



Our ref : 7146592
Enquiries : Michael Court
Telephone : (08) 9222 9203

Senator Mathias Cormann
Chair
Senate Select Committee on the
Scrutiny of New Taxes
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Senator Cormann

ANALYSIS OF THE COMMONWEALTH'S PROPOSED NEW MINING TAX ARRANGEMENTS

Thank you for the opportunity to provide further information to the Committee in relation to the Commonwealth Government's proposed new mining tax regime.

I am pleased to offer the enclosed paper (Attachment A) which provides an updated analysis by the Department of Treasury and Finance of the proposed regime. The original paper was submitted to the former Senate Select Committee on Fuel and Energy (which you also chaired) on 13 July 2010.

At the hearing held in Perth on 8 November 2010, I committed to provide responses to three Questions on Notice, relating to: (1) the historic series on Western Australia's net fiscal subsidy to the nation; (2) the National Institute of Economic and Industry Research (NIEIR) submission to the Committee; and (3) the process the State Government undertakes when it sets out to increase royalties.

In response to Question (1), attached is further information (Attachment B) on Western Australia's estimated net fiscal subsidy to the nation (which looks at the source and destination by State of all Commonwealth revenues and expenditures respectively), as well as Western Australia's estimated subsidy to the nation through the Commonwealth Grants Commission process (which focuses more narrowly on the distribution between States of Commonwealth grants), since 1985-86.

With respect to Question (2), it appears that the NIEIR's submission is drawing a distinction between total output and 'value added' in the mining sector. If the intention is to measure the overall 'importance' of the mining sector, then we agree that value added is a better measure, since it abstracts from the cost of intermediate inputs.

As NIEIR also intimates, value added shows the contribution of the mining sector to gross domestic product (GDP), rather than total national income. Foreign ownership in the mining sector means that its direct contribution to national income is lower than its direct contribution to GDP (but of course this also works the other way, with Australian-owned resource companies earning income overseas).

In relation to Question (3), in most cases the three tier system of ad valorem royalty rates that was set in the early 1980s continues to apply today. This system is based on the form of mineral product sold. A rate of 7.5% applies to bulk material, 5% to mineral concentrates and 2.5% to minerals in metallic form, recognising in broad terms the relative degree of processing undertaken.

Royalty rates for new commodities produced in Western Australia are generally established by an amendment to the Mining Regulations by the Minister for Mines and Petroleum, or by Parliamentary amendment to Agreement Acts, consistent with these principles.

Certain mineral royalties are levied on a rate per tonne basis (e.g. industrial and construction minerals) and these rates are escalated in accordance with a formula set out in the Mining Regulations.

Should you require clarification or further information on these responses, including the attached analysis, please contact Mr Michael Court, Executive Director (Economic), Department of Treasury and Finance in the first instance.

Yours sincerely

Timothy Marney
UNDER TREASURER

26 November 2010

Enc.



Government of **Western Australia**
Department of **Treasury and Finance**

Western Australian
Department of Treasury and Finance's

Analysis of the Commonwealth Government's Proposed Resource Rent Tax Regime

November 2010

Contents

Introduction.....	1
Brief Overview of Western Australia's Mining Industry	3
State Royalty Regime	5
Revenue Estimates	8
Commonwealth-State Financial Relations.....	9
Impact of Commonwealth Resource Rent Tax Regime	14
Uncertain Impact on Growth and Jobs.....	14
Uncertain Application	14
North West Shelf Project and Barrow Island Royalty Sharing.....	16
Incentives for Exploration.....	16
Recommendations.....	18

Introduction

On 2 July 2010, the Commonwealth Government announced that it would replace its previously proposed Resource Super Profits Tax (RSPT) with a Minerals Resource Rent Tax (MRRT) applied only to iron ore and coal, and an extension of the existing Petroleum Resource Rent Tax (PRRT) to the North West Shelf and onshore petroleum (including gas) projects (commencing 1 July 2012).

Intuitively, the parameters of the proposed new Commonwealth resource rent tax regime suggest that it should pose less risk to the Western Australian and national economies, relative to the previous RSPT proposal.

