Our Ref:
Your Ref:

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

23 December 2011

Dear Committee Members

Submission to the Senate Economics Legislation Committee ("Committee") on the Review of the Mineral Resource Rent Tax Bill 2011 and Related Bills ("MRRT Bills")

The Committee is reviewing the MRRT Bills; this letter constitutes a submission by Fortescue Metals Group Ltd ("Fortescue") to the Committee setting out Fortescue's concerns about the MRRT Bills as they apply to the mining industry and in particular to the iron ore industry.

Executive Summary

The Mineral Resource Rent Tax ("MRRT") grew out of an intention to capture alleged Economic Rents being earned by mining companies due to the fact that they were mining non-renewable resources. However the MRRT will only be imposed on iron ore and coal companies, in effect taxing only particular types of bulk commodity producers, namely those enjoying Quasi Rents generated by short term inelasticity of supply. That inelasticity is in turn a function of the massive amounts of downstream infrastructure required to support increases in supply and the long lag times involved in implementing such massive infrastructure projects. So, far from capturing Economic Rent derived from non-renewable resources, the MRRT will only capture the Quasi Rents generated by short term inelasticity of supply that characterizes certain bulk commodities and only then to an extent that the Quasi Rents are not protected by overly generous tax concessions based upon a market valuation methodology that correlates the concessions with the level of Quasi Rents being earned.

The MRRT will impose an additional layer of taxation on top of the existing State and Territory based royalty regimes in a manner that will not simplify taxation, or improve the efficiency of taxation. Indeed since it is now an entirely additional tax, it has increased complexity (and the associated administrative burden) and it necessarily acts as an investment deterrent to the extent that it reduces projected returns on investment. More worryingly since it also necessitates some form of regulation over the returns being earned on downstream investment it will act to deter investment in such associated infrastructure.

The MRRT puts into effect the terms of a Heads of Agreement negotiated between just three large mining companies and the government. Those three companies were rightly interested in protecting the interests of their shareholders; they were not representing the interests of the mining industry generally. What was agreed to will have the effect of giving preferential treatment to the three companies involved in the negotiations; an associated indirect effect

Fortescue Metals Group Limited ABN 57 002 594 872 ACN 002 594 872
ADDRESS Level 2, 87 Adelaide Terrace, East Perth, Western Australia 6004
POSTAL ADDRESS PO Box 6915, East Perth, Western Australia 6892
TEL +61 8 6218 8888 FAX +61 8 6218 8880 EMAIL fmgl@fmgl.com.au

will be to make it more difficult for new mining companies to obtain the necessary finance for their projects thereby raising barriers to entry into an industry that already has substantial barriers to entry. Ultimately this means that the Heads of Agreement that was negotiated will give rise to legislation that will result in a substantial lessening of competition in various markets in Australia. It is wrong for the government to negotiate an agreement that is contrary to s.45(2)(a)(ii) of the *Competition and Consumer Act 2010* ("CCA2010").

Finally and most importantly the MRRT has not been negotiated or agreed with the States, but rather has been designed whilst attempting to leave the existing royalty regimes in place and essentially unaffected. However the very nature of what has been designed seeks to treat different States differently in order to accommodate the existing differences in the royalty rates levied. This means that States that have lower royalty rates in order to encourage exploration and development activity within their borders are discriminated against to the extent that the MRRT will be levied at a higher rate within their jurisdictions. This is in effect a form of indirect discrimination and as such the MRRT is contrary to s.51(ii) of the *Commonwealth of Australia Constitution Act* ("Constitution") under modern interpretations of the meaning of discrimination. Indeed this tax appears to interfere with State's capacity to manage what is clearly the State's business, which is regulating and managing the activities of mining companies that are mining the State's resources and as such would appear to exceed the limitations on the Commonwealth that flow from the very nature of the federal structure established by the Constitution.

A tax that doesn't tax what it set out to tax; a tax that was supposed to be simpler and more efficient but has ended up more complicated and less efficient; a tax that is based upon an illegal agreement and is contrary to the Constitution; surely such a tax is one that a Senate with integrity, seeking to represent the interests of the States, would send back to the House of Representatives for a reconsideration.

