Our Ref:
Your Ref:

Secretary of the Standing Committee on Economics
House of Representatives
PO Box 6021
Parliament House
Canberra, ACT 2600.

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

7 November 2011

Dear Committee Members

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

The Committee is examining the adequacy of the MRRT Bills in achieving their associated policy objectives and is also inquiring into whether there are any associated unintended consequences.

Executive Summary

Fortescue Metals Group Ltd (Fortescue) believes that BHP Billiton Iron Ore (BHPBIO), Rio Tinto Iron Ore (RTIO) and Fortescue will pay little, if any, MRRT, because the concessions given to them in the form of the market valuation of resources in the ground will provide such an effective tax shield that there will be no significant MRRT liability for them for at least the next 10 years. This is in stark contrast to the position faced by the junior miners (which Fortescue is not) who will be unable to adopt the market valuation approach and will therefore face much higher tax rates than the major miners. This will leave the junior miner competitively disadvantaged, and facing higher financing costs which will also be more difficult to achieve.

This inequitable situation can be ameliorated by amending the legislation to ensure that the rate of MRRT paid by junior iron ore miners cannot be more than the rate paid by either of BHPBIO or RTIO. If Fortescue is correct in its assertion, then the amendments will serve to protect the junior miners, whereas if Fortescue is mistaken and BHPBIO and RTIO do end up paying significant amounts of MRRT then the proposed amendments will have little or no impact – in short if we are right the juniors will be protected and if we are wrong no harm will be done.

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

Detailed submission

Fortescue is making this submission because:

- It believes that the MRRT Bills will fail to capture much if any of the economic rent currently being earned by the larger mining companies because of the generous nature of the concessions negotiated between the biggest three mining companies and the government. This belief has been substantiated by research work undertaken by BDO, a copy of their press release on this matter is attached to this submission. It will therefore fail to lock in the benefits of the current mining boom.

    - Part of the difference between the government's projected MRRT revenues and Fortescue's view of what the major mining companies (including Fortescue) will be paying is believed to result from different assumptions about what the effective life of mines will be for tax purposes. It is Fortescue's view that for many projects the effective mine life will be 10 years or less – considerably lower than the government's assumption of 25 years.

    - The current boom in iron ore is not expected to last indefinitely. Economic rents only last as long as it takes for factors of production to be attracted to the high economic rents (unless they are protected by sufficiently high barriers to entry) and then to compete them away.

    - The likely overall result is that the major iron ore mining companies will be able to shield themselves in the short term by utilising the accelerated write-off of the market value of their resources in the ground; whilst over the longer term the price of iron ore will fall sufficiently so as to remove the economic rents from the industry and hence the associated MRRT liability.

    - The value of the economic rents currently being earned by the major iron ore mining companies will have largely been capitalised into the assumed value of the resources in the ground. It is therefore absurdly counterproductive to attempt to tax the value of those economic rents by allowing their capitalised value to be used as a shield against MRRT liability. The very thing that was sought to be taxed is being allowed to be used as a shield against that tax. Small wonder that the major miners will escape almost any liability whilst the smaller miners that were not a party to the negotiations have been foisted with a tax regime that will damage their prospects.

- Fortescue believes that those same generous concessions are not available to smaller miners and therefore the MRRT Bills will engender the iniquitous consequence that the smaller miners will pay a higher rate of tax on their calculated MRRT revenue that the larger miners.

    - Junior miners will mostly be unable to utilise the market value methodology because in the early stages of development the markets heavily discount the expected value of any resources in the ground to reflect the project risk

associated with its eventual development or otherwise.

- The competitive disadvantage faced by the smaller miners as a result of their iniquitous treatment under the MRRT Bills will make it far more difficult for them to raise finance (either equity or debt). This is likely to result in them finding themselves either unable to secure the necessary finance or forced to seek finance via strategic investors (motivated more by a desire to increase the global supply of iron ore as opposed to being purely motivated by direct profitability of the investment). There is therefore the likely unintended consequence that the MRRT Bills will force smaller miners to finance their activities from overseas investors thereby also ensuring that the benefits of their projects predominantly flow to overseas investors – the very antithesis of seeking to ensure that the benefits of the mining boom remain as much as possible in Australia.

