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Mr Scott Gregson
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Australian Competition and Consumer Commission
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Dear Mr Gregson

Ref No: C07/01542

Applications for Authorisation by Pacific National (PN), Port Waratah Coal Services (PWCS) and Queensland Rail (QR)(Applications Nos: A91068-A91070); and Applications for Authorisation by the Newcastle Port Corporation (NPC) (Application Nos. A91072-A91074)

I refer to your letter of 19 November 2007 seeking comments on the application for authorisation for a Vessel Management Queue System (VQMS) and your letter of 4 December 2007 seeking comments on a separate application for authorisation for a continuation of the current Capacity Balancing System (CBS).

The letter from Mr John Karas dated 30 November 2007 provided our initial comments on the PWCS, PN and QR ("The Providers") application for an *interim authorisation* of the VQMS. This letter provides some further comments on the application for authorisation of a VQMS for 2008. Given the close linkages between this application and the subsequent application by the NPC, this submission addresses both applications together.

In summary:

- The international demand for coal will continue to be strong for the foreseeable future, resulting in ongoing capacity constraints in the Hunter Valley Coal Supply chain;
- Against this scenario a capacity allocation system to match supply to the system capacity, and reduce the length of vessel queues and potential demurrage costs continues to be justified but only as a **transitional measure** pending new and expanded rail and port capacity coming on line;
- An interim authorisation of a capacity allocation system appears to be justified to avoid leaving any gap between the expiry of the current CBS arrangements and a final determination on arrangements for the remainder of 2008, and thereby avoid a potential blow out in the vessel queue and demurrage costs;
- Interim authorisation of either of the two applications is likely to have irreversible effects;
- Any capacity allocation system should include the following broad principles:

- It should promote the economic and operating efficiency of the Hunter Valley Coal supply chain and minimise the distortion of market based signals to producers and infrastructure providers;
 - Allocation arrangements should be as transparent as commercially possible;
 - It should not inhibit competition in the supply chain except on broader public interest grounds; and
 - It should seek to maximise coal throughput in the supply chain;
- Further, it is likely that a capacity allocation system that aligns individual contractual arrangements between, producers, customers and infrastructure providers with total system capacity rather than individual elements of the supply chain (e.g. port, haulage services or track capacity) would have several advantages, including:
 - Reducing the potential for “gaming” the system by companies seeking to maximise their individual allocations by overestimating potential exports
 - Helping avoid system capacity being over contracted;
 - Providing greater certainty for producers, customers and infrastructure providers that that contracts will be met;
 - Providing a firmer underpinning for future investments in additional system infrastructure capacity; and
 - Enhancing Australia’s international reputation as a reliable supplier of coal.

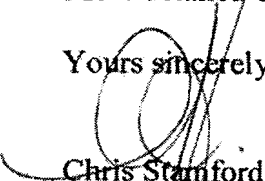
However, that system will need to account for the PCWS common user requirements

For 2008, I note that the ACCC will need to assess the relative public benefits and public detriment of the two proposals as well the benefit and detriments of each application relative to the absence of any authorised rationing of allocated capacity. This should include consideration of:

- The costs and benefits of the new allocation arrangements which are proposed as a transition to arrangements beyond the end of 2008;
- The impact of moving from a system based on contracts underpinned by a common user facility requirement (PWCS) to one with an increased emphasis on private contracts (between coal suppliers and rail service providers) which do not entail common user obligations;
- The impact of the proposed arrangements on production and investment decisions of both stable and expanding producers and on the investment decisions of infrastructure providers; and
- The extent to which both the proposals promote or impede operational efficiencies and future investment in the coal supply chain, including the entry of potential new rail service providers, and maximise total system coal throughput.

More detailed comments on the above issues are at Attachment A to this letter.

Yours sincerely


Chris Stamford
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December 2007

Interim Authorisation Application

Demand will continue to exceed System Capacity to supply for at least the medium term

Both the Providers' application and the NPC application state that the international demand for coal exported from Newcastle will continue to exceed the capacity of the coal chain infrastructure for the medium term given forecasts for continuing strong demand growth in international coal markets. PWCS notes that it has already received indicative nominations of 144 Mt for 2009, well in excess of proposed system capacity for that year.

