Non-confidential Version

# PORT WARATAH COAL SERVICES LIMITED

## Proposed medium term capacity distribution system to address the imbalance between the demand for coal loading services at the Port of Newcastle and the capacity of the Hunter Valley coal chain

**Submission in support of the application for authorisation under sections 88(1) and 88(7) of the Trade Practices Act 1974**

1 October 2004

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**Attachments**

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## 1 Executive Summary

### 1.1 Introduction and structure of submission

This submission is made by Port Waratah Coal Services Limited ("**PWCS**") in its capacity as operator of the Newcastle export coal terminals. This submission supports PWCS's application for authorisation of the proposed medium term capacity distribution system (**"Proposed Medium Term CDS"**) to address the imbalance between the demand for coal loading services at the Port of Newcastle and the capacity of the Hunter Valley coal chain, under sections 88(1) and 88(7) of the *Trade Practices Act 1974 (Cth)* ("**TPA**").

This submission focuses on the Proposed Medium Term CDS in the context of a request for an interim authorisation for that solution under section 91 of the TPA. The Proposed Medium Term CDS, which is intended to operate from January 2005 until the long term solution can come into operation, is part of the transition required for a longer-term proposal involving significant changes in rail and coal chain logistics in the Hunter Valley, which will seek to improve the coal supply chain over several years. For this reason, this submission also contains some background material on the longer term proposal.

### 1.2 Duration of authorisation

PWCS requests that the Commission grants an authorisation for the Proposed Medium Term CDS for a period of at least 3 years and up to 5 years to allow the proposed long term solution to come into operation.

### 1.3 Existing authorisation for the Short Term CDS

The Commission will have considerable background on the Hunter Valley coal chain from its consideration of PWCS's previous application for authorisation (Authorisation Nos A90906, A90907 and A90908) for a short term capacity distribution system ("**Short Term CDS**") which was lodged on 5 February 2004 and granted on 9 July 2004 ("**Short Term Authorisation**") to operate until 31 December 2004. That application raised the Proposed Medium Term CDS as being the next part of the transition process for a more efficient coal supply chain in the Hunter Valley in the long term. Accordingly, this submission will not provide detailed background on the Hunter Valley coal chain as that has already been the subject of the previous authorisation application. In addition, this authorisation application is based on similar, although updated, facts.

## 1.4 PWCS

PWCS owns and operates the Carrington and Kooragang Island coal loading terminals at the Port of Newcastle in New South Wales ("**Port**" or "**Port of Newcastle**"). Those terminals comprise the largest export coal handling facility in the world.

PWCS is owned by a number of coal producers and other participants in the Hunter Valley coal industry. Attachment A lists all PWCS's shareholders, all of which are coal producers or exporters in the Hunter Valley, or importers of coal from the Hunter Valley. While this proposal has been the subject of considerable industry consultation, it is brought on behalf of PWCS in its capacity as owner and operator of the coal terminals at the Port of Newcastle, and not on behalf of the coal industry in general.

## 1.5 The issue - why a medium term solution is required

***Short term solution***

On 5 February 2004, PWCS applied to the Commission for an interim authorisation for the Short Term CDS. The Short Term CDS proposed a pro-rata reduction in the amount of coal loaded by PWCS from exporters to match the coal chain capacity, in order to reduce the deadweight loss associated with demurrage costs arising from the substantial vessel queues off the Port. These long vessel queues resulted from an unprecedented global demand for Hunter Valley coal, resulting in a high arrival rate of vessels, rail delivery system limitations in the Hunter Valley and, for historical reasons, the lack of a commercial mechanism to match vessel arrivals with coal chain system capacity.

As the Commission found from its market inquiries, it would have made little or no difference to the capacity limitation or associated vessel queues if PWCS had increased port loading capacity, as other elements of the coal supply chain would have maintained the limitation and effective bottleneck at the Port.

***The short term solution has delivered substantial public benefits***

On 5 March 2004, the Commission granted an interim authorisation, following which PWCS implemented the Short Term CDS. Since its implementation, the Short Term CDS has delivered substantial public benefits -- the vessel queue has reduced from a peak of 56 ships at 13 March 2004, to the current level of efficient operation which is approximately 10 ships. This significant reduction in the vessel queue has produced savings of approximately US$47 million in demurrage fees to the end of July 2004. However, PWCS' conservative estimates are that US$173.5 million will be saved in demurrage by the end of 2004. For the reasons set out in the Commission's previous authorisation, PWCS submits that these are clear public benefits.

