BUDGET ESTIMATES FOR 2011-12
SENATE ECONOMICS LEGISLATION COMMITTEE

SCHEDULE OF TABLED DOCUMENTS

1. Letter from the Hon Troy Buswell MLA to the Hon Wayne Swan MP, 18 March 2010.
2. Letter from Mr Timothy Marney to Dr Ken Henry, 11 May 2010.
3. Submission from Western Australian Department of Treasury and Finance to Policy Transition Group, 7 October 2010.
4. Letter from Mr Timothy Marney to Dr Ken Henry, 16 November 2010.
5. Letter from the Hon Andrew Fraser MP to the Hon Wayne Swan MP, 9 February 2011.
6. Letter from Mr Alan Henderson AM to the Hon Andrew Fraser MP, 17 February 2011.
7. Letter from the Hon C. Christian Porter MLA to the Hon Wayne Swan MP, 18 May 2011.

Senate Economics Legislation Committee
Budget Estimates 2011-12
30 May-2 June 2011

Tabled Document No 5

By: Nigel Ray, Executive Director, Fiscal Group, the Treasury

Time/Date: 9.38am, 01/06/2011

69553

TREASURER; MINISTER FOR COMMERCE; SCIENCE & INNOVATION; HOUSING & WORKS

Our ref : 7064900 RECEIVED

Correspondence Received - Office of the Treasurer
18 MAR 2010

The Hon Wayne Swan MP
Treasurer
PO Box 6022
Parliament House
CANBERRA ACT 2600

Dear Treasurer Wayne,

COMMONWEALTH GRANTS COMMISSION 2010 REVIEW

When you visited Western Australia on 10 March 2010 we discussed issues arising from the Commonwealth Grants Commission's recently released 2010 Review. I am now writing to elaborate upon these issues.

We are pleased that the Commission has finally recognised the cost of providing social infrastructure to a growing population. For many years, fiscal equalisation has redistributed the revenue benefits from Western Australia's strong economy, without compensating us for all the associated costs. Although many of the other recommended method changes do not benefit Western Australia, we generally accept that they are the decision of the independent umpire.

However, as well as method changes, the Commission has recommended that from now on GST shares be based on an average of three instead of five data-years. During the Review we highlighted that transitioning to a shorter averaging period distorts fiscal equalisation. This was also the Commission's conclusion in its 1999 Review (see page 45 of its Main Report), when it last considered the length of the averaging period (in response to its then terms of reference).

In the context of the 2010 Review, the immediate shift from five to three year averaging means (for example) that States' relative circumstances in 2004-05 (a high GST 'relativity' year for Western Australia) are never subject to full equalisation.

Accordingly, Western Australia submitted to the Grants Commission that changing the averaging period should be phased-in, thereby reducing the impact of the distortion. The Commission has advised us that it did not address this issue in its 2010 Review Final Report, as it considered transitional issues to be outside its terms of reference for this Review.

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As you are aware, the Grants Commission reported that the impact of moving to three-year averaging is a $490 million loss for Western Australia. The Department of Treasury and Finance (DTF) has advised that this figure is in 2009-10 terms, and calculated that the cost to Western Australia is $170 million in 2010-11, and around $650 million over the five year period 2010-11 to 2014-15.

On this basis, I request that the Commonwealth provide some level of compensation to Western Australia. The DTF would be pleased to share its numerical analysis with officers from your Department.

More generally, I am concerned that the current egalitarian system of fiscal equalisation in Australia inevitably dampens incentives for States to grow their economies and revenue bases, and to address their service delivery 'disabilities', in the national interest (i.e. by substantially redistributing the benefits of success to other jurisdictions).

In recent years, this system has seen continuing dramatic reductions in Western Australia's relativity, including the recommended reduction in 2010-11 to an unprecedented 0.68 (by far the lowest ever recorded by any State). The move to three year averaging will make future movements even less predictable, constraining the State's medium and longer term economic and financial planning.

I request that these issues be recognised initially by introducing a 'floor' below which no State's relativity could fall. This would be similar to the minimum grant of 30% of an equal per capita share that applies under the fiscal equalisation distribution of local government financial assistance grants. However, as the GST grant pool is far greater than the local government grant pool, a higher floor is appropriate.

As a starting point, I request that a relativity floor of 0.75 be considered by the Commonwealth. Western Australia would be the only State subject to this floor in 2010-11, and the impact on each other State would be small.

Also underpinning this request for a relativity floor is the need to address the distortionary impact on government policy making of the Grants Commission's method of assessing mining royalties. In this regard, the Commission's recommendations included a last-minute change away from an energy/non-energy categorisation (similar to that reported by the ABS) to a high royalty rate/low royalty rate split, with lump iron ore being included with fuel minerals in the high rate group.

