xstrata
coal

2 March 2005

Mr Scott Gregson
Acting General Manager, Adjudication Branch
Australian Competition & Consumer Commission
PO Box 1199
DICKSON ACT 2602

Attention: Mr David Hatfield / Ms Jaime Norton

Dear Mr Gregson

PWCS Authorisation Applications (A30236 - A30238) - Non-confidential version

Introduction

Xstrata would like to briefly respond to certain issues that have been raised in relation to the Commission's draft determination in respect of the authorisation applications for the Medium Term Capacity Distribution System ("**MTCDS**").

Xstrata strongly supports the Commission's draft determination. The only issue Xstrata notes is that the time period of the proposed authorisation may not be sufficient to allow Port Waratah Coal Services ("**PWCS**") to expand capacity to meet anticipated demand given external planning issues such as environmental impact statements and third party investment.

Otherwise, Xstrata's response is simply intended to be a factual response from a coal producer's perspective in relation to the following issues:

1 The impact of the proposed authorisation on investment in coal loading capacity at the Port of Newcastle and capacity expansion by PWCS in particular.

2 The impact of the high levels of demand for export coal at coal terminals on the eastern seaboard of Australia.

3 The impact of the authorisation on exports.

Xstrata is strongly supportive of the work undertaken by PWCS and the HVCCLT on coal supply chain improvement initiatives and believes that once the authorisation is finalised, industry focus should be on co-operation in this area to achieve improvements and efficiencies.

Xstrata also appreciates the constructive approach taken by the Commission in this matter.

XCN Coal (NSW) Pty Limited ABN 18 097 573 258
PMB 8 Singleton NSW 2330 Australia / Broke Road Singleton NSW 2330 Australia
Tel +61 2 6570 2097 Fax +6570 2505 www.xstrata.com

The Impact of the authorisation on investment in coal loading capacity at the Port of Newcastle

There have been numerous articles in the press as to the high levels of demand for coal from the growing economy which is China and whether resource companies or even Governments fully appreciated the consequences for their exports or existing infrastructure arising from this level of demand.

Irrespective of whether or not companies accurately predicted these high levels of demand, the current issue is the need for increased investment in new port facilities ***together with*** investment and co-ordination in the overall export supply chain in order to meet the current and anticipated levels of demand.

As with any investment program, in order to fund the substantial amounts required for such an investment, a sufficient level of commercial certainty is required to ensure that the investment earns an acceptable economic return for the infrastructure owner. In the case of PWCS, PWCS has sought from producers estimates of future demand. We understand that in the future PWCS will seek to have firmer commitments whether through extended take or pay or other means, in order to fund the necessary capital investment to increase the capacity of its operations to over 100 Mtpa at the Port of Newcastle.

Xstrata has previously indicated that it supports take or pay arrangements, which are common in this industry, and recognises the financial and commercial necessity in PWCS requesting such arrangements to underpin the capital outlay in expanding capacity. Xstrata supports the Commission's views of take or pay arrangements in the draft determination and specifically notes that producers have the ability to allocate their take or pay commitments in such a manner as to support the introduction of alternative facilities if they so wish.

Take or pay is an essential mechanism for ensuring that the significant volume risk in major, long life infrastructure investment is best managed by those able to control it, that is the coal producers. If volume risk is imposed on third parties or governments, decision-making will be slowed and/or inappropriate outcomes in terms of capital investments will result. In fact, Xstrata has long duration take or pay arrangements in place for all its logistics arrangements, including the ports of Abbot Point (PCQ), Dalrymple Bay (Prime) and Gladstone (GPA) and rail provision with PN and QR in NSW and Queensland.

Xstrata notes the recent comments by NCIG as to whether or not Xstrata and Rio Tinto have less incentive to support investment in increased coal loading capacity at the Port of Newcastle because they have mature mines. The Commission has been provided with confidential data as to Xstrata's production, forward demand indications and plans for production expansion in the Hunter Valley. The actual data does not support NCIG's contentions.

We also note that the ability of any expanded PWCS facility to export coal depends on the overall coal chain capacity. Leaving aside the commercial and financial commitments needed to fund such an expansion, it is unreasonable for NCIG to request that the Commission impose conditions on PWCS to provide benchmarks for expansion, where important elements of the overall export coal supply chain are dependent on investment by a number of stakeholders and are outside the control of PWCS.

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The impact of high levels of demand for export coal at coal terminals on the eastern seaboard

Xstrata is exporting coal from various coal terminals on the east coast of Australia. Almost all of those coal terminals which have more than one user or owner are experiencing vessel queues.

