Government of **Western Australia**
Department of **Treasury**

Attachment 2

Pilbara Ports Assets (Disposal) Bill 2015 Legislative Council Standing Committee on Legislation

Attachment to Department of Treasury Submission

31 May 2016

BACKGROUND TO THE PRESENTATION

OVERVIEW

This short presentation has been prepared to provide further information to assist the Committee with its consideration of the Bill.

It focuses on the following topics:

1. Risk profile of Utah Point BHF
2. Lack of conventional ‘take or pay’ contracts and the risk taken by Pilbara Ports Authority in relation to volumes at Utah Point BHF
3. Construction cost and asset base of Utah Point BHF
4. Return on Asset and IRR calculations on a standalone basis for Utah Point BHF
5. Timeframe for divestment of Utah Point BHF
6. Access and Pricing – interaction of price monitoring with the access regime and enforcement

1. RISK PROFILE OF UTAH POINT BHF

UTAH POINT IS HIGHLY LEVERAGED TO THE IRON ORE MARKET AND THE RISK PROFILE REFLECTS THIS SUBSTANTIAL COMMODITY RISK

- Concentrated customer risk with only two current customers (Atlas Iron Limited and Mineral Resources Limited) currently both shipping iron ore
- Lack of conventional 'take or pay' contracts with customers (discussed further in this presentation) which impact Utah Point BHF when customers suspend export operations – which has happened in the past and may happen again
  - Atlas suspended operations in April 2015 following a drop in spot prices
  - MRL's Mesa Minerals ceased exports at Utah Point BHF in August 2014 with the facility contract expiring in September 2015
  - Consolidated Minerals closed its Woodie Woodie mine in January 2016 and no longer ships manganese ore from Utah Point BHF – currently in care and maintenance mode
  - PPB Advisory, the Independent Expert appointed for Atlas Iron Limited[1] on its debt restructure noted Atlas Iron volumes are expected to fall in the financial year ending 30 June 2017 as the Wodgina and Abydos mines reach their end of lives (and new mines are in ramp-up phase). It also noted that at current iron ore prices it may not be commercial to invest in development of new mines
- Counter party risk – major customers have a below investment grade credit rating
- Operations at a single berth without the ability to diversify across other geographies or commodities
- Past performance is not a reflection of future performance and current market conditions have reverted to longer term average pricing. Utah Point BHF returns going forward may be materially lower than historical returns