This is consistent with the general outlook for Australian coal demand. The Australian Bureau of Agricultural and Resource Economics (ABARE) forecasts that world thermal coal trade is projected to increase at an average rate of around 3 per cent a year to total nearly 727 million tonnes (Mt) in 2012 compared to 619 Mt in 2006. The key drivers of growth in world thermal coal trade over this period are expected to be increased imports by key Australian markets, including Japan, the Republic of Korea, Taiwan, India and China. Australian thermal coal exports are projected to be around 150 Mt in 2011-12: up from around 115 Mt in 2006-07 as a result of strong world demand.

The global demand for metallurgical coal is also expected to be strong with trade forecast by ABARE to increase by 3.5 per cent per year between 2006 and 2012 to reach over 251 Mt. The supply of Australian metallurgical coal for export is projected to increase from nearly 126 Mt in 2006 to over 155 Mt in 2012. This is being driven by the global production of steel (particularly in China and India) which ABARE forecasts will increase by 4.8 per cent a year to more than 1.6 billion tonnes per annum over the six years to 2012.¹

A Vessel Management System is required from 1 January 2008

In the light of the continuing strong international demand for coal, capacity constraints will remain a feature of the Hunter Valley coal supply chain for the short to medium term. It is likely that the absence of a vessel management system pending final decisions by the ACCC on arrangements for the remainder of 2008 will lead to a repeat of the rapid build up of the coal vessel queue and increased demurrage costs that occurred after the decision by Hunter Valley coal producers to terminate the medium term Capacity Balancing System (CBS) from 1 January 2007. The CBS was subsequently reinstated at the request of the producers.

Factors outside the CBS, including weather related issues (such as the June floods in the Hunter Valley which resulted in some 2.5Mt of lost throughput), vessel ordering arrangements and other unplanned losses have reduced capacity and added vessels to the queue in 2007. However a vessel management system will result in lower queue levels and lower demurrage costs at Newcastle than the absence of a vessel management system.

Interim arrangements based on either of the applications are likely to have irreversible impacts

Mr Karas's letter of 30 November identified a broad range of issues that the ACCC should have regard to in reaching a determination on the VQMS. While an interim authorisation for a vessel management system appears to be justified, it is likely that even the interim authorisation of either application may result in irreversible impacts. Both the VQMS proposal and the proposal to retain the CBS aim to deliver at least 95 MT in 2008 which is the estimated system throughput

¹ ABARE, *Australian Commodities*, March Quarter, 2007.

capacity. While both the VQMS and the CBS seek to maximise system throughput while managing the vessel queue, they will result in differing distributional outcomes for individual producers, which means that the basis for calculating individual company allocations will also need to be considered.

Supporters of each application have since claimed that they will suffer reduced operations and staff retrenchment if the others' proposal is adopted. Opponents of the Providers' application have claimed that the increased emphasis on contracts with rail providers is likely to have an adverse long term effect on coal suppliers that were anticipating a continuation of the current CBS, and that have yet to lock in rail contracts to meet their 2008 port contracts. Opponents of the current CBS have claimed that suppliers whose output is stable will continue to have their capacity allocations pro rata-ed back to accommodate new capacity or capacity increases by competitors.

More generally, the VQMS proposal that capacity allocation should be based on the lesser of existing rail and port contracts is a substantial change from the current CBS, where capacity allocations are based on port contracts alone. This represents a shift from an allocation based on contracts underpinned by a common user facility requirement to an arrangement that places much greater emphasis on contracts with rail providers that are not bound to a common user obligation. A move to this system may also qualify as an irreversible impact, and it is not clear what effect this would have in a capacity constrained environment in the longer term.

Final Determinations on Applications for Authorisation

Long term investment in additional infrastructure capacity is required

The long term solution to ongoing coal supply chain capacity constraints is substantial investment in new infrastructure capacity to meet the increased demand for coal. This includes further expansions at PWCS, the development of the new coal export terminal by the Newcastle Coal Infrastructure Group, investments in Newcastle port facilities and services, investments in rail infrastructure and expansions in coal rail freight services by existing players and potential new entrants.