As noted by Coal and Allied Industries ("**CNA**") on page 3 of their submission dated 19 May 2004 in relation to the Short Term Capacity Distribution System ("**STCDS**"), a vessel queue management system was implemented at Dalrymple Bay Coal Terminal when a stockpile reclaimer failed and the port was operating at below nameplate capacity. Although the vessel queue was initially dissipated it is an example that deadweight demurrage costs are unacceptable. It is also noted that the vessel queue has now returned and is currently in the vicinity of 40 vessels as has been noted in the media, an issue that is causing national and international focus as well as customer complaints. The attached article from The Australian Financial Review of 24 February 2005 states as follows:

> *"Mr Allen [Chairman of the Dalrymple Bay User Group] said the Dalrymple Bay agreement was likely to need special approval from the Australian Competition & Consumer Commission, similar to that granted to a quota system operating at the Hunter Valley coal port."*

Accordingly, we would not agree with what NCIG appears to have suggested (based on the minutes of the meeting with the Commission on 7 February 2005), that mechanisms are not being put in place or contemplated at other ports for unacceptable demurrage costs associated with high vessel queues.

One of the important points from the CNA submission (noting for completeness that CNA is a subsidiary of Rio Tinto), is that vessel queues are not always good indicators or signals of the need for new capacity. As CNA state on page 11 of their submission:

> *"To use an analogy, relying on a queue as a signal for expansions is like driving a car through the rear vision mirror. The key issue is that the queue in and of itself serves absolutely no purpose because it does not allow any increase in port throughput. The pressure or otherwise of a queue during a period in which coal sales are being foregone creates no additional incentive whatsoever to expand port capacity."*

Accordingly, in order to deal with these high levels of demand, it is important for the port operator to obtain appropriate indications of the future need for capacity (which PWCS has done) and to plan accordingly to meet those forecasts. Xstrata is satisfied that PWCS is undertaking the proper forward planning that is required and has taken steps with the HVCCLT to implement expansion plans.

The importance of undertaking expansion plans in such a careful manner is highlighted by reviewing the submissions on the STCDS. In that situation many parties asserted that the Barlow Jonker figures were overestimations of the likely levels of demand, in particular from China. At that time the Commission was requested not to grant authorisation beyond one year as the level of demand from China could not be estimated. Many of the same parties who have sought that limitation are now saying that there will continue to be strong excess demand for at least the next three years. The need for careful consideration is underscored by rapid price changes (see chart of A$ and Rand spot prices below). The Richards Bay price indicates the state of Atlantic thermal coal sales, while the Newcastle spot price is the best indication of the state of Pacific thermal coal sales. This chart shows that, with such rapid price changes, producers are best places to manage such risks as they have access to a number of market arrangements to mitigate market risks in a way that infrastructure providers do not.

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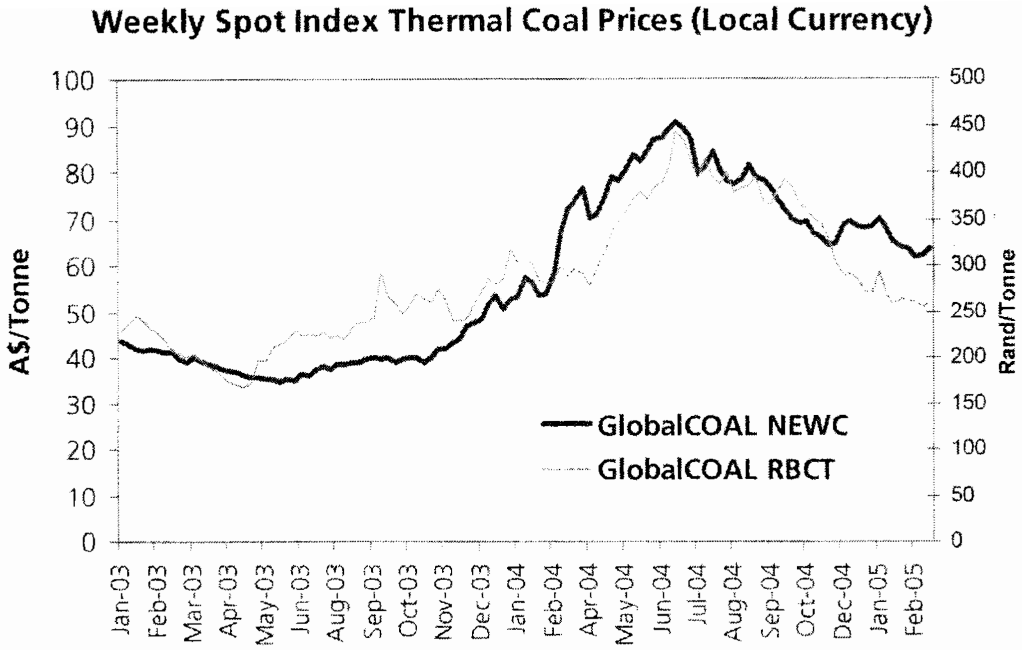
Tel +61 2 6570 2497 Fax +61 2 6570 2505 www.xstrata.com



In summary, provided the relevant Port is doing all it can to commercially expand capacity, Xstrata believes that the relevant issue at this time is as stated by CNA in its submission at page 11 as follows.

