DEPUTY PRIME MINISTER
TREASURER

PO BOX 6022
PARLIAMENT HOUSE
CANBERRA ACT 2600

Telephone: 02 6277 7340
Facsimile: 02 6273 3420

www.treasurer.gov.au

8 NOV 2011

Mr John Murray
BDO Corporate Tax (WA) Pty Ltd
38 Station Street
SUBIACO WA 6008

Dear Mr Murray

I am writing regarding substantial errors in your analysis of the Minerals Resource Rent Tax (MRRT) to be paid by our largest miners, released on 1 November 2011. These errors demonstrate that your analysis should in no way be taken as representative or even indicative of the expected operation of the MRRT.

It would be clear even to the casual observer that your analysis does not constitute a detailed model of the Australian mining industry. Firstly, it is immediately apparent that you assume that mining revenues, investment and royalties do not change over five years. You might argue that this is just a simplifying assumption, however even the most rudimentary analysis of the mining industry in Australia indicates that this assumption is utterly unrealistic.

However, there are even more fundamental problems with your analysis, not to mention a simple mathematical error.

Your analysis over-states the deductions and under-states the revenue of the miners. In particular, you have included a range of deductions that do not count for the MRRT. Under the MRRT, only investments in Australian iron ore and coal mines, inside the mine, are deductible. You have included all of the vast downstream capital costs outside of the mine as a deduction.

Further, almost half of Rio Tinto's deductions in your analysis appear to come from investments in Guinea and Canada, whereas the MRRT clearly does not allow for such off-shore deductions. You even seem to allow a deduction for the cost of a salt project.

Your assumptions are also internally inconsistent. You assume the mineral has a high value when valuing the starting base (which flows through to large deductions), but you also assume it generates low returns when it is sold and brought to account as revenue (and is taxable). This means that 30 per cent of the revenue of BHP Billiton and Rio Tinto is subject to MRRT, but 70 per cent of the value of their iron ore operations is deductible as starting base. The MRRT has rules which specifically disallow such artifice.

Based on budget economic parameters and consultation with the mining industry, Australia's largest miners will pay the bulk of the MRRT because they account for the vast bulk of mining profits.

Finally, your representation of a "commercially realistic" smaller miner is curious. Your smaller miner earns a pre-tax rate of return of over 300 per cent – well above the single or at best double digit returns that any ordinary investor would receive from shares, bonds, or an interest-bearing account. Put another way, investors put in $100 million and get $1 billion out over the next five years.

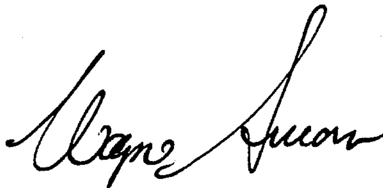
Those returns are due to one thing – cheap access to a high value non-renewable resource that is owned by the community 100 per cent. Even after tax and the MRRT, your "realistic" project makes a return of over 200 per cent. While I realise your analysis has been commissioned and funded by the mining sector, I nonetheless consider it extraordinary that any fair-minded Australian would consider such a business is being treated unfairly by the MRRT and is worthy of tax relief.

I am advised that you have just released revised modelling that attempts to correct for some of these errors, but on an initial assessment it appears to still fall well short of being in any way indicative of expected outcomes for the MRRT, and as a consequence it is distorting the public debate.

If you would like to discuss these matters further, please call Patrick Sedgley, Manager Resource Tax Unit, Australian Treasury (6263 3115). I attach a copy of his minute for your interest.

I have copied this letter to Mr Andrew Forrest of Fortescue Metals Group and Mr Simon Bennison of AMEC given their interest in your analysis. I will also place this letter on the Treasury website to help inform public understanding of the MRRT given its vital role in spreading the benefits of the mining boom to more Australians, not just extremely profitable mining companies.

Yours sincerely



WAYNE SWAN

TREASURY EXECUTIVE MINUTE

Minute No.

