



**Keynote Address**

**Stockbrokers Association of Australia  
Conference**

**Wednesday, 9 June 2010**

**Crown Promenade, Melbourne**

**by**

**Mitchell H Hooke  
Chief Executive Officer, Minerals Council of Australia**

**CHECK AGAINST DELIVERY**

I'd like to acknowledge the Traditional Owners on whose land we meet, the Kulin Nation, and pay my respects and those of the Minerals Council of Australia to their elders and their ancestors.

Chairman, Mr Rob Thomas; Managing Director and CEO, Mr David Horsfield; distinguished guests, members of the Stockbrokers Association of Australia, ladies and gentlemen.

David Horsfield extended this invitation to me early in November last year to talk about the Government's carbon pollution reduction scheme.

I questioned the merit of giving a speech that would address the policy and technical manifestations of that debate and that would probably drive an audience like this either to sleep or to distraction.

Rather, I considered then, as I do now, that the Government's construct of that policy proposal and the subsequent fierce public debate went to the very core of an emerging uneasiness [at least within business circles] of increasing sovereign risk of doing business in Australia, whether that is actual or perceived.

By sovereign risk I mean the extent to which Governments' intervention in the market is unwarranted, unexpected, changes the rules upon which investment decisions were made, and that the process of those policy determinations is manifestly flawed.

The mining industry is a global industry – it is capital intensive with considerable and high risk exploration outlays, large upfront capital commitments, long life assets, seriously technologically challenged and sophisticated, with long lead times to profitability, and its capital, people and technology are highly globally mobile.

The industry understands risk management for market uncertainty in a highly volatile, highly competitive global market.

Our confidence in the underlying fundamentals of this cycle of minerals demand has been vindicated – we said throughout 2009 that the demand cycle was checked, not compromised by the global financial crisis, and that demand would kick back to and exceed supply, putting upward pressure on commodity prices.

The industry has a solid track record of managing its way through economic cycles.

### **[SLIDE 2 – Minerals Cycles]**

The Australian minerals industry has long contended with, and been sensitive to, significant changes in global economic growth and in turn industrial production, fluctuating demand, volatile prices and variable exchange rates.

The industry has been able to increase supplies as real prices decreased and real costs increased.

This, even though ore grades declined and as environmental and social stewardship responsibilities increased consistent with the industry's commitment to sustainable development.

But, the industry is far less geared to, and capable of, managing sovereign risk – that rightly falls to governments.

A fundamental pre-requisite to investment is confidence in government policies that establish a socio-economic environment conducive to growth.

In a world that is minerals resources rich, and an industry that is increasingly globally integrated and diversified, there is no shortage of opportunity for the strategic deployment of highly mobile capital.

Australia's comparative advantage in natural endowment does not automatically equate to competitive strength and attractiveness to foreign direct investment.

Whether perceptions of increasing sovereign risk are real or not – any policy changes in the key areas of carbon pricing and energy, skills and workplace relations, infrastructure, and taxation policy, which compromise predictability, equity and efficiency, undermine Australia's international competitiveness and jeopardise investment and business growth to the ultimate detriment of the nation.

The World Economic Forum Global Competitiveness Report 2009-10 reaches a similar conclusion. They identified the top four problematic factors for doing business in Australia are: restrictive labour regulations; access to financing, tax rates and tax regulations.

They identified the next priorities are inefficient government bureaucracy, inadequate infrastructure, and an inadequately educated workforce

Within this space, we had cause for optimism and confidence in Australia's ability to endure the ill-effects of the global financial crisis and to address the capacity constraints in social and physical infrastructure that so limited the industry ability to capture the full extent of the opportunities in the run up to the global financial crisis.

This, for a complex of key reasons that I can identify.

