Fortescue
The New Force in Iron Ore

Company Insight
the intelligent market update

## Fortescue Metals Group Limited

## Date of Lodgement: 17/11/11

# Title: "Company Insight – Update of recent MRRT Analysis"

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**Highlights of Interview**

Fortescue Metals Group Limited (ASX code: FMG, market capitalisation A$15 billion) Chief Financial Officer Stephen Pearce:

- Discusses the analysis of the MRRT conducted by industry and Fortescue
- Pinpoints fundamental weaknesses in Commonwealth's MRRT projections, identifies the likely revenue 'black hole' faced by the Commonwealth
- Identifies Fortescue's likely MRRT liabilities over the next few years.
- Outlines Fortescue's fundamental objections to the proposed MRRT and why it should be scrapped, or at least amended
- Clarifies Fortescue's corporate tax obligations and payments

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**Record of interview:**

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Fortescue has been a very vocal opponent to the proposed MRRT, can you provide some insight into the company's main issues and concerns.

**Chief Financial Officer, Stephen Pearce**
The starting point for our concern is that good tax reform should be broad-based and simple. The proposed MRRT is neither of these as it reflects a politically expedient outcome rather than one based on good economics, arrived at through a proper consultative process. Our vocal opposition is based on a desire to ensure the Australian public is aware of this. Until the proposed legislation is enshrined into law, we have a chance to have this poor reform scrapped or at least remedied for the many inequities that are inherent in the initial drafting.

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Specifically, what are these inequities, as I understand both the Association of Mining and Exploration Companies (AMEC) and Fortescue have conducted considerable analysis on the impact of the MRRT? What is the nature and extent of that analysis? And what are the key findings?

**Chief Financial Officer, Stephen Pearce**
Our work, and the investigations of the independent advisors to AMEC, has involved substantial modelling and analysis of the MRRT covering the positions of the large industry players and the smaller miners. The modelling assesses the potential tax liabilities of these miners, using company information lodged with the Australian Stock Exchange.

There are several key findings. First, there are significant flaws in the Government's assumptions which make impossible the Commonwealth's MRRT revenue raising projections. Secondly, the tax is incredibly complex, so the likelihood is that many mining companies will be bogged down in Court for years to seek clarity as to how this tax will apply. Thirdly, the tax itself is simply bad policy and the secretive manner of its development is deplorable and its manifest unfairness is shameful. Finally, putting a tax on iron ore and coal is just the 'thin edge of the wedge' - it will clearly be extended to become an additional tax on many other minerals over time.

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The Commonwealth Government is forecasting MRRT receipts of A$11 billion in the first 3 years of the tax, a figure that critically underpins the Government's budget position. What are the reasons why you think the Commonwealth's MRRT estimates are wrong? What does your analysis show?

**Stephen Pearce**
The Government's stated collection of $11 billion over the first three years is wrong because of two key assumptions they've used:

1. The value of the mining rights deduction of the three majors.

2. The timing of those deductions.

The analysis clearly shows that these two factors combine to obliterate the MRRT payable by the majors over that period.

I'll explain why.

First, on the value of the mining rights deduction, the BDO analysis utilised the BHP/Rio joint venture valuations of over $100 billion from around June 2009. These are figures that BHP and Rio used and agreed between themselves. Even with this conservative valuation from 2009, the mining tax will not be payable. The huge deductions that these values provide simply means that no tax will be payable by the majors.

Secondly, the Government thinks these deductions will be made over a maximum of 25 years, whereas in fact the reserve mine life is significantly less than this. This information comes straight from the BHP and Rio Annual Reports. You can see for yourself that Rio's average reserve life is just under 12 years and a significant part of BHP's production also has 12 years of reserve life.

Since the value of mining rights is deducted over the shorter of mine life or 25 years under the MRRT, this means that massive deductions –likely to be hundreds of billions of dollars - will now be deducted over a shorter period than the government assumes.

In other words, the key conclusion is that the billions of dollars of mining rights deducted over a short period of time will shelter the iron ore divisions of BHP and Rio from the MRRT.

Moreover, the smaller miners who do not have these large deductions will end up bearing the larger part of the burden, and will pay a much higher effective tax rate.

We think Wayne Swan is dead right on one point and that is that MRRT tax collection estimates are hair-trigger sensitive to tiny changes in underlying assumptions. Our modelling tells us this. The net result is that it looks like there is a very large ‘black hole’ in the Commonwealth’s estimates of $11 billion, an amount they are relying on and have booked into recurring expenditure plans.