Rationing systems should therefore be considered as transitional measures pending increased capacity coming on line and only then when the national benefits exceeds the costs of not having a rationing system in place. Importantly, the rationing system minimise the distortion of market signals required to attract infrastructure investment and in particular, should support the application of long term supply contracts. As well as the direct costs associated with queues and long shipping delays, the long term impact that unnecessary shipping queues have on Australia's reputation as a reliable and secure supplier of coal should also be considered.

In circumstances of capacity constraints short term capacity allocation systems are justified.

While there appears to be broad based support within the Hunter Valley coal industry for a capacity allocation system, there is no agreement on the basis of such a system. Given that it appears some form of vessel management system is justified, any capacity allocation system should be based on the following broad principles:

- It should promote the economic and operating efficiency of the Hunter Valley Coal supply chain and minimise the distortion of market based signals to producers and infrastructure providers;
- Allocation arrangements should be as transparent as commercially possible;

- It should not inhibit competition in the supply chain except on broader public interest grounds; and
- It should seek to maximise coal throughput in the supply chain;

These principles would accommodate a capacity allocation system that aligns individual contractual arrangements between producers, customers and infrastructure providers with total system capacity rather than individual elements of the supply chain (e.g. port, haulage services or track capacity). This approach offers several potential advantages. It reduces the potential for “gaming” the system by companies that may seek to maximise their individual allocations by overestimating potential exports. It also helps avoid system capacity being over contracted, providing greater certainty for producers, customers and infrastructure providers that contracts will be met as well as providing a firmer underpinning for future investments in additional system infrastructure capacity; and enhancing Australia’s international reputation as a reliable supplier of coal. An allocation arrangement that seeks to align individual coal chain contractual arrangements with system capacity will also need to account for PWCS common user obligations

What type of Capacity Allocation System should be authorised for 2008?

While noting the above the ACCC will need to analyse the total level of public benefit versus public detriments that might arise from either of the two proposed capacity allocation systems as well as a no authorisation scenario for 2008. In terms of assessing the potential public benefits and public detriment of the various options the ACCC should have regard to the principles referred to above. The Department also requests the Commission to take into account the following comments in its assessment of these matters;

Potential detrimental impacts

As noted earlier the potential impacts of the current CBS port based allocation system on all producers with some existing producers potentially having to reduce operations and retrench staff as their allocations are cut at the expense of expanding producers.

Altering the current allocation rules at relatively short notice based on a “snap shot” of contracts taken at a particular moment in time can also potentially adversely affect producers who may have made investment decisions on the basis of current rules and an expectation that those rules would likely continue to apply into 2008. Such changes can also create uncertainty for future investment decision making.

We are not in a position to determine what the impact of either scenario would be on total system operating efficiency or throughput.

Impacts on economic and operating efficiencies

As a general rule allocation arrangements which apportion any system losses to individual producers and rail providers, rather than apportioning such losses across all producers and providers (such as occurs under current CBS arrangements) would provide better incentives for producers and rail haulage providers to improve their operational performances;

Any allocation system should also seek to promote as far as possible competition in rail haulage services, including through avoiding the creation of unnecessary barriers to entry for new operators. In our view, the VQMS proposal appears to provide that the only mechanism for a new rail provider to potentially enter the market for coal haulage services in the Hunter Valley in 2008 is through a transfer/swap system. It is questionable whether such an arrangement will provide a sufficient incentive or level of certainty for such an operator to undertake the necessary

financial investment to attempt to enter the market. This effectively could reduce competition in this segment of the market.

Allocation systems should seek to maximise throughput

The Department believes some level of operating flexibility needs to be built into the allocation arrangement to ensure system coal throughput is maximised while minimising incentives for vessel bunching. In this regard the current CBS flexibility provisions which enable producers to bring forward or carry over some level of the monthly allocation are may have contributed to some level of vessel bunching at the end of a month as producers/customers seek to maximise their allocations.

However, the proposal to remove this flexibility may create operating difficulties, particularly for smaller producers that might have less capacity to meet strict monthly allocation deadlines and potentially lead to reduced system throughput. As part of the development of any future capacity allocation system, consideration might be given to options such as potentially reducing the level of tonnage flexibility rather than fully eliminating it.

12 December 2007