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Commentary: Tough markets demand a rethink of rail in Labrador Trough

By: Glen Ireland and Mark Aplin, special to The Northern Miner
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During its successful 2014 election campaign, Quebec's Liberal Party vowed to revive *Plan Nord* — a cherished blueprint for opening up the province's vast northern mineral wealth for development. Brainchild of former Liberal Premier Jean Charest, the plan was shelved for two years after his defeat to the Parti Québécois in 2012.

The mining industry has recently given its strong support for Premier Philippe Couillard's refreshed Plan Nord, which includes an ambitious, greenfield 400+ km multi-user railway corridor and port connecting stranded mineral deposits in the legendary Labrador Trough to Sept-Îles on the coast. Energy and Natural Resources Minister Pierre Arcand, Plan Nord's helmsman, announced in October 2014 a major technical study of the project by Montreal-based Canarail, whose fees will be paid by Quebec taxpayers and supportive junior miners.

While "Plan Nord redux" now appears to be back on track, some awkward but important questions are being asked: Can an infrastructure mega-project in the Labrador Trough be justified at current, heavily-depressed iron ore prices? And, is a new railway corridor really the only viable logistics solution for planned iron ore mines?

Soon after Premier Couillard's government took office, a flood of iron ore from newly-expanded mines in Australia's Pilbara, combined with perceived weakness in core demand markets, drove prices from US$130 per tonne to US$70 per tonne — a five year low.

Many analysts predict that iron ore prices will remain soft for years, due to market oversupply meeting continuing global economic weakness and lower-than-expected public infrastructure spending.

The viability of operating iron ore mines and development projects alike is under threat, including in West Africa, China and the Labrador Trough.

While closure of high-cost iron ore mines and the gradual rebalancing of supply and demand will eventually support improved prices, falling energy costs could prolong this process. In any event, better prices will only help producers that survive the cull.

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So, within this challenging macro-environment, will the Labrador Trough be a survivor or a victim?

As with other globally-significant, undeveloped iron ore deposits, the main “structural” challenge facing Quebec’s iron ore resources is their location. This disadvantage is accentuated today by a lack of operational scale.

The global benchmark iron ore price is based on delivery to Qingdao, reflecting China’s role as the world’s dominant consumer of the metal. The theoretical distance from Sept-Îles by freighter results in a relatively low net-back price for Quebec’s iron ore output. This puts Labrador Trough mines at a competitive disadvantage, which is only partially offset by the quality of some deposits.

Therefore, in order to mitigate this disadvantage, every effort must be made to minimize logistics costs associated with delivering mined ore to Sept-Îles.

In terms of relative scale globally, Quebec is a minnow. Iron ore involves bulk mining of large quantities of material. Competitive advantage is achieved by spreading the high fixed costs of logistics and mine infrastructure over as much throughput as possible.

In Quebec, **Rio Tinto**-controlled (NYSE: RIO; LSE: RIO) Iron Ore Company of Canada (IOCC) has annual output of about 26 million tonnes, and **ArcelorMittal**’s (NYSE: MT) mine produces only about 24 million tonnes per year.

By comparison, Rio Tinto shipped around 270 million tonnes of iron ore from the Pilbara in 2014, using 15 mines, four port terminals and 1,700 km of interconnected railways.

The Labrador Trough will need both greater scale and more efficient use of infrastructure, or it will die.

The vision of building a new railway corridor through remote and harsh terrain is attractive to Quebec’s politicians and contractors, as well as northern communities suffering from chronic under-employment.

Construction of IOCC’s railway in the 1950s — a major engineering feat — inspired Hammond Innes to write the book The land God gave to Cain. Although the total cost of the proposed corridor is not yet known, it will likely be in the range of C$5-10 billion, and possibly more.

To put this into context, if the new corridor were to serve 100 million tonnes per year of incremental iron ore production, the cost of servicing capital on C$10 billion of infrastructure investment would be approximately C$14 per tonne. At current iron ore prices, sponsors of the proposed mines will struggle to generate positive value for their shareholders and, consequently, to raise the required capital.

Even if they did manage to invest, their high cost structure would perpetuate the boom-and-bust scenarios that led to the demise of Schefferville in 1982, and currently threaten Labrador City’s status as “Fort McMurray East”. The Labrador Trough has enough structural challenges, without adding expensive or under-utilized infrastructure to the list.

The Quebec government’s main priority in the Labrador Trough should be to encourage and enable the development of new mines of material scale, which are capable of creating sustainable jobs and long-term provincial royalty streams.

A grand railway project cannot, and should not, be an end in itself. Minister Arcand, in the face of commodity price headwinds, should consider alternative, more cost-effective infrastructure solutions.