However, a number of specific concerns remain outstanding and, if anything, have been heightened since the release of the Issues Paper by the Commonwealth's Policy Transition Group (PTG). These include:

- the lack of robust analysis of the likely economic impacts (particularly by region);
- the lack of transparency surrounding the revised revenue estimates and the key assumptions underlying those estimates;
- the extent to which the Commonwealth may seek to cap potential future increases in State royalty rates (for the purposes of crediting royalty payments against MRRT/PRRT liabilities) despite the Heads of Agreement with BHP Billiton, Rio Tinto and Xstrata;
- the proposed MRRT taxing point and the operation of the \$50 million threshold;
- the operation of the proposed Regional Infrastructure Fund, including the Commonwealth Grants Commission treatment of payments under the Fund; and
- the status of the 2007 Commonwealth election commitments (i.e. on a Western Australian Infrastructure Fund financed from Gorgon and/or Pluto project PRRT revenues, and a flow through shares scheme to encourage mining exploration).

Brief Overview of Western Australia's Mining Industry

Mining is Western Australia's largest industry, accounting for 24% of Gross State Product (GSP) in 2008-09.¹ As the mining industry gathers momentum following the global economic slowdown, this proportion is likely to grow.

Approximately 87,000 workers are directly employed by Western Australia's mining industry (around 7% of total employment in Western Australia).² The industry also creates jobs in supporting sectors of the economy. ABS Census data indicates that the State's mining sector employed more than 800 indigenous workers in 2006 (approximately 8% of our indigenous workforce).

Western Australia's mining industry makes an enormous contribution to the national economy. In 2008-09, its total value added was approximately \$41 billion, a 46% share of the national mining industry.³ This contribution is likely to increase in future years as global demand for resources grows, and as Western Australia's LNG sector expands.

At the individual commodity level, Western Australia generates 74% of Australia's crude oil and condensate production, 72% of natural gas (and LNG feedstock) output, and the vast majority (more than 95%) of the nation's iron ore production.⁴

Reflecting the strength of its mining sector, Western Australia's contribution to national export earnings is particularly striking. In 2009-10, total merchandise exports from Western Australia were valued at \$83 billion, representing 41.5% of the national total.⁵ Of the \$83 billion in total merchandise exports from Western Australia, \$67.6 billion (or 81.4%) is from the mining sector.

¹ ABS Cat. No. 5220.0. Data for 2008-09 are the latest available.

² ABS Cat. No. 6291.005.

³ ABS Cat. No. 5220.0. Data for 2008-09 are the latest available.

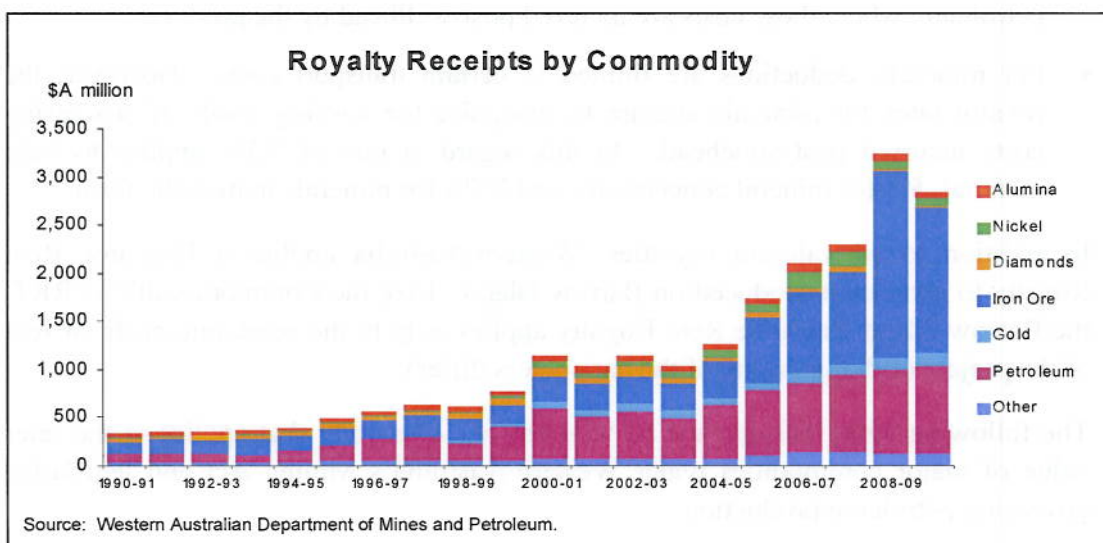
⁴ Department of Mines and Petroleum, Western Australia. (Note: figures are based on volumes for 2009-10, except iron ore which is for 2009. Natural gas figures are inclusive of LNG feedstock.)

⁵ ABS Cat. No. 5368.0.