<u>It won't do what it set out to do</u>

The Henry Tax Review proposed to levy a uniform 40% resource rent tax on all non-renewable resources in the form of a Resources Super Profits Tax ("RSPT"). The justification given was that the existing system of royalties, levied by the States, was inefficient and distorting and it failed to capture sufficient amounts of the profits being made by the miners of the non-renewable resources resulting in a situation where the Australian community did not receive an appropriate return for its non-renewable resources.

Leaving aside the false premise that non-renewable resources in Australia are owned by the community (they are in fact owned by the States) and concentrating instead on the notion that some of the profit being earned by mining companies, and in particular profit that was derived from the non-renewable nature of what was being mined, should be appropriated by the government on behalf of the community – the question then becomes does the MRRT deliver on the objective of appropriating value from the exploitation of non-renewable resources and deliver that back to the community?

Before addressing this question directly, it is perhaps worth considering exactly what it was about non-renewable resources that made it appropriate for them to be subjected to additional taxes. The answer appears to be that their non-renewable nature (and by implication limited supply) enables profits to be earned in excess of the normal rate of profit – namely what is termed an 'Economic Rent'. However within the all-encompassing term Economic Rent – there exists: 'Scarcity Rent'; 'Differential Rent'; and 'Quasi Rent'. In a resource context: Scarcity Rent reflects profits earned as a result of the inherent limitation in

the supply of non-renewable resources (a finite supply); Differential Rent is the profit that the owner of a particular deposit can earn in addition to any Scarcity Rent because their deposit has some characteristic that means it can be mined or processed or transported at a lower cost than normal, or alternatively there is some characteristic of the deposit that enables the product to command a higher price than normal (quality differences); and Quasi Rent is extra profit that can be earned, usually for a limited time, as a result of supply side lags or any other restrictions that prevent supply increasing immediately to a level that competes away the Economic Rent. If the intention was to impose an additional tax on non-renewable resources that appropriated the Economic Rent earned as a result of its non-renewable nature then the tax should have been targeted at the Scarcity Rent element.

The MRRT confines its application to just iron ore and coal and then seeks to define profit in a particular manner, which, ignoring existing projects (which were subject to transitional arrangements) will result in the tax being applied to any cash margin that is in excess of that necessary to earn a return equivalent to the 'long term bond rate ("LTBR") plus 7%' from just the capital invested upstream of the taxation point. Although it is very difficult to exactly apportion whatever Economic Rent is being earned into the aforementioned three different categories – in relation to the iron ore industry it would be fair to say that a majority of the Economic Rent currently being earned would fall into the category of Quasi Rent; and the rest should be classed as Differential Rent. The point is that the current high profits being earned by iron ore miners operating in Australia are nothing to do with the non-renewable nature of iron ore, but rather they are pre-dominantly a reflection of the massive amounts of capital typically required to bring new iron ore deposits into production (most of which is invested downstream from the taxation point) and the very significant time lags between market price signals being strong enough to induce an increase in supply and that increased supply reaching the market.

If the intention behind the RSPT and subsequently the MRRT was to tax non-renewable resources in order to appropriate Scarcity Rent on behalf of the Australian community, and I believe that it was, then the MRRT has completely and categorically failed to achieve that objective. The act of confining its application to coal and iron ore actually excluded those non-renewable resources that actually earned Scarcity Rent (such as gold) and confined its application to commodities that happen to be currently earning Quasi Rents. In relation to the iron ore industry, the MRRT as currently designed also targets Differential Rents and in so doing penalises exploration success and any other developments that increase the return through value adding activity above that allowed through the netback pricing mechanism. In other words explorers that happen to locate higher quality deposits will have the additional profit generated by this higher quality taxed, not only by the rate of corporation tax but by the MRRT rate as well – the combination of corporation tax at 29% and MRRT at effectively 22.5% means that Differential Rent profits from high quality iron ore deposits face a marginal tax at a rate of 45% - which is certainly high enough to act as a deterrent and may be sufficiently high to divert exploration and development expenditure to locations with more favourable tax environments. Also project developers that invest in downstream processing that seeks to add value will be penalised to the extent that that value adding activity achieves a return greater than that allowed through the netback pricing mechanism. The reason for this is that to the extent that the value adding activity adds value greater than the return allowed on the investment (under the netback pricing mechanism) that additional value will then be attributed to value created upstream of the taxation point effectively bringing such investment under the marginal tax rate of 45% that prevails there.

