PERFORMANCE EXAMINATION

Developing the State: The Management of State Agreement Acts

Report 5
June 2004

AUDITOR GENERAL
for Western Australia

Serving the Public Interest

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PERFORMANCE EXAMINATION – Developing the State: The Management of State Agreement Acts

This report has been prepared consequent to an examination conducted under section 80 of the *Financial Administration and Audit Act 1985* for submission to Parliament under the provisions of section 95 of the Act.

Performance Examinations are an integral part of the overall Performance Auditing program and seek to provide Parliament with assessments of the effectiveness and efficiency of public sector programs and activities thereby identifying opportunities for improved performance.

The information provided through this approach will, I am sure, assist Parliament in better evaluating agency performance and enhance Parliamentary decision-making to the benefit of all Western Australians.

D D R PEARSON
AUDITOR GENERAL
June 30, 2004

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Executive Summary

An Agreement is a contract between the State and a proponent, which is then ratified by an Act of Parliament. Agreements have been used for over 50 years to help facilitate private sector development of the State's natural resources. The Department of Industry and Resources (the Department) administers these Agreements, of which there are currently 64.

Key Findings

Agreements have delivered major projects however their success in delivering supplementary downstream processing is less clear. Agreement management has largely focused on facilitation and there is scope to use more robust and ongoing management practices:

- ***Nearly 90 per cent of current Agreements have delivered projects.***
- ***These provide the State with annual royalties of about $1 billion.***
- ***A 1995 government policy to remove iron ore royalty concessions, currently valued in excess of $40 million per annum, has not yet been achieved.***
- ***The State has had some success in using Agreements to develop further processing industries. However, notwithstanding efforts, benefits such as steel mills, pulp mills, aluminium smelters and petrochemical industries, have not yet been realised.***
- ***The Department has not methodically monitored how well companies discharge Agreement obligations to maximise the use of local labour, services and materials. In consequence, it is now difficult to demonstrate how effective Agreements have been in encouraging companies to maximise the use of local content.***
- ***The Department sees its role as primarily facilitative, establishing Agreements and assisting companies resolve government regulatory issues. While Agreements impose no explicit requirement for Agreement management, there is a need to:***
  - ***follow a structured process to evaluate how well Agreements are achieving their objectives and what lessons can be learned***
  - ***improve reporting to Parliament on Agreement status and performance.***

Key Recommendations

The Department should:

- ***develop a strategy, in consultation with industry, to implement government policy to phase out royalty concessions***
- ***adopt a structured approach to evaluating Agreement performance, including how companies discharge their obligations to maximise the use of local content***
- ***develop the reporting of Agreement status and performance to Parliament.***

About This Examination

In the 1950s, Western Australia was primarily an agricultural based economy with a massive untapped mineral resource. The natural resource sector is now the major driver of the State's economy, generating sales of $28 billion in 2002-03. Agreements are a key aspect of this industry. The examination reviewed the 64 natural resource related Agreements currently administered by the Department (Appendix II). The examination focused on:

- the extent to which Agreements have achieved their main objectives
- the effectiveness of their administration.

The State's project development approvals process was not examined as it is currently under Ministerial review.

About Agreements

An Agreement is the outcome of a negotiating process between the State and a private sector company. The resultant contract is presented, as a Schedule to a Bill, for approval ('ratification') by Parliament. Parliamentary ratification means that Agreement provisions, where they are inconsistent, may override the existing statutory laws of the State. Agreements commonly include:

- obligations accepted by the company to develop the project, often with significant associated capital infrastructure, within a reasonable timeframe
- obligations accepted by the company to support State economic growth and create jobs by:
  - maximising the use of local labour, services and materials
  - establishing further processing industries, if commercially viable
- the granting by the State of a range of concessions and exemptions from existing statutory law such as, royalty and rental concessions, exemptions from stamp duty and the obligation to lodge environmental bonds, restrictions on local and State government land rating, zoning and resumption powers
- an undertaking that the Agreement will not be subsequently amended by the State, without the concurrence of the company, for its duration (typically several decades).

Agreements Have Delivered Major Projects

The development of a project is the primary objective of an Agreement. Without a project, the State will receive neither royalties, taxes, job creation nor other economic and social benefits.

Departmental records indicate that 56 of the current 64 Agreements (nearly 90 per cent) have developed into projects. Agreements have therefore played a significant role in facilitating the State's economic growth and its emergence as an internationally recognised supplier of natural resources.

Of the remaining eight Agreements, three had projects that have been discontinued. The future of the other five that have so far not delivered projects is unclear. These five Agreements were ratified over 30 years ago and the regulatory framework created by these Agreements is dated.

The main direct economic benefit that the State receives from mining projects is royalty revenue – worth about $1.15 billion in 2002-03, of which nearly $1 billion came from Agreement projects.

The existence of concessionary royalty rates, without effective end-dates, in most iron ore Agreements has hindered the implementation of a 1995 government policy to remove royalty concessions. The value of these concessions is reported in the State's budget papers as being in excess of $40 million per annum.

The State has sought to encourage the development of further processing industries, beyond the direct shipping of unprocessed ore to export markets. Twenty-four Agreements contain provisions which provide for companies to establish and operate such industries. The further processing outcomes sought in some Agreements are explicit (for example, establish a mill or a smelter) whereas in others the outcomes sought are less clear (for example, investigate further processing opportunities). In all these Agreements, further processing obligations are subject to their commercial viability to the company.

The State has had some success in using Agreements to develop these more labour intensive and value adding further processing industries. Companies have also undertaken significant studies to investigate the commercial viability of further processing opportunities. Notwithstanding efforts, benefits such as steel mills, pulp mills, aluminium smelters and petrochemical industries, have not yet been achieved.

The Department has not methodically monitored how well companies discharge Agreement obligations to maximise the use of local labour, services and materials. For example, several companies that stopped submitting required local content reports were not followed-up. In consequence, it is now difficult to demonstrate, across the range of Agreements, how effective they have been in encouraging companies to maximise the use of local content.

In order to better manage local content outcomes in the future, the Department advises that it is considering requiring companies to submit forward procurement plans. This will be a positive step, particularly if the Department follows through this initiative with detailed monitoring and analysis.

Ongoing Agreement Management Can Be Improved

The Department sees its role as primarily facilitative – drafting the Agreement, Cabinet submissions and relevant legislation; overseeing the development of the project; and assisting the company resolve government regulatory issues that arise over time.

