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Mr John Feil
Executive Director
National Competition Council
Level 9 / 128 Exhibition Street
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Mr Stephen Dillon
Project Manager
National Competition Council
Level 9 / 128 Exhibition Street
Melbourne VIC 3000 Australia

Dear Messrs Feil and Dillon,

Re: FMG Rail Access Application

I refer to the meetings and communications between BHP Billiton Iron Ore and the Council in recent weeks to discuss the issues associated with FMG's Rail Access Application.

I appreciated the opportunity to meet with you. Subsequent to the meetings with the Council a number of questions were put to BHPB that (a) showed the difficulties the Council was having in understanding the admittedly complex system that is under consideration; and (b) a particular focus by the Council that I believe addresses only some of the issues that the Council needs to consider.

More generally, I remain concerned that the Council has not fully appreciated the costs and benefits associated with developing another facility to provide the service as well as the costs and benefits of declaration generally.

It is not "uneconomical" to develop another facility

The concept of "uneconomical" under criterion (b) in section 44G(2) requires the Council to bring to account the total costs and benefits to society as a whole of developing another facility. In order to recommend declaration, the Council must be satisfied that it is socially uneconomical to develop another facility in the sense that the social costs of developing another facility outweigh the social benefits of developing another facility. In making that assessment, the NCC must account for the likely costs of shared use of the existing facility.

Annexure 1 to this letter summarises, in a form already familiar to you, why BHP Billiton Iron Ore holds the view that, if the Council's "social" test is adopted, the costs of not developing another facility greatly outweigh the minor benefits of sharing infrastructure use.

The net initial capital costs of track construction are only a very minor factor in this analysis, although they may be relatively easy to quantify. In our discussions regarding the application of criterion (b) to date, however, the Council appears to have focused too narrowly on net initial capital costs of developing/not developing another facility. That is only one factor in the matrix of costs/benefits involved.

Much more significant are the large diseconomies of shared use of the existing facility, which include loss of export sales, perception of BHPBIO by customers as a less reliable supplier, delayed expansions, delayed rollout of new technology, direct second operator costs and inefficiencies, rail optimisation costs, distortion of investment incentives and substantial regulatory and administrative costs (BHPBIO Submission at paras 85-108). While these costs may be difficult to quantify ex ante, compared to these costs of shared use of the existing facility, the social costs of developing another facility are very insignificant.

Costs of Access Disputes

Among the costs of shared use of the facility, I emphasise the likely ongoing administration and dispute resolution costs of shared use of the Mt Newman Line (which are picked up in Annexure 1 among the other relevant costs/benefits). In its *Guide to Part IIIA*, the Council recognises that "regulatory costs" are important in assessing whether the benefits of declaration outweigh the costs. In our discussions though, NCC officers have tended to dismiss these costs.

In this case, these costs are likely to be very significant and are highly likely to accrue, for the following reasons:

- It must be assumed that FMG's incentives are and will remain to minimise its costs of rail operations.
- FMG must be assumed to have the incentive not to agree to costs of use of the Mt Newman Line unless those costs reflect its best likely outcome from arbitration/dispute. This is confirmed by the fact that costs of rail operations involve large amounts of money, compared to the likely costs to FMG of arbitration.
- The factors impacting on "costs" of rail operations are myriad and complex. Thus, it is highly likely that there will be many disputes arising in seeking to resolve appropriate arrangements for shared track use.
- Arbitrations over those issues will be very time consuming for the BHPBIO executives involved (especially those responsible for the front line rail operations who have the greatest operational knowledge) as well as BHPBIO's legal advisers. Arbitrations will be very disruptive to the proper management of the Mt Newman Line operations. FMG on the other hand, will be able to engage these disputes during a period where it is not in production, or only in initial production stages, or otherwise has arrangements in place to use its own newly constructed rail line. Hence any reduced efficiency of the Mt Newman rail operations will not impact adversely on its business.
- Arbitration in this context is essentially a no-cost jurisdiction – each party will bear its own costs. Asymmetric costs of arbitration will be of no concern to FMG.