In addition, this management of the vessel queue and turn-around time for vessels at the Port has also released a significant number of bulk carriers into the world fleet and may have contributed to a reduction in sea freight costs and increased certainty in loading and delivery dates.

As a result of the extensive industry consultation PWCS has engaged in throughout 2004, PWCS is also aware of positive comments by customers in Japan regarding the quicker loading times at the Port since implementation of the Short Term CDS and the greater business planning certainty that this has provided to producers and buyers alike. PWCS firmly believes that these improvements generated by the Short Term CDS have been extremely beneficial to the domestic and international reputation of PWCS, the Port, and the Hunter Valley and Australian coal industry generally. PWCS believes that the improved reputation of Australian coal exports is an additional public benefit, in that the increased certainty of export coal delivery times increases the international competitiveness of Hunter Valley and Australian coal in general.

***The reasons why the vessel queue will return from 1 January 2005 absent the implementation of the medium term solution***

The Authorisation for the Short Term CDS expires on 31 December 2004, at which time the Short Term CDS is intended to cease to operate. In the Short Term Authorisation, the Commission declined to extend authorisation of the Short Term CDS beyond 31 December 2004, notwithstanding the request of PWCS, as the Commission believed that at that time it was unable to assess properly whether a vessel queue was likely to persist during 2005. This was because the Commission considered that there were practical difficulties in forming a view whether existing Barlow Jonker or new forecasts would accurately predict the aggregate level of Hunter Valley coal exports for 2005 and in particular, whether economic growth in certain countries would continue at high rates in 2005, leading to continued high levels of demand. The Commission also considered that at that time, it was unaware of the likely production capacity of the Hunter Valley coal chain in 2005 and accordingly, it could not properly assess whether a vessel queue would persist during 2005.

Since the Short Term Authorisation, the high levels of demand forecast for Japan, South Korea, Taiwan, China and Europe have continued. While the Chinese Government has taken steps to reduce growth rates, which have been described in the economic press as seeking a "soft landing", demand has not decreased to any significant degree. One of the best tests of market balance is price. Prices for export coal have remained at unprecedented levels in 2004. Spot prices have remained over US$50/tonne for thermal coal from Newcastle, double the levels experienced in mid 2003. Supporting media documentation on the continuation of high levels of demand for coal appear at Attachment B.

In order to assist the Commission, PWCS has sought to provide more up to date demand and supply forecasts. PWCS has received indicative demand nominations from Hunter Valley producers in July 2004, which are approximately 96 million tonnes and are higher than the previous demand nominations provided to PWCS in August 2003. Confidential Attachment C contains individual producer forecast demand and supply data, which shows that aggregate demand for loading capacity will exceed capacity by approximately 10-14 million tonnes in 2005, based on declared capacity of between 82-86 million tonnes. More recent producer submissions indicate even higher demand at 99 million tonnes for 2005.

Accordingly, PWCS believes demand during 2005 will continue to remain high. As such, ship arrival rates will increase beyond capacity and if not managed by a scheme, an excessive vessel queue will re-form. As capacity at the Port and the Hunter Valley coal chain has not significantly changed in 2004, PWCS believes the gap between demand and capacity for coal handling services at the Port will re-emerge and in the absence of a mechanism for matching the capacity of the Hunter Valley coal chain with vessel arrivals, PWCS believes that the vessel queue problem will return immediately from 1 January 2005.

If this were to occur, PWCS submits that the substantial public benefits which flow from the Short Term CDS, in an efficiently managed vessel queue and significant savings in demurrage fees, would be lost, with the return of very substantial demurrage costs.

***The long term solution to which PWCS is committed***

Ideally, the ultimate competitive outcome would be for the Hunter Valley coal chain to possess sufficient capacity for all producers to export as much coal as demand requires. This is a long term solution to which PWCS is committed. However, this will involve significant further investment by parties at all levels of the Hunter Valley coal chain such as rail track owners and operators, rail fleet operators, coal producers, coal handling sites and PWCS itself. PWCS estimate that approximately $350 million will be involved in that investment to achieve around 100 Mtpa throughput by 2008. That investment and upgrades involves several matters outside of the control of PWCS. In particular, the Australian Rail Track Corporation ("**ARTC**"), which took up a lease of much of the Hunter Valley rail track in September 2004, must deliver on $150 million of agreed and announced rail infrastructure upgrades intended for the Hunter Valley Coal chain to achieve that throughput.