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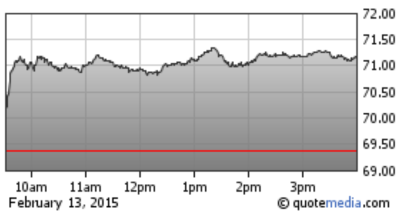

Price Data

Last Price	**71.10**	Last Trade	**4:50**
Change	**1.73**	% Change	**2.49%**
Tick	**–**	Volume	**82.24m**
Open	**69.21**	Previous Close	**69.37**
Day High	**71.35**	Day Low	**69.21**
Bid	**70.85**	Bid Size	**0**
Ask	**71.29**	Ask Size	**0**

Fundamental Data

52 Week High	**85.05**	EPS (TTM)	**N/A**
52 Week Low	**57.68**	PE Ratio	**N/A**
Ex-Div Date	**N/A**	Dividend	**N/A**
Yield	**N/A**	Shares	**N/A**
Market Cap	**N/A**	**Exchange**	**TSX**

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In particular, he must find a way to leverage the Labrador Trough's existing railways owned by IOCC and ArcelorMittal, for the greater benefit of the province. These facilities are purpose-built, have available capacity, and can be readily expanded.

Indeed, in a 2013 presentation, Rio Tinto told investors that IOCC's 100%-owned railway has an "current capacity of about 35 million tonnes per year" (of which about 26 million tonnes per year is being used) and is "expandable to about 82 million tonnes per year and beyond."

As for IOCC's port, Rio Tinto said its capacity is "expandable to 31 million tonnes per year with minimal investment" and has "potential up to about 200 million tonnes per year."

The capital cost of building additional sidings, passing loops, spur lines and wharfs would be much less than the price tag for a new corridor. Moreover, a logistics solution could be achieved more quickly, and with lower project execution risk.

The costs to prospective mining projects of supporting new rail and port infrastructure will likely be prohibitive, and will certainly be sub-optimal.

So, why isn't Quebec's government pursuing the opportunity to achieve lower industry costs through the shared-use of existing infrastructure?

The main impediment to the shared-use of existing railways in the Labrador Trough is legal, rather than financial or technical. There is, at present, no regulatory framework by which third parties can gain fair access to the track. Access can only be achieved through private negotiation with the owners, who clearly hold all the cards.

ArcelorMittal's railway is sited entirely within Quebec's boundaries. Therefore, it falls outside federal legislation governing the access and tariff policies of Canadian Pacific, Canadian National, and other regulated "common carriers".

The legal status of IOCC's railway is unclear, although it appears to disclaim common carrier status.

ArcelorMittal has declined to share its railway and, although IOCC grants limited access to competitors, its terms are considered onerous.

Following the painful decision to close its Bloom Lake iron mine near Labrador City last year, **Cliffs Natural Resources** (NYSE: CLF) recorded a C$450 million write-down related to its rail transportation commitments to IOCC over the next three years. The strong competitive advantage conferred on IOCC by its railway was alluded to in Rio Tinto's 2013 investor presentation, which billed the asset as the "only third party accessible rail in [the] Labrador Trough."

If the government wishes to make the development of new mines in northern Quebec commercially viable, it needs to consider regulating the Labrador Trough railways, in common with other "essential facilities".

It could, for example, impose an obligation on IOCC and ArcelorMittal to deal with third-party access requests fairly, to charge reasonable and "cost reflective" tariffs for use, and to undertake/permit capacity expansions under certain conditions.

Helpfully, there is strong precedent for regulating access to private mining infrastructure in other mineral-rich countries. In the 1990s, the Australian government introduced a "National Access Regime", which provides a road map for "declaring" bottleneck infrastructure to be operated on "open access" principles.

Interestingly, one of the targets of the legislation was the Pilbara iron ore railways owned and controlled by Rio Tinto. Although this initial effort failed in the face of an aggressive defense mounted by the Pilbara behemoth, open access legislation and undertakings were eventually used by the Western Australian government to open up other private iron ore railways and ports.

There is much that Quebec's government can learn from the positive and negative experiences in Australia, and similar experiences in other countries, should it seek to impose open access in the Labrador Trough.

Following the closure of Bloom Lake, Plan Nord's critics publicly predicted its demise. Minister Arcand was defiant, claiming that "the prices of metals are cyclical and we are now putting the right conditions in place for when they rise back up."

His confidence is admirable, but may be misplaced. Major structural changes are occurring in the global iron ore industry, and the Labrador Trough is at serious risk. The Quebec government must address the new market reality, even if this requires a limited Plan Nord rethink.

— Glen Ireland and Mark Aplin are with London-based InfraShare Partners, which is engaged in brokering and implementing shared-use solutions for mining, oil & gas and other resource infrastructure assets. InfraShare's solutions support operationally workable, commercially fair and financially bankable outcomes that promote broad-based economic development in host countries. Visit www.infra-share.org *for more information*.

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