67. It is noted in the Explanatory Memorandum that "**lower** than normal resource values could be generated by the alternative valuation method (because the prescribed rate of return on downstream capital could be too high for a particular operation)" (emphasis added). On the same basis a **higher** than normal resource value could be generated under the AVM.

68. It is the inherent nature of a short cut method that it will result in a proxy for the actual calculation based on the assumptions used. However in other legislation requiring complex calculations (eg tax consolidations), the use of a short cut method does not result in restrictions being imposed on a taxpayer.

69. The taxpayer should be allowed to carry forward all elements of the allowance components into the later years, on the basis of what would have been allowed, had the election not have been made in prior years, and that appropriate MRRT records are maintained to support the relevant components.

70. AMEC strongly recommends the removal of the restrictions to transfer allowances where the AVM is elected by an emerging miner as it is both unnecessary and punitive, and it will act as a deterrent for emerging miners to make the election, which is contrary to the policy to introduce the AVM.

Recommendation:

71. ***Removal of the restrictions to transfer allowances where the Alternative Valuation Method is elected by an emerging miner.***

Administrative amendment 7 - Simplified MRRT method

72. The simplified MRRT concept is intended to provide small taxpayers with the opportunity of reducing their record keeping compliance burden. In practice, it is highly likely that all small taxpayers will still maintain full MRRT records to determine whether they are below the threshold and in the event of a future merger or acquisition and therefore the proposed simplified method will have no practical benefit to small miners.

Recommendations:

73. ***That if a taxpayer elects for the simplified MRRT Method then entitlements to the allowance components are allowed to be carried forward. (This proposal would enable small taxpayers the advantage of a reduced compliance burden, but without the permanent loss of the allowance components).***

74. ***That the taxpayer be allowed to bring forward all elements of the allowance components into the later year, on the basis of what would have been allowed, had the election not have been made in prior years, and that appropriate records are maintained to support the relevant components.***

Administrative amendments 8 - Pre-mining losses – exploration expenditure

75. Farm in agreements often involve commitments by the in-coming participant to expend agreed amounts over time for the purpose of defining the presence and quantity and quality of possible mineralisation. This expenditure, sometimes complemented by cash consideration, would result in an in-coming participant progressively acquiring equity in a project. Under the provisions of

the Income Tax legislation these expenditures are immediately deductible in the year in which they are incurred. Under the MRRT proposal these expenditures appear to be deemed to represent consideration for the acquisition of equity in the project and as a consequence would not create a pre-mining interest.

76. Such an approach would:

- Not recognise the fact that the value would have been added to the project as a result of exploration activities,
- Severely undermine the future capacity to raise funds for exploration and the capacity to spread risk, and
- Affect the fundamental principles and structure of future farm in/out agreements.

77. Under the MRRT legislation a *pre-mining* loss arises if during an MRRT year an entity holds a *pre-mining project* interest and the entity`s *pre-mining* expenditure for the interest exceeds the *pre-mining revenue* (Division 50). This requires a taxpayer to hold an interest in an exploration right in the year the expenditure is incurred.

78. Generally under a deferred farm out agreement a farmee does not commence to hold an interest in an exploration licence until specified exploration commitments have been satisfied. As a consequence, a farmee will not be able to claim a deduction for exploration expenditure as pre-mining expenditure until they acquire an interest in a tenement.

79. This is likely to lead to a change in the commercial arrangements for farm out agreements whereby a farmee may have to acquire a nominal interest in an exploration licence at the time of entering into the agreement.

80. This will lead to additional and unnecessary complexity in the industry, as well as a potential additional stamp duty impost as this type of arrangement will not qualify for farm out exemptions under various State Stamp Duty Acts.

81. AMEC recommends that the pre-mining losses provisions are amended to allow exploration expenditure incurred by an entity *prior* to earning an interest in the tenement to be included in an entity`s pre-mining expenditure. In this regard it is noted that *pre-mining project operations* included activities *preliminary* to holding the pre-mining project interest.

82. AMEC also recommends that where a farmee incurs exploration expenditure which does not lead to the farmee acquiring an interest AMEC considers these restrictions are both unnecessary and punitive for small emerging miners and that they will act as a deterrent for emerging miners to make the Alternative Valuation Method election.

83. In the event that they decide not to proceed under the agreement, this expenditure should still qualify as pre-mining expenditure and would attach to another pre-mining project interest which relates to the same taxable resource. The same rationale applies for regional exploration (eg aerial mapping) for a taxable resource which does not relate to a specific pre-mining project interest.

Recommendations:

84. ***That the pre-mining losses provisions are amended to allow exploration expenditure incurred by an entity prior to earning an interest in the tenement to be included in an entity`s pre-mining expenditure.***

85. ***That exploration expenditure should still qualify as pre-mining expenditure even if it does not lead to the farmee acquiring an interest, and would attach to another pre-mining project interest which relates to the same taxable resource.***

Administrative amendments 9 - MRRT instalments / Return lodgement / Frequency of returns/payment of MRRT

86. Under the proposed MRRT regulations, default MRRT instalment rates have been prescribed for iron ore and coal of 8% and 3% respectively. A miner can elect to vary their instalment rate however penalties will apply where the varied amount is less than 85% of the actual amount.