As to the Quasi Rent profits from iron ore mining they are expected to dissipate over time – indeed it is unlikely that iron ore projects that are not already under active development will

reach fruition before those profits have been eroded to zero. Of course that leaves Quasi Rent profits being earned by the existing producers, but the Heads of Agreement, that gave rise to the MRRT in its current form, sought to compensate existing producers so as to remedy the retrospective nature of what was proposed and in so doing ended up granting concessions based not on levels of prior investment but based instead on a market valuation of the current business including the value of resources in the ground. The problem with this approach is that it will grant such a large tax shield to existing large producers – actually based upon the current level of Quasi Rent profits being enjoyed – that it is likely to shield the bigger miners from paying any MRRT for the entire period that the Quasi Rent profits are expected to endure.

So in summary, the tax started out as an attempt to appropriate some of the Economic Rent being earned by companies that extract non-renewable resources in Australia for the benefit of the wider community. However a series of compromises have converted it into a tax that applies solely to iron ore and coal (which are industries enjoying temporary Quasi Rents consequent upon the large increase in demand emanating from China and the massive investment required to bring on new projects and the associated long lag times involved), but not to the projects of existing producers (who have negotiated concessions that will effectively exempt them from paying most if not all of the tax for the duration of the period when they are likely to be earning Quasi Rents) so that in effect the tax falls mainly upon new producers that were not in a position to obtain huge concessions based upon May 2010 market valuations. This effectively means that the perceived sovereign risk associated with investing in Australia (and the attractiveness more generally of Australia as an investment destination) will be undermined by a tax that won't raise anything like the projected revenues (due to the generous but misunderstood concessions that have been granted) but will increase the complexity of taxation, will increase the administrative burden and will act more generally as a deterrent to investment and as an inefficient tax.

It is unambiguously a worse tax

The original RSPT was at least able to claim that in some theoretical sense it would improve the efficiency of the taxation being applied to the mining industry. The original thesis was that a royalty regime was inefficient because the royalty rate applied to the total revenues being earned rather than to the profits being generated. This meant that entities that were not actually making profits were still subjected to paying the royalty payments. At the margins this meant that what were projected to be low profit projects, where the expected rate of return was just equal to the required rate of return before the payment of royalties, would be dragged below the required investment threshold by the payment of royalties, and so wouldn't happen. Similarly, for projects that were experiencing rising marginal cash costs (which typically occurs where miners are chasing ever deeper resources) there would come a time where the marginal cost exceeded the marginal revenue, and therefore the mining of that particular deposit would cease. Since the royalty payment is part of this equation (whether modeled as an input cost or a revenue reduction) there are circumstances where mining ceases due to the impost of the royalty, but where if it were to be replaced by a profits tax, the mining would have continued for longer.

In essence this is an argument against the inefficiency of royalty regimes. Initial modeling work was undertaken at the behest of the government, in order to quantify these effects, and somewhat surprisingly came up with the answer that a royalty regime tax was likely to reduce mining output in Australia by around 8%. This is undoubtedly a massive overestimation of the likely impact of royalties upon mining production in Australia. It was generated using a Computable General Equilibrium ("CGE") model that contained, amongst others, the following assumptions: That mining companies have access to perfect capital markets from

which investment will flow for projects which show a suitable risk adjusted rate of return; there are no barriers to 'entry to' or 'exit from' the mining industry; and that the mining industry earns only normal profits. Clearly these are false assumptions – however the issue is whether 'the extent to which they are not correct' fundamentally changes the outcome. I would argue that it does. Take for example the assumption that mining companies only earn normal profits – a strangely bizarre assumption to be adopted when the ultimate purpose is to show the benefits of a new tax which is supposed to target above normal profits. In a world where mining companies only earn normal profits after the payment of royalties, there would exist a project that was projected to earn slightly less than a normal profit (after the payment of royalties) that would not be expected to proceed because of the royalty payments. However in a world where mining companies earn substantially greater than normal profits (greater to the extent that the additional profit exceeds the associated rate of royalty) then no project would ever be prevented from proceeding as a result of the associated rate of royalty. In other words the deterrent effect (equivalent to 8% of production) that was modeled by the CGE model was critically dependent upon the assumption of only normal profits, because that deterrent effect necessarily disappears as profits rise above normal levels; or to put that differently in the current situation where profits are significantly higher than normal, existing royalty regimes have had absolutely no impact on levels of production.

