UNITED MINERALS
CORPORATION NL

15th October 2008

Mr Russell Dumas
Director – Gas & Rail Access
Economic Regulation Authority
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Dear Mr Dumas

Please find enclosed the response from United Minerals Corporation for The Pilbara Infrastructure (TPI) Rail Determination of the Weighted Average Cost of Capital in response to Economic Regulatory Authority Issues Paper.

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

Regards,

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The Pilbara Infrastructure (TPI) Rail Determination of the Weighted Average Cost of Capital

response to

Economic Regulatory Authority Issues Paper

by

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Executive Summary

This submission is the United Minerals Corporation NL (United Minerals) response to the Issues Paper dated 4 September prepared by the Economic Regulation Authority (Authority) on the determination of the Weighted Average Cost of Capital (WACC) for the rail facilities operated by The Pilbara Infrastructure Ltd (TPI).

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 Rail Access 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. United Minerals recognises the significant elements of judgment required by regulators in reaching practical determinations that will fairly balance the interests of rail infrastructure access providers and seekers. 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.

It is important that TPI be treated as a stand-alone provider because the construction and configuration of TPI physical rail assets reflects decisions taken by FMG regarding its financial and market obligations during construction with the necessary premise to optimise the mine-port logistics chain. Thus the capital structure of the railway is different to that of purpose built efficient rail transport provider.

Acceptance of TPI's response to the WACC Issues Paper (involving an uplift in relation to claimed stranding risk) and the Costing Principles (in relation to accelerated depreciation on a non-optimal capital base for a stand-alone rail provider) would be to overcompensate TPI for the actual risks it faces in providing rail services to FMG and other third party iron ore producers.

The TPI consideration in relation to an uplift in WACC is the claimed asymmetric/stranding risk arising from market downturn exposure as a single product access provider, compared with a more diversified railway. However, United Minerals would contend 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 as detailed in this submission. The effect of the proposed treatment of depreciation would be to greatly enhance this risk mitigation.

TPI has very significant scope to mitigate this risk via long term contractual commitments from FMG and third parties, with third parties providing capital contributions to meet capacity expansions of the main line. The residual risks not addressed by mitigation strategies are likely to be low because of:

- the low cost and high quality of the mines potentially seeking access,
- the freight rate advantage to Asia over the access seekers and FMG's competitors,
- the low per capita consumption of steel in China and India where structural factors will continue to drive strong steel intensive growth over the next 20 years providing a floor on prices.
- The WACC is to be reviewed annually and the Regime five yearly allowing time for adjustments if necessary in downturns.

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During the period which the Regime will operate, the favourable position of TPI's customer base on the global supply curve and over the commodity price cycle United Minerals would contend there is no substantive evidence that there would be significant mine closures leading to stranding of capacity on the main line.

Therefore there is no factual base for TPI's stand-alone rail business requiring additional returns via WACC or the Costing Principles to compensate for stranding risk. Given that there is no substantive argument put forward by TPI or CRA International (as advisor to the Authority) as to the existence of significant asymmetric or stranding risk there is no need for complex approaches to risk valuation as proposed in the Issues Paper

In conclusion United Minerals would make the following points in relation to the judgments that the Authority will apply to a TPI WACC.

First, there is a need for a consistent approach to risk evaluation to be applied across the WACC calculation and the Costing Principles and if there is to be an allowance for stranding risk it should apply as a WACC parameter on a stand-alone rail provider capital base and not in operating costs which have available benchmarks. If the case for significant residual risk is not accepted then there should be no depreciation uplift included in third party charges.

Secondly, from the current construction configuration the railway will require regular renewal in order to meet the tonnage capacity required and from an access seeker perspective United Minerals would be prepared to share the cost of ensuring the railway can perform the task and is renewed. Given the difficulties of estimating the capital base, United Minerals would suggest that the Authority consider the use of an approved Major Periodic Maintenance program in lieu of a depreciation charge in order to ensure the railway can be operated at maximum efficiency.

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1. Introduction

This submission is the United Minerals Corporation NL (United Minerals) response to the Issues Paper dated 4th September, 2008 prepared by the Economic Regulation Authority (Authority) on the determination of the Weighted Average Cost of Capital (WACC) for the rail facilities operated by The Pilbara Infrastructure Ltd (TPI).