87. Given the complexity of the MRRT legislation and the difficulty in accurately estimating MRRT instalments, AMEC recommends that small emerging miners (<10mtpa) are excluded from the instalment system for a period of 2 years from the introduction of MRRT, or from commencing production.

88. MRRT returns are due to be lodged on the first day of the six month after a miner`s year end which coincides with the due date for payment of a miner`s income tax liability. This places additional pressure on the small emerging miner`s limited in-house resources (and their advisors) to accurately calculate the annual MRRT liability.

89. AMEC recommends the lodgement date for small merging miners is extended until the end of the eighth month (28 February for a 30 June year end) to allow sufficient time for MRRT returns to be completed and lodged.

Recommendations:

90. ***That small emerging miners (<10mtpa) are excluded from the instalment system for a period of 2 years from the introduction of MRRT, or from commencing production.***

91. ***That the lodgement date for small merging miners is extended until the end of the eighth month (28 February for a 30 June year end) to allow sufficient time for MRRT returns to be completed and lodged.***

Administrative amendment 10 - Mining Revenue

92. AMEC notes that the mining revenue calculation is now subject to a more prescriptive two step process involving the determination of the realised sales and subtracting from it revenue attributable to downstream activities. In this regard, it is noted that the downstream amount comprises amounts actually paid or payable by the miner to procure downstream processing, transport and/or other activities from another entity.

93. In broad terms, it also requires a miner to assume (amongst other things) that in-house processing operations, transport and/or other activities were in fact carried out by a third party in a competitive market.

94. This approach will create a significant challenge in determining what an appropriate charge would need to be for different operations given their vastly different scope of operation, tonnage of ore throughputs, degree of blending and/or processing etc. In addition to making allowance for economies of scale, complexities will also arise in determining appropriate rates of return on capital for the hypothetical service suppliers.

95. The legislation also attempts to clarify that certain assumptions must be made when determining the downstream value, and provides a prescribed hypothetical situation which the miner must use in applying the 'arm`s length principle', and appears to direct miners towards some form of 'netback' transfer pricing method.

96. The legislation suggests the use of appropriate transfer pricing methods as described in the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines. AMEC consider this approach sound and recommends that all mechanisms included in the above guidelines should be capable of being applied. In particular AMEC would not wish to see the use of 'profit-split' or similar mechanisms to determine the taxable value excluded.

97. The MRRT legislation does not appear to have taken consideration of a distinct trend in new developments towards increased use of contractors particularly in the upstream parts of the value chain. This is a consequence of the difficulty experienced by small emerging producers in raising both equity and debt finance due to their higher risk profile. This set of circumstances will have the effect that emerging producers will have relatively low levels of asset values in their balance sheets and as a consequence becoming unable to benefit from the significant depreciation tax shields provided by the MRRT legislation to larger enterprises that own most of their assets.

Recommendation:

98. ***That all mechanisms included in the Organisation for Economic Cooperation and Development (OECD) Transfer pricing Guidelines should be capable of being applied.***

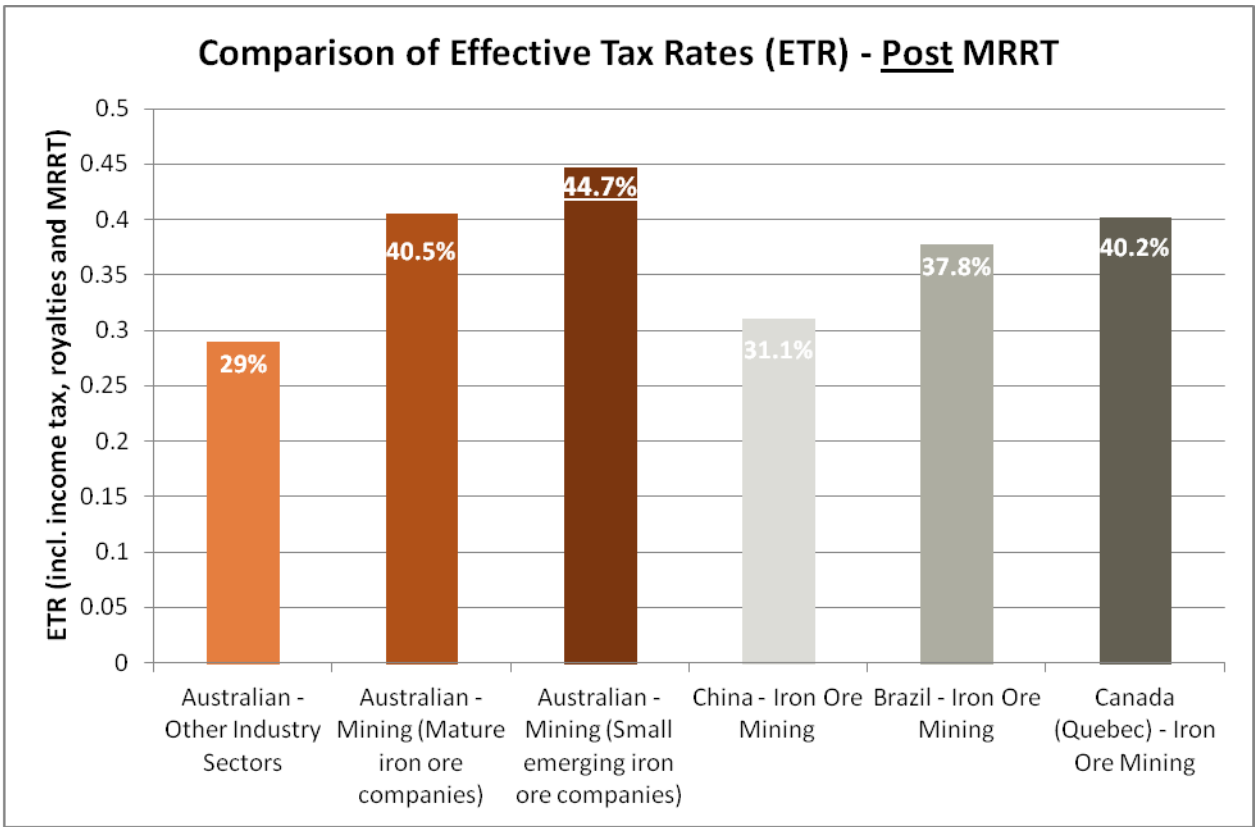
Administrative amendment 11 - Review of the MRRT legislation