While Agreements establish a contractual relationship between the State and a private sector company, with rights and obligations on both parties, they place no explicit requirements on the Department for Agreement management. There is however scope to apply more robust management practices to Agreements as:

- The State now has a mature and internationally significant natural resource economy and is committed to better balancing economic, social and environmental objectives.
- The principle of outcome-based management and reporting is established and the public demands high standards of accountability.

The Department applies existing resources to a primarily facilitative approach and does not follow a structured process to evaluate how well Agreements are achieving their objectives, where they have succeeded and failed and what lessons can be learned.

Mining can be a high risk activity, creating many challenges and opportunities for the State. Departmental project managers have a keen sense of the importance of their job and of their responsibility to protect the State's interests. However, the Department has not yet adopted a systematic and comprehensive approach to identifying, assessing and managing Agreement risks. This is because most Agreements were established long before modern risk management principles and practices were developed. The importance and value of the natural resource sector to the State now warrants a more rigorous and systematic approach to Agreement risk management.

The need for earlier Agreements was reasonably self-evident but it is unclear why some later projects were established under Agreements. There has been little written policy to guide when and why Agreements should be used, however, Government issued an industry policy – *Building Future Prosperity* – in January 2004. Its release provides an opportunity for the Department to develop clearer criteria to guide the future use of Agreements in order to better ensure consistency, equity and transparency.

The State owns the natural resources and Parliament ratifies the Agreements to facilitate and regulate their development, yet Agreements contain no provisions for reporting their status and performance. Because of the wide scope of the Department's operations, Agreements get limited coverage in Annual Reports. By comparison, public companies have to comply with continuous disclosure obligations to meet the information needs of their shareholders.

The Department has not developed structured procedures and guidelines to assist its staff manage Agreements, once established. It has compiled a collection of documents that warrant developing into comprehensive guidelines regarding key Agreement management tasks.

The Department does not have a suitable management information system to compile, analyse and report Agreement status and performance information. The Department acknowledges this situation and advises that it is being addressed. This current situation, aside from not routinely providing meaningful reporting, limits the Department's ability to implement structured evaluation and more purposeful management practices.

About Agreements

What Are State Agreement Acts?

State Agreement Acts (Agreements) are powerful contractual and regulatory arrangements. Agreements have primarily been used as a policy tool of Australian governments to encourage and facilitate major natural resource projects. While all States have used Agreements, their greatest use has been in the resource rich States of Western Australia and, to a lesser extent, Queensland.

An Agreement gives a private sector company exclusive rights to develop a natural resource (owned by the State) in return for the company undertaking to establish and operate a resource project. In addition to being an economic development policy tool of government, Agreements are also:

- a contract between the State and the company containing financial and non-financial concessions granted by the State in return for project obligations accepted by the company (see Appendix I)
- a regulatory mechanism that 'defines the rules' under which a specific resource project will operate.

An Agreement is the outcome of a negotiating process between the State and a company. The resultant contract is signed by the Premier and the company before being presented, as a Schedule to a Bill, for approval ('ratification') by Parliament. The provisions of the ratified Agreement, where they are inconsistent, may override the existing statutory laws of the State, for example the *Mining Act 1978* and the *Land Administration Act 1997*.

Agreements do not specify the detail of the proposed resource projects. This detail is provided in later developed project proposals, which the company submits for Ministerial approval. Most Agreements also provide for the company to submit additional proposals for Ministerial approval, at any time during the life of the Agreement, if it desires to significantly expand or vary its activities.

Agreements are binding on both the State and the company for their duration, which is often many decades. The term of the Agreement can be tied to the term of the mining lease, typically up to 63 years, or it can be for a fixed term. The term of some Agreements is indefinite, with no stated end date (Figure 3). All Agreements contain a provision that they cannot be subsequently amended without the consent of the parties. For Parliament to act unilaterally could be seen as a breach of good faith and detrimental to the State's reputation and interest. Ultimately however, Parliament's authority to amend or repudiate its legislation cannot be shackled. Audit did not examine the sometimes complex legal and constitutional context of Agreements.

Agreements are administered by the Department of Industry and Resources (the Department) as part of its mission to *"advance the responsible development of the State's industry and resources for the benefit of Western Australians"* (Annual Report 2002-03).

The Importance of Agreements

In the 1950s, Western Australia was primarily an agricultural based economy with a massive untapped mineral resource. The natural resource sector is now the major driver of the State's economy, generating sales of $28 billion in 2002-03. These sales accounted for the majority of the State's merchandise exports of $32 billion, which represented about 30 per cent of the nation's total exports in that year.

The State is a major mineral exporter in a very competitive global economy. Western Australia supplied the following percentage quantities of world production in 2002: diamonds – mainly industrial (29 per cent); alumina (20 per cent); nickel (18 per cent); iron ore (16 per cent); gold (8 per cent); LNG (7 per cent) and mineral sands such as zircon (32 per cent), rutile (28 per cent), and ilmenite (19 per cent).

With the exception of gold, most of these mineral exports are produced at projects established and operated under Agreements. They include major projects such as the North West Shelf natural gas processing projects, the Pilbara iron ore projects, the bauxite and alumina projects, nickel refining and smelting and the Argyle diamond mine.

Western Australia currently has 64 natural resource related Agreements (Appendix II). Industries covered by current Agreements are shown in Figure 1. The decade Agreements were entered into is shown in Figure 2. The estimated lifespan of current Agreements is shown in Figure 3.

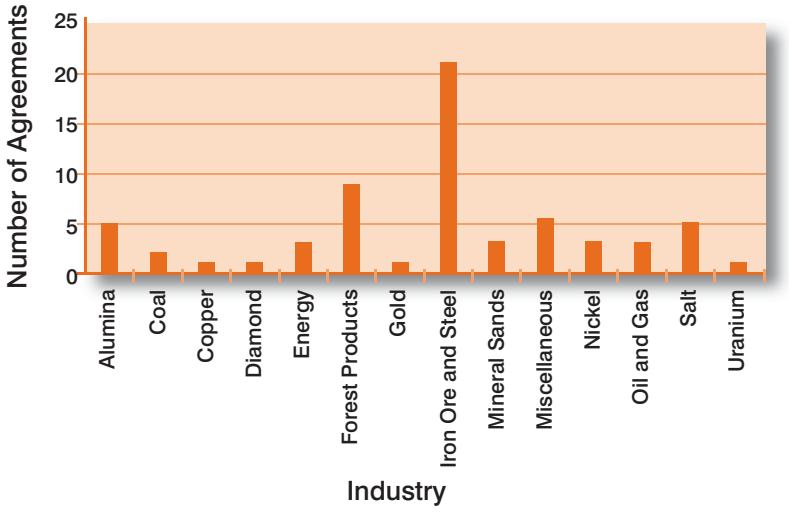

Figure 1: Current Agreements by Industry Group

Agreements are used across a wide range of natural resource industries.

