MINERAL ROYALTY ACT

Royalty Guideline

RG-MRA-005: Operating Costs

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Purpose

1. This Guideline outlines allowable and excluded operating costs for the purpose of calculating the amount of royalty payable under the *Mineral Royalty Act 1982* (NT) (the MRA).
2. This Guideline is issued by the Secretary under section 4E of the MRA.

Introduction

1. Section 10 of the MRA sets out the formula for calculating the net value of a saleable mineral commodity sold or removed without sale from a production unit. The rate of royalty is applied to the net value to establish liability for the relevant royalty year.
2. Under section 10, net value is calculated in accordance with the formula:

**GR – (OC + CRD + EEE + AD)**

where -

GR is the gross realization from the production unit in the royalty year;

OC is the operating costs of the production unit for the royalty year;

CRD is the capital recognition deduction;

EEE is the eligible exploration expenditure, if any; and

AD is any additional deduction.

1. The Northern Territory’s profit-based mineral royalty regime applies on an individual mine or project basis, rather than a company, business or enterprise basis. Accordingly, expenditure of a particular production unit only is to be taken into account for the purposes of calculating operating costs, costs relating to the business or enterprise of which the production unit forms part, are not.
2. In other words, ring-fencing principles apply (where each of the royalty payer’s operations are treated independently, for royalty purposes, from all of the royalty payer’s other operations and, accordingly, the accounts from the individual production unit may not be mixed with the accounts for activities outside the production unit). There is no ability to aggregate income or revenue and expenses from all operations carried on by the royalty payer within the Northern Territory.
3. Under the MRA, royalty applies to profits derived from the production of a saleable mineral commodity within the boundaries of a production unit. The objective is that, generally, only those expenditures necessary to produce that commodity are allowable as deductions against gross revenue from the sale or value of the saleable mineral commodity.
4. Operating costs are items of expenditure, reasonable in amount, in relation to a production unit which are directly attributable to:
	1. the production of the saleable mineral commodity; or
	2. maintenance for the purposes of production; or
	3. the sale or marketing of the saleable mineral commodity; and

includes various specified items closely connected with those activities.

1. Operating costs do not cover exploration activity, tenement acquisition costs, capital improvements to the production unit, deferred rehabilitation and various specified items (refer to paragraphs 46 to 58 below). Guidelines RG‑MRA-008*: Eligible Exploration Expenditure* and RG-MRA-006*: Capital Recognition Deduction* provide further information on exploration expenditure and capital expenditure respectively.

What are operating costs

1. Operating costs are defined in the MRA. To be eligible as an operating cost, the expenditure must meet all of the following criteria:
	1. the cost must be incurred in relation to the production unit;
	2. the cost must be reasonable in amount; and
	3. the cost must be directly attributable to the production, maintenance for the purposes of production, or the sale or marketing of the saleable mineral commodity of a production unit.

Meaning of “in relation to” the production unit

1. The expression “in relation to” requires that there is a sufficient link or nexus between the expenditure and the production unit from which the saleable mineral commodity is produced. Expenditure arising from a connection which is insubstantial, tenuous or distant is not an allowable operating cost in relation to the production unit.
2. This means that the expenditure must result from the carrying on of mining activities on the specific production unit. Guideline RG-MRA-002*: Production Unit* provides further information on the definition and scope of a production unit.

Meaning of “reasonable in amount”

1. To be “reasonable in amount”, an amount expended must represent the fair and realistic value of the activities carried out. Accordingly, expenditure resulting from an arm’s length commercial transaction or arrangement will generally be accepted as reasonable in amount. A royalty payer is not entitled to recover any cost to the extent that it is extravagant or artificially inflated.
2. For related party transactions, the royalty payer must substantiate the amount expended for each claim and establish the reasonableness of the amount expended.
3. A royalty payer may be requested to provide a written explanation and supporting documentary evidence of:
	1. the nature and extent of the expenditure, including the link between the expenditure and production, maintenance for the purposes of production, or sale and marketing of the saleable mineral commodity;
	2. the character of the expenditure in the context of the arm’s length principle; and
	3. why the expenditure is an acceptable approximation of an arm’s length price.

