INVESTING IN RISKY GEOGRAPHIES

MELBOURNE MINING CLUB - 30TH OCTOBER 2002

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Good afternoon Ladies & Gentlemen. What a privilege it is to be with you in Melbourne today ! I am now into my second year in this great city, and so far I have but one complaint: That it's tough to make a good weather forecast. Therein lies a fair amount of risk. For example, my wife and I hope to attend our first Derby Day this Saturday, and then on Tuesday, also our first Melbourne Cup. Now I am personally fairly relaxed about horse races, but my wife has developed this obsessive interest in the weather, for apparently THAT will determine what hat and dress she must wear on the day. No doubt, many men here will understand the downside in this for me, the personal risks that I take on in my marital relationship, if I venture a forecast in this risky weather geography that is Melbourne. And so it is somehow fitting that my subject today should be *"Investing in Risky Geographies"*.

It seemed to me that there were two ways for me to approach this subject. Either I could read to you those sections of our Investment Process Manual which deal with geographic risk; or alternatively, I could follow the Harvard Business School method, use case studies, and extract a few Pearls of Investment Wisdom as we go along. Those among you who have even a passing acquaintance with the tortured syntax of modern corporate writing will be pleased indeed that I have opted for the case study method !

Well, let me start by telling you that international investors, those who provide the capital which is the lifeblood of major corporations like BHPBilliton, are always a rather nervous bunch. They are obsessed, and understandably so, that those to whom they give their money should achieve good returns at minimum risk. If you let them down in this, they will take your share price down in turn, and your market rating will disappear, like mist before the morning sun.

An important part of my job is therefore to visit investors at least twice a year, so that they might judge whether my colleagues and I are getting that risk-return balance right. Often I have been asked why we put so much money into *"Risky Geographies".*

Now on such occasions, it would be nice if I could say: "Well, actually we invest only in projects that lie within a 100km radius of this Melbourne Town Hall" - though on a nice spring day in Europe, one might extend that also to a 100km radius, centred on the Eiffel Tower in Paris, and one centred on the Bahnhofstrasse in Zurich. But all in our industry know that when the Creator formed the world, the really good mineral deposits somehow got scattered into geographies that the major capital markets view as risky. And as the old geologist said: *If you want to hunt elephants, you must go to elephant country.*

So instead of rattling on about Melbourne, and Paris and Zurich, I have learned to answer that investor question about *Risky Geographies* with a question of my own: I ask in which countries the investor would prefer me to invest? The answer almost always suggests that there is no better way, than in the US of A. So I let that idea hang there in the air for a while, then I tell them about the testimony of Mr Douglas Yearley, in the late Nineties, before the Natural Resources Subcommittee of the US Senate. Mr Yearley was the head of one of the most important metals companies in the United States, and he told the Senate subcommittee that "--- *regulatory uncertainty springing from the United States government's unsettled policies and programs --- is prompting* *metal mining companies to curtail US exploration and go outside the country".*

After a few moments of thought, my questioner will invariably concede that indeed, the US might not be the perfect investment region. But he will then quickly suggest Canada as the preferred geography.

So I let that one sink in, and then I remind my questioner of Voisey's Bay. Voisey's Bay, Ladies and Gentlemen, is probably the greatest mineral discovery made in the past 30 years. It has the potential to be a fabulously rich nickel mine, and to bring investment and employment to a region much in need of both. But for years that project has been mired in complex disputes and litigations with the Provincial government and local communities. And so not a single job has been created, or a cent of revenue earned, and the cost to the mining company involved has been simply staggering.

It is while my questioner is struggling with that body blow that I deliver the knock-out punch: I tell him about our Mozal project in Mozambique, a country that until recently epitomised risk.

Some of you may know the Mozal story. We set out to build a single-line Pechiney smelter, meeting the highest environmental standards anywhere in the world, and capable of producing 250 000 tons of aluminium per annum. The estimated cost was US$1300 million, thus the single largest private sector investment ever made into Mozambique.