Source: DOIR

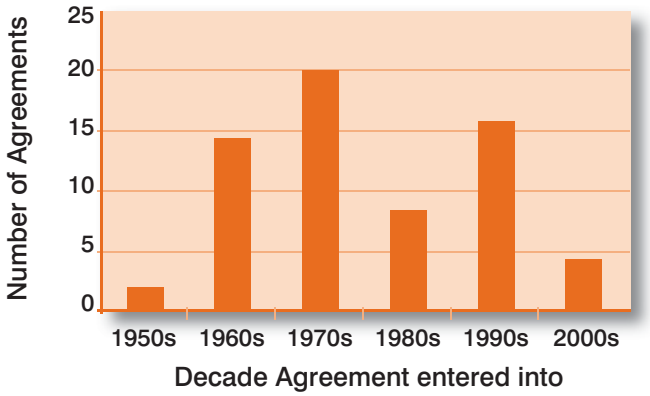

Figure 2: Start Dates, by Decade, of Current Agreements

Most current Agreements commenced during the State's mining resource boom of the 1960s and 1970s. However, new Agreements continue to be introduced by successive governments.

Source: DOIR

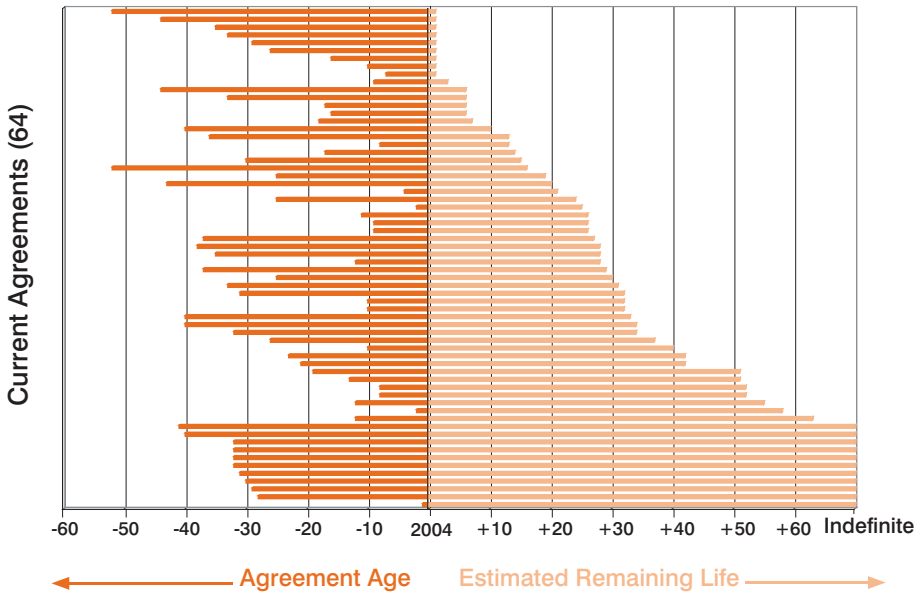

Figure 3: Estimated Lifespan of Current Agreements

The rights and obligations arising from Agreements can continue for many decades.

Source: DOIR and OAG

Agreements Have Delivered Major Projects

Findings and Recommendations

Findings

- *The use of Agreements has achieved the aim of facilitating development of major natural resource projects, and associated infrastructure. Departmental records indicate that 56 out of 64 Agreements (nearly 90 per cent) have progressed into projects.*
- *Agreement projects provide the State with annual royalty revenue of nearly $1 billion.*
- *A 1995 government policy to remove iron ore royalty concessions, valued in excess of $40 million per annum, has not yet been achieved.*
- *The State has had some success in using Agreements to develop further processing industries. However, notwithstanding efforts, benefits such as steel mills, pulp mills, aluminium smelters and petrochemical industries, have not yet been realised.*
- *The Department has not methodically monitored how well companies discharge Agreement obligations to maximise the use of local labour, services and materials. In consequence, it is now difficult to demonstrate how effective Agreements have been in encouraging companies to maximise the use of local content.*

Recommendations

The Department should:

- *develop a strategy, in consultation with industry, to implement government policy to phase out royalty concessions*
- *actively monitor how companies discharge their obligations to maximise the use of local content.*

Main Agreement Obligations

The main obligations commonly accepted by companies in Agreements are to:

- develop the project as proposed within a reasonable timeframe
- pay royalties to the State at rates prescribed in Agreements or in the *Mining Regulations 1981*
- deliver wider economic benefits by:
  - seeking to establish value added 'further processing' industries within Western Australia, if commercially viable
  - agreeing to maximise the use of local content for labour, services and materials.

Project Development

The development of a project is the primary objective of an Agreement. Without a project, the State will receive neither royalties, taxes, job creation nor other economic and social benefits.

Almost all Agreements oblige companies to develop detailed proposals for projects by a specified date (typically between one and two years following the ratification of the Agreement). Agreements also contain provision for the extension of these and other time deadlines.

Departmental records indicate that 56 of the current 64 Agreements have developed into projects (Table 1).

Status – Agreements with:	
Active Projects	48
Completed Projects [1]	8
No Development to Date:	5
Alumina Refinery (Mitchell Plateau) Agreement Act 1971 Iron Ore (Mount Bruce) Agreement Act 1972 Iron Ore (Rhodes Ridge) Authorization Agreement Act 1972 Iron Ore (Wittenoom) Agreement Act 1972 Iron Ore (Murchison) Agreement Authorization Act 1973	
Discontinued Projects	3
Total	**64**

Table 1: Status of Agreements Since Ratification [2]

Most Agreements have developed into projects.