State Royalty Regime

The High Court has confirmed that the State Government owns, on behalf of the community, all (onshore) mineral and petroleum resources in Western Australia.⁷ Compensation in the form of a royalty is paid to the State for the extraction and sale of these resources.

The chart below shows total royalty receipts (including North West Shelf petroleum grants) in Western Australia from 1990-91 to 2009-10, broken down into receipts by major commodity type.



Implicit in the chart is the fact that the Commonwealth's proposed resource rent tax regime targets the commodities that are already the dominant contributors to Western Australia's total royalty revenues (i.e. iron ore and petroleum).

In the 2010-11 State Budget it is estimated that Western Australia will collect \$4.2 billion in royalties in 2010-11 (including North West Shelf grants), which represents 18.6% of total State general government revenue.

⁷ Western Australia v Ward (2002) 213 CLR 1 at [384].

Mineral	Ad valorem royalty rate
Iron ore	
– lump ore	7.5%
– fine ore	5.625%
– beneficiated ore	5.0%
Coal – exported ⁸	7.5%
Petroleum (excluding ‘tight’ gas)	10-12%
Base metals, gold, nickel	2.5%

Many mining royalty rates are also set under various legislated State Agreements between the State and a miner. These are generally long-standing agreements, which in some cases include concessional royalty rates that recognised (among other things) the start-up costs for major projects in remote areas (requiring substantial infrastructure investments by mining companies). More recent agreements reflect the Mining Act rates.

From 1 July 2010, the majority of the concessional iron ore royalty rates in State Agreement Acts (vis a vis the current Mining Act rates) were removed following the Western Australian Government’s negotiations with BHP Billiton and Rio Tinto. The State Government has also publicly flagged its intention to move, at some point in the future, the 5.625% royalty rate on ‘fine’ iron ore to the 7.5% ‘lump’ rate.

Overall, Western Australia’s royalty regime is considered to strike a reasonable balance between the often competing objectives of maximising economic efficiency, fairness, simplicity, and relative stability and predictability of revenue streams. Further, and relative to a profit-based resource rent tax (which can delay the receipt of revenue for many years), the current royalty regime delivers revenue up-front. This is an important consideration, as State governments will often fund common user infrastructure (and supporting social infrastructure) to ensure potential projects get off the ground.

⁸ In the past, all of Western Australia’s coal supplies have been sold domestically. These are subject to a royalty of \$2.52 per tonne. More recently, small quantities of coal have been exported on a trial basis.

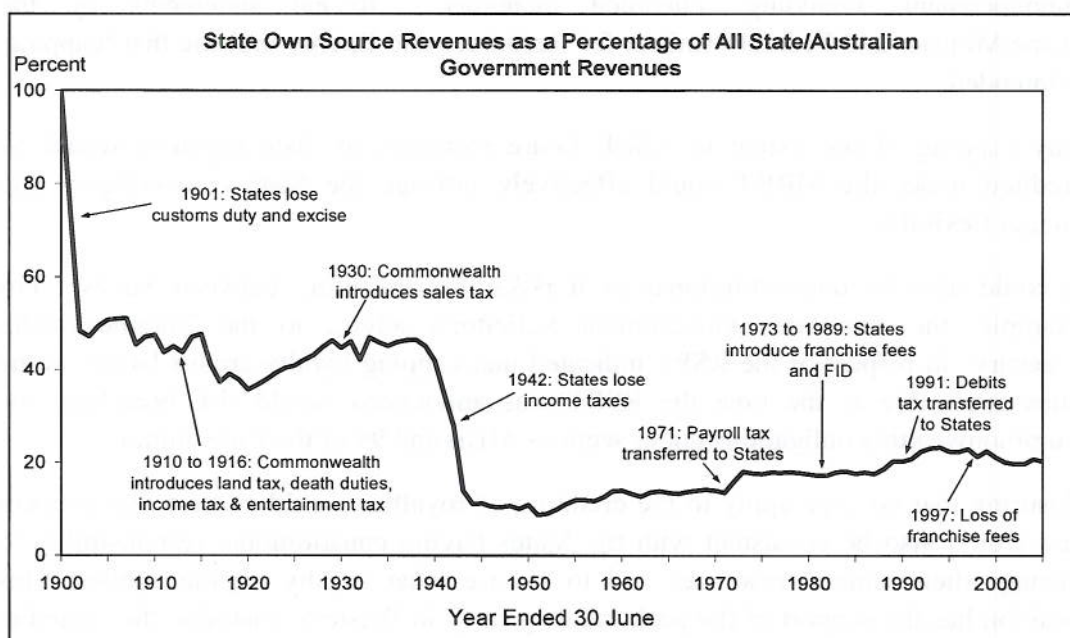
Commonwealth-State Financial Relations

A key concern with the Commonwealth Government's proposed resource rent tax regime is the further erosion of the sovereignty of the States and of the associated benefits that should flow from a healthy federal system of government.

