UMC

UNITED MINERALS
CORPORATION NL

1st October 2008

Mr Russell Dumas
Director – Gas & Rail Access
Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

Dear Mr Dumas

Please find enclosed United Minerals Corporation submission for The Pilbara Infrastructure (TPI) Rail Part 5 Instruments submission for the proposed:

- Overpayment Rules

  and

- Costing Principles

Please don't hesitate to contact me if you have any queries.

Regards,

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The Pilbara Infrastructure (TPI) Rail Part 5 Instruments submission

for the proposed

Overpayment Rules

&

Costing Principles

by

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Executive Summary

United Minerals Corporation NL (United Minerals) is making this submission to the Economic Regulation Authority of Western Australia (Authority) regarding the Costing Principles and Over-payment Rules proposed by The Pilbara Infrastructure Pty Ltd (TPI) under the Rail Access Code 2000 regarding the terms of third party access to the TPI Railway in the Pilbara.

United Minerals is supportive of the State, TPI and TPI's parent, Fortescue Metals Group (FMG), to provide rail access to third parties and is prepared to meet its fair share of the cost in achieving such access if it were to seek access inside the Code. It is well recognised that TPI below rail facilities potentially offer the most cost effective method of delivering ore transport services to the eastern Pilbara. In accordance with other rail Access Regimes such access should be on fair terms to both parties similar to the Authorities Determination for WestNet Rail (WestNet) treating the rail as a stand-alone business.

Cost of a Greenfields Railway

TPI is proposing that the Authority accept their actual costs as the infrastructure is in effect a greenfield railway. However, United Minerals suggest that the below rail component was constructed in a manner to meet FMG financial and market contractual obligations. Such construction was not necessarily with modern equivalent assets (MEA) which would have had longer lead times reducing major periodic maintenance (MPM). Accordingly United Minerals requests that the Authority consider the Costing Principles, Over-payment Rules and the Weighted Average Cost of Capital (WACC) reflect the efficient costs of a stand-alone railway and these costs are estimated from a building block approach. United Minerals is of the view the railway has been constructed not as MEA nor represents efficient cost and is proposing that the Authority consider that the approach to MPM, unit rates, design, project management, and finance charges be similar to that of the WestNet Determination.

Stranding Risk

TPI are proposing stranding or asymmetric risk either applies in WACC, or in the Costing Principles. The Authority's WACC Issues Paper dated 4th September, 2008 discusses the stranding risk and United Minerals is responding to that Paper in detail and in this submission is providing a brief summary to the effect that there is minor stranding risk.

Route Sections

TPI are defining route sections as only one section of line from Cloud Break to the Port Headland dumping facility. This approach overly aggregates costs whereas the regulatory principle has generally been that the access seeker pays for the assets on the section of the main line it uses.

Economic Life of the Asset

The economic life determines the rate of capital renewal and where this is at variance to industry accepted rates for heavy haul railways there should be a list of consideration factors in order to justify this variance including consideration of any actual leases related to below rail infrastructure involved.

Major periodic maintenance (MPM) and Depreciation

TPI is proposing MPM be included in operating costs but MPM is not repairs and maintenance it is renewal of the asset. In estimating the capital base on which to apply WACC TPI are proposing that as this is a greenfield railway and its actual costs of construction are the gross replacement value. However, as stated above the Authority should consider the design and structure of the railway were driven by FMG's commercial imperatives and the railway is not necessarily based on MEA's and nor does it necessarily represent efficient cost.

United Minerals from an access seeker perspective is prepared to share the cost of ensuring the railway can perform the task and is renewed and, given the difficulties of estimating the capital base, and would suggest that the Authority consider the use of an approved MPM program in lieu of a depreciation charge.

Financing charges during construction

The TPI proposal is that TPI "will include in the capital cost an allowance for its cost of capital and related financing charges during the construction period" and "reliance may be able to be placed on actual historical cash flows during the construction period"[1]. United Minerals would request the Authority that the TPI railway be considered for access pricing purposes as a stand-alone entity using a Regulatory building block approach.