Notes:

1. *The eight completed projects include five that have reached the end of their productive life and three that have been superseded by later Agreements.*
2. *Information on Agreement status was compiled by Departmental staff.*

Source: DOIR

Agreements have therefore played a significant role in facilitating the State's economic growth and development and its emergence as an internationally recognised supplier of natural resources.

The future of five Agreements that have so far not delivered projects is unclear. These Agreements were ratified over 30 years ago and the regulatory framework created by these Agreements is dated. For example, some contain outdated royalty concessions, others refer to square miles, pounds, feet and inches and one contains references to now repealed Acts. Should any company now develop project proposals under these Agreements, the relevance and appropriateness of the previously negotiated terms and conditions would need to be re-evaluated.

A further three Agreement projects were discontinued because of government policy decisions, project technical problems and/or company decision. These were the *Uranium (Yeelirrie) Agreement Act 1978*, the *Mineral Sands (Beenup) Agreement Act 1995* and the *Iron and Steel (Mid West) Agreement Act 1997*.

Royalty Revenue

The main direct economic benefit that the State receives from mining projects is revenue in the form of royalties. The State received royalty revenue of about $1.15 billion in 2002-03, of which nearly $1 billion came from projects covered by Agreements. (Both these figures include offshore North West Shelf Petroleum royalties of $415 million – negotiated under special arrangements with the Commonwealth government at the time.)

The royalty rates payable for different minerals mined in Western Australia are prescribed in the *Mining Regulations 1981* (the Regulations), subsidiary legislation to the *Mining Act 1978*. Government has the flexibility, with the approval of Parliament, to use the Regulations to adjust royalty rates in response to changes in economic and/or technical conditions.

Most Agreements require companies to pay royalties at rates prescribed in the Regulations, however some Agreements provide for the company to pay royalties at a lower rate specified in the Agreement. This mainly applies to the iron ore industry, which has ongoing royalty concessions in excess of $40 million per annum. Table 2 shows the State's royalty revenue by mineral for 2002-03 with related royalty concessions and exemptions.

Mineral	Royalty Revenue	Royalty Concessions and Exemptions	Percentage of Royalties Received from Agreement Projects
Iron ore	$287 million	$43.5 million	97 %
Diamonds	$89 million	nil	100 %
Gold	$85 million	$1.5 million	nil
Petroleum(1)	$73 million	nil	84 %
Nickel	$57 million	nil	39 %
Alumina(2)	$55 million	nil	100 %
Mineral sands	$26 million	nil	100 %
Coal	$16 million	nil	100 %
Base metals	$14 million	nil	10 %
Tin/Tantalum(3)/Lithium	$6 million	$4.5 million	nil
Manganese	$3 million	nil	nil
Salt	$2 million	$0.5 million	98 %
Limestone	$2 million	nil	58 %
Other	$9 million	nil	nil
Total	**$724 million**	**$50.0 million**	**78 %**

Table 2: Mining Royalties 2002-03

The iron ore industry is the main beneficiary of ongoing royalty concessions.

Notes:

1. *NW Shelf petroleum royalties of about $415 million excluded as they are levied under Commonwealth legislation.*
2. *The Regulations specify a royalty rate for bauxite but not for alumina. The Department estimates that the 1.65 per cent royalty rate for alumina in Agreements is approximately equivalent to the 7.5 per cent royalty rate for bauxite in the Regulations.*
3. *The Regulations are being used to phase out Tantalum concessions and the full royalty rate will apply from 1 July 2004.*

Source: DOIR

The reasons for royalty concessions in the iron ore industry are historic. The early iron ore Agreements were negotiated prior to the passing of the *Mining Act 1978*, when no other prescribed 'benchmark' royalty rate for iron ore existed. The royalty rates imposed in the iron ore Agreements ratified in the 1950s to 1970s were part of the overall negotiated package, which reflected trade offs to the private sector for its significant investment in capital infrastructure in the State's North West (for example towns, railways, roads and ports).

Following the passing of the *Mining Act 1978*, government made a policy decision in September 1981 that concessionary Agreement royalties should be progressively renegotiated to be consistent with the rates set in the Regulations. In March 1995, government reinforced this earlier decision with specific reference to iron ore concessionary royalties. This 1995 decision prescribed a new royalty rate structure that should:

- apply to all future iron ore projects
- be applied to existing iron ore Agreements as the opportunity arose.

The first part of this policy decision has been effectively applied as the three iron ore Agreements established since 1995 have not been granted royalty concessions. However, the removal of royalty concessions from existing Agreements has not been achieved. In contrast, during the same period, government has been successful in using the Regulations to impose a gold royalty, where none had previously existed (Figure 4).

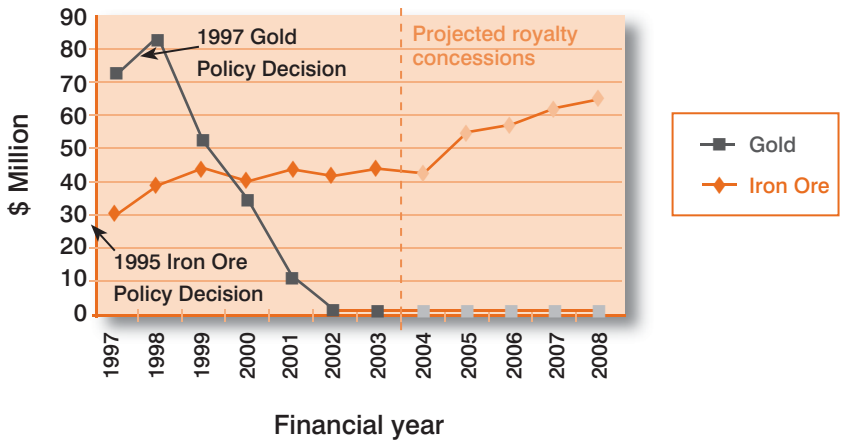

Figure 4: Annual Royalty Concessions for Gold and Iron Ore

Successive governments have been unsuccessful in implementing policy to remove iron ore royalty concessions fixed in Agreements. In contrast, government policy to remove gold royalty exemptions was effectively implemented through Regulations.

Note:
The Regulations exempt low volume gold producers from paying royalties. The ongoing cost of this exemption is estimated to be about $1.5 million per annum.

Source: DOIR and OAG

Further Processing

The State has sought to encourage the development of further processing industries, beyond the direct shipping of unprocessed ore to export markets. Further processing of ore, such as the production of iron ore pellets or alumina from bauxite ore, results in a higher valued product. Further processing is seen to be in the interests of the State and national economic growth as well as resulting in job creation within the more labour intensive value added processing facilities.