***Medium term solution is a necessary transition to the long term solution***

Implementing the long term upgrades and reforms necessary to achieve this long term solution requires considerable time. PWCS believes that the long term solution will not be operational until at least 2007 - 2008. Consequently, a transitional mechanism is needed until this time to prevent the situation at the Port from reverting to its pre-authorisation state once the Short Term CDS ceases in January 2005. Accordingly, PWCS appointed the independent consultants, Accenture, to develop a medium term solution with broad industry / customer support, which is outlined below.

## 1.6 The Proposed Medium Term Solution

***Introduction - a more market based system***

The Proposed Medium Term CDS is a more market-based system, involving transparency and accountability, designed to ensure the efficient distribution of the coal chain capacity among producers in an equitable, transparent and accountable manner.

Under the Objectives Principles and Protocols for the Medium Term Capacity Distribution System set out in Attachment H (“**Protocol**”), which govern the Proposed Medium Term CDS, producers will be individually required to nominate demand to Accenture, who will act as administrator (“**Administrator**”) as it does under the Short Term CDS. In addition, an independent auditor (“**Auditor**”) will be appointed after nomination and consultation by the industry to verify, where required, any production forecasts that appear to be higher than expected and the Auditor, once satisfied with the accuracy of these forecasts, will provide them to an independent expert appointed by the industry (“**Arbiter**”), who will ultimately determine the forecast demand amounts, which it considers best reflects each producer’s capability. The producer has the option of rejecting the Arbiter’s determination, subject to then being restricted in selling in the auction process, engaging in secondary trading and being possibly liable for financial compensation to producers for the lost opportunity arising from unused allocation based on any over-statements.

The Administrator will then assess the total nominations in relation to the capacity of the coal chain and if total demand nominations exceed capacity at the Port of Newcastle by 3 million tonnes or more, then the available capacity will be distributed by allocation among producers (this is a form of demand reduction).

The Proposed Medium Term CDS then presents producers with an option to choose to accept a pro-rata reduction or to participate in an auction supervised by the Administrator, whereby producers may trade to allocate efficiently the required decrease in demand between each other.

The audit, together with a take or pay component, creates incentives to producers to ensure that all capacity is used or is returned to those with additional demand at the earliest opportunity. It also ensures that “gaming” through over-estimation of demand nominations is very unlikely and that the entire process is both transparent and independently verified.

The Proposed Medium Term CDS is a more market based solution, which allows greater commercial alignment of demand, supply and coal chain capacity as well as providing significant public benefits, with little, if any, impact on competition. In this manner, the Medium Term CDS should not have any impact on competition as it is a more market-based mechanism which gives producers the opportunity to compete for allocation, rather than simply an administrative allocation of the available capacity.

Any issues associated with any unused distributed capacity are dealt with in the Medium Term CDS through a take or pay component and compensation provisions for under-use, so that any producers with potentially additional unused capacity should have an enhanced incentive to use the secondary market to ensure allocations are utilised.

Table One below compares features of the Short Term CDS and the enhancements proposed by the Proposed Medium Term CDS.

**Table One: Comparison of Short Term CDS and Proposed Medium Term CDS features and rationale**

| | Short Term CDS (CDS 2004) | Proposed 2005 Amendment | Rationale |
|---|---|---|---|
| **Demand Forecasts** | Demand determined by Barlow Jonker forecasts (submitted prior to the system design). | Producers submit new demand nominations. Nominations are subject to: Transparency, Audit, Take-or-Pay obligations. | Controls provide incentives for producers to nominate demand, consistent with genuine intent to export. |
| **Demand Adjustment** | Producers receive a pro-rata reduction, based on their demand forecast and the declared capacity. | Producers have a choice to either accept a pro-rata demand reduction, or participate in an auction. | Provide producers with a choice of a market-based demand-reduction mechanism or a pro-rata adjustment. Provides a mechanism for an economically efficient allocation outcome. |
| **Incentives for efficient use of capacity** | Producers may return allocation to the Administrator "as soon as practicable" if they cannot use it. If a producer uses less than their lower flexibility limit in a quarter, the remaining producers are compensated with an increase in allocation in the following quarter. | Allocation cannot be returned to the Administrator. The Administrator will facilitate re-distribution of allocation at any time, but the producer retains responsibility for the take-or-pay charge on that allocation. | Improve the incentives for the efficient and timely re-distribution of loading allocation between producers. Timely re-distribution ensures against lost capacity through under-use of capacity share. |

