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Griffin, Peter

From: Bartley, Scott
Sent: Tuesday, 22 June 2010 7:11 PM
To: Barrett, Chris (Treasurer's Office)
Cc: Parker, David; Davis, Graeme; Bastian, Bruce
Subject: 100622 TEM Application of RSPT to Fortescue Metals Group.doc ~~(SEC-PROTECTED)~~
Attachments: 100622 TEM Application of RSPT to Fortescue Metals Group.doc

Importance: High

Security Classification: ~~PROTECTED~~

Chris

Attached is an advance draft of our considerations of the FMG proposals. We are still fine tuning the calculations. The estimates are based on capital spend data provided by Stephen Pearce this afternoon but I am not sure whether we have spending intentions in that data. Will need to follow up in the morning.

Regards

Scott Bartley
Senior Adviser
Business Tax Division
The Treasury

COMMERCIAL IN CONFIDENCE

23 June 2010

Treasurer

APPLICATION OF RSPT TO FORTESCUE METALS GROUP

Timing: Input to ongoing discussions with FMG.

Recommendation:

- That you note the attached briefing requested by your office on the impact of the RSPT on FMG and their proposals to reduce that effect.

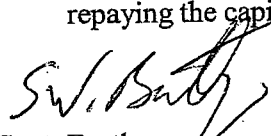
Noted

Signature:

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KEY POINTS

- FMG's primary concern is that RSPT should not be payable until after financiers have been repaid in full. This concern is linked to FMG's "bootstrap" project financing, which involves lots of debt and little equity, with the debt repaid from project cash flows.
 - Businesses do not typically have the opportunity to repay their capital before paying tax.
- There are two key issues relating to the RSPT on FMG's iron ore operations:
 - A timing issue - the impact of the RSPT on company cash flow and upon debt service and retained earnings for capital investment.
 - A tax value issue - the impact of the RSPT on the net present value (NPV) of FMG's mining operations.
- FMG has proposed a number of 'options' that might be used to address these impacts. Collectively, the proposals would ensure that FMG would pay very little if any RSPT in excess of existing royalties. Several options are particularly problematic.
- Providing transferability, accelerated deductions for new upstream capital, a more generous valuation for upstream starting capital and an uplift rate above the long term bond rate would improve FMG's cash flow in the early years of the RSPT, but would only marginally reduce the impact on the estimated return to the project before financing costs.
- Substantially reducing the impact of the RSPT would require significant changes to policy settings. For example, a netback rate of return on downstream infrastructure of 50 per cent or more appears necessary to eliminate much of the cash flow impact of the RSPT (relative to royalties) at current prices, and much of the impact on project returns (before financing costs) below iron ore prices of \$US80/tonne. A netback return of 50 per cent is equivalent to repaying the capital every 2 years.


 Scott Bartley
 Principle Adviser
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ADDITIONAL INFORMATION

FMG issue

FMG's primary concern is that RSPT should not be payable until after financiers have been repaid in full. This concern is linked to FMG's "bootstrap" project financing, which involves lots of debt and little equity, with the debt repaid from project cash flows.

As the RSPT impacts on cash flows, FMG claims it reduces the viability of the bootstrap model - instead, FMG would need more equity. Our understanding is that FMG's situation is not just about the financing of debt, i.e. meeting interest payments, but meeting capital repayments of short term debt.

There are two key issues relating to the imposition of the RSPT on FMG's iron ore operations:

1. A timing issue - the impact of the RSPT on company cash flow and upon debt service and retained earnings for capital investment.
2. A tax value issue - the impact of the RSPT on the net present value (NPV) of FMG's mining operations.

FMG proposal

FMG has identified a number of 'options' that might be used to address these impacts.

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 (36%, 24%, etc);
3. Interest deductibility - only on the debt, not total capital employed. Fortescue 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 plus 10%. Fortescue's 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.

Comments on the FMG proposal

FMG has a vertically integrated mining and transport business. The transport arm of the business includes some transport of third party ore. Much of the capital invested is in the transport arm of

the business. This structure is not unique, being common to iron ore operations in the Pilbara and proposed investment in some Queensland coal operations.

Collectively, the proposals would ensure that FMG would pay very little if any RSPT in excess of existing royalties. Most problematic are the proposals relating to the taxing point value (Option 1), an arbitrary uplift of the project capital (Option 2), interest deductibility (Option 3) and the uplift rate (Option 4).

Option 1

The FMG proposal amounts to double counting the downstream capital, once in arriving at the netback price of ore and again in the calculation of the cost base for the ore valued at 'mine gate' or 'shovel'.

Capital downstream of the taxing point should only be taken into account through netback pricing when assessing RSPT liabilities.