An undoubtedly unintended result of this method change (which the States had no opportunity to debate) is that if Western Australia successfully negotiates an increase in the royalty rates on fine iron ore that currently apply under State Agreements (as it is currently endeavouring to do), and this leads to fine ore being reclassified as a high royalty rate mineral, our GST revenue would be reduced by about three times the amount of additional royalty revenue that we would collect.

A relativity floor would enable Western Australia to optimise the use of its revenue capacity, based on good policy decisions that benefit the broader community. In the absence of a suitable floor I request that the Commonwealth agree to instruct the Grants Commission to continue to assess fine iron ore as a low royalty rate mineral. Other States will otherwise also lose, as they stand to gain over half of the additional royalties if our negotiations proceed and are successful.

Looking ahead, I believe that there needs to be a fundamental review of the principle of fiscal equalisation. While the Grants Commission has done a good job under its restrictive terms of reference, its processes remain complex and subject to many judgements. As noted, the current process also reduces incentives for States to grow their economies, provide services efficiently and appropriately exploit their revenue bases.

Accordingly, before the Grants Commission commences its next five-yearly review of the methods it uses to implement fiscal equalisation, I would like to see an independent body examine the underlying principles.

I also wish to take this opportunity to again remind you that arrangements for implementing the Commonwealth Government's pre-election commitment to establish a Western Australian Infrastructure Fund from Gorgon/Pluto petroleum revenues (quarantined from the Grants Commission process) are still outstanding. Could you please urgently advise the next steps, building as appropriate on Western Australia's previous proposal to develop a National Partnership Agreement.

I would welcome an opportunity to discuss these matters with you further. While it is appropriate that in some cases they also be discussed at the Ministerial Council meeting on 23 March 2010, I am conscious that they all ultimately involve decisions for the Commonwealth Government.

Yours sincerely

TROY BUSWELL MLA
TREASURER; MINISTER FOR COMMERCE;
SCIENCE AND INNOVATION; HOUSING AND WORKS

1 8 MAR 2010

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

Office of the Under Treasurer

Our ref : 7080400
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FAXED 11/5/2010 S.M.

Dr Ken Henry
Secretary to the Treasury
The Treasury
Langton Crescent
PARKES ACT 2600

Dear ~~Dr Henry~~ Ken

RESOURCE SUPER PROFITS TAX AND STATE ROYALTIES

I refer to the Government's announcement on 2 May 2010 proposing the introduction of a Resource Super Profits Tax (RSPT) from 1 July 2012, under which a "refundable credit" would be provided for State royalties "at least up to the amount of royalties imposed at the time of announcement, including scheduled increases".

As you are aware the Western Australian Government has expressed its opposition to the RSPT and is considering further its response. Without prejudice to those considerations there are some points on which some clarity of the Commonwealth's position is required.

To that end, I seek your urgent confirmation that "scheduled increases" in Western Australia would include the removal of existing iron ore royalty rate concessions, which would see both fine and lump iron ore royalty rates being levied at 7.5%, and beneficiated iron ore at 5%, by 1 July 2012.

I also seek your assurance that the Commonwealth will guarantee that there will be no change to the Grants Commission's classification of "high" vs "low" royalty rate minerals as a consequence of the changes in royalty rates proposed by Western Australia (and other States), pending the next full review of the Grants Commission's methods.

In this regard you may recall that an unintended consequence of the Grants Commission's late decision in its 2010 Review to base its assessment of mining royalty capacity on a high/low rate classification is that an increase in Western Australia's royalty rates on fine iron ore could lead to fine ore being reclassified as a high royalty rate mineral, reducing our GST by more than the additional royalty revenue we would collect.

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This issue was previously raised in correspondence between the then Western Australian Treasurer Hon Troy Buswell and the Hon Wayne Swan ahead of the March 2010 meeting of the Ministerial Council for Federal Financial Relations, and subsequently at the Heads of Treasury dinner the night before that meeting (where assurances were given that the Commonwealth would 'direct' the Grants Commission on this matter).

Thank you for your assistance.

Yours sincerely

Timothy Marney
UNDER TREASURER

MRRT TECHNICAL DESIGN ISSUES

The following comments are made on a without prejudice basis. In this regard, the Western Australian Government's position is that it is strongly opposed to the introduction of a Minerals Resource Rent Tax (MRRT).

Taxing Point

- It is considered that the 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.
- It would also be consistent with the Commonwealth's stated aim that "only the value of the resources extracted is taxed".

Valuing the Resource at the Taxing Point

- The 'netback' method seems the most appropriate option.
- Is any further clarity emerging on how the appropriate return on capital (for capital invested in downstream operations) would be calculated/determined?
  - The Issues Paper says this will be done through "arm's length pricing of downstream activities" -- but what does this actually mean for the return on capital?