**[SLIDE 3 – Underpinning Australia's Economic Performance]**

- two and a half decades of free market economic reforms that delivered Australia one of the strongest balance sheets of the OECD economies, and an open economy where the benefits from the “minerals boom” of an increase in terms of trade and national income wash through the economy.
- Australia's unique (compared to other OECD economies) position as a global supplier of minerals to the industrialising/urbanising developing economies particularly in Asia – and thus the minerals industry's contribution to the underlying strength of Australia's economy.
- the critical role of China's stimulus package in reinforcing minerals demand, with obvious consequences for Australian minerals and energy exporters and the economy as a whole – nearly \$1 trillion US of Chinese domestic fiscal stimulus carries a fair amount of demand weight with it.
- Australia's Prudential Regulation – the regulation of Australia's financial system proved to be critical protection against the adverse excesses of the extraordinary expansion and a lack of proper transparency and governance of global financial markets.
- the Government's fleet of foot shift in emphasis in economic policy to the need for the public sector to fill the gap in spending and investment created by a lack of confidence in business and among consumers – referred to as the fiscal stimulus package; and
- that the Rudd Government was elected on a platform of national capacity building and laid down early positive markers in that direction, specifically:
  - its intention to control spending; to rein in debt and return the budget to surplus;
  - a continuing commitment to trade and investment liberalisation;
  - national occupational health and safety reform;
  - reform of business red tape/regulation—an ambitious COAG reform agenda ; and
  - investment in nation building, specifically in addressing the deficiencies in Australia's physical and social infrastructure – especially, in education and training.

BUT.... our confidence started to unravel when the Government failed to recapture that early impetus in national capacity building. There appeared to be more in the rhetoric of policy than in the substance of its implementation, especially when the Government gave every indication of heading in a different philosophical direction.

As the Prime Minister outlined, in his now famous quarterly essay for The Monthly, his predilection towards intervention in the market and big government underpinned a philosophical view that “Governments know better”, than efficiently functioning markets.

In the Prime Minister's words “This [building a fairer and more resilient order for the long term] can only be achieved through the creative agency of government – and through governments acting together”.

This shift appears to have also given a greater focus on a continuing emphasis on the redistributive, rather than the productive, side of the economy –the Government's own declaration of the need for a greater redistribution of wealth appears focused more on carving up the pie rather than growing it.

This appears to be a significant departure from the Labor Government's of Hawke and Keating.

Today, there are arguably no more obvious examples of the manifestation of this policy shift than the highly contentious debate over how to achieve a carbon price through an emissions trading scheme market mechanism, and the even more highly contentious Government's proposed so-called super profits tax on minerals resources.

But if you stop and pause just for a moment, in these examples and other key policy questions, there is not great disparity between the industry and Government, in the objectives of proposed reforms, at least the state objectives.

The much criticised Carbon Pollution Reduction Scheme failed not because of its objectives in establishing a carbon price through a market mechanism, but because of failure in design, which in turn was a product of failure in consultation with business.

Added to which was the underlying philosophical contradiction in taxing in the order of \$120 million over the period 2011-20 from business and repatriating two-thirds of this in the form of compensation assistance to households and motorists, undermining any claims to an environmental integrity measure.

So too, we are visited with the so-called super profits resource rent tax scheme.

Again, we are on the same page as those seeking real reform of the myriad of complex State royalties.

#### **[SLIDE 4 – Current Minerals Royalty Arrangements]**

When you examine the array of mineral royalty arrangements across the States, they are a real complex:

- the method of levying royalties for the same mineral differs across States;
- rates differ for the same mineral across States;
- in some cases, rates differ for different mines extracting the same mineral in the same State;
- volume royalties are usually imposed on low value minerals; and
- there is no uniformity in the legislative base adopted by the States.

We have consistently said there is a conceptual argument to reform the basis of determining minerals royalty payments from the existing revenue based system to a profits based regime.

A profits-based royalty calculation methodology has merit as it can more appropriately share risk and reward between the State and mining companies, better reflecting the interdependency between the State governments and mining companies in converting natural resources into societal capital in Australia.

But, as is repeatedly pointed out, though we advocated a shift to a profits based royalties system, we are aghast at the design before us.