Equity raising costs

United Minerals would request that these types of cost be benchmarked.

Cost Model

TPI are proposing the development of a Costing Model within 18 months of Regulatory approval of the Costing Principles in relation to having actual cost data experience[2]. Again United Minerals would submit that the principles of Regulated access pricing are that of a stand-alone building block approach, in accordance with a predetermined operational standard, rather than actual costs. The timing of the model therefore could be reduced significantly.

Capacity

United Minerals would request that capacity the network to meet current and reasonably projected demand be "for all users taken together"[3].

Objectives and Definitions

The Alliance would suggest that an objectives clause and a definitions clause be added to the Costing Principles.

1 TPI proposal Section 3.1.1

2 TPI proposal Section 2

3 WestNet Rail Costing Principles September 2007 Section 2.3

1. Introduction

United Minerals Corporation NL (United Minerals) is responding to an invitation by the Economic Regulation Authority of Western Australia (Authority) on 20th August. 2008 for public submissions regarding the Over-payment Rules and the Costing Principles submissions by The Pilbara Infrastructure Pty Ltd (TPI) with regard to third party access pricing for access to the railway recently constructed by TPI, for iron ore haulage of Fortescue Metals Group Limited (FMG) mine, in the Pilbara region of Western Australia.

The Authority is also separately requesting public comment with regard to an Issues Paper dated 4th September prepared by the Authority on the Weighted Average Cost of Capital (WACC) for access pricing capital components of the rail facilities operated by TPI. As there are common regulatory considerations in both the TPI proposals and the WACC Issues Paper this submission by United Minerals references both.

The Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004 provides for the TPI rail assets to be subject to the Railways (Access) Act 1998 and the Railways (Access) Code 2000.[4] Section 2A of the Access Act provides that the main object of the Act is to "establish a rail access regime that encourages the efficient use of, and investment in, railway facilities by facilitating a contestable market for rail operations".[5] The Access Act and the Code provisions are directed toward establishing a level playing field and empowering the Regulator to seek these objectives under section 29 of the Access Act.

The aim of the rail access regime is to establish and implement a framework that ensures effective, fair, and transparent competition, on Western Australia's railway network to achieve a net public benefit to the State.

2. Cost of Greenfield Railways

United Minerals strongly supports the underlying intent and the actions taken so far by the Government and FMG to put in place an alternative rail transport corridor for iron ore and other minerals in the east Pilbara that offers rail access to third parties on fair terms.

However, the TPI railway is vertically integrated with the FMG mine and there are related features of the commercial and operational context to which must be considered by the Regulator in determining the Costing Principles elements and the WACC elements together regarding the access cost of an efficient railway.

TPI in their Costing Principles and response to the WACC Issues Paper are submitting, either directly or indirectly that as this is a new greenfield railway this is an efficient railway. TPI also submit that their actual costs in building the railway that make up the capital cost in the gross replacement value, to which WACC is applied, are both Modern Equivalent Assets (MEA) and efficient costs, and as there are no direct comparators for the calculation of elements of the WACC the Authority should accept their actual costs for:

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[4] Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004, Part 3.
[5] Railways (Access) Act 1998

- replacement values, unit rates of costs and design/project management fees in calculating gross replacement fee;
- finance charges – include in the capital cost its cost of capital and related financing fees and charges during the construction period;
- equity raising charges.

In addition to this TPI is also proposing in the Costing Principles to reduce asset economic life on earthworks, bridges and rail curves compared to WestNet and include MPM (capital) in operating costs.

Section 3.1.1 of the TPI Costing Principles proposes to use the actual costs incurred by TPI in developing the gross replacement values. These values are applied in two ways in determining the access charges, firstly as a capital charge with regard to WACC principles and then for replacement charges in the Costing Principles.

