Fortescue
The New Force in Iron Ore

4 July 2013

ATTENTION: JEREMY THRELFALL

Assistant Director Rail
Economic Regulation Authority
PO Box 8469
PERTH WA 6849

Dear Mr Threlfall

Submission to the Economic Regulation Authority ("ERA") under Section 10(1) of the Railways (Access) Code 2000 ("Code")

This is a submission by Fortescue Metals Group Limited (**Fortescue**) pursuant to the ERA's request of 4 June 2013 for submissions relating to the access proposal (**Brockman Proposal**) made by Brockman Iron Pty Ltd (**Brockman**) for access to a part of the railway infrastructure owned by The Pilbara Infrastructure Pty Ltd (**TPI**), a wholly owned subsidiary of Fortescue.

Pursuant to section 10(1) of the Code, TPI has notified the ERA that it considers that the Brockman Proposal would involve the provision of access to the railway system to an extent that will preclude other entities from access to that railway system. Accordingly, the ERA must now determine if TPI and Brockman can enter into negotiations on the Brockman Proposal under the Code.

We note that the version of the Brockman Proposal seen by Fortescue is a redacted version of the proposal submitted to TPI, as provided by Brockman. Relevant to this submission, Brockman redacted information relating to its funding strategy and details of the capacity sought by Brockman.

<u>Fortescue's Requirement For Rail Capacity</u>

Fortescue has by far the largest land holding in the Pilbara, comprising a JORC resource of 15.6 billion tonnes and over 2.2 billion tonnes of reserves. In order to exploit this vast portfolio of reserves and resources and realise value for its shareholders, Fortescue designed, constructed and exclusively funded TPI's entire railway system, including the current expansion of the railway to a name plate capacity of 155mtpa.

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It is of course completely contrary and contradicting to Fortescue's interests and that of its shareholders to invest in large sunk capital projects, such as railway infrastructure, that it does not intend to fully utilise. TPI's railway was designed, constructed and funded by Fortescue to meet its sale and production targets. There is, therefore, no logical basis for Brockman to infer, as it has in its access proposal, that Fortescue has designed, constructed and funded a railway system with capacity surplus to Fortescue's needs.

The current expansion of TPI's railway to 155mtpa is due for completion in the second quarter of FY2014. Fortescue's budgeted production is 133mt for FY2014, with a budgeted run-rate of 155mtpa by December 2013. In addition, Fortescue has commenced early planning of how to economically expand the capacity of TPI's port and rail infrastructure in order to exploit its further production targets and its additional significant portfolio of reserves and resources.

As Fortescue is utilising all the capacity of TPI's railway, unless there is further expansion beyond Fortescue's planned expansions, there is no capacity available to Brockman. In this regard, Fortescue notes that Brockman does not propose any extension or expansion to TPI's railway in order to accommodate Brockman's proposed trains.

Displacement of Fortescue's Existing Entitlements

The Brockman Proposal seeks "sufficient Train Paths to facilitate an annual railed capacity of up to 20mtpa of Product, together with associated train movements". Fortescue is not told of the details of the train paths proposed by Brockman as these have been redacted by Brockman in the version of the proposal released to Fortescue.

Fortescue is fully utilising the available capacity of TPI's railway and will use all future expansions of TPI's rail system that are or have been funded by Fortescue. If Brockman is granted access under the Code to transport 20mtpa on TPI's railway, Fortescue's existing use of the railway will be displaced. This displacement is:

- contrary to section 20(4)(a) of the Act and clause 6(4)(i)(i) of the *Competition Principles Agreement* as it will reduce the incentive to Fortescue to make future investments in maintaining and expanding TPI's railway as Fortescue will not obtain the full benefit of the investment;

- contrary to the interests of BC Iron and other partners of Fortescue in the development of resources in the Pilbara who have contracts for use of the railway (section 20(4)(d) of the Act and clause 6(4)(i)(iv) of the *Competition Principles Agreement*); and

- contrary to Fortescue's rights to continue to utilise all of the existing railway capacity and any expansions it funds (section 20(4)(e) of the Act and clause 6(4)(i)(v) of the *Competition Principles Agreement*).

These adverse impacts are matters that the ERA must properly take into account in making a determination under section 10(1) of the Code.

No Increase In Competition

One of the fundamental objects of the Rail Access Regime is to promote competitive markets. Therefore, in making a determination under section 10(1) of the Code, the ERA must take account of the benefit to the public from having competitive markets pursuant to section 20(4)(h) of the Act.

The global market for iron ore supply and production is highly fragmented and, as such, the introduction of an incremental 20mtpa of Brockman production will not have a material impact on its competitiveness. The level of competition in a market is commonly measured using the Herfindahl-Hirschman Index (**HHI**). When applied to the expected iron ore supply for 2017[1], which is when Brockman expects to be in production, the HHI calculation yields a result of 0.05[2]. This indicates that the market is highly fragmented. Therefore, based on the HHI, the global market for iron ore is a competitive market and the introduction of an additional 20mtpa of iron ore by Brockman will not have an impact.