TPI is currently a wholly owned subsidiary of Fortescue Metals Group Ltd (FMG) and to treat FMG and third party access on transparent and equitable terms. It is essential in evaluating a number of the critical parameters about the appropriate capital base and WACC for TPI that these judgments are based on an evaluation of TPI as a stand-alone commercial provider of below rail services. This is important because the current configuration of TPI physical rail assets reflects decisions taken by FMG to optimise the construction time frame and the mine-port logistics chain in relation to market and financing requirements. As such, it does not reflect the configuration that would be adopted by an independent rail operator in terms of engineering design and operating performance, on which both the Costing Principles and WACC calculations should be based. Therefore the parameters of the WACC calculation are likely to be different and generally lower than that claimed by TPI in the WACC and Costing Principles for a greenfield vertically integrated railway because of the ability to diversify commercial risk across a range of customers.

The comments in this paper reflect the above approach and are in accord with the Authority's approach to the calculation of WACC for WestNet Rail (WestNet). The comments are provided in the same order as the questions posed in the Authority's Issues Paper and only focus on those areas where United Minerals has material differences of view to those presented in the Issues Paper and/or the TPI WACC submission.

There are important linkages between proposals in the TPI WACC paper and those in the TPI Costing Principles.[1] This paper should therefore be read in conjunction with United Minerals submission on the Costing Principles.

2. Issue 1): mineral resources in the vicinity of TPI railway

Potential tonnages for shipment within the TPI rail catchment

The United Minerals Railway Prospect is located 330km south of Port Hedland and production is due to commence in 2010 at an initial rate of 2-5mtpa increasing to 10mtpa during its target mine life of 10-20 years.

Other producers or potential producers within the TPI rail catchment include FMG who have already indicated an intention to initially transport some 45mtpa over the TPI infrastructure, doubling this to 80mtpa and rising to 120mtpa by 2011 as Christmas Creek is developed.[2], Hancock Prospecting with initial production planned as 35mtpa rising to 75mtpa and the members of the North West Iron Ore Alliance (Alliance) with plans for initial tonnages of 50mtpa from 2012 rising to 80mtpa by 2020.

[1] Fortescue Winds Back Ambitions, The Australian, p19, October 3, 2008

[2] FMG presentation to Diggers and Dealers Conference, June 2008

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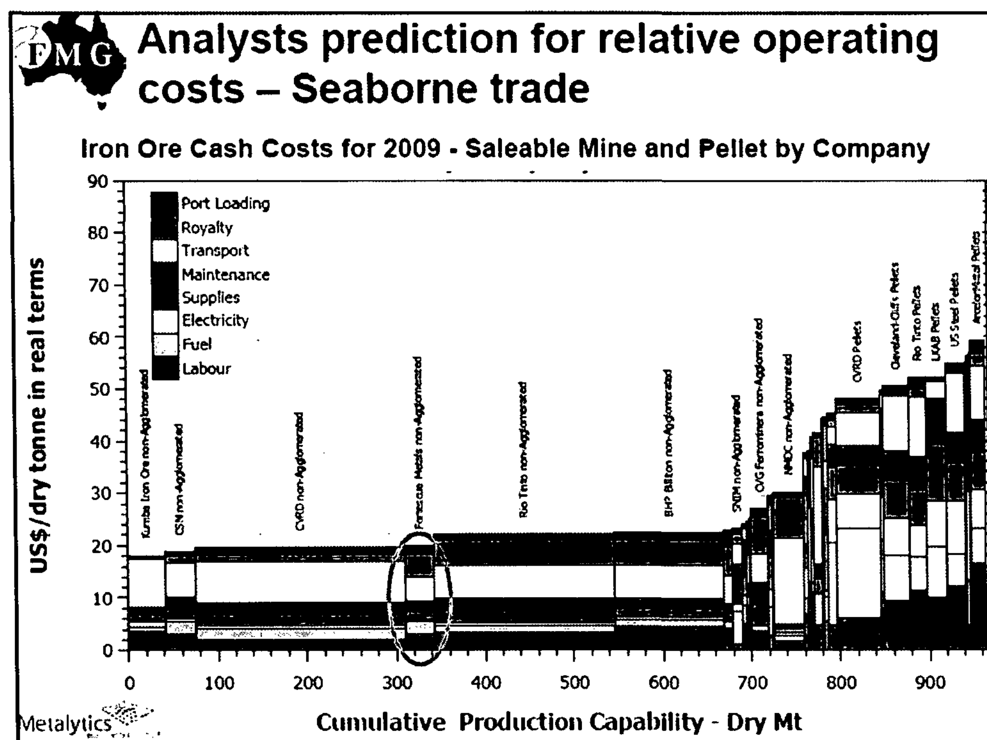
Grade/quality in relation to supply viability

