

# COAL & ALLIED

*Managed by Rio Tinto Coal Australia*

17 March 2008

The Acting General Manager  
Adjudication Branch  
Australia Competition and Consumer Commission  
GPO Box 3131  
Canberra ACT 2601

Attention: Mr David Hatfield

Dear Mr Hatfield

**Draft Determination - Applications for Authorisation A91075 – A91077 lodged by Donaldson Coal Pty Limited (Donaldson) and A91072 – A91074 lodged by Newcastle Port Corporation (NPC)**

Thank you for providing us with the opportunity to comment on the ACCC's draft determination.

Coal & Allied (C&A) welcomes the ACCC's comments that a long term solution is required for the coal industry and agrees that the underlying issues are not being addressed, in particular, the contribution the Common User Provisions within PWCS' Kooragang Lease has to the ongoing capacity imbalance.

C&A has expressed this in submissions to the Hon. Nick Greiner, who is working with the NSW Government to facilitate a medium-term solution for the NSW Industry. C&A has made two submissions to Nick Greiner, which are attached. In summary, C&A believes that the barriers to implementing a long term solution are:

- the fact that PWCS is subject to a common user obligation in its lease with NPC, which substantially restricts its ability to enter into long term contracts to underpin future expansions; and
- the fact that the New South Wales government has not imposed such an obligation on the operators of the new NCIG terminal, which places PWCS at a competitive disadvantage and further entrenches sub-optimal investment outcomes.

C&A has previously indicated its concerns with implementing a CBS using the 2008 nominations.<sup>1</sup> Specifically:

- (1) C&A believes the 2008 nominations were gamed; and
- (2) Even in the absence of gaming behaviour, use of the 2008 nomination creates a system whereby expanding producers receive priority over existing users, which can, and has, resulted in existing users having to hand coal chain capacity to new producers who are in the process of bringing on capacity.

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<sup>1</sup> Refer to letter from Mr Matt Coulter to Mr Scott Gregson dated 19 December 2007.

C&A agreed with the concept put forward in the original NPC application of continuing the CBS into 2008 referencing the 2007 nominations<sup>2</sup>.

The ACCC would also be aware<sup>3</sup> that C&A has advised the Newcastle Ports Corporation that notwithstanding its concerns with using the 2008 nominations, it would be prepared to support such a CBS on condition that:

(1) CBS nominations are absolutely capped at 116 Mt until coal chain capacity above 116 Mt becomes available; and

(2) The NSW commits to engaging in discussions on addressing the practical application of the common user clauses in the Kooragang lease to allow all producers to enter into fixed and firm long term port contracts which will allow all coal producers to pursue their growth agendas over the long term.

These conditions have not yet been satisfied, but are being addressed in the industry discussion being facilitated by Nick Greiner, which is yet to conclude.

### **C&A Does Not Control PWCS**

C&A's position as both a producer and a shareholder in PWCS has resulted in a number of ill informed and erroneous claims being made to the Commission that C&A has the ability and incentive to achieve, and is actually responsible for, the capacity problems experienced by PWCS (see for example the submission to the ACCC by Allen Consulting dated 12 December 2007 and the submission by Freehills on behalf of Centennial Coal Company dated 12 December 2007). These claims are misleading and are without foundation. C&A does not, individually or together with Xstrata, "control" PWCS:

- As noted above, C&A only has a 30% direct interest in PWCS. Xstrata has no direct interest in PWCS.
- Under PWCS's Constitution, a single shareholder with a 10% shareholding, or a group of shareholders with a collective 10% shareholding, may appoint one director to the board of PWCS by reason of that 10% shareholding.
- Accordingly, C&A's direct shareholding in PWCS only gives it the right to appoint three out of the 10 PWCS directors. This obviously does not give C&A the ability to control the PWCS Board. Xstrata has no direct rights to appoint any PWCS directors.
- NCS has a 36.95% direct shareholding in PWCS. This shareholding gives NCS the right to appoint three out of the 10 PWCS directors (by virtue of 30% of NCS's 36.95% direct shareholding). Two of NCS's current three appointees are officers of the Xstrata group, and the third is an officer of the Anglo Coal group.

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<sup>2</sup> Refer to letter from Mr Matt Coulter to Mr Scott Gregson dated 17 December 2007.

<sup>3</sup> Refer to letter from Mr Hubie Van Dalsen to Mr Gary Webb, copied to Mr Scott Gregson dated 18 December 2007.

- NCS is also a member of a 10% PWCS shareholding group with Bloomfield and a 10% shareholding group with Tomen, under which an officer of Bloomfield and an officer of Tomen (respectively) are appointed as PWCS directors.
- In terms of the 8.39% indirect interest in PWCS held by C&A and its associated companies, this arises by virtue of C&A's 11.41% shareholding in NCS and shareholdings in NCS totalling 11.30% held by the sales companies of the Warkworth and Bengalla joint ventures (which are themselves not wholly owned subsidiaries of C&A). These shareholdings in NPC do not provide C&A with an ability to control the appointment by NCS of directors to the PWCS board.
- In summary, of PWCS's 10 directors, three are appointed by C&A; three are appointed by NCS (two of whom are currently officers of Xstrata and the other being an officer of Anglo Coal); one is appointed by NCS and Bloomfield acting as a group (currently a Bloomfield officer); one is appointed by Tomen and NCS acting as a group (currently a Tomen officer); and two are appointed by two further 10% shareholding groups made up of PWCS remaining "Importer" (ie, non-producer) shareholders.
- Claims that C&A and Xstrata collectively control PWCS are false. The only way that such control could occur would be if C&A and Xstrata acted collectively within NCS to control the appointment of three NCS nominees to the PWCS board, and if C&A and Xstrata then acted in concert in directing the three C&A nominees and those three NCS nominees in relation to the exercise of their powers and duties as directors of PWCS. This is not the case:
  - C&A and Xstrata do not act collectively within NCS to control the appointment of NCS' nominees to the PWCS board, and do not have the power to do so. As noted above, one of NCS current direct appointees is an officer of the Anglo group.
  - Allegations that C&A and Xstrata collectively control PWCS imply that the directors appointed by C&A and by NCS would place the interests of C&A and Xstrata above the best interests of PWCS, and would act in concert in doing so. This allegation is without foundation. Speaking from C&A's perspective, its nominees are fully aware of their duties to act in the best interests of PWCS and its shareholders as a whole, and C&A believes that any assessment of the deliberations of the PWCS board would show that the directors appointed by C&A and Xstrata have not acted in concert to advance the interests of C&A and Xstrata over and above the interests of PWCS and its other direct and indirect shareholders.