*Source: PWCS*

### *Proposed Medium Term CDS enjoys broad industry support*

The information and customer feedback PWCS obtained through its industry consultation over recent months indicates that, while the Hunter Valley coal industry would prefer that adequate capacity is available, the Proposed Medium Term CDS will have broad based industry support as it has been designed based on industry submissions and feedback during an extensive and intensive process of consultation. This is not to say that the industry and PWCS do not acknowledge that it is necessary to move to a completely market based system in the long term. Throughout 2004, PWCS has conducted in-depth industry consultation and investigations in order to determine the most appropriate long-term solution to vessel queues, including conducting individual discussions with all PWCS customers, organising industry forums and workshops as well as commissioning an industry survey.

PWCS has kept the Commission informed of this industry consultation and copies of PowerPoint presentations to the Hunter Valley coal industry are attached as Attachment D. Attachment E contains a table, setting out an outline of industry consultation initiatives undertaken by PWCS in 2004 as well as tables showing the key initiatives and cost summary for the four year capacity plan.

## 1.7 Benefits and detriments of the Proposed Medium Term CDS

***Proposed Medium Term CDS will not give rise to public detriments***

PWCS believes that the Proposed Medium Term CDS will produce little public detriment and in particular, it reduces the public detriment concerns noted by the Commission in relation to the Short Term CDS. PWCS believes the Proposed Medium Term CDS will produce little impact on competition in any market, for the following reasons:

- it will not impact on the total volume of coal shipped through the Port and as with the Short Term CDS, under the Proposed Medium Term CDS, the coal chain will continue to operate at maximum capacity. The Proposed Medium Term CDS includes incentives to return capacity as soon as practicable, such that the amount of unused capacity is likely to be lower than the 1% figure the Commission considered in relation to the Short Term CDS. In any event, PWCS believes the "unused" allocated capacity of 1% to be theoretical, in the sense that it was never "unused" as there was always a vessel queue and coal loading occurring. Unused capacity only occurs when there is no vessel queue and empty berths for a sufficient period for stocks to build up and prevent full capacity in rail delivery to PWCS (which has not occurred); and

- exporters will continue to compete against each other for overseas customers. The Proposed Medium Term CDS is a fair and equitable solution, allowing coal exporters to participate equally and fairly. Indeed, the market-based nature of the Proposed Medium Term CDS is pro-competitive. It provides producers with the choice and flexibility to manage their particular demand requirements and trade through one way or two way trades in order to achieve optimal resource allocations and to deal with day to day management and operational issues involved in coal mining. In addition, PWCS has included force majeure provisions, dispute resolution and provisions for new mining entrants to provide flexibility for the Proposed Medium Term CDS.

***Proposed Medium Term CDS provides enhanced public benefits***

As well as producing no significant public detriment, PWCS also believes that the Medium Term CDS will give rise to a number of substantial public benefits, including:

- ***industry cost savings,*** as the Proposed Medium Term CDS will ensure demand and capacity are matched through minimising vessel queues and reducing demurrage fees paid by exporters. Such savings are estimated to be, on a conservative basis, at least US$163 million over 2005 if there are 56 ships in the vessel queue (the number of vessels in the queue in March 2004) and significantly greater savings if the vessel queue is higher. PWCS believes that demurrage fees will increase after 1 January 2005 unless a medium-term measure is in place;

- ***efficiencies*** arising from the auction which permits exporters to trade demand reductions according to their individual valuation of the loading allocations, thus producing a more efficient allocation of a scarce resource. It is anticipated that the lower cost producers will be willing to acquire increased loading allocations and the higher cost producers will be willing to release loading allocations;

- ***certainty for coal exporters and buyers***. The Proposed Medium Term CDS will provide more certainty regarding the volume of coal they can ship, loading times and vessel schedules, which will enable exporters and buyers to plan and manage their operations more efficiently. This in turn will produce a number of "flow-on" benefits to the Australian economy and the regional Hunter Valley economy, including:

