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TREASURY EXECUTIVE MINUTE

Minute No.

10 June 2010

Treasurer

KPMG REPORT ON THE RESOURCE SUPER PROFITS TAX (RSPT) FOR THE MINERALS COUNCIL OF AUSTRALIA (MCA)

Timing: As convenient.

Recommendation/Issue:

- That you note this briefing

Noted

Signature:.....

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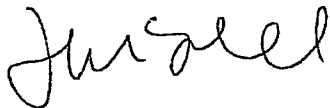
KEY POINTS

- KPMG's Report for the MCA 'Potential financial impacts of the Resource Super Profits Tax on new mining projects in Australia' finds that compared to countries chosen by the MCA, Australia would have the highest tax on mining projects and that reductions in net present values and the inability to fund 40 per cent of investments at the Long Term Bond Rate (LTBR) means mining projects are likely to be deferred or cancelled in the short-medium term.
- This report is a misleading and deeply flawed representation of the of the RSPT. In particular:
 - since losses are assumed not to be transferable, the results do not apply to any investment decisions of the major mining companies. In reality, the vast majority of mining deductions will be offset against tax liabilities rather than being refunded;
 - the assumption that the moderately profitable projects would need to continue to finance projects at the cost of equity effectively assumes the potential refund is worthless;
 - : KPMG assumes that the refund has risks and transaction costs which mean companies will face a higher financing cost than the LTBR. However, KPMG then appears to proxy such costs by using the project cost of equity, which is too high and inexplicably vary across projects (although we cannot confirm this because KPMG has refused our request to release their modelling).
 - : Making it easier for refunds to be used to finance projects by improving access to cash flows for miners would further erode the justification for KPMG's assumptions (see Additional Information).
 - the report is in direct contrast to KPMG Econtech's modelling of the RSPT for the Government that showed increased investment in the mining sector. KPMG Econtech was briefed on the details of the RSPT for their modelling.

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- Importantly, the Report concedes that if the RSPT were to operate as is proposed ('Theoretical RSPT'), project internal rates of return would actually improve for all projects chosen by the MCA (except gold). See the table below from the Report.

Equity IRRs	Status quo	RSPT today	Theoretical RSPT
Iron ore	22.5%	19.3%	25.0%
Coal	20.5%	17.3%	24.0%
Nickel	19.1%	14.9%	20.6%
Copper	18.3%	14.2%	19.5%
Bauxite	15.7%	15.4%	26.5%
Gold	15.1%	11.2%	14.5%



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ADDITIONAL INFORMATION

BACKGROUND

- KPMG have produced a Report for the MCA entitled 'Potential financial impacts of the Resource Super Profits Tax on new mining projects in Australia'.
 - KPMG developed whole-of-life financial models for Australian mines across six commodities (iron ore, coal, copper, nickel, bauxite and gold) for 'typical' greenfield tier two mines.
- The key findings of the Report are:
 - The introduction of the Resource Super Profits Tax (RSPT) will result in Australian mining projects having the highest effective tax rates relative to the countries against which it is benchmarked.
 - Capital markets will be unable to appropriately price funding at the Long Term Bond Rate (LTBR) due to risk and pricing issues.
 - Mining companies are likely to defer or cancel Australian mining projects in the short to medium term due to the reduction in net present value (NPV) as a consequence of the RSPT.

ANALYSIS

- The Report assumes the Government's guarantee of 40 percent of project losses 'does not affect the cost of equity, the cost of debt or the gearing', or consequently the capital structure of the projects.
 - The Report claims that the tax credit will be difficult to value as there is no precedent or historical reference point against which to measure its practical effect. It takes a view of the world today, rather than recognising that the guaranteed tax credit will lower the cost of capital for mining investment as Michael Blythe from the CBA has already shown. However, it concedes that 'debt markets can be expected to innovate and develop over time so that mining companies can, by virtue of the tax credit, access a greater level of debt funding than at present'. The Report is uncertain as to the timing of this outcome and the final pricing.
 - Given the RSPT will commence in 2012, it would be reasonable to expect that financial markets may have begun to adjust to appropriately value the guarantee. This would undermine the Report's key assumption.
- The Report finds that projects that were profitable prior to the introduction of the RSPT, become unprofitable as a result of the RSPT.
 - By design, projects that were profitable prior to the introduction of the RSPT will not become unprofitable as a result of the RSPT. Less profitable mines would benefit most from the Government's reforms. Existing mines (with few capital requirements) would also benefit from the abolition of royalties.