Any mega-project is a complex undertaking, and Mozal seemed about as complex as it could get. When we committed to the project back in 1998, Mozambique was still emerging from a bitter civil war, which had ravaged its infrastructure, its institutions. The population was impoverished, standards of literacy low and the economy dormant. There was no aluminium smelting experience, the port (through which alumina would have to be imported from Australia) was functioning poorly, and the civil engineering industry - the life-blood of a mega-project ! - was, to be generous, poorly developed. The state of health of many of our potential employees was poor, and malaria was rampant. I could go on, but won't. Suffice it for me to record that the end outcome was a huge success. The smelter was completed in 25 months, which was six months ahead of schedule, and I think a world record. The final capital cost was more than US$100 million below budget. Measured along any dimension - economic, social or environmental - Mozal will stand as an industry benchmark and will do for many years to come.

Let me add - *en passant* - that what turned out to be a good investment for the company, proved outstanding for the host country. The total Mozal investment - original plus expansions - will ultimately exceed US$2 billion, and has been pivotal in the country's economic recovery, contributing a third of the national growth rate in 2001. It has brought training, skills and jobs, and net export earnings that will ultimately exceed half a billion US dollars per annum. It marked the country as *"attractive to international capital".* Perhaps happiest of all, our community health initiatives have reduced the prevalence of malaria in the southern part of Mozambique by more than 40%, greatly improving the lives of a myriad of people.

That successful history of the Mozal project thus prompts me to offer you my first *"Pearl of Widom"* for investing in *Risky Geographies*. It is this: "*Risk can be turned into opportunity".*

Well, by the time I have spoken to my shareholder questioners in this way about Mozal, and drawing the contrast with Voisey's Bay, they will almost always have shifted their initial perceptions of *"Risky Geographies".* And that is important progress, for it brings me to my second *"Pearl of Wisdom"*. Here it is: *"Risk takes many forms: You may not recognise it when you meet it."*

I have 2 mini-case studies to illustrate this Pearl. The first is the acquisition of the Magma Copper Company of Arizona, USA, back in 1996 - one of a series of investments made by BHP in the early Nineties that proved disastrous. At the time, Magma was thought to position BHP's investment risk profile firmly in the "good geographies" (for that, read Australia and the USA) - rather than in the "bad" (ie everywhere else). The real issue SHOULD have been Magma's inherently low-grade, high-cost operations; focussing on safe geography at the expense of basic economics was a key mistake. With the wisdom of hindsight, this attempt to balance the political risks of investing in the high grade deposits of Latin America against offsetting investments in low political risk but high-cost North American mines was a doomed strategy in a globalising world. The prospects of Magma were not improved by the fact that the key calls were made as the copper price was peaking. The investment never had a chance. In the years that followed, the entire investment, over US$2.4 billion, was written off. It was, I think, the largest write-off taken to date in our industry on a single investment. That BHP could emerge after only a few years of hardship from this - and the other bad investments of that period - is testimony to the remarkable strengths of the cash flows from its other businesses.

Ah, I hear you whisper, these things would not have happened if you had kept within that 100km radius of Melbourne - or at least, if you had stayed in Australia. Well even in Australia, mining projects can commence in the belief that they accord with the existing legislative and regulatory frameworks, but can be put at risk, or not proceed, or be delayed, because community expectations and the responses of governments have, for understandable reasons, changed the ground rules and the risk profile. Examples are Coronation Hill, Jabiluka and the Mabo Legislation, about which you will know much more than I. I shall therefore rather use a simpler case study. In most countries that are blessed with natural resources, it is the cherished wish of every regulator that the mined product should be upgraded and beneficiated in the local economy. By "adding value" to the mined product, jobs will be created and export earnings enhanced. Well, sometimes it makes sense to do so, sometimes not. What makes for comparative advantage in mining is not necessarily the same as makes for comparative advantage in smelting, refining or fabrication. And so, it is not unheard of for countries to destroy more value than is created in promoting such development, particularly when subsidy or protectionist measures are employed. But this weighty issue is not my topic today. My case study, drawn from our own files, is much simpler. As a condition of the State Agreement relating to our iron ore leases in Western Australia, BHP was required to assume certain downstream processing obligations. These obligations - and to be fair, other considerations also, such as the production of excess iron ore fines - led the company to pioneer the HBI plant in Western Australia.

