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Senator Mathias Cormann
Chair
Senate Select Committee on Fuel and Energy
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Senator

SENATE SELECT COMMITTEE ON FUEL AND ENERGY – INFORMATION REQUEST

Thank you for the opportunity to provide further information to your Committee in its deliberations on the proposed Mineral Resource Rent Tax (MRRT).

At the hearing held in Canberra on 13 July 2010, Mark Altus (Director Revenue and Intergovernmental Relations) and I presented to the Committee our perspective on the proposed MRRT. The views expressed are also largely captured in our analysis of the MRRT, provided at Attachment A.

During the course of the hearing I committed to provide responses to two Questions on Notice, one relating to whether the Commonwealth Treasury has made contact with the Western Australian Department of Mines and Petroleum (the agency responsible for administering the State's royalties), and the second relating to the assumptions underpinning the royalties forecasts in the Western Australian Government's 2010-11 State Budget.

With respect to the first Question on Notice, I can confirm that the Commonwealth Treasury (or any other relevant Commonwealth agency) has not consulted with the Western Australian Department of Mines and Petroleum on either the former Resource Super Profits Tax or the MRRT.

In response to the second Question on Notice, Attachment B includes the key assumptions related to the royalty income estimates contained in the 2010-11 State Budget.

Should you have any questions relating to our analysis, please contact me on (08) 9222 9223.

Yours sincerely

for. Michael Barnes
ACTING UNDER TREASURER

13 July 2010

ATTACHMENT A

WA DEPARTMENT OF TREASURY AND FINANCE ANALYSIS OF THE PROPOSED RESOURCE RENT TAX REGIME

Introduction

On 2 July 2010, the Commonwealth Government announced that it would replace its previously proposed Resource Super Profits Tax (RSPT) with a Minerals Resource Rent Tax (MRRT) applied only to iron ore and coal, and an extension of the existing Petroleum Resource Rent Tax (PRRT) to the North West Shelf and onshore petroleum (including gas) projects (commencing 1 July 2012).

Intuitively, the parameters of the proposed new Commonwealth resource rent tax regime suggest that it should pose less risk to the Western Australian and national economies, relative to the previous RSPT proposal. Some major concerns and outstanding issues remain, however. These include:

- the lack of robust analysis of the likely economic impacts (particularly by region);
- the lack of transparency surrounding the revised revenue estimates and the key assumptions underlying those estimates;
- the extent to which the Commonwealth may seek to cap potential future increases in State royalty rates (for the purposes of crediting royalty payments against MRRT/PRRT liabilities);
- the operation of the proposed Regional Infrastructure Fund, including the Commonwealth Grants Commission treatment of payments under the Fund; and
- the status of existing Commonwealth election commitments (i.e. on a Western Australian Infrastructure Fund financed from Gorgon and/or Pluto project PRRT revenues, and a flow through shares scheme to encourage mining exploration).

While the Commonwealth has indicated that a 'Policy Transition Group' will oversee the development of the detailed design and implementation of the new tax regime, the process to-date provides little confidence that this will include adequate consultation with all sectors of the resource industry or State governments.

Even if the above issues are resolved, the proposed tax regime is considered to be an unwelcome intrusion by the Commonwealth into an area of State responsibility, undermining the State's autonomy and budget flexibility. Of most concern is the Commonwealth's apparent intention to ultimately completely replace State royalties (at least on iron ore, coal and petroleum) – something no Western Australian Government is likely to agree to.

The proposed tax regime will also substantially exacerbate the large redistribution of wealth from Western Australia to other States that already occurs through the Commonwealth Budget and Commonwealth Grants Commission process, eroding the incentives for the State Government to support Western Australia's growth in the national interest.

Brief Overview of Western Australia's Mining Industry

Mining is Western Australia's largest industry, accounting for 24% of Gross State Product (GSP) in 2008-09.[1] As the mining industry gathers momentum following the global economic slowdown, this proportion is likely to grow.