Crediting of State Royalties

- The Issues Paper provides no further clarity around the crediting of State royalties.
- The Commonwealth's 2 July announcement said that "the MRRT will provide a full credit for State royalties" -- there was no mention of any 'capping' of royalty credits.
- But the Issues Paper says royalties will be creditable "at least up to the amount imposed at the time of announcement, including scheduled increases and appropriate indexation factors".
- WA sees any capping of the extent to which future increases in State royalties would be allowed as MRRT credits as effectively infringing the State's sovereignty and budget flexibility.
- In this context, how does the Commonwealth propose to define "scheduled increases" in State royalties?
- In particular, will the recent increase in the iron ore 'fines' royalty rate paid by BHP and Rio (from 3.75% to 5.625%) be creditable under the MRRT?

- This increase was formally announced by the Premier on 21 June 2010 – which was before the time of announcement of the MRRT (2 July), but after the original announcement of the RSPT (2 May).

- How will the publicly flagged increase in the iron ore 'fines' rate (5.625%) to the 'lump' rate (7.5%) be treated for MRRT purposes?

Definition of Project

- A definition of project based on State production licences would be consistent with the way in which States assess royalties, and help minimise compliance costs for companies calculating royalty credits.

OTHER RELATED ISSUES

- There is a strong case for exempting magnetite iron ore from the MRRT – refer to Premier's letter of 14 July to the Prime Minister (copy attached).

- Need confirmation that the current North West Shelf and Barrow Island revenue sharing arrangements will continue unchanged.

- Need clarity around the operation of the Regional Infrastructure Fund, including Commonwealth Grants Commission treatment and selection of projects.

- What is the status of the Commonwealth's 2007 election commitment to establish a separate WA Infrastructure Fund financed from Gorgon/Pluto PRRT revenues?

- Has any analysis/modelling of the economic impacts of the proposed mining tax regime (including at the industry and regional levels) been undertaken?

- The Department of Treasury and Finance has estimated that 60-65% of the MRRT revenue will come from WA projects. Can the Commonwealth confirm this?

DEPARTMENT OF TREASURY AND FINANCE

7 October 2010

Premier of Western Australia

Our ref : 7104885

The Hon Julia Gillard MP
Prime Minister
Parliament House
CANBERRA ACT 2600

Dear Prime Minister

MAGNETITE IRON ORE AND THE PROPOSED MINERALS RESOURCE RENT TAX

I am writing to you in relation to the treatment of magnetite iron ore under the Commonwealth Government's proposed Minerals Resource Rent Tax (MRRT).

The Western Australian Government has a number of significant concerns with the Commonwealth's proposed mining tax package and considers it more appropriate to leave this revenue base with the States as owners of the minerals.

A key concern with the proposed resource rent tax regime is the inconsistent treatment of the magnetite iron ore industry compared with commodities such as gold and nickel.

Unlike the traditional hematite iron ore which is essentially crushed and screened into saleable product, magnetite iron ore is a lower grade ore that requires extensive processing to convert it into a marketable product. For example, the average direct shipping hematite ore consists of approximately 62 per cent iron, whereas the recoverable iron in magnetite ore averages 25-30 per cent. This requires two and a half to three times more ore to be mined, extensive fine grinding, with significant power needs, followed by magnetic concentration with large water requirements. As such, magnetite products cost substantially more to make, approximately double, for the same price outcome.

Magnetite development, of any substantial scale, is a fledgling industry with only two moderate scale magnetite projects currently in operation in Australia. However, in Western Australia alone, there are two new magnetite projects under construction, (totalling approximately $8 billion in investment), and another 16 projects (totalling potentially in excess of $40 billion in investment) under various stages of consideration. It would be unacceptable if there were any reduction in investment in this industry in Western Australia as a consequence of the imposition of the proposed MRRT.

Significantly, in recent days the new MRRT proposal has been raised with State Government officials, particularly its application to magnetite and new projects which are the focus of Chinese investment in Western Australia.

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Our strong view is that, for magnetite iron ore, a better option is to exclude it from the scope of the MRRT. This approach would:

- be considerably simpler;
- provide certainty to an emerging industry;
- be more equitable with respect to other minerals that incur high processing costs such as gold and nickel (which are not covered by the MRRT); and
- have a negligible impact on the revenue yield given that most of the value of magnetite comes from its processing, which is not intended to be captured by the MRRT anyway.

Failing this, the Commonwealth should ensure that, in finalising the detailed design parameters of the MRRT, emerging participants in the iron ore industry (including magnetite producers) are not disadvantaged relative to established participants. This would include recognising the extensive processing required for magnetite iron ore by assessing the taxable value only at the mine. This would avoid capturing the value added component of the ore in the MRRT.