Following shortly was the Orinoco plant in Venezuela. Both of these proved financial debacles, as major technical difficulties crippled the planned production forecasts. Both investments were ultimately written off in full, costing the company, in aggregate, US$2 billion before tax. It is only recently, four years later, that the HBI plant is approaching acceptable performance. Of course the time elapsed, and costs sunk in the interim, have obviated any chance of earning a good return on that particular investment.

My third *Pearl of Wisdom* goes as follows: *"Judgments about Risky Geographies are tough calls"*. An inspired judgment was taken by BHP in the Eighties regarding Chile. Back then, Chile's economy, including the copper sector, was stagnant. Codelco, the state-owned copper company was unable to fund further development of known mineral resources in the country, and foreign companies considered the political and economic risks of investment too great. The BHP and Rio-led consortium got the call on Escondida exactly right. A global financing partnership involving the export-import agencies of 4 sovereign countries, involving the World Bank via its IFC arm, helped to mitigate the perceived country risk. The rest is history: Minera Escondida became one of the most successful copper mines in the world. Chile too gained much, becoming the most important copper producer and recording GDP growth of over 6.3 per cent per annum between 1988 and 2001. In the process, the country became a model for others seeking to promote the development of their own mining sectors. In the Antofagasta region, where Escondida is located, annual average investment has been over US$700 million over the last decade. This has stimulated related industrial activities, and technical training levels, for example are three times higher than the national average. The

Antofagasta region now ranks fourth among the 13 regions in the country in terms of human development.

The Escondida story in Chile provides an example of a "GO"-decision in a *"Risky Geography"* - in retrospect, a decision that seems easy, but at the time, a very difficult call. Sometimes of course, decisions go the other way. The Tenke project in the Democratic Republic of Congo (known as Zaire from 1971 to 1997) is an example. The Tenke-Fungurume leases cover formations that are rich in copper and cobalt. The deposits are high grade, outcrop at surface, and are amenable to tank leach processing. Mapping has indicated that the resources might be large. There is access to reasonable infrastructure, and the environmental issues seem straightforward. Some of you may have seen that, notwithstanding these potentially attractive project parameters, BHPBilliton has decided recently NOT to proceed with its options on those leases. The reasons are varied, and are really too complex to summarise simply in a talk of this duration. Ultimately though, it was our judgment that we would not be able to achieve in the DRC the high ideals that are enshrined in our Charter. Only time will tell whether others will achieve success where we have stepped away.

Here is Pearl of Wisdom number 4: *"Few things are as helpful as the support of the local community - and vice versa"*. Our investments in Colombia provide my case study. Say that word, Colombia, and many people will respond *"Risky Geography"*. They see a country racked by civil strife, a haven for drug trafficking, prone to extreme violence. Yet we have two outstandingly successful operations in that country, one of the world's lowest cost producers of ferro-nickel, the other, potentially the most competitive supplier of thermal coal around the Atlantic Basin.

In the years we have operated there, we have experienced almost none of the disturbances that the casual observer might anticipate. Much of this I attribute to our operations being closely integrated with the surrounding communities. In the Municipality of Montelibano, for example, we support an Educational Centre that gives pupils access, on a centralised basis, to the latest technology, to two laboratories and a computer science room. By 2004 this Centre might cater for 10 000 students out of the 18 000 in the Municipality. As you will know, almost nothing is closer to the heart of a parent than the education of his children.

These activities in Colombia reflect the commitment in our Charter, that communities in which we operate should value our citizenship. In line with those Charter values, we will contribute 1 per cent of our pre-tax profit to community programs, every year, based on a three-year rolling average. Last year the figure was 1.4 per cent, significantly exceeding our target. Many of the programs focus on helping communities to maximise and sustain the benefits of our activities through employment opportunities, training, education and health care.

Pearl of Wisdom number 5: *"Respect the sensitivities of your hosts"*.

When you operate in 20 different countries, as we do, a wide range of issues arise. What seems unimportant in one, might be much more important in another. Whatever the corporate view, what is real and relevant to the host country must be treated with respect. I again have 2 case studies.