We appear destined to follow the same path as the debate over an emissions trading scheme – comparable objectives, failure to consult, failure in design, public conflict, real or perceived increasing sovereign risk of doing business in Australia, and ultimately a lose-lose for all concerned.

For those of you who think we doth protest too much, let me take you through a series of questions in three key areas – the design, the Government's justification and market sensitivity – I want to foreshadow that some of this may get a little technical, but it is fundamental to the public cacophony of claim and counter-claim in the current debate.

#### **[SLIDE 5 – Royalty Reform Principles]**

**FIRST – TO THE DESIGN** – the key question being, is this a tax grab in lieu of tax reform where tax reform is defined by the five key high-level principles we identified early in the Henry Review process and few contest?

**Prospective:** Changes in taxation and royalties must not undermine the basis upon which long-run investment decisions have been made, nor compromise the principles of equity and efficiency.

The RSPT is to apply to both prospective and all existing resource projects (except for those within the scope of the existing Petroleum Resource Rent Tax).

The proposed starting base is the written down or depreciated accounting book value of existing projects, with provision for accelerated depreciation of the base over 5 years.

This is strongly biased against mining companies with older, more depreciated or impaired assets and against companies that own their assets or lease them.

And it is a marked departure from the depreciation arrangements under the PRRT where 100 per cent of capital expenditure (also net of purchase costs and financing) is deductible in the year spent. As a result, companies are forced to pay higher revenues sooner than would be the case under a PRRT model.

The proposed arrangements reflect neither the risk already undertaken by companies, nor the true value of capital already invested in projects.

Quite simply, the Government was not a “partner” risking capital in existing mines, but now wants a significant share of the returns from them – imposing the highest taxation on any type of business income in Australia.

The Petroleum Resource Rent Tax when introduced applied prospectively and so too recently announced comparable reforms in the Quebec province of Canada.

**Internationally competitive:** The overall taxation burden (resources, local, state and federal taxes and levies) should be internationally benchmarked and be competitive against other global investment destinations.

The current proposal is for the RSPT to apply at a 40 per cent rate across all commodities. The result (when proposed company tax changes are taken into account) is a marginal effective tax rate on so-called “super profits” of 57 per cent.

Australia would be the only country with such a tax regime and more heavily taxed than petroleum – also virtually unprecedented in global resource taxation arrangements.

The Australian mining industry will bear the highest statutory tax rates of resource rich countries in the world.

**Equitable and efficient:** Genuine reform of taxation and royalty arrangements should promote economic activity and improve the efficiency, simplicity and fairness of the system without compromising neutrality, and in minimising the deadweight loss to the economy of taxation and royalty collection.

This goes to the theory behind the RSPT which is predicated on what economists call a “perfect tax”, ie. that it will not introduce distortions to capital availability nor investment decisions.

The critical theoretical assumptions are that there will be unlimited capital with 40 per cent funding being available at the Long Term Bond Rate, ie. the rate deemed to be the risk free return on capital.

And this “perfect tax” assumes that there is no change in investment behaviour.

Taxing resource rents assumes no change in behaviour because the resources can’t move in response to higher tax rates.

To drill down further into the economic theory behind this is that it is assumed that “super profits” are a mechanical proxy formula for resource rents, ie. the rent from the return to the minerals resources themselves.

But if the “super profits” definition does not adequately differentiate between “normal profits” and “super profits” it becomes an even worse proxy for a resource rent tax. It assumes there is no difference between “resource rent” and “super profits”.

It confuses the inherent value of the resource and the effort and entrepreneurial expertise required and value added in developing it.

And that’s the real problem!!!

The upshot of this proposed super tax is that miners will be taxed on their “normal profits” as well as any “super profit”.

Let me ask you – do you seriously think that the Long Term Bond Rate (circa 6 per cent) applied to an already compromised tax base (ie. net of capital purchasing and financing costs), is an appropriate proxy in identifying resource rents?

In the real world, mining companies evaluate projects according to post tax risk adjusted returns.

Or put more simply, do you think it is reasonable that for every dollar a mining company earns above that if it had lent the money to the Government or put it in a fixed term deposit at the bank, is a super profit – which will attract the new 40 per cent super tax in addition to the company tax?

