

28 October 2010



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Dear Policy Transition Group Secretariat,

This letter constitutes the Chamber of Minerals and Energy of Western Australia's (CME) submission on the Minerals Resources Rent Tax (MRRT) to the Policy Transition Group (PTG).

CME is the peak resources sector representative body in Western Australia. It is funded by its member companies who generate 90 per cent of all mineral and energy production and employ 80 per cent of the resources sector workforce in the state.

The Western Australian resources sector is diverse and complex covering exploration, processing, downstream value adding and refining of over 40 different types of mineral and energy resources and also incorporates power generation.

The value of the Western Australian minerals and oil and gas industries reached \$70.9¹ billion in 2009/10 and royalty payments to the state government alone totalled \$2.8 billion. These are expected to climb to \$3.27² billion for the 2010/11 year. The resources sector is also the largest private employer in regional and remote Western Australia, and the largest private sector employer of Indigenous Australians.

CME welcomes the removal of the Resources Super Profits Tax (RSPT), as originally proposed by the federal government on 2 May 2010, and recognises recent progress in negotiations towards a profits-based tax in the form of the MRRT and expanded Petroleum Resources Rent Tax (expanded PRRT).

CME firmly believes the implementation of these measures must not adversely impact on the Australian minerals and energy sector's international competitiveness. CME opposes the introduction the MRRT/expanded PRRT until the full impact of the proposed changes is fully understood.

In relation to state royalties, CME has always maintained a strong preference for retention of the current state regime, administered by the state government and with revenues flowing to the state. The state has prime responsibility for resource project approvals and the provision of non-privately owned infrastructure. As such, it is imperative the state government maintains and receives a dividend for WA resources.

Further to CME's preference for the retention of the state based royalty's regime, it could be potentially argued that the imposition of the MRRT breaches the Constitution of the Commonwealth of Australia. It is the states' constitutional responsibility to properly manage its mineral resources and it is up to them whether they charge an ad valorem royalty or a profits-based royalty.

That said, CME has always supported genuine reform of the Australian taxation system in order to provide for an efficient and effective tax regime. Thus we have argued, in relation to any consideration of a federal tax on resources, that it should:

- be prospective, that is apply only to new investment;
- protect Australia's international competitiveness;
- be differentiated by resource commodities;

¹ Western Australian Department of Mining and Petroleum, 2009-10 State Royalty Receipts

² Western Australian Department of Treasury and Finance, 2010-11 Budget Fact Sheets

- be levied on primary resource value; and
- be equitable and efficient.

While the MRRT/expanded PRRT to some extent addresses the aforementioned principles, CME still has serious concerns around a range of issues not least of which is that there has been no streamlining of resources taxes, instead a new tax has been added.

This submission is divided into two parts. The first part provides feedback and recommendations on specific issues within the PTG's Terms of Reference as published on 3 August 2010 and should be read in conjunction with the joint industry body submission titled "Minerals Resource Rent Tax: Implementation & Transition Issues - Submission to the Policy Transition Group" (the MCA Submission).

The second part of this submission is concerned with broader core policy issues in relation to the proposed tax that may fall outside the PTG Terms of Reference. Here, CME has highlighted five core policy issues with the proposed MRRT, including the potential impact of the tax on Australia's international competitiveness and sovereign risk profile. A more comprehensive range of CME concerns with the proposed tax are detailed in the attached issues paper, titled "Minerals Resources Rent Tax Issues Paper". While comprehensive, the issues paper does not cover all CME concerns with respect to the MRRT.

Please note that, with the release of the PTG Issues Paper on 1 October 2010, CME has added commentary at end of relevant key points raised within this submission. This commentary relates to a number of the key questions raised in the PTG Issues Paper but does not attempt to cover all of them. CME will be submitting a further joint industry submission, with the MCA and other state peak bodies, addressing key issues raised in the PTG Issues Paper.

Part 1: PTG Terms of Reference Recommendations and Issues

CME, together with the Minerals Council of Australia (MCA), the Queensland Resources Council, the New South Wales Minerals Council and the Minerals Council of Australia (Victorian Division), will be lodging the MCA Submission that deals solely with the key design issues within the remit of the PTG Issues Paper. CME would like to re-iterate the following recommendations covered in the joint submission:

a) Taxing Point

In keeping with one of the key principles of the MRRT, the tax should only apply to the value of the resource. Any value added to the commodity via beneficiation should not be subject to the MRRT.

In keeping with this principle, the taxing point should be as close to the "mine gate" as practicable. It is important the concept of mine gate be employed when determining the taxing point as it should be capable of being consistently identified by all taxpayers and is not as ambiguous as "first saleable form".

CME proposes, as per the joint submission, that the mine gate be the point where primary crushed ore exits the ore extraction activities from whichever of the following activities come first:

- Delivery of primary crushed material to the next unit of operation; or
- removal of the extracted ore from the mining works from where it was extracted.

The definition of mine gate should be:

- applied consistently across different commodities (i.e. haematite, coal), mining operations and mining methods;
- easy to identify and administer; and
- fairly captures activities undertaken upstream (before the mine gate).

Please refer to the MCA Submission, Section B1, for further detail on taxing point recommendations.

PTG Issues Paper: (Ref. Section 5.1) –

- *CME strongly advocates the PTG position that the taxing point be at the mine gate. This position is critical to functioning of the MRRT and ensuring only the resource is taxed.*
- *Further to the above recommendations and in light of the PTG Issues Paper, CME advocates that the taxing point, within the boundaries of the mine gate, should be at the taxpayer's election for each project.*
- *In electing a taxing point, it is recommended that it be bounded upstream and downstream to provide some certainty on allowable deductions.*
- *Upstream bounding of the taxing point should be at the run of mine (ROM) stockpile. If the mine does not operation a ROM, the taxing point is where mined ore is removed from the mining pit/face and delivered to the next unit of operation post extractive mining activities*
- *CME recommends the tax payer is able to elect a taxing point downstream of the ROM to reduce compliance costs and administrative burden. The furthest downstream the taxing point can be moved is to the rail load out facility (or equivalent).*

b) Valuation of resource at mine gate

In order to determine tax payable, the value of the resource at the mine gate needs to be determined. As it is unlikely that many miners have a sale of the commodity at the mine gate, the taxpayer will be required to determine the market value of the commodity at the mine gate.

Where there is a sale of the commodity after the mine gate, the market value of the commodity should be determined on the following methodologies:

- Comparable uncontrolled price (CUP) method;
- If CUP is not available, a deductive method such as netback.

CME advocates that, where a CUP is not available, a net back method be used that applies arm's length principles (including appropriate returns on capital) on all downstream transactions/activities to determine an accurate taxable value for the resource.

Please refer to Section B2 of the MCA Submission for more details on the recommended methods for determining the value of the resource at the mine gate.

PTG Issues Paper: (Ref. Section 5.2) –

- *Where there is a sale of the commodity after the mine gate, CME advocates, where possible, the CUP method be used for determining the market value of the commodity.*
- *Further to the above recommendations and in light of the PTG Issues Paper, CME recommends that where CUP is not available, the following methods be applied:*
 - *A deductive method such as netback method;*
 - *A MRRT specific residual profit method (RPM); or*
 - *A cost plus method for vertically integrated operations (i.e. brown coal for electricity generation).*
- *CME recommends that taxpayers be able to elect to use the MRRT specific residual profit split methodology as a safe harbour.*
- *When using the netback method, commercial arms length principles on all downstream activities must apply i.e. commercial rates of return must apply when valuing downstream activities/transactions.*

c) Starting base

CME recommends, as per the joint submission, the following with respect to the starting base:

- The choice as to whether the starting base is determined based on book value or market value of project assets should be made on a project by project basis.
- Where project assets relate to activities both inside and outside the mine gate, it is recommended a predominant use test should be adopted. In applying this test, the total value of assets predominantly used (i.e. greater than 50%) in connection to activities inside the mine gate are included in the starting base. This method will provide greater certainty to taxpayers
- PTG to provide clarification if the choice of using either market or book value on determining the starting base is revokable and if it needs to be made within a certain timeframe.
- The term “book value” should be defined in the MRRT transitional rules to provide certainty to tax payers. Section D2 of the MCA Submission provides a recommended definition and also ensures all capital expenditure incurred between 1 July 2009 and 1 May 2010 is included in the starting base.
- Project assets need not be “used or installed ready for use” at 1 July 2012 in order to be included in the starting base deduction.
- Effective lives of project assets should be determined in accordance with the income tax principles to ensure consistency.
- As only “capital expenditure” incurred after 1 May 2010 will be added to the starting base, that the term “capital” be qualified given the meaning for accounting and tax purposes.

Please refer to the MCA Submission, Section D, for further detail on starting base recommendations.

PTG Issues Paper: (Ref. Section 7) –

- *CME advocates that intangible assets within the mine gate, including mining rights/information, should be deemed project assets and included in the starting base. CME does not agree that intangible assets are attributable to the extraction allowance, which recognises the miners expertise to profits at the mine gate,*
- *While CME recognises the need to apply limits to when a starting base can be recognised, it does not support the PTG option that only projects with a production licence as of 1 May 2010 will have starting base recognition. CME believes this approach will disadvantage many miners who have spent significant capital in establishing a project but as yet do not have a production licence.*
- *CME recognises that under the current proposed transitional arrangements, distortion in investment behaviour is probable given that capital expenditure deferred to post 1 July 2012 is immediately deductible and transferable. CME also advocates that transitional rules do not discourage exploration, especially if no deduction is available under the MRRT.*
- *CME does recognise that book value of projects assets at 1 May 2010 may not fairly reflect the value of those assets due to the economic downturn at that time (Global Financial Crisis).*
- *CME advocates that starting base losses (depreciation) be uplifted and transferable.*

- *CME advocates that generally accepted methodologies and practices should be adopted for MRRT market valuations of project assets and that there is no requirement for the PTG to prescribe the use of a specific valuation methodology.*

d) Project losses and transferred losses

Taxpayers should be able to choose how much loss to use or transfer to another project to ensure the integrity of the MRRT regime is maintained (refer Section E of the MCA Submission).

