

Australian Coal Conference

Coal Taxation in NSW

**Implications for a Sustainable Industry:
Killing the Goose that Laid the Golden Egg?**

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Oscar Wilde once said that “an idea that isn’t dangerous is hardly worth having”. Until I joined the NSWMC, I’d always subscribed to that view, but I must confess that the very dangerous ideas that the NSW government has in respect of coal taxation don’t appear to qualify as ones worth having. As the title of my presentation suggests, I believe the State Government must reassess its position - otherwise it may well emasculate one of its most important revenue streams, a significant driver of the economic and social health of regional NSW, the engine that is powering the quality of life that we enjoy and the State’s future prosperity.

Fighting words you may think, but for too long this fabulously productive and entrepreneurial industry has weathered the relative indifference and sometimes capricious regulation of government. Much greater recognition of the consequences of government action is needed if the economic sustainability of the industry is to be truly nurtured in an increasingly complex and competitive marketplace.

Coal royalties are the major form of direct taxation levied by the State Government on the industry: so I want to look in some detail at the new regime and the issues relating to it. However, I’m going to take some licence with the definition of taxation and also touch on government imposts, regulation and the like which add to costs and so, in effect, are similar in nature to a tax. Under this broader definition, I want to mention workers’ compensation costs, the NSW Government’s greenhouse benchmark scheme for electricity retailers and the development approval process for new projects.

1. Profitability

As a general statement, current coal prices are the best they’ve been for a number of years, although, as exporters no doubt point out to their customers, contract prices are still below the level of the early 1990s in real US dollar terms.

It’s also generally acknowledged that current industry profitability is good and commentators seem to agree that the immediate outlook is for continued healthy profitability.

However, as those of you who have been involved in the coal trade for some time know, the industry has a chequered history in terms of profitability. Market conditions can, and regularly do, change. There is no guarantee (but lots of hope) that current profitability levels will be sustained into the long term.

As an indication of the potential for conditions to change, in a recent publication, AME Mineral Economics pointed out that - in relation to semi soft coking and high vol PCI coals – in Asian markets, China has a significant average cost advantage over Australian (and Canadian) suppliers. AME suggests that a future domestic market downturn in China could see low cost Chinese exports surge, at the expense of their higher cost competitors. And

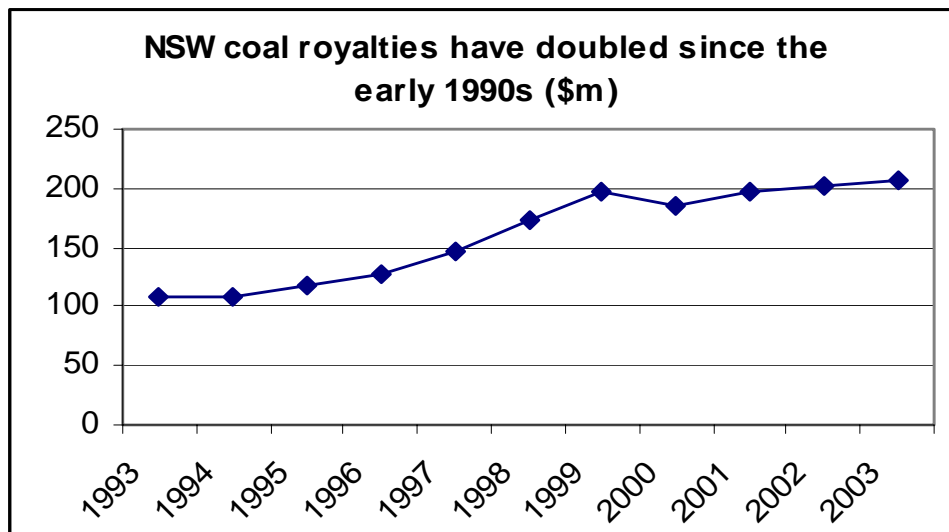
where China is currently a hungry importer, AME notes that foreign investment in dedicated export mine projects could ultimately result in a significant increase in Chinese semi soft coking and PCI coal exports. So caution is advised.

Over the last ten years or so, the NSW coal industry has achieved an after tax rate of return on shareholder funds of around 7% per year. That's comparable to the average long term bond rate and, whilst the bond rate is a pre tax rate, the coal figures don't indicate a highly profitable industry or an unlimited capacity to either pay higher taxes or to continuously absorb other imposts.