99. 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.

Recommendation:

100. ***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.***

Figure 1 Comparison of Effective Tax Rates (ETR) – Post MRRT



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Is MRRT competitively neutral?

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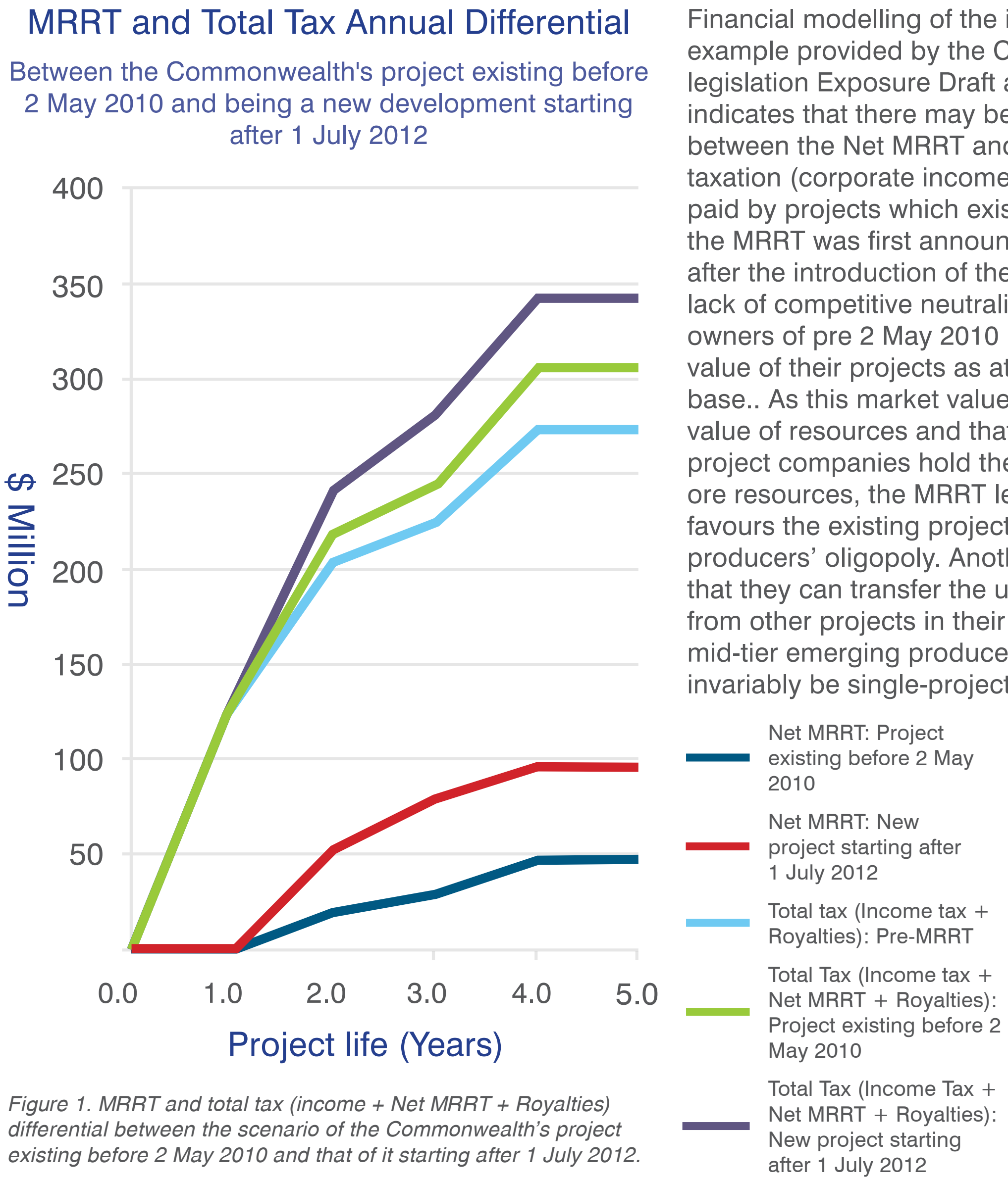

Figure 1. MRRT and total tax (income + Net MRRT + Royalties) differential between the scenario of the Commonwealth's project existing before 2 May 2010 and that of it starting after 1 July 2012.