PTG Issues Paper: (Ref. Section 6) –

- *As per above, CME advocates that companies should be able to choose how much loss to use or transfer between projects within a wholly owned group. It does not advocate that losses must be transferred to offset against a MRRT profit.*
- *Subject to MRRT specific grouping rules being developed, CME advocates that losses from acquired projects should be transferable. In addition, CME does recognise the need for integrity rules to prevent the trading of MRRT losses.*
- *CME advocates that starting base losses should also be transferable as long as the requisite integrity and grouping rules are established.*

e) Credits for royalties paid

CME recommends, as per the joint submission, the following with respect to the crediting of royalties:

- The PTG should confirm that the rate applied in calculating the royalty, including changes to the rate of the royalty over time, should not be relevant in determining the entitlement to the royalty credit. The provision of a full royalty credit will, amongst other things, provide certainty as to the maximum effective tax rate applicable to projects.
- The definition of State and Territory royalties should include all royalties levied pursuant to the State or Territory mining legislation and associated regimes.
- The PTG should consider the impact on the autonomy of state governments to make changes to royalty rates should this credit mechanism not be automatically reflective of changes to rates.

Please refer to the MCA Submission, Section F, for further detail on the crediting of royalties under the MRRT regime.

PTG Issues Paper: (Ref. Section 6.6) –

- *The crediting of all State and Territory royalties under the MRRT, including any rises post 2 May 2010, is critical to ensure the impact on the Australian resource industries international competitiveness is limited. CME advocates that if the crediting of all royalties is not part of the MRRT design, the MRRT should not be introduced.*

Part 2: Broader MRRT Issues

This part of the submission covers broader issues in respect to the MRRT that lie outside the PTG's Terms of Reference and should be read in conjunction with the attached issues paper.

a) Lack of genuine tax reform

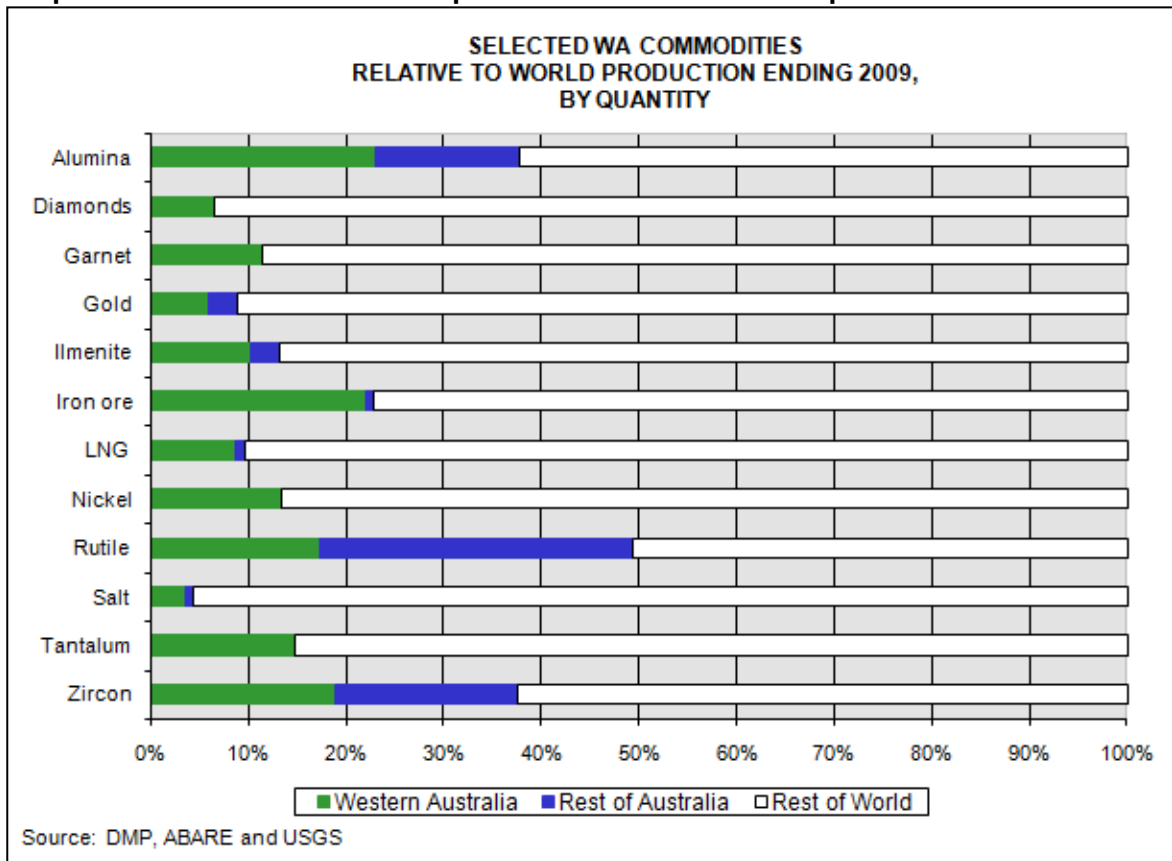
The proposed MRRT does not constitute genuine tax reform but rather adds another layer of complexity and an additional layer of administrative and compliance burden on Australia's resource industry, specifically coal and iron ore. It diverges significantly from the Henry Tax Review recommendations, which, although flawed, did attempt to design an efficient and neutral tax that was not meant to distort investment decisions.

However, under the MRRT, no such efficiency is attempted in its design. Under the MRRT, state royalties are still payable and no refundable credit is provided in periods where no MRRT is payable. Hence, there is no benefit to marginal projects under an MRRT while more profitable projects are subject to a higher effective tax rate. Therefore, as with the RSPT, the MRRT will influence investment decisions.

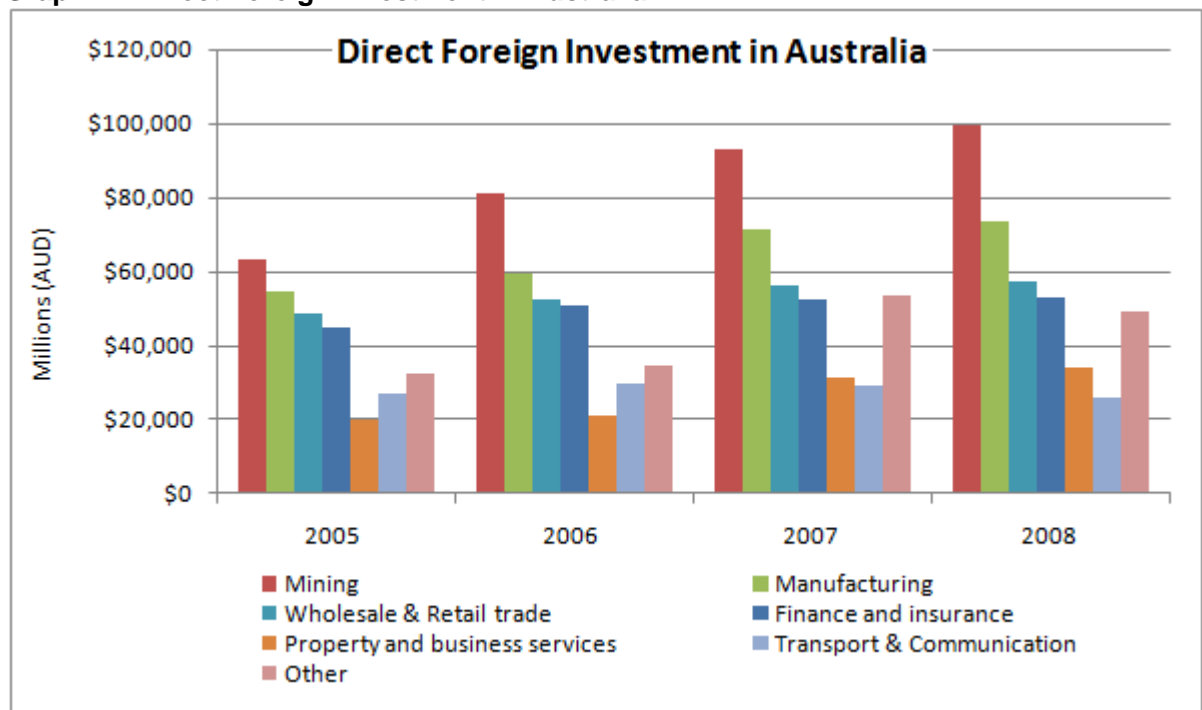
b) 30% Tax Rate and International Competitiveness

While the Australian resources industry has an important foothold in the global industry, it does not dominate any one market (refer Graph 1). Therefore it remains susceptible to changes in policy that alter its attractiveness against resource industries in other jurisdictions that compete for market share. In addition, Australia is a high risk, remote and infrastructure challenged environment that has a small population which exacerbates skills shortages.