Moreover, there are very significant risks of regulatory error to take into account here. There is a high likelihood that decisions made by the arbitrator in relation to difficult operational issues will involve error and further costs to the operators on the Mt Newman Line.

The NCC cannot simply defer any consideration of these costs to another day – they must be taken into account in balancing the relative costs of developing another facility and shared use of the existing facility.

Benefits and costs of declaration

The Council's *Guide to Part IIIA* indicates that the key public interest consideration under criterion (f) is economic efficiency. Declaration, the *Guide* provides, should be avoided "where it may yield short term static gains in technical and allocative efficiency that constrain the realisation of longer term dynamic efficiency gains."

In our discussions, the Council does not appear to appreciate the magnitude of the costs of declaration in comparison to the minor possible benefits. Annexure 1 sets out details of the very significant net detriments of declaration to Australia.

Of course, whatever the Council recommends and the Minister decides as to declaration, FMG seems to be committed to developing its Cloud Break project. Hence, on the basis of its own statements, the emergence of FMG as an Australian iron ore mining company will occur whether declaration is granted or another rail track is constructed.

This is consistent with FMG's statement that declaration only serves to "increase the options available to FMG" and that declaration would simply place FMG "in a very comfortable position". FMG has confirmed this position as recently as last week:

> "Mr Forrest said Fortescue's plan was to build its own railway line to ship ore to Port Hedland…. Mr Forrest said the legal challenge seeking access to BHP Billiton's Pilbara railway system was a distraction but he said "it is something I feel should be done"."[1]
>
> "Forrest stressed that while Fortescue had been fighting in the National Competition Council to get access to ore railway lines run by BHP Billiton and Rio Tinto, the development of its Cloud Break deposit was independent of getting rail access."[2]
>
> "On Fortescue's bitter battle to have the National Competition Council force BHP Billiton to open up its Pilbara railway to third-party users, Mr Forrest said he had never wavered from his plan to build a standalone "multi-user" railway."[3]

Indeed, FMG, BHPBIO and the WA Government have all provided submissions to the NCC in relation to FMG's Application outlining the benefits which are likely to accrue, both in a private sense and a social sense, should another facility be developed. This has been confirmed by FMG in its most recent presentation regarding the construction of the FMG Line.

In this case, the NCC is considering one of the most efficient rail systems in the world, which is fully integrated into a highly efficient iron ore production system from mine to port. Our production system has expanded and is continuing to expand rapidly to meet unexpected demands from burgeoning global iron ore demand. This is being done by removing bottlenecks

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[1] Australian Financial Review, 11 August 2005, p17.

[2] Herald Sun, 11 August 2005, p82.

[3] The West Australian, 11 August 2005, p41.

and investing at critical points in the production system in a most cost-efficient way. These increases in capacity are only possible by virtue of the fully-integrated and centrally controlled nature of the single-user production system in place, and are to be contrasted with the difficulties faced in relation to multi-user infrastructure assets such as Dalrymple Bay Coal Terminal and the rail system used by Kumba in its iron ore operations.

The ability to respond rapidly to changes in demand is critical to maximising the efficiency of the Australian iron ore industry. Many hundreds of millions of dollars in export revenues are dependent upon this ability.

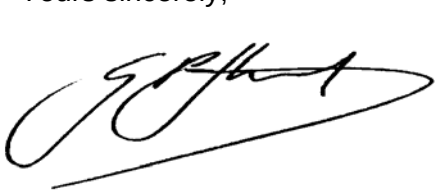
This ability will be substantially destroyed, in BHPBIO's case, if the Mt Newman Line is declared. Further, there will be no off-setting advantage from declaration. There will be no increase in competition in the global iron ore market – FMG will enter the industry notwithstanding, and will have no impact on international competition when it does.

Further assistance

We remain concerned that the NCC has focussed only on one area in this analysis – capital costs. The NCC's recent inquiries of us have not disclosed a concern for the broader and much more significant costs that will arise if the Facilities are declared.

BHP Billiton Iron Ore is happy to discuss any of these issues with the Council in more detail.