Approximately 80,000 workers are directly employed by Western Australia's mining industry (7% of total employment in Western Australia).[2] The industry also creates jobs in supporting sectors of the economy. ABS Census data indicates that the State's mining sector employed more than 800 indigenous workers in 2006 (approximately 8% of our indigenous workforce).

Western Australia's mining industry makes an enormous contribution to the national economy. In 2008-09, its total value added was approximately $41 billion, a 46% share of the national mining industry.[3] This contribution is likely to increase in future years as global demand for resources grows, and as Western Australia's LNG sector expands.

At the individual commodity level, Western Australia generates 65% of Australia's crude oil and condensate production, 75% of natural gas (and LNG feedstock) output, and more than 95% of the nation's iron ore production.[4]

Reflecting the strength of its mining sector, Western Australia's contribution to national export earnings is particularly striking. In 2009, total merchandise exports from Western Australia were valued at $77 billion, representing almost 40% of the national total.[5] Of the $77 billion in total merchandise exports from Western Australia, $61 billion (or nearly 80%) is from the mining sector.

Overall, Western Australia currently accounts for 14% of the Australian economy, despite having a population share of only just over 10%.[6] It follows that the continued strength of Western Australia and its mining sector is vital to the well-being of the national economy.

The success of Western Australia as a mining province not only reflects its mineral wealth. It is also a testament to the State's low sovereign risk, due to the stability and certainty provided by its regulatory system (including its royalty regime) in a globally competitive market.

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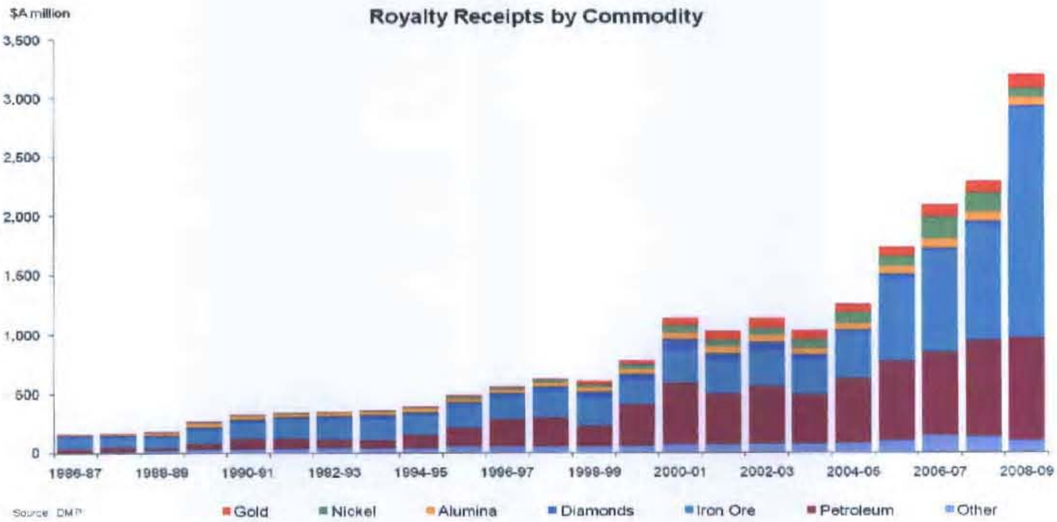
[1] ABS Cat. No. 5220.0.
[2] ABS Cat. No. 6291.005.
[3] ABS Cat. No. 5220.0.
[4] Department of Mines and Petroleum, Western Australia.
[5] ABS Cat. No. 5368.0.
[6] ABS Cat. No. 5220.0 and 3101.0.

According to the Fraser Institute's latest annual *Survey of Mining Companies,* Western Australia ranked in the top 20 investment destinations in a worldwide review of 72 mining jurisdictions. A sudden and significant increase in taxation, particularly in the absence of widespread consultation, could jeopardise Western Australia's future ranking.