It is accepted that the royalty regime is not, in theory, a particularly efficient form of taxation. It is, however, worth considering what sort activity is deterred by the inefficiency of a royalty regime. The answer is that it is it is projects or activities that create so little added value that they cannot cover the required royalty payments that are the ones that are deterred. Going back to the earlier distinction between 'new projects' and 'existing projects with rising operating costs': New projects that are deterred by the effect of being required to make royalty payments do not result in the resource being lost or deteriorating in any way – the resources remains in the ground until such time as more favourable conditions eventuate that justify their development; existing projects on the other hand cease to chase marginal ore where rising costs overtake the expected revenue generated – this high cost ore may or may not be recoverable at a later date, depending upon whether rehabilitation will render such later recovery totally uneconomic or not. In other words the inefficiency associated with the application of a royalty regime does not usually result in the destruction of the resource but rather postponed development until such time as the added value from its being developed does enable the royalty costs to also be paid. Equally critically, given that iron ore resource development is dependent upon associated infrastructure, and usually that associated infrastructure is what determines the export capacity, it is not clear that royalties have or ever will actually reduce the level of production as claimed by the CGE modeling. In particular it is likely that development of new projects, with lower mining costs, will replace deposits with higher mining costs at a time before those rising mining costs render a particular deposit uneconomic at the margin and under those circumstances the royalty regime doesn't reduce production at all.

It was also initially argued that the RSPT was a perfectly efficient tax (as in 100% efficient) because it was akin to a Brown Tax - which is perfectly efficient. However that only holds true where the proposed tax regime contributes its share of the cash required for any investment. In the case of the proposed RSPT, the requirement to contribute cash towards investments was replaced by a government IOU note that yielded only the equivalent of the LTBR with even those payments effectively rolled into the capital sum to be redeemed out of future RSPT tax liabilities, or if none eventuated to be redeemed with cash but only once the project had terminated. To the extent that the proposed government IOU was worth less than the face value of the note (and any sensible analysis suggested that it was worth considerably less) – so the efficiency of the tax regime diverged from perfect.

In the transition from the RSPT to the MRRT this IOU was changed from one yielding the LTBR but with at least the certainty that it would actually be redeemed at some uncertain point in the future, to one yielding the 'LTBR plus 7%' but with no actual certainty that it would ever be redeemed (if the project never made any profits then it never would be). Whether this represents a better outcome in terms of the efficiency of the tax or not depends on the risk aversion of the assessor. Clearly the increase in yield from 'LTBR' to 'LTBR + 7%' would considerably increase the face value of the IOU, but conversely the fact that it might never be redeemed would considerably increase the associated risk. Either way the one thing that is certain is that neither the RSPT not the subsequent MRRT were perfectly efficient taxes in the mould of a Brown tax.

Even worse from the point of view of the efficiency of the tax was the fact that the original decision to give cash rebates for the royalty payments (in the event that the MRRT liabilities were less than the royalty payments) was replaced by a system that only rebated the royalty payments out of future MRRT liabilities. This change meant that whatever the inefficiencies of the royalty regimes were, that inefficiency would remain in place. The new MRRT would always and only ever be an additional payment, over and above the existing royalty regime. Thus whilst one could debate the extent to which the original royalty regime applied by the States acted as an inefficient tax (and as a result reduced the level of mining production in Australia), what is unambiguously true is that those same inefficiencies remain in place, but now there is an additional impost on iron ore and coal that is also a less than perfect tax and the aggregate effect of both taxes necessarily results in a less efficient tax regime than was original in place (namely the States' royalty regimes).

So what started out as a tax designed to improve the efficiency of the tax regime as applied to non-renewable resources has ended up as an unambiguously less efficient tax regime than what was in place, but only applied to iron ore and coal as opposed to all non-renewable resources. But unfortunately that is not the end of the problems faced by those who will come under its auspices. Not only is it less efficient (as in it will have a greater adverse impact on production levels), but it will also be fiendishly complicated to administer and will impose a large bureaucratic load on the companies which are impacted by it.