2. Coal Royalties: The Old Regime

The old royalty regime in NSW was a fairly simple one which had remained unchanged for many years. All producers paid a standard rate of \$1.70 per tonne of coal, with many open cut mines also paying an additional 50 cents per tonne. Adjustments for moisture content meant that effective rates were slightly lower.

With steady growth in production, that regime produced a very healthy revenue stream to the NSW Government: rising from just over \$100 million in the early 1990s to over \$200 million in FY 2002 - 03.



3. Coal Royalties: The New Regime

The NSW Treasurer, Michael Egan, introduced a mini budget in April this year, in which he announced a major overhaul of the coal royalty regime. Since July this year, producers are paying an ad valorem royalty – one based on the value of the coal rather than the volume. Minister Egan stated that Government expected to collect an additional \$44 million in FY2004 - 05 from the industry. He was projecting increased revenues to Government of around 20%.

Under the new regime, there are now three royalty rates:

- 5% for deep underground mines (i.e., those with more than 400 metres cover);
- 6% for other underground mines; and
- 7% for open cut mines.

These rates now apply to the “ex mine” value. Very simply, the ex mine value is calculated by taking the sales value of the coal and deducting costs such as coal washing, rail freight to the port, loading costs and industry levies.

Unsurprisingly, the industry has major concerns regarding this new regime not only relating to the costs but also the differential rate structure.

3.1 The cost to the industry

Rather than the \$44 million per year which the Treasurer originally anticipated, a recent NSW Minerals Council survey of members indicates that the additional revenue flow to the Government will be far, far higher.

In FY2002-03, royalties totalled some \$206 million. In FY2004-05, our members expect that this could jump by close to 80% (depending, of course, on assumptions about prices and exchange rates).

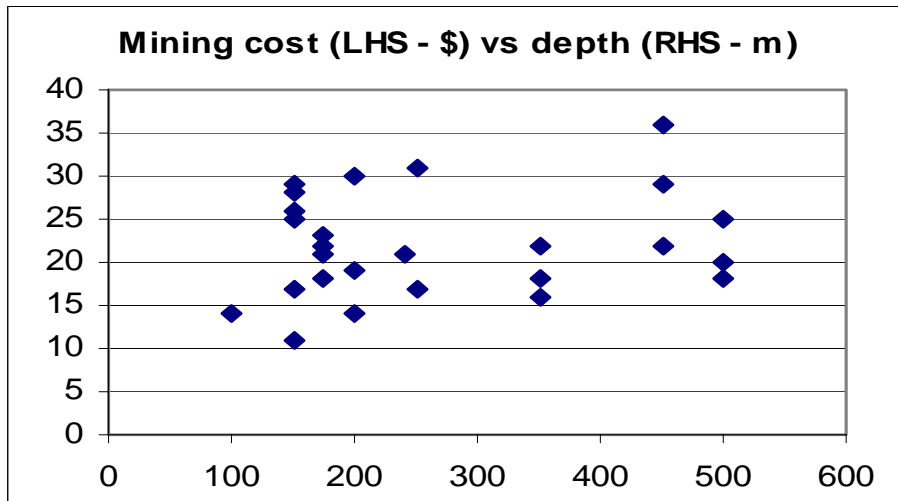
3.2 The differential rate structure

The Government states - and I’m quoting here from a Department of Primary Industry presentation - that the differential structure of rates takes into account the higher costs and greater difficulties and risks of underground mining relative to open cut mining.

As part of our response to this issue, the NSW Minerals Council asked mining consultants Minarco to provide a report on cost structures. Minarco concluded that there was, in fact, little correlation between depth of cover and mining costs.

They also concluded that the more profitable mines tended to have higher depth of cover and that, contrary to the government’s assertion, the new royalty regime will actually impose higher royalty costs on the least profitable mines.

The chart below compares the 26 underground mines in the Minarco analysis in terms of their ROM pit head mining costs – which are on the vertical axis - with their depth in metres – on the horizontal axis. As you can see, there is no clear correlation between costs and depth. Some of the deepest mines have very low costs, while some of the relatively shallow mines have above average costs.



Source: Derived from Minarco report

The decision to make the 400 metre depth the point at which the royalty reduces from 6% to 5% appears to be an arbitrary one – and, as you can see from the chart – benefits only a minority of mines.