Graph 1: Australian commodities production relative to world production



Graph 2 – Direct Foreign Investment in Australia³

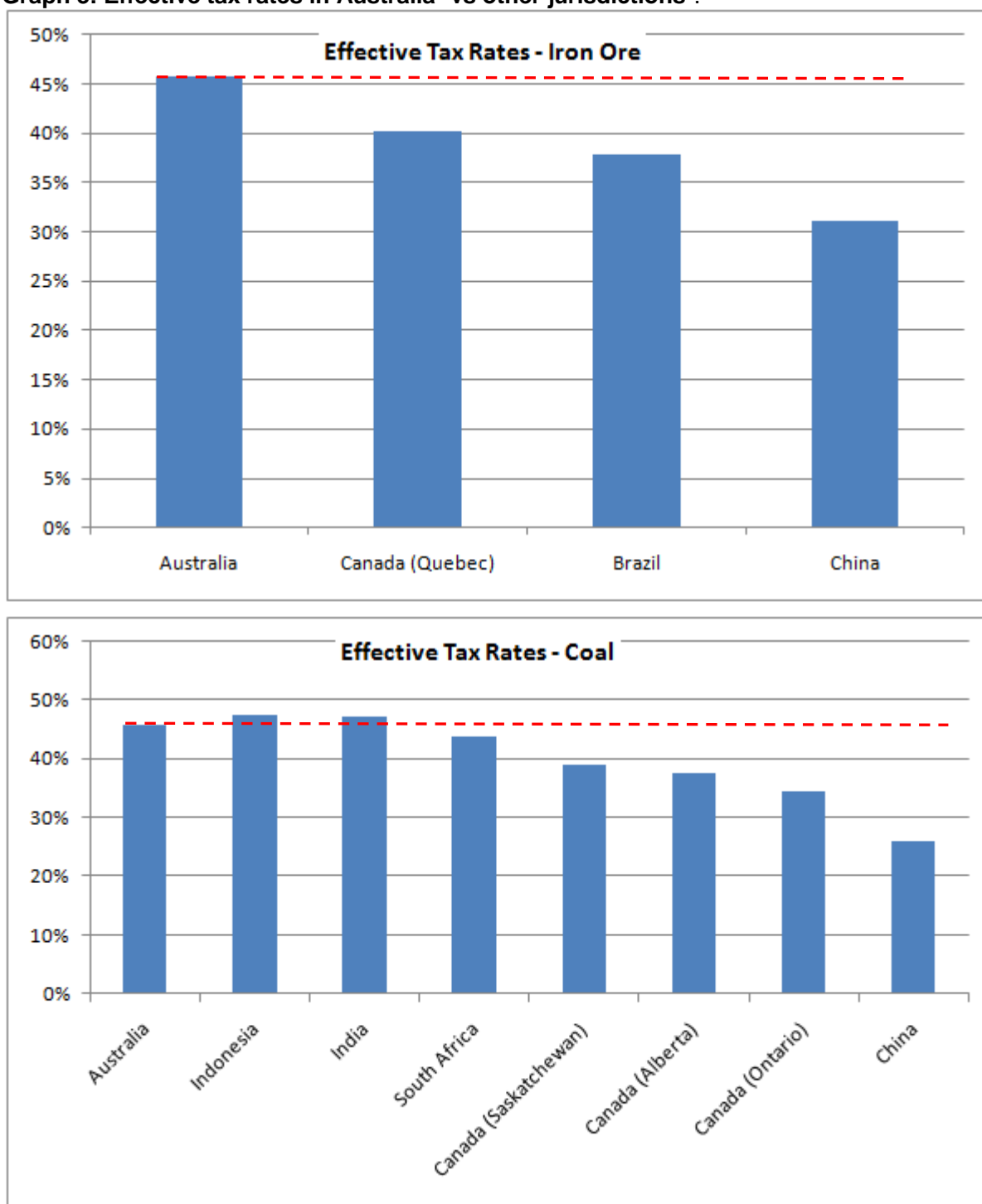


Under the MRRT, iron ore and coal projects face an increase in their maximum effective headline rate to 45.75%⁴. This may alter investment decisions into Australia compared to other

³ Source: Foreign Investment Review Board Annual Report 20089, Table 2.4: Total approvals by industry sector in 2008-09; ABS: 53520 - International Investment Position, Australia: Supplementary Statistics, 2008 - Table 15a. Foreign Investment in Australia(a): Level of Investment at 31 December 2008 by Industry Division (ANZSIC), Direct Investment in Australia

lower taxed jurisdictions. Ultimately, the additional impost of the MRRT will mean less revenue will be available to fund projects, repay debt and provide a return and refund to investors and this may be a real point of difference between funding a project in Australia versus one outside Australia that is not subject to an MRRT equivalent.

Graph 3: Effective tax rates in Australia⁵ vs other jurisdictions⁶.



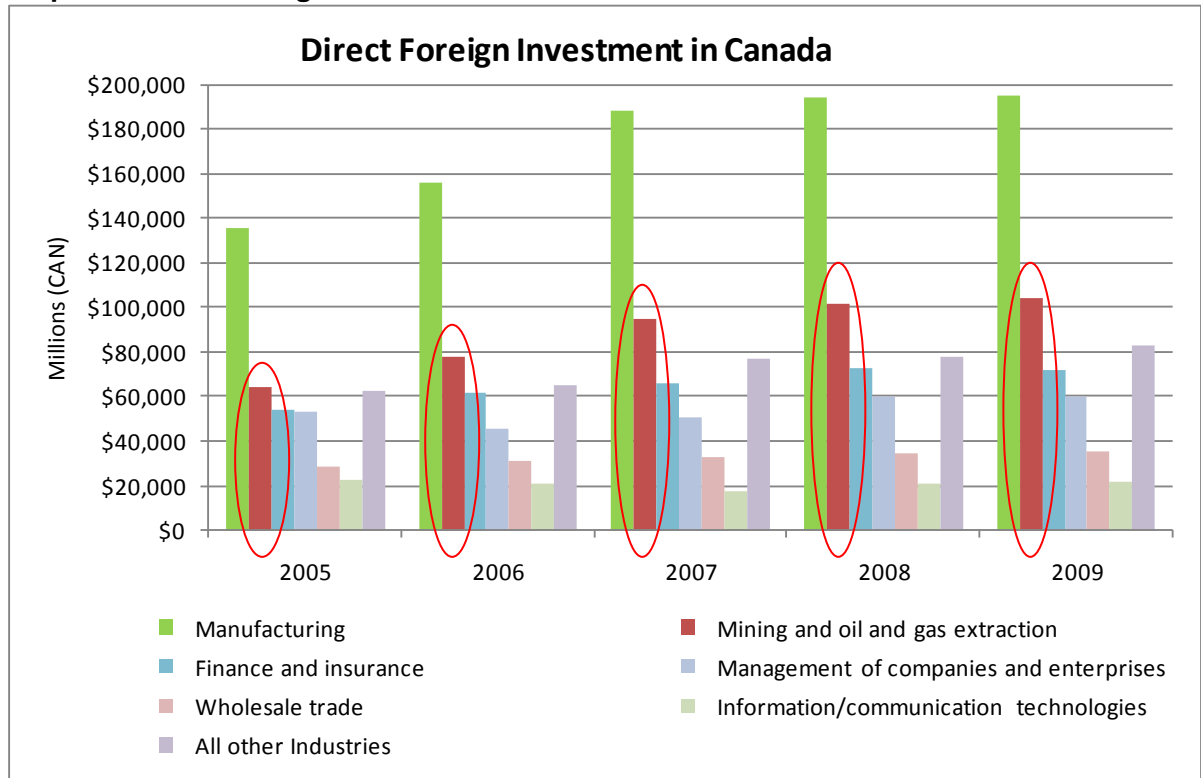
⁴ Calculated as follows: MRRT rate of 30% less the extraction allowance of 25% = MRRT effective tax rate of 22.5%. Plus corporate tax of 30% less deduction for MRRT paid = total effect tax rate of 45.75%. Applying to pre-mine gate activities and assuming no starting base deductions of uplift at LTBR + 7%

⁵ Calculated as follows: MRRT rate of 30% less the extraction allowance of 25% = MRRT effective tax rate of 22.5%. Plus corporate tax of 30% less deduction for MRRT paid = total effect tax rate of 45.75%. Applying to pre-mine gate activities and assuming no starting base deductions of uplift at LTBR + 7%

⁶ Minerals Council of Australia, Potential Financial Impacts of the Resources Super Profits Tax On New Projects In Australia, 1 June 2010

For example, as shown in Graph 4, the Canadian resources industry is also reliant, to a large extent, on foreign capital. Second only to manufacturing (of which \$30 billion is the manufacture of petroleum and coal products), \$104 billion was invested in the Canadian mining and oil and gas extraction industry. Furthermore, foreign capital investment in the Canadian resources industry has increased nearly 63% between 2005 and 2009. It is with jurisdictions like Canada that they Australian resources industry competed for foreign capital.

Graph 4 – Direct Foreign Investment in Canada⁷



Given the above concerns, CME requests the government releases the economic modelling and the basis upon which the 30% headline tax rate was determined and deemed to be internationally competitive.

c) Sovereign Risk

Sovereign risk is defined as the risk to a participant in a project that a Government action will cause a loss which could not have been foreseen when the project was committed to, and with no adequate legal remedy available. As Australia's sovereign risk increases due to the introduction of the MRRT which could not have been foreseen, foreign companies are less likely to invest in Australia, especially those foreign companies that have made past investments in Australia.

In the context of the original RSPT and now the MRRT, sovereign risk arises due to the application of the tax to existing projects from 1 July 2012 and the magnitude of the reforms themselves. In addition, investors may perceive that once introduced the Government may in the future seek to increase the MRRT tax rate or change other design features of the tax, such as application to minerals other than iron ore and coal, which will adversely affect existing projects

It must be highlighted that existing projects were financed (both debt and equity) under an assumed set of stable factors, including tax rates and risk profile. Significant changes to these factors, such as the introduction of the MRRT, impact investor's returns on existing projects and hence increase Australia's sovereign risk profile.

⁷ Foreign Affairs and International Trade Canada, Foreign Direct Investment Stocks in Canada, CANSIM Table 376-0052

An example of the impact of the proposed tax changes on Australia's sovereign risk profile and hence investment attractiveness was recently highlighted by the Fraser Institute's 2010 mid-year mining survey, taken while the RSPT was still being proposed. The survey showed the following with respect to exploration investment attractiveness⁸:

- The average score of the Australian states declined from 62.9 out of 100 in the 2009/10 annual survey to 40.9 in this survey update.
- The average rank of the Australian states fell to an average of 31st out of 51 jurisdictions in the update from 18th in the 2009/2010 index.
- Both Nevada and Quebec also suffered drops in their attractiveness to investment due to attempts to introduce resource rent taxes, in Quebec's case without consultation.

A further example on the effect the proposed resource taxes have had on Australia's investment attractiveness is the ability for resource projects to raise capital overseas. When the RSPT was announced, project owners found that their ability to raise capital overseas, especially in the USA and UK, severely impaired, with the overseas fund managers citing the RSPT as the primary cause.