In addition, the Brockman Proposal will lead to the displacement of Fortescue tonnes, there will only be rent transfer from one competitor to another, and not an increase in supply. This is not only fundamentally contrary to section 20(4)(h) of the Act, but is also contrary to:

- the objective of the Act, which is to encourage the efficient use of and investment in railway facilities (section 2A of the Act);
- the economically efficient use of the rail system (section 20(4)(g) of the Code); and
- the public interest (section 10(4)(b)(ii) of the Code).

Inefficient Use Of TPI's Railway

As TPI's railway is operated at full capacity, the introduction of trains operated by Brockman on TPI's railway will de-rate the capacity, and result in the inefficient use of TPI's railway. This is fundamentally contrary to section 20(4)(g) of the Act.

For example, any future expansions to the railway that Fortescue might make will most likely be delayed if Brockman trains are introduced, resulting in lost iron ore sales to Fortescue. This is because:

- Fortescue will require the consent of Brockman to such expansions. The resultant negotiation of who benefits and pays for the expansion, including complex dispute resolution process and appeals, will materially add to the process. This could add years to the approval process;

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[1] Data sourced from an AME Database (3 July 2013) for 2017 Global Iron Ore Supply

[2] $HHI = \sum_{i=1}^{n} s_i^2$ *where s_i is the market share of firm i, and n is the number of firms.*

- The impact of any expansion on Brockman's use will likely need to be minimised. The mechanism to do this will similarly require complicated dispute resolution processes and appeals;

- Brockman is likely to require third party finance to fund its contribution to the expansion of TPI's railway, which will cause delay, in part due to the negotiation of security arrangements between Brockman, its financiers and TPI; and

- Fortescue's own internal decision making process will be longer than would otherwise be the case because Fortescue will need to be assured that all of the above issues have been resolved to its satisfaction prior to making a commitment to incur the significant capital expenditure required for an expansion of TPI's railway.

There will also be material inefficiencies that will arise from the introduction of Brockman trains, for example, in respect of:

- Train scheduling because Fortescue will no longer be able to reschedule trains so as to respond immediately to changing events such as equipment failure, changes in daily mining production schedules, changes to shipping schedules, weather and track failures;

- The conduct of maintenance because Fortescue will no longer be able to conduct minor maintenance on an opportunistic basis because this requires flexible train controlling systems to alter the rail and trains schedules on short notice to fit opportunistic maintenance activities into windows of capacity on the rail system;

- The timely implementation of changes by Fortescue to operating methodologies to improve efficiency as changes to operating methodologies will impact third party rights (likely subject to disputation) and will delay the introduction of any such improvements.

By reason of section 20(4)(g) of the Act, the ERA must have regard to the inefficiencies that will result from the introduction of Brockman trains, including the examples set out above, in making a determination under section 10(1) of the Code.

The ERA should also give consideration to the 2007 review of the Goonyella Coal Supply Chain commissioned by the Queensland Government and the Queensland Resources Council, which provides a very real example of the inefficiencies and losses that can arise from third party access. That review found that the multi user system resulted in the under-utilisation of the name plate capacity of the infrastructure and over AU$900 million in lost export sales over a 12 month period.

Not In The Public Interest

In exercising its power under section 10(1) of the Code, pursuant to section 10(4)(b)(ii) of the Code, the ERA must have regard to what it “determines to be the public interest".

The Brockman Proposal notably redacted that section which deals with Funding Strategy. However, it is apparent from the title of that section and from publicly available information that Brockman does not have an economically viable project that can underwrite all necessary components of the project, including construction of a port terminal, construction of rail spur, acquisition of sufficient rolling stock, mine development and access charges. Until such time as Brockman can establish the economic viability of its project, significant time and expense will be unnecessarily incurred by TPI, Fortescue, Brockman and the ERA. As such, it is not in the public interest for the ERA to permit negotiations for access to commence under section 10(1) of the Code.

Further, the de-rating of TPI’s railway and corresponding reduction in through put of that system, which will occur if Brockman trains gain access to TPI’s railway under the Code will result in:

- a reduction in the royalties paid to the Western Australian Government;
- reduced federal taxes payable by Fortescue;
- decreased employment in the Pilbara (including adverse impacts on indigenous employment and welfare initiatives); and
- decreased payments to native title holders from lower production.

Pursuant to section 10(4)(b)(ii) of the Code, the ERA must take these adverse effects into consideration in making a determination under section 10(1) of the Code.

Fortescue welcomes further discussion with the ERA in relation to the matters set out in this submission.

Yours sincerely
Fortescue Metals Group Limited

Mark Thomas
Company Secretary