4 November 2011

Deputy Prime Minister and Treasurer

MRRT – BDO ANALYSIS

Timing: At your convenience.

Recommendation: That you note that we have identified several flaws in analysis undertaken by BDO purporting to show that BHP Billiton and Rio Tinto will pay no MRRT.

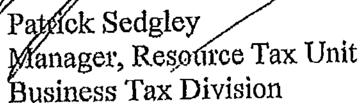
Noted Signature: ..../..../2011

KEY POINTS

- The Association of Mining and Exploration Companies (AMEC), along with Fortescue Metals Group and accounting firm BDO considers the design of the MRRT unfairly favours large, established miners at the expense of smaller, emerging ones.
- On 3 November 2011, these groups published a BDO paper purporting to show that neither BHP Billiton nor Rio Tinto will pay any MRRT for at least the first five years of its operation.
- We do not find this analysis credible. Its findings are contingent on several incorrect or unrealistic assumptions (including some that are mutually inconsistent). For example:
  - Almost half ($936 million) of the figure used as an estimate of Rio Tinto's annual capital expenditure ($2.08 billion) comprises expenditure on Canadian and Guinean projects, rather than Australian ones that will be subject to the MRRT.
  - BDO assume that only 30 per cent of mining revenue is attributable to the resource at the valuation point. The paper does not explain how this estimate is derived.
    - However, for the purposes of estimating the companies' starting base, BDO assume that over 70 per cent of their market value rests with the taxable resource.
    - The MRRT Bills would not allow taxpayers to rely on this kind of inconsistent approach. It would not be permissible to argue that the resource is highly valuable in order to generate a large starting base shield, only to then argue that the same resource has little value when it comes to calculating MRRT revenue.
  - BDO assumes all of the companies' capital expenditure is on 'upstream' activities (which are immediately deductible for MRRT purposes). In reality, most of the established miners' capital expenditure occurs 'downstream' of the valuation point, meaning that it will not be directly deductible (for example, railway infrastructure).
  - BDO does not include any operating expenses in its analysis of the large miners.
- If BDO's model were to be applied using more realistic (but still conservative and highly simplifying assumptions), then both BHP Billiton and Rio Tinto would be shown as paying MRRT. For example, if the same expenditure and revenue estimates were split equally between 'upstream' and 'downstream' (and an arithmetic error in BDO's year 4 figures for

Rio Tinto is fixed) , BDO's model would show the two companies paying $2 billion a year MRRT between them.

- The BDO paper also includes a 'commercially realistic small miner example' of how the MRRT would affect a new project commencing after 1 July 2012.
  - This example follows the same approach as adopted by AMEC in its submissions throughout the consultation process. A new project (with no starting base) is assumed to be highly profitable after only a modest amount of capital expenditure. Because the project is highly profitable, its owners incur MRRT, meaning that it faces a higher overall tax rate than it would in the absence of the MRRT.
  - As we have advised you previously (see 2011/2443), the tax rate faced by a new project has nothing to do with the miner's overall size (except to the extent that small miners are favoured through the low-profit offset).
  - BDO's example does not show that small miners will face a higher effective tax rate than large miners under the MRRT. What it does show is that notwithstanding the introduction of the MRRT, projects such as those in BDO's example will remain very highly profitable.
    - BDO's example project has an internal (pre-tax and royalties) rate of return of 358 per cent.
    - Under the current tax settings (no MRRT, 30 per cent company tax rate), the project's post-tax (and royalties) rate of return is 233 per cent.
    - The introduction of the MRRT, along with the reduction in the company tax rate to 29 per cent, would reduce this project's rate of return to 219 per cent. This means that investors putting in $100 million in capital at the start of the project will have made $943 million after five years of production, even after paying $165 million in MRRT.



Patrick Sedgley
Manager, Resource Tax Unit
Business Tax Division

Contact Officer: [redacted]