Whilst the decision to locate the taxation point where the run of mine product is first created was commendably based on the idea that it was only the value created by the mining of the product, and not any further processing or associated value adding activity, that ought to be taxed (but as noted earlier, what will happen in reality will actually negate that attempt and end up taxing downstream investment anyway) – the effect is to introduce a wholly artificial distinction that will have other perverse consequences. It will necessitate a raft of other measures designed to corral as much profit as possible upstream from the taxation point in order to prevent leakage to elsewhere. Iron ore production is, in reality, an integrated production process in which significant value is created by the system as a whole, and where there is not actually any real basis from which to attribute that whole to the constituent parts. For example it is not unreasonable to suggest that iron ore, mined and then dumped on the ground at the mine-site, might have no value at all. If the mine-site is located inland, sufficient distance from the coast to render trucking the ore to costal export facilities uneconomic, then in the absence of a railway capable of transporting the ore at a far lower cost, the ore is indeed worthless. Under those circumstances what is the basis under which value adding activity ought to be appropriated between the transport infrastructure that makes it possible to monetise the ore, and the act of digging the ore out of the ground? Similarly, if there are no port facilities available, then even 'ore that is located close enough

to the coast to make trucking that distance economic' is worthless, because it still cannot be sold without the access to port facilities.

The MRRT Bills do not address this issue of exactly how the creation of value should be allocated across the different activities that go into a product, such as iron ore, which is sold only when the product is transferred into customer vessels at a coastal port facility – they simply make reference to comparable market transactions and netback pricing mechanisms as if that will somehow solve this problem. But iron ore is a particularly heavy bulk product and it requires quite different facilities, capable of dealing with the additional weight, than for example those that service coal production on the East Coast of Australia. This means that there are no comparable facilities with which to make the necessary comparisons in order to derive a market based assessment of what the value of the service ought to be. The inevitable fall-back position is likely to be some sort of attempt to calculate an allowable return to be earned on the associated necessary infrastructure (port, rail and processing facilities) in order to put such a figure into a netback calculation. In other words we are likely to end up with what effectively will amount to regulation of the amount that can be earned on iron ore infrastructure (port, rail and processing facilities) but done through arguments between iron ore companies and the tax office - and without any of the normal protections accorded to industry when traditional regulators are normally let loose on such an issue.

Not only will the MRRT Bills result in legislation that will set in train years of litigation between the tax office and the affected companies, but it will also require the affected companies to create a whole new set of accounts to deal with the different accounting treatments introduced. Companies will need to keep one set of records for the calculation of royalty payments, another set of records for the calculation of corporation tax, and now yet another set to be able to calculate the MRRT liabilities. Nor will the accounting necessary to calculate the MRRT liabilities be straight forward even once the methodology has been agreed, because calculations will have to be done for each project at a project level and this will also include the need to attribute centralised costs across all the different projects as appropriate, and at the same time also attributing costs between the upstream part of a project and the downstream part because it is only the part attributable as upstream that counts as a direct deductible cost (the downstream portion has to go through the netback pricing calculation).

To give an illustrative example consider the following simple scenario: A new iron ore company is established which is therefore allowed to count any investment as a cost for MRRT calculation purposes; but it is only allowed to count upstream investment because any investment downstream is accounted for through the netback pricing mechanism. The iron ore company builds accommodation for its workforce – to the extent that the accommodation is for workers that work upstream of the taxation point, the cost of the accommodation units is fully deductible as a cost as that cost is incurred. To the extent that the same accommodation is required for workers that work downstream from the taxation point – say in the processing plant – the cost of their accommodation needs to be factored into the calculation of downstream costs netted off from the final sale price when undertaking the netback pricing calculation. So the company will need to apportion the accommodation between upstream and downstream workers. However the accommodation may start off accommodating workers that work exclusively downstream of the taxation point (say clearing the site for a processing plant) but then transition to working upstream (say moving into overburden removal in preparation for mining). So the accommodation would not be deductible as a cost whilst the workers were working downstream but would then become fully deductible once they moved to upstream. Alternatively for the same company consider the use of trucks that have been purchased on a lease finance basis. Those trucks may

transport ore from where the ore is excavated to the ROM pad (taxation point) and then subsequently from the ROM pad to central processing facilities. Whilst transporting the ore from excavation to the ROM pad the initial capital investment in the truck would be a deductible cost but if they were lease financed the financing charges would not be allowable. When the trucks subsequently transport the ore away from the ROM pad the full lease cost of the truck, including financing charges becomes a deductible via the netback calculation. Now suppose that over time the mining moves ever further away from the established central processing facilities – this means that over time the trucks would spend proportionately more of their time working downstream as compared to working upstream and so the apportionment would need to alter to reflect that fact. This merely gives some idea of the complexity of what will be involved.