In light of the above, it is clear that C&A does not have, either directly or indirectly in its own capacity, or in combination with Xstrata, a controlling interest in PWCS. Arguments which have been made to the Commission, such as those by Allen Consulting, to the effect that C&A and Xstrata 'control' PWCS and have a duopolistic vertically integrated mine and port structure, are therefore simply wrong. They are

based on a simplistic aggregation of C&A's and Xstrata's indirect interests in PWCS, without a proper understanding of the fact the neither company's interest in NCS gives them control over NCS. Such simplistic and false arguments serve only to perpetuate inefficient, short term capacity balancing systems by creating an atmosphere of distrust and suspicion against industry participants who in fact have no ability to control PWCS to their own ends.

Yours sincerely



**Matt Coulter**  
**General Manager – Corporate Development**

# COAL & ALLIED

*Managed by Rio Tinto Coal Australia*

## **Submission to The Hon Nick Greiner**

29 January 2008

Dear Mr Greiner

Coal and Allied (C&A) has a significant stake in the Hunter Valley coal industry. C&A and its predecessor companies have mined coal in the Hunter Valley for over 150 years. It currently operates three large open-cut mines in the Hunter Valley, which accounted for 28% of coal exports through Newcastle in 2007, and employs approximately 1500 people directly, and a further 500 in contracting roles on its sites. C&A has a 30% direct interest in PWCS and an additional 7% indirect interest through its stake in Newcastle Coal Shippers. C&A is 76% owned by Rio Tinto, and is managed by Rio Tinto Coal Australia.

C&A has been significantly impacted by the capacity constraints in the Hunter Valley system, and the capacity allocation resulting from the Capacity Balancing System (CBS) which was introduced to control the length of the vessel queue off Newcastle. Over the period of operation of the CBS, C&A's total sales<sup>1</sup> have reduced from 29.0 Million tonnes (Mt) in 2005, to 27.6 Mt in 2006, to 25.5 Mt in 2007. There has been a corresponding reduction in earnings – A\$291 M in 2005, A\$207 M in 2006, and A\$110 M in 2007.

As large as these impacts have been on C&A, they are relatively small compared to the potential value loss in the future for C&A if the infrastructure issue is not satisfactorily resolved. C&A has the largest reserves and resources of any company in the Hunter Valley. Recent planning work suggests that C&A's current coal resources could support expansions which could more than double exports from current levels. For example, C&A is currently finalising a feasibility study for the Mount Pleasant Mine which could commence production in 2011 with investment of about A\$1 billion and create 350 long term jobs. However, C&A is most unlikely to approve construction of Mount Pleasant until there is some certainty of long term access to infrastructure.

C&A appreciates your willingness to assist the coal industry in attempting to come to an agreement on the allocation methodology under a CBS for the short to medium term. Later in this submission we will propose specific suggestions to address the allocation issues facing the industry in the short-term. Before we do so, we feel it is important to provide a perspective on the challenges facing the industry in the longer term, as it provides an essential context for the short-term issues.

C&A believes that a significant overhaul of the commercial framework relating to the allocation of infrastructure capacity is required to provide long term certainty for coal producers, (and their customers, employees and shareholders), infrastructure providers and, indeed, the Hunter region. We note that the ACCC seems to share this view. In a recent letter to coal producers, the ACCC wrote:– *“The ACCC has previously expressed the view that capacity allocation systems are transitional measures only and that continued operation of the CBS on an extended basis may*

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<sup>1</sup> Total sales include both export and domestic sales. C&A's total sales would have been around 29-30 Mt if export coal chain capacity was available.

*hinder the development of a long term solution to address the underlying issues behind constrained coal chain capacity in the Hunter Valley.”<sup>2</sup>*

Regulation of the access to PWCS is currently governed by the “common user clauses” contained in the Kooragang Terminal Lease. While no doubt well intended, these clauses are now preventing the establishment of a sensible infrastructure contracting regime in the Hunter Valley. C&A believes that the dysfunction that currently exists in the Hunter Valley coal industry stems largely from the lack of certainty inherent in these provisions. C&A believes the NSW Government must address these clauses to allow for the establishment of long term contracts between producers and the port.

Any steps taken to resolve short-term issues should be consistent with the objective of providing certainty across the coal chain.

### **Why is the industry in this position?**

Ideally, infrastructure should be contracted and committed before mine expansions. This has clearly not happened in this case. In the absence of firm long-term contracts with coal producers, PWCS has no firm guidance on how much capacity to build, nor in what timeframe. It must make investment decisions based on historical growth and external forecasts (e.g. ABARE). Such an approach may be satisfactory in periods of slow growth, but is almost certain to fail in a boom. As a consequence, there will be insufficient port capacity in coming years.

Rail haulage providers and rail track providers are also in a dilemma. While haulage companies can, and do contract with customers, they must decide whether to invest to meet their full contracted tonnage, or the tonnage they believe will actually be transported down the coal chain. As a result of this “second guessing”, the indications are that there has been and will continue to be under-investment in rail capacity over the coming years.

The lack of a long term contracting framework has made it almost certain that there will be recurring periods of capacity constraints, and that these constraints will endure for as long as the lead time to build new capacity. Without an effective contracting framework, the most reliable indication that a period of insufficient capacity is imminent is when a queue of ships appears off the coast of Newcastle.

Coal producers are reluctant to invest in major capital at the mines, unless they have some confidence that they will be able to export all of the product once they have invested the capital.

### **What is the long term solution?**

C&A believes that the PWCS should be allowed to enter into firm long- term contracts with its customers. This is how all other major Australian coal ports work.

However this process is complicated by the following:

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<sup>2</sup> Letter from Scott Gregson (General Manager Adjudication Branch, ACCC) to interested parties, dated 20 December 2007.

(1) Once the current expansion to 113 Mt is completed, PWCS appears to be getting close to its full capacity on its current land footprint, although the ultimate capacity of PWCS has not yet been defined;

(2) the only suitable land available for use for coal loading in Newcastle has been given exclusively to NCIG, which is controlled by six of the sixteen Hunter Valley producers;

(3) NCIG has only committed to build 30 Mt of the 66 Mt of capacity approved for the site;

(4) once the PWCS and NCIG projects are both completed (towards the end of 2010), the nominal port capacity will be 143 Mt, which will be insufficient for the industry's indicated tonnage requirement of 168 Mt for 2011;

(5) the capacity of the coal chain has typically been less than any single element, so coal chain capacity will, in reality, be less than 143 Mt, particularly if rail haulage companies or track providers under-invest.