Further, FMG proposes that the netback rate be based on the return it derives from others through the exercise of its market power in the infrastructure (the 25% + rate of return). Other operators of transport infrastructure intensive mining operations have suggested that such assets are low risk and should attract a rate of return in the order of 10-12 per cent.

More generally, we have very considerable concerns about pre-empting the determination of tax value where a price is observed downstream of the taxing point. This is a difficult area of the RSPT and one that is crucially important in ensuring that resource value is not shifted to downstream activities. Setting precedents that would limit the ability of the ATO to determine appropriate returns to downstream activities could provide considerable opportunity for firms to minimise the value of resources subject to the RSPT.

Option 2

This proposal provides an arbitrary uplift to the entire capital base. Capital downstream of the taxing point should only be taken into account through netback pricing when assessing RSPT liabilities. FMG has previously indicated that much of the capital is invested in the transport arm of their business.

Its application for capital upstream of the taxing point would need to be considered relative to market value and other approaches for assessing the value of starting capital.

- The proposed uplift appears to be broadly equivalent to the historical cost of the assets.

Option 3

Including interest payments within the RSPT calculation would change the fundamental design of the tax from a rent tax to an income tax surcharge. Debt and equity are given equal recognition through the RSPT capital allowance. Allowing interest to be deducted would provide a means to dissipate resource rents.

No other "normal" business gets the capital repaid before a tax kicks in - still that is what FMG appear to be asking for.

Option 4

The RSPT allowance set at the long term bond rate is intended to compensate companies for the deferred recognition of some RSPT expenditure. The bond rate is appropriate where there is

guaranteed recognition through transferability and refundability. Where transferability is insufficient to achieve the equivalent of refundability and refundability is not provided, a higher rate discount may be appropriate.

The cost of borrowing is one basis upon which to set the uplift rate in such circumstances. The borrowing cost of 10.2 per cent is similar to the bond rate plus five percentage points used for development expenditure in the PRRT.

Overall assessment

Note: the following results are based on preliminary modelling of FMG's activities using data derived mostly from public sources and a series of working assumptions (Attachment A). More detailed information is required from FMG to improve our confidence in the modelling.

Providing transferability, immediate expensing of new upstream capital, a more generous valuation for upstream starting capital (historical cost) and an uplift rate above the long term bond rate (LTBR+5) would improve FMG's cash flow in the early years of the RSPT but would only marginally reduce the impact on the estimated return to the project (before financing costs.)

Further reducing the NPV impact of the RSPT would require significant changes to policy settings.

- For example, a netback rate of return on downstream infrastructure of 50 per cent or more appears necessary to eliminate much of the cash flow impact of the RSPT (relative to royalties) at current prices. This would also remove much of the impact on project returns (before financing costs) below iron ore prices of \$US80/tonne.
- A netback return of 50% is equivalent to repaying the capital every 2 years.

It is unclear how such a precedent could be managed on a broader industry scale.

ATTACHMENT A

Key modelling assumptions and results

The modelling of FMG's activities is based largely on publicly available data and significant working assumptions. More detailed information is required from FMG to improve our confidence in the modelling. Some key working assumptions are listed below.

- The profile of capital spending in 2010-11 and subsequent years has been imputed from aggregate investment information available in public releases. This profile influences the timing of RSPT liabilities, particularly under accelerated depreciation.
- 75 per cent of starting capital is assumed to be in downstream transport infrastructure. Most by not all new capital spending is assumed to be allocated on a 25/75 per cent upstream/downstream basis.
- The analysis has been performed on a pre-finance basis. The inclusion of financing costs would affect project effective tax rates and rate of return calculations.
- Short term iron ore price projections are based on those used to cost the RSPT. The projected downward movement in medium to long terms prices is limited to the level specified in the IRR charts.
- Royalties are assumed to be creditable and thus represent a minimum resource tax liability in any one year.
- All modelling assumes starting capital is deductible using the 36/24/15/15/10 depreciation profile.
- A nominal return to downstream capital of 14.5 per cent is assumed except where explicitly varied.
- Royalties are assumed to be rebateable rather than refundable.