Yours sincerely

Colin Barnett MLA
PREMIER; TREASURER

14 JUL 2010

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

Our ref : 7143678
Enquiries : Alex Scherini
Telephone : 08 9278 6739

Dr Ken Henry
Secretary to the Treasury
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Dr Henry Ken

COMMONWEALTH GRANTS COMMISSION TREATMENT OF IRON ORE FINES

I refer to the matter of the Commonwealth Grants Commission's treatment of iron ore fines as outlined in my previous correspondence of 11 May 2010. I remain very keen to receive confirmation as soon as possible that iron ore fines will not be reclassified (from low rate to high rate), given the potential implications for Western Australia's budget revenues and associated policy settings.

A change to the classification of iron ore fines would lead to a reduction in our GST of around three times the additional royalty revenue we would collect from removing the royalty rate concession on these fines. As we expect around $300 million per annum from this measure, our GST share could fall by nearly $1 billion. This would be an untenable outcome both in terms of the policy neutrality and equity of the GST distribution process.

The Commonwealth Grants Commission has released a New Issues Paper for the 2011 Update noting the anomaly and seeking States' views. However, it also notes that no decision is required until the 2012 Update, as there is no effect on revenue until the 2011-12 assessment year. In addition, the Commission would not issue its 2011 Update report until February 2011.

Our submissions to the Grants Commission (see attached) have provided strong arguments for maintaining the low rate status of iron ore fines.

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Nevertheless, I am concerned that Western Australia faces significant continuing uncertainty on a matter of large importance to the State budget, over which it has no control. I also consider it unusual practice for the Commission to, in effect, undertake a mini-review of one of its methods between major reviews, in response to an issue which is not a new development for Annual Update purposes (as the impending removal of concessions on iron ore fines has been well known for some time).

I therefore seek your assurance that the Commonwealth will instruct the Commission on this matter, to ensure that iron ore fines continue to be assessed as a low rate mineral.

Yours sincerely

Timothy Marney
UNDER TREASURER

16 November 2010

Att.

Western Australian August 2010 Submission
New Issues for the 2011 Update

Key Points

Commonwealth Payments that Commence in 2009-10

- We generally agree with the guidelines for Commonwealth payments but have a couple of concerns about the proposed treatment of some specific Commonwealth payments (particularly with respect to the transparency of the Commission's reasoning).

Commonwealth Payments Commencing in 2010-11 and 2011-12

- We agree with the Commission's proposal to not back cast equalisation of any of the Commonwealth payments commencing in 2010-11 or 2011-12.

Treatment of the NBJP – Social Housing National Partnership Payment

- The Commission's proposed treatment for the social housing payments appears to be consistent with treatment in other categories.

Welfare and Housing Assessment – Victorian Data

- We agree with the Commission's proposal to not change the existing income sources proportions for users of family and child services in the 2011 Update.

Mining Revenue – Treatment of Iron Ore Fines

- Western Australia considers it inappropriate to change the classification of iron ore fines in an Update.
- In support of this view, Western Australia notes that:
  - the 2010 Review Report implies that the 5% threshold rate (used by the Commission to distinguish low royalty rate commodities from high rate commodities) was a pragmatic choice taking into account a range of factors (i.e. not just actual royalty rates);
  - iron ore fines are appropriately recognised as lower capacity than lump iron ore, as the profitability of iron ore fines has been, and remains, significantly less than lump ore;
  - the principle of policy neutral capacity equalisation implies that incremental policy change should lead to no more than incremental capacity change that allows a State to keep a share of its additional revenue; and
  - Reclassification of iron ore fines based on a 5% threshold would lead to Western Australia losing about three times as much GST as it raised from abolishing fines concessions, and in theory could mean that levying $1 additional royalties could shift our grant share by $700 million.

Commonwealth Payments That Commence in 2009-10

We have a couple of concerns with the Commission's proposals.

- It is not clear why the Commission has proposed that funding for VET providers under the Education Investment Fund should have no impact on the relativities. The Commission has suggested that this funding does not affect State needs, but it needs to explain how a Commonwealth funding injection to a service sector that States are intimately involved in does not do so.
- The discussion paper proposes no impact on the relativities in relation to payments for *Victorian bushfire reconstruction and recovery plan*; *Queensland Premier's Disaster Relief appeal*; and *Development of a national emergency warning system*. We do not object to this. However, these payments may fund State expenses classified as natural disaster relief, which the Commission assesses actual per capita. If this is the case, then the revenues will have to also be assessed actual per capita to achieve no net impact on the relativities.

Commonwealth Payments Commencing in 2010-11 or 2011-12

We agree with the Commission's proposal to not back cast equalisation of any of the Commonwealth payments commencing in 2010-11 or 2011-12.

Treatment of the NBJP – Social Housing National Partnership Payment

The Commission's proposed treatment for the social housing national partnership payments appears to be consistent with treatment in other categories.