> *"CNA understands that the simple reality is that port capacity enhancements are being pursued [by PWCS] as quickly as possible but that there are long lags associated with installing additional capacity. In the meantime the issue is how to maximise throughput and minimise demurrage penalties to producers."*

The MTCDS is not perfect, but it is the best the industry has developed through extensive industry consultation, discussion and involvement.

The impact of the authorisation on exports

As Xstrata has previously noted, there is an important difference between port and coal chain capacity and the utilisation of allocation.

The MTCDS under the interim authorisation has had a record month in January for coal exports through PWCS, although there has been some theoretical under use of loading allocation. This is not determinative of any impact on exports or actual capacity as there is an over allocation of loading allocation built into the system by the Administrator to ensure that there is no decrease in exports.

In this sense there appears to be a misapprehension as between under-use of allocation with under-use of capacity.

Leaving aside the fact that there is no evidence exports have been decreased as a result of the MTCDS, the issues raised by some parties as to the loss of exports if capacity expansion does not occur, seem to be well countered by the firm expansion plans put forward by PWCS.

XCN Coal (NSW) Pty Limited ABN 18 097 523 358
PMB 8 Singleton NSW 2330 Australia / Broke Road Singleton NSW 2330 Australia
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Comments have also been made that the current allocation system and conditional allocation does not create sufficient certainty to allow vessel scheduling. Xstrata's experience has not borne this out. In Xstrata's case, we aim to run our business with approximately 10% product stocks and hence short term fluctuations report to stock. Now that conditional allocation is available, Xstrata plans its production, sales and vessel scheduling decisions to take into account the availability of the 5% additional allocation. As vessel stems are requested by end user customers, typically one to three months out, Xstrata updates its schedules and notifies the customer of its ability to accept the nomination. If conditional allocation is not available when an end user customer requests a vessel (which is only where high queues have formed), Xstrata can merely respond by requesting a later vessel arrival time. In this case, the production planned for the earlier time will simply create a small increment to mine stocks which can be scheduled for the following quarter.

Conditional allocation is an effective method of balancing queuing with maximum flexibility and throughput. The uncertainty inherent in the cargo assembly nature of PWCS can only be managed through mine stocks as shipping and queue variability cannot be accurately predicted. Since Newcastle producers are all familiar with the PWCS operating mode, the requirements are well known. The scale of the conditional allocation, being 5%, is appropriate - any higher level of conditional allocation than 5% has the potential to create excessive queuing on top of existing flexibility mechanisms (being the vessel arrival window and the 90,000 allowance each quarter). The MTCDS does benefit from the feedback mechanism inherent in having the "5% switch on and off" and the timing is appropriate for the nature of the control that producers can exercise over vessel nomination decisions.

Xstrata Plans

Xstrata plans to significantly lift the output from its Hunter Valley business, after significant production increases in the last two years. Further details are provided in a confidential attachment.

Conclusion

PWCS has provided conservative estimates of demurrage savings as a result of the STCDS. CNA has published financial reports on its website which confirm the accuracy of such estimations and the savings made by CNA on demurrage. Xstrata has had similar levels of savings on the deadweight cost of demurrage, and other Hunter Valley coal producers have also had significant savings. We would be happy to confirm exact demurrage figures on request.

Xstrata has every incentive to increase exports to take advantage of strong coal demand. 2004 shipments were a record for Xstrata through PWCS. Xstrata's experience was that ample allocation was available from underusing producers, particularly in the second half of the year. If additional allocation continues to be available (and anecdotal evidence is that it is), Xstrata has previously indicated it has the sales and production capacity to achieve still higher figures in 2005

Xstrata would also like to point out that recent evidence from DBCT, where it has a small shareholding in the operating company and where the infrastructure is owned by a third party, shows that even where firm take or pay contracts are in place, queues can develop if throughput does not match vessel arrivals. The fact that a capacity distribution system is being contemplated at DBCT to deal with the high levels of demurrage is a strong indication that systems such as the MTCDS may be required at multiple user ports to achieve efficiency and are consistent with capacity increases.

In conclusion, the MTCDS is working very well, has achieved record volumes in its first month and has provided substantial public benefits. Xstrata strongly supports the authorisation of the MTCDS for a period of time necessary to ensure a transition to the long term solution and looks forward to

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working co-operatively with industry stakeholders to achieve improvements in the export coal supply chain.

Xstrata appreciates the opportunity to provide a submission to the Commission in relation to this matter and would be pleased to assist the Commission if it has any questions on this submission.

Xstrata also appreciates the extensive work undertaken by the Commission in this manner. Balancing the various viewpoints is not an easy task, but the Commission has undertaken this approach in a constructive manner. The NCIG members are large and respected companies. They are also customers of PWCS, as is Xstrata, and PWCS has every incentive to satisfy their reasonable commercial requests as customers. It is hoped that the authorisation will proceed and that the NCIG members and PWCS and the HVCCLT will be able to work constructively together to achieve an outcome that is in the best interests of all concerned and the Australian economy in general.

Yours sincerely

Mick Buffier
Chief Operating Officer

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