‘Silent Partner’ distorts investment and production decisions

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“A well-designed rent-based tax is less likely to distort investment and production decisions… essentially, the Government is a silent partner whose share in the project is determined by the tax rate.” (Henry Tax Review, pg 222)

While Treasury Secretary Ken Henry might have been aiming at an economic purist’s form of resource rent tax, with no distortion of investment and production decisions, that is not what the Rudd Government has imposed.

The economic ‘seamless wonder’ of the cheekily dubbed “Resources Super Profits Tax” fails completely to recognise the risks inherent in the mining industry and the way that both investors and companies will respond to a change in incentives.

The basics of the tax are as follows: As of 1 July 2012, a new tax will be levied at 40 per cent of profits on all existing mining projects, once companies have covered the cost of the project and the cost of capital, set at the long-term bond rate.

The quid pro quo on this arrangement is that the Government, our industry’s generous ‘silent partner’, also undertakes to return to investors 40 per cent of the tax value of losses. That is, when project losses are greater than project costs in any given year, this can be transferred to other profit making projects, or carried forward to the following year to offset future RSPT. The RSPT tax losses are only refunded when the project is closed.

The two big questions the Government should be asking itself are:

- Will the new tax adversely affect the ability of mining companies to raise capital for Australian based projects?
- Will the new tax adversely affect the attractiveness of Australia as a destination for exploration and mining investment by large miners?

If the answer to either of these questions is “Yes”, then the Government has – to cite the most commonly invoked cliché in relation to this tax – killed the goose that laid the golden egg, or at best plucked, clipped and even seasoned the goose while expecting it to continue to live a highly productive and happy life.
Will the new tax adversely affect the ability of mining companies to raise capital?
The answer to this question is: Most probably, yes. Investors generally do not pick mining stocks, particularly small to medium sized miners without the diversified assets of a BHP-B or Rio Tinto, because of the inherent romance of the industry. These stocks are risky. They are risky because of the fluctuation of commodity price cycles, and the sudden adverse affect these fluctuations can have on projects. As we saw in 2008, these fluctuations result in exploration programs put on hold and mines closed or put on care and maintenance. During this time, the value of shares plummeted and dividends became a distant memory.

Moreover, due to the inherently variable nature of Australia’s geology (or any geology for that matter) there is significant technical risk at each stage of development. A mining operation is not like an off-the-shelf manufacturing plant. It requires successful completion of exploration, mining and mineral processing phases, each of which carries considerable risk. An exploration program will be revised and reconsidered with each new set of results. The method of extraction utilised in the course of mining operations will be designed around the properties of the orebody, which will vary throughout. Further, ensuring the processing plant is capable of delivering to customer specification often requires costly trial and error.

When both macro and micro factors are able undo millions of dollars worth of exploration, construction and planning at any moment, why would anyone in their right mind choose to invest in such an uncertain undertaking? Could it be the promise of considerable reward? The prospect of – dare we say it – “better than average profits” at the end of a nerve-racking venture that involves economic fortitude and technical ingenuity?

This has traditionally been the case. Many have made their fortunes on a technically sound vision made good.

But with the new super profits tax cutting in at only six per cent rate of return on capital (I think a Dollarmite kiddies’ savings account earns more) and taking 40 per cent of the profits away from investors, there is little incentive to invest in these high risk stocks. This is particularly so for explorers and small, undiversified miners which have little in the way of fallback options, should their projects go pear-shaped.

Will the new tax adversely affect the attractiveness of Australia as a destination for exploration and mining investment by miners?
There are several design elements of the government’s RSPT which will make Australia an unattractive prospect for future investment in Australia. For one, the point for return on investment at which the tax cuts in is very low, meaning a sizeable chunk of profits will be taken away from mining companies. Many will make the decision to direct new investment to jurisdictions where they can get a better bang for their buck.

For another, companies that have already expended considerable capital in getting their projects up and running will also be hit with the tax, indicating that our government is not above imposing retrospective, opportunistic taxes and raising our sovereign risk.

In its pure form, the kind of tax envisaged by the Henry review is meant to apply from the outset of projects, or at least to allow all costs incurred to be brought to account.
The tax proposed by the government will have an immediate effect on all projects from the start date, making it retrospective. Existing projects will only get a one-off credit for the cost of their project when they are dragged into the system. That credit, though, is based on the book value not the market value of the project, which means that past investment that has been written down for accounting purpose is appropriated for nothing.

These existing projects are not a random selection of all Australian mining projects over recent decades. As stated by one commentator: “They are the lucky survivors: the projects profitable enough to start and remain in production. Many others were terminated and have been written off the books, even by current producers. Those projects costs will apparently be ignored in calculating the tax liability.”

Thus, the new tax strips reward without fully taking into account risk. Those companies that have their key assets overseas may see the new imposition as a benefit, increasing the relative attractiveness of their stocks. Those with asset bases in Australia may now be regretting their decision. To assume that this will not influence future behaviour is foolhardy at best and negligent at worst. In this new risk sharing arrangement, the industry has gained a not-so-silent partner who wants to be handsomely rewarded without having been exposed to the risk.

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