– as Chris Richardson, Director of Access Economics said at Minerals Week,” if you do [believe the RSPT proxy is perfect at identifying resource rents], you’d also have to believe Australia’s banks and breweries have been doing a lot of mining.”

If the theory of neutrality, ie. no distortions on account of this tax, is to “hold water,” then the super profit should be defined as when the returns are in excess of the project’s weighted average cost of capital (WACC) – the real cost of capital over the life of the project weighted for debt financing and returns to equity – plus a premium for the systemic risk associated with the very nature of the mining activity.

Research undertaken for the MCA indicates that the WACC for a range of minerals is two to three times the long-term bond rate, ie. 10-15 per cent. The Government simply assumes that “financial engineers” will take full account of the supposed “government guarantee” in providing finance for 40 per cent of projects at the bond rate.

And this goes to my last point on the underpinning theory to the proposed super tax which is this notion of theoretical symmetry in risk and reward in defining a profits tax – the unique design feature which involves the Government combining a de facto 40 per cent interest in mining projects with a “tax credit” for project losses.

Apart from the inherent logic of the industry’s response – it doesn’t want the Government to be a silent partner in a quasi-nationalisation of the industry, the risks on existing projects have already been taken, and nor does it plan for future projects to fail – let me ask you:

- do you think the Government’s “promissory note” of 40 per cent of losses is bankable in raising capital?
- do you think it offsets the 40 per cent reduction in retained earnings for continuing capital investment in the project,
- what store do you put on any government honouring its obligations to pay the minerals industry at a time when in all probability there would be a queue of competing creditors for taxpayers funds, and,
- what is the trigger point for the realisation of those 40 per cent losses and to whom are they paid – is it the original investors which will likely be long gone if the project is tracking to the point of falling over or is it opportunistic investors looking to pick up either cheap assets or bad debts?

**Differentiated:** Capital investment and financial return characteristics differ across resources commodities, starkly between oil and gas and minerals commodities, but also significantly between minerals commodities.

Achieving a competitive taxation and royalty regime for different resources products requires different designs and taxation/royalty rates specific to the characteristics of each resources product group.

The rate is not differentiated.

There is no policy or economic rigour to justifying 40 per cent.

And the simple extrapolation from the Petroleum Resource Rent Tax to minerals ignores the flatter capital and operational expenditure incurred and at risk throughout the total project life compared with the much higher upfront capital costs and subsequent cash flow nature of petroleum projects.

**Minerals resource based:** Minerals resources taxation and royalties should be levied on the primary resource value only, and not on the value added in downstream transport logistics and industrial processing and smelting etc.

The taxing point is the point at which revenues and costs are determined to assess RSPT liability. The Henry Review proposed that, in principle, the taxing point be set close to the point of extraction of the resource (e.g. the mine gate or well head). While seeking an approach that taxes profits earned on the resource, the Government is leaving open the possibility that “some additional downstream processes (beyond the existence of a saleable commodity) might be included within the reach of the RSPT”.

My second of the three key areas is the Government's justification of its proposed super tax.

The key questions here are simply that if the Government's proposal for a super tax on the minerals resources industry has the merit they claim, why then has the Government launched such an assault on the integrity and credibility of the industry seeking to denigrate and discredit it without apparent regard to the consequences to the industry, the economy as a whole, and all Australians.

And why did the Government reject our overtures to a full and meaningful consultation where we were prepared to share commercially sensitive information on the full ramifications of the Government's proposal.

More specifically:

#### **[SLIDE 6 – Total Tax/Royalty Contribution]**

- why would the Government, and again reinforced in the taxpayer funded advertising, have you believe that the industry's tax contribution over the decade to 2008-09 was only \$9 billion, when in actual fact it was \$80 billion accounting for both royalties and corporate tax paid?

– notwithstanding that the Treasurer has on numerous occasions conceded publicly that the industry's tax contribution is the combination of company tax and royalty payments.