Financial modelling of the iron ore mine development example provided by the Commonwealth in their MRRT legislation Exposure Draft and Explanatory Material, indicates that there may be significant differences between the Net MRRT and consequently the total level of taxation (corporate income tax + Net MRRT + Royalties) paid by projects which existed before 2 May 2010 (when the MRRT was first announced) and those that will start after the introduction of the MRRT on 1 July 2012. This lack of competitive neutrality is due to the fact that the owners of pre 2 May 2010 projects may select the market value of their projects as at 2 May 2010 as their starting base.. As this market value is largely represented by the value of resources and that large multi-national, multi-project companies hold the lion share of Australia's iron ore resources, the MRRT legislation, at present, not only favours the existing projects but also reinforces the major producers' oligopoly. Another benefit for major miners is that they can transfer the unutilised losses against profits from other projects in their portfolio, while the small to mid-tier emerging producers cannot do so, as they tend to invariably be single-project companies.

continued on page 4.

In this issue...

Photo (top): An exploration drill rig on Lake Lefroy, south of Kambalda.
This photograph is reproduced with the kind permission of BHP Billiton Mineral Exploration, from the Western Mining Corporation Holdings Limited 1990 Annual Report to Shareholders.

continued from page 1.

Introduction

The submission by the Association of Mining and Exploration Companies (AMEC, 2010) to the Policy Transition Group (PTG) in October 2010 details all the points of differentiation and the disadvantages to its members, primarily the smaller iron ore and coal companies., These were the result of the three major multinational, multi-project and multi-commodity corporations, negotiating the general terms of the proposed Mineral Resource Rent Tax (MRRT) legislation with Government, presumably with their interests in mind and with a low awareness of the implications for smaller and emerging producers.

The disadvantages include amongst others:

— Lower economies of scale and consequently higher unit-cost of production,

— Inability to individually fund dedicated transport and port infrastructure. Also, inability to access in spite of significant efforts on their side and on Government's side, proprietary transport infrastructure belonging to existing major producers even if declared open to third party access. This severely limits the scope of their developments in spite of the magnitude of their resource base;

— Their often single-project status which prevents the transfer of unutilised losses and royalty allowances to a related project, thus delaying cash flows, reducing profitability and introducing the risk that some losses will never be recovered;

— Generally, their higher risk profile reduces the availability and increases the cost of both equity and debt and this would aggravated by the higher level of taxation due to the MRRT;

— Inability to attract and retain high-quality key professional personnel, other than at very high cost, because of more restricted career paths and significant demand from major companies.

As for the current corporate income tax regime, these disadvantages are not taken into consideration by the proposed MRRT legislation and results in single-project companies, which do not have the capacity to off-set unutilised losses against taxable income from other projects or associated companies, already being at a distinct disadvantage.. Additionally a recent article in the 22 June 2011 edition of the Financial Review, based on an analysis by Mr. Stephen Pearce, Chief Financial Officer of Fortescue Metals Group, suggests that the proposed MRRT would be further biased in favour of existing, large iron ore producers at the expense of emerging smaller developers starting operations after the MRRT implementation date, i.e. after 1 July 2012.

This lack of competitive neutrality is attributable to the fact that major established producers have secured tenure on and largely delineated the vast majority of the high-grade Australian iron ore resources, and that as a consequence, the market value of their projects is so large as to provide them with significant future MRRT tax shields over a long period of time. This in combination with their capacity to set-off unutilised MRRT losses and royalty allowances from one project against MRRT liabilities incurred in other projects in their portfolios, also accelerates their cash flows significantly increasing their rate of return on equity compared to that of generally single-project emerging producers.

The purpose of the financial modelling and analysis in this paper is to independently test this hypothesis.

Outline of the proposed MRRT Legislation

It is proposed that an MRRT should apply as from 1 July 2012 at a rate of 30% to the mining profit realised by all iron ore and coal projects upstream of the taxing point which is placed at the Run of Mine (ROM) pad. The mining profit is derived by subtracting from the mining revenue at the taxing point all capital and operating costs upstream of that point. Unutilised losses can be carried forward and uplifted at the long term bond rate (LTBR) plus 7%. The MRRT is subsequently reduced by 25% by way of an Extraction Allowance recognising the value of the miners' expertise to a net 22.5%. Royalties paid to States and Territories are then deducted by way of a Royalty Allowance. Any unutilised royalty credit is also carried forward and uplifted at the LTBR plus 7%. Projects with an annual mining profit less than $ 50 million do not pay any MRRT. This benefit is, then progressively reduced to zero for mining profits between $ 50 million and $ 100 million.

