Digging deeper on the MRRT

Robert Gottliebsen

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We are now only just getting to the bottom of how the miners expect to pay about two thirds less tax under the new minerals resource rent tax rules yet the Gillard government is expecting a relatively minor reduction in revenue from what was expected under the original plan.

And as we look deeper we also discover why copper, gold nickel and uranium escaped, leaving the tax confined to iron ore and coal. There's also the miscalculation by the coal seam gas/LNG producers who opted to be treated under the petroleum resource rent tax. They should have stayed in the mining camp.

As we delve into these issues we discover a lot about the future of our country which is why today's comment is a little longer than usual. In my view, at best, the government has only a 25 per cent chance of achieving its projected $10.5 billion in revenue from the revised mining tax in the tax's first two years. There is an equal chance they will receive almost no revenue, with the most likely outcome that the income the first two years will fall by about two thirds from the original $12 billion to $4 billion. Importantly, for the assumptions behind the government's $10.5 billion tax revenue forecast to prove correct the Australian All Ordinaries index will have to soar above 6,000 and the Dow index of US shares will have to rise well above 11,000.

To understand how I reached these remarkable conclusions I have to take you through four key steps in the decision-making process by relevant stakeholders following the realisation that the original tax was completely flawed.

Most of the action took place before Julia Gillard became Prime Minister, which is why she was able to act so quickly.

The first step was that the coal gas/LNG producers, led by Santos, wanted to move coal seam gas to the petroleum resource rent tax and indeed some of the Curtis Island players had come to Australia to do a deal with Kevin Rudd on the day he was deposed.

Going in with the petroleum rent tax represented a major reduction in the tax burden for the Curtis Island group and made most of the projects economic. But with a bit of patience and some risk taking, they would have achieved a far better outcome had they stayed with BHP, Rio Tinto and Xstrata.

The second step was meticulous logic of the chief executive of South African-based AngloGold Ashanti, Mark Cutifani. Cutifani spent time with Rudd, Resource Minister Martin Ferguson and anyone else who would listen, explaining that Australia's gold and copper reserves were deep in the ground and so exploration was high risk and high cost. (*Australia's own-goal*, June 15.)

AngloGold has discovered a rich gold deposit, Tropicana, in a remote area off Western Australia, but under the first version on the mining tax Anglo could not go ahead with the development of the project. If the Tropicana bonanza ore body could not be justified, then there was no point in looking for copper or gold in Australia.

Cutifani's logic could not be faulted which was supported by the pleas from South Australian Premier Mike Rann, who realised that the giant BHP Billiton Olympic Dam copper and uranium expansion would be mothballed by the tax. Accordingly the government concluded that it really only needed to concentrate on iron ore and coal – that's where the money was.

Thirdly, there were a series of other issues like making sure expensive treatment plants, such as OneSteel's steelworks at Whyalla, were not taxed.

Fourthly, the crazy idea of the government underwriting losses was quickly seen as an idea in the Treasury shower that should have stayed in the bathroom.

Finally, and most importantly the original estimate that the tax would accrue $12 billion in revenue over the first two years appears to have been based on commodity price estimates prepared by the Australian Bureau of Agriculture and Resource Economics (ABARE) some months ago.

Just before Rudd was sacked, the bureau lifted its forecasts showing a rise of about 35 per cent in the expected iron ore revenue and a rise in coal earnings by about 16 per cent. That sent the expected revenue from the mining tax way above the original $12 billion estimate. Combined with the withdrawal of the loss underwriting, there was now room for the new Gillard government to move.

The ABARE estimates are in line with the bullish Treasury budget forecasts which estimate global growth will rise by 4.5 per cent.

My guess is that both the ABARE and the Treasury budget forecasts have their genesis in December last year when there was a wave of optimism around the world. We then had a market correction in January 2010, but after that fall the All Ordinaries index market recovered to go past 5,000 on April 15. That's about the time both the Treasury budget and ABARE estimates were locked in.

Since then there has been sharp falls in global stock markets and we are looking at slowdowns around the world, including in Asia. Even more importantly, copper and other metal prices have fallen sharply, including a 22 per cent decline in the spot iron ore price. According to Ivor Ries from EL & C Baillieu, writing in the *Eureka Report*, over the next three years around 39 global iron ore projects will create a massive 500 million tonnes of extra iron ore capacity. If that capacity comes on stream when demand is depressed there will be little mining tax revenue from iron ore because prices will slump.

None of these factors worried the government mining tax negotiators. They had their revenue figures which allowed the miners to get most of what they wanted and Julia Gillard to look brilliant.

As it is now constructed, the mining tax is very sensitive to rises and falls in revenue as a result of commodity price changes. Treasury and ABARE could still be right, but if they are right then the stock market has completely misread the play. If the estimates are wrong, then Lindsay Tanner's replacement as Finance Minister will have to slash government expenditure at the eve of the 2013 election.

The key for miners is to lock in market values for their assets based on the latest ABRE numbers. The central person in that negotiation will be former BHP Billiton chairman Don Argus. At this point, Argus very important to both BHP and Rio Tinto. So much for Don's retirement.