Meaning of “directly attributable”

1. To be an allowable operating cost, the expenditure must be directly attributable to the production, maintenance for the purposes of production, or sale and marketing of the saleable mineral commodity of the production unit.
2. The nexus between the expenditure and production, maintenance for the purposes of production, or sale and marketing must be material and close. This degree of necessary connection is generally determined using a commonsense approach, where a reasonable person, applying commonsense, would conclude that the expenditure was necessarily incurred in the production, maintenance for the purposes of production, or sale and marketing of a saleable mineral commodity of the specific production unit.
3. An expenditure that is only remotely, tenuously or insubstantially connected with the requisite activity is not an allowable operating cost of the production unit.

“Production, maintenance for the purposes of production, sales and marketing”

1. The expression “production, maintenance for the purposes of production, or sale and marketing of a saleable mineral commodity” generally covers the following:
	1. Production of a saleable mineral commodity:
		1. work done on a production unit in preparation for or ancillary to the extraction of the mineral commodity or saleable mineral commodity;
		2. extraction of the mineral from the soil; and
		3. work done on the production unit subsequent to the extraction for the purpose of production of the end product (that is, the mineral in a state suitable for sale into any market).
	2. Maintenance for the purposes of production of a saleable mineral commodity:
		1. repairs and maintenance (including preventative repairs and maintenance) and work undertaken to keep the production unit in good working order; and
		2. periods of temporary closedown for such purposes.
	3. Sales and marketing of a saleable mineral commodity:
		1. expenditure incurred under any agreement with a third party to arrange or effect the sale or undertake the marketing of the saleable mineral commodity; and
		2. expenditure incurred in respect of transportation of the saleable mineral commodity from the production unit to the first point of sale, port or storage facility in the Northern Territory (whichever is the earlier).
2. The expression “production, maintenance for the purposes of production, or sale and marketing of a saleable mineral commodity” does not cover the following:
	1. exploration activity – Guideline RG-MRA-008*: Eligible Exploration Expenditure* provides further information on deductions for exploration activity under the MRA.
	2. tenement acquisition costs – which can include exploration expenditure, capital assets (which may qualify for a capital recognition deduction) and assets purchased as part of a sale which do not have a direct relationship to the production unit.
	3. improvements – something that substantially enhances the value of a facility or the production unit (which may qualify for a capital recognition deduction).
	4. deferred rehabilitation – MRA Overviewprovides further information on deductions for deferred rehabilitation under the MRA.
3. Expenditure that is not considered to be materially or closely connected to the production, maintenance for the purposes of production, or sale and marketing of the saleable mineral commodity of a production unit includes, but is not limited to, the following:
	1. bad debt;
	2. entertainment;
	3. exploration expenditure;
	4. fines & penalties;
	5. foreign exchange (gain)/loss;
	6. gifts/donations;
	7. hedging costs;
	8. maintenance of share registers;
	9. management fees not directly attributable to the production unit;
	10. provision for mine rehabilitation (deferred rehabilitation); and
	11. local community/school support and activities.

Example 1

Production Unit A is situated in a remote part of the Northern Territory. In order to maintain its workforce the mine provides mine site entertainment such as concerts, cinema, satellite television and recreational magazines to its employees. While this expenditure supports onsite employees’ morale, health and wellbeing, these costs do not have a materially close connection with the production, maintenance for the purposes of production, or sale and marketing of the saleable mineral commodity of the production unit. Accordingly, they are not allowable as operating costs (unless the cost represents a benefit described in paragraph 31 below).

Example 2

Under normal circumstances, gold or silver is removed from a production unit in a concentrated state known as dore (being an alloy, amalgam or mixture of gold and silver as well as other impurities) for treatment and processing in a refinery that may be outside the Northern Territory.

When dore is transported from the production unit for further refining, the gold and silver are considered to have been removed from the production unit without sale. Accordingly, they are to be valued at the precise time of removal from the production unit.