The United Minerals Railway Prospect is very high grade at 61% Fe with low overburden rates. The deposits listed above are direct-shippable high grade ores that do not require beneficiation and are low cost producers in the lowest quartile of the global supply curve.

The grade and quality of the ores in the catchment area is generally of a comparable or somewhat higher quality than that of FMG's Cloud Break/Christmas Creek tenements. As such, they are likely to be well positioned to remain viable across the price cycles compared to lower grade ores such as India and China or ores with a freight rate disadvantage such as Brazil OR South Africa to Asian markets.

FMG's places its own projected FOB costs in the bottom third of the supply curve[3] at prices well below long term averages.

Table 1: Seaborne global iron ore supply curve



This is an important factor in considering the issue of asymmetric or stranding risk raised by TPI in relation to their rail assets which is addressed in more detail in Section 4 below.

3. Issues 2) & 3): appropriate methodology and parameter values for the determination of the WACC for TPI Railway, including CRA commentary and question

General considerations

United Minerals accepts the Capital Asset Pricing Model (CAPM) framework and its constituent elements as a practical and transparent framework for determining WACC.

[3] Source: FMG presentation to Diggers and Dealers Conference, June 2008

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The forward parameters of WACC are difficult to measure creating doubt of the value of a forward looking WACC in making regulatory judgements and therefore the CAPM should be used as a tool for informed and consistent judgement. Rather than placing emphasis on establishing individual parameter values involving complex comparator models United Minerals requests the Authority instead to focus on the overall outcome in terms of the underlying purpose of the Access Regime. Accordingly the Authority also needs to take into account the proposed TPI Costing Principles together with Segregation Arrangements, Train Path Policy and Train Management Guidelines.

United Minerals considers that the total arrangements proposed by TPI would more than adequately compensate a stand-alone rail operator for the level of non-diversifiable risk in prospective demand and supply conditions. The proposed elements that would over compensate TPI for risk are:

1. The claimed requirement to increase WACC for asymmetric/stranding risk for which there is no factual justification.

2. The alternative inclusion of compensation for stranding risk in the Costing Principles as accelerated depreciation and as a value included in the operating costs, and as an uplift factor in calculating the ceiling price.

3. The treatment of the entire TPI line as one route section, hence exaggerating the likelihood of stranding risk across the whole main line (average cost of total capacity) and not limiting the stranding risk to the incremental cost of that capacity.

4. The inclusion of accelerated depreciation for major capital items such as earthworks, bridges and rails, using asset lives of one half/one third of that determined by the Authority as appropriate for WestNet.

5. The treatment of major periodic maintenance (renewal of assets) as operational cost rather than capital cost.[4]

6. The estimation of the capital base by the use of the actual capital and financing costs incurred by FMG which have been dictated by FMG's broader commercial and financing considerations and mine-port logistics.

Item 1 above - stranding risk - is addressed in this submission. Items 2-6 are addressed in more detail in the United Minerals submission on the TPI Costing Principles proposal.

Cost of a Greenfield Railway

The United Minerals Costing Principles submission contends that the TPI railway is neither a modern equivalent asset (MEA), nor an efficient cost railway.

[4] In the submission on Costing Principles and Overpayment Rules, United Minerals would suggest that the Authority consider the use of Major Periodic Maintenance in lieu of depreciation. Such an approach would: ensure that the railway was at a standard appropriate to meet the task, would better align TPI and third party user's incentives to undertake and fund the required investments; provide openness as to the capital works program to meet the operational standard. and reduce the areas of problematic judgments in estimating WACC.

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The TPI railway construction under taking was a rapid development project which resulted in several diseconomies compared to a normally constructed railway[5].