There are further complications such as how to deal with multi-product mines where some of the production is subject to MRRT and some isn't – a titanomagnetite deposit would be such an example. The point is that the calculation and payment of royalties is quite straightforward and the calculation and payment of corporation tax is at least done at a company level – this new tax needs calculations based upon projects and within such projects a split between upstream and downstream activities and potentially also a split between different products where there are products that aren't subjected to MRRT. All of this will require auditing and then probably arguments with the tax office about the methodology chosen and with the risk of penalties being applied for the tax not paid because of the adoption of a subsequently rejected methodology. And finally small companies that escape liability because they come under the threshold will have to go through the same pain each year because they couldn't be certain they won't grow and produce above the threshold and so they will also need to undertake this accounting exercise.

It is contrary to CCA 2010

If three companies got together and wrote an agreement with a fourth entity that enabled them to get a service from that entity that not only guaranteed them the service at a lower cost than their competitors (for an extended period) but actually acted to prevent potential competitors from being able to enter the markets in which they operated – that agreement, to the extent that it substantially lessened competition in any of those markets, would be contrary to s.45(2)(a)(ii) of the *Consumer and Competition Act 2010* ("CCA 2010"). If that fourth entity was the government, and the service was effectively the right to exploit iron ore and coal deposits, and the markets were the markets for track access services, rail haulage services, port services and the seaborne iron ore and coal markets, it would not alter the fact that the agreement was contrary to CCA2010.

The very existence of enduring Quasi Rent profits demonstrates that there are barriers to entry that ultimately prevent supply from responding quickly to increases in demand. Although most of the significant players in the iron ore industry act in varying degrees as a vertically integrated suppliers (and that vertical integration has prevented the establishment of independent markets providing the various services) that doesn't mean that that the various processes that make up the production of iron ore (as supplied into the seaborne market) are not a series of separate markets in which these vertically integrated companies exercise geographical monopoly control.

When BHP, Rio and Xtrata made an agreement with the government, to accept the MRRT in exchange for certain concessions, they would have known that those concessions would not only give them a massive capital shield to largely protect them, for the foreseeable future, from the requirement to pay any MRRT, and therefore that they would be getting the right to mine at a lower cost than their competitors, but they would have also known that the

imposition of the MRRT (a tax that is biased against debt financing because it doesn't allow financing costs as a deduction) would raise barriers to entry into markets already characterised by high barriers to entry caused by the significant and lumpy capital costs associated with the provision of services within these markets. In other words the companies knew that although there would be some increase in costs, associated with the resultant MRRT liabilities, that impost was balanced by a 'silver lining' which was that the tax would fall more heavily on their competitors and in particular would increase the barriers to entry into already notoriously difficult to enter markets over which they exerted strategic control.

Part of the problem of the initial construction of the RSPT and then subsequently the MRRT was that it was put together by individuals that simply didn't have any detailed knowledge about the industry they were seeking to impose the tax upon. And then to make matters worse they engaged in faux consultation which was rigged so that all the matters that were of genuine concern to the industry were effectively removed from the arena of consultation by the terms of reference. The final insult was the fact that the MRRT was based upon an agreement between just three large mining companies and the government which was negotiated to protect the interests of just those three companies and without any safeguards to protect the remaining companies that made up the industry. Once the agreement had been made, there was simply was no consideration of any changes that would be contrary to what had already been agreed. So in effect the MRRT Bills are a legislative expression of an agreement between three companies and a government that didn't understand even quite basic considerations that affect the industry, and represented the wishes of just those three companies without any genuine wider consultation with the rest of the industry.