Welfare and Housing Assessment – Victorian Data

We agree with the Commission's proposal to not change the existing income sources proportions for users of family and child services in this Update.

MINING REVENUE – TREATMENT OF IRON ORE FINES

We consider it inappropriate to change the classification of iron ore fines in an Update, for the three reasons detailed below.

Firstly, we believe that altering the classification of iron ore fines would be a significant method change.

- The Review Report indicates that the Commission examined various factors, including mineral prices, costs, mineral quality and extraction difficulty, as well as actual royalty rates, when determining its classification of minerals. This involved judgements. Although a 5% royalty rate was specified as a cut-off (for low versus high royalty commodities), the Report implies (e.g. paragraphs 5-6, 11-12, 14, 18-20 in Chapter 8 on Mining Revenue) that this was a pragmatic choice after considering all the evidence.
- Accordingly it would not be appropriate to use this 5% cut-off in a mechanical fashion, without reviewing the judgements in full, which would not be appropriate in an Update.

Secondly, iron ore fines are appropriately recognised as having lower capacity than lump iron ore in the 2010 Review Report.

- Lump iron ore continues to attract a significant price premium (currently around 15%) compared to fines, while there are no fundamental differences in the cost of production. This results in a significantly lower profit margin for iron ore fines.
- While the price/profit difference is currently less than in previous years, ad valorem royalty systems (the major policy approach in Australia) are not designed to respond to short term profit movements, unlike profit based royalty systems.

Thirdly, policy neutral capacity equalisation implies that GST shares would undergo no more than small changes, not enormous changes, as a result of small changes to one State's royalties policy.

- If iron ore fines are reclassified to the high royalty rate category as a result of Western Australia's increased royalty rates, this would have a massive impact on the redistribution of GST among the States.
  - We estimate that, in 2013-14, Western Australia would lose over $900 million in GST grants while collecting only about $300 million additional royalties as a result of the State government lifting the fine ore royalty rate in State agreements and the Commission reclassifying iron ore fines to its high royalty rate category.
  - This reflects that the marginal GST decline from each royalty dollar increase is about 60 cents, plus a $700 million drop when the 5% threshold is crossed.

- More generally, States should retain a share of any revenue gains resulting from a change in policy, so as to be consistent with the principle of policy neutrality and not create perverse incentives for State policies.
  - A reclassification of iron ore fines would remove Western Australia's incentive to follow through with fine ore royalty rate increases (which is in the interests of all States).
- Similarly, allowing reclassification of minerals based on a 5% threshold would open up considerable scope for States to manipulate their grant shares.
  - For example, if reducing our lump iron ore royalty rate to 4.9% would result in lump ore being reclassified as 'low rate' for the purposes of the Commission's assessments, we estimate that Western Australia could increase its 'needs' by about $160 million per annum more than the foregone royalty revenue.
- Even without reclassifying iron ore fines, Western Australia estimates that about 60% of additional royalty revenue from fine ore will be redistributed to other States collectively.

Western Australian Department of Treasury and Finance

August 2010

Western Australian November 2010 Rejoinder Submission
New Issues for the 2011 Update
Mining Revenue – Treatment of Iron Ore Fines

Key Points

- Consistent with the role of Annual Updates, the CGC should preserve the current method as much as possible while arriving at an outcome consistent with its guiding principles.
  - This requires maintaining the classification of fine iron ore as 'low rate'.
- We do not agree with other States' comparison of moving fine iron ore with a change in payroll tax thresholds, as in the latter case a marginal shift in State policy in principle only results in a marginal change in the assessments.
- We do not agree with other States' claim that Western Australia's fine ore concessions were not standard policy.
- The CGC should confirm, in the 2011 Update or before, that fine iron ore will not be reclassified as 'high rate' to maintain the transparency of the equalisation process, and given the potential implications to revenue and the resulting considerations for future State policy.

This rejoinder submission responds to some of the issues raised by other States in earlier submissions and outlines Western Australia's views on how the CGC should consider the treatment of iron ore fines in respect to its current Mining Revenue assessment.

Preserving the Existing Method

As an Annual Update is not a review of methods, Western Australia considers that there is a need to preserve the current Mining Revenue method as much as possible. To do otherwise would be selective, in terms of reviewing this method above other methods where very significant method issues exist. For example, while some States want the Mining Revenue assessment reviewed, we have grave concerns about the assessments for water subsidies, welfare and services to industry.

Also, given the nature of this revenue category, with significant differences in State policies and revenue capacities, and high redistributive impacts, Western Australia expects continuity in the way the method works and for it to be applied in a policy neutral way.

The changes to the iron ore fines royalty rate (aligning all producers at 5.625% rate) have been known for some time. They are not a 'new development' for the Annual Update. Further changes are not on the horizon.