Apportionment of revenue between that derived from activities upstream and downstream of the taxing point, can be done by the most appropriate of five methods, as described in the OECD Guidelines. Operations with an annual throughput of less than 10 million tonnes of ore, or integrated to steel mills or power generation, can elect to use the "alternative" MRRT accounting method which estimates the revenue at the taxing point by netting back from the revenue derived from the first at arm's length sale of a product and all the costs incurred below the taxing point.

Small miners with a profit below the $ 50 million threshold can elect to use a "simplified" MRRT accounting method, which however implies foregoing the starting base and other deductions, if their profit were to exceed this threshold in future years.

Multi-project corporations can transfer their unutilised losses (other than starting base losses) and allowances from any of their projects against the mining profits derived from other projects in their portfolio.

To the extent that the MRRT will also be applied retrospectively, i.e. to projects which were in existence before it was first announced on 2 May 2010, a range of transitional rules have been drafted to recognise capital investments which were incurred before this date and in the transitional period between 2 May 2010 and 1 July 2012. Owners of projects which were in existence before 2 May 2010 have two choices to determine the starting value for their projects, i.e. either the:

— Book value as at 1 July 2012, excluding the value of the resource or

— Market value at 1 May 2010 plus any capital investment which takes place in the transitional period. The market value of a project includes the value of the resource which may constitute the bulk of it.

Under the MRRT regime the book value of the project can be depreciated over 5 years on an accelerated basis, e.g. at the rate of 36%, 24%, 15%, 15% and 10% respectively. The written-down starting base balances will be uplifted yearly at LTBR + 7%.

The market value starting base will be depreciated over the remaining life of the project on a straight line. The relevant written-down balances will be uplifted yearly at the rate of change in CPI (March to March quarters).

As discussed below, it is the option of adopting the market value of a project as its starting base that is the source of potentially significant differences between the tax paid by new projects starting after 1 July 2012 compared to that paid by projects which were in existence before 2 May 2010.

General Results

The worked out example of how the MRRT would be calculated, included in the Commonwealth Government Exposure Draft and Explanatory Material released on 10 June 2011, was modified in the present study to find out whether and to what extent the MRRT would in fact be discriminative by not being competitively neutral.

While essentially retaining the Commonwealth's model assumptions other than for introducing more realistic capital cost, two versions of the same iron ore mine project were developed. The first is analogous to the Commonwealth's model with the project starting with capital investment in financial 2012-13, i.e. after the MRRT is introduced. The