All costs incurred subsequent to the removal without sale from a production unit of the saleable mineral commodity such as refining and transportation cannot be claimed as operating costs for the purposes of calculating the royalty payable because the connection between the item of expenditure and the production unit is not sufficient. However, the costs may be relevant in determining the gross value of the saleable mineral commodity (Guideline RG-MRA-004*: Gross Realization* (example after paragraph 37) provides further information on determining the gross value of gold and silver).

Allowable operating costs – specific items

1. The MRA sets out specific items that are allowable operating costs provided they also satisfy all of the eligibility criteria described in paragraphs 10 to 19 above. A discussion of each specific item is detailed in paragraphs 24 to 40 below.
2. For the sake of convenience the expression “operation of the production unit” shall be used hereinafter to cover (unless a contrary intention appears):
	1. production;
	2. maintenance for the purposes of production; and
	3. the sale or marketing;

of the saleable mineral commodity of that production unit.

Eligible research and development expenditure

1. Eligible research and development expenditure is expenditure reasonably incurred by a royalty payer for research into and development of efficient methods of mineral extraction and processing designed to either minimise eligible capital assets expenditure and/or ongoing operating costs or improving the rate and amount of recovery of a saleable mineral commodity from the production unit. Such activities may include:
	1. creating new or improved materials, products, devices or systems; or
	2. acquiring new knowledge which directly supports (1) above.

*Example*

ABC Mining Pty Ltd (ABC) undertakes research into a new mining technique as part of its optimisation and improvement initiatives. The mining technique is to be solely utilised for its Northern Territory mining operation. If successful, the technique will increase production by 30 per cent with no additional production cost. The expenditure incurred by ABC in relation to the new mining techniques is eligible research and development expenditure. Given that the cost is incurred in relation to ABC’s production unit in the Northern Territory, the expenditure is allowable as an operating cost.

1. Expenditure incurred in research and development activities such as market research, market development, exploration or management studies is not deductible as an operating cost unless it meets the criteria set out in paragraph 24 above. However, some of these items may fall under other categories of allowable deductions, provided the relevant eligibility criteria are satisfied.

Accounting and auditing fees

1. Accounting and auditing costs that are required to meet the needs of the royalty payer to maintain the operation of the production unit are allowable operating costs. Where the accounting and auditing costs are incurred as part of a broader business structure of the royalty payer, these costs will need to be apportioned between the activities which relate to the operation of the production unit on the one hand, and costs which are related to other activities on the other hand.

Legal fees (other than those directly attributable to royalty matters)

1. Legal fees which may be claimed as operating costs are professional legal fees that are necessary, appropriate and have a sufficiently close connection to the operation of the production unit.

*Example*

The tenement holder of Production Unit A incurs legal fees as a consequence of commencing legal action, for breach of contract, against a supplier, for failure to supply materials used by Production Unit A in the production of a saleable mineral commodity. The legal fees are allowable as operating costs as they have a sufficiently close connection with the operation of the production unit.

1. Legal fees incurred on royalty related matters are not deductible as an operating cost. For example, any fees for legal work carried out on behalf of a royalty payer, which allows the royalty payer to comply with their obligations under the MRA, are not deductible as an operating cost.

Insurance premiums

1. Insurance premiums (including stamp duty) covering risks directly related to the operation of the production unit are allowable operating costs. Where insurance costs cover a business or enterprise that includes a production unit, an apportionment of the costs will be required. Only the costs that are materially connected with the production unit are allowable operating costs.

*Example*

The tenement holder of Production Unit A holds an insurance policy which covers all of its physical assets including its head office building located in Western Australia. The total amount of the insurance premium (including stamp duty) is not recognised as an operating cost. Only the proportion materially connected with the risks directly related to the operation of the production unit can be claimed.

Salaries, allowances, approved benefits and employee wages

1. Remuneration is an allowable deduction provided that throughout the period of employment in the royalty year, the employees were, during their ordinary hours of duty, engaged primarily in work materially connected with the operation of the production unit.
2. Remuneration includes salaries, wages, allowances termination or similar payments and employer superannuation contributions. In addition, TRO will generally accept benefits identified in a written contract of employment (which attributes a specified or ascertainable value for the benefit(s)).

