



Mr Scott Gregson
General Manager
Adjudication Branch
Australian Competition & Consumer Commission
470 Northbourne Avenue
DICKSON ACT 2602

30 November 2007

Attention: Mr David Hatfield / Ms Jaime Martin

Dear Sir,

Pacific National (NSW) Pty Limited ("PN"), QR Limited ("QR") and Port Waratah Coal Services Limited ("PWCS") applications for authorisation (A91068 - A91070) - interested party consultation

Thank you for your letter of 19 November 2007 inviting Xstrata Coal Australia Pty Ltd ("**Xstrata**") to comment on the applications for authorisation.

Xstrata believes it is time for urgent and material change in the way in which Hunter Valley coal chain capacity is created and contracted. The on-going opportunity cost of billions of dollars of lost export earnings to Australia's coal industry generally, and direct losses to Xstrata's business as a result of continued under-delivery of our contracted coal chain volumes, is not an acceptable or sustainable basis on which to continue to operate the supply chain. We believe that fundamental reform to the commercial structure of the coal chain is necessary if we are to see any progress to addressing the environment of on-going capacity shortfalls. Fundamentally we believe that access to capacity must be based on contractual entitlements, and that there needs to be significant reform to ensure that track access, train and port contract commitments are brought into alignment and reference deliverable system capacity.

Xstrata strongly supports the application for authorisation of the proposed Vessel Queue Management System ("**VQMS**"). This support is notwithstanding Xstrata's expectation that the VQMS will result in Xstrata being allocated significantly less entitlement to capacity than the capacity that Xstrata has contracted with the service providers for 2008. Xstrata accepts that some system for rationing capacity is inevitable in an environment where demand for capacity significantly exceeds currently available capacity and if it were not in place there would be a substantial vessel queue giving rise to substantial demurrage costs.



Background

Xstrata has previously supported port-based vessel management systems implemented by PWCS. These systems have been generally effective in managing vessel queues which resulted from a combination of demand exceeding coal chain capacity, and under-performance against forecast capacity of the Hunter Valley coal chain (“**Coal Chain**”). The service providers in the Coal Chain, in these circumstances PWCS, QR, PN and the Australian Rail Track Corporation (“**ARTC**”), play an integral role in advising/contracting capacity, and then delivering against such obligations, however they do not incur any demurrage as a result of errors and/or underperformance.

In such an environment, the incentive for service providers to implement systems to reduce vessel queuing has been minimal, and it has, until now, only been PWCS who has stepped forward to address the issue in the form of the Capacity Balancing System, albeit in a somewhat urgent fashion.

The development of a solution for post 2007 has been the subject of significant consultation across the entire industry, and has enabled producers and service providers to consider and debate the key principles of any system that allocates Coal Chain capacity. Through a series of meetings between producers and service providers during 2007, it became apparent that over-contracting of Coal Chain capacity was occurring not only at PWCS (which has no choice but to accept nominations from producers), but also in the upstream rail components of the Coal Chain. To this day, service providers are contracting isolated ‘nominal’ or standalone capacities without due reference to sustainable and actual Coal Chain capacity – i.e. capacity that takes into account the operation of the entire coal chain as a system.

The additional time spent in discussing a 2008 allocation system has also enabled the previous systems to be critiqued in terms of equity in allocation, and most importantly in terms of alignment of contracts and capacity so as to create a longer-term sustainable solution that does not require intervention and/or rationing. Xstrata is of the opinion that most parties recognise that any system that allocates coal chain capacity should take into account the upstream rail as an integral component of the coal chain. However, previous port-based systems have effectively over-ridden rail contracts, both to the detriment of the existing rail providers and with the result of significant inequity in the allocation of available capacity compared to contracted positions.

Accordingly, Xstrata takes the opportunity to elaborate on our support for the VQMS as follows:

1. VQMS is an interim measure for 2008

- 1.1. It is essential for the VQMS to be implemented as an interim measure for 12 months to 31 December 2008 to efficiently manage vessel queues and minimise demurrage costs while stakeholders in the Coal Chain work together on a longer-term solution.