In June 2007, PWCS sought a waiver of the common user clauses from January 1 2010 (the then expected completion date of the facilities), on the basis that NPC is obliged under the terms of the Kooragang Lease to waive the common user clauses if the clauses put PWCS at a competitive disadvantage as against a new provider of port services. This would allow PWCS to enter into firm long term contracts with its customers. It would also allow PWCS capacity to be offered first to producers who do not have access to NCIG. Because NCIG producers have their own terminal (which is not subject to common user clauses), it is necessary for PWCS to give priority to producers that do not have access to NCIG to allow all producers in the Hunter Valley to realise their growth ambitions.

The NSW Government responded in September that it is of the view that the circumstances under which it is required to give a waiver do not exist.

### **How should the limited capacity be divided in the short term?**

To deal with the ship queue and the high cost of demurrage which results, the industry was forced to introduce a Capacity Balancing System in 2004. The Capacity Balancing System was initially based on annual nominations, however in September 2005 PWCS sought binding nominations for the following three years on a take-or-pay basis. Nominations provided by the industry were substantially above what the industry was actually exporting, and C&A believes that the nominations were gamed by some producers. That is, they nominated more than they expected they would actually require, in the expectation that they would be scaled back. C&A nominated for tonnages that it actually required to utilize its existing installed mine capacity. C&A's nominations for the three years (2006, 2007 and 2008 respectively) were 28.3 Mt, 28.3 Mt, and 28.9 Mt.

C&A voted against the continuation of the CBS in September 2006, because it was not clear at that time whether there would be a shortage of infrastructure capacity in 2007, and because pro-rating based on the total nominations of 119 Mt would have resulted in an unacceptably low allocation to C&A. C&A supported reintroduction of the CBS in early 2007, based on the revised total nominations of 107 Mt. In May 2007, C&A was obliged to announce the reduction of 250 jobs in its operations, due to the capacity constraints.

In the absence of any other proposal for an allocation system for 2008, C&A supported the application by PWCS, PN and QR to implement the Vessel Queue Management System (VQMS), as it was based on existing contractual relationships between producers and the service providers. Following the announcement that the ACCC decided not to grant an interim authorisation for the VQMS, C&A supported the initial proposal put forward by NPC to maintain the current CBS based on the 2007 nominations until a final decision was made for 2008. C&A did not support the amended NPC application based on the revised 2008 nominations of 116 Mt.

C&A believes that capacity allocation should be based on a number of principles:

- Existing, operating producers should not be forced to give up capacity to allow new producers to enter, i.e.. no-one should go backwards from their historical usage. To do otherwise creates no value for the industry, it merely shifts volume from one set of producers (and their current employees) to another set of producers. Failure to adhere to this principle in the past has resulted in significant industry layoffs.
- New mines should have equal opportunity to participate in the industry's growth, but only when infrastructure capacity is available, not at the expense of existing operators and their employees.

Given that 2007 nominations have not yet been satisfied, it is difficult to see why PWCS should attempt to satisfy 2008 nominations when 2007 (and even 2006) nominations have yet to be satisfied. Furthermore, C&A does not see any point in seeking further nominations for 2009. If the previous nominations have been inflated, it seems inevitable that the 2009 figures will be too.

C&A believes that PWCS should advise the industry that there will be no further capacity available until existing binding nominations have been satisfied, and new capacity is constructed to satisfy demand above the existing binding nominations. To allow PWCS to make such an announcement, NPC must grant a waiver of the common user clauses.

In the circumstances, C&A believes that the CBS should be rolled over, with allocations based on the producers' revised nominations for 2007 which totalled 107 Mt. When those nominations are fully satisfied, allocations should be based on the producers' nominations for 2008 of 116 Mt.

I appreciate the opportunity to provide this briefing note to you, and please feel free to contact me if you have any further queries or need any further information.

Yours sincerely



**Hubie van Dalsen**  
**Managing Director**



# RIO TINTO

COAL AUSTRALIA

29 February 2008

The Hon Nick Greiner AC  
Facilitator  
Newcastle Ports Corporation  
PO 663  
Newcastle 2300

Dear Nick

Thank you for the opportunity to provide a submission regarding long-term principles and solution for the industry going forward.

We agree with the great majority of the long-term principles you have put forward and for those where our agreement is qualified, we have set out the basis for this in Attachment 1.

However we believe there is a fundamental issue which is not dealt with by the long-term principles as they are at the moment and believe this should be addressed in the principles. If the NCIG port is not also to be subject to an open access regime, then PWCS' current common user obligations should be modified so as to allow it to take into account a coal producer's access to the NCIG port in making allocations at PWCS in the event that there is insufficient capacity at PWCS to satisfy all producers' requests. This may also foster the merger of the two ports on just terms, with the merged port allocating capacity based on firm long-term take-or-pay contracts, which we believe is crucial to achieving an optimised port for the Hunter Valley coal industry in the long run.

With regard to the specific questions you have asked, we believe that these should be answered with reference to an over-arching model for the coal chain. Attachment 2 is a paper which outlines the issues with the current industry architecture and proposes changes to address these issues. The paper suggests there are two key elements that are fundamental to creating the necessary foundation for sustainable growth of end-to-end coal chain capacity -

- the adoption of a Long-Term Commercial Framework (LTCF) to provide the necessary certainty for producers and service providers to invest in the mine, rail and port; and
- the creation of a 'Producer Controlled Integrated Infrastructure Provider (IIPCo)' to facilitate the alignment of accountability for key industry decisions and system performances with risk.

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Coal & Allied has been considering options for reforming the NSW coal chain infrastructure for some time, and the proposal set out in the paper is one outcome of these considerations. The paper has not been widely distributed outside our organisation, although we have discussed the principles in the paper in preliminary terms with other producers, including members of the NCIG consortium.

The five specific questions raised in your "Call for Submissions" are addressed within this broader discussion paper. For the most part, they are addressed in Section 2 of the paper, which outlines an approach for redesigning the Hunter Valley Coal Chain. Our views on the specific questions you raise are repeated and elaborated upon below:

**1 Are contractual commitments from port and track providers a necessary pre-requisite to gaining access to the coal chain?**

Aligned contractual commitments from port and below-rail providers should be a pre-requisite to gaining access to the coal chain. In the IIPCo model, below-rail and port access rights would be bundled and sold together, reducing the chance of misalignment occurring.

Above-rail arrangements are not a pre-requisite for accessing units of infrastructure capacity, but it would be anticipated that a producer holding a take-or-pay contract for port and below rail infrastructure would have every incentive to procure above-rail capacity, as well. Producers would remain free to source their above rail capacity from above rail operators or haul their own coal. Above-rail operators would be expected to fulfil firm haulage contracts with producers before hauling tonnes on a "best endeavours" basis.