United Minerals contends that the TPI railway is neither a MEA or represents an efficient cost as the line was built in to a budget and timeframe to meet FMG financial obligations and to optimise the FMG supply chain. The TPI railway construction under taking was a rapid development project which resulted in several diseconomies compared to a normally constructed railway namely:

- Higher project management and labour costs to build the railway as a result of completing tasks to a schedule rather than to an efficient costs process,
- Purchasing of materials for the railway with shorter economic life that could be supplied quickly rather than longer life components with longer lead times, in some cases this will lead to higher maintenance costs than the MEA

Therefore the Authority should consider with regard to both the Costing Principles elements and the WACC elements that the railway be treated on a stand-alone basis and the efficient costs be estimated from a building block approach.

3. Stranding Risk

The Authorities WACC Issues Paper dated 4th September, 2008 discusses stranding risk and as United Minerals is responding to that Paper in detail this submission is providing a brief summary in effect that there is minor stranding risk.

TPI are proposing stranding risk either applies in WACC, as the difference between the TPI actual debt margin and the benchmark BBB bond rating, or in the Costing Principles as accelerated depreciation for a term contract, as a value included in the operating costs, and as an uplift factor in calculating the ceiling price.

In addition TPI are proposing that there is only one section of line from Cloud Break to the Port Headland dumping facility and is asking the Authority to accept their direct costs of construction and finance and the application of stranding risk therefore applies to the whole line (average cost of total capacity) and not limiting the stranding risk to the incremental cost of that additional capacity.

United Minerals is of the view that if there is to be an application of a factor applied to reflect stranding risk it should apply in the capital component (WACC) and not distort operating costs as these have benchmark comparisons. However United Minerals suggests to the Authority that there is minor stranding risk to the main line and there are mitigation factors and global supply considerations which support this view.

The risk mitigation factors are to be considered firstly and these include:

- FMG's tonnage provides a high degree of risk mitigation to a stand-alone railway,
- encouraging third parties to access the network spreads the risk further regarding the main line capital component,
- it is unlikely that any access agreement will be operational within the first two years of the pricing regime commencing and as the Authorities review of WACC is annually and a broader review of the Regime is five yearly this allows for unforeseen adjustment within a prompt timeframe,
- if a market downturn was so severe and immediate that it represented a fundamental threat inside the above timeframe then TPI would be able to seek from the Authority an immediate review.

However, there are some fundamental factors with regard to the grade quality, and low cost of Pilbara producers in relation to global supply that suggest that price reductions will not result in mine closures, namely:

- The Asian markets are of such volume and growing from low per capita levels of steel consumption that there is and will be a significant Asian base load requirement even during downturns,
- The Chinese and Indian ores are low grade and the Pilbara ores are of the highest grade,
- Australia is the closest supplier and has a freight rate advantage,
- The Pilbara producers are in the lowest quartile of production cost of global producers and low cost producers generally survive the bottoms of commodity pricing cycles especially if they are in proximity to major consumers[6].

4. Route Sections

[6] Analysts prediction for relative operating costs – Seaborne trade, FMG presentation to Diggers and Dealers Conference, June 2008

Appendix C of the TPI submission of Costing Principles and section 2.1.1 of the Overpayment Rules defines the Route Sections as:

> *"The railway infrastructure described in the TPI Railway and Port Agreement between the loadout at the Cloudbreak mine and the dump station servicing TPI's port facilities and additional infrastructure at Anderson Point, Port Hedland".*

And,

> "It is proposed that the railway constructed by TPI from Cloud Break to Port Hedland form one route section"

United Minerals would request that the Authority consider the aspect of fairness in access pricing as the TPI definition aggregates costs and does not provide transparency or fairness to access seekers. As a general principle Rail Access Regulators apply access pricing to the section of line over which the access seeker is to run. However, as it is likely that there will be many access seekers, based upon existing mining and exploration tenements, between Cloudbreak and Port Hedland who will not run over the entire line and whom, under this proposal would be paying a tonnage share of the cost of the entire line involving all assets.

A fairer and more transparent approach would be to define sections of the entire railway based on identifiable management sections such as between sidings, passing loops and terminals. In this way access charges will more fairly reflect the costs over which the access occurs.