- 1.2. Xstrata supports the VQMS as an important next step towards a longer term permanent solution. Xstrata believes that when capacity is constrained, it should be allocated by reference to contracted demand. In this regard, the VQMS is an important step towards aligning demand for system capacity (which is constrained) with contracted demand, which will provide producers (and therefore offshore customers) with increased confidence and commercial certainty that they will receive what they have contracted for and will also provide rail and port operators with secure commercial incentives to underpin expansions to meet forecast and contracted demand. It is important to recognise that such a system also increases commercial certainty for customers dealing with coal producers that have underpinned their supply obligations by commercial contracts along the supply chain.
- 1.3. However, Xstrata does not view the VQMS as a solution for 2009 and beyond. While the above rail operators now participate in the VQMS together with the port operator, Xstrata believes that in 2009 it is essential for the ARTC - which operates the below rail infrastructure that services the Coal Chain - to be brought into any longer term solution. In seeking to align the contracts for train, port and track capacity with access to system capacity, it is important that the operator of the track infrastructure be an integral part of such a solution so that the industry as a whole can grow through a co-ordinated and transparent approach to capacity expansion.

2. The urgent need for the VQMS and support for an interim authorisation

- 2.1. Xstrata supports the urgency of granting an interim authorisation for the PN, QR and PWCS' application because it recognises the substantial costs that will be incurred in relation to demurrage if there is no system in place when the current capacity balancing system ("CBS") expires on 31 December 2007. Xstrata believes the estimated demurrage costs provided by PN, QR and PWCS in their joint submission supporting the authorisation are appropriate, and potentially low given forecast increases in demurrage rates for 2008.
- 2.2. Xstrata believes that absent the VQMS, the likely scenario ("**counterfactual**") is that:
 - a) demand for coal haulage and loading services ("**system demand**") will continue to exceed the capacity of the Coal Chain ("**system capacity**");
 - b) there will be no mechanism available for coal exporters to work with PN, QR and PWCS to allocate system capacity in a predictable manner;
 - c) consequently, each coal exporter will face considerable uncertainty as to how much of that coal exporter's demand can be fulfilled by the Coal Chain;
 - d) to ensure access to as much of their contracted capacity as possible, there is a material incentive for each of the producers and coal buyers to seek to place their vessels in the queue early, thereby creating a high probability that a large vessel queue will be created and sustained; and



e) since aggregate demand is likely to exceed system capacity by a considerable amount, the vessel queue at the Port of Newcastle will grow beyond an efficient level to the levels experienced at the end of 2006 when there was no vessel queue management system in place.

2.3. Xstrata expects demand for coal from its Hunter Valley operations to continue to be strong given the strength of the global economy and in particular demand for coal from Japan, China and India. When the CBS expires on 31 December 2007, vessel arrival rates will increase beyond Coal Chain capacity and, if not managed by the VQMS, Xstrata believes that an excessive vessel queue will re-form from 1 January 2008.

3. Vessel queue and demurrage costs with VQMS and without VQMS

3.1. Based on Xstrata's experience during periods when a capacity balancing system is not in operation, Xstrata expects that, with high probability, the vessel queue will increase to potentially over 70 vessels without the VQMS. In contrast, Xstrata believes that the VQMS should be able to ensure that the vessel queue remains at an efficient level.

3.2. Xstrata estimates the difference between the monthly vessel queue under the VQMS and the monthly vessel queue without the VQMS for the 12 months to 31 December 2008 would result in significant demurrage costs for Xstrata. Please see Confidential Attachment 1 for the details on Xstrata's forecasts around vessel queue and demurrage costs.

3.3. In short, Xstrata agrees with the submission by PN, QR and PWCS that by authorising the VQMS as an interim measure for 2008, the ACCC will enable the industry to avoid in the order of AUD 400 million of demurrage costs. This is a public benefit that would be realised through the VQMS and which would not exist without the VQMS.

4. No adverse impact on long term demand and investments in system capacity provided that contracts underpinning major investment decisions are not undermined

No evidence of adverse impact on investments in Coal Chain capacity

4.1. The VQMS is an interim measure for 2008 and therefore should not have any impact on long term demand for, nor investments in, system capacity. In this respect, Xstrata notes that Attachment E to PN, QR and PWCS' submission in support of the authorisation application summarises the capacity expansion initiatives in the Coal Chain that are already in place or planned, and we do not anticipate any impacts to this programme arising from the operation of the VQMS. The current environment of strong global demand for Newcastle coal is one of the better periods in which coal chain participants are able to secure the commercial arrangements necessary to underpin on-going expansion.