- Indeed when it comes to the debt financing of projects, the MRRT Bills will legislate yet a further impediment. Since there is no deduction for financing costs when calculating MRRT liabilities, it is entirely possible that circumstances may arise where a project is unable to fully service its debt obligations whilst simultaneously being forced to make MRRT payments. This is because on an ongoing basis the MRRT effectively converts the government into a 22.5% equity investor in new projects (paying 22.5% towards new investments by way of MRRT allowances and then recouping 22.5% of net revenue subsequently earned), but at the same time gives this quasi-equity stake a preference over debt. The fact that quasi equity is taking preference over debt will give rise to considerable concern on the part of debt providers who will perceive this as an added risk and respond accordingly. The result will be, at best, even higher interest costs for smaller miners and more onerous associated conditions, but more likely a reluctance to provide them with any finance at all.

- There appears to be a pervasive lack of understanding about the structure of the iron ore industry (an industry in which the vast majority of the required investment sits downstream from the mining activity) and also the importance of infrastructure in creating value from iron ore deposits. Thus whilst the setting of the point of taxation at the mine gate prior to any processing or transportation ensures that in theory only the economic rent earned from extraction is captured by the provisions of the MRRT Bills, the consequences are:

    - That what is an integrated production process will necessarily be artificially segmented and then in order to attribute value will require a netback calculation that has no market based equivalent transactions from which to compute the value of the service and therefore will inevitably result in the tax office seeking to use some sort of regulated return to calculate the value added created by the use of infrastructure.

    - The inevitable use of a regulated return approach in attributing value to infrastructure will also inevitably undervalue that infrastructure and therefore act to discourage further investments in infrastructure.

- Although not explicitly detailed, it has been heavily implied that there was the additional policy objective of using the MRRT to ameliorate what was characterised as Australia's two speed economy. In essence asserting that mining was making life more difficult for the rest of the economy (predominantly through exchange rate appreciation) and that therefore it would be sensible and fair to use the MRRT revenues to help those suffering from a deterioration in the competitiveness of their offerings. However:

    - The use of MRRT revenues to cut the rate of company tax will do nothing to assist businesses that have seen their competitiveness eroded by a rising exchange rate. Indeed for most, that have seen profitability eroded to the point where no profit is actually being made, the reduction in the company tax rate will offer no benefits simply because they don't make any profits to enable them to gain from a rate reduction. Similarly, for those businesses that are struggling to make ends meet, the increase in their ability to instantly write off investment in assets is of little assistance if they aren't earning enough to be investing in new assets.

    - The use of MRRT revenues to pay for the reduction in government tax revenues following on from an increase in superannuation guarantee charges from 9 per cent to 12 per cent will do nothing to encourage consumer expenditure or increase aggregate demand for the services supplied by those that are currently struggling due to a lack of consumer demand. Indeed somewhat bizarrely the increase in the superannuation guarantee charges will ensure that workers effectively save more of their incomes (whether they wish to or not) thereby reducing disposable income and ultimately demand on the high street.

    - The correct policy response to so called "Dutch Disease" should be to direct the MRRT revenues into a future fund invested overseas in order to drive the exchange rate towards sustainable levels thereby assisting trade exposed industries and services to be more competitive.

- If you accept the premise that the major mining companies will pay little if any MRRT in the early years due to the generous concessions given, then it also follows that because the expected MRRT revenues (which will not materialise in the short term) have been given away in cuts to company tax and increases in superannuation – the outcome will be an increase in the government's budget deficit. Moreover looking out longer term, the economic rents being earned by iron ore mining are not expected to last indefinitely, because they will eventually attract new entrants (though not necessarily in Australia) that will compete away the rents. The long term implications of this are that the MRRT Bills will lead to a structural budget deficit as the enacted concessions build in value whilst the MRRT revenues fail to materialise.

- The measures adopted to exclude junior miners are based on a threshold of MRRT profits of $50m per year which is then phased out as the MRRT profit assessment increases between $50 and $100m. This will have the perverse effect of subjecting junior miners in the range from $50 to $100m of MRRT profit to a marginal MRRT tax rate equivalent to 45% as opposed to 22.5%. It would have been simpler and more equitable to allow the tax threshold to be a tax free threshold without a clawback mechanism. It

would have been even simpler to exclude small miners on the basis of tonnage rather than MRRT profit as this would have generated certainty and excluded unnecessary compliance costs.

- Finally it is difficult to agree with the notion that what is proposed is a simple, or efficient or 'fair' tax, when the MRRT Bills do not replace the State's royalty regimes with a more efficient tax as proposed under the Henry Review, but rather the MRRT Bills impose an entirely additional tax, over and above the existing State based royalty regime which still applies with all its alleged inefficiencies and it does so in a manner that prejudices any States seeking to vary their royalty rates in pursuit of any of their own policy objectives. In particular States that seek to encourage exploration and development expenditure within their borders by lowering the associated royalty rates will find such action thwarted as a consequence of the way in which the MRRT interacts with the royalty regime - automatically offsetting any royalty reduction with increased MRRT payments. The MRRT therefore acts to indirectly prejudice States (the prejudice is not to be found directly in the MRRT Bills per se but nevertheless comes about indirectly as a consequence of their implementation) and therefore would appear to be in contravention of s.51(ii) of the Constitution when a more modern interpretation is applied to the concept of discrimination.