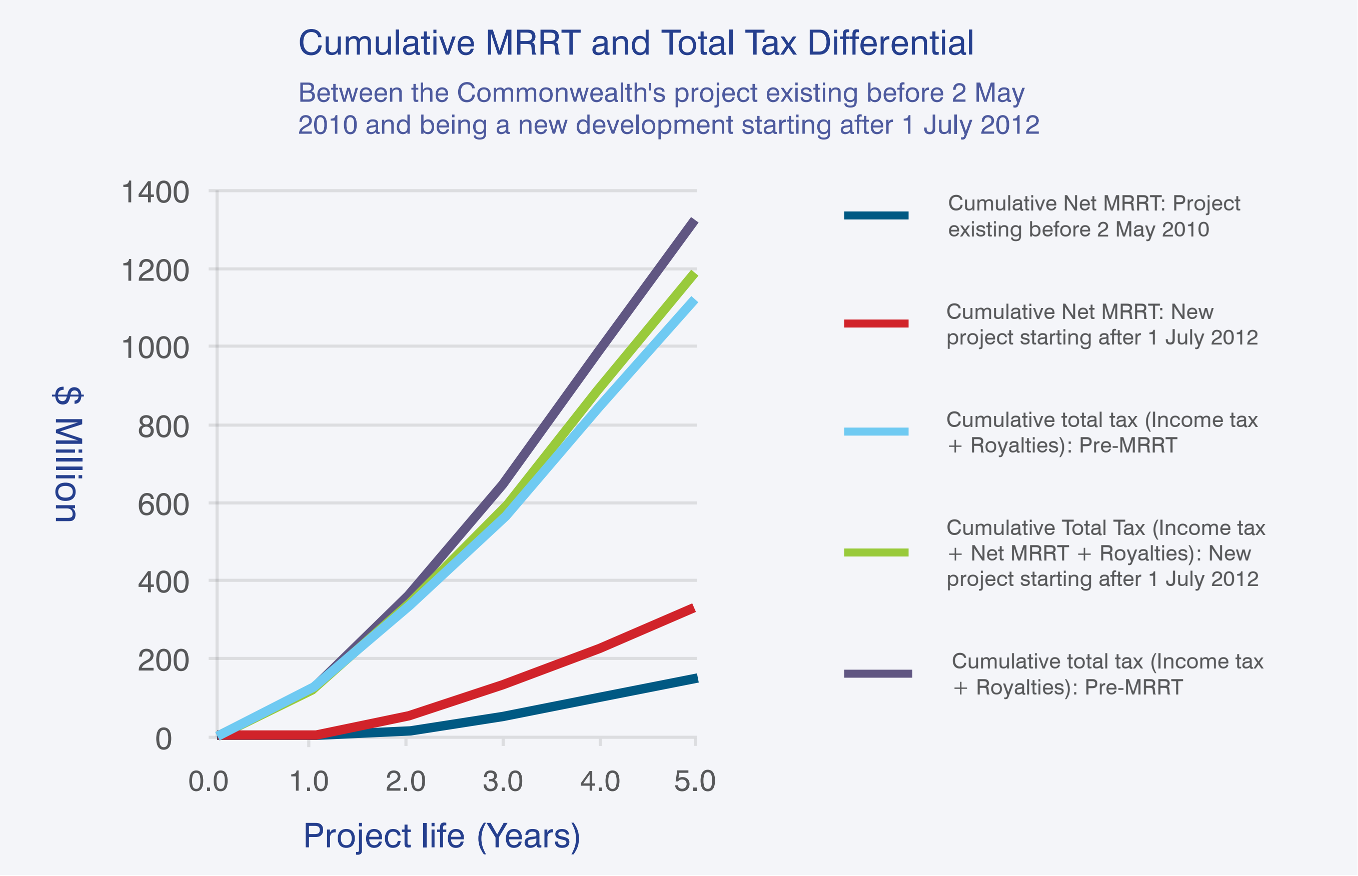

Figure 2. Cumulative MRRT and total tax (income + Net MRRT + Royalties) differential between the scenario of the Commonwealth's project existing before 2 May 2010 and that of it starting after 1 July 2012.

second model portrays the same project as if it had been in existence before 2 May 2010 (the date when MRRT was first announced) with the same capital investment taking place in the transition year 2011-12 and operations starting after the introduction of the MRRT on 1 July 2012.

A comparison between the two models (see Figures 1 and 2) indicates that, at least in the example in question, there is evidence that the project which was in existence before 2 May 2010, with an average tax rate of 40.5%, would enjoy a much lower level of annual and cumulative Net MRRT, resulting in a much lower level (about 4.3% less) of total taxation (including corporate income tax, Net MRRT and Royalties), than that paid by the same project (44.7%) if starting after 1 July 2012.

The Net Present Value (NPV) of the project starting after 1 July 2012 at $ 1,072.5 million is also, not surprisingly, lower than that of the existing project at $ 1,157.0 million, reducing its attractiveness to investors and making it harder and more costly to raise exploration and development equity capital and to secure project finance, than for the established project.

The 44.7% average rate of total taxation to be levied on the project following the introduction of the MRRT represents a 6.8% increase over that which would have been levied in the absence of this tax (i.e. 37.9%). This higher level of taxation will reduce the NPV of the project at a discount rate of 12% by $ 152.1 million, i.e. from $ 1,224.6 million to $1,072.5 million.

It is likely that a similar conclusion may be reached for projects with lives longer than the five years used in the example. Thus, owners of very large projects which were in existence before 2 May 2010 can opt to use the market-value as a starting base, which includes the potentially high value of their often large resources, and benefit from very significant tax shields in some cases over very long periods of time. They would continue to pay a much lower rate of total taxation compared to that paid by emerging and particularly smaller developments, until all starting base losses have been set off, after which the effective rate of taxation will become the same.

It is hoped that the conclusions of the present paper may encourage the Commonwealth Government to expand the scope of this type of analysis, and if a systemic inequity is confirmed, amend the draft MRRT legislation to redress any inequities and establish a higher degree of competitive neutrality. Failing to address this issue would re-enforce the current iron ore oligopoly and lock potential new smaller/mid-tier producers out of the market, thus acting as a significant disincentive for new developments and supply diversification of the industry.

Supporting Financial Modelling

Project parameters

The MRRT legislation Exposure Draft and Explanatory Material released by Government on 10 June 2011 provide among others a worked out example of how the MRRT should be calculated for an iron ore mining project with a production life of five years. This example, while clear and useful, is strictly prospective, i.e. it focuses exclusively on an entirely new, single equity project starting after 1 July 2012.

The example does not provide any physical parameters for the project as for instance its total recoverable diluted reserves, their grade and related annual ore throughputs.

However, an idea of the scope of this project can be derived by dividing the total operating cost over its life ($ 1,120 million) by an order-of-magnitude estimate of the average operating cost per tonne of ore ($ 22.5 per tonne), which indicates that the total recoverable reserves are of the order of 50 million tonnes of ore and that the annual ore throughput is just over 10 million tonnes of ore per annum after a ramp up in the first year. This would make the project a typical mid-tier one.

If the total revenue over the life of the project ($ 4,450 million) is divided by the above total reserves of 50 million tonnes, the project will realise on an average of $89 per tonne of ore sold at the taxing point. Although, we are not aware of the iron ore price forecasts and protocol to net the project revenue back to the taxing point used in the Commonwealth's model, we consider this mining revenue estimate to be somewhat optimistic in light of current more modest industry projections for iron ore prices, even if the ore is assumed to be quite high grade.