5. Economic Life of Assets

The TPI proposal is the same as that determined by the Authority for Westnet except with regards to earthworks, bridges and rail with curves greater than 800m as per Table 1.

Table 1: TPI compared to WestNet Economic Life of Assets comparison.

Infrastructure	TPI Life Expectancy (Years)	WestNet Life Expectancy (Years)
Earthworks for track	50	100
Bridges (not footbridges)	50	100
Curve > 800m & tangent	20	60

WestNet's approved Costing Principles sets out their evaluation of the economic lives of its infrastructure based on the application of MEA with new components together with key determinants of asset life which will have an impact to extend or reduce the life of the asset. This evaluation is based on generally accepted industry lives and WestNet's own experience. The lives adopted by WestNet are generally consistent with those accepted in other regimes. Whilst there may be valid reasons for TPI to propose different lives to the three categories listed in the above Table, it is suggested that the Principles should include a basis or list of consideration factors for economic life calculation in justifying this to the Authority.

Commercial railways are able to lease railway track and it is suggested that where track is leased that the actual leases be considered especially with regard to residual risk.

TPI also propose the concept of a shorter life for a time limited project but once again by having only one section of line this means that there is a main line to multiple locations and spurs to a single terminal. Therefore the shorter life application should be for non-main line extensions or expansions, which relates to the limited possibility of main line stranding.

6. Major Periodic Maintenance and Depreciation

TPI is proposing that where MPM is undertaken to achieve the economic life of the assets that MPM be included in operating costs but MPM is not repairs and maintenance it is renewal of the asset and a capital charge. In estimating the capital base on which to apply WACC TPI are proposing that as this is a greenfield railway and its actual costs of construction are the gross replacement value. However, as stated above the Authority should consider the design and structure of the railway were driven by FMG's commercial imperatives and the railway is not necessarily based on MEA's and nor does it necessarily represent efficient cost.

The depreciation in WACC is applied to the asset base which should be a gross replacement value of an efficient railway not adding to the replacement cost by accepting TPI's actual costs. MPM is replacement of the track and the cost driver should relate to operational standards. TPI do not state a standard that the railway will operate to and propose that any cost of relocation during construction be included in the gross replacement value.

The Australian Rail Track Corporation (ARTC) in their Access Undertaking do not claim depreciation but claim only MPM as this is renewing the track. ARTC treat replacement as that needed to a greenfield site to a performance standard. The Australian Competition and Consumer Commission in its Draft Decision, Access Undertaking – Interstate Rail Network, April 2008[7] accepted this approach.

United Minerals would suggest that the Authority consider the use of MPM in lieu of depreciation. Such an approach would ensure that the railway was at a standard (to be nominated) to meet the task, TPI had incentive to undertake MPM and the access seekers had incentive to fund the investment. Another benefit of this approach is that it would reduce the estimation errors in estimating WACC and provide openness as to the capital works program to meet the operational standard.

7. Other Issues

Financing charges during construction

[7] Section D.5.3.10 Return of Capital

The TPI proposal states that TPI "will include in the capital cost an allowance for its cost of capital and related financing charges during the construction period" and "reliance may be able to be placed on actual historical cash flows during the construction period"[8]. United Minerals would request the Authority that the TPI railway be considered for access pricing purposes as a stand-alone entity using a Regulatory building block approach.

Equity raising costs

United Minerals would request that these types of cost be benchmarked.

Cost Model

TPI are proposing the development of a Costing Model within 18 months of Regulatory approval of the Costing Principles in relation to having actual cost data experience[9]. United Minerals would submit that the purpose of Regulated access pricing is a stand-alone building block approach, in accordance with a predetermined operational standard, rather than actual costs. The timing of the model therefore could be reduced significantly.

Capacity

United Minerals would request that capacity the network can meet current and reasonably projected demand "for all users taken together"[10].

Objectives and Definitions

United Minerals would suggest that an objectives clause and a definitions clause be added to the Costing Principles.

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[8] TPI proposal Section 3.1.1

[9] TPI proposal Section 2

[10] WestNetRail Costing Principles September 2007 Section 2.3