**2 What is the term of these binding commitments?**

We would expect that most capacity would be allocated on the basis of renewable (evergreen) ten year contracts, but suggest that shorter-term contracts would also be available. An incumbent producer having a mine with, for example, five years of mine life remaining should be allowed to match their infrastructure allocation with their remaining mine life (but would not be offered a renewable option). The precise structure of the contracts and their prioritisation would need to be agreed amongst producers as part of implementing the IIPCo model and associated LTCF arrangements.

**3 What is the lead time that a mine should be expected to provide for investment in expansion in coal chain capacity?**

Producers (existing and new) would be required to commit to contracts for new capacity approximately three years in advance of their requirement for coal chain capacity (with the possible exception of transitional arrangements). Assuming an appropriate master plan is in place for the coal chain (discussed below), this should provide adequate lead-time for investment in port and rail capacity (both above and below rail).

**4 a) What determines whether an expansion is economic?**

Currently PWCS operates under a regime where it earns a sub-commercial rate of return relative to its assets. The requirement for a commercial rate of return could be considered as part of the revised industry arrangements.

The integrated infrastructure provider will need to have a master plan in place that indicates the likely sequence, timeframe and associated costs for various expansion options. IIPCo will also need to have a defined set of industry agreed rules that provide guidance on when and to what extent, an expansion opportunity is deemed economic and may progress to the next level of project planning or implementation. Such agreements exist at other ports where, in general, no investment proceeds unless a certain (agreed) proportion of its capacity is contracted for at least for the first ten years. Another condition may require that port and below rail charges are not increased by more than a set percentage as a result of the expansion. Where these conditions are not met, the expansion will not occur.

**b) What happens if it is uneconomic to increase the coal chain capacity?**

Since capacity is allocated under firm, take-or-pay contracts, allocated capacity must be delivered upon in full by the infrastructure provider and will not be able to be "crowded out" by expanded mine capacity. That is, where it is not economically feasible to invest in additional coal chain capacity, the expansion aspirations of new or incumbent producers cannot be used to squeeze the entitlements of existing port users.

**c) Who bears the cost of the expansion?**

In general, producers will pay an averaged price, rather than having incremental producers pay for the cost of incremental expansions. Although a single price for all producers is preferred in most cases, there may be times when the industry (acting through their participation in IIPCo's decision-making procedures) deems a two-tiered or "user-pays" pricing structure more appropriate. However, it is inherently difficult to differentially price individual "tiers" of capacity, as often a significant investment at one stage opens up subsequent lower-cost expansions.

**d) What role would the central co-ordinating body have in this decision making process?**

IIPCo will determine the size and timing of investments in the coal chain and the execution of these would be enforced through long-term management agreements between IIPCo and the port and below-rail providers

**5 a) How should the central coal chain co-ordinating body be governed?**

IIPCo will be owned and controlled by all producers, as this will be the best means by which to align accountability for the operation of the coal chain with risk in a multi-user system. One way to achieve this would be to have each producer's interest in IIPCo being determined by its share of industry throughput. For example, a producer that has a 10% share of industry throughput would have 10% of the IIPCo ownership. The governance rules would need to address the approval thresholds required for particular categories of decision and provide all shareholders in IIPCo with appropriate input and protections.

**b) What is the role of the central coal chain co-ordinating body?**

The key accountability of IIPCo is to identify and fulfil the need for port and rail infrastructure to support the growth initiatives of Hunter Valley coal producers. IIPCo would have the decision making powers over when and where future investment in the coal chain infrastructure should be made and would develop the operating and maintenance protocols for the coal chain. IIPCo need not execute the day-to-day implementation of the IIPCo operational plan, as it is anticipated that this would be handled by a number of specialist service providers.

Closely related to IIPCo's role in the investment in new infrastructure is its role in allocating existing and new port and below-rail capacity under an agreed long-term commercial framework and in administering the contracts that give effect to such arrangements.

Please do not hesitate to contact me if you require further information.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Hubie van Dalsen', written in a cursive style.

**Hubie van Dalsen**  
**Managing Director**

## Attachment 1 - Long-term Principles

<b>A Government Principles</b>	
i	<p><b>Maximise exports given available infrastructure</b></p> <p>Agree, on the proviso that 'available infrastructure' means both infrastructure which exists now and infrastructure which could be built in the future. To achieve maximum exports, suggest an additional principle needs to be considered, which is: "Ensure both PWCS and NCIG are expanded as fast as possible, to allow all producers to maximise their growth plans".</p>
ii	<p><b>Be competitive in the short and long-term</b></p> <p>Agree that the competitiveness of the NSW coal industry in the global thermal coal industry is of critical importance.</p>
iii	<p><b>Reduce the queue of vessels off the port</b></p> <p>Agree, ensuring that sufficient capacity is made available to maintain an efficient queue of approximately 15 ships at all times.</p>
iv	<p><b>Protect jobs in the Hunter Valley</b></p> <p>Growth in the Hunter Valley coal industry will facilitate employment growth.</p>
v	<p><b>Minimise costs to the coal industry from gaming</b></p> <p>Agree</p>

<b>B Draft Coal Industry Principles</b>	
<b>Coal Producer Principles</b>	
i	<p><b>Coal producers need certainty over future capacity available to the producer to sell coal through the coal chain</b></p> <p>Agree.</p>
ii	<p><b>Coal producers may require access to additional coal chain capacity to grow production</b></p> <p>Agree.</p>
iii	<p><b>Service providers must guarantee the delivery of contracted chain capacity</b></p> <p>Agree, however this would require changes in the contractual structure to place a service provider in a position to guarantee the delivery of capacity across the coal chain e.g. IIPCo</p>
iv	<p><b>Service producers must offer contracts upon request from coal producers</b></p> <p>Agree, but service providers must only offer contract <u>if capacity is available</u>.</p>
v	<p><b>Contracts offered by service providers must be fair, just and on comparable terms</b></p> <p>Contracts should be fair and just. Terms must be based on principles of competition and comply with all relevant legal requirements including the Trade Practices Act.</p>
vi	<p><b>Service providers must deliver expanded capacity if and only when demanded by coal producers</b></p> <p>Agree. Expansions will generally be based on contracts, but nothing will preclude service providers from building more if they determine that it is required.</p>

vii	<b>Protect the Hunter Valley Coal brand.</b> Agree
<b>Service Provider Principles</b>	
i	<b>Coal producers will not be guaranteed any access to the coal chain without a commercial contract</b> Agree. For this to be achieved the common user clauses currently imposed at PWCS will need to be removed.
ii	<b>Service providers may require long-term commercial contracts to underpin investment in coal chain infrastructure and chain capacity</b> Agree.
iii	<b>Coal mines must provide adequate notice for any expansion of capacity</b> Agree.
iv	<b>Contracts offered to coal producers may take into account the relative cost of servicing the mine in question</b> Agree, on the proviso that all cost factors will be made transparent.
v	<b>Service providers are entitled to earn a reasonable commercial return</b> Agree.
vi	<b>Service providers may charge for different elements of their operation separately</b> Agree.
<b>Coal Chain Coordination Principles</b>	
i	<b>An independent body should oversee the coordination, planning and management of the coal chain</b> Key decisions on the planning and operation of the coal chain should be in the hands of the industry itself, not outsiders
ii	<b>Coal producers and service producers may be required to provide information to the independent coal chain body</b> Agree, there should also be far greater transparency than presently exists.
iii	<b>Contracts and allocations will be based on coal mines, not coal producers</b> Agree, as long as there is a mechanism to allow swaps/transfers between coal mines.
iv	<b>Contracts and allocations will be based on a common measure of system capacity</b> Agree. There should be a common unit of capacity measurement across the coal chain.
v	<b>A regular review of the coal chain will be conducted</b> Agree.