State Royalty Regime

The High Court has confirmed that the State Government owns, on behalf of the community, all (onshore) mineral and petroleum resources in Western Australia.[7] Compensation in the form of a royalty is paid to the State for the extraction and sale of these resources.

The chart below shows total royalty receipts (including North West Shelf petroleum grants) in Western Australia from 1986-87 to 2008-09, broken down into receipts by major commodity type.



Source: Department of Mines and Petroleum

Implicit in the chart is the fact that the Commonwealth's proposed resource rent tax regime targets the commodities that are already the dominant contributors to Western Australia's total royalty revenues (i.e. iron ore and petroleum).

In the 2010-11 State Budget it is estimated that Western Australia will collect \$4.2 billion in royalties in 2010-11, which represents 18.6% of total State general government revenue.

[7] Western Australia v Ward (2002) 213 CLR 1 at [384]

Mineral and petroleum royalties in Western Australia are generally designed to return to the community a benchmark 10% of the wellhead or minehead value of the resource (i.e. the value of the resource when it is first extracted) – the State's royalty rates generally apply to the value of mining production (not just volume). More specifically:

- an ad valorem royalty applies to petroleum (both oil and gas) produced onshore and in offshore areas within the State's jurisdiction, together with the North West Shelf Project, based on the value of petroleum at the wellhead; and
- an ad valorem royalty applies to most minerals produced in Western Australia, designed broadly to apply to the value of the mineral at the minehead (although a set rate royalty per tonne is applied to low-value, bulk commodities).

Certain deductions from the sales value (i.e. at the first point of sale) of petroleum and minerals are permitted to arrive at the wellhead/minehead value of those commodities.

- For petroleum, these include the cost of processing, storing and transporting the petroleum, where these costs are incurred post-wellhead by the producer.
- For minerals, deductions are limited to certain transport costs. However, the royalty rates for minerals attempt to recognise the varying levels of processing costs incurred post-minehead. In this regard, a rate of 7.5% applies to bulk material, 5% for mineral concentrates and 2.5% for minerals in metallic form.

In addition to ad valorem royalties, Western Australia applies a Resource Rent Royalty to petroleum produced on Barrow Island. Like the Commonwealth's PRRT, the Barrow Island Resource Rent Royalty applies only to the economic profit or rent of the project (although some of the parameters differ).

The table below indicates the ad valorem rate of royalty that applies to the sales value of major commodities under Western Australia's Mining Act and legislation governing petroleum production.

Mineral	Ad valorem royalty rate
Iron ore	
- lump ore	7.5%
- fine ore	5.625%
- beneficiated ore	5.0%
Coal – exported[8]	7.5%
Petroleum (excluding 'tight' gas)	10-12%
Base metals, gold, nickel	2.5%

Many mining royalty rates are also set under various legislated State Agreements between the State and a miner. These are generally long-standing agreements, which in some cases include concessional royalty rates that recognised (among other things) the start-up costs for major projects in remote areas (requiring substantial infrastructure investments by mining companies). More recent agreements reflect the Mining Act rates.

The Western Australian Government has recently negotiated with BHP Billiton and Rio Tinto to remove (from 1 July 2010) the majority of the concessional iron ore royalty rates in State Agreement Acts (vis a vis the current Mining Act rates). The State Government has also publicly flagged its intention to move, at some point in the future, the 5.625% royalty rate on 'fine' iron ore to the 7.5% 'lump' rate.

Overall, Western Australia's royalty regime is considered to strike a reasonable balance between the often competing objectives of maximising economic efficiency, fairness, simplicity, and relative stability and predictability of revenue streams. Further, and relative to a profit-based resource rent tax (which can delay the receipt of revenue for many years), the current royalty regime delivers revenue up-front. This is an important consideration, as State governments will often fund common user infrastructure (and supporting social infrastructure) to ensure potential projects get off the ground.