In relation to the iron ore industry BHP and Rio already have a long track record of preventing others from being able to access or in any way utilise nationally significant infrastructure (namely their port and rail systems) despite both being parties to State Agreements that obliged them to offer such services to third parties in order to assist with the development of a wider iron ore industry in the Pilbara. They were able, over a significant period of time (from the early 1980s through to the late 2000s) to deny entry to all potential competitors through their duopoly control over this infrastructure – and it remains the case that despite record prices for at least 5 years there have not been that many entrants that have successfully managed to overcome the barriers to entry caused by this control over the infrastructure.

The MRRT proposes to effectively limit the return that can be earned on investment in downstream infrastructure (which will apply via the netback pricing calculation) and to then impose an additional tax on the profits that can be attributed to the mining activity – effectively undermining the ability to use the mining profits to subsidise the downstream infrastructure investment. So from the point of view of a new entrant into the iron ore mining industry the investment in infrastructure will effectively only be allowed to earn a regulated rate of return and anything higher will be subject to the MRRT. Debt providers to such a project (via the bond markets), who will inevitably require a higher rate of return than that allocated to the return on downstream capital (imposed through the netback pricing mechanism) will face the prospect that when iron ore margins fall from their current exalted levels, there will be the possibility that the additional return required to be made from iron ore mining, necessary to bridge the gap between the allowable return on downstream infrastructure and the interest payments associated with the bond financing, will be sufficiently heavily taxed by the MRRT (which doesn't recognise financing costs as a deduction) so as to bring the overall available funds below the level required to meet all the funding obligations. Now whilst the prospect of such circumstances eventuating may be relatively low, the existence of such a risk will act as a huge deterrent to potential bond

financiers – effectively making such a source of funds far more difficult, if not impossible, to access. It is important to note that this deterrent effect does not impact large companies, with substantial balance sheets and with revenues high enough to be able to finance the required infrastructure out of retained earnings, but it absolutely destroys the prospects for small companies seeking essentially project finance via the bond markets. If the proposed MRRT had been in place at the time when Fortescue was seeking the initial finance required to get its first project up – Fortescue would not have succeeded; in effect the MRRT is denying Australia the benefit of encouraging companies similar to Fortescue from being developed. It is also important to note that it is not the imposition of the tax *per se* that is having this deterrence effect, it is the way that the tax has been structured that does the damage.

The MMRT makes the financing of downstream infrastructure which was already extremely difficult for new entrants to achieve, far more difficult. In essence, the MRRT has raised barriers to entry into markets associated with the production of iron ore and in so doing has significantly reduced future competition in this market – this is about contestability in markets. This is the reason that the agreement between the big 3 miners and the government is contrary to CCA2010.

<u>It is Unconstitutional</u>

Section 51(ii) of the Constitution states that:

> *The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to: ...*
>
> *(ii) taxation; but so as not to discriminate between States or parts of States;*

This section basically states that Parliament is limited in its powers to implement taxes by a requirement to ensure that the taxation does not discriminate between the various States.

The Constitutional requirement to avoid discriminating between the States was tested as far back as *Colonial Sugar Refining v Irving (1906)* when the Privy Council in London decided that the way to determine whether an Act was discriminatory between the States was to examine the wording of the Act and if there was no discrimination to be found in the wording of the Act because the rules found in the Act were general in their application, and applied equally to all States, then there was no discrimination. This interpretation was then confirmed again as recently as *Conroy v Carter (1968)* where it was held that if the rule was uniform but it caused different outcomes because of different circumstances in different States then it would be Constitutional. In essence these cases were based on the notion that it was the form of the law rather than its effect that should be used to determine whether any legislation was discriminatory.

Some might suggest that that ought to be the end of the matter because the MRRT is indeed a uniform rule which causes different outcomes in different States because of different circumstances prevailing in those States (namely the rate of royalty set by the States). However post-dating these two cases was a seminal case heard in the US Supreme Court being *Griggs v Duke Power Co (1971)*. Although not directly relevant to Australian law – this case established the now widely recognised concept of 'indirect

discrimination'. It involved a power company that applied the requirement for a high school diploma in order to determine the suitability of candidates for employment. The question considered was whether this was discriminatory against African-Americans, given their lower likelihood of having achieved a high school diploma. The Court found that since the company's employment requirements weren't directly related to the ability to perform the job that the company was discriminating against African-Americans even though it didn't intend to. In effect the ruling established that although the power company hadn't intended to discriminate its policy had the effect of discriminating and it is this notion that forms the basis of the concept of indirect discrimination.

