

25 June 1999

RE: INQUIRY INTO VALUE ADDING

The Chamber of Minerals and Energy of Western Australian (“the Chamber”) is pleased to make the following submission to the Standing Committee on value adding to Australian raw materials. As requested, a copy has also been emailed to isr.reps@aph.gov.au.

Overview

The Chamber supports moves to add value to raw materials. Such developments have the potential to increase Australian employment and the returns from Australia’s mineral wealth. However, downstream processing is not always the best policy and may in some cases be counter productive. The Chamber strongly argues that value adding should be pursued only where it is economically efficient to do so. A consequence is that decisions on value adding should be made largely on commercial grounds. It should also be recognised that there is already substantial value adding in the industry.

Definition

It is important to note what value adding actually is. It is not, as is often assumed, always the same as downstream processing, although processing of some sort is a necessary condition of value adding.

The Economist’s *Dictionary of Economics* defines it as “the difference between total revenue of a firm and the cost of bought-in materials, services and components”. Therefore value adding occurs when the final product is worth more than the cost of producing it. It should be recognised that under this definition the minerals industry already adds a great deal of value via primary production. A survey conducted by the Centre for International Economics for the Minerals Council of Australia found that for every dollar of mining production 60 cents is value added. The same survey also found that mining has by far the highest value added per employee ratio, with mining adding over \$200,000 per employee compared to the economy wide average of \$50,000.

The Chamber argues that this definition is highly relevant to any discussion of value adding. Unless the end result of a process is worth more than the sum of its parts it does not represent true value adding. Indeed it is literally “value subtracting” and actually represents a net decline in the nation’s economic welfare.

However, the Chamber also recognises that value adding of the type referred to by the Committee has a strong element of further processing in it. This may be entirely appropriate and desirable but the Chamber reiterates that this will only be if it does actually add value. To avoid confusion, this submission will use the term “further processing” rather than value adding to refer to downstream processing of primary products.

History

Some accounts of the minerals industry in Australia seem to argue that it was historically a quarry, extracting minerals and sending them overseas in unprocessed form, at the expense of Australian jobs and export revenues. In fact, further processing has been a feature of the Australian minerals industry from the last century. For instance, branches of the Royal Mint were established in the Australian colonies, meaning that gold products were produced and exported worldwide. Further processing also occurred during the past 40 to 100 years across a range of minerals, including aluminium, nickel and iron/steel.

Current Situation

In Western Australia, further processing currently occurs across a wide range of minerals including iron ore, bauxite, nickel, gold, mineral sands and gold. There are also a number of proposals in the pipeline in areas such as petrochemicals and iron and steel.

An indication of the strength of further processing in Western Australia is provided by employment in the Australian Bureau of Statistics (ABS) categories of mining and manufacturing. In September 1998, mining accounted for 30,200 jobs and manufacturing for 92,400 (the WA Department of Minerals and Energy, which calculates "mining" jobs on a different basis finds 45,000 people employed). The significance of the ABS manufacturing figure is that the Bureau classifies downstream mineral processing as "manufacturing". An extremely conservative estimate would be that at least 50% of those in WA manufacturing jobs are in fact engaged in further processing. Therefore there is more employment in further mineral processing than in actual mining in Western Australia.

The Chamber advocates that the ABS consider amending its classifications so that the true extent of further processing in the industry is clear. The Chamber acknowledges, however, that this may be difficult in the light of international statistical conventions.

Advantages

There are significant reasons why further processing is attractive, from the viewpoint of both individual firms and from a wider economic view.

Leverage From Strength

In contrast to many other economic activities, minerals extraction is an area where Australia enjoys a competitive advantage. A combination of factors including resource endowment and productivity make Australian minerals production a world leader. It is argued that further minerals processing offers an opportunity to use this competitive advantage in extraction to support related economic activity. This contrasts with manufacturing in other areas where it is not immediately obvious that Australia enjoys any particular advantage, indeed some such sectors still rely upon tariff protection.

The Chamber believes this is perhaps the strongest argument for further processing, provided that it is economically justified. If it is not, then the effect is to use the efficient minerals extraction industry to subsidise inefficient activities elsewhere – no different in principle to tariff protection.

Price Stability

It is often argued that, while commodity prices are both unstable and on a long term downwards trend, value added products have more stable prices. This can be the case, although it does not always apply. There are instances where prices of some further processed products have also declined precipitously.

Establishing Stable Relationships

Another argument advanced is that further processing, by integration further into the chain of production, makes trade relationships more stable as the purchaser is more locked into a particular source of supply rather than simply being in the market for an undifferentiated commodity. In some instances this is the case, although not all commodities are as uniform as this argument supposes. Australia produces particularly high quality materials in such instances as certain grades of iron ore or gas and hence can be seen as a preferred supplier even in some commodity markets. It should also be noted that being locked into particular markets is only an advantage if those markets are sustainable. Australia would have been much more severely damaged by the Asian crisis had it been locked into selling to traditional Asian markets with limited ability to switch. In fact, Australian exports were successfully diverted elsewhere – a positive outcome from “unstable” commodity markets.