There is also every indication that the differential rate structure of the new royalty system will disadvantage the open cut sector compared with the underground sector, and the shallower underground mines compared to those deeper underground. You don't have to be a rocket scientist to see that this has the potential to impact on relative profitability. Under certain market conditions, it could also impact on the ability of some mines to successfully win sales contracts. Some of you will no doubt recall, as I do, times when margins of 10 or 20 cents per tonne were critical in the winning or losing of contracts.

Furthermore, the calculation of the ex-mine value of production on which the royalty is payable, is quite complex. The Government - to its credit - agreed to a number of costs being included as eligible deductions, however there will be administrative costs involved for companies in accurately calculating ex-mine values each month and there will be extremely awkward administration issues for any mine which operates at varying depths. Mines will be required to track and record the production of coal from different areas of their operations and to apply different royalty rates according to the depth of those operations. No-one who understood the first thing about coal mining would have dreamt up such a clumsy and impractical requirement.

3.3 Comparisons with Queensland

Some in the Government have attempted to justify the new regime by comparing the NSW industry with that in Queensland.

The royalty rate in Queensland is 7% of the ex-mine value. If stated like that – without any understanding of market, product or logistics differences - the new rates in NSW seem comparable or even reasonable. Forgive me for teaching those of you familiar with the Australian east coast coal market how to suck

eggs, but let's look at the facts that seem to have escaped the eye of some in Government.

The first and most obvious difference is the dominance of hard coking coal in Queensland. Hard coking coal is a significantly higher value product compared with the steaming and semi-soft coking coals which predominate in NSW. That fact alone allows Queensland producers to – perhaps - more readily absorb a higher royalty structure.

Secondly, Queensland enjoys a geographic advantage over NSW, being much closer to our major export markets in Asia, and thus enjoys lower export freight costs.

Thirdly, if we look at the last four years for example, we have a workers compensation system in NSW with costs averaging 3 times greater than those that prevail in Queensland.

Clearly, the comparison with Queensland is spurious and does not provide a basis for sound policy in this area.

4. Other Industry Imposts

4.1 Workers' Compensation

The NSW coal industry is the victim of a monopoly workers' compensation scheme. The benefit schedule is significantly higher than that of Queensland primarily because the NSW coal industry has been isolated from reforms. This monopoly – enshrined in legislation – not only differentiates our sector from mainstream business in NSW, it does so at massive competitive disadvantage for NSW companies compared to their Queensland counterparts.

The industry has fought long and hard to reduce the costs of the scheme run by CSPL. Individual companies – and indeed, the industry as a whole - have worked with vigour and determination, in partnership with their employees, to improve safety with resulting dramatic reductions in the numbers of injuries and claims but without a concomitant reduction in workers' compensation premiums. Indeed, the costs of claims have continued to rise. An August 2004 Ernst and Young Report found that the average premium rates for workers compensation in NSW coal are 16.4% for underground mines and 10.6% for open cuts. In Queensland, whilst the figures aren't precisely comparable, the rates are 4.8% for undergrounds and 1.5% for open cuts. Differential and separate regulation has not served the NSW industry well and it's difficult to see how such a monopoly can continue to be justified.

4.2 Greenhouse Benchmarks Scheme

The State Government's scheme to reduce greenhouse emissions requires electricity retailers to achieve a 5% per capita reduction in the emissions associated with the electricity they retail from FY1989-90 levels by FY 2006-

07. Additionally, that reduction must be maintained at the new, lower level for a further five years.

To meet the mandatory target and avoid costly penalties, electricity retailers must purchase electricity from less CO₂ intensive sources than coal or achieve emissions savings in other ways.

In announcing the go ahead for the scheme in May 2002, the Premier stated that total emissions at that time were over 15% above 1990 levels – although on a per capita basis, the figure would have been somewhat less. He also stated that the additional cost to consumers would be small.

This scheme was sold to the public as a low cost – or virtually pain free – way of reducing emissions. Whether the cost will be so low remains to be seen. If it does prove to be higher than the Government stated, there will be consumers and businesses wanting an explanation.

From the coal industry's point of view, the scheme, of course, impacts on the local market for coal. Depending on overall market conditions, there may well be implications for the price of coal in domestic markets. One thing is for sure – the scheme will not improve the domestic price for coal!!