However, for consistency and ease of understanding the following modelling will make use of the revenue and cost assumptions presented in the Commonwealth's example as doing so, while making comparisons easier, does not significantly impact on the logic and conclusions of our analysis.

The capital expenditure estimate in the original Commonwealth's example of $1 billion is considered unrealistically high for an emerging producer developing a project with a limited five year life. This is because most small to mid-tier emerging iron ore producers make significant use of mining contractors. As a consequence they do not own high levels of fixed assets particularly up-stream of the taxing point in their balance sheet. Accordingly, a more realistic capital investment of $250 million was used in the present analysis to reflect the fact that the project would benefit from capital plant and equipment in large part owned by the contractors, which cannot be depreciated and deducted by the project owners for the purposes of assessing its taxable profits for both MRRT and corporate income tax. A premium of ten percent was applied to the recurrent operating costs of the project provided in the Commonwealth's model to recognise that contractors' charges need to include an allowance to compensate them for their capital costs.

Prospective and retrospective project taxation and values

Two differently timed version of the same project are presented at Table 1 and 2.The first (Table 1) is analogous to the Commonwealth's model with the project starting for simplicity sake with an instantaneous $ 250 million capital investment in financial 2012-13, i.e. after the MRRT is introduced.

YEAR	0	1	2	3	4	5	
RESOURCE CHARGE	$M	$M	$M	$M	$M	$M	
Revenue	0.0	520.0	830.0	910.0	1090.0	1100.0	
In-house operating expenses	0.0	130.0	210.0	230.0	270.0	280.0	
Contractor premium	0.10						
Operating expenses		143.0	231.0	253.0	297.0	308.0	
Depreciation	250.0						
MRRT allowance @ 13%		32.5	0.0	0.0	0.0	0.0	
MRRT unutilised losses		250.0	0.0	0.0	0.0	0.0	
MRRT profit / loss	-250.0	94.5	599.0	657.0	793.0	792.0	
MRRT @ 30%	0.0	28.4	179.7	197.1	237.9	237.6	
Extraction allowance @ 25%	0.0	7.1	44.9	49.3	59.5	59.4	
MRRT after extraction allowance	0.0	21.3	134.8	147.8	178.4	178.2	
							Total
Royalty @ 7.5%	0.0	39.0	62.3	68.3	81.8	82.5	333.8
Uplifted royalty offset	0.0	0.0	20.0	0.0	0.0	0.0	
Net MRRT	0.0	0.0	52.5	79.6	96.7	95.7	324.4
Total resource charge	0.0	39.0	114.7	147.8	178.4	178.2	658.2
Company tax							
Revenue	0.0	520.0	830.0	910.0	1090.0	1100.0	
Operating expenses	0.0	143.0	231.0	253.0	297.0	308.0	
Depreciation		50.0	50.0	50.0	50.0	50.0	
Total resource charge	0.0	39.0	114.7	147.8	178.4	178.2	658.2
Company taxable income	0.0	288.0	434.3	459.2	564.6	563.8	
Company tax @ 29%	0.0	83.5	125.9	133.2	163.7	163.5	669.8
Profit before tax	0.0	327.0	549.0	607.0	743.0	742.0	2968.0
Total resource and company tax	0.0	122.5	240.7	281.0	342.2	341.7	1328.0
Total tax as a percentage of profit		37.5%	43.8%	46.3%	46.1%	46.1%	44.7%
							Weighted average effective tax rate
Net Cash Flow	-250.0	254.5	358.3	376.0	450.8	450.3	
NPV @ 12%	1072.5						

Table 1. Exposure draft MRRT model modified to reflect lower level of capital investment.

The second model (Table 2) portrays the same project as if it had been in existence before 2 May 2010 (the date when MRRT was first announced) with the same $ 250 million capital investment taking place one year earlier in the transition year 2011-12 with operations starting after the introduction of the MRRT on 1 July 2012.

Table 1 shows that a project starting after 1 July 2012 would over its life, pay a total of $ 333.8 million in State royalties, $ 324.4 million in MRRT and $ 669.8 million in corporate income tax, amounting to total taxation including income and resource imposts of $ 1328.0 million. This figure represents a weighted average rate of taxation of 44.7% out of a total taxable income of $ 2,968.0. The projected annual mining profits never dip below the minimum $ 50 million profitability threshold.

The Net Present Value (NPV) of this project at a nominal discount rate of 12% is $ 1072.5 million. As already mentioned we feel that this value may be somewhat optimistic in light of more modest industry projections for future iron ore prices. This difference in value, however, is irrelevant in relative terms in the present comparison.

Table 1 was modified in Table 2 to include the market value of this project as of 2 May 2010 assuming that it had been in existence before that date. For the purpose of the exercise the project has been attributed a market value at that date of $ 783 million. This is consistent with the NPV obtained in the model of Table 1 net of the $ 250 million in capital investment which we assumed would be invested in 2011-12 and after accounting for inflation over two years @ 2.5% p.a. The bulk of the market value of the project is, of course, attributable to the value of the resource.