Twenty-four Agreements provide for the companies to establish and operate further processing facilities. The further processing outcomes sought in some of these Agreements are explicit (for example, establish a mill or a smelter) whereas in others the outcomes sought are less clear (for example, investigate further processing opportunities).

All further processing obligations are subject to their commercial viability to the company. It is up to the company to satisfy the Minister of the non-viability of the further processing obligation. Companies have undertaken significant studies to investigate the commercial viability of further processing opportunities. Many factors can work against commercial viability. The Minister's acceptance of the non-viability of the processing obligation at a point in time does not set aside that obligation. Rather, the obligation is deferred and remains in force.

It is difficult to objectively assess the impetus that Agreements have provided over many decades to stimulate further processing industries. The Department considers that, if the Agreement obligations had not existed, there would have been a reduced industry focus on further processing. The achievement of further processing benefits to date is summarised in Table 3.

Mineral	Processing Agreements (24)	Supplementary Benefits Sought	Benefit Achieved	Elapsed Years
Bauxite/Alumina	4	Aluminium Smelter	No	25 - 30
Copper	1	Further processing	Yes	–
Diamonds	1	Sorting Facilities	Yes	–
		Further processing	No[2]	20
Iron Ore	11	Further processing	Yes[3]	–
	5 [1]	Steel production	No	30 - 40
Mineral Sands	2	Further processing	Yes	–
Natural Gas	1	Petrochemical Industry	No	25
Nickel	3	Refinery/Smelter	Yes	–
Timber Products	1	Pulp Mill	No	35

Table 3: Achievement of Further Processing Benefits

The State has had some success in using Agreements to develop further processing industries. Notwithstanding efforts, benefits such as steel mills, pulp mills, aluminium smelters and petrochemical industries, have not yet been realised.

Notes:

1. *Of the eleven iron ore Agreements with further processing obligations, five have the additional obligation of establishing an integrated iron and steel industry. These additional obligations are listed separately.*
2. *While the full requirements of the Agreement have not been met, some cutting and polishing of high-grade diamonds occurs in Perth.*
3. *Currently, Western Australia has one secondary iron ore processing facility at Port Hedland, with the construction of another underway at Kwinana and scheduled for commissioning in late 2004.*

Source DOIR and OAG

Local Content

The expenditure accompanying major resource projects brings benefits to the State's economy both through the initial project development and the ongoing operation, maintenance and upgrading of facilities. The proportion of this expenditure which benefits the Western Australian economy depends on the use of local content for labour, services, and materials.

Successive State governments have promoted local content policies for resource projects, which have also been reflected in Agreements. Most current Agreements require the use of local labour, services, and material. Typically they contain the proviso *"as far as is reasonably and economically practicable"* or, more recently, *"except where it can be demonstrated that it is impracticable to do so"*. Thirty-four of the current Agreements with local content obligations also require company reporting of actual local content achieved. The frequency of reporting required varies from monthly, quarterly, half-yearly to 'when requested'.

The examination reviewed six Agreements with local content obligations and found that the Department had not, in consultation with the companies, developed the strategic intent of these local content clauses into operational plans with targets, timeframes and performance indicators. Neither did the Department methodically monitor company performance in discharging their local content obligations.

In fact, for three of the six Agreements, the company had stopped submitting the required local content reports several years ago. The Department did not take follow-up action nor could it provide evidence of Ministerial exemption from reporting obligations. In another of the Agreements, the company was only required to submit reports when requested. The Department advised that, since the Agreement's inception over 20 years ago, no request had ever been made for a local content report.

In consequence, it is now difficult to demonstrate how effective Agreements have been in encouraging companies to maximise the use of local content.

The Department advises that it did not follow-up outstanding reports because it considered that company reporting obligations related more to the initial project construction phase, and to subsequent significant expansions, rather than to the ongoing operational phase. However, only three of the 34 Agreements specifically provide for local content reporting only during the construction phase.

The Department advises that, in order to better manage local content outcomes in the future, it is considering requiring companies to submit forward procurement plans. This would be a positive step, particularly if the Department follows through this initiative with detailed monitoring and analysis. By comparing actual achievements to planned achievements, the Department should be able to assess the amount of local content in an Agreement project, and depending on the percentage, identify causes why local firms did not get certain business, and explore ways to redress the situation.

Ongoing Agreement Management Can Be Improved

Findings and Recommendations

Findings

- *The Department sees its role as primarily facilitative, establishing Agreements and assisting companies resolve government regulatory issues. While Agreements impose no explicit requirement for Agreement management, there is a need to:*
  - *follow a structured process to evaluate how well Agreements are achieving their objectives and what lessons can be learned*
  - *develop a more systematic approach to Agreement risk management, consistent with their value and importance to the State*
  - *improve reporting to Parliament on Agreement status and performance.*
- *It is unclear why some resource projects are established and operated under Agreements and others under existing statutory laws. It is therefore timely to develop criteria in order to better ensure consistency, equity and transparency.*
- *The Department's procedural guidelines and management information systems, which support Agreement administration, are underdeveloped.*

Recommendations

The Department should:

- *improve the procedural guidelines and management information systems that support the management of Agreements*
- *adopt a structured approach to evaluating Agreement performance*
- *implement systematic Agreement risk management systems and practices*
- *develop the reporting of Agreement status and performance to Parliament*
- *develop criteria to better guide the use of Agreements in a mature natural resource economy.*

Agreement Facilitation and Management

Agreement Facilitation

The Department sees its role as primarily facilitative – drafting the Agreement, Cabinet submissions and relevant legislation; overseeing the development of the project; and assisting the company resolve government regulatory issues that arise during the life of the project.

The Department employs about 12 industry based project managers, plus around five support staff, to facilitate Agreements using a devolved management structure. These project managers also facilitate non-Agreement projects and staff from other areas of the Department may work on Agreements. Project managers are recruited from industry and from within the public sector. They receive induction training, project management training and subsequent on-the-job training. The Department also hires specialist consultants as required.

Project managers recognise the importance of maintaining regular contact with the company and appear well informed about relevant issues facing the company and the industry it operates in. A briefing system operates to alert executive management and the Minister to emerging issues.

