



*Insight beyond the rating.*

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## Is the Pen Mightier Than the Sword? – a New Round of Taxes Appears to Be Looming in the Mining Sector

A proposed Australian Resource Super Profits Tax (RSPT), which has been re-jigged as the Minerals Resource Rent Tax (MRRT), appears to have brought down a sitting prime minister and led to a federal election call in that country. Miners get very uncomfortable when mining taxation makes the headlines and they begin to question, Why now, why us, what is fair and will it ever stop?

To the debt investor, it looks like someone is after a bigger slice of the pie, leaving less to satiate the service needs of their investments. The question is whether the potential Australian tax will trigger broad-scale higher taxation in what is otherwise an industry with a positive long-term economic outlook.

Political risk, including resource taxation, has long been an important consideration in rating mining company debt. You can't take a mine out of a country, but a mining company can choose not to stay. Miners need to go where the ore bodies are. Once found and the mine infrastructure developed, mining companies are subject to the rules and regulations of the nations in which they operate. Ore bodies don't respect political boundaries, so mining companies make active choices where to explore and, if successful, where to mine.

From a rating perspective, political risk is the broad term used to assess the share of expected income from an operation that may be demanded by legislation (at its best) in the operating jurisdiction and (in its most extreme) at the point of a gun. Many mining jurisdictions may tout social stability and just rule of law as harbingers of low political risk, which they can be, but they don't necessarily eliminate political risk. The importance of resource income to governments, the country's fiscal needs and the country's tax legislation history are all factors that contribute to the assessment of political risk.

Tax stability is important to mining operations. The life cycle of a mining project can easily last more than 30 years, with more than ten years of exploration, development and construction activity before any income is generated. High up-front capital costs mean that debt normally peaks early and, with successful projects, is repaid over time. Debt investors get nervous when the tax rules change before they have recovered their investments.

Resource taxation is competitive among political jurisdictions. Almost all political jurisdictions consider that resources are owned by the "people" as embodied by the government. There may be exceptions, such as freehold mineral rights in some Canadian jurisdictions, but even those can be subject to government taxation in one way or another. Governments lease their potential mineral endowment to prospective mine finders and developers. The real question becomes how the wealth derived from resource extraction will be shared among the owner, developer and governments. Economists often term this the resource "rent" issue.



In recent years, the value of resource development has been widely recognized and political jurisdictions have competed to have fiscal regimes that stimulate investment. Jurisdictions that don't have competitive tax and regulatory regimes for mining have suffered a lack of investment and development despite being highly prospective from a geological point of view – British Columbia in the 1990s and much of the last ten years comes to mind as an example.

The proposed RSPT would have had a negative impact on Australian miners and the riskiness of their debt issues. The proposal arose out of the 2000–2008 period of growing prosperity in the mineral sector as lesser developed countries industrialized and urbanized. The economic and financial crisis of late 2008 and early 2009 has led many governments to seek new revenue to cover growing costs, including stimulus spending, and to replace the loss of income caused by the economic downturn. The mining industry, with many large players, suffered less and recovered faster than many other industries, making it a seemingly logical target to meet government fiscal needs.

Accordingly, it was neither unique nor entirely a surprise when the Australian government announced the RSPT in early May 2010. The RSPT was part of a package of loosely defined proposals that would significantly have increased taxation for big Australian miners in general but also introduced a number of measures that would have helped smaller companies and reduced income tax rates. Under the RSPT, the government's share of mining company income would have increased from the low 40% level to more than 55%. The Australian government took pains to point out that profit-based taxes were fairer than royalties (often charged by state governments) and that other well-known mining jurisdictions, such as Canada and Nevada, had moved to similar profit-based resource rents.

The industry reaction to the proposal was swift and harsh. Some of the biggest players in Australian mining (BHP Billiton plc, Rio Tinto Plc and Xstrata plc) made their views known widely and publicly. Many industry players announced they would re-examine their proposed Australian investments. Industry concerns revolved around several key issues:

- The international competitiveness of the Australian mining tax regime.
- The fairness of increasing rents on projects already built.
- The blanket nature of the proposal (largely on all non-petroleum minerals).
- The nature of profits that were to be subject to the tax (basic mine-mouth profits or full mineral supply-chain profits).

It only took the Australian government a couple of weeks to realize it had a tiger by the tail in its proposed RSPT and to admit it was willing to seek “middle ground” between the RSPT and what the industry might find more palatable. Part of the issue was the potential impact of the RSPT on the taxing capacity of the resource-rich state governments of Western Australia and Queensland. In the end, the RSPT was scrapped (as was the prime minister who proposed it) and replaced by the less aggressive MRRT in early July 2010.

Under the new MRRT proposal, tax rates will be lower and only apply to iron ore and coal; however, some offsets included in the RSPT that would have been helpful to smaller companies have been dropped (the details of the proposal have yet to be released). The response from industry to the MRRT has been cautious but favourable, deeming it a good reference point for further discussion on taxation. The whole matter became somewhat moot when the Australian called a federal election on July 17, 2010, before any further meaningful discussion on the MRRT could occur or any legislation be passed.



These Australian resource tax proposals may represent a swing of the pendulum to higher resource taxes (or worse) around the world. Although the MRRT is on hold until after the election on August 21, 2010, the cat is out of the bag and other jurisdictions have been watching and are sure to react to the same circumstances. In mid-May 2010, Chile proposed an increase in mining taxes, ostensibly as part of a financing package to help pay for the post-earthquake cleanup. The proposed tax increases were modest and accompanied by a promise of tax stability for several years. The mining tax proposals in the financing package, however, were defeated for not being tough enough. The government is planning to modify the proposal to get it passed. On March 30, 2010, Québec, in response to the same need for funds as Australia and the success of its mining industry over the last decade, announced an increase from 12% to 16% by 2012 in its tax rate on resource income.

It is probably fair to assume that the period of stable-to-decreasing tax burdens in the mining industry has come to an end and further increases can be expected. It is difficult to say how far the pendulum will swing, but it is hoped that enlightened jurisdictions will be judicious in their tax levies – killing the golden goose does no one any good. From a global perspective, miners can be content that these tax increases are a far better alternative than Venezuela's vexatious plans to seize aluminum, iron ore and other metal operations from firms in its Guayana region.

The near-term rating impact of the tax changes will likely be small. The companies that would be most affected by the passing of the Australian MRRT are among the largest and most diversified in the world (BHP Billiton, Rio Tinto, Xstrata and, potentially, Alcoa Inc., if bauxite is included in the mix). Over the longer term, these companies have the ability to focus their investments in jurisdictions that promise the best combination of geologic and mining potential and appropriate fiscal regimes. They also generally have a significant degree of profitability. For them, the price volatility of metals will have more of an impact on their available cash flow than tax obligations. Similarly, in jurisdictions where taxes have increased or may increase, mining companies should be able to adjust their operations to mitigate the impact of higher taxes. Eventually, higher tax rates will lead to lower investment and higher metal prices, pushing the main impact of tax change to customers.

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