

Exempt - section 22

From: Binsted, Paul
Sent: Tuesday, 22 June 2010 10:28 AM
To: Parker, David; Davis, Graeme; Francis, Geoff; England, Andrew; Bartley, Scott
Cc: Barrett, Chris (Treasurer's Office); Henry, Ken; Ray, Nigel
Subject: RE: FMG work [SEC=PROTECTED]

Colleagues,

the FMG proposal is contrary to the very nature of the RSPT as a cash-flow type tax and instead seeks interest deductibility to, as David as explained below, turn it into an income tax surcharge. My initial reaction is that this would be a very bad precedent and would defeat some of the objectives of RSPT as a non distorting tax.

I am about to trespass on to areas that are certainly not my comparative advantage, however as a corporate financier, I feel them strongly. Income taxes, as interest is deductible, favour debt as opposed to equity finance. This systemically increases the proportion of debt financing in the corporate system thereby increasing the level of financial risk. One reason (out of many) we had less corporate failures during the GFC as compared to the 1989 Australian property and banking crisis, is that after dividend imputation was introduced (1987 from memory) corporate Australia degeared. That is why, among other things, I am very attracted to the RSPT package of reforms to reduce the company tax rate to 25%. The next logical step is, as the AFTS Review recommended ,move to a system of company taxation that does not distort as between equity and debt financing. I had favoured an expanded dividend imputation system, modified for international rather than purely Australian based shareholders. AFTS however recommended an ACC system, which sounds very sensible,(although I am still trying to integrate the ACC concept that within my understanding of global capital flows).

My conclusion is therefore, that if Government wishes to assist FMG with its highly leveraged financing proposal , for transitional reasons, this should be done outside of the tax system by an industry grant or soft financing (eg preference shares).

I am interested in the views of the experts.

regards

Paul

From: Parker, David
Sent: Tuesday, 22 June 2010 9:38 AM
To: Davis, Graeme; Francis, Geoff; England, Andrew; Bartley, Scott
Cc: Barrett, Chris (Treasurer's Office); Binsted, Paul; Henry, Ken; Ray, Nigel
Subject: RE: FMG work [SEC=PROTECTED]

This is a frame.

A. FMG has two businesses - mining and transport which are vertically integrated. If I have heard Mr

Forrest correctly his primary concern is that RSPT not be payable until after has financiers have been repaid in full - this concern is linked to his "bootstrap" project financing, with lots of debt and little equity with the debt repaid from project cash flows. Hence a tax which impacts on cash flows reduces viability of bootstrap model - instead, FMG would need more equity. (If I have understood it correctly it is not just the financing of debt, i.e. meeting interest payments, but meeting capital repayments of short term debt that is the core of this.)

B. Note that immediate expensing (largely) does this job for investment within the taxing point, so long as the uplift rate is not too far below the WACC. (With high gearing at high interest rates that gets a bit harder - but note the cost of borrowing at 10.2 per cent in very close to bond + 5)

C. From the points below, it appears that FMG are also worried about the investment outside the taxing point. No other "normal" business gets the capital repaid before a tax kicks in - still that is what FMG appear to be asking for.

- Re 1 below: This is equivalent to saying "Count the downstream capital twice - once in the base and once in determining the upstream price. And on top of that take the netback rate based on the return we achieve from others by use of market power in the infrastructure.
- Re 2 below: Use the "X" factor to count the upstream 1.5 times (and the downstream capital 2.5 times?)
- Re 3 below: Change the fundamental design of the tax from a rent tax to an income tax surcharge.
- Re 4 below: Would this only be on equity capital or the full capital employed. If the latter and if combined with 3 this would be equivalent to a triple deduction for interest.
- Re 8 below: With all of the above, transferability would imply substantially higher, albeit later, tax if the project is profitable.
- Re 3 and 8 below: Not sure how this would interact - but, if there is a loss transfer and hence no tax paid then that would presumably have to reduce the debt base on which interest deductibility was claimed otherwise it would reduce tax forever rather than shift it in time??

D. This looks like the second biggest ask from miners - it is short of total prospectivity, but looks like more than coal seam gas which worked within the basic structure of PRRT.

David

From: Davis, Graeme
Sent: Monday, 21 June 2010 7:20 PM
To: Parker, David; Francis, Geoff; England, Andrew; Bartley, Scott
Subject: FW: FMG work [SEC=PROTECTED]

From: Barrett, Chris (Treasurer's Office)
Sent: Monday, 21 June 2010 7:10 PM
To: Davis, Graeme
Cc: Ray, Nigel; McDonald, Hamish
Subject: FMG work [SEC=PROTECTED]

Graeme,

Latest on FMG. We are expecting them to come forward with a list of recommended reforms either this evening or early tomorrow.

We will need a fairly quick view from Treasury on merits and demerits, so I thought I'd try to document them quickly ahead of the paper arriving:

Elements:

1. "Infrastructure charge" ie: the amount that will be used to produce a taxing point at the shovel (not the mine gate) while allowing the rail and other infrastructure to be counted as qualifying investment. Note that FMG think their commercial return (apparently validated by deals signed before the RSPT announcement) is "in excess of 25%". They also believe third party deals are the only way to validate these;
2. Starting base: last 3 years of spending, grossed up by an "X" factor of 50%, uplifted by the agreed uplift rate (see below) to 1 July 2012, and then depreciated according to our current 5 years schedule (35%, 25%, etc). Don't know why 3 years, but they argued that was a resonable "transitional period" argument;
3. Interest deductibility - only on the debt, not total capital employed. They argue it is non-negotiable for them to be able to pay their financing costs before they pay RSPT;
4. Uplift rate should be cost of borrowing (I don't know why not capital) plus 10%. Their current cost of borrowing is 10.2%;
5. Royalties to be credited, not refunded;
6. Accelerated depreciation of new investment. Ideally immediate, alternatively 3 years;
7. Refundability goes; and
8. Transferability stays.

Would be worth you guys having some thoughts on this - or defensible public policy positions approximating this wherever possible - given the request will be coming, and may need a turnaround for early tomorrow.

It would also be good to have a sense of the cost of this. Most we have looked at already, but 1 is new, 2 is a different way of calculating what we have already, and 3 is presumably expensive. Some sense of the global \$ impact if applied more broadly will be important.

Regards,

Chris

Chris Barrett

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