- The report focuses on 'second tier' mines, which compete internationally to raise capital. Such firms would benefit from the government guarantee to recognise the tax credit, irrespective of the success or failure of the project. This would make it easier for them to raise capital for the portion that can be secured against the guaranteed tax credit. This is not the case under the royalty arrangements where investors bear all of the risk of the project and pay royalties to the government based on production, irrespective of whether the project has failed.
- However, where the Report has accepted the theoretical assumptions of the RSPT:
 - projects that were profitable prior to the introduction of the RSPT, do not become unprofitable as a result of the RSPT; and
 - the internal rates of return for all projects (except gold) increase as a result of the lower corporate tax rate, the removal of state royalties and the reduction in funding costs.
- The international comparison of effective tax rates is flawed in several regards.
 - A comparison of international effective tax rates is only provided for the 5th year of a project's life.
 - : It is meaningless to present a single effective tax rate for mining operations, as this can vary significantly over the course of a project's life. For example, a project may have a highly profitable year, followed by a year of high investment (financed from the previous year's profit). This second year would show a much lower (or even negative) profit compared to the first year.
 - The effective tax rates are only compared under the current royalty arrangements and the RSPT.
 - : An international comparison using the effective tax rates over the life of a project would be more valuable than for a single year.
 - : A more useful international comparison would include all taxes, charges, allowances and concessions.
 - : The Report concedes that there is an 'inherent difficulty in estimating life of project ETRs for foreign jurisdictions', although the inherent problems are prevalent in any sort of analysis.
 - The taxing point is assumed to be consistent across jurisdictions for profit based taxes.
 - : This is unlikely to be the case and the choice of taxing point can have a significant impact on effective tax rates.
- Ignoring the pre-production phase of a project's life can be expected to overstate the effective tax rate.
 - The Report indicates that only the production phase (evaluation, construction and operation) of a mine's life is modelled, while the exploration phase is ignored. The RSPT allows exploration to be expensed.
- The projects modelled are not marginal resource projects.

- Marginal and low profit projects benefit the most from the RSPT.
 - : Royalties are usually fixed in size. As a consequence, royalties can result in an otherwise low viable project not going ahead.
 - : Whereas, the RSPT is flexibly set and changes with the profitability of a project.
- Highly profitable projects will remain attractive to investors.
- At lower commodity prices, effective tax rates will rise under the royalties system relative to the RSPT.
- The modelling is of standalone projects only.
 - This ignores the benefit of transferability of losses.
- RSPT taxable profits are defined as all profits that provide a return on invested capital above the LTBR.
 - This is not how the RSPT works and is structured.
- The report does not provide the actual models or project information for us to verify their findings. This is in contrast to the extensive report issued by KPMG Econtech, which used the widely understood and respected MM900 model.
- Important design elements that are explicitly the subject of consultation and which, given the assumptions used by KPMG, would make a significant difference to the modelled returns include:
 - Capital allowance arrangements or the rate at which assets are depreciated. The announcement documentation states that the capital allowance arrangements for income tax purposes could be used for the RSPT but that 'industry will be consulted on the potential to streamline capital allowance arrangements for RSPT purposes'. The difference this makes under these assumptions is substantial.
 - Access to the refund. Much of the argumentation in the paper surrounds a perceived lack of certainty in the access of losses. The announcement paper states that 'the RSPT value of losses will be refunded on a reasonable basis. For example, losses would be refunded when a project is closed and the loss cannot be transferred to another project'. One of the issues for consultation is what is a reasonable basis. More broadly, the issue is how to provide certainty for companies in accessing losses. Large companies with multiple projects would access losses through transferability (using losses on one project to offset profits on another). There are a number of options we are exploring for making it easier for smaller or single project companies to access the tax credit. It may make it easier for these firms to borrow at lower rates against the guaranteed tax credit, if the tax credit is paid out in a defined, predictable manner.