In 2004 the Ministerial Council for Mineral and Petroleum Resources investigated the fiscal environment in which Australia's mineral and petroleum industries operate. The Ministerial Council found that "No single type of resource tax is likely to be ideal for all circumstances and a range of resource tax regimes is probably unavoidable".

Revenue Estimates

The lack of transparency around the revenue estimates for the proposed new Commonwealth resource rent tax regime ($4 billion in 2012-13 and $6.5 billion in 2013-14), including the impact of changes to key parameter assumptions since the revenue estimates for the previously proposed RSPT were released ($3 billion in 2012-13 and $9 billion in 2013-14), makes the robustness of the estimates difficult to assess.

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[8] In the past, all of Western Australia's coal supplies have been sold domestically. These are subject to a royalty of $2.52 per tonne. More recently, small quantities of coal have been exported on a trial basis.

To our knowledge the Commonwealth Government has not released a breakdown of the expected revenue from the MRRT or expanded PRRT components, nor longer term projections beyond 2013-14 (e.g. to indicate to what extent the $6.5 billion estimate in 2013-14 does or does not reflect an indicative full year revenue 'take'). This information would help inform analysis of regional and longer term economic impacts of the proposed regime.

In Western Australia, the assumptions that underpin State royalty forecasts are clearly documented in State Budget Papers. The production (volume) estimates are based on an annual survey of producers by the Department of Mines and Petroleum. Generally only those projects or project expansions having received both final investment approval by the company and formal government approvals are included.

Short-term $US iron ore price forecasts are based on recent spot prices, while longer-term projections are informed by the outlook for international demand and supply and private sector forecasts. In the 2010-11 State Budget (parameters for which were set at the Budget cut-off date of 22 April 2010), it was assumed the price of iron ore would fall from an average of $US107 per tonne in 2010-11 to an average of $US75 per tonne in 2013-14. This reflects an assumption that current high prices are likely to induce more supply in coming years, thus putting downward pressure on prices.

Assumptions in relation to other commodity prices (e.g. crude oil, gold and base metals) are based on a combination of futures prices and long run averages.

The $A/$US exchange rate projections that also underpin Western Australia's royalty forecasts are based on an assumption that the current spot rate will return to the long-run average (approximately US72 cents) over the course of the Budget period. This methodology (which is partly based on the purchasing-power parity theory of exchange rate determination) has been shown to compare favourably to alternative exchange rate forecasting techniques.[9]

Western Australia's Budget Papers also transparently disclose the sensitivity of the royalty estimates to changes in key parameters, such as the iron ore price and the $A/$US exchange rate.

Commonwealth-State Financial Relations

A key concern with the Commonwealth Government's proposed resource rent tax regime is the further erosion of the sovereignty of the States and of the associated benefits that should flow from a healthy federal system of government.

A large, diverse country like Australia demands a federal system. Strong States are needed to ensure local needs and preferences are recognised; to foster competition and innovation in service delivery across the country (the States

