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Exempt - section 22

From: Francis, Geoff
Sent: Wednesday, 19 May 2010 6:48 PM
To: McDonald, Hamish; Jacobs, Martin
Cc: Davis, Graeme; Parker, David; Parham, Dean; McDonald, Jason; Phipps, Kate; Gallagher, John
Subject: Bond rate op ed [SEC=~~UNCLASSIFIED~~]

Hamish/Martin

Attached is a draft op ed for the Treasuer on why the bond rate is the best rate to use given the features of the RSPT. We think this is a pretty important issue to hit given the way it is widely being misinterpreted. Even if we may move away from the bond rate, industry should know that they will lose transferability and refundability as a consequence.

Cheers

Geoff

Misapprehensions about the RSPT bond rate need to be cleared up

The mining industry has been quick to reject the Resource Super Profits Tax (RSPT). Some have even claimed it represents their worst-case scenario.

It would seem though that they have not given a lot of thought to how the scheme would actually work and are content to let misapprehensions flourish as long as it serves their opposition to the tax.

One case in point is the proposed use of the long-term bond rate as an 'allowance rate' in the RSPT. It is variously claimed that this rate: is too low, especially when compared to the rate used in the Petroleum Resource Rent Tax (PRRT), which uses the long-term government bond rate plus 5 percentage points; makes inadequate allowance for the inherent riskiness of mining activity; and will have the effect of taxing normal profits and not just super profits.

These statements are not correct. Misapprehensions need to be cleared up.

A proper understanding of the risks involved — in taxation benefits as well as in mining — is the key.

But, first of all, where does this allowance rate apply? What is its relevance?

Companies will not be able to immediately deduct all their expenses as they occur in order to reduce their RSPT liabilities. They cannot under income tax rules either. The prime example is investment in assets, for which only annual depreciation is deductible.

But, unlike income tax assessment, an interest allowance is applied to any part of investment expenditure that is not deducted and is carried forward for future resource tax assessment. The role of the interest allowance is to preserve the value of miners' deductions over time. The interest allowance is deducted from resource profits in future years, thereby reducing future resource tax liabilities.

The RSPT interest allowance also applies to any losses (another form of undeducted expense) that are carried forward. Again, allowances are not applied to carried-forward losses under company income tax.

Providing an interest allowance under the RSPT therefore means that resource companies receive a more generous treatment of investment and other expenditures for resource tax purposes than is the case for all companies under income tax assessment.

The next question is, 'What is the appropriate rate to use for this interest allowance?' Is it the long-term bond rate without a premium (the RSPT rate) or with a premium (the PRRT rate)?

The answer depends on the features of the resource tax scheme in place. The RSPT and the PRRT have different interest rates because of major differences in the way they operate.

The RSPT will give companies certainty that they will receive the *full* tax benefit of *all* their expenditures. The petroleum scheme does not.

The RSPT will allow companies to transfer losses (which inevitably occur in the early investment phase of a project) from one project to another within the same company or group. So a company can get certainty about the benefit of a tax deduction for its early investment by transferring and using losses on projects that are already operational and profitable, rather than carry them forward.

Secondly, companies will be refunded the tax benefit of any remaining undeducted expenses on a reasonable basis — for example, if a project fails. So if a miner spends a lot in exploration and in developing infrastructure and extraction capacity, but the project fails to hit 'pay-dirt', the company will still receive a refund of 40 per cent of all of its undeducted expenditures plus interest allowances.

In one way or another, companies are certain to get the resource tax benefit from all of the expenditures they incur.

This does not happen under the PRRT. There is not the same freedom to transfer losses between projects and there are no refunds if a project fails.

So here's the crux.

Under the RSPT, there is no *project risk* associated with miners getting all their tax benefits associated with all their expenditures. They get all their tax benefits irrespective of whether or not the project is a success. A risk-free rate of interest, as in the long-term government bond rate, is therefore appropriate.

Under the PRRT, miners do bear a risk — that they will not be able to use all their deductions on a project before it fails. There is a project risk associated with gaining their full tax benefits. Providing an interest rate that incorporates a premium for project risk is therefore appropriate.

It is the difference in miners' risks that explains the difference in allowance rates between the two schemes.

The important message is that the right interest rate to use — whether it be the bond rate or whether it also includes a risk premium — depends on how much risk mining companies bear about gaining tax benefits from their expenses. If the scheme allows transferability and refundability of losses, miners bear no risk.

Now, there have been calls for a risk premium to be incorporated into the allowance rate to be used in the RSPT. It is argued that this would bring the allowance rate into line with miners' cost of capital.

That might be okay in principle. But mining companies obviously cannot have it both ways. They cannot have the benefit of both a risk premium *and* the certainty that comes with transferability and refundability of losses.

It would have to be one or the other.

There is also a practical problem. What is the appropriate risk premium? The risk premium might be relatively similar across petroleum projects. But there are all sorts of different risk premiums for mining different commodities and even for mining the same commodity from different deposits. Getting the premium even roughly right would be a problematic issue.

With the proper allowance for risk, an RSPT rate of interest allowance pinned to the long-term government bond rate does not tax miners' normal returns. That is, if miners bear no risk about getting tax benefits from their expenses, as envisaged under the RSPT, the use of the bond rate will mean that the RSPT taxes only super profits and not normal returns.

I would concede that, if the properties of transferability and refundability of losses were not in place, the use of the bond rate without risk premium would implicitly involve an element of taxing normal returns. Equally, however, incorporating a risk premium along with transferability and

refundability would give resource companies an implicit resource tax subsidy. It would effectively provide them with a government-guaranteed asset that returns more than a government bond.

An RSPT based on the bond rate, with transferability and refundability of losses in place, takes proper account of resource tax risk. It makes sense from both a risk assessment point of view and a practical point of view.

[1109 words]