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 and the financing charges be estimated from a building block approach.

Debt and Equity Raising Costs

As these can vary depending on the capital requirement of the corporation and the revenue risk United Minerals would suggest that, where possible, these be benchmarked with rail comparators rather than vertically integrated mining organisations.

Pre and Post Tax Rate of Return

With regard to the use of a post tax nominal rate of return, given the problematic nature of the forward parameters generally, United Minerals supports the Authority's use of a pre-tax WACC on the grounds of consistency with the WA Rail Access Regime.

4. Issues 4), 5) and 6): stranding/asymmetric risk

Mitigation Strategies

The Alliance is of the view that there is minor stranding risk to the main line as there are mitigation strategies inherent in the access process, and on both the supply and demand sides, there are fundamental market forces which, by any reasonable consideration, suggest this risk is minor and there are also some timing considerations as follows:

- If TPI is considered as a stand-alone railway then FMG's tonnage provides a high degree of risk mitigation and even greater surety than WestNet,
- Further risk mitigation is available by encouraging third parties to access the network from 2010 onwards and provides opportunity to plan for this demand and configure the network efficiently.
- The Authorities review of WACC is annually and a broader review of the Regime is five yearly which allows for unforeseen adjustment.
- 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.
- The grade, quality, and low cost of Pilbara producers in relation to global supply is a consideration in that these are low cost producers in proximity to major users and price reductions will not result in mine closures as the Asian markets are of such volume and the Pilbara producers are in the lowest quartile of cost.

TPI also propose shorter economic lives for some major asset components and suggest the use of accelerated depreciation to recover the required return of capital over the user contract lives.

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[5] United Minerals Costing Principles Submission to the Authority, "Cost of a Greenfield Railway", October 1, 2008

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Residual risk – the outlook for global iron ore supply and demand

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:

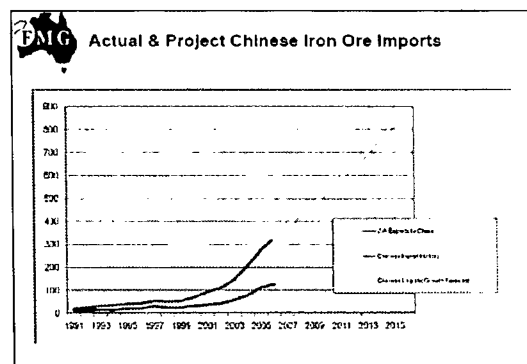
- The Asian markets are of such volume and growing from low per capita levels of steel consumption that there is and will be a significant Asian base load requirement even during downturns,
- The Chinese and Indian ores are low grade and the Pilbara ores are of the highest grade,
- Australia is the closest 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 (refer Table 1).

There is in the iron ore and steel industries emphasis on the strength of the medium/long term outlook for global iron ore demand. In summary, major iron ore companies (including FMG) are forecasting that demand for seaborne iron ore is expected to increase by a third by 2012 and nearly double by 2020. This is underscored by the recent surge in Chinese and Indian interest in direct investment and takeover of emerging Australian iron ore miners. In particular in relation to the takeover bid by BHP Billiton for Rio Tinto there is focus by the European Union Regulatory Review of competition implications on one product only, namely iron ore. "For all the concert of commodities produced by BHP and target Rio Tinto the regulators have focused their reviews firmly on the impact of a deal on the once very mundane market that is iron ore. The fear is that the proposed BHP-Rio would be able to constrain the supply of iron ore out of Australia's Pilbara mines and so drive prices even higher"[6]

This growth is driven by continuing growth in Chinese steel demand and growing Indian demand. China is forecast to double iron ore imports in the next 6 years.