While the MRRT does, to some extent, provide quasi-grandfathering protection to existing projects via the market value starting base mechanism, it falls short of full project exemption. To minimise the damage to Australia's sovereign risk profile, more adequate transitional arrangements should be considered. In addition, CME advocates legislating, rather than regulating, the current MRRT design. This would provide some surety to project owners and investors that the current regime cannot be easily changed in way that would adversely affect their investments and project viability without adequate consultation with the affected parties.

d) Low value resources and the \$50 million threshold

While an exemption threshold is welcome, CME has concerns on how this threshold was determined and whether it provides the necessary shelter for junior and emerging miners. In order to better comprehend the impact of the threshold, CME would welcome an opportunity to evaluate the federal governments calculations used in the establishment of this exemption threshold amount. Until the impact of the MRRT on Australia's resource industries' international competitiveness and project costing is fully understood, CME recommends particular consideration needs to be given to a possible increase to the \$50 million threshold. The magnitude of the increase, to be determined in consultation between government and industry with the support of extensive modelling, should ensure junior and emerging miners are not adversely impacted by the introduction of the MRRT.

Furthermore, CME strongly advocates the following with respect to the threshold:

- with regard to the operation of the threshold, the MRRT should only apply to profits exceeding the threshold, rather than the entire profit which could lead to distorting behaviour;
- to ensure the policy intent of excluding small miners is met in ensuing years, the threshold should be subject to indexation;

Any potential reduction in MRRT revenue resultant from the above CME recommendations on the operation of the threshold should not be offset by design changes elsewhere within the proposed resource rent tax.

CME has significant concerns that projects mining low value resources, which usually required significant processing to add value, will be required to undertake significant and costly compliance measures even though they will be paying minimal or no tax under the MRRT. These concerns also apply to junior developers trying to get their projects up and running.

⁸ Source: The Fraser Institute Survey of Mining Companies: 2010 Mid-year Update was sent to approximately 3,000 exploration, development, and other mining-related companies around the world. The survey, conducted from June 1 to June 30, represents responses from 429 of those companies; 51 jurisdictions were ranked.

Furthermore, the Henry Review recommended that resources expected to deliver little or no rent should be exempted where the administration and compliance costs are likely to outweigh any gains from a rent-based tax.

In light of the above, CME recommends low value resources which are likely to pay minimal, if any, taxes have adequate transitional allowances and shelter from the ongoing administrative burden of MRRT compliance.

PTG Issues Paper: (Ref. Section 8) –

- *As per above, CME advocates that the MRRT applies only to profits exceeding the threshold which would ensure competitive neutrality and address any distortionary effect of the threshold.*
- *The threshold should be calculated using the MRRT methodology and not accounting net profit after tax or taxable income. The CME advocates that the threshold calculation should include applicable deductions including the starting base and carry forward losses.*
- *The administrative burden on mining companies (both small and large) will be significant. CME does not support the PTG proposed solution of small miners being able to elect to not maintain MRRT accounts but in doing so, MRRT allowances and historical costs would therefore not be deductible from receipts in calculating profits or uplifted. CME believes this proposed treatment would penalise junior miners and a more equitable and efficient means of minimising the administrative burden needs to be determined.*

e) Uplift rate and cost of capital

CME has concerns the uplift rate of the long term bond rate (LTBR) plus 7% is not representative of the true cost of capital for all resource companies, in particular those miners with a weak balance sheet and who rely heavily on the debt market.

CME believes that companies with higher costs of capital are significantly more affected, in terms of project value and tax payable, than those with a lower cost of capital under the MRRT.

Therefore, there is a risk that the proposed uplift rate may disadvantage new projects or small miners whose cost of capital is higher due to large borrowings and/or uncertainties as well as high risk projects which require a higher rate of return due to the imbedded risks. To ensure that these projects are not adversely affected by the MRRT, CME recommends an increase in the uplift rate, again to be determined by government/industry consultation supported by extensive modelling.

f) Exploration incentives

CME advocates the introduction of a national flow through shares scheme to provide a much needed boost to resource sector. CME strongly believes the implementation of a flow through shares scheme will increase access to capital for mineral exploration and promote exploration activity.

CME, along with other State and National resources sector representative bodies, have sponsored the report “Costs and benefits of Flow Through Shares for Australian junior exploration companies” (May 2009) which shows the positive impact such a scheme could have in both the short and medium terms. The report is available to the PTG upon request

It is also important to note that the Federal Labor Government made an election promise during its 2007 campaign to promote investment in exploration by allowing the selective use of flow through share schemes for smaller operators in the resource exploration industry. CME would like to highlight concerns about the commentary in the PTG Issues Paper on revenue neutrality and these concerns may be addressed in more detail in any subsequent submission on this matter.

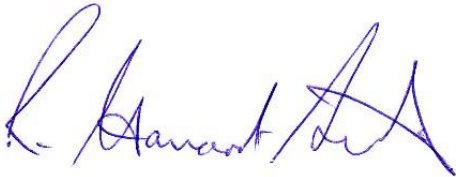
CME will consult with the PTG on this important matter and will be attending the PTG Exploration consultation session in Melbourne on 18 November 2010. CME reserves the right to submit a separate paper to the PTG on exploration incentives.

Conclusion

While CME's preference is the retention of the current state based royalty regime, it will support genuine taxation reform. However, the proposed MRRT falls significantly short of delivering this reform and given the critical importance of the proposed changes to the future of the Australian resources sector and the broader economy, it is imperative that the federal government fully understand the core issues outlined in this submission and accompanying issues paper.

CME looks forward to engaging with the federal government via the PTG consultation process.

Yours sincerely



Reg Howard-Smith

Chief Executive

The Chamber of Minerals and Energy of Western Australia (CME)

Encl: Minerals Resources Rent Tax Issues Paper (enclosed)

The Chamber of Minerals and Energy of Western Australia Minerals Resource Rent Tax Issues Paper

This paper has been prepared for the Chamber of Minerals and Energy of Western Australia (**CME**) in response to the Federal Government's announcement of resource taxation reforms on 2 July 2010. Specifically, this paper addresses the proposed introduction of a Minerals Resource Rent Tax (**MRRT**) to iron ore and coal projects.

The issues paper will be used by the CME to develop its arguments and position in relation to the MRRT debate and inform the CME of the MRRT implementation and transitional issues. In accordance with this objective, this paper identifies and discusses a number of the issues associated with the proposed application of the MRRT, the specific design features and their impact, and highlights matters that are currently unclear or have not been addressed by the Federal Government in announcements to date.

Background

In May 2008 the Federal Government announced the Australia's Future Tax System Review (**the Henry Tax Review**) chaired by Dr Ken Henry. The Henry Tax Review was to undertake a comprehensive evaluation of the Australian Commonwealth and State taxes (excluding GST) and provide recommendations.

The Henry Tax Review delivered its recommendations in a confidential Report to the Federal Treasurer in December 2009. The Report was publicly released on 2 May 2010, along with the Government's response to the Henry Tax Review's recommendations.

One of the few recommendations of the Henry Review that were adopted by the Government was the introduction of a new resource rent tax regime to replace the existing state based royalty regimes. The recommendation was based on the premise that the state based royalty regimes failed to capture an appropriate return to the nation from mining profits during the preceding economic boom period. It was argued that a resource rent tax (with a 40 per cent rate) would have collected about \$20 billion more than actual royalty collections during the period 2001/2002 to 2008/2009.

In light of the Henry recommendations, the Government announced the introduction of the Resources Super Profits Tax (**RSPT**). The RSPT in its original form was strongly opposed by the resources industry.

On 2 July 2012, after a change in government, the Government announced a revised resource taxation regime in the form of a MRRT (and extension of the existing Petroleum Resource Rent Tax (**PRRT**) to onshore oil and gas projects). This paper only considers matters associated with the MRRT.

To date there has been limited guidance released on the MRRT, its design or policy. This paper has been prepared based on the following documentation and press releases to date:

- The Australian Government Fact Sheet: A New Resource Taxation Regime dated 2 July 2010.
- Media Release No. 055: Breakthrough Agreement with Industry on Improvements to Resources Taxation dated 2 July 2010.
- The Policy Transition Group Membership and Terms of Reference released 3 August 2010¹.

¹ Note: The membership and terms of the PTG were released as part of the Labor Party's election campaign.

The CME Position

The CME has always maintained a strong preference for retention of the current state regime, administered by the State Government, with revenues flowing to the State. The State has prime responsibility for resource project approvals and the provision of non–privately owned infrastructure. As such, it is imperative the State Government maintain and receive a dividend for WA resources.

The CME has advocated that any proposals which aim to shift the benefits derived from the resources sector out of the State should be resisted and only undertaken with the agreement of the State Government and consultation with industry. There is a strong belief that a federal resource tax could see WA miss out on its fair share of the income derived from projects in WA as a result of federal distribution principles.

The CME acknowledges that if a rent or taxation regime was introduced with prospective application to new projects (e.g. greenfields projects and not to existing/brownfields projects), the likelihood would be that it would be a profits based regime.

The CME continues to have serious concerns regarding the Federal Government's tax changes, particularly the design of the proposed resource taxation and the impact such a tax, in its proposed form, would have on the Western Australian resources sector and broader economy.

That said, industry has supported genuine reform of the Australian taxation system to provide for an efficient and effective tax regime and argued, in relation to any consideration of a federal tax on resources, that it should:

- be prospective, that is apply to only new investment;
- protect Australia's international competitiveness;
- be differentiated by resource commodities;
- be levied on primary resource value; and
- be equitable and efficient.

Consultation and Terms of Reference

The membership of the Policy Transition Group (**PTG**) and its Terms of Reference² were announced on 3 August 2010. The PTG will advise the Australian Government in the development of the technical design of the MRRT. The PTG is co-chaired by Mr Don Argus AC and the Minister for Resources and Energy, Martin Ferguson AM MP.

In developing its advice, the PTG is instructed to consult with industry, government and other stakeholders to ensure that the new MRRT is enacted as efficiently and consistent with the design principles as possible. Any policy deviation must be fully offset within the recommendations in terms of the impact on budgeted revenue or costs.