Yours sincerely,



Graeme P Hunt

President Iron Ore

Annexure 1 – Social Costs and Benefits of NOT developing another Facility to provide the Service.

Revenue	+ Decreased Australian iron ore sales due to delayed expansion of infrastructure	Shared use of track will delay infrastructure expansions significantly, as consensus will be required among users. Increased risks of infrastructure investments in this context will reduce levels of investment.
	+ Decreased Australian iron ore sales due to less efficient operations	Multiple users will cause additional missed train slots that cannot be recovered due to fixed timetabling. This will directly reduce export sales by existing operators for given infrastructure investment when operating at full capacity, as is currently the case.
	+ Decreased Australian iron ore sales due to decreased operational flexibility	Operational flexibility will be reduced. This will result in reduced capacity utilisation and output, and delayed rollout of new work practices (eg longer trains) and technology.
	+ New entrant unlikely to increase total sales of WA iron ore.	Export customers are likely to take up new entrant sales only by reducing purchases from other Australian suppliers.
Capex	+ Possible small net capital saving by expanding existing rail infrastructure	Existing rail infrastructure is at capacity. Expansion will require detailed negotiation and will impact on existing operations. Notwithstanding, a small net capex saving may be achievable if existing rail infrastructure is expanded to accommodate other operators.
	+ Increased capex required at Mt Newman JV mine and port to offset increased rail bottleneck and reduced efficiency.	Existing rail infrastructure is part of a fully vertically integrated and managed production process. To ameliorate the impact of reduced flexibility in rail system, additional capacity will be required at interfacing mine and port operations.
Opex	+ Delays in achieving cost reductions by implementing new technology	New technology uptake will be delayed significantly. The different scale of operations means that new technology appropriate to the major producers will be extremely difficult to introduce. *e.g.*, driverless train technology cannot be adopted unless all operators take it up.
	+ Increased stockpiling at mine and port	To ameliorate the impact of reduced flexibility in the fully vertically integrated rail system, additional buffer stockpiles will be required at interfacing mine and port operations.
	+ Increased coordination and administration costs. Disruptive arbitration and ongoing dispute costs.	Operational costs will increase due to coordination and administration costs due to multiple operators on the Mt Newman Line. Equally significant will be the "friction" costs of multiple dispute resolution processes over operational issues, where FMG will have overwhelming incentives to invoke those processes on all issues.
	+ No change to likely productive efficiency	Existing operators in the highly competitive iron ore market are already very efficient (at world's best practice). Further Australian iron ore producers will not change incentives/efficiency. FMG will enter the iron ore market in any event, as they have committed to constructing own track.
	+ Loss of opportunity for facilities based competition with new players	There is a possibility that increased facilities-based competition would emerge if FMG built a parallel track to the Mt Newman Line – ready source of operational benchmarking.
Taxation	+ Decreased royalties and taxation	Reduced total sales of iron ore ex Australia will reduce WA and Federal Government revenue.
Social	+ Decreased incentives for investment in mining infrastructure	Increased regulatory risks and potential costs in infrastructure investments will reduce incentives for further investment. This is at a critical time in BHPBIO's own investment program, with many billions of dollars of potential investment under consideration. Other mining operators will adopt "lessons" from the BHPBIO experience.
	+ Decreased reliability of supply for export customers	Where BHPBIO and FMG operations are both dependent on operation of the Mt Newman Line, there will be higher delivery risks for export customers – unlike other contexts, each producer will be exposed to the risks of the operations of the other. This will reduce customer confidence in both producers.
	+ Increased safety and operational risks on and around the Mt Newman Line	Interaction of two or more operators on the Mt Newman Line will necessarily increase safety and operational risks, under any management system, as compared to single operator system.
	+ Reduced employment in regional Australia	Combined rail operations will reduce employment. Separate FMG track construction and operations will involve increased employment in the region.
Environmental	+ Slightly delayed increase in infrastructure footprint.	Two or more rail tracks will be necessary into the medium term. Declaration may delay the construction of the second track for a short period. Environmental approval for FMG track has already been granted.