Fostering efficient investments in mining infrastructure

- 4.2. It is essential that the VQMS (or any other capacity rationing system that may be in place in the future) does not undermine pre-existing contracts that underpin major investment decisions, both in Coal Chain capacity as well as in mining infrastructure. Xstrata invests significant sums in mining infrastructure and logistics and manages risks associated with such investment through long term contracts with rail and port operators to secure coal haulage and loading services.
- 4.3. Xstrata fundamentally believes that priority should be given to contracted demand over uncontracted demand. Furthermore, pre-existing contracts held by coal exporters should be fulfilled in full before any future additional contract volume is taken into account. Until such time as additional port and rail capacity becomes available, the introduction of any new rail or port contracts can only have an adverse effect on existing investments and undermine efficient investment incentives going forward.
- 4.4. Using contracted demand as the basis for allocating constrained capacity should foster the confidence of coal exporters in the reliability of the long term rail and port contracts which is necessary to support efficient infrastructure investments at all stages of the Coal Chain.

Fostering investment in rail and port infrastructure

- 4.5. Over the longer term, the preferred solution is to see current track and port expansion projects accelerated to deliver significant additional coal chain capacity. Substantial additional investment in new rolling stock will also be required if the underlying track and port capacity is to be realised. Such infrastructure investment should be stimulated and underwritten by long term contracts with coal exporters which in turn highlights the importance of fostering confidence in the reliability of these contracts.
- 4.6. PN and QR as commercial enterprises will be seeking to underpin substantial investment in new rolling stock with long term contracts to underpin such investment. A deficiency of the current CBS is that it operates without reference to rail contracts while allowing parties to benefit from "spot" availability of rail capacity due to allocation being based solely on port nominations and, while not intended, this may not provide sufficient signals and commercial pressure to expand. This is clearly an unintended outcome of the CBS and not something that was envisaged. As such Xstrata can appreciate PN and QR no longer supporting the CBS continuing into 2008.
- 4.7. Against this background of ensuing appropriate incentives, for any solution in 2009 and beyond, Xstrata believes it is essential that the ARTC track access regime be brought into the solution, and that all parties work together to ensure that their contracts reference Coal Chain capacity rather than some artificial notion of standalone capacity that cannot be turned into coal exports. To this end, Xstrata considers the development of ARTC's new access regime to be developed through the ACCC in 2008 as a critical element in the design of a sustainable solution for the Coal Chain. Please see Confidential Attachment 2 in this respect.



5. Competitive neutrality between coal exporters

5.1. The VQMS is competitively neutral as between coal exporters. It allocates constrained capacity by reference to contracted demand. While this means contracted demand has priority over uncontracted demand, there are strong investment efficiency considerations for this approach for the reasons explained above. In all other respects, the VQMS does not confer a competitive advantage on any coal exporter.

6. Competitive neutrality between rail operators

6.1. The operation of the VQMS explicitly provides for the ability to “swap” or “transfer” volume between rail providers, providing no impediment to competition in the rail haulage market beyond what would exist in the absence of the VQMS. Any new rail operator seeking to participate in the Coal Chain in 2008 could also access system capacity through the swap and transfer mechanisms provided for under the VQMS. (We note that any new rail provider entering the market in 2008 other than through this mechanism should not be possible given the existing coal chain capacity is already fully utilised and cannot support existing contractual obligations. We also understand that any additional rolling stock beyond that already committed by PN and QR in 2008 will not create additional coal chain capacity.)

6.2. Additionally the operation of the VQMS is limited to 2008 only, and as such will have no impact on long term demand for coal haulage services.