The Premier recently indicated that "the State has no intention of increasing royalties, but we will certainly preserve the right to do so" (West Australian, 21 October 2010). To apply a single royalty rate to all iron ore produced in Western Australia (i.e. at the lump ore rate of 7.5 per cent), the Government would again need to either negotiate this with the State Agreement companies of BHP Billiton and Rio Tinto (since the royalty rates are actually fixed in the Agreements, rather than being linked directly the Mining Act rates) or to legislate unilaterally, which would invoke the 'sovereign risk' issue for the industry.

The Commission's 2010 Review report (Volume 2, page 133, paragraphs 16 and 21) makes it clear that the Mining Revenue assessment is a rough justice assessment, because of the need to "balance ... the competing issues of accurately capturing States relative revenue capacities and policy neutrality". Replacing one rough justice assessment with another in an Annual Update would be quite inappropriate.

As outlined in our earlier submission, a reclassification of iron ore fines would result in Western Australia losing around three times as much in GST grants than raised in additional royalty revenues.[1] This would be incomprehensible both on a political and public level.

Finally, were the methodology to sanction minerals shifting between high rate and low rate, based around a 5% decision point, this would create substantial gaming opportunities (as exampled in the previous Western Australian and Queensland submissions) that would undermine the CGC processes by not reflecting the 'true' capacity of States to raise their own revenue (i.e. by influencing State decisions based on GST shares).

POLICY NEUTRALITY

In Western Australia's view, it is not reasonable that a marginal shift in State policy to align all producers at the 5.625% royalty rate for iron ore fines should result in an approximate doubling in the standard rate applying to fines.

Some States have expressed a view that the treatment of iron ore fines switching from 'low rate' to 'high rate' is analogous to changes in the payroll tax threshold.

However, a marginal change in the average payroll tax threshold will move only a marginal amount of wages across the threshold, which will only have a marginal impact on each State's grant share.[2] By contrast, a mechanical interpretation of the 5% threshold in the mining assessment would allow a

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[1] All GST losses in this submission are the impact on 'assessed differences', which impact on GST grants over a lagged three-year period.

[2] Data limitations may lead to some discontinuities, but these will not have a major impact.

marginal change in the iron ore fines royalty rate (e.g. from 4.99% to 5.01%) to result in a major portion of Western Australia's mining value of production to move into the 'high rate' component, with a substantial impact (in excess of $700 million) on our grant share.

The Commission's 2010 Review report (Volume 2, page 133, paragraphs 16 and 21) makes it clear that the CGC did not wish to adopt a finely disaggregated (i.e. mineral by mineral) Mining Revenue assessment because of the effect on policy neutrality. However, a finely disaggregated revenue assessment would always affect any State's grants by less than 100% of its policy change. This is far less than the potential effects of a mechanical interpretation of the 5% threshold (e.g. 300% in the case of Western Australia's new iron ore fines rates, and around 10,000% for the example quoted in the previous paragraph).

Accordingly, a mechanical interpretation of the 5% threshold would not be consistent with the CGC's views on policy neutrality in the 2010 Review.

The Commission therefore needs to keep the composition of the 'high rate' and 'low rate' mining components fixed in the Annual Updates. Even under this method, Western Australia will lose around 60% of its additional iron ore fines royalties through a reduced GST grant share.

Concessions as Standard Policy

Western Australia disagrees with claims by some States that the iron ore fines royalty concession provided under State Agreement Acts was not average policy. As in all of the CGC's revenue assessments, national average policy is determined by dividing national revenue collections by the national revenue base. Given Western Australia is responsible for 97% of the value of production from iron ore, the concession formed a significant part of national average iron ore royalty policy.

Timing

Western Australia considers that the CGC should confirm, in the 2011 Update or sooner if possible, that fine iron ore will not be reclassified as 'high rate', to maintain the transparency of the equalisation process, and given the potential implications to revenue and the resulting considerations for future State policy.

Western Australian Department of Treasury and Finance

November 2010

92098

Hon Andrew Fraser MP
Member for Mount Coot-tha

Queensland Government

Treasurer and Minister for Employ[ment] and Economic Development

TRX-15533

-9 FEB 2011

Correspondence Received
Office of the Deputy Prime Minister & Treasurer
☑ Substantive response
☐ Constituent response
☐ Acknowledgment
To be signed by: ☑ DPM ☐ Chief of Staff ☐ Adviser

11 FEB 2011

☐ Refer to policy area for appropriate action ☐ URGENT
☐ Refer to appropriate Minister ☐ No Further Action
☐ Refer to appropriate Tsy Minister ☐ Other ....

The Honourable Wayne Swan MP
Deputy Prime Minister and Treasurer
PO Box 6022
Parliament House
CANBERRA ACT 2600

Wayne,

I am enclosing a copy of a letter sent to the Chairman of the Commonwealth Grants Commission about my strong concerns with the Commission's Mining assessment and the impact it has on the Queensland budget

Yours sincerely

ANDREW FRASER

Encl.