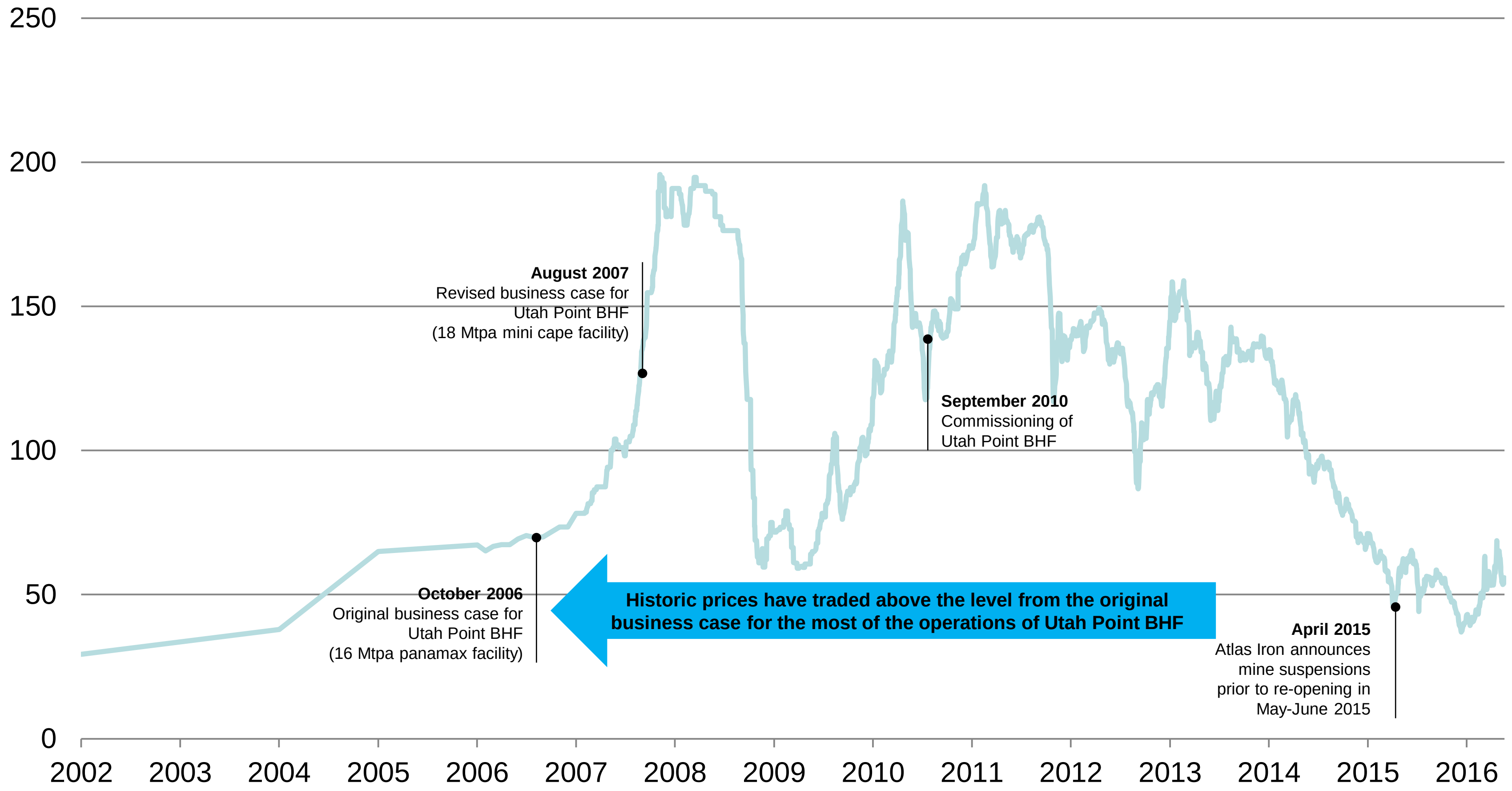
Notes

1 PPB Advisory prepared an independent expert report Independent Expert Report in relation to the proposed Scheme of Arrangement for Atlas Iron Limited dated 24 February 2016

1. RISK PROFILE OF UTAH POINT BHF

UTAH POINT BHF IS EXPOSED TO DOWNSIDE RISKS FROM MINE CLOSURES; HOWEVER, GIVEN FACILITY CHARGES ARE FIXED FEE, THE TERMINAL DOES NOT SHARE IN GAINS FROM FAVOURABLE PRICE MOVEMENTS