On 1 October 2010 the PTG released an Issues Paper which outlines many of the issues associated with the MRRT and on-shore PRRT, comments on possible approaches to these issues and, in some cases, the PTG's current preference.

² <http://www.alp.org.au/federal-government/news/policy-transition-group-membership-and-terms-of-re/>

MRRT Design Features

Based on the guidance and publications released to date, the known features of the proposed MRRT have been outlined below:

- The MRRT will apply to the extraction of iron ore and coal in Australia from 1 July 2012.
- The MRRT will apply at a headline tax rate of 30% to assessable profits. The MRRT will be imposed in addition to corporate income tax, but will be deductible for income tax purposes.
- In principle, MRRT will apply a taxing point as close to the extraction (i.e. mine gate) as practicable. The value of the resource will be determined using appropriate pricing arrangements to ensure only the value of the resource extracted is taxed.
- An extraction allowance equal to 25% of the otherwise taxable profit will be deductible to recognise the value of mining expertise, including intellectual property and capital of the mining companies that is attributable to the extraction process.
- Smaller taxpayers with MRRT assessable profits of \$50 million per annum will be excluded from the application of MRRT.
- All post 1 July 2012 expenditure (whether capital or operating) will be immediately deductible. Capital expenditure incurred between 1 May 2010 and 1 July 2012 will form part of the starting base.
- The MRRT will broadly adopt the same categories of non-deductible expenditure as those for PRRT. Therefore, financing and other corporate costs not directly related to the project will be non-deductible.
- Excess expenditure (losses) will be carried forward. These carried forward losses will be indexed annually at the long term government bond rate (**LTBR**) plus 7 per cent.
- MRRT losses will be transferable to other projects the taxpayer has to allow them to be set off against those projects that are MRRT payable.
- The MRRT will provide recognition for past expenditure on existing projects through a starting base credit. The starting base will be a choice of either book value (excluding the value of the resource) or market value (including the value of the resource) as at 1 May 2010.
 - Where book value is used to calculate starting base, depreciation will be accelerated over the first 5 years. The starting base value will be uplifted at the LTBR rate plus 7 percent.
 - Where market value is used to calculate starting base, there will be no annual uplift and depreciation over an appropriate effective life, not exceeding 25 years.
- State royalties remain payable, and will be credited against any MRRT liability. Where royalty credits exceed MRRT profits in any given year, the balance will be carried forward and uplifted at LTBR plus 7 per cent but will not be transferrable to other projects or refundable.

Based on current Federal Government forecasts, the MRRT (based on revised revenue estimates) will raise additional revenues of \$10.5 billion in the first two years of operation.³

³ Economic Statement July 2010 by the Honourable Wayne Swan MP and the Honourable Lindsay Tanner MP.

Comparison of MRRT with original RSPT and current PRRT regime

The following table illustrates the differences between the proposed MRRT, the original RSPT proposals and the current offshore PRRT regime.

	MRRT	RSPT (now replaced)	PRRT (offshore)
Base upon which tax is applied	Tax on profits	Tax on profits	Tax on profits
Minerals covered	Specific minerals only as follows: <ul style="list-style-type: none"> • Iron Ore • Coal 	All minerals	All petroleum products from offshore projects, including: <ul style="list-style-type: none"> • Crude oil • Condensate • Natural Gas, LPG
Threshold	MRRT assessable profits exceed \$50million p.a.	None	None
Allowances – Additional Deduction	25% Extraction Allowance - MRRT Profit x 25% (effectively this limits tax rate to 22.5%)	None	150% uplift of frontier area exploration spend (limited number of permits are designated as “frontier”)
Capital and Operating Expenditure	Pre 1 July 2012 capital expenditure - depreciable Post 1 July 2012 expenditure (capital and operating) - immediately deductible	Pre and post 1 July 2012 capital expenditure is depreciable	Capital and operating expenditure immediately deductible
Expenditure transferability	Transferability of losses, transferability of starting base unclear	Undeducted expenditure is transferable, other than RSPT starting base	Transfer of exploration expenditure only
Refundability of undeducted expenditure on project cessation	No refundability of unutilised expenditure on project cessation	Refundability of unutilised expenditure on project cessation provided no other projects	Only closing down expenditure is refundable
Uplift rate	10 year LTBR plus 7 per cent	10 year LTBR	Various rates, including LTBR +5% for development and LTBR +15% for exploration
Transferability and refundability of credits for state royalties paid	Credit for state royalties paid. Unused royalty credits carried forward and uplifted. Unused royalty credits will not be transferrable or refundable.	State royalties refundable	n/a

Summary of Design and Implementation Issues with MRRT

There are significant issues associated with the new MRRT, including the following:

- 1. Divergence from Henry Recommendations:** The implementation of the MRRT diverges from the reforms recommended by the Henry review, which recommended an efficient tax which would benefit marginal projects based on an Allowance for Corporate Capital (**ACC**) model⁴. Rather the MRRT has a similar design to that of the Garnaut – Clunies Ross Resource Rent Tax⁵ that has been the basis for the PRRT.
- 2. Sovereign Risk:** The application of the MRRT to existing projects continues to impact on Australia's perceived sovereign risk and Australia's international competitiveness to attract foreign investment to develop Australian natural resources.
- 3. International Competitiveness:** The MRRT is an additional tax which results in an effective tax rate for iron ore and coal projects of up to a maximum of 45.75%.⁶ This effective tax rate is higher than that of a number of other countries which compete with Australia for foreign investment. This could impact on attracting foreign investment in new projects or expansions of existing projects.
- 4. Application:** The application of the MRRT has been limited to iron ore and coal production on the basis that these are Australia's largest and most profitable commodities. There remain significant issues with this application to magnetite ore and low grade brown coal production.
- 5. Design Features Based on PRRT:** A number of PRRT design features (on which the MRRT is based) are unsettled and have been the subject of uncertainty and dispute for many years, including the deductibility of expenditure, distinguishing upstream and downstream activities and the application of transfer pricing principles to determine the price of the resource at the taxing point. These need to be resolved before they are applied to MRRT.
- 6. Definition of a Project and Liable Entities** There could be difficulties in applying PRRT principles such as mine gate value, the definition of a "project" and determination of liable entities in the context of onshore mineral extraction.
- 7. Exclusions:** There are many questions around developing a workable exclusion for small miners using MRRT assessable profits as the basis. Compliance costs in "proving" exclusions will need to be considered in the future design phase.
- 8. Headline Rates:** There is no clear or reasoned basis for the adoption of the 30% headline tax rate that has been described as "internationally competitive". Further, there is no differentiation between the levels of mining expertise brought to a project under the flat 25% extraction allowance rate.
- 9. Starting Base Issues:** Allowing a market value starting base is welcomed, however a number of open issues remain such as whether the MRRT should allow for an immediate deduction for the starting base and why there are inconsistencies in the depreciation rate applied to book vs. market valuations. In addition, issues are likely to arise with how market valuation principles will be applied, costs of compliance and how goodwill will be recognised.

⁴ Boadway and Bruce (1984) included in Ken Henry, Secretary to the Treasury "Fiscal Policy and the Current Environment Post-Budget Address to the Australian Business", 18 May 2010.

⁵ Ross Garnaut, Vice-Chancellor's Fellow and Professorial Fellow in Economics, "The New Australian Resource Rent Tax" The University of Melbourne, 20th May 2010.

⁶ Applying to pre-mine gate activities and assuming no starting base deductions.

- 10. Uplift Rate:** There is no clear guidance as to the basis for the uplift rate at the LTBR plus 7%. There is concern that the rate is not representative of the cost of capital for all resource companies, in particular those with a weak balance sheet who rely heavily on the debt market. Furthermore, since the cost of capital generally decreases as a project moves further into production, there is a risk that the rate may disadvantage new projects and smaller miners who generally have a much higher cost of capital.
- 11. Taxing Point:** The Government has stated that in principle, MRRT will apply a taxing point as close to the extraction (i.e. mine gate) as practicable and that the sales price will be determined using appropriate pricing arrangements to ensure only the value of the resource extracted is taxed. The determination of the taxing point and pricing methodologies require further development.
- 12. Transferability:** While the transferability rules are welcome, the ordering of expenditure deductions will be important to the extent that royalty credits and starting base transferability is not permitted.
- 13. Interaction with State Royalties:** The imposition of an additional tax on top of existing state royalties increases the administrative burden on taxpayers with no benefits for marginal projects. There is also a risk of double taxation arising to the extent that state royalties are increased in the future without a corresponding credit recognised by the MRRT regime.
- 14. Exploration Assistance:** There is need for the Government to instigate exploration assistance following the repeal of the Resource Exploration Rebate, for example by revisiting flow through share opportunities or other exploration incentives. The impact of any such arrangements on the MRRT design (such as deductions for exploration) would also need to be considered.
- 15. Terms of Reference:** The MRRT design is based upon government consultation with the mining industry, including negotiations with BHP Billiton, Rio Tinto and Xstrata. The underlying economic modelling and assumptions behind the design should be publicly released.
- 16. Treatment of Carbon Pricing:** How the MRRT will interact with any future carbon taxes could affect future investments in Australia. With the emergence of policy regarding carbon, investors may be even more hesitant to invest in Australia where this represents an additional cost. In addition, it will be important to understand whether a new carbon tax will be deductible for MRRT.
- 17. Administration:** There are a number of administrative issues associated with the implementation of the MRRT to iron ore and coal mining projects. Significantly, the Henry Tax Review recommended that the MRRT replace the existing state royalty regimes, which were complex and inefficient. Rather, the MRRT now represents an additional tax with an additional compliance burden.

Each of these items is discussed in further detail below. CME looks forward to working with the PTG to resolve these key issues and developing a suitable framework for the proposed resource tax arrangements.

Discussion on Design and Implementation Issues with MRRT

1. Divergence from Henry Recommendations

The Henry Review recommended state royalty regimes be replaced with a resource rent tax. The recommendation was advocated on the basis that:

- State royalties are inefficient as they are levied on production rather than profits, thereby affecting investment in marginal projects.
- Rent taxes are more responsive to the economic cycle than traditional ad-valorem royalties and only apply to the extent that profits are generated. That is, taxes are payable over the life of the project only to the extent that revenues exceed operational, exploration and capital costs.