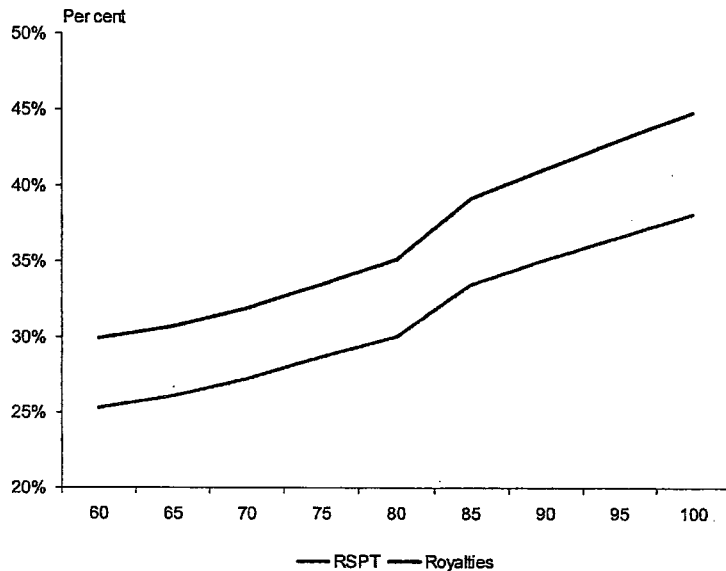
Results*Royalties and announced RSPT*

- The impact of the RSPT on Fortescue's IRR is estimated to be around 4½ per cent at \$US60 per tonne, rising to 6½ per cent at \$US100 per tonne (figure 1).
 - The RSPT is estimated to reduce Fortescue's cash flows by around 35 per cent in the first year of operation, over 100 per cent in 2013-14 and around 90 per cent in 2014-15 (see Table 1). Post 2018-19, the impact on cash flows stabilises between 20 and 25 per cent. This is in part because we have assumed no capital expenditure beyond 2018-19.
 - The effective tax rate (in net present terms) rises from 37.6 per cent under the royalty arrangement to 50.6 per cent under the RSPT.

Table 1: RSPT impact on cash flows relative to royalties

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 to 2039-40
Deviation from royalties	-544	-792	-868	-964	-1,526	-1,801	-1,562	
	-35%	-112%	-92%	-21%	-34%	-32%	-31%	= -20% – -25%

Figure 1: RSPT impact on IRR under varying long-term price assumptions



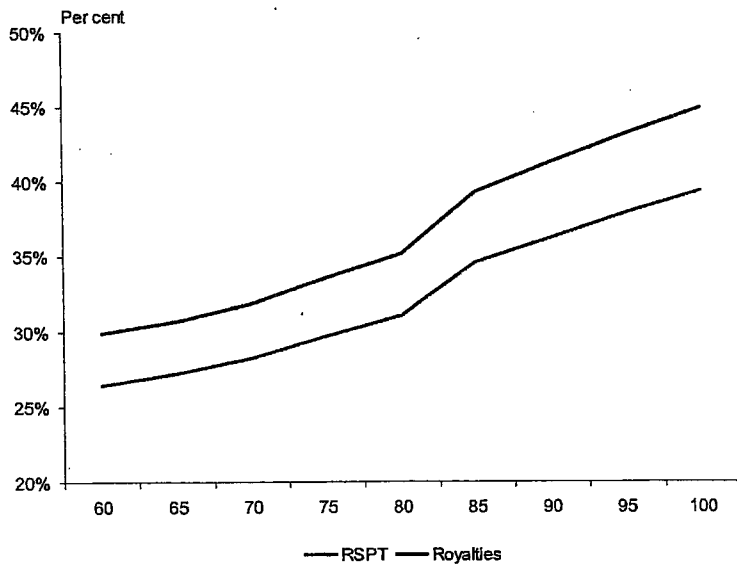
Modified RSPT

- Providing, immediate expensing of new capital, a more generous valuation of upstream starting capital and an uplift rate above the long-term bond rate, reduces the impact on the cash flows in the first two years of operation (see Table 2). Cash flows are 75 per cent lower in 2014-15.
 - The impact on Fortescue's IRR is estimated to be around 3½ per cent at \$US60 per tonne, rising to 5½ per cent at US\$100 per tonne (figure 2).
 - The effective tax rate (in net present terms) under the modified RSPT scenario is 49.5 per cent.

Table 2: RSPT impact on cash flows relative to royalties

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 to 2039-40
Deviation from royalties	6	52	-707	-1,056	-1,476	-1,789	-1,562	= -22% - -25%
	0%	7%	-75%	-23%	-33%	-32%	-31%	

Figure 2: Impact on IRR under case 2



Substantially modified RSPT

- Allowing Fortescue to utilise a netback price based on a return on the transport infrastructure of 50 per cent provides a sizeable boost in cash flows (up 7 per cent in 2013-14 and 11 per cent in 2014-15) (see Table 3).
 - The impact on Fortescue’s IRR is estimated to be less than ½ per cent at \$US60 per tonne, rising to 3½ per cent at US\$100 per tonne (figure 2).
 - The effective tax rate falls to 40.4 per cent, compared with royalties at 37.6 per cent.

Table 3: RSPT impact on cash flows relative to royalties

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 to 2039-40
Deviation from royalties	6	52	107	97	-529	-602	-375	= -2% -- -13%
	0%	7%	11%	2%	-12%	-11%	-7%	

Figure 3: Impact on IRR under scenario 3