vi	<p><b><i>A coordinator general will mediate and arbitrate between members of the coal chain where the principles are insufficient</i></b></p> <p>Agree, but the key objective should be industry agreement on contractual principles which are clear, minimise disagreements and of themselves, provide appropriate dispute resolution mechanisms.</p>
vii	<p><b><i>Competition should be promoted in the coal industry and coal chain.</i></b></p> <p>Agree, where competition is productive. In particular, we do not believe that the potential competition created by having two ports will increase the performance of the industry.</p>

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## **Attachment 2 – Laying the Foundations for Sustainable Industry Growth in the Hunter Valley Coal Industry**

Refer to separate attachment.



**Attachment 2 – Submission to Nick Greiner**

**Laying the Foundations for Sustainable Industry  
Growth in the Hunter Valley Coal Industry**

Discussion Paper

February 2008

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## Executive Summary

The Hunter Valley coal industry is at a critical point in its history. While prices are at record levels and the industry has a large number of attractive growth options, the arrangements that underpin the coal chain infrastructure are constraining the industry's ability to fully capture the opportunity at hand.

This document outlines the rationale for and overview of a proposal for changes to the industry architecture that address the critical issues facing the Hunter Valley coal industry. There are two fundamental components to the proposal. Specifically, the industry, with the support of the NSW government should:

1. Redesign the architecture of the industry such that accountability for key industry decisions and system performance is aligned with risk. Producers have the most value at risk and therefore the greatest incentive to deliver. To be held accountable for the performance of the coal chain producers require control over (particularly) the four most important decisions that underpin industry arrangements: infrastructure investment, capacity allocation, pricing and operations and maintenance. This document outlines an architecture whereby producers control an integrated infrastructure provider that allocates units of infrastructure capacity
2. Adopt an unambiguous and firm Long Term Commercial Framework (LTCF) that will:
  - Provide certainty to producers over capacity allocations which will facilitate future investment at the mine and grow industry employment
  - Provide certainty to infrastructure providers over demand for infrastructure capacity and a mechanism for infrastructure investment to be underwritten by producers
  - Ensure that infrastructure capacity allocations are in line with what the coal chain can realistically deliver, thus keeping the queue of ships off the Newcastle coast at optimal levels

This document is intended to launch the necessary debate and discussion that will ultimately lead to broad agreement in relation to both the preferred industry architecture and the roadmap for achieving this goal.

## **1. Background & Current Issues: The Current Situation has led to Poor Outcomes**

The Hunter Valley coal chain is the largest export coal operation in the world. It consists of 30 coal mines owned by 17 individual coal producers; 23 points for loading coal onto trains; approximately 28 train sets; and more than 80 different blends of coal. In 2008, approximately 95 million tonnes of coal is expected to be exported from Port Waratah Coal Services (PWCS) – generating more than A\$7 billion in export revenue for NSW.

The current architecture of the Hunter Valley coal industry is extremely complex. The coal chain – from mine to rail to port and then to customer – is on course to consist of two ports (PWCS and the Newcastle Coal Infrastructure Group) – operating and investing independently, two above rail providers (Pacific National and Queensland Rail) – investing and contracting independently, one below rail provider (Australian Rail Track Corporation) that invests based on public and internal estimates of future demand, and an overarching logistics team (the Hunter Valley Coal Chain Logistics Team) that aims to coordinate both long-term investments and day-to-day operations of the coal chain. Exhibit 1 provides a simplified overview of the current architecture of the Hunter Valley coal chain.

Multi-user infrastructure systems are inherently complicated. The interests of numerous parties – which are often conflicting or misaligned – must be balanced and decision making is inherently slow. There are many problems with the current industry architecture that render it unsustainable (summarised in Exhibit 2).

Most importantly, producers lack the contractual certainty over access to rail and port infrastructure necessary to underpin investments in new capacity:

- As PWCS is currently operated, producers have no certainty over future port entitlements since they can be forced to “squeeze up” (and reduce their own production) to make way for new producers or to cater for the expansion plans of existing producers. In fact, in the last several years, producers have had no certainty as to their allocation looking only 12 months ahead, let alone for a longer timeframe
- With uncertainty over port allocations, contracts between producers and above-rail service providers are also rendered uncertain; what appears to be a firm, take-or-pay rail contract may be scaled back due to port constraints and fulfilled only on a “best endeavours” basis. On the other hand, producers receiving a port allocation may be provided with above-rail haulage services even in the absence of a take-or-pay rail contract. This leads to some producers to not contract for rail (as is currently the case). This will ultimately lead the above rail operators to underinvest in rolling stock
- Whilst such uncertainty exists for producers with respect to access to both port and rail capacity entitlements, producers are unwilling to