The original RSPT announced by the Government was based on the ACC proposed by Boadway and Bruce (1984)⁷. Although different to a pure economic rent such as the Brown tax, (in which an immediate deduction is available for all expenditure and capital investment and a refund is provided for the tax value of any negative cash flow) the RSPT was in theory an efficient and neutral tax that was not meant to distort investment decisions. Furthermore, theoretically it was considered that the RSPT may increase investment by de-risking, to some extent, marginal projects.

Whilst this may have been the theory on which the RSPT was based, it was attacked by both academics and the mining industry as being highly detrimental to investment in Australia and in practice, would not meet the theory on which it was founded.

In contrast to the Henry Review recommendations, the MRRT has a similar design to that of the Garnaut – Clunies Ross Resource Rent Tax⁸ that has been the basis for the PRRT.

This paper advocates neither the RSPT nor the MRRT in terms of resource rent tax regime.

Rather, it notes that because state royalties are still payable under an MRRT, and no refund is provided for state royalties in periods where no MRRT is payable, there is no benefit to marginal projects under an MRRT. As with the RSPT, the MRRT will influence investment decisions and represents an additional layer of tax and an additional administrative and compliance burden on the Australian iron ore and coal resources industry.

2. Sovereign Risk

The original announcement of the RSPT and subsequent amendment to the MRRT has introduced a significant amount of sovereign risk to the Australian minerals industry.

Sovereign risk is defined as the risk to a participant in a project that a Government action will cause a loss which could not have been foreseen when the project was committed to, and with no adequate legal remedy available.⁹ As Australia's sovereign risk increases, foreign companies are less likely to invest in Australia.

In the context of resource rent taxation in Australia, sovereign risk has arisen due to the retrospectivity of the application of the MRRT (i.e. its application to existing projects from 1 July 2012).

⁷ Ken Henry, Secretary to the Treasury "Fiscal Policy and the Current Environment Post-Budget Address to the Australian Business" 18 May 2010.

⁸ Ross Garnaut, Vice-Chancellor's Fellow and Professorial Fellow in Economics, "The New Australian Resource Rent Tax" The University of Melbourne, 20th May 2010.

⁹ http://www.minerals.org.au/__data/assets/pdf_file/0013/10255/Young_Douglas9C3.pdf

In addition, there is concern by investors that the Government may in the future seek to expand the MRRT to other profitable resources, increase the tax rate, decrease the extraction allowance or change other design features of the tax that will adversely affect existing projects. In fact, the mere proposition of the introduction of the original RSPT and subsequent MRRT has been enough to damage Australia's sovereign risk reputation. Even if the MRRT does not proceed, the fact that the MRRT was proposed for existing projects raises doubts that it may be proposed again in the future.

In practice, uncertainty around Australia's proposed new taxation policies appears to have eroded Australia's attraction for investment. In particular, a study undertaken by the Fraser Institute provides that:

"The response to the RSPT was extraordinarily negative. The average score of the Australian states declined from 62.9 out of 100 in the 2009/10 annual survey, conducted late in 2009 and released in the spring of 2010, to 40.9 in this survey update. Fifty-one jurisdictions were included in this update. The average rank of the Australian states fell to 31st out of 51 jurisdictions in the update from 18th in the 2009/2010 index, adjusted to include the same 51 jurisdictions as in the update to create an apples-to-apples comparison".¹⁰

The issue of sovereign risk was also recognised by the Henry Review which stated:

"... depending on the transitional arrangements, the transfer of existing projects into the new system may increase perceived sovereign risk in the short to medium term".¹¹

To minimise damage to Australia's sovereign risk, more adequate transitional arrangements should be considered. In addition, the impact of the tax on Australia's bilateral tax treaties and investment treaties also needs to be considered.

Importantly, it should be noted that investors are generally aware that some changes may be made to the rate or application of taxation regimes during the life of a project. However, such changes are generally expected to be minor in nature. Given the significant reforms proposed by the Federal Government in relation to the taxation of the mining sector, there is clear basis for existing projects to be excluded from the MRRT.

For example, in comparison with the overarching application of the MRRT to all projects, it should be noted that when the PRRT was implemented in the 1980's, it was effectively prospective in the fact that:

- a) The PRRT only applied to production licences granted on or after 1 July 1984; and
- b) The two existing production areas at the time (being the Northwest Shelf and Bass Strait) were exempt from the application of PRRT. Although the Bass Strait project eventually transitioned into PRRT in the 1990's, the Northwest Shelf project continues to be exempt from the PRRT regime applicable to offshore projects¹².

It is acknowledged that the availability of a market value starting base does give existing producers quasi-grandfathering protection. However, as the starting base is a valuation (and hence an estimate of future performance), is only depreciable over time and is not uplifted, it falls short of a full exemption for existing projects.

¹⁰ Fraser Institute, survey of mining companies 2009/2010, page 7

¹¹ Australia's Future Tax System: A report to the Treasurer, December 2009, page 238

¹² Note: under the proposed extension of the PRRT announced on 2 July 2010, the NWS will be included in the PRRT regime from 1 July 2012.

3. International Competitiveness

The Australian resources industry has an important foot hold in the global industry. However, it remains susceptible to changes in policy that alter its attractiveness against the resources industries of other countries that compete for market share. In particular, Australia's resource industry is shaped by the following:

- Australia does not currently hold a dominant share of the iron ore or coal market.
- Australia is a high risk, remote and infrastructure challenged environment.
- Australia has a small population which exacerbates skills shortages and it relies heavily on foreign investment.

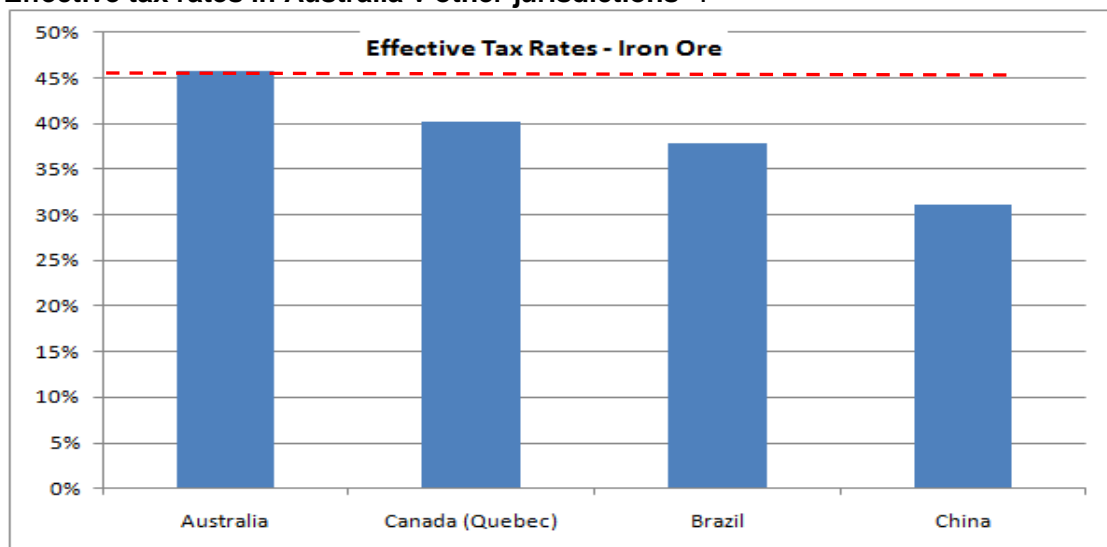
The impact of the MRRT on international competitiveness is concerning. One of the main outcomes of the introduction of an additional tax on top of state royalties and corporate income tax is that ultimately, less revenue will be available to fund project costs, repay project debt and provide a refund to investors. This is likely to present a real point of difference between funding a project in Australia that is subject to the MRRT or funding a project outside Australia. Decisions made on this basis may well impact on Australia's international competitiveness.

In addition the expanded PRRT regime, announced at the same time as the MRRT could also impact Australia's international competitiveness.

With a headline effective tax rate for Australian resource projects of up to a maximum of 45.75%¹³, the reality is that a higher effective tax rate could alter investment decisions into Australia in comparison with other lower taxed jurisdictions.

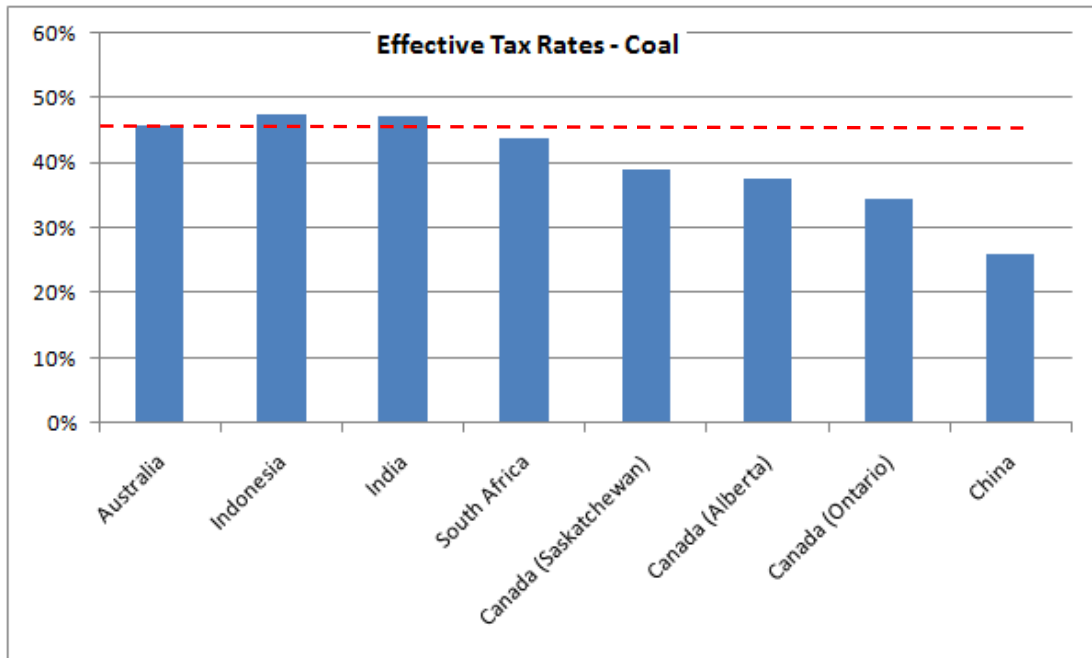
A summary of effective tax rates in relevant jurisdictions is outlined below:

Effective tax rates in Australia v other jurisdictions¹⁴.