6.3. Consequently, the VQMS is competitively neutral as between rail operators

7. Key requirements for a sustainable Coal Chain moving forward

7.1. Xstrata considers the following requirements are key issues for the development of a sustainable Coal Chain for 2009 and beyond:

- a) ***Coordinated Coal Chain Master-Planning*** - Xstrata considers the development of the first Hunter Valley Coal Chain Master Plan (“**Master Plan**”), due for release by the HVCCLT at the end of November 2007, as a positive step towards a more efficient Coal Chain. It is intended that this Master Plan shall list the Coal Chain capacity associated with each expansion, and hence identify the sequence of expansions required to increase overall export capacity.
- b) ***Interface Agreements*** - In the current environment, a 1Mt contract for track, haulage and port capacity does not equate to 1Mt of Coal Chain capacity and associated exports. Service providers and producers must develop a standard approach to enabling all coal chain contracts to reference an agreed coal chain capacity. This will ensure that contracted volumes across the coal chain represent deliverable obligations on the service providers and increase overall confidence in the commercial operation of the coal chain.
- c) ***ARTC Access Undertaking*** - The current NSW Hunter Valley track access regime under IPART, has not resulted in a system that requires the track-provider to limit



access rights to sustainable Coal Chain capacity. This has resulted in competitive haulage operators being able to over-contract their obligations compared to the capacity of the coal chain as a whole. ARTC has recognised this short-coming, and there is a general acknowledgement that it should be rectified under the proposed ARTC Hunter Valley access undertaking, which is expected to be submitted to the Commission in early 2008. This needs to be expedited, and in the interim measures need to be implemented to ensure that the current situation of excess contracted volumes is not exacerbated.

- d) ***Consistent Access Protocols*** - Xstrata considers that clear and consistent access protocols need to be implemented for Coal Chain infrastructure so as demand growth can be aligned with expanded infrastructure capacity. Xstrata supports open-access / common user infrastructure, however equal terms of access for new growth must be linked to the commissioning of the required infrastructure expansions.
- e) ***Acceleration of Expansions*** - Following the release of the Master Plan, it will be critical for key infrastructure projects to be expedited. These include the Newcastle Coal Infrastructure Group ("NCIG") terminal and further track projects. Producers will also need to under-write additional investment in rolling-stock, where lead times are approaching 18 month to -2 years. There is a risk that any delay to investment in new infrastructure could place capacity in 2010/2011 at risk, and therefore the creation of a system that recognises contracts as the basis for operation of the coal chain is critical in 2008.
- f) ***Central Coordination*** - Xstrata believes that coal producers are the key stakeholders in the performance and growth of the Coal Chain. Recently, service providers have invited limited producer representatives to attend meetings of the HVCCLT Steering Committee, and this is a positive step. However, Xstrata believes more can be done in terms of central coordination of not only short-term planning and execution of Coal Chain operations, but also for implementation and management of Coal Chain initiatives and expansions. In this respect, it is incumbent on both service providers and producers to develop improved Coal Chain management structures which recognise the stakes and value-at-risk of the coal producers.
- g) ***Development of Vessel Queue Management System(s) for 2009 and 2010*** - Xstrata notes that indicative forecasts of Coal Chain capacity in 2009 may only be in the order of 100Mt, and that 2010 capacity (the NCIG development is to be confirmed and is not included) may only be in the order of 108Mt. With current lesser of rail and port contracts at 108.494Mt for 2008 it is probable that an allocation system will be required for 2009 and 2010. In the interim, measures must be established to ensure that there is no increase in the level of mismatch between current contracted capacity and the available capacity of the coal chain.

8. Conclusion

- 8.1. Xstrata supports the fundamental premise which underpins the VQMS - the alignment of port and rail contracts is a commercially equitable basis upon which to allocate scarce



capacity in an environment where contracted demand has been allowed to exceed system capacity, and that such alignment is also critical to ensuring a co-ordinated investment approach across all aspects of the Coal Chain in the longer term.

- 8.2. Xstrata fully supports PN, QR and PWCS' application for authorisation of the VQMS. As PN, QR and PWCS have indicated in their submission to the application, the VQMS will deliver significant public benefits and is a significant step to an efficient long term solution.
- 8.3. Xstrata also strongly supports the PN, QR and PWCS interim authorisation application and the authorisation application generally.
- 8.4. Xstrata thanks the Commission for the opportunity to make a submission.

If the Commission has any further questions, Xstrata would be pleased to assist.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Steve Bridger', written over a light grey rectangular background.

Steve Bridger
General Manager, Commercial