Table 2: rising Chinese iron ore imports[7]



[6] "Samuel skewers EU on takeover" article by Matthew Stevens the Australian October 2 page 19

[7] Diggers and Dealers Conference , May 2008

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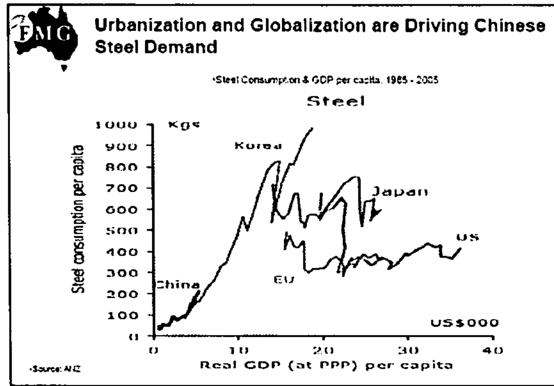
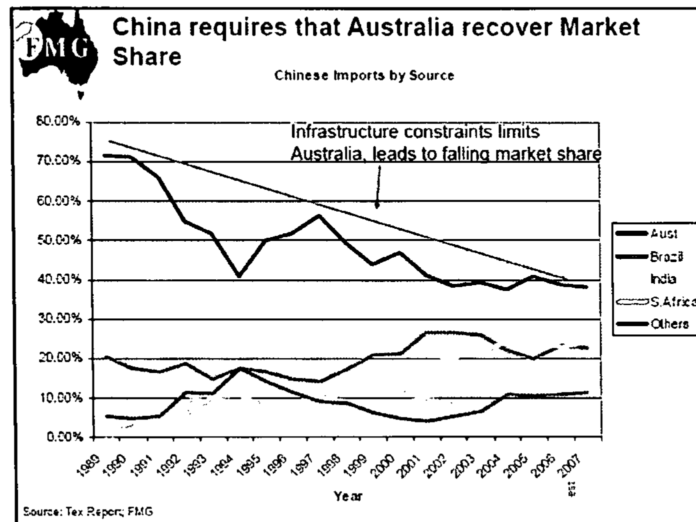
Table 3: Per Capita Consumption[8]



Indian steel demand is at a much lower level than China but steel output is still expected to double by 2020. Much of the resulting increased iron ore demand will be sourced domestically but this will divert Indian exports to China into the Indian domestic market.

Given the Pilbara's generally advantaged position on the global supply curve (see Section 2 above), the increased investment in mines and logistics infrastructure in the region is expected to stabilise and then increase the Pilbara's market share into China.

Exhibit 1: Australian market share of Chinese iron ore imports



5. Conclusion

During the period during which the Regime will operate and the favourable position of TPI's customer base on the global supply curve and over the commodity price cycle United Minerals would contend there is no substantive evidence that there would be significant mine closures leading to stranding of capacity on the main line.

[8] Diggers and Dealers Conference , May 2008

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The stranding risk on the main line is negligible and if so would likely to be mitigated by others requiring the incremental capacity. Stranding risk on the spur lines is also negligible as the construction of such spurs is most likely to be undertaken by the access seeker(s).

Therefore United Minerals can see no substantive argument for TPI's stand-alone rail business requiring additional returns via WACC or the Costing Principles to compensate for stranding risk. Given that there is no substantive argument put forward by TPI or CRA International (as advisor to the Authority) as to the existence of significant asymmetric or stranding risk there is no need for complex approaches to risk valuation as proposed in the Issues Paper

TPI has a surety of captive tonnage greater than that of a more diversified network such as WestNet or the Alice Springs – Darwin Railway and the residual risks arguments would seem to point the other way i.e. towards a lower risk profile for TPI and hence a WACC determination that is somewhat lower than that judged appropriate under the CAPM arithmetic for WestNet.

The Alliance supports the approach and structure the Authority has recently applied to WestNet[9] based on the view that the factual base for the existence of asymmetric/stranding has not been established. Accepting the WACC parameters for WestNet eliminates the need for complex or econometric approaches to risk valuation canvassed by TPI and/or CRA.

In addition to the above there are, two other main points that we would make in relation to the judgments that the Authority will apply to a TPI WACC.

First, United Minerals considers there is a need for a consistent approach to risk evaluation to be applied across the WACC calculation and the Costing Principles. TPI's current proposals would in principle allow for the reflection of their assessment of residual risk to be included via an enhanced depreciation charge. If the case for significant residual risk is not accepted then there should be no depreciation uplift included in third party charges.

Secondly, from an access seeker perspective United Minerals would be 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, would suggest that the Authority consider the use of an approved Major Periodic Maintenance program in lieu of a depreciation charge.

[9] Final Determination 2008 Weighted Average Cost of Capital for the Freight (WestNet Rail) and Urban (Public Transport Authority) Railway Networks; ERA, 23 June 2008.

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