In 2008-09 the company tax paid (\$12.6B) by the minerals resources industry doubled from 2006-07 and represented 16 per cent of total company tax receipts from an industry that accounts for around 8 per cent of GDP – company tax is of course a profits based tax.

Royalty payments to the States have doubled over that period to \$7.6B in 2008-09.

As a proportion of GDP total company and royalties tax paid has increased four-fold.

And only yesterday State Governments in NSW, Queensland and WA announced an increase in their royalty take for 2010-11 on the previous year of 86%, 63%, and 48% respectively – giving lie to the myth that the royalty system does not increase the tax take as prices rise (even though it is a production based royalty).

#### **[SLIDE 7 – Effective Tax Rates by Industry Sector]**

- why would the Government rely on an obscure United States University Graduate study to try to promote to the Australian public that the industry only paid an effective tax rate of 13-17%, when its own Tax Office official statistics and audited company statements have us at a combined effective tax rate in the range of 36-43% in 2008-09 – and every respected economic commentator, including the public declarations of our own companies, calculate the effective tax rate after the imposition of the 40% super tax to be in the order of 57 cents in the dollar, and that's before it gets in the hands of our investors?
- why does the Government refuse to recognise the extent of the industry's contribution to the physical and social infrastructure in the communities in which it operates over and above what it is required to pay by law?

The industry takes its corporate social responsibility seriously. So too do governments continue to regard the industry as a proxy in providing community level services most of us on the eastern seaboard take for granted, including child care facilities, housing, health care and training in basic life skills such as work readiness and financial management skills.

The industry has built in the order of 35 towns, 15 ports, 25 airfields, thousands of kilometres of railway lines, significant water and energy infrastructure, power transmission, information and communications technology, etc.

And specifically, in building sustainable Indigenous communities, as the largest employer of Indigenous Australians, the industry is a critical provider of education, training and mentoring of Indigenous Australians and Indigenous enterprise development.

- why does the Government continue to mischievously misrepresent the tax contribution the industry makes royalties as a proportion of mining profits, ie. the Government claims the industry paid \$1 of tax in \$3 of profit before the last boom, compared

to \$1 in \$7 now – yet this fails to recognise that the benchmark the Government chooses was at a time when the industry was barely recovering the cost of its investment capital, again it does not include company taxes, and because royalties are currently production based they are paid regardless of returns and therefore will always be a higher return of profits when profitability is low – this is hardly a rational benchmark for determining “Australians fair share of the wealth created by mining companies development of natural resources”.

- why would the Government attempt to portray the largest tax payer companies in Australia as something akin to foreign multi-national “carpet baggers” expatriating profits overseas when quite the contrary is the case? – when in reality the costs incurred and the investments made by these companies is either lineball with, or in excess of the revenues they generate.
- why would Government officials seek to discredit the importance of the mining industry in recession-proofing Australia through the global financial crisis – even to the point of running a simple extrapolation of the industry’s shedding of largely contract and itinerant part-time workers to an unemployment rate for the country as a whole.

#### **[SLIDE 8 – Growth Rates of Key Economic Indicators]**

And yet, the real economic data shows that without exception, every indicator indicates that the economic performance of the mining sector dominated the performance of the overall Australian economy during that period.

For the record, let me state categorically that mining was a standout sector in the Australian economy throughout the difficult 2008-09 period, with gross value added, industrial production, exports, employment, wages and investment all growing more rapidly than the same indicators for the economy as a whole.

Added to this are numerous other falsifications or deceptions around comparisons to the petroleum resource rent tax, the sincerity of the consultation process, and promotion of a two-speed economy as justification for slowing investment in our sector to benefit, if not protect, other industries.

Finally, to my third key area that I have categorised as “market sensitivity”, capturing the results of our own real world project specific modelling of the destruction of project value which is likely to result in mining companies deferring or cancelling projects in the short to medium term.