Historic iron ore price movement (US$/tonne) 62% Fe spot China Import CFR

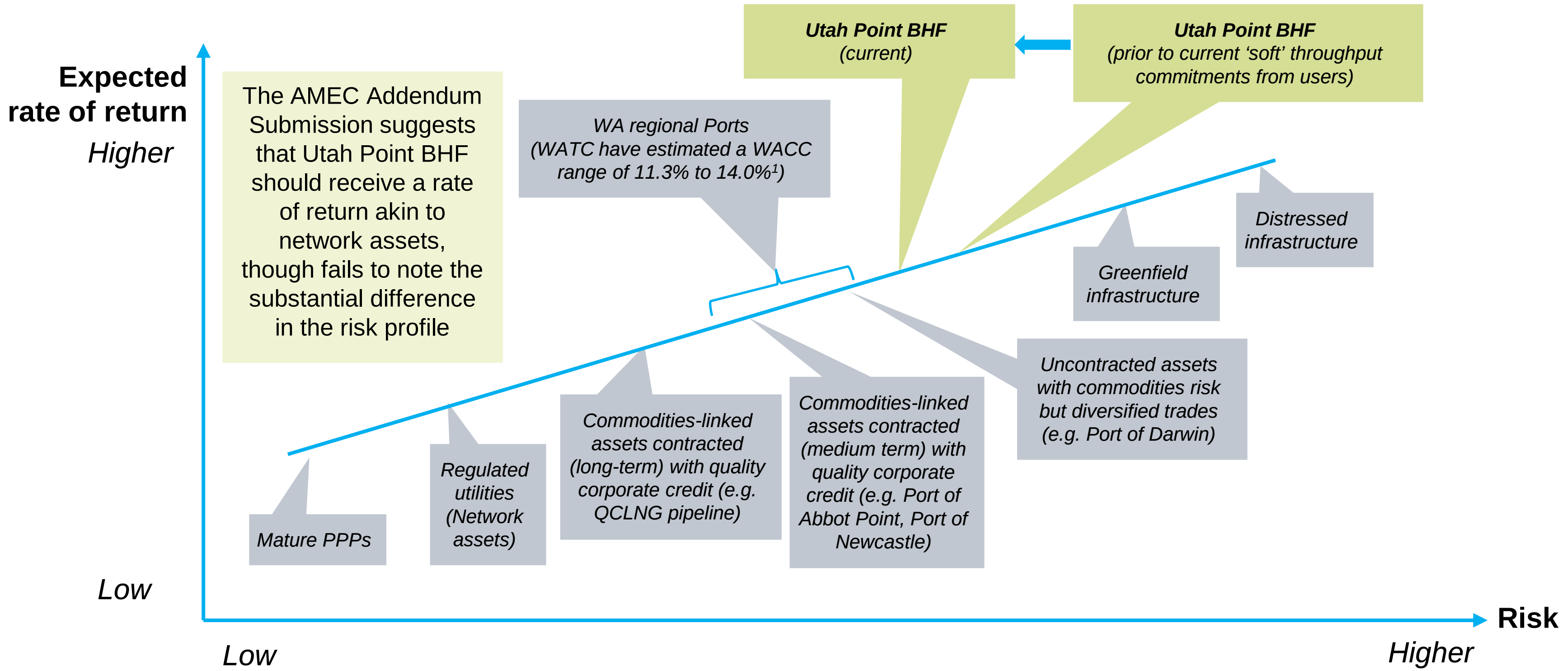


Source The TSI 62%Fe benchmark began in November 2008. Prior to this an Asian Metal 63.5%Fe daily benchmark price has been converted to a 62%Fe equivalent price back to February 2007. World Bank 62%Fe China CFR price series used prior to February 2007 (which provides annual prices prior to 2006)

1. RISK PROFILE OF UTAH POINT BHF

THE REQUIRED RATE OF RETURN FOR ASSETS IS DEPENDENT ON THE ASSET RISK PROFILE

Riskiness of asset and required rate of return



Utah Point BHF Considerations

- Commodity linked exposure
- Lack of conventional 'take or pay' contracts
- Customer concentration
- Creditworthiness of customers – sub credit grade
- Lack of diversification of operations
- Has been impacted already by mine shutdowns
- Limited alternative uses

Notes

1 WA Treasury Corporation – Rates of Return for Western Australian Ports (October 2013) estimated the following pre-tax nominal WACCs: Albany 13.9%, Broome 14.0%, Bunbury 12.6%, Dampier 11.3%, Esperance 13.1%, Geraldton 13.1%, Port Hedland 11.6%

2. LACK OF CONVENTIONAL ‘TAKE OR PAY’ CONTRACTS

SOME USERS HAVE PROVIDED ‘SOFT’ COMMITMENTS FOR VOLUMES WHICH PROVIDE ONLY LIMITED PROTECTIONS

- The current users of Utah Point BHF have provided some ‘soft’ commitments for volumes. However, these fall short of what is expected in conventional ‘take or pay’ commitments
- During construction, PPA required the foundation users to prepay facility fees. However, this was not analogous to conventional take or pay contracts and a significant proportion of the prepayments were subject to interest charges:
  - Users were permitted to draw down against these amounts at their convenience, and provided for the accumulation of interest (similar to a form of loan) and the arrangements provided for the accumulation of interest on prepaid amounts
  - By contrast, typical take or pay obligations generally prescribe an amount of goods or services to be paid for in each year, irrespective of whether or not the relevant service is used or product taken
  - As outlined in the PPA Submission, these prepaid fees have now been offset against facility charges or repaid