According to the retrospective transitional provisions, if the market value option is selected, the $ 783 million market value starting base plus the $ 250 million capital investment in the transitional period are depreciated on a straight-line basis over the five-year life of the project. The written down value of the unused starting base losses would be uplifted at the rate of change in the CPI (March quarter on March quarter).

The project which was in existence prior to 2 May 2010 is subject to a much lower rate of total taxation (corporate income tax plus net MRRT and royalties) at 40.5% relative to the same project starting after 1 July 2012 at 44.7%. This 4.3% difference is mainly due to a much lower Net MRRT of $ 146.2million compared to $ 324.4 million balanced by a slightly higher level of corporate income tax at $ 721.5million compared to $ 669.8 million.

In addition the established project has a higher NPV of $ 1157.0 million (compared to $ 1072.5 million for the corresponding new development starting after 1 July 2012) making the established project more attractive to potential investors and financiers thus lowering its relevant cost of equity and debt funding.

Conclusions

Financial modelling using modifications of the Commonwealth's model provided with the MRRT legislation Exposure Draft and Explanatory Material indicates that:

— An emerging producer starting after 1 July 2012 would be paying a much higher level (i.e. 44.7% versus 40.5%, a difference of 4.3% more) of total taxation (corporate income tax plus net MRRT and royalties) compared to an identical project which was already in existence prior to 2 May 2010, i.e. before the MRRT was first announced.

— The NPV of the established project is also higher at $ 1157.0 million (compared to $ 1072.5 million for the corresponding new development starting after 1 July 2012), making the established project $ 84.5 million more valuable and therefore more attractive to potential investors and financiers thus lowering its relevant cost of equity and debt funding relative to the new development.

— The larger the value of the resource relative to capital investments in the market-value of the starting base of a project existing before 2 May 2010, the larger will be the total taxation difference between the two project valuations. There will also be a time lag before the project which was in existence before 2 May 2010 will pay the same effective annual rate of total tax as that of a new project staring after 1 July 2012.

— It would be justifiable for the Commonwealth Government to expand the scope of this type of analysis and, if a systemic inequity is demonstrated and quantified for projects of various sizes and lives, amend the draft MRRT legislation to redress it and establish a higher degree of competitive neutrality. Failure to do so would re-enforce the current iron ore oligopoly, lock potential new smaller/mid-tier producers out of the market and act as a significant disincentive for new developments and diversification in the future sources of iron ore supply.

YEAR RESOURCE CHARGE	0 $M	1 $M	2 $M	3 $M	4 $M	5 $M	
Revenue	0.0	520.0	830.0	910.0	1090.0	1100.0	
Operating expenses	0.0	143.0	231.0	253.0	297.0	308.0	
Market value starting base	783						
Transitional CAPEX	250						
Depreciation		206.6	206.6	206.6	206.6	206.6	
MRRT allowance @ CPI		0.0	20.7	15.5	10.3	5.2	
MRRT unutilised losses		826.4	619.8	413.2	206.6	0.0	
MRRT profit / loss	0.0	170.4	371.7	434.9	576.1	580.2	
MRRT @ 30%	0.0	51.1	111.5	130.5	172.8	174.1	
Extraction allowance @ 25%	0.0	12.8	27.9	32.6	43.2	43.5	
MRRT after extraction allowance	0.0	38.3	83.6	97.9	129.6	130.6	
							Total
Royalty @7.5%	0.0	39.0	62.3	68.3	81.8	82.5	333.8
Uplifted royalty offset	0.0	0.0	0.7	0.0	0.0	0.0	
Net MRRT	0.0	0.0	20.6	29.6	47.9	48.1	146.2
Total resource charge	0.0	39.0	82.9	97.9	129.6	130.6	479.9
Company tax							
Revenue	0.0	520.0	830.0	910.0	1090.0	1100.0	
Operating expenses	0.0	143.0	231.0	253.0	297.0	308.0	
Book value	250.0						
Depreciation		50.0	50.0	50.0	50.0	50.0	
Total resource charge	0.0	39.0	82.9	97.9	129.6	130.6	479.9
Company taxable income	0.0	288.0	466.1	509.1	613.4	611.4	
Company tax @ 29%	0.0	83.5	135.2	147.7	177.9	177.3	721.5
Profit before tax	0.0	327.0	549.0	607.0	743.0	742.0	2968.0
Total resource and company tax	0.0	122.5	218.1	245.5	307.5	307.9	1201.5
Total tax as a percentage of profit		37.5%	39.7%	40.4%	41.4%	41.5%	40.5%
		Weighted average tax rate from model of Table 1					44.7%
					Difference		4.3%
Net Cash Flows	-250.0	254.5	380.9	411.5	485.5	484.1	
NPV @ 12%	1157.0						

Table 2. Commonwealth's model modified to portray a project that existed prior to 2 May 2010, where the market-value method was used to determine the starting base and $ 250 million in capital expenditure was incurred in the transitional financial year 2011-12.

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