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The irony of the MRRT

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If Federal Treasury is now using the most up-to-date information to estimate the revenue raised by the government's resource tax proposals, Ken Henry might want to crank up his model again.

Yesterday Henry shed light on how the dumping of his beloved resource super profits tax and its replacement by the much narrower and gentler minerals resource rent tax had produced only a surprisingly modest $1.5 billion reduction in revenues in its first two years. Treasury changed its assumptions on iron ore and coal prices and volumes to reflect 'quite significant' increases in prices in the past few months.

When it was asserted by a Liberal senator that the revisions were convenient for the government because they enabled it to avoid disclosing how much revenue was foregone by scrapping the RSPT, with its headline tax rate of 40 per cent, and introducing the MRRT, with its 22.5 per cent rate, Henry responded aggressively.

''I hope you weren't suggesting that, had the government asked us for a costing of its negotiated package, that we would have relied on forecasts of commodity prices that were a couple of months old when the whole world knows that commodity prices have been increasing quite strongly over that two-month period [between the announcement of the RSPT and its replacement by the MRRT],'' he said.

''If we get asked to provide a costing of a particular proposal we will use the most up-to-date information available to us.''

Well, if Treasury is going to use current prices as the basis of its estimate of industry profitability in 2012 and 2013 when the tax is supposed to cut in, the most up-to-date information available on iron ore prices isn't quite so supportive of Treasury's belief that the MRRT will raise $10.5 billion in those years.

Spot prices for seaborne iron ore are tumbling. According to Goldman Sachs, citing resources information provider Platts, last week the spot price for fines delivered to China was $US130.50 per dry metric tonne, its lowest level for 18 weeks. In the derivatives market, third-quarter swaps are being settled at $US117 a tonne. The further out one looks in that market, the lower the forward price.

Except for the worst few months of the global financial crisis, spot prices have traded at a substantial premium to contract prices. In April that premium was just under 150 per cent. More recently, it evaporated.

As Goldman says, spot cargoes are now trading at an implied discount of nearly 20 per cent to the proposed third-quarter contract price being sought by Australian producers. It expects steel mills to vigorously resist paying a premium over spot and being disadvantaged against competitors not locked into the new quarterly pricing deals.

In fact the history which led to the breakdown of the long-standing annual benchmark pricing system says the Chinese mills will refuse to pay the premium and will be prepared to renege on their contracted volumes if they feel disadvantaged.

That’s particularly likely as Goldman also says there is no shortage of supply of seaborne iron ore, with Brazilian ore being offered via tender, spot cargoes being offered by suppliers not normally involved in the spot trade and reports that Vale has as much as 885,000 tonnes of ore floating off China’s coast.

Just as the shift to market-related pricing was inevitable as the benchmark system broke down, it would appear equally inevitable that if the market remains volatile there will be pressure to move the quarterly priced elements of the market closer to spot, making the price even more volatile.

There is a lot more supply coming into the market both from the large and small Pilbara producers and from Brazil, where Vale is pursuing a 50 per cent increase in its production. It has also starting buying and building its own ships, which will presumably shift its emphasis at the margin from price to volume.

In the long term, growth in Asian demand and particularly China’s demand might underwrite the massive increases in production volume. Rio Tinto alone is considering expanding its capacity by about a third by 2015.

In the short term, however, China’s economy is slowing as its authorities try to stamp out speculative bubbles.

While the target for GDP growth appears to be around nine or 10 per cent, that represents a material slowdown in growth and is raising some concerns that the authorities might overshoot in an environment where the introduction of harsh economic austerity packages in Europe, a still-spluttering US economy and fears of a double-dip recession could impact China's exports.

Thus, predicating MRRT revenues in 2011-12 and 2012-13 on prices for iron ore – with coal, the key revenue generator for the MRRT – at or near record levels when they are already rapidly receding would appear bold, or foolish, and the forecasts based on them even more dubious than Treasury's usual forecasts.

Unless, of course, Dr Henry is committed to his new approach to forecasting, based on ''the most up-to-date information available.''

In which case the budget estimates could be updated almost on a weekly, if not daily, basis and presumably today the estimated revenues raised by the MRRT would be somewhat less than the $10.5 billion in its first two years on which the re-worked Budget has been built.