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Hon Andrew Fraser MP
Member for Mount Coot-tha

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TRX-15533

-9 FEB 2011

Mr Alan Henderson AM
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BRADDON ACT 2612

In the broader debate about the implementation of the proposed Mineral Resources Rent Tax, I am writing to draw the attention of the Commonwealth Grants Commission to current inequities in the method of assessing states' mining royalty capacities for the distribution of the GST.

I am concerned that before any further changes are suggested that an assessment needs to be taken of the nature of the current redistribution of public revenues from resource extraction.

In particular I note the potential for the benefits of infrastructure funding allocations to states (or more particularly, through states) with a stated policy goal of assisting with the infrastructure requirements of the expansion in the resources industry being effectively redistributed to other states by the current Grants Commission methodology. The Australian Government proposes that funding allocations from the proceeds of the MRRT have some correlation with the contribution of the relevant state to the nation's mining production.

As you would appreciate, a redistribution of these funds would likely result unless such payments are excluded from the relevant assessment, an option that is possible under the current arrangements.

This has potential to render the proposed allocations to the resource states illusory – with the benefits effectively clawed back by other states through a reduction in the GST grants to the resource states.

A key policy goal of the MRRT stands to be frustrated should the infrastructure financing proposal not be excluded from the Grants Commission's consideration of GST allocations.

One of the Commission's key guidelines is that its methods of implementing Horizontal Fiscal Equalisation should be policy neutral. The Commission identifies in its final report for the GST Revenue Sharing Relativities - 2010 Review that the intentions of policy neutrality are that actual policies of individual states do not directly affect their GST shares, and that the GST distribution process does not provide states with incentives to alter their policies.

Indeed, the broader matter of current redistribution of existing public revenue from resource extraction also requires reconsideration.

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It is apparent that the Commission's assessment of state capacities to raise revenue from mining royalties does not conform to the policy neutrality goal.

Individual policies of states directly impact on their GST shares and there are clear incentives for states to alter their mining royalty regimes to maximise their GST. For example, when Western Australia removes some concessions for iron ore fines, they will lose far more GST from this policy change than is gained in mining revenue under the current methodology.

When I removed the historically anomalous coal royalty discount in 2008, the notional increase in royalty revenue to the State of Queensland was forecast to be $578 million. In fact, given the operation of the Grants Commission methodology, around 49 per cent of this money was redistributed from Queensland. The change in Queensland coal royalties to remove the discount provided a benefit to Victoria, New South Wales and South Australia.

The lack of policy neutrality of the Grants Commission current methodology is best illustrated by the following perversity. Queensland currently has the most competitive stamp duty regime for housing in Australia. Had Queensland raised its transfer duty rate to the national average (a change in the effective rate of tax from 2.9 per cent to 3.7 per cent in 2007-08), and decreased the royalty rate on export coal to three pre cent (placing export coal in the 'low royalty rate' category), the state would have benefited by around $500 million per year. Around $300 million of this benefit is purely the result of the Commission's methodology.

It is clear that the Commission's methodology places undue emphasis on mining royalties. As outlined in Queensland's 2010-11 Budget papers, mining revenue comprises only 7 per cent of all revenue of all states. It however, represents 70 per cent of the GST funds that are redistributed based on states' revenue raising capacities.

The perception that resource states are awash with royalty revenue is deconstructed by the facts of the Grants Commission's operations.

For example, on an annual average basis Western Australia's mining revenue for 2006-07 to 2008-09 was $2.6 billion. More than $2 billion was deducted from its GST revenue as a result. This left Western Australia with just $518 million in net revenue from mining. In Queensland, nearly half of the $2 billion annual average mining revenue over the assessment period was similarly deducted from our GST allocation (Table 1). In 2008-09, this meant that the Commission assessed Queensland as needing to contribute over $1.6 billion of its mining royalties to other states.

The upshot of the current process is the person with the most interest in the resources sectors of Queensland and Western Australia is the Victorian Treasurer. Leaving aside the territories, Victoria gets more revenue per capita from mining than any other state. For a state that generated just $0.043 billion of mining revenue they receive more than $1.5 billion of the mining revenue generated by the states.

On a per capita basis Victoria receives $294 from mining – while Queenslanders and Western Australians are left with less ($250 and $242 per capita respectively). Every Victorian man and woman gets a bigger benefit from the resources industry growth in Queensland and Western Australia.

Given that the Victorian taxpayer does not contribute to any of the economic and social infrastructure required to support mining communities and to facilitate exports, the result is pure, risk-free profit to Victorians while Queenslanders and Western Australia fund the expansion.