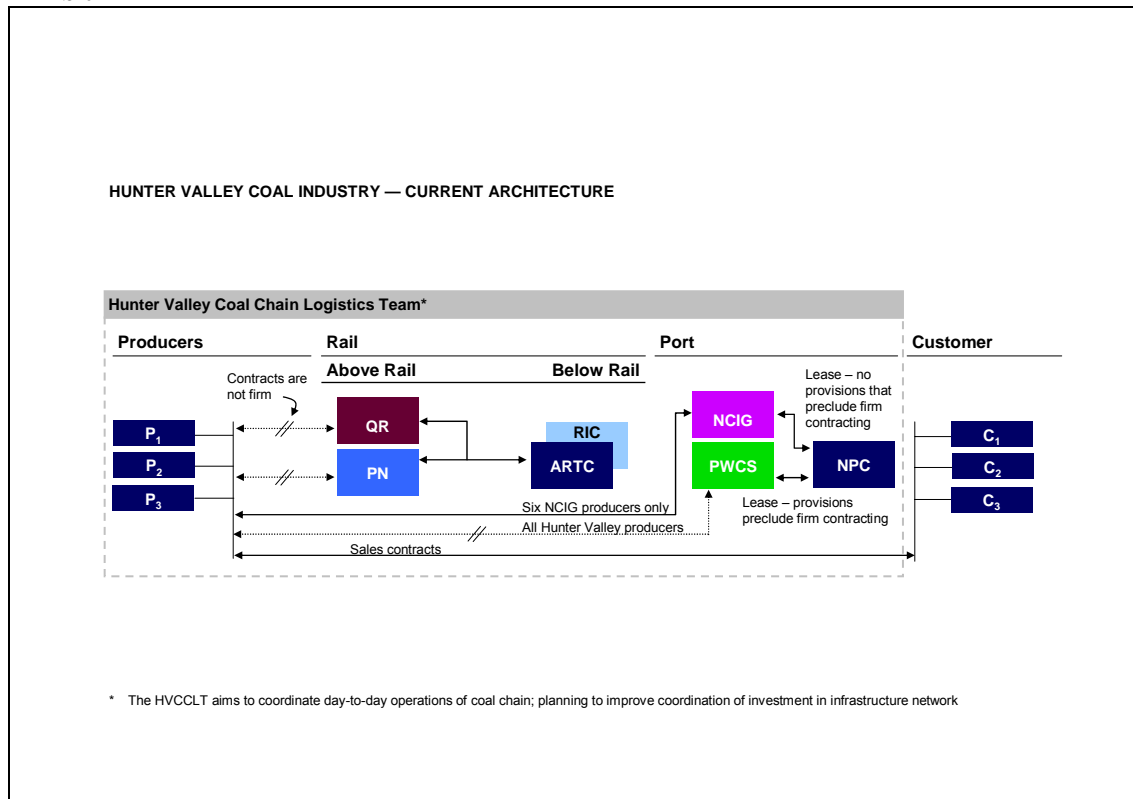
approve investments in mine expansions, which leads to industry-wide underinvestment

While the HVCCLT attempts to “balance” the coal chain in a way that satisfies the needs of all stakeholders, and minimises the problems above, it can only operate on a “best endeavours” basis. The HVCCLT can provide sensible advice to coal chain stakeholders on capital investment decisions and operational planning, but it does so with limited regard for the relative “value at risk” by the stakeholders they represent. That is, the HVCCLT processes do not necessarily reflect the high cost of underinvestment in coal chain infrastructure for producers relative to the much lower cost of “missed tonnes” for rail and port infrastructure providers.

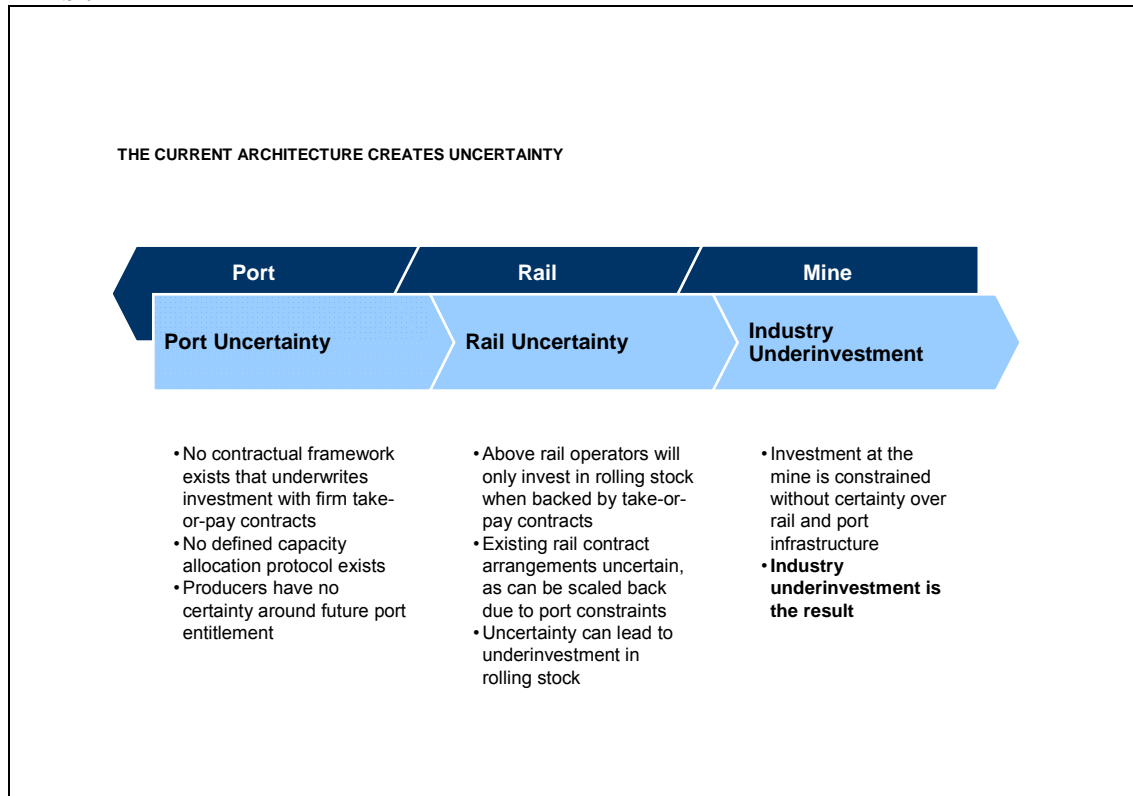
The root cause of these industry problems lies in the misalignment between financial risk and accountability for the performance of the coal chain. For every missed tonne of exported coal, producers lose the margin between the sales price and their costs (~\$20-50), while above rail providers lose only their margin on haulage rates (say ~\$1-2) and port operators (who are effectively under a revenue cap) lose nothing. Producers have the most at risk in the coal chain; they have the greatest incentive to ensure that adequate investment is made across the entire coal chain, that the infrastructure is adequately maintained and that operational service providers are both incentivised and held accountable for providing appropriate levels of service.

As a (primarily) producer-controlled entity itself, PWCS should already have the incentive to ensure that adequate investment is made in port-related infrastructure. The provisions in the Kooragang leases, however, constrain PWCS from entering into firm, long-term contracts with producers, which has resulted in under-investment in port capacity, despite industry involvement in the investment process. In addition, the current industry architecture diffuses accountability for matching rail and port capacity.

**Exhibit 1**



**Exhibit 2**



The underinvestment in the Hunter Valley coal industry is illustrated in Exhibit 3 where the export growth of coal from Newcastle is compared with the export growth of iron ore from Western Australia (WA). The exhibit shows how Newcastle's coal exports have grown at a rate less than half that of WA's iron ore exports since 2003. It is important to note that the WA iron ore industry is not currently characterised by the same multi-user complexities that characterise the Hunter Valley coal industry. The two major iron ore producers in the Pilbara, Rio Tinto Iron Ore and BHP Billiton Iron Ore, both own their entire supply chains from mine, to below rail, above rail through to the port.