  - fostering efficiency which will, in turn, improve the international competitiveness of Hunter Valley coal and Australian coal exports;

  - facilitating efficient investment decisions by participants in the Hunter Valley and Australian coal industry; and

  - increasing incentives for coal producers to invest in the Hunter Valley coal production and handling industry;

- ***improving the international reputation of the Port of Newcastle***. Although in its consideration of the Short Term CDS, the Commission formed the view that extensive vessel queues were unlikely to reduce Hunter Valley coal exports, PWCS considers the delay from such queues harms the international reputation of PWCS, the Port and the Hunter Valley and the Australian coal industry in general. Accordingly, by reducing such queues, the Proposed Medium Term CDS will improve the Port's, and the Australian coal industry's, international reputation and competitiveness as against other coal exporting nations; and

- ***transition.*** In turn, the market-based design of the Proposed Medium Term CDS will flow smoothly into the proposed long term arrangements.

## 1.8 Conclusion on Proposed Medium Term CDS

The Proposed Medium Term CDS will have very limited, if any, public detriment. Certainly, the enhancements to the Proposed Medium Term CDS will lead to any public detriment being less than the Short Term CDS. It will also deliver substantial public benefits in 2005 in demurrage savings of US$163 million based on a conservative assessment of 56 ships being in the vessel queue, as occurred in 2004 when demand was lower. Demurrage savings are dependent upon the estimated length of the queue, as set out in Table Two. A conservative estimate would be to assume a vessel queue of 56 since this was seen at the Port in March 2004. This estimate has been used throughout the document, but the high levels of demand mean that it is possible that the vessel queue (and hence demurrage savings) could be higher.

**Table Two: Estimated Demurrage Savings in 2005 under the Proposed Medium Term CDS for various queue lengths**

| Queue Length (number of vessels) | Annual Demurrage Saving With CDS (USDm) |
|---|---|
| 56 | 162.87 |
| 75 | 216.35 |
| 90 | 251.91 |
| 100 | 272.32 |

*Source: Accenture*

**Table Three: Estimated Demurrage Savings in 2005 under the Proposed Medium Term CDS with an assumed vessel queue of 56 vessels.**

| Quarter | Year to date cum./(Avg) Queue Days | | Demurrage (USDm) | | Demurrage Savings (USDm) |
|---|---|---|---|---|---|
| | with CDS | w/out CDS | with CDS | w/out CDS | |
| Q1 | 1,080 (12) | 2,642 (47) | 3.92 | 22.66 | **18.74** |
| Q2 | 2,172 (12) | 7,649 (56) | 3.29 | 50.27 | **46.98** |
| Q3 | 2,916 (12) | 12,801 (56) | 2.59 | 51.17 | **48.58** |
| Q4 | 4,380 (12) | 17,953 (56) | 3.30 | 51.88 | **48.58** |
| **Total/Avg** | **4,380 (12)** | **17,953 (56)** | **13.10** | **175.98** | **162.87** |

*Source: Accenture*

The additional controls and safeguards on producer demand forecasts (including take or pay provisions, extensive independent audit mechanisms, resolution of disputes by an Arbiter, an audit of production forecasts and compensation for unused tonnes) will further improve the accuracy, transparency and certainty of demand forecasts. These additional elements over and above the Short Term CDS previously authorised by the Commission should provide the Commission with sufficient comfort to allow the Proposed Medium Term CDS to proceed in 2005.

## 1.9 Duration of authorisation - why a longer term is warranted

In this application, authorisation is sought for a period of at least 3 years (with the scheme being subject to annual reviews and a continuing and demonstrated mismatch in demand against available capacity) and up to 5 years to allow sufficient time for the proposed long term solution to come into operation. It is hoped that the Commission will take comfort in allowing such a longer period of authorisation for the reasons that:

- the Proposed Medium Terms CDS includes mechanisms which mean it will not operate to distribute available capacity unless demand exceeds supply. Confidential Attachment C demonstrates substantial producer demand forecasts for 2005, 2006 and 2007 in circumstances where the producers are aware that these nominations must be accurate or they have financial consequences; and

- it is quite clear that there is genuine and considerable work being undertaken by PWCS on the longer term solution (see Attachments D and E) and certainly the authorisation to date has not taken off any pressure on PWCS in seeking solutions to the capacity issue. For example, the PWCS Board at its meeting on 29 September 2004 approved funding for definitive engineering of an expansion of PWCS that will allow coal chain throughput of a nominal 102 million tonnes per year.