Elements of a conventional take or pay contract	Applicable to Utah Point BHF?
Obligation to pay charges linked to a significant proportion of allocated capacity	×
Obligation to pay charges backed by creditworthy entities[1] or guarantees	×
Appropriate level of revenue is received by facility operator from recovery of charges	×
Application of take or pay or level of commitment are not linked to commodity prices	×

Notes

1 Atlas Iron Limited remains below investment grade - On May 9, 2016, S&P Global Ratings lowered its long-term corporate credit rating on Atlas Iron Ltd. to 'SD' from 'CC‘ and at the same time, lowered the rating on the company's senior secured notes to 'D' from 'CC‘

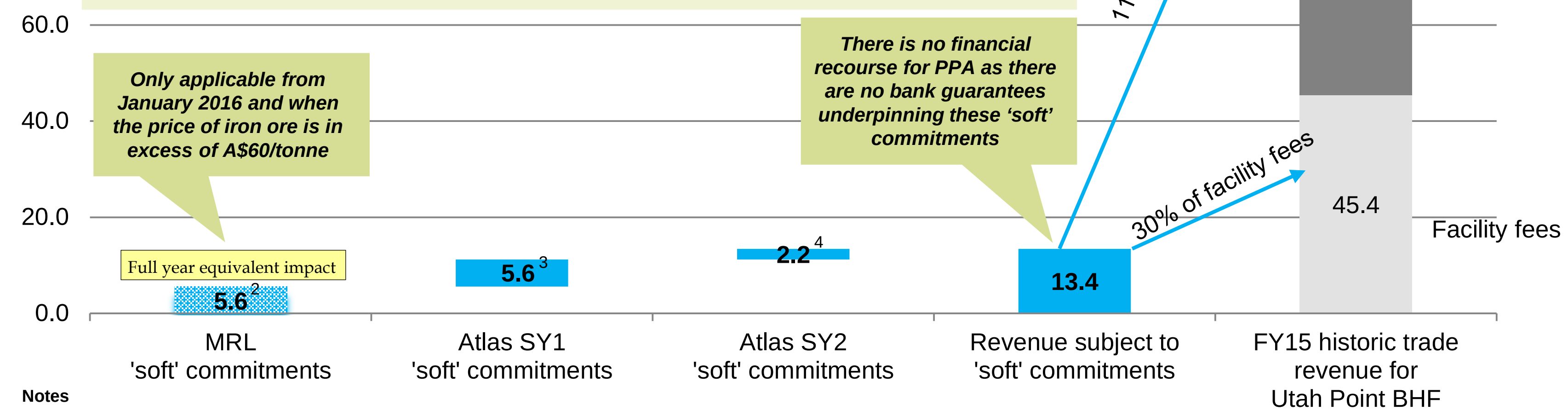
2. LACK OF CONVENTIONAL ‘TAKE OR PAY’ CONTRACTS

THE ‘SOFT’ COMMITMENTS FROM USERS RELATE ONLY TO THE FACILITY FEE AND REPRESENT ~11% OF TOTAL TRADE REVENUE

Illustrative Utah Point BHF ‘soft’ commitments[1] as compared to total revenue ($m)

Key Assumptions:

- This chart has been calculated assuming no throughput at Utah Point BHF (and assumes the iron ore price restrictions noted below are not triggered)
- The previous slide highlights the other elements that are usually expected in take or pay agreements but do not apply to these soft commitments from users
- This assumes that Atlas and MRL will deliver on ‘soft’ take or pay commitments which are not backed by bank guarantees and therefore present counterparty default risk



