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## GOVERNMENT PLANTS A BOMB

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Resources companies will suffer volatility in coming months as the industry holds urgent talks with the federal government over its proposed 40 per cent tax on mining profits.

Mining companies will be able to comment on the policy's design in July. BHP Billiton and Rio Tinto have already started work on a response.

As the two biggest resource groups in the country, there is considerable wealth at stake. UBS resources analyst Glyn Lawcock estimates that when introduced in 2012, the tax will reduce BHP's earnings before interest and tax by 15 per cent and Rio's by 18 per cent. For BHP that might amount to more than \$2 billion a year in additional tax.

Since the Rudd government announced the tax on May 2, industry leaders have galvanised in opposition. BHP chief executive Marius Kloppers warned it could threaten the viability of the \$20 billion Olympic Dam copper/uranium mine expansion in South Australia, as well as new coal projects in Queensland.

Fortescue Metals' Andrew Forrest has called the tax a nationalisation of 40 per cent of the mining industry and claims his iron ore company could never have succeeded had the tax been in place when he started building the business.

Rio Tinto has put under review its future iron ore and coal expansions and other companies have announced plans to review, suspend or shelve new mine plans or take their exploration and production focus overseas.

Investors have also been unsettled, with \$16 billion wiped off the value of resource companies in the first three days of trading after the announcement.



Industry auakes: Resource companies put their projects under review

"What a mess!" one fund manager has exclaimed. "The tax proposal represents a naive and complete lack of understanding of how the Australian people see the resources sector and the market. To single out one sector, where state royalties already deal with the intermediate level of taxation represents a federal grab that doesn't fit into the system. Now there are considerable worries within the markets about 'what next', as bank bashing could be this government's next port of call."

The chairman of BlackRock-managed resource fund Global Mining Investments, John Robinson, says the long-term change in the industry's profitability that the tax would bring and the sovereign risk issues raised by the application of the tax to projects means investors will have to review their portfolios. The fund, which has about 20 per cent of its portfolio weighted in BHP and Rio, will adopt a "wait and see approach" but Robinson says he would be "amazed" if the tax stayed in its current proposed form.

Macquarie Group economists have expressed concern the tax will force global investors to shift funds out of Australia, precipitating a fall in the value of the local dollar.

The two big industry concerns are the low hurdle rate before the tax kicks in and the application of the tax to existing projects, which were built on long-term models using the existing tax system.

UBS's Lawcock dismisses the government's assertion it is a tax on excessive profits: "This is not a tax that somehow targets 'super profits' of the mining sector; it is simply a tax on profits."

Under the proposal tax, anything miners earn over the return rate of a 10-year government bond – about 6 per cent – will be subject to the new tax but they will receive credits for state royalties in place and there are some other offsets such as start-up costs that can be used to lower the effective tax rate.

"While the new tax targets profit only, and the proposed impost will be offset by rebates and a cut to the corporate tax rate," Lawcock says. "We still regard this change as a large new burden that slashes miners' profits and dividends beyond 2012. The tax also threatens the viability of already approved projects and may even deter longer-term investment in Australian mining equities and projects."

The investment community has also been disturbed that in defending the tax, Prime Minister Kevin Rudd says it is fair as it takes money from largely foreign-owned firms and redistributes it to all Australians (he signalled out BHP and Rio in comments).

Southern Cross Equities head of dealing Charlie Aitken says that with its low population base and savings, Australia relies on foreign investment to fund growth. He says government attacks on telecommunications giant Telstra and the new proposed resource tax have wiped some \$82 billion off equities, affecting all super funds.

Aitken says it's ridiculous to ask people to put more into retirement savings while at the same time devaluing the assets backing those savings.

However, some analysts say the sell-down has been overdone and they expect a rebound in resource stocks in coming weeks as investors come to terms with the new tax and any conciliatory moves by the government to compromise on the detail of the new tax emerge.

Of primary concern to miners is moving the hurdle rate higher before the tax takes effect. The government says 6 per cent is an acceptable rate of return and any profits above it are "super" profits. That gives no weight to the risk that companies take in developing a project. Big resource projects take years to bring to the production stage and if the company gets the timing wrong the results can be disastrous – such as BHP having to close its \$4 billion Ravensthorpe nickel mine in Western Australia in 2008 just a year after mining started.

Given the boom-bust cycle of the commodities market, companies often have to decide whether to develop a project when prices are poor and demand slow, so as to be ready for when the company believes the cycle will turn upwards again.

The Prime Minister also argues marginal projects will be more viable as they will not be earning "super" profits and so will not adversely affected by the new tax. However, no responsible mining company would put large amounts of capital at risk for a long-term rate of return anywhere near 6 per cent. On a risk-reward basis, shareholder wealth would be better protected by simply buying government bonds.

Under the proposed timetable for the new tax, the final design paper is expected to be released late this year, with draft legislation tabled in mid-2011 and legislation lodged in federal parliament in late 2011 with the tax starting in mid-2012. That means there will be an election before the tax is enacted and the opposition says it will oppose the tax in its current form.

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Damon Frith is a former senior business writer for The Australian Financial Review and The Australian. He joined BRW after five years freelancing from Western Australia. His impeccable contacts and more than 20 years dealing with the business community delivers insight into corporate takeovers and developments, and analysis of the new pathways being pursued by business.

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