It is a little difficult to comment further because the Commonwealth has not released its numbers, and the Government’s deal with the three majors was reached in secret negotiations. Regardless, we do know the Government has announced projections of $11 billion for the first three years of the tax, and based on both our and independent analysis, we clearly believe the Government won’t raise anything like that.

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But what about Fortescue’s own MRRT position - given your extensive reserve position, doesn’t that mean you will pay only nominal MRRT also?

**Stephen Pearce**
Yes, that’s right. Inadvertently, as Australia’s third largest iron ore producer, we seem to have the benefit of the secret negotiations of the three large companies with the Government. So, while we will pay billions of dollars in government royalties and corporate tax, we will not pay significant amounts of MRRT because of the shelter provisions that seem to be in place.

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So – if it’s not the ‘big boys’ - who’s going to be paying the tax?

**Stephen Pearce**
I’d love to know the answer to that question - because from the work we’ve done, it looks like the little guys.

These small producers are the backbone of the Australian resources industry. They will pay the lion’s share of the tax and we believe that is grossly unfair. And that’s because the tax has been deliberately constructed so that the large guys can avoid having to pay their share.

This is just not fair. With this added cash flow impost, smaller companies will now have a much harder time in financing project start-ups. The flow-on effect to regional Australia will be enormous in terms of jobs, infrastructure and regional communities. If projects can’t be financed and can’t proceed, regional Australia will suffer, and so will Australians generally.

To give you a specific example – if the MRRT had existed when Fortescue was looking to get its projects off the ground – then Fortescue would not exist today. I’ll put that in perspective - since then we have invested billions of dollars, created thousands of jobs, paid hundreds of millions of dollars to Governments, and we’re about to pay billions of dollars in tax and royalties. None of that would have existed if the MRRT had been around.

So those exact same benefits – all those permanent employment, social and community benefits that their future projects will bring - will never eventuate because of the extraordinarily bad and short-sighted MRRT.

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What, then, does Fortescue propose should be done?

**Stephen Pearce**
Fundamentally, we believe the tax should be scrapped. It is bad policy and a very poor example of how reform should be implemented with secret negotiations between a few select industry players that masqueraded as broad consultation. Scrapping the tax also means avoiding the gross unfairness to the junior resource companies. Finally, since the Government has conceded so much revenue in its secret negotiations – it is reasonable to conclude that the tax on iron ore and coal is just the ‘thin edge of the wedge’. Why? Simply, because the black hole will need to be filled. It must follow, therefore, that the MRRT will be extended to other minerals and projects.

But if the tax isn’t scrapped, at the very least there should be an equalisation regime included in the structure of the tax so that the smaller miners are protected and do not pay a higher % tax rate than the larger miners. With this amendment the smaller miners will not by virtue of the MRRT be placed at a competitive disadvantage relative to the big players in developing their projects and selling their product into the marketplace.

We believe this amendment can be very simply incorporated into the structure. But the best course, we believe, is to scrap the tax and look for a simple, fair solution.

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What are the effects of the equalisation regime that you propose?

**Stephen Pearce**
If we’re right in our analysis, the smaller miners will be protected. If we’re wrong, there will be no harm in this amendment because they will be paying the same rate as the larger miners. So it’s a very simple ‘no-lose’ approach for the Government - to ensure that the smaller end of the resources sector can prosper - and continue to provide the benefits that they bring.

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One final point – there is developing insinuation that Fortescue doesn’t pay any tax. What is the accurate position?

**Stephen Pearce**
The suggestion that Fortescue does not pay tax is profoundly untrue.

On present estimates Fortescue will contribute corporate tax to the Commonwealth of about $800 million arising from our operations in 2012, rising to $2.35 billion for 2015. These are extremely significant contributions. We will also pay State Government royalties to Western Australia of about $400 million in 2012, rising to $1.200 billion in 2015. Additionally, we will be paying somewhere between nil and $60 million in MRRT over the next 3 years.

And - as our business expands - these extraordinary contributions to Government will increase even further.

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So, how would you summarise Fortescue's and AMEC's case against the proposed MRRT?

**Stephen Pearce**
The extensive modelling and analysis has produced several key findings. First, the tax is simply bad policy and the secretive way it was negotiated compounds this problem. Secondly, the tax is incredibly complex, so years of pointless litigation is likely in attempting to obtain clarity. Thirdly, the major flaws in the Government's assumptions means the Commonwealth's revenue raising projections are badly wrong. It is grossly unfair to the junior resource companies and the 'black hole' means this tax on iron ore and coal must be just the 'thin edge of the wedge'. It will clearly be extended to the other minerals.

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Thank you, Stephen.

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