 Office expenses

1. Office expenses materially connected with the operation of the production unit are allowable operating costs.
2. Where office expenses cover a business or enterprise that includes a production unit, an apportionment of the costs is required. For further information on acceptable methods of costs allocation refer to paragraphs 59 to 66 below.

Example

ABC Mining Pty Ltd (ABC) owns two mines in Australia, one in the Northern Territory and one in South Australia. The head office (which is located in Western Australia) provides accounting, systems and OH&S support to its Northern Territory and South Australian mines. Approximately 30 per cent of the head office employees’ time is spent on activities that are materially connected to the Northern Territory mining operation.

Assuming ABC select the timesheet method of costs allocation outlined in paragraph 64 below, they may claim 30 per cent of the head office costs as office expenses materially connected to the operation of the Northern Territory production unit.

Fees for management services

1. Fees for management services which are materially connected with the operation of the production unit are allowable operating costs. Apportionment of total fees is necessary and the royalty payer may be required to substantiate and justify any amounts claimed. The requirement for the fees to be materially connected with the operations of the production unit means that fees relating to strategic or higher level policy management may not be allowable.

Example

ABC Mining Pty Ltd (ABC) provides management support to its subsidiary which operates a production unit in the Northern Territory. The costs incurred by ABC are on-charged to the subsidiary as management fees based on a pre-determined percentage accepted by the Secretary. Included in the management fees are costs relating to the maintenance of the share registry and expenditure incurred to defend a take-over bid. As these costs are not materially connected with the operation of the production unit, they are not allowable operating costs and must be excluded from the cost base prior to allocation (refer to paragraphs 59 to 66 below).

Tenement rentals

1. A mineral lease is granted subject to standard conditions such as the grantee having to pay the prescribed rent for the use of the land comprised in the mining tenement and royalties. This statutory obligation to pay prescribed tenement rent is an allowable operating cost.

Fees and charges imposed under a law in force in the Territory

1. A fee or charge imposed under a law in force in the Territory, which is materially connected with the operation of the production unit may be claimed as an operating cost.
2. Such a fee or charge does not include a tax, pecuniary penalty or fine.

Fees, charges or costs as may be prescribed

1. Fees, charges and costs which are prescribed, from time to time, by a Commonwealth or Territory law, that are materially connected with the operation of the production unit may be allowable operating costs.

Payroll tax

1. Payroll tax on wages (as defined in the *Payroll Tax Act (NT)*) paid or payable to employees performing functions that are materially connected with the operation of the production unit are allowable as an operating cost.

Other matters as necessary for the proper administration of the production unit

1. This item requires a sufficiently material connection between the activity which is absolutely necessary for the operation of the production unit and the expenditure. For example:
	1. expenditure incurred as a consequence of work carried out to protect and keep safe the mine and mining rights; or
	2. expenditure incurred as a consequence of any work done in relation to current rehabilitation, which takes place during the production phase of the mine.

Allowable operating costs – rehabilitation

1. Whether or not rehabilitation costs are deductible as an operating cost will depend upon when the expenditure takes place in relation to the life cycle of the mine.
2. Rehabilitation costs actually incurred while a production unit is producing a saleable mineral commodity are deductible as an operating cost in the royalty year in which they were incurred. However, where the specified accounting basis of the production unit is an accrual basis and amounts are provided for rehabilitation in a royalty year, these amounts are not allowable deductions.
3. Where the entire production unit is transferred or conveyed and the new owner intends to operate the same production unit as a going concern, any existing rehabilitation obligations attached to the production unit may be claimed by the new owner as an operating cost in the year in which the rehabilitation costs are actually incurred for rehabilitation work undertaken provided that:
	1. the rehabilitation is directly attributable to the production or maintenance for the purpose of production of a saleable mineral commodity; and
	2. the previous owner of the production unit is not entitled to any royalty adjustment in respect of the actual rehabilitation costs claimed.
4. Paragraphs 25 to 30 of MRA Overviewprovide further information on deferred rehabilitation costs.