In terms of the operation of the Proposed Medium Term CDS, there is provision in the Protocol for an annual review of the scheme by the PWCS Board as set out in Section Four. In September each year the Board would review the operation of the system and determine whether it should continue for part or all of the following calendar year. Any decision to continue the system would take into account any Authorisation Conditions, recommendations made by the Administrator to the Board and any submissions received from producers or customers.

As key indicator as to whether the system should continue during part or all of the following calendar year will be whether the coal chain capacity is sufficient to meet demand without causing excessive queuing.

It is noted for completeness that in the event that the PWCS Board determined that there was not a requirement to operate the scheme, producers would still be required by PWCS to submit a demand forecast to which take or pay obligations would attach.

There are also operational issues if the system is limited to one calendar year. The Administrator has noted that the incentive to use allocation provided by 'physical compensation' (a reduction of allocation in the quarter following under-use beyond flexibility limits) has no effect in the final quarter if the system is limited to one calendar year. The removal of this incentive creates an unquantifiable risk of under use of allocation. Usage of allocation is important to maintain demand and to achieve high coal chain throughout.

## 1.10 Request for interim authorisation

For the reasons set out in Section Two of this application, PWCS requests the Commission to grant an interim authorisation so that PWCS can begin the steps necessary to implement the Proposed Medium Term CDS -- in particular, to conduct the auction in October 2004, which will underpin the capacity distribution mechanism when excess demand exists at the Port and which will provide industry participants with greater commercial certainty for the year ahead, including entering into customer contracts.

Without the Proposed Medium Term CDS, based on individual up to date producer forecasts, PWCS believes that the extensive vessel queues experienced at the Port prior to the Short Term CDS will begin to re-form from 1 January 2005. In these circumstances, PWCS submits that this is a matter which warrants interim authorisation, particularly in the manner requested which seeks interim authorisation in two parts. These matters are now considered in more detail.

# 2 Request for interim authorisation

## 2.1 Introduction

The purpose of this section of the submission is to provide detail on a request for an interim authorisation in two parts, the first commencing in approximately mid/late October 2004 in relation to the auction process and associated matters and the second part commencing on 1 January 2005.

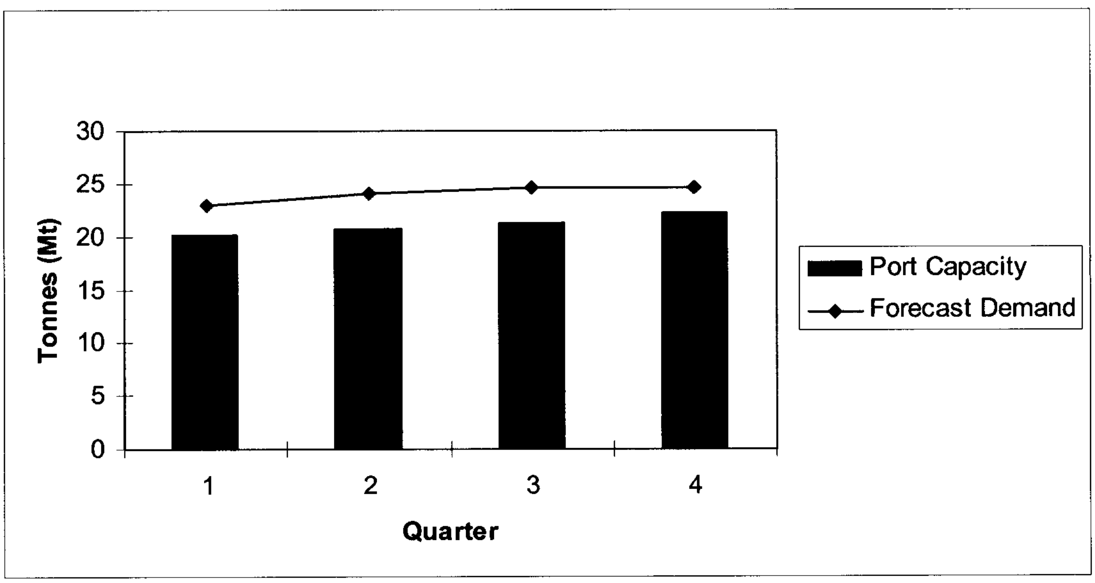
## 2.2 The need for a medium term measure

The key contributors to the vessel queue problem that existed prior to the Short Term CDS were the high demand for Hunter Valley coal from offshore buyers attracting a large number of ships to the Port and the limitations of the coal chain and rail delivery system. Accordingly, the resulting mismatch between demand and capacity resulted in extensive vessel queues off the Port of Newcastle.

