

Exempt - section 22

From: Binsted, Paul
Sent: Monday, 17 May 2010 8:46 AM
To: Barrett, Chris (Treasurer's Office); Chalmers, Jim; Jacobs, Martin
Cc: Parker, David; Davis, Graeme
Subject: FW: RSPT - taking stock Confidential [SEC=PROTECTED]

Chris, Jim and Martin,

I haven't yet discussed this with David or Graeme but thought I ought to keep you in the loop promptly (as things are moving quickly).

regards

Paul

From: Paul Binsted [mailto:pbinsted@bigpond.net.au]
Sent: Sunday, 16 May 2010 1:57 PM
To: Davis, Graeme; Parker, David
Cc: Binsted, Paul
Subject: RSPT - taking stock Confidential

Dear David and Graeme,

Introduction

The perception of the RSPT, in the minds of the community, lags well behind the significant advantages it has, as both an instrument of microeconomic efficiency for the resources industry, and as an instrument to enhance macro economic stability during, and particularly just after, resource price booms. I am working on three initiatives today to assist you and your wider team to correct this. These initiatives are:

1. An explanation of why corporate financiers (like me) get confused between the ACC uplift rate (being the bond rate) and a corporate WACC. This explanation will follow later in this email.
2. A draft letter from David Parker, as Chair of the RTCP, to the Minerals Council of Australia, seeking further information, in writing, on their five enunciated principles for introduction of a resources profits tax, for you both to consider. This will follow later.
3. A draft speech on the history of commodity price booms in Australia and why a measure like the RSPT will assist the nation achieve a better outcome at the end of the present commodity price boom (which

"smells" to me as if it might be close, but I will be fascinated by the PSM on China later in the week because China's demand for commodities is, as you are well aware, the price setter at present).

Why the paradigm gap between economists and corporate financiers on the RSPT uplift rate

The very best minds in Treasury have developed a tax like a Brown Tax, modified to include an allowance for corporate capital. A Brown Tax is of course a cashflow tax. Once the RSPT was modified to be an ACC type tax, an uplift rate was required. Treasury concluded that this ought be the Commonwealth Bond Rate ("CBR") as this was an unconditional liability of the Commonwealth. It took me about three weeks to move from my corporate finance paradigm of a WACC, to seeing it from the paradigm of the Commonwealth's liability management. This was with a lot of goodwill and openness on my part. Accordingly, I think it unlikely that many or even any others are going to accept this proposition in a time frame which is relevant for our purposes.

The other proposition which has been put to me, which I have difficulty in integrating, even though I now understand it, is that including a risk free asset such as Government bonds as a corporate asset reduces the corporation's required rate of return; that is there is a risk return trade off and it is applicable to mining companies which are "compelled" to acquire Government "bonds". I assume that this idea is founded in Harry Markowitz's "Modern Portfolio Theory" or some derivative of it. Corporate Finance types are unlikely to accept this, it took me two months of thinking about it every day and even then, I think that I only understood it, because I have just read three books on Asset Allocation (to assist me in managing my own portfolio). You see, we all become very specialized very quickly these days. Take my example, I studied Modern Portfolio Theory at University in 1973 or 1974 and I didn't think about it again until earlier this year when I read "The Intelligent Asset Allocator" by William Bernstein. Corporate Financiers, as opposed to Asset Allocators or Asset Managers (yes these roles have also become quite distinct and specialized) basically think in terms of:

Cash flow, NPV, IRR, interest coverage, LVRs, earnings per share and so on. We don't think about efficient frontiers or risk return tradeoffs much or at all depending on our sub-specializations. Corporate balance sheets are basically constructed in three different ways: 1. Insurance Companies. 2. Non-Financials. 3. Banks.

1. Insurance Companies

Here you start acquiring contingent liabilities (the potential claims on the policies you write). Then you decide what assets to acquire to finance them.

2. Non-Financial Companies.

Here you decide what kind of assets to acquire (eg shopping centres for Westfield, supermarkets for Woolworths, broadcasting equipment for radio broadcasters, mines for miners etc). You then decide on the appropriate type of liabilities to fund the assets eg shares, bank loans, corporate bonds etc.

3. Banks

Banks can start as liability driven (the deposits are there, what assets can we acquire to make a turn) or asset driven (gee, home mortgages have fat margins now, how do we finance some, securitization looks sweet doesn't it).

It is only the Asset Allocators who can consider the risk return trade off from including bonds in a portfolio. The Asset Allocator will advise Fund Trustees on the proportion of bonds, real estate, domestic equities, foreign equities, large cap or small cap equities, growth as opposed to value equities etc. (by the way after some years of a commodity price boom mining company shares become regarded as growth assets, some years after a commodity price bust, when they get cheap enough they become value assets).

Recommendation

Drop the Commonwealth guarantee. Mining company execs would find it difficult to value now even if they had some goodwill towards the RSPT proposal. They have no goodwill and won't be able to "get it".

You are of course correct in saying that the markets would, in time, securitize this Commonwealth risk. That time is of course after the passage of legislation, and I don't think this securitization idea would succeed until after the RSPT was operational. Therefore that won't help us get it to be operational.

Regards

Paul

Exempt-section 22