Allowable operating costs – pre-production

1. To recognise the significant pre-production costs (in the nature of operating costs) which can be incurred in setting up a production unit, the MRA allows for expenditure (in the nature of operating costs) up to four years prior to the commencement of production of a commercial quantity of a saleable mineral commodity as an allowable operating cost. The costs must relate to a mining tenement that is part of the production unit. In this regard, it is noted that the definition of mining tenement excludes exploration licences and exploration retention licences (or successor titles of same or similar nature). These costs need to be claimed in the first royalty year after the commencement of production of a commercial quantity of a saleable mineral commodity.

Excluded operating costs – specific items

1. Certain expenditure is not recognised as operating costs. The MRA sets out specific items that are excluded as operating costs. A discussion of each item is detailed in paragraphs 47 to 55 below.

Compensation payments

1. Section 184 of the *Mining Act* requires holders of exploration licences and mining tenements to compensate pastoral lessees and owners or occupiers of private land for the use, disturbance and damage to private land which has been granted under the licences. Payments made in excess of what is reasonably required under section 184 cannot be claimed as an operating cost.
2. Any compensation payment for the use or disturbance of land or improvements in respect of Aboriginal land is not allowable as an operating cost.

Taxes on income or profits

1. Payments in the form of taxes on income earned or profits generated are not able to be claimed as an operating cost.

Mineral royalties

1. Payments made in the form of mineral royalties (that are levied by government) cannot be claimed as operating costs.

Cost of negotiating with land holders

1. Unless the expenditure is of an amount required to be expended by legislation (for example, the *Aboriginal Land Rights (Northern Territory) Act 1976* (Cth) or *Native Title Act 1993* (Cth)) in force in the Northern Territory, any costs associated with negotiations with land holders is not able to be claimed as an operating cost.

Interest and depreciation

1. Interest payments or payments in the nature of interest are not able to be claimed as an operating cost. The MRA makes provision for interest payments arising from borrowings to acquire eligible capital assets and depreciation relating to those assets to be captured when establishing the amount of capital recognition deduction which can be claimed. Guideline RG-MRA-006*: Capital Recognition Deduction* provides further information.

Payments in the nature of royalties

1. Payments in the nature of royalties cannot be claimed as operating costs. The following are examples of such payments:
	1. payments made to an owner or occupier of private land or a lessee of Crown land (such as a pastoral lease) calculated on an ad valorem or profit basis; and
	2. negotiated payments calculated on an ad valorem or profit basis made to traditional Aboriginal owners or representatives of such owners.

Levies on mineral output, value, profits, income or export

1. Any payments, whether or not in the nature of a levy, made on mineral output, value, profits, income, or export are not able to be claimed as operating costs.
2. Such payments may be imposed through a range of different approaches including by primary legislation. Irrespective of how the obligation to make the payment is imposed or what the payment will be used for, the payment is not recognised as an operating cost.

Excluded operating costs – foreign exchange losses

1. Losses resulting from foreign exchange, financing arrangements or capital transactions are not allowable operating costs. Foreign exchange and hedging transactions are treated as business decisions or risks independent of the profitability or operation of a production unit.

Excluded operating costs – revaluation

1. Once the principal sum relating to an asset has been determined for capital recognition deduction purposes (Guideline RG-MRA-006*: Capital Recognition Deduction* provides further information on the concept of principal sum), it remains unchanged for all future determinations of royalty liability. Costs associated with the revaluation of assets are not recognised as operating costs.
2. If a royalty payer pays a third party to value an asset for the purposes of revaluation, this payment is not an allowable operating cost. Neither is any gain or loss on the revaluation.