Upon expiry of the Short Term CDS on 31 December 2004, no measure will be in place to prevent the demand/capacity imbalance from returning at the Hunter Valley coal chain and the Port.

As set out in Confidential Attachment C, production and demand for Hunter Valley coal in 2005 is forecast to remain high - in fact higher than 2004, ensuring a large number of vessels will again arrive off the Port from 1 January 2005. During 2004, there have been some improvements to the capacity of the coal chain (largely through coal chain logistics improvements -- none of the rail track upgrades have been implemented as they are forecast in late 2005 into 2006) and capacity has increased from 74 million tonnes in 2003 to 80 million tonnes in 2004. However, despite this increase, coal chain capacity has not been able to match the continuing increase in demand for coal forecast for 2005 as illustrated in Figure One below.

**Figure One: Forecast demand and Port capacity for 2005 based on producer demand nominations**




*Source: Accenture*

PWCS believes that the most current demand nominations/forecasts from individual producers provided on a confidential basis and included as Confidential Attachment C should be able to address the Commission's concerns expressed in the Short Term Authorisation that no up-to-date data for 2005 was available and demonstrate that the demand and supply conditions will continue throughout 2005 (as well as for 2006 and 2007).

PWCS believes that the medium term solution is transparent and equitable. It is necessary to allow efficient operation of the Port for the period of time required for the multitude of parties in the coal chain to invest in the infrastructure necessary to establish the long term solution. The long term solution is discussed later in this submission.

Importantly, the Proposed Medium Term CDS should not affect the amount of coal that is *actually* exported through the Port of Newcastle. PWCS will continue to operate at full capacity and the enhancement of the capacity distribution system through take or pay and tighter provisions on used tonnes provide added incentives to return any unused capacity earlier than under the Short Term CDS so that it can be redistributed. Through these and other enhancements, the concerns of some smaller producers and traders raised in relation to the Short Term Authorisation are dealt with in the Proposed Medium Term CDS.

## 2.3 Interim relief needed to ensure Proposed Medium Term Solution operates at 1 January 2005

In order for the Proposed Medium Term CDS to be operational upon expiry of the Short Term CDS on 1 January 2005, PWCS will need to commence a number of tasks before this date, including audits of demand nominations not linked to the audit process and any associated audits or processes required to verify the demand nominations by individual producers in accordance with the Protocol, conducting the auction in October 2004, obtaining any forms of financial security (eg bank guarantees) that may be required and allowing parties to take steps based on that auction as the first part of the interim authorisation.

These tasks are necessary for the implementation of the Proposed Medium Term CDS and to provide producers with certainty regarding allocations. In particular, PWCS and the Administrator will need to conduct the auction process in late October 2004. October is the month in which Japanese contract negotiations begin and late October provides industry participants with the required notice (approximately 2-3 months) needed to order vessels and determine vessel and coal loading interaction. Accordingly, PWCS respectfully requests the Commission to provide interim authorisation to conduct the auction and for parties to implement physical decisions based on that auction process by approximately late October 2004/very early November 2004, to give coal producers as much time as practicable as well as increased certainty regarding allocations.

A second part of the interim authorisation is requested for 1 January 2005 when the physical allocation processes under the Proposed Medium Term CDS officially commence and PWCS would be loading vessels under these arrangements. PWCS proposes that this second part of the interim authorisation would allow it to decline to load vessels that exceed the first quarter's allocation by producer (ie that allocation relating to January 2005 to March 2005) and to implement the Protocol arrangements.

## 2.4 The counterfactual - what will occur absent the Proposed Medium Term Solution

As noted earlier, once the Short Term CDS ceases operation, PWCS believes long vessel queues will begin to re-form off the Port from January 2005. Coal exporters and the Hunter Valley coal industry will again incur substantial demurrage costs arising from these extensive vessel queues unless a medium-term measure is implemented. As set out in section 1.4, estimated demurrage costs in 2005 with the vessel queue returned are at least US$163 million, assuming a vessel queue of 56 vessels.