Notes

1 As at 30 June 2016 (therefore excluding commitments that expire prior to this time)

2 3 Mtpa commitment at the Stockyard 1 Facility Charge (currently $1.87/tonne) – has been in place since January 2016 (full year benefit applied)

3 3 Mtpa commitment at the Stockyard 1 Facility Charge (currently $1.87/tonne) – deficit charges have been in place since 2014. The target throughput amounts have been temporarily increased for the period 1 July 2015 - 30 June 2016

4 2 Mtpa commitment at the Stockyard 2 Facility Charge (currently $1.10/tonne) – deficit charges have been in place since 2014. The target throughput amounts have been temporarily increased for the period 1 July 2015 - 30 June 2016

5 If the $2.50/tonne discount applied in FY15, the total revenue would have decreased by $48.8 million to $77.7 million. In this scenario the soft commitments would cover 17% of adjusted revenue

2. LACK OF CONVENTIONAL ‘TAKE OR PAY’ CONTRACTS

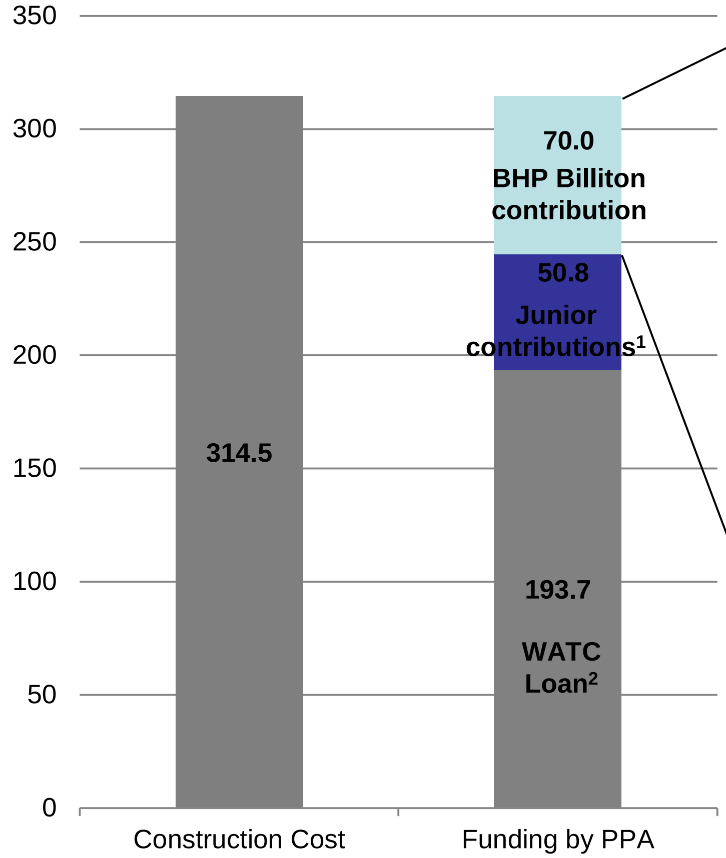
IF PPA IS ABLE TO ENCOURAGE USERS TO ADOPT CONTRACTS THAT PROVIDE A MORE CONVENTIONAL FORM OF ‘TAKE OR PAY’ PROTECTION, THIS WILL ASSIST IN MOVING THE CONTRACTS DOWN THE RISK / RETURN PROFILE

- On 15 May 2015, the State announced a $2.50 / tonne discount, which expires on 30 June 2016, which was not conditional on any reduction to volume risk
  - In negotiation with its customers, PPA has been able to introduce some amendments to abandonment clauses and some level of ‘soft’ commitments from users as outlined on the previous slide
- The State is supportive of offering lower charges to users in exchange for a lower risk to PPA on volumes as it results in a risk adjusted return to PPA with a natural sacrifice of revenue in exchange for lower risk taken on volumes
  - For example, PPA entered into a Supplemental Deed with Mineral Resources Limited in January 2016 which introduced the concept of a ‘Material Deficit Charge’ providing a ‘soft’ commitment for 3 Mtpa
  - Since the submission and Treasury presenting in front of the Committee, PPA has entered into a new Supplemental Deed with Mineral Resources Limited which extends the additional throughput capacity and effectively removes the higher spot charges that applied in the original agreement
  - Should users be willing to introduce more conventional ‘take or pay’ qualities to the contracts, it is understood that PPA’s intention would be to continue implementing the above approach by reducing charges that take into account the revised risk profile