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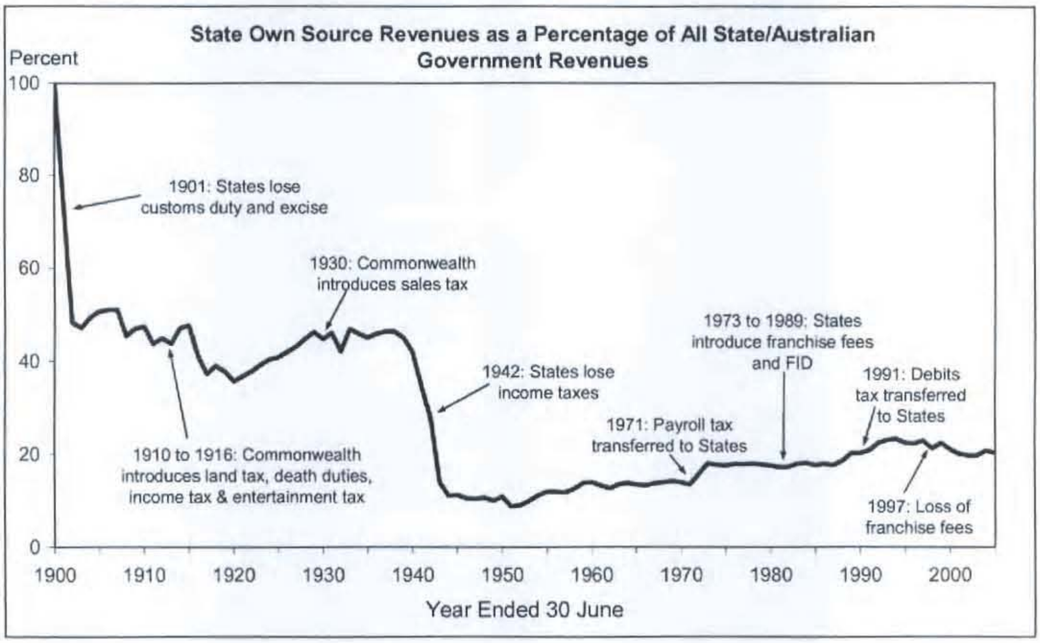
[9] See http://www.dtf.wa.gov.au/cms/content.aspx?id=3551&terms=exchange+rate for more information.

being responsible for the majority of core community services in Australia); and to limit the abuse of power potentially resulting from a dominant central government.

However, the historical erosion of States' tax powers over time (as shown in the following chart) has left Western Australia, like other States, in the situation of relying on Commonwealth grants for a large proportion of the revenue it requires to fund its expenditure responsibilities. Prescriptive conditions on how the States can spend the grants have exacerbated the reduction in the States' budget and policy making flexibility.



More recently, the GST-based funding arrangements have further increased the States' dependence on the Commonwealth, with the States being required to abolish a number of taxes in return for GST grants.

Against this background, it is of major concern that the Commonwealth seems to envisage its new mining tax regime ultimately completely replacing State royalties (at least on iron ore, coal and petroleum). This would directly increase Western Australia's reliance on Commonwealth grants, with the State being exposed to future cuts and increased conditionality on those grants.

Over time, the increase in compliance costs under the dual tax/royalty regime proposed by the Commonwealth could be expected to bring industry pressure to bear on State royalties. However, it is highly unlikely that any Western Australian Government would ever agree to abolish its royalties, which have historical and constitutional primacy over any Commonwealth mining tax. The Commonwealth will need to be fully accountable for the increase in compliance costs brought about by its proposed MRRT/expanded PRRT regime.

Even with State royalties continuing, there is uncertainty about the Commonwealth's intentions to 'cap' the extent to which they would be creditable against liabilities under the new MRRT and expanded PRRT. Under the RSPT, only 'previously scheduled' royalty rate increases would have been recognised for the purposes of the then proposed Commonwealth refunds. Western Australia requires full flexibility to alter its royalty regime as appropriate.