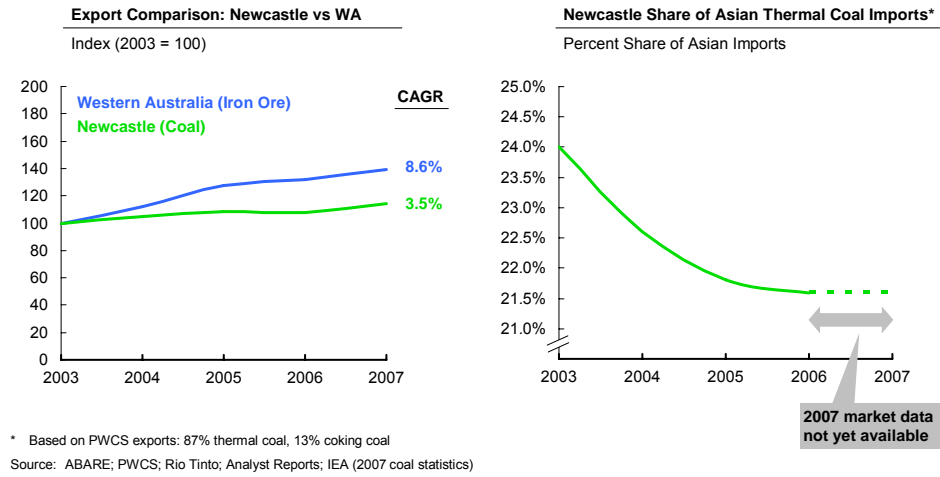
Although expansions to react to increases in coal prices are constrained by lead times to design and expand the coal chain, it is worth noting that if the Hunter Valley coal industry had expanded at the same rate as the WA Iron Ore Industry between 2003 and 2007, there would have been an additional 10 Mtpa (at least) of coal being exported today, worth approximately A\$1 billion per annum in export earnings (at current prices).

The industry-wide underinvestment is also reflected in the industry's loss of share of sales into the Asian market for coal. Exhibit 3 shows how Newcastle's share of Asian imports has reduced from 24% in 2003 to below 22% in 2006. Again, if the industry had been able to expand at the same rate as the WA iron ore industry, NSW would have held its share of the Pacific thermal coal market.

The Newcastle coal industry is a major exporter of thermal coal into the Asian region – accounting for almost one-quarter of all Asian imports. Hunter Valley mines, however, are situated towards the right hand side of the global thermal cost curve (as demonstrated by Exhibit 4). This makes the imperative to grow all the more critical: expansion options placed towards the top of the curve that fail to expand with the market are at the greatest risk of being “replaced” by mines in other regions that rapidly expand to fill the supply gap. While low-cost producers can regain lost share by expanding over time, high-cost producers, such as those in the Hunter Valley, cannot – instead sustaining share losses over the long-term. If the Hunter Valley coal industry continues to underinvest, then it will continue to lose share that it will not be able to regain.