A large, diverse country like Australia demands a federal system. Strong States are needed to ensure local needs and preferences are recognised; to foster competition and innovation in service delivery across the country (the States being responsible for the majority of core community services in Australia); and to limit the abuse of power potentially resulting from a dominant central government.

However, the historical erosion of States' tax powers over time (as shown in the following chart) has left Western Australia, like other States, in the situation of relying on Commonwealth grants for a large proportion of the revenue it requires to fund its expenditure responsibilities. Prescriptive conditions on how the States can spend the grants have exacerbated the reduction in the States' budget and policy making flexibility.

More recently, the GST-based funding arrangements have further increased the States' dependence on the Commonwealth, with the States being required to abolish a number of taxes in return for GST grants.



Source: Western Australian Department of Treasury and Finance.

At a minimum, the Commonwealth Government should confirm that the increase in the iron ore ‘fines’ royalty rate paid by BHP Billiton and Rio Tinto (from 3.75% to 5.625%), which took effect from 1 July 2010, will be fully creditable under the MRRT.

Another impact of the Commonwealth’s proposed mining tax regime will be to substantially increase Western Australia’s net financial contribution to the Commonwealth budget, which already far exceeds that of the only other State that makes a net contribution (New South Wales) – especially if measured on a per capita basis.

In 2008-09, it is estimated that the Commonwealth derived around \$38 billion in revenue from Western Australia, while expenditure for the benefit of the State (adjusted for the State’s share of the Commonwealth deficit) totalled only \$27 billion. This means that the Commonwealth collected around \$11 billion more from Western Australia than it spent on the State (see following chart).

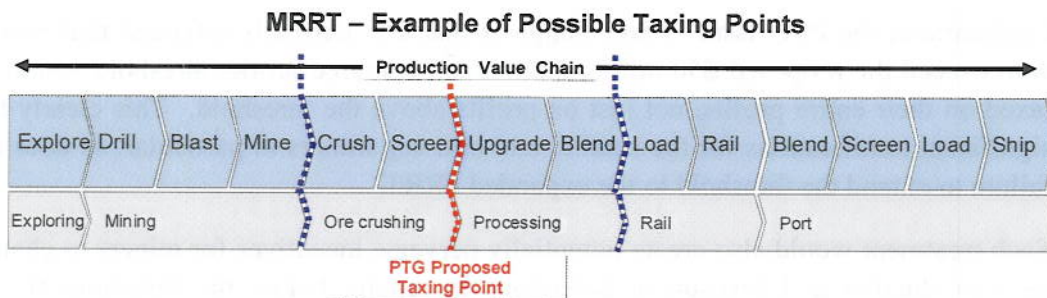
This figure is already expected to grow substantially over the next few years. Western Australia’s low share of the GST accounted for ‘only’ \$300 million of the State’s \$11 billion net contribution to the Commonwealth in 2008-09. This is estimated to rise to about \$1.5 billion in 2011-12 and \$2.5 billion in 2013-14 as Western Australia’s GST share continues to fall (to an estimated 5.4% by 2013-14).

It is estimated that the MRRT (net of company tax reductions and related Regional Infrastructure Fund distributions) will further increase Western Australia’s net contribution to the Commonwealth by around \$3 billion in 2013-14.

This raises the more general issue of uncertainty over how the Regional Infrastructure Fund will operate. Issues requiring confirmation, clarification or addressing in consultation with State governments include the quantum of infrastructure funding, basis of apportionment between the States, whether these distributions will be quarantined from the Commonwealth Grants Commission process and whether the States will have full autonomy to determine how funding is spent.

Related to this is the Commonwealth Government's 2007 pre-election promise to Western Australia to establish a Western Australian Infrastructure Fund, financed from Gorgon and/or Pluto gas project PRRT revenues. The promise was for \$100 million per annum to be paid into this Fund, quarantined from the Grants Commission process. 'Down-payments' are justified by the need for up-front infrastructure investment to support such projects.

Efforts by Western Australia to enter into a national partnership agreement with the Commonwealth to give effect to this election promise have so far proved fruitless, and the Commonwealth's commitment to this promise is unclear.