¹³ Calculated as follows: MRRT rate of 30% less the extraction allowance of 25% = MRRT effective tax rate of 22.5%. Plus corporate tax of 30% less deduction for MRRT paid = total effective tax rate of 45.75%. Applying to pre-mine gate activities and assuming no starting base deductions or uplift at LTBR + 7%.

¹⁴ Minerals Council of Australia, Potential Financial Impacts of the Resources Super Profits Tax On New Projects In Australia, 1 June 2010



The Government should release the economic modelling and the basis on which the 30% headline rate has been deemed to be “internationally competitive”.

Furthermore, although some would argue that any deferral of activity is only temporary (i.e. by definition the resource will still be mined when supply forces this to occur), any deferral of investment in Australia comes with the risk that in the mean time, substitution occurs such that the resource is no longer valuable or as valuable and the risk of technological obsolescence.

For example, there is a risk that nickel products may be substituted by Chinese products such as nickel pig iron which is used as a substitute for nickel in stainless steel production. Nickel pig iron emerged in the Chinese market in late 2005 and was widely used by Chinese stainless steel mills in 2006 and 2007 as a substitute of refined nickel due to its comparatively low price at a time of high nickel prices. By 2008, China's use of the nickel pig iron pushed nickel prices down by more than 50 percent from a record high in May 2007 on the London Metal Exchange.

Even without substitution, any deferral of investment in the Australian resource sector, and hence deferral in resource extraction means that the resource will be sold at a different point in the pricing cycle. It is generally acknowledged that “boom” prices will not last forever.

4. Application to Iron Ore and Coal Projects

The application of the MRRT has been limited to iron ore and coal production in Australia. As a result, of the 2500 companies engaged in the mining of resources in Australia, it is expected that just over 320 will be affected by the MRRT¹⁵.

The stated basis for the application of the MRRT to iron ore and coal is that these are Australia's largest and most profitable commodities. However, the proposed MRRT does not differentiate between different grades of iron ore and coal, including:

- Magnetite ore which is of a lower grade than hematite ore in the ground and which requires significant processing before a saleable form is reached.

¹⁴ Government Fact Sheet on the new Resource Taxation Regime

¹⁵ [footnote deleted]

- Brown coal which is of lower grade than black coal and has significantly less value.

We understand that both magnetite and brown coal have a low value at the mine gate and hence are unlikely to generate significant (if any) MRRT liabilities. There is concern that taxpayers will have to incur all the administration costs associated with the MRRT, even if it is ultimately unlikely to apply. Therefore, as for other minerals and low value bulk commodities, there is an argument that these projects should also be excluded from MRRT.

Importantly, it should be noted that the Henry Review recommended that “The resource rent tax should be applied to non-renewable resources other than those expected to generate low rent where the administration and compliance costs are likely to outweigh any gains from a rent-based tax.”¹⁶

In respect of magnetite in particular, there is substantial processing required to concentrate the ore into a saleable form. There is a legitimate concern in the magnetite industry that some of the profit arising from this value added processing could fall within the tax net.

Whilst this is not meant to be the case, it will depend on having a mechanism to accurately distinguish the value of the resource at extraction from the sales price. There is a concern that such a mechanism may not be achieved.

Furthermore, as a highly processed ore, magnetite is more akin to many of the ores that have been excluded from MRRT (such as bauxite and nickel) than it is to hematite ore. As such, there is a strong argument that magnetite ore should also be excluded from the MRRT regime.

5. Design Features Based on PRRT

A number of PRRT design features (on which the MRRT is based) are unsettled and have been the subject of uncertainty and dispute for many years. It is not expected that these principles will be any easier to apply in the MRRT regime than they have been proven to be in the PRRT regime. For example there are issues with:

- Deductibility of expenditure, including the treatment of administrative and overhead expenditures associated with the projects, including allocation issues for such project related expenditure. The Inspector General of Taxation (**IGOT**) raised the uncertainty arising from the ATO's views on the meaning of exploration for PRRT purposes and the treatment of indirect costs for PRRT purposes in its report on ATO 'U-turns' and audit practices.¹⁷ The IGOT was commissioned to review and report on concerns in relation to any perceived ATO delays or changed approaches on significant interpretive matters and past administrative practices.
- Determining the price at the first saleable form based on transfer pricing principles including, the limitations of netbacks and the complexity of residual pricing methodology for integrated upstream and downstream projects.
- Distinguishing between upstream and downstream activities in integrated projects and determination of the taxing point before sale, particularly where more than one product is produced. It is often difficult to determine the relevant project boundaries, particularly where additional processing (for example for fines or magnetite ore) is required before the product(s) can be sold.

¹⁶ Australia's Future Tax System: A report to the Treasurer, December 2009, Part Two, volume 1, page 225.

¹⁷ “Review into delayed or changed Australian Taxation Office views on significant issues: A report to the Assistant Treasurer Inspector-General of Taxation” March 2010, refer pages 67 and 68 of the report.

These same principles have been proposed to apply to MRRT despite a number of these principles remaining unclear or not tested in the context of the PRRT regime. Any future policy design should address these uncertainties.

6. Definition of a Project and Liable Entities

The PRRT is imposed on a project basis. A project is defined as a production licence with combinations available for production licences that meet certain ownership and geographical criteria.

For MRRT, it is currently not clear whether the definition of a project will be linked to a mining lease or a specific taxpayer. There are many issues associated with defining a project as a mining lease in an onshore context in the case where there are multiple leases at the one site.

Clear guidance and design principles will need to be developed to ensure that large projects are treated correctly, for example through a project combination system similar to that which works for PRRT or a consolidation principle which levies the MRRT on a legal entity rather than a project.

While the definition of a project may not be a significant issue in the context of sharing expenditure between projects (given the system of full expenditure transferability) there may still be significant impacts of the definition in the context of:

- The starting base (The PTG Issues Paper states that it should not be transferrable).
- The sharing of royalty credits which are currently non-transferrable.
- The administrative and compliance costs associated with preparation of returns and calculations for multiple projects.
- Joint venture arrangements and farm-out arrangements.

These sensitivities may have a material impact on the timing and amount of MRRT imposed on projects.

7. Exclusions: \$50million p.a. test

While the \$50 million p.a. threshold exclusion is a welcome break for smaller projects, there is little guidance on how and when the calculation will need to be undertaken, including:

- Whether the calculation needs to be performed on an annual basis?
 - The PTG Issues Paper states the threshold test should be applied on an annual basis
- Whether once failed the project will always be subject to MRRT or whether the exclusion can still be applied in following years?
- Whether the \$50million threshold is a per project test or whether it a corporate group test?
 - The PTG Issues Paper assumes the threshold be applied an aggregated entity level.
- How the starting base will be calculated if the \$50m cap is reached in a year well after commencement of the MRRT?
- Whether state royalty credits that were unused before the \$50 million threshold is reached may be carried into the regime once the threshold is reached?

These issues will need to be investigated and clarified by the Government before the full impact of the MRRT can be determined on the junior projects.

In addition, it is not clear whether in calculating the MRRT assessable profits, the MRRT will only apply to the profits exceeding \$50 million, or whether once the threshold is reached, the entire profit is subject to MRRT. If the entire profit is taxable once the \$50 million threshold is reached, this could lead to distorting behaviour. The PTG Issues Paper considers that once above the \$50M threshold, all MRRT profits would be taxable. The distortionary impact is recognised.

In addition, although junior miners who do not meet the threshold will not have to pay MRRT, it is likely that they will still be required to comply with the administration and compliance of MRRT calculations and maintain records to evidence that the threshold is not breached. This burden will be costly to many entities that may have limited resources to dedicate to this increased responsibility.

8. Headline Rate of 30% and 25% Extraction Allowance

There is currently little justification or rationalisation for the 30% rate of the MRRT. The Government has indicated that this rate is an “internationally competitive” rate, despite no evidence being released to support this.

Furthermore, whilst the 25% extraction allowance is welcome as a method of recognition for the contribution of the miner’s expertise to profits at the mine gate, in the same way there is no basis for the 25% allowance. This rate seemingly does not take into account the difference in expertise required for different projects, such as underground coal mining vs. open pit iron ore mining etc.

9. Starting Base Issues

The Starting Base is intended to be the mechanism to allow for a fair implementation of the MRRT to existing projects. Taxpayers will have a choice of either book value (excluding the value of the resource) or the market value (including the value of the resource) as at 1 May 2010 to determine the starting base for a project.

Where the book value method is chosen, the depreciation will be accelerated over the first 5 years with the undepreciated value being uplifted at LTBR plus 7 percent. Where market value is used to calculate starting base, there will be no uplift and depreciation will be based on an appropriate effective life of assets, not exceeding 25 years.

While the choice to use book or market value is welcome, there are significant issues associated with the implementation of the starting base from the information announced so far. These issues challenge Australia’s sovereign risk. In particular there is no clear reason why:

- the value of the resource should not be included in both a book and market value basis. How the value of the resource will be determined will also need to be confirmed;
- the starting base should not be immediately deductible to ensure capital costs are recouped before MRRT is payable;
- if the starting base is depreciated, why both the book value and market value should not be depreciated using the accelerated 5 year write off;
- the market value starting base post 1 July 2012 is not also uplifted by the LTBR plus 7% to recognise the cost of capital and/or financing for the project to date; and
- all post 2 May 2010 expenditure is to be added to the starting base rather than being treated as immediately deductible for MRRT on 1 July 2012.