We commissioned KPMG last year to develop whole of life financial models for Greenfield mines across six commodities. The key assumptions of that modelling work are:

- project development would commence 1 July 2012;
- capital and operational expenditure of the mines would put them in the second quartile of the world cash cost curve; and
- external forecasts for capital and operational expenditure, commodity prices, and exchange rates are used.

The KPMG findings (the KPMG report – “*Financial impacts of the Resource Super Profits Tax on new mining projects in Australia*”) demonstrates the disastrous consequences of the Government’s RSPT on new greenfield mining projects in Australia. The report states that new projects will suffer significant destruction of value which is “likely to result in mining companies deferring or cancelling Australian projects in the short to medium term”.

#### **[SLIDE 9 – KPMG Model Outputs – Net Present Value]**

Under the realistic scenarios modelled by KPMG, and relative to the “status quo”, the project modelling shows:

- A 46% fall in Net Present Value (NPV) calculated on financial models for iron ore projects
- A 57% fall in NPV on modelled black coal projects
- A 15% fall NPV on modelled bauxite projects
- Negative NPVs for nickel, copper and gold mines (such that they become economically unviable)

The KPMG cites a number of reasons for this massive loss of value that will slow mining investment in Australia.

**[SLIDE 10 – KPMG Model Outputs – Effective Tax Rates]**

First, the RSPT will sharply increase effective tax rates (ETRs) on Australian mining projects. Under the RSPT, modelled ETRs over the life of projects are:

- 54.7% for iron ore (up from 43.6% – an increase of 25.5%)
- 55.0% for black coal (up from 41.1% – an increase of 33.8%)
- 55.1% for nickel (up from 34.3% – an increase of 60.7%)
- 55.0% for copper (up from 34.4% – an increase of 60.4%)
- 54% for bauxite (up from 50.1% – an increase of 7.8%)
- 54.1% for gold (up from 34.6% – an increase of 56.4%)

International comparisons show the degree to which Australian tax rates will be uncompetitive under the RSPT. The result is that Australia will have the highest ETRs of all comparable investment destinations benchmarked by KPMG.

Second, KPMG identifies deep flaws in the assumptions used by the Government which underpin the design of the RSPT:

- the “theory” is based on “unlimited capital with 40% funding being available at the Long Term Bond Rate (LTBR), which in turn will require mining companies to “fundamentally change their approach to funding mining projects”;
- the “theory” assumes no change in behaviour – that is, the RSPT is a perfect tax which will not change investment behaviour.

KPMG concludes that, for a range of reasons including risk and pricing issues, this is impractical over the short- to medium-term. The capital markets, and in particular debt markets, “will be unable to price funding at the LTBR”. As a result, “the Government will need to actively intervene and become the purchaser of the debt at the LTBR”.

KPMG concludes that the reduction in returns to Australian mining projects under the RSPT will likely result in Australian mining projects moving “down the list” of international projects. And that it is “unlikely in the short to medium term that new entrants will fill all of the void left by large project deferrals or reallocations to projects offshore”.

KPMG conclude that the “impact on the mining sector from the introduction of the RSPT at 40% means that it will take a long time for the sector to recover”.

Mr Chairman, the Minerals Council of Australia is not in the business of politics, we are in the business of public policy.

When politics so comprehensively and so acutely compromises public policy in the nation’s interests and so flagrantly abuses our credibility and integrity, we have no option but to vigorously and publicly contest.

The industry is committed to economic reforms that ensure the stability, efficiency and effectiveness of fiscal policy and taxation and royalty arrangements that promote investment growth and global competitiveness of the Australian minerals industry.

If you come to the same conclusions as we have in working through the questions I have posed today, the inescapable conclusion is that the Government’s proposed super tax will weaken the Australian minerals industry, and if you weaken mining, you weaken the Australian economy.

The generation of tomorrow will be the generation of lost opportunities for this “lucky country”. If nothing else, this is entirely at odds with our commitment to sustainable development where this generation does not compromise the ability of future generations to meet their needs.

We are not confident the Government has thought this through and it will affect everyone!!

**MITCHELL H HOOKE**  
**CHIEF EXECUTIVE OFFICER**  
**9 June 2010**