Now whilst US legal cases are not directly relevant to Australian law this concept of indirect discrimination was picked up in subsequent cases in Australia and therefore became adopted within Australian law. *Queensland Electricity Commission v Commonwealth (1985), Street v Queensland Bar Association (1989), Castlemaine Tooheys v South Australia (1990),* and *Re Australian Education Union & Australian Nursing Federation; Ex Parte Victoria ("AEU case") (1995)* were all cases in which the High Court recognised the concept of indirect discrimination and the need to look beyond the terms of any legislation to its impact upon the subject to which it applied. Of particular note in *Street v Queensland Bar Association (1989)* was Justice Gaudron's clear recognition of the concept of indirect discrimination:

> *"...recent developments within the field of anti-discrimination law which have led to an understanding that discrimination may be constituted by acts or decisions having a discriminatory effect or disparate impact (indirect discrimination) as well as by acts or decisions based on discriminatory considerations (direct discrimination)".*

In other words post-dating the most recent s.51(ii) case involving discrimination against States, the whole notion of discrimination has been modernised to recognise the existence of indirect discrimination and indeed the need to look beyond the form of any legislation to its actual effect.

Iron ore is owned by the States within which it is located. The individual States have enacted their own laws to govern the activities of mining companies within their borders and to levy royalties - which are the mechanism by which mining companies pay the States for the minerals that they mine. Each State is entitled to levy royalties at whatever rate it deems appropriate for the sale of its resources. Most critically the States are entitled to vary royalty rates in pursuit of their own objectives. So for example when the then fledgling iron ore industry was being established in the Pilbara, the State of Western Australia granted royalty concessions to the iron ore industry in order to encourage the development of an iron ore 'fines' product. In particular under the terms of State Agreements the rate of royalty levied on 'fines' was initially set at 3.75% in contrast the rate levied on 'lump' which was set at 7.5%. Later this same differential was recognised in the Mining Act 1978 (and associated Mining Regulations 1981) – in which the royalty rate on 'fines' was set at 5.625% in contrast to the rate on 'lump' which was set at 7.5%. Although these concessions are now being phased out – it still remains that case that the State of Western Australian retains the power under its Mining Act to reduce the amount of Royalties required to be paid if the circumstances warrant it.

If the MRRT Bills are implemented in the form proposed then they will have the effect of exactly offsetting any reduction in royalties that a State may be inclined to give for its own policy reasons. For example the State of Western Australia still maintains a royalty reduction for any iron ore that undergoes beneficiation – for which the associated rate of royalty is 5%

rather than 7.5%. This lower royalty rate is designed to encourage value adding activity namely the upgrading of lower value ore (in some cases arguably unmarketable) to achieve a higher (acceptable by the market) quality of ore.

Once the MRRT is in operation any State which has sought to encourage development or seeks to encourage such development by using the attraction of lower royalty rates will find that that measure attracts offsetting additional taxation at a Federal level. In other words States seeking to encourage development will be discriminated against. Although the discrimination is not to be found directly in the form of the legislation its effect will be discriminatory - this is indirect discrimination between the States and therefore contrary to s.51(ii) of the Constitution. It may not be the intention of Parliament to discriminate between the States but the MRRT will have the effect of discriminating and this modern and widely accepted (including within Australian law) interpretation of how anti-discrimination law should be applied means that the MRRT is unconstitutional.

The unconstitutional nature of the MRRT is deeper than merely being contrary to s.51(ii) under a more modern interpretation of the meaning of discrimination, the very nature of the tax, which attempt to impose taxation in an area that is the prerogative of the States (not least because they are the owners of the resources; but also because they administer the regulation and control over mining activities within their borders) would appear to be contrary to the implied restrictions on Commonwealth powers that flow from the very nature of the federal structure established by the Constitution. This interference within what is rightfully the jurisdiction of the States would effectively result in the destruction of the State's governmental capacity to encourage exploration and development activity by varying the associated royalty rate and is sufficient to render the MRRT an unconstitutional tax.

This tax should be sent back to the House of Representatives on the basis that the Senate should not be asked to pass legislation that undermines the very basis of the Constitution.

Yours sincerely
FORTESCUE METALS GROUP

JULIAN TAPP
Director Strategy