Methods of costs allocation – head office costs or management fees

1. In respect of a royalty year, operating costs are determined in relation to a specific production unit and not on a company, business or enterprise basis. As such, where a production unit forms part of a larger business arrangement, certain costs must be apportioned between the production unit and the other parts of the business.
2. Therefore, it is important to ensure that head office costs and management fees are analysed and allocated to the operations of the individual production unit. Prior to any allocation, ineligible operating costs must first be excluded from the operating cost base.
3. There are different methods of allocation that may be relied upon to determine the appropriate amount of head office costs and fees for management services relating to the specific production unit.
4. The method of allocation should reflect, in all the circumstances, a realistic estimation or value of those costs. Methods that do not fairly and reasonably reflect the effort or resources used in relation to the operations of the production unit are not accepted.
5. The royalty payer must disclose in writing to the Secretary, the reasons for relying on a particular method of allocation coupled with information establishing and verifying the cost(s) claimed.
6. The types of method for allocation that are acceptable to the Secretary are as follows:
	1. Timesheet Method – to determine effort or resources

This allocation method is based on the actual time spent by employees on activities that are materially or closely connected with the operation of the production unit. To utilise this method, the royalty payer needs to maintain detailed time sheets for the relevant employees or another reasonable system for estimating the actual time spent by employees on these activities.

* 1. Proportion of direct operating costs

This method allocates head office costs or fees for management services to the production unit in the same proportion as direct operating costs of the production unit over the total operating costs for all projects. To utilise this method, the royalty payer must maintain adequate records to establish and verify total operating costs and the proportion of total operating costs which relates to the specific production unit.

* 1. Agreed Percentage

A fixed percentage of total costs may be agreed between the royalty payer and the Secretary as the basis for costs allocation. The royalty payer must submit a written application requesting that the Secretary approve a fixed percentage of total costs as being the operating costs attributable to that production unit, coupled with supporting information.

1. In default of a royalty payer selecting one of the above methods, any claim for head office costs or fees for management services will need to substantiated and verified by relevant written records.
2. Once a method for the allocation of operating costs has been selected, it is to be consistently applied from year to year. Where the selected method is no longer appropriate for the operation of the production unit, for example due to changes in operating circumstances, the royalty payer is required to apply for the allocation method to be varied or substituted. The application must be made in writing, setting out in full the grounds for, and reasons in support of, such a request.

Adjustment to amount of operating costs - recoverable costs

1. Recoverable costs such as rental income or fuel rebates received in respect of operating cost expenditure must be offset against that expenditure. Where a timing difference results in the receipt of the recoverable cost in a royalty year which is different to the royalty year in which the related expenditure is claimed as a deduction, the recoverable cost should be recognised in the royalty year it is received as an offset to the operating costs of that royalty year.

Example

A royalty payer may claim the cost of diesel fuel that is used for items of plant within the production unit as an operating cost for that production unit’s 2010 royalty year. If the royalty payer receives a rebate towards the cost of this fuel, the rebate must be offset against the expenditure claimed. If the rebate is received in 2011 it should be used to offset the operating costs of that production unit’s 2011 royalty year.

Rule against double deductions

1. Where an amount expended in respect of a production unit is capable of falling under more than one deduction category (for example, certain capital equipment could be an operating cost or qualify for a capital recognition deduction) the royalty payer needs to decide how the expenditure will be treated as only one deduction is allowed. The royalty payer should claim the expenditure under the most appropriate deduction category.
2. Any expenditure relating to activities in the nature of production (where the expenditure is more appropriately to be treated as an operating cost) should be claimed as an operating cost.

Conversion of foreign currency to Australian currency

1. Where an item of expenditure is in a foreign currency, the value for royalty purposes must be converted to an Australian dollar equivalent at the exchange rate current at the time that the expenditure is brought to account.

GST

1. Generally, an amount of operating costs is the amount exclusive of the GST (if any) payable in relation to that expenditure. Where an item claimable as an operating cost is input taxed, the amount claimable is inclusive of GST.

Record keeping requirements

1. For general record keeping requirements, refer to MRA Overview.
2. In respect of operating costs, the royalty payer must maintain proper records including, but not limited to:
	1. trial balances;
	2. cost centre reports;
	3. detailed general ledger reports; and
	4. invoices.

MRA publications

1. Guideline RG-MRA-001: *Guidelines and Advance Opinions*, which sets out information on the Guideline system, is incorporated into and read as one with this Guideline.



Anne Tan

Secretary

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