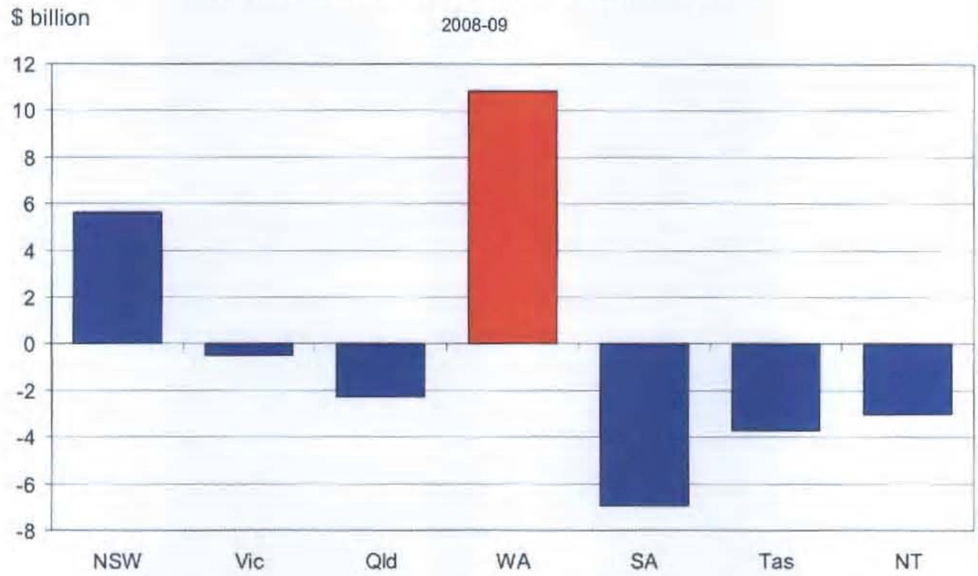
Another impact of the Commonwealth's proposed mining tax regime will be to substantially increase Western Australia's net financial contribution to the Commonwealth budget, which already far exceeds that of the only other State that makes a net contribution (New South Wales) – especially if measured on a per capita basis.

In 2008-09, it is estimated that the Commonwealth derived around $38 billion in revenue from Western Australia, while expenditure for the benefit of the State (adjusted for the State's share of the Commonwealth deficit) totalled only $27 billion. This means that the Commonwealth collected around $11 billion more from Western Australia than it spent on the State (see following chart).

This figure is already expected to grow substantially over the next few years. Western Australia's low share of the GST accounted for 'only' $300 million of the State's $11 billion net contribution to the Commonwealth in 2008-09. This is estimated to rise to about $1.5 billion in 2011-12 and $2.5 billion in 2013-14 as Western Australia's GST share continues to fall (to an estimated 5.7% by 2013-14).

It is estimated that the MRRT (net of company tax reductions and related Regional Infrastructure Fund distributions) will further increase Western Australia's net contribution to the Commonwealth by around $3 billion in 2013-14.

Net State Contribution to the Commonwealth



Source: Western Australian Department of Treasury and Finance estimates, using a range of data sources including the Commonwealth Final Budget Outcome publications and Australian Bureau of Statistics publication 5220.0.

Western Australia's net contribution is largely driven by the high per capita level of Commonwealth revenue derived from the State, including company tax, personal income tax and petroleum extraction revenues. In addition, Western Australia makes a significant contribution through its low per capita share of (for example) Commonwealth social security and health benefit payments. These outcomes are, to a degree, an accepted outcome of Western Australia being an integral part of the Australian federation.

However, it is not clear that such comprehensive wealth redistribution is in the national interest. It reduces incentives for States such as Western Australia to put in place growth promoting policies and infrastructure, as the costs are borne by the State while the benefits in the form of increased tax revenue are received primarily by the Commonwealth, with only some of this revenue directly flowing back to the States through increased GST revenues (and even then it is distributed on the basis of equalisation principles rather than where the revenue originated).

In this regard, Western Australia is concerned by statements by the Commonwealth, including by the Prime Minister during her visit to Perth on 9 July 2010, that Western Australia would be allocated only $2 billion from the mooted $6 billion Regional Infrastructure Fund to be financed from the Commonwealth's mining tax regime over the long term. In this regard, preliminary estimates suggest that Western Australia's contribution to the MRRT/expanded PRRT revenues would be in the order of 60-65%.

This raises the more general issue of uncertainty over how the Regional Infrastructure Fund will operate. Issues requiring confirmation, clarification or addressing in consultation with State governments include the quantum of infrastructure funding, basis of apportionment between the States, Commonwealth Grants Commission treatment of the allocations to the States, and the definition of (and process for selecting) eligible projects.

Related to this is the Commonwealth Government's pre-election commitment to Western Australia to establish a Western Australian Infrastructure Fund, financed from Gorgon and/or Pluto gas project PRRT revenues. The promise was for $100 million per annum to be paid into this Fund, quarantined from the Grants Commission process. 'Down-payments' are justified by the need for up-front infrastructure investment to support such projects.