Project managers are also skilled in facilitating the company's many contacts with differing government agencies, can help cut through 'red-tape' and can bring parties together to help resolve disputes that arise from time to time. This latter role primarily applies to assisting the company in its dealings with State government agencies. However, the Department also offers assistance in dealing with local and Commonwealth government agencies.

Agreement Management

The majority of the projects that the Department facilitates are established and operated under the existing statutory laws of the State. The existence of an Agreement empowers the Department in its project facilitation role, especially when dealing with State government agencies. In addition, Agreements establish a contractual relationship between the State and a private sector company, with rights and obligations on both parties.

While Agreements establish a contractual relationship there are no explicit requirements on the Department for Agreement management. When the State was in the process of establishing its natural resource industry through Agreements, many of today's management practices had either not been developed or the need to apply them was less apparent. There is now a clear need to apply more robust management practices to Agreement management as:

- The State has a mature and internationally significant natural resource economy.
- Governments are committed to meeting community expectations that they better balance economic, social and environmental objectives.

- Outcome focused management and reporting is established within the Western Australian public sector.
- The public demands high standards of accountability and transparency from government and its agencies.

Performance Evaluation and Risk Management

Performance Evaluation

The Department does not evaluate Agreements in a structured and comprehensive way. It is therefore difficult to objectively assess how well Agreements are achieving their objectives, where Agreements have succeeded and failed and what the main lessons learned are.

Agreements are of sufficient importance to the State to warrant adoption of a structured Agreement evaluation process, which could include:

- turning the broad strategic aims, contained in the Agreement and associated documentation such as the Minister's second reading speech, into agreed and quantifiable targets and performance indicators
- progress reviews against targets and indicators to attribute causes of success and failure and take corrective action
- more comprehensive performance reviews (say every five years) that bring in a wide range of stakeholders to identify any unintended outcomes or significant change in Agreement objectives that have occurred
- completing post project reviews when Agreements run their course or when, in some instances, projects fail.

Such an approach is indicative and not all Agreements will require the same intensity and frequency of evaluation. A risk based assessment should be done for each Agreement.

As well as identifying opportunities and threats facing individual Agreements, structured evaluation and monitoring can better identify systemic issues. An example of a systemic issue is the provision of regulatory exemptions and/or financial concessions in Agreements, without specified review or end dates. This means that the State is honour bound for the duration of the Agreement, typically 63 years or longer. This has caused problems in the past, and continues to cause problems, as regulatory standards and community expectations change over time. Examples include:

- **Exemptions from environmental protection legislation.**
  The *Environmental Protection Act 1986* exempted pre-1972 Agreement projects from the obligation to comply with its provisions. This exemption was increasingly seen to be inappropriate and the

relevant Agreements were amended and the exemption removed from the *Environmental Protection Act 1986* in 2003. The Department is of the view that the companies fully complied with the Act's provisions, notwithstanding that the Agreements did not require them to do so.

- **Discontent from several local governments with ratings concessions and other issues.**
  The impact of Agreements on local governments, mainly through rating concessions, was raised by the then Public Accounts and Expenditure Review Committee in 1996 and 1998. In January 2004, the Minister for State Development announced an increased government commitment to consult with local governments on future Agreements. Resolving issues relating to existing Agreements is likely to be more problematic.

- **Unwinding iron ore royalty concessions.**
  A 1995 government policy to remove royalty concessions on existing iron ore Agreements has not yet been achieved.

There is a balance to be struck. Companies and their financiers require regulatory certainty over the life of a major project before committing the significant capital funds needed for project construction and operation. However, in making their investment decision, companies are unlikely to rely on estimated rates of return for the whole 63 year life of the mineral lease. They will require a positive financial return within a much shorter period to justify their investment decision. It would be expected, therefore, that the State would only grant financial concessions for a similarly reduced period. In practice they are nearly always granted for the duration of the Agreement.

These complex issues warrant a more focused and structured approach to performance evaluation (and risk assessment) by the State. There are well developed methods of performance evaluation in both the contract management and public policy fields.

Systematic Risk Management

The Department does not take a systematic and comprehensive approach to identifying, assessing and managing risks for the State created by Agreements or accentuated by them.

Departmental project managers have a keen sense of the importance of their job and of their responsibility to protect the State's interests. They are conscious of risk and the need to manage it. For example, they:

- are aware of the risk to the State if an important project, that could have proceeded in Western Australia, is established elsewhere or if an established Western Australian project fails
- have worked carefully over many decades, with the assistance of the staff of the State Solicitor's Office, to protect the legal robustness of Agreements.

As well as providing significant opportunities, mining can be a high risk activity for both the private sector and the State. The State faces a wide range of risks including: economic development risk, environmental

risk, revenue risk, resource risk, regulatory risk and political risk. While Agreements may mitigate against many risks, overall Agreements can involve a transfer of risk from the company to the State. Particularly as Agreements have very distant or no end dates, with regulatory clauses that cannot be varied without the consent of the company.

Departmental project managers, whose primary role is facilitative, face a major challenge in managing these many diverse risks. The Department therefore places reliance on other government agencies to manage many of these specific risks, as part of each agency's normal and ongoing regulatory activity. Nevertheless, as the following example illustrates, some risks can be better managed.

Early iron ore Agreements placed no production limits on companies. To provide for a higher level of State control, more recent Agreements have required companies to obtain approval to increase production beyond pre-set limits. However, these same Agreements contain a clause specifically excluding variations in royalty or rental rates as a condition of approval.

Because of increasing world demand for iron ore, production from these more recent Agreement projects has more than doubled the initial maximum set limits (production increases were approved in successive increments). This has reduced the estimated life of the mine and has revenue and cash flow implications for the State. For example:

- The present and next government will benefit from a two to threefold revenue increase with future governments missing out. While receiving a dollar today is generally preferable to receiving a dollar tomorrow, a consistent revenue stream can be more desirable for State budgeting.
- One of these Agreements provides for a rental rate increase of $0.25 per tonne on all iron ore mined following the fifteenth year of mine operation. This represents additional revenue of $3.75 million per annum, based on the anticipated maximum production rate of 15 million tonnes per annum set when the Agreement was ratified. The scale of the production increases meant that the State would likely forego most of this future rental revenue as, based on the recoverable reserves known at the time, mining would now cease before or shortly after year 15.

The Department did not identify this as a revenue risk and did not therefore assess the revenue implications of these significant production increases.