The scheme also raises issues relating to the NSW Government's views on the long term role of coal in the domestic electricity generation market and, by definition, may sour the taste of investors and financiers for investing in coal projects. Those issues could impact on the availability and cost of finance in the long term.

4.3 Development Approvals and Environmental Controls

Over the last few years, in response to changing community expectations around the size, nature and longevity of the environmental and social footprint our industry leaves, the development approval process in NSW has become far more demanding. In itself, that is a legitimate government response. However, what is far less legitimate is the fact that the development approval process has become progressively more time consuming, labyrinthine in its complexity and exponentially more costly. New mines or major extensions of mines are still being approved, but the delays and cost impacts on the companies involved are significant as the capital requirements for new projects climb an ever steeper axis. When combined with increasingly stringent environmental controls and approval processes for ongoing mining operations, the impact on the cost structure of the industry becomes significant.

The industry has made and continues to make tremendous strides in improving its environmental management practices and is proud of its achievements to date. However there seems little recognition by Government that industries such as coal operate in fiercely competitive local and overseas markets and that, therefore, Government processes must themselves be

continually reviewed and streamlined if the benefits of a healthy coal industry are to be enjoyed.

5. Coal Industry Contributions and Benefits

From time to time, people ask me why it matters if the coal industry has to pay higher taxes and is subjected to more and more demanding regulation.

During this, the 21st century, the NSW coal industry has generated annual revenues to governments of close to \$1 billion per year. This figure will jump once the new royalty revenues are factored in. The \$1 billion includes royalties, payroll tax, company tax, PAYG taxes paid by employees, local government rates and other taxes. In addition, 100s of millions of dollars are spent by companies each year investing in their local communities – building social capital across the state.

In recent years, the coal sector has accounted for close to 20% of the State's export revenue: far ahead of the next most important commodity. With current coal prices in mind, that proportion will no doubt be even higher this year.

Although not a large employer (the industry has direct employment of around 10,000), it is a high value employer and there are major multiplier – or spin off – benefits. On the basis of national multiplier data, the industry in NSW generates around 30,000 to 40,000 jobs nationally.

Much of the industry's direct employment, and employment in related industries, is of course located outside the Sydney metropolis, in communities which now depend heavily on mining for their livelihood.

NSW also enjoys some of the most competitive electricity prices in the world, thanks to a coal industry which generates about 85% of the state's power. This has obvious benefits for a range of energy intensive industries such as aluminium, cement and steel. It also has major benefits for the average household's standard of living.

6. Sustainability

The coal industry clearly faces major challenges to its long term future, most notably from potential responses here and overseas to climate change.

This conference is not the time to explore the greenhouse challenge in detail, but let me stress that the industry is taking its role in a carbon constrained future very seriously and is working to ensure that coal has a legitimate place in a balanced energy mix.

Our Coal21 program is central to this issue and, as many of you will be aware, has attracted support from other key sectors including government, power generators and research institutions. The program has developed a national plan of action to guide Australia's involvement in the development and

deployment of low and zero emission technologies for coal. Recently the Federal Government endorsed the program and announced substantial funding of \$500 million to support pilot and demonstration projects for low emission technologies such as IGCC, oxy fuel combustion and CO2 capture and storage.

The challenge of sustainability of course is much broader than just greenhouse. It involves the challenge to remain financially viable and competitive with other suppliers and other energy sources. It also involves the challenge of acting with integrity and foresight to manage our social and environmental impacts and thus secure our licence to operate.

Governments have responsibilities to the community to raise revenue to pay for essential services and infrastructure and to provide an appropriate regulatory system in terms of environmental management, health and safety and the like.

Our industry accepts those government responsibilities and our accountabilities. However, killing the goose that lays the golden egg is not the answer.

Taxation regimes must be both administratively efficient and fair in their application.

Development approval processes must take account of community demands and interests but also involve minimum delays and costs.

Policy affecting the coal industry must take into account questions of international competitiveness, the underlying cost drivers of the industry and the price cyclicity of commodities.

My final shot across the bows would have to be to say that it's easy to extract taxes from the coal industry. But it would be impossible to fill the void if the unrestrained application of those taxes, in tandem with an incoherent regulatory regime, saw the widespread closure of mines and the diversion of investment into less hostile and more predictable operating environments.