Efforts by Western Australia to enter into a national partnership agreement with the Commonwealth to give effect to this election promise have so far proved fruitless.

Impact of Commonwealth Resource Rent Tax Regime

Uncertain Impact on Growth and Jobs

As noted in earlier parts of this document, Western Australia remains concerned about the lack of robust analysis supporting the proposed new Commonwealth mining tax regime. In particular, there appears to be very limited analysis on the impact of the tax on particular industries/commodities or regions.

Notably, the Commonwealth Treasury indicated to the Senate Select Committee on Fuel and Energy on 5 July 2010 that the Commonwealth Government had not asked it to conduct (or commission) any modelling of the impact of the new tax arrangements on investment and jobs.[10] This is exacerbated by the limited consultation on the proposed regime, including the lack of consultation with smaller mining companies and State governments.

It is considered unacceptable that there be any reduction in investment in Western Australian mineral projects as a consequence of the imposition of the proposed MRRT, or any reduction in North West Shelf gas output as a consequence of the imposition of the proposed expanded PRRT.

Uncertain Application (Including to Mid-Cap Miners)

Western Australia is similarly concerned over the ongoing uncertainty with respect to details of how the proposed new tax will operate. For example, the Commonwealth has indicated that the MRRT will apply to assessable profits calculated according to the value of the commodity in its first saleable form, less all costs post the mine gate. However, very limited detail is available on how these complex calculations would be performed.

[10] Senate Select Committee on Fuel and Energy – 5 July 2010 transcript – p FUEL ENE 22

Taxing value only at the mine gate (to avoid capturing valued added by processing) is particularly important to Western Australia's fledgling magnetite iron ore industry, reflecting the extensive processing required to convert magnetite ore into a marketable product. Consideration should be given to excluding magnetite iron ore from the MRRT, consistent with the approach for gold and nickel (which also incur high processing costs).

Furthermore, in testimony to the Senate Select Committee on 5 July 2010, the Commonwealth Treasury indicated that no decision had been made on the operation of the $50 million exemption threshold – whether miners would be taxed on their entire earnings or only on their earnings above $50 million per year. This clearly has significant ramifications for the smaller and mid-cap miners in particular, as does the failure to extend the threshold to the expanded PRRT.

While the Commonwealth Government purports to have recognised the views of industry, the consultation on the proposed new MRRT and expanded PRRT arrangements appears to have been disproportionately focussed on a small number of large miners.

The uncertainty and complexity surrounding the implementation and structure of these proposed new tax arrangements increases business risk, making Australia less attractive for investors. The longer this uncertainty exists, the greater will be the disincentive to invest in mining projects in Australia. Again, any reduction in investment in projects in Western Australia as a consequence of this uncertainty is considered unacceptable.

North West Shelf Project and Barrow Island Royalty Sharing

Also in testimony to the Senate Select Committee on 5 July 2010, the Commonwealth Treasury indicated that the existing royalty and excise arrangements would continue to apply to the North West Shelf project at least in the short term (with liabilities to be credited against the expanded PRRT). This and the longer term arrangements need to be confirmed by the Commonwealth Government. Western Australia has around $1 billion per annum of royalty revenues at stake under the existing royalty sharing agreement.

Similarly, clarification is required in relation to application of the expanded PRRT to the Barrow Island petroleum operation, including any implications for the current Resource Rent Royalty revenue sharing arrangements.

Incentives for Exploration

Australia's existing tax settings favour larger mining companies that undertake exploration and production, as these miners are much more able to fund exploration activity from internal sources or borrowings, and are able to recoup part of their exploration costs through the taxation system by offsetting these expenses against other income.