It may not be reasonable, or even desirable, for government to veto increased mine production because of uneven cashflows and the risk of foregoing future rental/royalty revenue. However, it is reasonable to expect government to be fully informed so as to be able to bring these concerns to the negotiating table.

Most Agreements were established long before risk management principles and practices, developed initially within the insurance industry, were adopted by the wider private sector and then the public sector. Standards Australia issued a generic risk management standard, designed to be applicable to any industry or economic sector, in 1995 (revised and updated in 1999). Within the Western Australian public sector,

a Treasurer's Instruction to adopt risk management practices was issued in July 1997. The Department of Premier and Cabinet issued further Guidelines in 1999. The 1999 Guidelines define risk management as follows:

> *"Risk management is the term applied to a logical and systematic method of identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process in a way that will enable organisations to minimise losses and maximise opportunities. Risk management is as much about identifying opportunities as avoiding or mitigating losses".*

The importance and value of the natural resource sector to the State warrants a more rigorous approach to Agreement risk management. It is almost certain that the company, and its financiers, carry out ongoing rigorous risk assessments. The negotiating position of the State is weakened if the company has completed a rigorous assessment of its risk profile but the State has not done the same.

Agreement Criteria

Western Australian governments in the 1960s to 1970s used Agreements as a means of overcoming some major hurdles to the development of the State's natural resources, in particular to:

- provide the substantial capital funding for infrastructure (towns, railways, roads, power, water, ports and airports) needed to support mining development in remote areas
- compensate for the then many inadequacies of the State's statutory laws which were more suited to the mining activity of the 1890s
- demonstrate the State's long-term commitment to projects by having them ratified by Parliament. This was important as Western Australia was then relatively unknown within the international mining and finance industries.

The initial need for Agreements was therefore reasonably self-evident. However, since then, their use has expanded to include projects which:

- while making a valued contribution to the State's economy, are small both in terms of royalty revenue and export earnings, for example the solar salt industry
- require comparatively little infrastructure provision, for example more recent iron ore Agreements
- could, with relatively minor legislative amendments, have proceeded under the existing statutory laws of the State, for example some of the timber products Agreements.

The need for some of these Agreements is by no means self-evident. It is also unclear why some resource projects are established and operated under Agreements and others under the existing statutory laws of the State. There has been little written policy to guide when and why Agreements should be used.

An October 1996 report by the then Public Accounts and Expenditure Review Committee – *Western Australian Government Financial Assistance to Industry* – stated that the absence of a government industry policy tended to encourage an ad-hoc approach by government to assisting industry development. The Committee included Agreements in the scope of its review and recommended that government give priority to developing and implementing an industry policy.

The Department issued an information paper in August 1997 titled *In Agreement: How major developers obtain project security through State Agreement Acts*. As the paper's title suggests, the primary aim of this paper is facilitative, to encourage private sector companies to consider establishing their project under an Agreement and to help them better understand the Agreement process and its associated benefits and obligations.

The present Government issued an industry policy – *Building Future Prosperity* – in January 2004 to address the Committee's 1996 recommendation. This document is broad in scope, providing an 'umbrella' under which more detailed sector specific guidelines can be developed. Its release provides an opportunity for the Department to develop clear criteria to guide the future use of Agreements in natural resource development, in order to better ensure consistency, equity and transparency.

Reporting to Parliament

Although ratified by Parliament at inception, Agreements contain no provisions for reporting back to Parliament on their status and performance. Because of the wide scope of the Department's operations, Agreements get limited coverage in Departmental Annual Reports. There is no aggregate or analytical reporting to Parliament on:

- Agreement Status – for example, whether the Agreement project is under construction, operating, inactive or near completion, and whether there have been any material changes to the scale or scope of the Agreement project
- Agreement Performance – for example, a clear statement of key Agreement objectives, an assessment of how successful Agreements have been in meeting these key objectives, identification of any unintended outcomes that have resulted and advice about what is being done to build on successes or address failures.

Given the importance of Agreements to the State, there should be regular disclosure of Agreement status and performance to Parliament. By comparison, public companies have to comply with continuous disclosure obligations to meet the information needs of their shareholders.

To enable Agreements to adapt to changing circumstances over time, the parties may agree in writing to add to, substitute for, cancel or vary any of the Agreement's provisions. Most Agreements require such variations *"to be laid on the Table of each House of Parliament within 12 sitting days next following its execution"*. The tabled variation then has effect if neither House passes a resolution to disallow it within a further 12 sitting days after tabling.

Some earlier Agreements do not require Agreement variations to be tabled to take effect. Others only require 'material or substantial' Agreement variations to be tabled. The Department advises that, although not specifically required, it has been long-standing government policy to seek Parliamentary ratification of all significant Agreement variations.

However, for proper public scrutiny, Parliament should be informed of any additions, deletions, substitutions or variations made to ratified Agreements. An improved system of reporting Agreement status and performance to Parliament could be used to inform Parliament of all Agreement variations.

Agreement Administration

Procedures and Guidelines

The Department has developed comprehensive flow charts and procedures to assist companies to work through the State's complex major project development approvals process. These are publicly available on the Department's web site.

However, the Department has not developed complementary procedures and guidelines to assist its own project managers in the management of Agreements once established. The Department has compiled a collection of interpretations and explanations of some common Agreement clauses, and some relevant legal opinions, that warrant developing into comprehensive guidance including:

- a process manual outlining the key Agreement management tasks – what must be done, when, who by, how and where decisions should be documented
- guidelines regarding the management of the many discretionary clauses within Agreements such as when time extensions can be approved, on what basis and for how long.

Management Information Systems

The Department does not have a suitable management information system to compile, analyse and report the considerable amount of project information, which it and other government agencies collect. The Department has a project database but it has key data missing and is underdeveloped.

The Department's project database could not produce basic summary information about current Agreements, such as their status and expiry date. Production of such information for Audit required Departmental staff to manually search paper files, which took considerable time and effort.

Similarly, Departmental project managers could not readily provide detailed information about the outstanding obligations for a sample of seven Agreements. Project managers were ultimately able to provide most information requested.

The Department does have a well managed Agreements library and its records section was readily able to obtain requested records from various repositories. Given the general soundness of this information base, it should be possible to develop an appropriate management information system.