Source: Policy Transition Group Secretariat

The ‘mine gate’ concept is not used under Western Australia’s royalty principles, and is regarded as ambiguous. It is considered that the PTG Issues Paper dismisses too quickly the option of using the point of extraction as the taxing point. This option has significant advantages from a simplicity and consistency (across projects) perspective.

Taxing value only at the mine head is particularly important to Western Australia’s fledgling magnetite iron ore industry, reflecting the extensive processing required to convert magnetite ore into a marketable product. These higher processing costs mean that magnetite ore is likely to remain a smaller proportion of the iron ore market into the very long term.

Consideration should be given to excluding magnetite iron ore from the MRRT. This would significantly reduce compliance costs for magnetite producers, provide certainty to an emerging industry, be more equitable with respect to other highly processed commodities such as gold and nickel, and have only a negligible impact on MRRT revenue given the taxing point preferred by the PTG.

While Western Australia’s royalty regime does not provide for exemptions for particular minerals, the royalty rate structure is intended to reflect the degree of processing required for certain commodities, with a lower rate applying to highly processed commodities.

The PTG Issues Paper also flags the need to decide the application of the Commonwealth tax arrangements to multi-product mines (such as where copper or gold are produced as a by-product of iron ore, or iron ore as a by-product of bauxite).

One of the options proposed would be to include the value of the otherwise excluded commodities in the tax base, in view of the compliance costs of otherwise trying to apportion the relevant revenues and costs. This could create inequitable tax treatment for producers of the same commodity and could have a potentially significant impact on tax payable for some miners.

In contrast, smaller explorers typically raise capital from equity markets to fund their exploration activity. These explorers usually do not generate sufficient cash-flows from their activities to fund exploration or against which to offset exploration costs. As a result, they face a higher cost of capital than larger miners, and often find it difficult to borrow because of the risks associated with exploration.

The Commonwealth Government has withdrawn the previously proposed exploration rebate, which would have provided a refundable tax offset at the prevailing corporate tax rate for eligible exploration expenditure (the rebate was one of the positive features of the previously proposed arrangements). Instead, the PTG has been asked to “consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations”.

The PTG Issues Paper briefly canvasses a number of options for further Commonwealth Government assistance to promote exploration in Australia, including a refundable tax offset, a tax credit, a flow-through shares scheme and tax concessions for exploration.

In its submission to the Henry Review, the Western Australian Government recommended a flow-through shares scheme (such as operates in Canada) to address some of the biases in the taxation system by allowing exploration costs to be used as a tax credit for shareholders in smaller exploration companies.

Furthermore, the Commonwealth Government made a pre-election commitment in 2007 to introduce a flow-through shares scheme for smaller explorers, potentially as part of a broader flow-through taxation approach for small businesses which may be particularly disadvantaged in raising finance from traditional sources.

8. In relation to the proposed Regional Infrastructure Fund (to be funded from MRRT and expanded PRRT revenues), the Commonwealth should confirm States' shares of the funding (in consultation with State governments); ensure States have sufficient autonomy and flexibility over how and where the funding is spent; and quarantine payments from the Fund from the Commonwealth Grants Commission process.
9. The Commonwealth should deliver on its 2007 election commitment to Western Australia in relation to the Western Australian Infrastructure Fund (financed from Gorgon/Pluto PRRT revenues), and to the mining industry in relation to a flow-through shares scheme to encourage exploration activity.