Greater Margins

It is argued that processed products have greater margins than commodities and hence give greater returns to producers. This can be the case and some commodity market margins are currently at very low levels. However, the extent to which margins are improved by processing depends very much on demand and price for particular products. Where prices have fallen substantially or where there is excess supply, margins for processed products are unlikely to be as significant as often supposed.

Employment

Greater employment is often advanced as a reason for further processing. However, the Chamber argues that what is important is net employment rather than gross figures in any particular industry. The Chamber's own research shows that mineral processing has among the highest employment multipliers of any industry, but this does not mean that overall employment will be maximised by uneconomic further processing. Economic efficiency and employment will be maximised by the most efficient use of resources and this will include further processing where it is economically justified. Where it is not and has occurred for other reasons, resource misallocation means that jobs will be lost elsewhere in the economy, outweighing any employment benefit from processing jobs.

Possible Concerns

As suggested above, there are a number of possible negatives associated with further processing which do not always receive appropriate recognition.

Cost

It is an obvious point, but further processing has both financial and opportunity costs. Both need to be fully taken into account in any assessment of the benefits of further processing.

The opportunity cost means that resources will be diverted from elsewhere in the economy. Unless further processing is economically justified, the economy as a whole will suffer.

Government Intervention

Despite the above concerns, further processing remains a goal of many governments. This often gives rise to further processing projects which are distorted by government involvement and hence corrupted world markets. Australian further processing projects are therefore not always competing on a level playing field in these areas, in contrast to the relatively pure competitive environment of international mineral commodity markets.

Policy Environment

Although the concerns expressed above need to be taken into account in any consideration of further processing, they do not mean that it is not a desirable goal and should not be pursued. Where it is true value adding and is economically sustainable, it represents a valuable addition to the nation's economy and competitive advantage. To do this, however, will require action on a number of fronts.

Domestic Market

One barrier to further processing is the relatively small size of the domestic market. Overseas experience has often been that further processing is contingent upon production for domestic as well as overseas custom. In contrast, any projects in Australia will need to be aimed primarily at the export market and are unlikely to be able to rely upon domestic demand to sustain them. This is not necessarily an insurmountable barrier but it does highlight the importance of ensuring that the final products can compete effectively in international markets.

Trade Barriers

As noted earlier, processed products are often more prone to government support than unprocessed commodities. Protection of local industry may mean trade barriers to Australian processed products. For instance, if the mooted US moves to protect its steel industry against Asian imports eventuate, this would have obvious implications for further processing of iron in Australia. As with other sectors of the economy, Australia's interests are best served by minimising international trade barriers.

Microeconomic Reform

Moves towards further processing will require provision of all inputs on as competitive a basis as possible. While Australia's minerals resources mean it has a comparative advantage in extraction, the same is not necessarily true of processing. In order to maximise the opportunities for further processing, continued microeconomic reform is necessary. This includes labour market, tariff and utility reform.

Energy Costs

Further processing is typically extremely energy intensive and Australia is, by comparison with many of its competitors, a high cost producer. This will necessarily prejudice prospects for further processing. Continued action to reduce energy costs to the lowest possible level via maximising competition throughout the production and supply chain will maximise the chances for further processing to succeed.

A notable feature of the move to further processing in Western Australia in recent years is that, despite it having been an avowed aim of State Governments for several decades, the catalyst was not Government exhortation but rather a sharp reduction in gas prices as a result of reform of the gas supply contracts on the North West Shelf.

Greenhouse

Just as energy is a crucial input into further processing, conversely restrictions on its use will be a major impediment. A likely consequence of the Kyoto obligations is that carbon emitting energy use (which is the only feasible means in WA at least) will be constrained via emissions reduction measures. This will inevitably impact on the prospects for further processing. Policy measures are necessary which do not prejudice new developments and allow for the right to use energy to be directed to its most valuable use. Any measures which force the minerals sector to bear an unfair portion of the emissions reduction burden will retard the prospects for further processing even more. To the extent that this sends processing offshore to countries unconstrained by emissions reduction protocols, this will of course not improve the global emissions scenario and may, if the producer is a less efficient user of energy than Australia, actually worsen it.

Government Policy

Despite the reservations expressed above, the Chamber agrees that further processing, provided it is economically justified, is a worthwhile policy goal. It is obviously one favoured by Governments and various policy tools have been employed to advance it. In Western Australia, these range from effective penalties for non processing in the form of higher royalty rates for unprocessed products through to requirements to consider the prospects for processing and report to Government. Given the importance of undertaking further processing only where it does represent true value adding, the Chamber argues that it should generally be a decision of the companies concerned rather than one forced upon them. The Chamber would therefore favour a light handed rather than command approach towards directing companies into further processing. Measures which force further processing by distorting input costs (such as differential royalty regimes) raise concerns that, while such a decision may make economic sense from a firm's point of view, it may not be economically beneficial.

It is hoped that these comments are of assistance. Please contact Charles Crouch, Executive Officer – Economic Affairs at the Chamber if any clarification or further details are required.

Yours sincerely

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