In contrast, smaller explorers typically raise capital from equity markets to fund their exploration activity. These explorers usually do not generate sufficient cash-flows from their activities to fund exploration or against which to offset exploration costs. As a result, they face a higher cost of capital than larger miners, and often find it difficult to borrow because of the risks associated with exploration.

The Commonwealth Government has withdrawn the previously proposed exploration rebate, which would have provided a refundable tax offset at the prevailing corporate tax rate for eligible exploration expenditure. Instead, the Policy Transition Group (led by the Federal Minister for Resources and Energy and Mr Don Argus AC) has been asked to "consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations".

In its submission to the Henry Review, the Western Australian Government recommended a flow-through shares scheme to address some of the biases in the taxation system by allowing exploration costs to be used as a tax credit for shareholders in smaller exploration companies. It noted that Canada, for example, has introduced a flow-through shares scheme and has seen increased levels of exploration activity.

Furthermore, the Commonwealth Government made a pre-election commitment to introduce a flow-through shares scheme for smaller explorers, potentially as part of a broader flow-through taxation approach for small businesses which may be particularly disadvantaged in raising finance from traditional sources.

Recommendations

1. At a high level, it is considered that the Commonwealth's proposed mining tax regime should not proceed, appropriately leaving the revenue base to the States (as owners of the minerals). The following recommendations should be read with this as a proviso.

2. The Commonwealth should undertake detailed analysis of the economic impacts of the proposed mining tax regime (including by industry and region) as a matter of priority. This is necessary to inform consultations and debate on the appropriate design of any new tax arrangements.

   Related to this, the Commonwealth should release disaggregated and longer term revenue estimates for its proposed mining tax regime.

3. The Commonwealth should commence consultation with State governments on the crediting of State royalties under the proposed mining tax regime, particularly the application of any cap on the available credits.

4. Consideration should be given to excluding magnetite iron ore from the proposed MRRT. Failing this, the Commonwealth should ensure that, in finalising the detailed design parameters of the MRRT, emerging participants in the iron ore industry (including magnetite producers) are not disadvantaged relative to established participants.

5. The Commonwealth Government should formally confirm that the revenue sharing arrangements with Western Australia in relation to the North West Shelf and Barrow Island projects will remain unaffected by the proposed expanded PRRT regime.

6. In relation to the proposed Regional Infrastructure Fund (to be funded from MRRT and expanded PRRT revenues), the Commonwealth should confirm States' shares of the funding (in consultation with State governments); ensure States have sufficient autonomy and flexibility over how and where the funding is spent; and quarantine payments from the Fund from the Commonwealth Grants Commission process.

7. The Commonwealth should deliver on its election commitment to Western Australia in relation to the Western Australian Infrastructure Fund (financed from Gorgon/Pluto PRRT revenues), and to the mining industry in relation to a flow-through shares scheme to encourage exploration activity.

ATTACHMENT B

2010-11 BUDGET

MAJOR ROYALTY PARAMETERS

Western Australia

	2008-09 Actual %	2009-10 Estimated Actual %	2010-11 Budget Estimate %	2011-12 Forward Estimate %	2012-13 Forward Estimate %	2013-14 Forward Estimate %
Oil Price ($US per barrel)	68.9	82.5[a]	86.8	88.4	89.2	89.8
Iron Ore Price ($US per tonne)	75.4	61.7	107.4	96.5	85.7	74.9
$US/$A (cents)	74.6	92.0[a]	88.5	83.5	79.0	74.5

(a) Estimated average over the remainder of 2009-10.

Western Australia's shipments of iron ore were strong in 2009-10, and are expected to increase further over the next few years. This partly reflects a relatively low base in 2008-09 (due to the global financial crisis), as well as solid contributions from recently completed projects, including BHP Billiton's Rapid Growth Project 4 and expansions at Rio Tinto's projects. Total iron ore shipments in 2009-10 are expected to rise to 379 million tonnes, an increase of 20.3% relative to 2008-09. Iron ore shipments are expected to grow over the outyears by an annual average increase of 8.1% per annum.