Although it is not obvious how most of the problems highlighted could be rectified by simple amendments to the existing MRRT Bills, there is a simple solution to the problem of the unfairness as between the smaller miners and the big miners that negotiated the deal with the government. Amendments could be inserted that would limit the level of MRRT paid by the smaller miners such that it was always no higher than the rate being paid by the bigger miners.

The below points are a summary of the proposed amendments to the MRRT to address concerns raised by small and start up miners:

- Safe harbour – increase the MRRT threshold from approximately 2 million tonnes iron ore production based on MRRT revenue per annum to a threshold based on tonnage of say 10 million tonnes production per annum to alleviate the very small iron ore miners from excessive monitoring and compliance costs.

- Embed a "tax cap rate" in the legislation tied to a Regulation. Each year a Regulation is passed which sets the cap. In broad terms, the cap is the highest of the following calculation with respect to the mining companies who signed the Heads of Agreement ("the Parties"):

$$\frac{\textbf{MRRT Liability for iron Ore/Coal Mining Projects Interests (Section 7-5)}}{\textbf{MRRT Revenue for Iron Ore/Coal Mining Project Interests (section 19-20)}}$$

- Those miners besides the Parties only pay MRRT when any one of the Parties has a MRRT liability. If all of the Parties do not have a MRRT liability, then other miners do not pay an MRRT.
- In the first year of the tax, all taxpayers, including the Parties, pay an estimated liability until the "cap" is determined, after which time an appropriate true-up rate would be calculated (not dissimilar to the current Company Tax installment regime).

Yours sincerely
FORTESCUE METALS GROUP

JULIAN TAPP
Director Strategy
jtapp@fmgl.com.au
+61 414 013 836

Attached: A copy of the BDO press release

Media release

Date	November 6, 2011	For immediate release
Subject	Mining tax expert modelling reveals safeguards required to protect small miners	

Updated modelling on the impact of the Minerals Resource Rent Tax (MRRT) by national accounting firm BDO has reinforced the need for the inclusion of safeguards for small miners to make the tax fair. On any analysis it currently is not.

The updated modelling confirms that larger mining companies will not pay MRRT when the tax is imposed due to their large capital shield, placing smaller mining companies at a competitive disadvantage to their larger counterparts in equity and debt markets. The updated modelling indicates the tax-free period for larger miners may last even longer than the initial modelling showed.

BDO Corporate Tax Director John Murray said: "The modelling proves the MRRT hits small miners and leaves alone the big established miners with big established profits."

"The addition of safeguards to protect smaller mining companies, such as timing and rate parity, would make the MRRT significantly fairer," he said.

"In its own words the Government wants a fairer, simpler tax system. Time and rate safeguards will provide the MRRT with the fairness the Government says it wants."

BDO's timing and rate equality proposal recommends that:

- The MRRT only becomes liable to be paid in the year following the first year Rio Tinto, BHP Billiton or Xstrata become liable for payment of MRRT, and that the timing is applied to iron ore and coal separately; and
- The rate of MRRT payable by taxpayers should not exceed a benchmark rate calculated by reference to the highest of the MRRT liabilities for Rio Tinto, BHP Billiton and Xstrata for the preceding MRRT year to each class of taxable resource (either coal or iron ore)

An alternative is that all companies will pay instalments and on receipt of the MRRT returns the cap referable to any of Rio Tinto, BHP Billiton or Xstrata could be applied in assessing the current year of tax.

The BDO modelling is based on publicly available information only and is based on BDO's extensive experience in the iron ore sector and the MRRT's prohibition of "cross over". Cross over prevents mining companies from using iron ore taxation credits to offset coal liabilities and vice versa.

BDO Australia Ltd ABN 77 050 110 275, an Australian company limited by guarantee, is a member of BDO International Ltd, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. Liability limited by a scheme approved under Professional Standards Legislation (other than for the acts or omissions of financial services licensees) in each State or Territory other than Tasmania.

BDO has continued to employ a conservative model due to the continued lack of clarity about the tax's application and the limited publicly available information.

Updates to the Rio model (below) include refining the deduction for relevant expenditure incurred in the carrying on of upstream mining operations, while recognising that excluded expenditure has not been deducted due to the difficulties in identifying this non deductible expenditure.