By not allowing an immediate deduction for the starting base, the above design features affect existing projects, whether producing or developing, that may pay MRRT before all capital costs are recouped. In contrast, projects which commence post 1 July 2012 and which will be able to immediately write off initial investment expenditure will not be MRRT taxable until all capital costs are recouped.

Furthermore, mature projects with heavily depreciated assets will need to use the market value method to fully recognise the value of the project in the starting base. However, such projects will be required to use the longer write off period for the starting base, as compared to new projects which commence on or around 1 July 2012 which will have a relatively small starting base and which may either take advantage of the 5 year book value accelerated write off method, or are likely to have significant expenditure treated as immediately deductible if incurred after 1 July 2012.

Finally, there are also likely to be issues with how the market valuation will be determined, what principles will be applied, the costs of compliance where independent valuations are required and how goodwill will be recognised.

These design features appear to penalise existing projects rather than grandfathering such projects into the new regime in comparison with new projects commenced after 1 July 2012.

10. Uplift Rate

There is no clear guidance as to the basis for the uplift rate at the LTBR plus 7%. There is concern that the rate may not be representative of the cost of capital for all resources companies. In particular it is unclear whether the uplift rate will reflect the true cost of capital for miners, especially those with a weak balance sheet who rely heavily on the debt market.

Furthermore, since the cost of capital generally decreases as a project moves further into production, there is a risk that the rate may disadvantage new projects and smaller miners who generally have a much higher cost of capital.

Therefore there is a risk that the uplift rate may disadvantage:

- a) New projects or smaller miners that have a higher cost of capital due to large borrowing and uncertainties; and
- b) High risk projects that require a higher rate of return as a result of the higher risks taken on by investors.

It will be important that the basis for the LTBR + 7% be considered as part of any policy development to ensure that the rate is appropriate for both existing and emerging projects.

11. Taxing Point Issues

The Henry Tax Review recommended that the taxing point be in principle as close to the point of extraction of the resource as possible i.e. the well head or mine gate¹⁸. In accordance with this principle, the Government has stated that the MRRT will apply a taxing point as close to the extraction point as practicable. However, the Government has indicated that because it is unlikely that a sale will take place at this taxing point, the sales price will need to be determined using appropriate pricing arrangements to ensure only the value of the resource extracted is taxed.

¹⁸ Australia's Future Tax System: A report to the Treasurer, December 2009, page 248.

There are significant issues associated with this including:

1. If the taxing point of the commodity is when it becomes saleable there will be issues associated with determining the profit allocation across the entire value chain.
2. For industry's such as the WA iron ore industry which rely on heavy investment in supporting infrastructure to get the commodity to a port or transport link, the infrastructure and transport costs incurred in getting the commodity to port or rail facilities will need to be treated appropriately.

In addition, the design of the MRRT will also need to consider the following:

1. Given the different processing levels between different types of iron ore and coal (for example hematite and magnetite ores) the taxing point will need to balance the variety of mining methods, processing and infrastructure.
2. Where a project produces two or more commodities (such as hematite and magnetite) there are likely to be added complexities in apportioning costs and other production value in working out mine gate values.
3. Where commodities are both exported and used domestically, there may be two different price structures. Importantly, if financing costs (including hedging costs) are non-deductible¹⁹ the impact of foreign exchange fluctuations on the taxing point values needs to be further considered.

Furthermore, the taxing point should not arise in such a way as to tax the value of intellectual property, processing, long term contracts or synergistic goodwill that can add significant value to commodities post the mine/well head.

12. Transferability

12.1 Starting Base

While the transferability rules for expenditure incurred post 1 July 2012 are welcome, the PTG Issues Paper states that the MRRT starting base and starting base losses should not be transferable to other owned projects.

A non-transferable starting base will result in inequitable treatment for taxpayers with existing projects which do not become profitable as such expenditure cannot set-off other potentially profitable projects. To reduce any inequity for projects with historically incurred expenditure and projects with expenditure incurred post 1 July 2012, the starting base should be transferable.

Furthermore, marginal projects could benefit from starting base transferability if such expenditure can be used by taxpayers investing in marginal projects to offset profitable projects from other operations. If the starting base remains non transferable, there should be ordering rules for deductibility which allow the starting base to be deducted from assessable income before other, transferable, expenditure is required to be deducted. An ordering system would maximise the extent to which starting base expenditure will be able to be utilised in preference to expenditure that is transferable to other payable projects.

12.2 State Royalty Credits

Under the original RSPT any state royalties not used to offset an RSPT liability were fully refundable meaning that from the taxpayer's perspective, the RSPT in effect replaced the state

¹⁹ This is on the basis that the principles of non-deductible expenditure are the same as those for PRRT.

royalty regimes. The new MRRT offers neither a refund for state royalties nor transferability of state royalties paid.

The non-refundability and non-transferability of these royalties will see projects which do not make a profit still pay royalties and therefore impact on cash flows. Given the non-refundability and non-transferability of state royalties, taxpayers should have a choice to use losses or credits in calculating their MRRT, as the ordering of expenditure deductions and royalty credit offsets can reduce the possibility of royalty credits being wasted.

Payments for access rights to land (such as native title royalties) should be deductible in calculating the MRRT liability.

13. Interaction with State Royalties

As discussed above, the Henry Review recommended that the current state royalty regimes which imposed over 60 different royalty arrangements on minerals in Australia be replaced with a uniform resource rent tax regime.

However, the changes announced by the Federal Government have not addressed this recommendation. Rather, the MRRT represents an additional tax on top of existing state royalties.

There are a number of issues associated with the credit for state royalties paid, including:

- How the credit will be linked back to the relevant MRRT project; and
- What is the royalty taxing point and how this will impact on the credit received for MRRT purposes.

There is also a risk of double taxation arising to the extent that state royalties are increased in the future without a corresponding credit recognised by the MRRT regime. The Government have recently made statements that only existing, or scheduled increases, in the State royalty rate be creditable.

The policy regarding royalties and the administration of the MRRT needs to be clearly set out and the policy needs to ensure that all future increases in royalties will remain creditable against MRRT payable to ensure no double taxation arises.

In addition, the Government has not outlined its position in relation to the overlap of MRRT with stamp duties and other state taxes. In particular, the Government did not address the Henry Tax Review recommendation that fees and stamp duties on the transfer of interests in a resource project should be abolished. The Henry Review specifically stated that:

“The Australian Government should abolish fees and stamp duties on the transfer of interests in a resource project except those related to administrative costs. These stamp duties and fees erode the value of resource rent available to the community because they inhibit the transfer of interest to the most efficient firm”²⁰

Furthermore, these duties represent an additional quasi royalty and can result in a cost at rates of approximately 5% on the gross value of resources at that time of the transfer. If not abolished, consideration should be given to also providing a credit for stamp duties and other state taxes paid against the MRRT, similar to that offered for state royalties.

²⁰ Australia's Future Tax System: A report to the Treasurer, December 2009, Recommendation 50, page 240

14. Exploration Assistance

As part of the introduction of the MRRT, the Government announced that it would no longer pursue the Resource Exploration Rebate, which was to provide cash back to explorers for expenditure incurred in exploration.

Given the cancelation of the Resource Exploration Rebate, there is significant need for the Government to instigate further exploration assistance.

Importantly, the PTG has been tasked with considering the best way to promote future exploration and ensure a pipeline of resource projects for future generations. Given this commitment, the PTG should be encouraged to revisit flow through share opportunities or other exploration incentives. We note that this is one of the incentives considered in the PTG Issues Paper.

However, the impact of any such arrangements on the MRRT design (such as deductions for exploration) would also need to be considered.

The CME ultimately supports an exploration incentive program. However, under the PTG terms of reference funding for such a program should not have to be offset by an increase in MRRT revenue.

15. Terms of Reference

Underlying the design features announced to date and the terms of reference of the PTG group are the principles negotiated between the Federal Government and three large mining companies.²¹

Given the impact of this proposed MRRT and its significance to all iron ore and coal producers, it is important that any further details surrounding these principles is released publicly along with the underlying economic modelling and assumptions.

16. Treatment Under the MRRT of any Future Price on Carbon

How the MRRT will interact with any future carbon taxes could have significant effect on future investments in Australia.

There is already uncertainty regarding the retrospective implementation of the MRRT which has heightened Australia's sovereign risk internationally. With the emergence of policy regarding carbon, investors may be even more hesitant to invest in Australia were this represents an additional cost.

In addition, it will be important to understand whether a new carbon tax will be deductible for MRRT as this may impact on calculations undertaken around new investments.

Therefore, the treatment of a future carbon tax under the MRRT should be clarified by the Government to ensure investors have the knowledge they need for future investments.

²¹ "Proposed Mineral Resource Rent Tax Heads of Agreement" between BHP Billiton, Rio Tinto and Xstrata, 2 July 2010, available at: <http://www.xstrata.com/media/news/2010/07/02/0531CET/> and http://www.riotinto.com/media/18435_media_releases_19354.asp

17. Administration

In addition to the above practical issues, there are a number of administrative issues associated with the implementation of the MRRT to mining projects. Significantly, the Henry Tax Review recommended that a resource rent tax replace the existing state royalty regimes, which were complex and inefficient.

Rather, the MRRT now represents an additional tax and is likely to result in the following administrative questions:

1. Whether separate returns will be required for each specific project. Given the number of mining and exploration projects, the compliance burden on both taxpayers and administration is likely to be significant.
2. Whether the year-end for MRRT will be 30 June and whether a substituted accounting period be allowed.
3. Whether those taxpayers using functional currency for income tax and/or PRRT will be able to calculate their tax liabilities using functional currency.
4. Whether monthly or quarterly installation calculations will be required and how these will interact with the requirement to prepare state royalty returns and pay state Royalties.

As discussed above, there is also the need for clear legislative design to minimize the interpretational disputes between taxpayers and regulator on the MRRT. This has been a significant issue for PRRT where industry accepted practices of allocating costs are being challenged.

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