For these reasons, PWCS submits that the interim authorisation is necessary to ensure that the Proposed Medium Term CDS is implemented once the Short Term CDS expires.

## 2.5 The effects of any interim authorisation are not irreversible

PWCS believes that granting an interim authorisation which enables it to take steps to implement the Proposed Medium Term CDS in terms of the auction process in late October 2004 or its commencement on 1 January 2005 would not in any way prevent the Hunter Valley coal industry from returning substantially to its "pre-authorisation" state if the Commission were ultimately to deny authorisation.

First, in relation to the auction process and the first part of the interim authorisation requested, if the Commission subsequently denied authorisation, PWCS would simply unwind any allocation transfers for 2005 that would have occurred as a result of the auction outcome and refrain from undertaking any further auctions after that date, which at any rate are proposed to occur only once annually. PWCS commits that it will not implement any financial consequences of the auction (such as compensatory payments) until final authorisation is granted by the Commission in relation to the Proposed Medium Term Solution.

Second, in relation to the commencement of the Proposed Medium Term CDS on 1 January 2005, being the second part of the interim authorisation requested, after the relevant three month period (it operates based on quarters), the capacity distribution system could be terminated with producers having the ability to re-schedule vessel and production timetables accordingly for the balance of 2005. As the likely percentage impact of the Proposed Medium Term CDS is relatively small in relation to the tonnage each producer has forecast to ship in the first quarter, the impact of any rescheduling is expected to be manageable.

An interim authorisation would allow the auction process to occur in late October and for the Proposed Medium Term CDS to operate until the Commission fully considers the authorisation application. Indicative producer forecasts for 2005 suggest that an adjustment will be required as demand exceeds capacity by over 3 million tonnes. However, even if as some smaller producers previously asserted, these nominations are ambitious and (notwithstanding that the audit, auction and take or pay processes create incentives and safeguards for precise and accurate forecasting) the Proposed Medium Term CDS would operate to provide additional capacity to those requesting capacity. In the event that capacity on the coal chain exceeds supply from producers, producers will be unconstrained and free to ship as much coal as they require. The Administrator will continue to monitor the process and extra capacity will be provided to producers on a 'first come first served' basis. Importantly, there would be no impact on the volume of coal that PWCS *actually* loads onto ships or the amount of coal that is *actually* delivered through the Hunter Valley coal chain in any given month, as across the industry it is very unlikely given current high levels of demand and pricing of coal that some producers would not have production to take up available export capacity. In addition, the take or pay processes and compensation provisions for under use themselves provide added safeguards that any over-estimates of demand for capacity are returned to the system as soon as practicable. As such, any slight under use of capacity (it was in theory, approximately 1% under the Short Term CDS), is expected to be smaller and *de minimis* under the Proposed Medium Term CDS.

On reasonable expectations, the timeframe for a complete review of the Medium Term CDS by the Commission should mean that it would not be operating beyond the first quarter or so of 2005 before the Commission had considered the matter in detail. Accordingly, given it would only start on 1 January 2005, and although it is not the strict legal test, as a practical matter there is very limited scope for public detriment if an interim authorisation was granted for either the auction process in October or the commencement on 1 January 2005. This is to be contrasted with the great scope for public benefit, given that absent the Short Term CDS, the updated demand forecasts indicate that excess demand for capacity at the Port of Newcastle will again result in extensive vessel queues and therefore substantial demurrage costs. Importantly, as a practical matter there would appear to be very little downside in allowing interim authorisation of the auction system in October 2004 and then allowing further public consultation for the implementation from 1 January 2005. In addition, interim authorisation of the auction system would provide greater certainty for allocation in 2005.

## 2.6 Conclusion - limited impact on competition and substantial public benefits

For the reasons set out in this application, PWCS also believes that the Proposed Medium Term CDS will not have a significant impact in any market in Australia and that the Proposed Medium Term CDS will give rise a significant number of substantial public benefits.

Accordingly, PWCS respectfully requests the Commission to grant an interim authorisation in respect of the Proposed Medium Term CDS described in this application, so that PWCS can begin implementing that solution under the auction process in October 2004 and in order for it to be operational upon the expiry of the Short Term CDS on 1 January 2005.