The Department recognises that its project database is aged but does not consider that this system weakness has compromised project management. It advises that processes are in place to begin updating its project database. Until the Department improves its Agreements management information system:

- any requests to compile, analyse or report Agreement summary information will impact on staff productivity due to existing inefficient work practices
- the Department will be limited in its ability to implement more advanced evaluation and risk management practices, and to meet more demanding public reporting requirements.

Appendix I – Typical Agreement Obligations and Concessions

Obligations

The main obligations accepted by companies in Agreements are:

- to develop the project, often with significant associated capital infrastructure, within a reasonable timeframe
- to pay royalties to the State at a rate prescribed by the Agreement, the *Mining Act 1978* or a combination of the two
- to deliver wider economic benefits to the State by:
  - seeking to establish value added 'further processing' industries within Western Australia to further stimulate economic growth and to create jobs in these more labour intensive industries
  - agreeing to maximise the use of local content.

Concessions and exemptions

Concessions and exemptions commonly granted by the State to companies under Agreements, in return for obligations accepted, include:

- mining lease areas of greater size than available under the *Mining Act 1978*
- the ability to hold mining leases for longer terms than available under the *Mining Act 1978*
- exemption from having to meet labour and expenditure conditions of lease holdings under the *Mining Act 1978* (although alternative conditions are sometimes imposed by the Agreement)
- exemption from the requirement to lodge environmental rehabilitation bonds required by the *Mining Act 1978.* The notional bond amounts for Agreements was estimated by the Department to be $262 million at June 2003
- lower royalty rates than imposed under the *Mining Act 1978*
- land leases at reduced or peppercorn rental
- assistance with infrastructure provision
- stamp duty exemptions during the establishment period of the project
- undertakings that local and state government land zoning powers will not impact on the activities of the company for the duration of the Agreement
- provision that all land within the lease, excluding accommodation, will be rated at unimproved value for the duration of the Agreement
- State undertakings not to resume land or other property used by the company for the purposes of the Agreement without the company's consent
- specific authority for the State to resume land on behalf of the company
- the inclusion of 'no discrimination' clauses prohibiting State agencies treating the company (often foreign owned) less favourably than other companies.

Appendix II – Current Agreements

The 64 natural resource related Agreements administered by the Department of Industry and Resources as at 9 June 2004 are:

Alumina

Alumina Refinery Agreement Act 1961
Alumina Refinery (Pinjarra) Agreement Act 1969
Alumina Refinery (Mitchell Plateau) Agreement Act 1971
Alumina Refinery (Worsley) Agreement Act 1973
Alumina Refinery (Wagerup) Agreement and Acts Amendment Act 1978

Coal

Collie Coal (Griffin) Agreement Act 1979
Collie Coal (Western Collieries) Agreement Act 1979

Copper

Western Mining Corporation Limited (Throssell Range) Agreement Act 1985

Diamonds

Diamond (Argyle Diamond Mines Joint Venture) Agreement Act 1981

Energy

Goldfields Gas Pipeline Agreement Act 1994
Ord River Hydro Energy Project Agreement Act 1994
Pilbara Energy Project Agreement Act 1994

Forest Products

Albany Hardwood Plantation Agreement Act 1993
Bunbury Treefarm Project Agreement Act 1995
Collie Hardwood Plantation Agreement Act 1995
Dardanup Pine Log Sawmill Agreement Act 1992
Paper Mill Agreement Act 1960
Wesply (Dardanup) Agreement Authorization Act 1975
Wood Chipping Industry Agreement Act 1969
Wood Processing (WESFI) Agreement Act 2000
Wood Processing (Wesbeam) Agreement Act 2002

Gold

Tailings Treatment (Kalgoorlie) Agreement Act 1988

Iron Ore and Steel

Broken Hill Proprietary Company's Integrated Steel Works Agreement Act 1960
Broken Hill Proprietary Steel Industry Agreement Act 1952
Iron Ore (Channar Joint Venture) Agreement Act 1987
Iron Ore (Goldsworthy-Nimingarra) Agreement Act 1972
Iron Ore (Hamersley Range) Agreement Act 1963
Iron Ore (Hope Downs) Agreement Act 1992
Iron Ore (McCamey's Monster) Agreement Authorisation Act 1972
Iron Ore (Marillana Creek) Agreement Act 1991
Iron Ore (Mount Bruce) Agreement Act 1972
Iron Ore (Mount Goldsworthy) Agreement Act 1964
Iron Ore (Mount Newman) Agreement Act 1964
Iron Ore (Murchison) Agreement Authorization Act 1973
Iron Ore (Rhodes Ridge) Agreement Authorisation Act 1972
Iron Ore (Robe River) Agreement Act 1964
Iron Ore (Wittenoom) Agreement Act 1972
Iron Ore Processing (BHP Minerals) Agreement Act 1994
Iron Ore Beneficiation (BHP) Agreement Act 1996
Iron Ore – Direct Reduced Iron (BHP) Agreement Act 1996
Iron Ore (Yandicoogina) Agreement Act 1996
Iron and Steel (Mid West) Agreement Act 1997
Iron Ore Processing (Mineralogy Pty Ltd) Agreement Act 2002

Mineral Sands

Mineral Sands (Beenup) Agreement Act 1995
Mineral Sands (Cooljarloo) Mining and Processing Agreement Act 1988
Mineral Sands (Eneabba) Agreement Act 1975

Nickel

Nickel (Agnew) Agreement Act 1974
Nickel Refinery (Western Mining Corporation Limited) Agreement Act 1968
Poseidon Nickel Agreement Act 1971

Oil and Gas

Barrow Island Act 2003
North West Gas Development (Woodside) Agreement Act 1979
Oil Refinery (Kwinana) Agreement Act 1952

Salt

Dampier Solar Salt Industry Agreement Act 1967

Evaporites (Lake MacLeod) Agreement Act 1967

Leslie Solar Salt Industry Agreement Act 1966

Onslow Solar Salt Agreement Act 1992

Shark Bay Solar Salt Industry Agreement Act 1983

Uranium

Uranium (Yeelirrie) Agreement Act 1978

Miscellaneous

Cement Works (Cockburn Cement Limited) Agreement Act 1971

Wundowie Charcoal Iron Industry Sale Agreement Act 1974

Industrial Lands (CSBP & Farmers Ltd.) Agreement Act 1976

Industrial Lands (Kwinana) Agreement Act 1964

Pigment Factory (Australind) Agreement Act 1986

Silicon (Kemerton) Agreement Act 1987