This reality is demonstrated in the following table:

Table 1 - Net mining revenue

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Mining revenue[1] ($m)	781	43	2,032	2,615	147	36	0	136	5,789
2010 Review GST redistribution[2] ($m)	1,123	1,501	-973	-2,097	292	107	103	-57	3,127
Net mining revenue ($m)	1,903	1,544	1,059	518	439	143	103	79	
Net mining revenue[3] ($ per capita)	274	294	250	242	276	289	302	363	

Notes:

1. Average Mining revenue from 2006-07 to 2008-09.
2. CGC redistribution for Mining revenue based on average assessed revenue raising capacity from 2006-07 to 2008-09.
3. Calculated using 2008-09 populations.

Sources: Queensland Treasury, Commonwealth Grant Commission Report on GST Revenue Sharing Relativities – 2010 Review

I am strongly of the opinion that the methodology the Commission developed for assessing mining royalties in the Review has fundamental problems, and needs to be reviewed as soon as possible.

However, it appears that the Commission's current intention is to make only minor changes to the mining assessment so that Western Australia is not unduly disadvantaged from the removal of concession for iron ore fines. This outcome would not be satisfactory because the iron ore fines issue is only a symptom of the problems with the mining assessment, not the underlying cause. To make an exception in favour of Western Australia only serves to demonstrate the fundamental inadequacy of the current methodology on mining.

It is particularly concerning that these problems have arisen with the mining assessment almost immediately after the release of the 2010 Review. It highlights my broader concerns about whether the Commission process remains the best way of delivering horizontal fiscal equalisation in a modern federation.

I would appreciate the opportunity to meet with the Commission to further advance consideration of this matter.

Yours sincerely

ANDREW FRASER

cc The Honourable Wayne Swan, Deputy Prime Minister and Treasurer

Australian Government

Commonwealth Grants Commission

Chairperson

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Hon Andrew Fraser MP
Member for Mount Coot-tha
Level 9, Executive Building
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BRISBANE QLD 4001

Dear Mr Fraser

Thank you for your letter of 9 February raising a number of issues concerning the way the Commission assesses the fiscal capacities of the States.

As you would be aware, the Commission's assessments are governed by the terms of reference it receives from the Commonwealth Treasurer for both annual updates of relativities and reviews of methodology. Between methodology reviews, such as the one which reported in 2010, our annual update processes usually operate on the basis that there are no changes to methodology unless that is necessary because of changes in the availability or quality of data that is used by the existing methodology or if there is a major change in Commonwealth-State arrangements. As many of the issues you raised relate to existing methodology, and seek changes to that methodology, it may be most appropriate to meet with the Commission to discuss these issues when it has terms of reference which enable it to review the existing methodology.

However, I understand the importance you place on the issues you have raised and I would be pleased to meet with you before such a meeting with the full Commission. I suggest that our offices liaise to set a mutually convenient date for our meeting.

In keeping with the Commission's principle of transparency I have copied your letter and this response to the other States and Territories for their information. I have also copied this letter to the Commonwealth Treasurer for his information.

Yours sincerely

Alan G Henderson AM

17 February 2011

Treasurer; Attorney General

Our ref: 35-14738

Hon Wayne Swan MP
Treasurer
Parliament House
PO Box 6022
CANBERRA ACT 2600

Dear ~~Treasurer~~ Wayne

ROYALTY RATE ON IRON ORE FINES

I am writing to inform you of a decision included in Western Australia's 2011-12 Budget, released today, to increase the royalty rate on iron ore 'fines' from the current 5.625% to 6.5% from 1 July 2012 and then to 7.5% from 1 July 2013.

This will remove the remaining royalty concession for iron ore fines, aligning the rate with the long-standing 7.5% rate on lump iron ore and other mineral ores subject to processing prior to sale that involves only crushing and screening.

The increases are subject to amendments to the royalty provisions in the iron ore State Agreement Acts that currently apply to Western Australia's largest producers, and to the *Mining Act 1978* regulations that currently apply to smaller producers.

The increases will complete the royalty reforms that commenced from 1 July 2010 with the replacement in iron ore State Agreement Acts of the then 3.75% iron ore fines royalty rate with the 5.625% rate that already applied under the *Mining Act 1978*.

The Premier, and then Treasurer, of Western Australia discussed this two stage approach to reforming the State's iron ore royalties with you, on 19 April 2010, in the context of the Commonwealth's proposed Minerals Resource Rent Tax (MRRT). The Premier was given assurance by you that the Commonwealth Government would accommodate this planned reform. In accordance with these assurances, I am now seeking your confirmation that the phased increase in Western Australia's royalty rate on iron ore fines to 7.5% will be fully creditable for MRRT purposes.

Yours sincerely

HON C. CHRISTIAN PORTER MLA
TREASURER; ATTORNEY GENERAL

18 MAY 2011

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