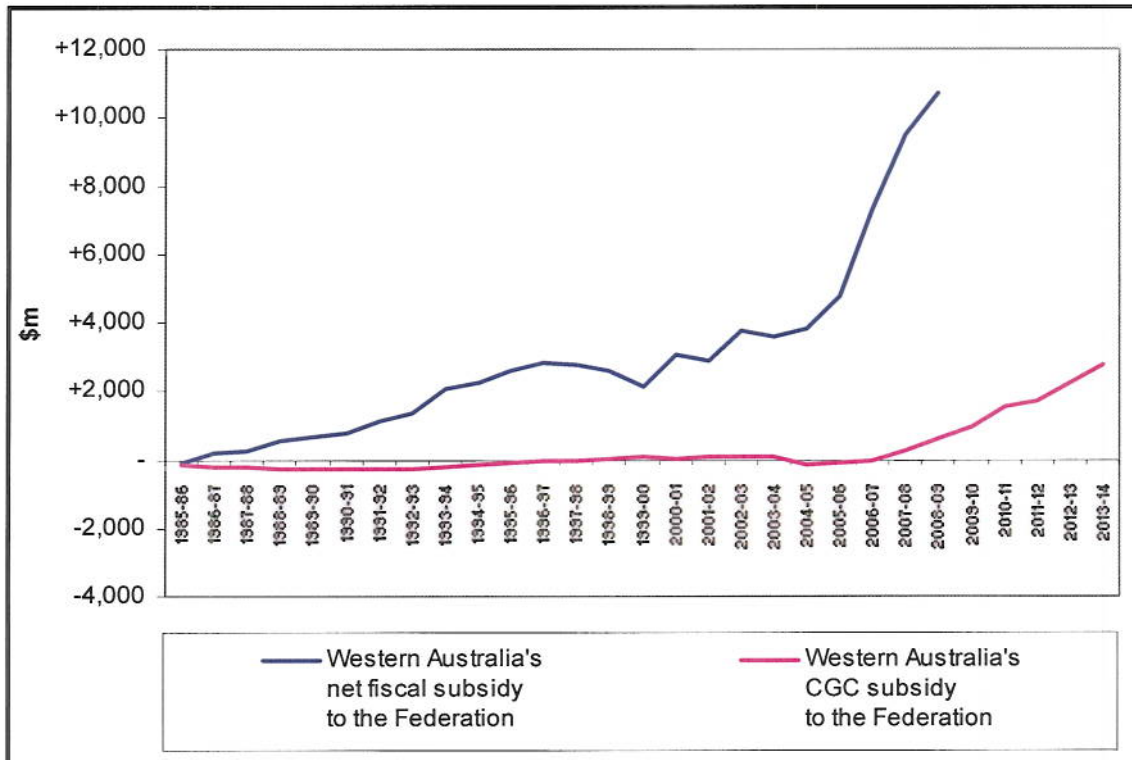
WESTERN AUSTRALIA'S ESTIMATED SUBSIDY TO THE FEDERATION

Western Australia's Net Fiscal Subsidy to the Federation

- Calculated as Commonwealth revenues derived from Western Australia less Commonwealth expenses for the benefit of the State (including a distribution of the Commonwealth deficit/surplus).
 - Commonwealth expenses include grants to the States, so this measure encompasses (but is broader than) the Commonwealth Grants Commission subsidy.
- Technical notes:
 - The Australian Capital Territory's revenues and expenses are allocated across all States and the Northern Territory on an equal per capita basis.
 - While the estimation methods used are largely consistent over time, there have been refinements in a couple of aspects, and adaptations for changes in available data.
 - Latest data available are for 2008-09. The Department of Treasury and Finance has not done any analysis prior to 1985-86.

Western Australia's Commonwealth Grants Commission Subsidy to the Federation

- Calculated as Western Australia's population share of the GST grant pool (since 2000-01) or financial assistance grants (prior to 2000-01) less Western Australia's actual share (incorporating Commonwealth Grants Commission recommendations).
- Technical notes:
 - Estimates for 2010-11 onwards are Western Australia's 2010-11 State Budget projections.
 - The grant pool (and associated national population) prior to 1988-89 excludes the Australian Capital Territory (which first received analogous funding to that received by the States in 1988-89).
 - Results for years prior to 2010-11 incorporate actual grants from Commonwealth budget documents (which have some differences from Grants Commission recommendations) and 31 December populations from the ABS (which may differ slightly from the population estimates used by the Commonwealth at the time to distribute the grants).



Source: Department of Treasury and Finance estimates

	Western Australia's net fiscal subsidy to the Federation \$m	Western Australia's CGC subsidy to the Federation \$m
1985-86	-75	-173
1986-87	+228	-192
1987-88	+256	-225
1988-89	+583	-254
1989-90	+645	-247
1990-91	+802	-266
1991-92	+1,139	-271
1992-93	+1,361	-272
1993-94	+2,067	-208
1994-95	+2,276	-160
1995-96	+2,586	-111
1996-97	+2,858	-46
1997-98	+2,769	-15
1998-99	+2,605	+23
1999-00	+2,110	+101
2000-01	+3,066	+11
2001-02	+2,869	+92
2002-03	+3,776	+77
2003-04	+3,609	+109
2004-05	+3,818	-137
2005-06	+4,780	-116
2006-07	+7,329	-17
2007-08	+9,499	+279
2008-09	+10,705	+603
2009-10		+966
2010-11		+1,559
2011-12		+1,740
2012-13		+2,248
2013-14		+2,770

Source: Department of Treasury and Finance estimates