It also calculates royalty allowances on an MRRT revenue (ROM stockpile) basis, rather than the actual royalty payable which is calculated by reference to FOB value. This is conservative.

The summary results of the Rio model are detailed below with all the assumptions in the previous release, to be incorporated into this model.

However, Mr Murray said the real public policy focus should be on fairness, rather than modelling assumptions.

"Amendments can be made to the Bill so that if the Government projections are correct about who will pay MRRT and when, there is no interference with the tax revenue flows. However, in the event that the BDO model more closely reflects the MRRT results, safeguards are in place to protect the small miner," he said.

"We believe that our rate and timing safeguard provisions contained in the Discussion Paper we submitted to Treasury (http://www.treasury.gov.au/documents/2202/PDF/BDO.pdf) provide one means of achieving this result.

"There is a very short time to address these important issues and to achieve the goal set by the Government of: "*...building a fairer, simpler tax system*."

ends

MRRT Modelling

Rio Tinto	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Resource charge	**US$b**	**US$b**	**US$b**	**US$b**	**US$b**	**US$b**
MRRT revenue	7.46	7.46	7.46	7.46	7.46	
Less: Upstream operating expenses	-3.83	-3.83	-3.83	-3.83	-3.83	
Less: Capital expenditure	-2.26	-2.26	-2.26	-2.26	-2.26	
Less: Royalty credits	-0.42	-0.48	-0.56	-0.56	-0.56	
Less: MV base of amortised capital cost	-2.56	-2.64	-2.72	-2.80	-2.89	
Excess subject to MRRT	-1.62	-1.76	-1.92	-2.00	-2.08	
Net MRRT liability	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	
Increase in capital cost base		52.82046	54.41	56.04	57.72	59.45
Amortised capital cost base per year		2.64	2.72	2.80	2.89	2.97

(For the purposes of consistency, a base production rate from 2009 has been utilised to remove variables such as iron ore prices, FX, production increase and associated infrastructure cap-ex)

New/ Emerging Miner	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Resource charge	**$m**	**$m**	**$m**	**$m**	**$m**	**$m**
MMRT revenue	0	480	700	650	540	520
Upstream operating expenses	0	-150	-225	-225	-240	-240
Depreciation	-100	0	0	0	0	0
MRRT allowance @13 per cent	0	-13	0	0	0	0
MRRT unutilised losses	0	-100	0	0	0	0
MRRT profit / loss	-100	217	475	425	300	280
MRRT @ 30 per cent	0	65	143	128	90	84
Extraction allowance @25%	0	-16	-36	-32	-23	-21
MRRT after extraction allowance	0	49	107	96	68	63
Royalty @ 7.5 per cent	0	36	53	49	41	39
Uplifted Royalty offset		0	0	0	0	0
Net MRRT liability	**0**	**13**	**54**	**47**	**27**	**24**
Total resource charge	0	49	107	96	68	63
Company tax						
Revenue	0	480	700	650	540	520
Operating expenses	0	-150	-225	-225	-240	-240
Depreciation	0	-20	-20	-20	-20	-20

Total resource charge	0	-49	-107	-96	-68	-63
Company taxable income	0	261	348	309	213	197
Company tax @ 29 per cent	0	76	101	90	62	57
Profit before tax	0	310	455	405	280	260
Total tax	0	125	208	185	129	120
Total effective tax rate	**0.00%**	**40.18%**	**45.68%**	**45.76%**	**46.12%**	**46.20%**

Note to editors

BDO offers a wide range of business and corporate advisory services to clients ranging from large corporate organisations to private businesses, entrepreneurs and individuals across a wide range of industry sectors.

In Australia, BDO can offer the expertise of more than 150 partners and directors supported by over 1300 staff.

Our service lines include: Audit, Business Recovery & Insolvency, Performance Improvement, Corporate Finance, Forensic Services, Tax, Private & Entrepreneurial Client Services and Risk Advisory. We also focus on a range of specialisations, including: Agribusiness, Environmental Sustainability, Family Businesses, Financial Services, Govt & Public Sector, Health & Aged Care, Infrastructure, Motor Dealer Services, Natural Resources, Not for Profit, Property & Construction, Retail, and Technology, Media & Telecommunications.

International BDO network

The combined fee income of all the BDO Member Firms was $5.28 billion in 2010. The global network has 1,082 offices in 119 countries and more than 46,000 people provide advisory services throughout the world.

Service provision within the international BDO network of independent member firms ('the BDO network') is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

For interviews or pictures contact :

Cameron Morse
FTI Consulting
cameron.morse@fticonsulting.com

Tel: +61 8 9386 1233
Mob: 0433 886 871