3. CONSTRUCTION COST AND ASSET BASE

THE ENTIRE CONSTRUCTION COST FORMS THE INITIAL ASSET BASE, WHICH PPA FUNDED THROUGH THE FOLLOWING THREE METHODS

Utah Point BHF Construction Cost ($m)



Commentary on BHP Billiton contribution

- BHP Billiton made an initial contribution of $70 million to the construction of Utah Point BHF in exchange for the reservation of capacity at the facility and other rights – this was not a ‘gift’
- The initial proposal was for BHP Billiton to reserve 6 Mtpa out of the original design specification of 16 Mtpa (prior to the redesign to the current larger facility), with the remainder of capacity available for junior miners
- PPA has subsequently entered into other commercial arrangements with BHP Billiton to release this capacity, which has allowed it to be reallocated to junior miners
- If PPA did not secure this funding from BHP Billiton, it would have had to seek funding from alternative sources and should therefore be included in the asset base

Notes

1 As PPA did not have take or pay protection to underwrite the construction of the facility, it instead required junior miners to prepay some of their facility fees. All of these prepayments have now been repaid to the junior miners

2 PPA funded the remainder of the construction costs with a loan to WATC

3. CONSTRUCTION COST AND ASSET BASE

THE SPECIFICATION AND DESIGN OF UTAH POINT BHF EVOLVED DURING A HIGH GROWTH PERIOD IN THE PILBARA

- The initial business case for Utah Point BHF was prepared in October 2006 by PPA (then Port Hedland Port Authority) which envisaged a $186 million development for panamax vessels of up to 70,000 dwt and throughput of up to 15 Mtpa
- As it became apparent that the demand would exceed initial specifications, the business case was revised in August 2007
  - The revised business case catered for small cape sized vessels of up to 120,000 dwt and throughput of up to 18 Mtpa at a revised cost estimate of $225 million
  - To facilitate this, other changes to the design included: raising the ship loading rate from 5,000 to 7,500 tonnes per hour, increasing the draft on the berth pocket from 13.2 to 14.2 metres and replacing traditional mooring line berthage with contemporary automated mooring suction capability
- By the time of commissioning in September 2010, the final construction cost exceeded this revised budget
  - The project took on a fast-track nature of delivery considering proponent pressures for the provision of increased throughput capacity and the delays incurred in obtaining the relevant environmental approvals. Price increases/escalation, scope changes, and other related factors all contributed to the delay and overrun to the project.
  - The construction of Utah Point BHF also occurred at a time of unprecedented growth in the Pilbara which resulted in shortages of engineering and construction services throughout the region

4. RETURN ON ASSET AND IRR CALCULATIONS

ALL RETURN ON ASSET AND IRR CALCULATIONS BY THE INDEPENDENT PRICING REVIEWS WERE UNDERTAKEN ON A STANDALONE BASIS FOR UTAH POINT BHF

- The AMEC Addendum Submission makes reference to the fact that AMEC has not been provided with the two independent reviews commissioned by Treasury
- However, the next statement in the AMEC Addendum Submission pre-supposes that calculations were done on the basis that the entire PPA asset base was included and not just Utah Point BHF on a standalone basis. This is not an accurate assumption as the Treasury submission only references return on assets and IRR calculations on a standalone basis for Utah Point BHF