Very topical in South Africa today is the Minerals Bill and the associated Mining Charter. There are 2 issues at stake. The first is that all mining and mineral rights are to be vested in the State. The intention is to implement a "use-it-or-lose-it" - policy, so as to prevent those rights being "sterilised" by private owners, and so as to encourage resource development. From the perspective of the mining company, although naturally preferring the right to lock up large tracts of land, this is an understandable thrust. The second issue, again understandable, is the wish to see the mining industry, in its staffing, management and ownership, reflect the social demographics of the population. Part of the latter involves the target of Black Empowerment Groupings (comprises of what are known as "Historically Disadvantaged South Africans") acquiring up to 15% of mining operations in the next 5 years, and 26% in 10 years. We are on record as saying that we generally support the broad objectives of the Charter, many of which accord with long-established programs underway in BHPBilliton. Indeed we are already a prominent participant in empowerment process, through the Eyesizwe Mining and Kuyasa Mining transactions, through corporate social investments by the BHPBilliton Development Trust, and through employment equity programs across our operations. We have cautioned however, that the effect of the Charter will ultimately depend on the specifics of the implementation process. Those specifics will only begin to emerge when the first "old order" rights are submitted for conversion to the new order. I suspect BHPBilliton may be among the first to do such a submission. In this regard, it is probably worth bearing in mind also that BHPBilliton has a long history of major partnerships in South Africa, so that these developments might generate new opportunities.

My second case study for this fifth Pearl - *respecting the sensitivities of the hosts* - will seem to many of much less import than the South African Minerals Bill. Yet in its own way, it provides just as good an illustration of the importance of local sensitivities. I must therefore tell you the story of the robin.

Among our prized assets is the Ekati Diamond Mine, located in Canada's Northwest Territories. It produces about 4 million carats of rough diamonds annually, nearly 4% of world production by weight - but, thanks to the quality of the stones, 6% by value. Because of the mine's location, so close to the Arctic Circle, water and land use, and waste management, are carefully monitored. We work closely with the Authorities, under some of the most stringent environmental regulations in the world, and we share their concerns. Rehabilitation is an ongoing, long-term activity, and environmental awareness is an integral part of our staff training. Our staff were therefore well prepared on the day that a prefabricated building needed to be moved from one site to another. Careful inspection of the eaves of the structure revealed a robin's nest, containing two eggs. Now of course a robin is not a Crested Shelduck or a Californian Condor, but it is part of the Ekati environment; and so the nest was very carefully taken down, and just as carefully relocated beneath the eaves of an adjacent building. As far as we could tell, the move was an outstanding success: Mother robin came back, babies robin hatched, everyone was happy. In due course we filed a report, one of MANY from such an environmentally sensitive site, stating that we had successfully relocated a robin's nest. At that point, we were alerted anew to the sensitivities of our host country. A senior investigator from the Canadian Department of Fisheries and Wildlife appeared, along with two colleagues, in a specially chartered plane, to investigate the state of contentment of said robin, and to determine why we had relocated an animal breeding area without government permission. I believe we passed the test, but we do keep a special eye out for robins these days.

Ladies and Gentlemen, I have come to the end of my time, and so I shall conclude with my sixth and final Pearl. It is this: *"Unless you are infallible, diversify"*. I think it is true to say that BHPBilliton is one of the best diversified companies in the world. I have already mentioned that we operate 100 mines or plants in 20 different countries. Thus BHPBilliton has reached the happy state, so ardently preached to me by my parents, of not putting all the eggs into a single basket ! Indeed, such is our diversification that one is stretched to conceive of a single *"Risky Geography"* - event that would SERIOUSLY detract from our investment merit. And to give you even further comfort, I remind you that our exposure to what capital markets perceive as *"Risky Geographies"* is in fact quite low. At the INSISTENCE of our VP: Investor Relations, I quote the following:

(i) More than 70% of our EBITDA is generated in countries that are rated A or higher by Moody's and by Standard and Poors.

(ii) 90% of our EBITDA comes from countries that have an Investment Grade credit rating (ie Triple B or better) from those same agencies.

Ladies and Gentlemen, I hope I have led you to the sound conclusion that BHPBilliton is in good shape, both in its current asset profile and in its decision-making along the *"Risky Geography"* dimension. Regrettably, I cannot say the same about my personal situation: You see I have promised my wife that forecast of Saturday's Derby weather by this evening ---- so any help you can give me afterwards would be very greatly appreciated !

xxx ENDS xxx