Methodology for calculating Return on Assets

- The Pilbara Ports Authority separately calculates a Return on Assets (on a whole of port basis) which is disclosed in its audited annual report. The methodology used by PPA is consistent with accounting standards and has been subject to review by PPA’s external auditor. The PPA calculation does not include the adjustments proposed by AMEC (and it is contended that such adjustments would be contrary to standard practice)
- The methodology utilised by the two independent reviews to calculate Return on Assets for Utah Point BHF on a standalone basis is also consistent with standard practice

5. TIMEFRAME FOR DIVESTMENT

DELAY IN THE PASSAGE OF LEGISLATION TO BEYOND JUNE 2016 WILL PREVENT THE TRANSACTION FROM BEING COMPLETED IN 2016

- Treasury and its advisers are working to deliver transaction completion by December 2016, which was premised on a timetable for enabling legislation being passed by 30 June 2016
- A delay beyond this could result in the commencement of the transaction process being deferred until after the 2017 State Government election which may have the following impacts:
  - no transaction proceeds in the forward estimates for the 2016-17 financial year
  - Transaction completion likely delayed until late 2017
  - the need to incur substantial additional advisory costs for significant rework through the first half of 2017 across all work streams including financial, economic, environmental, engineering, and legal prior to re-establishing the sale process (an update of these reports would be required to ensure current information is presented to the market and the State could consider its risk positions and warranties provided)
  - heightened uncertainty as to the State's ability to complete the divestment, which may lead to lower transaction proceeds
  - perception from external parties (including credit rating agencies) that the State is not able to deliver on its fiscal reform program

6. ACCESS AND PRICING

THE NEGOTIATE AND ARBITRATE ACCESS AND PRICE MONITORING REGIME ARE CONSISTENT WITH OTHER PORT ACCESS AND PRICING REGIMES

- Price monitoring is a well established pricing regime adopted for ports. It is consistent with similar, proven regimes (for example, South Australia has used price monitoring since 2001)
- To allow for pricing in the access negotiations would mean, in practice, an arbitrator setting the prices as opposed to the ERA having the central role
- Under the Utah Point BHF regime the ERA has the following options:
  - the ability for the regulator to seek an injunction to enforce the obligation to negotiate in good faith
  - the ability for the regulator to levy a pecuniary penalty for contraventions of specified obligations of the regime (the obligations of no hindering and no discrimination)
  - the ability for the regulator to issue a warning notice to incentivise the terminal operator to comply with the regime
- Additionally, an individual access seeker may elect to resolve a dispute under TerminalCo’s dispute resolution policy or the negotiate/arbitrate framework should they believe that TerminalCo is not complying with its obligations. The arbitration will be binding on the parties

6. ACCESS AND PRICING

RATIONALE FOR THE ERA AS REGULATOR

- In previously regulated arrangements such as the WA Rail Access Regime, concerns have stemmed from the fact that the ERA would not enforce the Code relying on the proponents to enforce the Code themselves. At Utah Point BHF the ERA will not have the option of using proponents to enforce the Code themselves (other than in respect of the complaints policy and negotiate/arbitrate regime). Rather, the ERA must take that action
- Further, if the regime is not functioning as required then it is open to the Minister to amend the regime simply via amending the regulations. Likewise, if the underlying transaction documents are amended this will trigger a review of the regime

REFERENCES

DEFINITIONS

- **Committee** – Legislative Council Standing Committee on Legislation inquiry into the *Pilbara Ports Assets (Disposal) Bill 2015*
- **AMEC Addendum Submission** – AMEC addendum to the Committee dated 11 May 2016
- **AMEC Submission** – Written Submission by Association of Mining and Exploration Companies to the Committee dated 19 April 2016
- **AMEC Hearing** – References to the Hansard from Association of Mining and Exploration Companies hearing at the Committee on 13 May 2016
- **Atlas Submission** – Written Submission by Atlas Iron Limited to the Committee received on 26 April 2016
- **Atlas Hearing** – References to the Hansard from Atlas hearing at the Committee on 13 May 2016
- **PPA Submission** – Written Submission to the Committee by Pilbara Ports Authority dated 26 Apr 2016
- **TerminalCo** – the future Utah Point BHF lessee