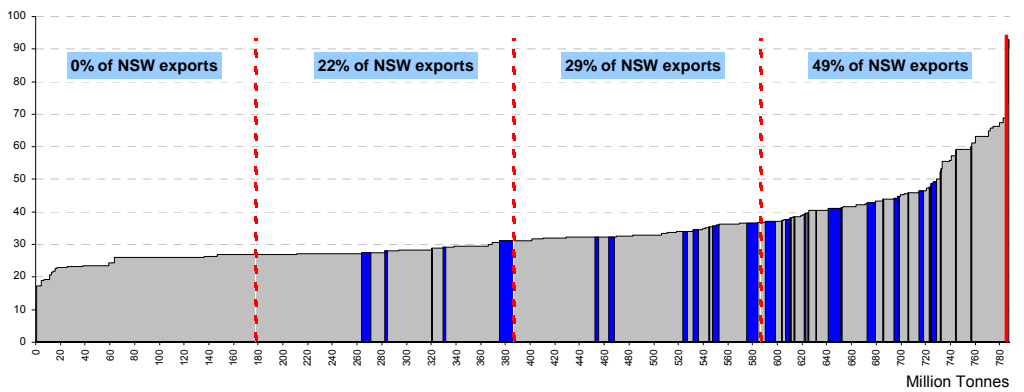
**Exhibit 3**

**UNDERINVESTMENT IN THE HUNTER VALLEY COAL INDUSTRY**



**Exhibit 4**

**GLOBAL EXPORT THERMAL COAL COST CURVE — 2015\***  
Real 2008 US\$/tonne (FOB)

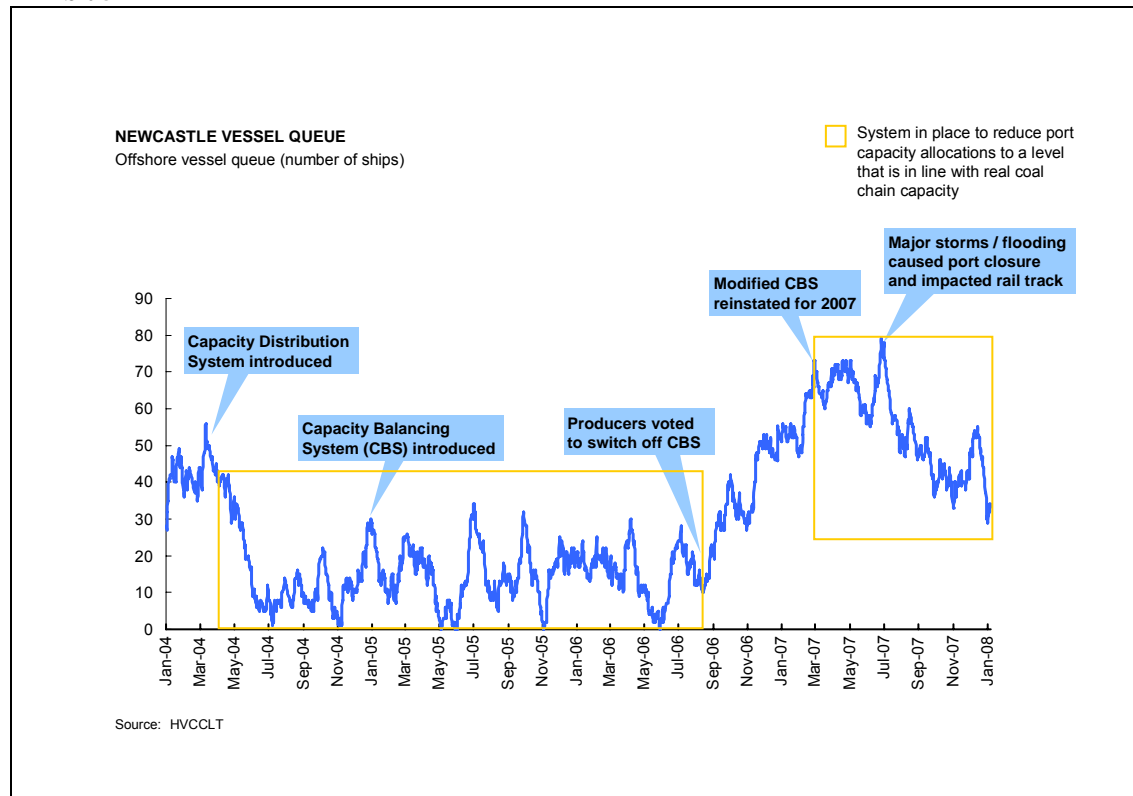


\* Costs energy adjusted to 6322 kcal GAR  
Source: Barlow Jonker



A further, and very visible, consequence of the lack of an appropriate commercial framework to govern industry contracting is the costly queue of ships off the coast of Newcastle waiting to be loaded with Hunter Valley coal (shown in Exhibit 5). The existence of the queue is costing the industry tens of millions of dollars every month and has attracted significant attention as a result.

**Exhibit 5**



Queues form as a result of allocated port capacity being greater than the real coal chain capacity; the greater the differential, the greater the queue. For instance; if 100 million tonnes of capacity is allocated for a given year, then producers will plan for this, and source enough ships to deliver 100 million tonnes of coal. If the coal chain can only move 90 million tonnes of coal, however, then a queue will form representing the remaining 10 million tonnes that were expected, but not delivered.

At a high level, there are two alternative approaches for reducing the queue:

- (i) Reduce producers' port capacity allocations to levels that, in aggregate, are closer to what the coal chain can realistically deliver; or
- (ii) Increase coal chain capacity in order to satisfy port capacity allocations

The first strategy was implemented by PWCS following consultation with the industry and authorisation from the ACCC; it is known as the Capacity Balancing System (CBS). The CBS, a "temporary" measure that has been in place over most of the last four years, has the advantage of having a short lead-time to take effect and is

a sensible course of action to take in an effort to reduce the queue. This strategy does nothing, however, to facilitate growth in the industry and therefore, growth in employment (in fact, it has resulted in confirmations of reduced allocations, which has resulted in layoffs). Exhibit 5 illustrates how the CBS has performed in reducing the queue of ships off the Newcastle coast.

The second approach, in which coal chain capacity is increased to match port capacity allocations (and ultimately, overall system demand) is more difficult to implement, but clearly preferable. This approach not only reduces ship queues, it also sustainably boosts industry growth and employment. The reforms outlined in this discussion paper are consistent with this approach.

\* \* \*

This discussion paper presents an industry architecture, and a commercial framework, that are the necessary foundations for sustainably growing end-to-end coal chain capacity. It addresses both the issues with the current industry architecture and provides a long-term sustainable approach for minimising the queue. The following section outlines the proposal to redesign the Hunter Valley Coal Chain Infrastructure.

## 2. Redesigning the Hunter Valley Coal Chain Infrastructure

In order resolve the major issues that are currently facing the Hunter Valley coal industry, and to create a platform for sustained growth, the industry, with the support of the government needs to:

1. Redesign the architecture of the industry such that accountability for key industry decisions and system performance is aligned with risk. Producers have the most value at risk and therefore the greatest incentive to deliver – this should be matched by making them as accountable for the performance of the coal chain as possible. Producers should have control over (particularly) the four most important decisions that underpin industry arrangements: infrastructure investment, capacity allocation, pricing and operations and maintenance
2. Adopt an unambiguous and firm Long Term Commercial Framework (LTCF) that will:
  - Provide certainty to producers over capacity allocations which will facilitate future investment at the mine and grow industry employment
  - Provide certainty to infrastructure providers over demand for infrastructure capacity and a mechanism for infrastructure investment to be underwritten by producers
  - Ensure that infrastructure capacity allocations are in line with what the coal chain can realistically deliver, thus keeping the queue at optimal levels without the need for continual “CBS-type” arrangements

The following two sections describe, and address the rationale for, the proposed redesign of the industry architecture:

- **A Producer Controlled Integrated Infrastructure Provider (IIP) Model Addresses the Underlying Issues in Infrastructure Development – Section 2.1**
- **A Long Term Commercial Framework is Critical in Facilitating Growth in Industry Employment and Ensuring a Minimal Queue (without the need for year-by-year CBS-type arrangements!) – Section 2.2**

## **2.1 A Producer Controlled Integrated Infrastructure Provider (IIPCo) Model Addresses the Underlying Issues in Infrastructure Development**

At the core of the proposed new industry architecture is an integrated infrastructure provider that is owned and controlled by the producers of the industry, as shown in Exhibit 6. The key elements of such an approach would be that:

- Industry producers would contract with the proposed Integrated Infrastructure Provider (IIPCo) for units of infrastructure capacity. IIPCo would allocate matched port and below rail capacity (i.e. rail paths) to producers. Such contracts would be a pre-requisite for producers to access the coal chain.
- Producers would remain free to source their above rail capacity (i.e. rolling stock and haulage services) from above rail operators or haul their own coal. Above-rail operators would be expected to fulfil firm haulage contracts with producers before hauling tonnes on a “best endeavours” basis.
- IIPCo would also have the decision making powers over when and where future investment in the coal chain infrastructure should be made.<sup>1</sup> The execution of the infrastructure investment projects would be enforced through long-term management/service agreements between IIPCo and the port and below rail providers. Further, IIPCo would determine the train schedule and influence the maintenance schedule and operational plan for each year.
- Contracting (between producers and IIPCo) would be carried out under a defined Long Term Commercial Framework that consisted of firm take-or-pay contracts, a defined capacity allocation protocol and a defined pricing mechanism (as discussed in the following section)
- Formation of an IIPCo could open up new financing options. Infrastructure assets could be financed either with existing vehicles (through banks) or through alternative financial structures, perhaps involving various levels of debt and/or equity. This paper does not go into any further detail on financing alternatives.

The proposed IIPCo architecture ensures producers have appropriate control over the four most important infrastructure decisions that drive value: infrastructure investment, capacity allocation, pricing and operations and maintenance. Illustrated in Exhibit 7, the “big four” decisions drive how the IIPCo operates under its LTCF (outlined in more detail in Section 2.2).

IIPCo might own some of the infrastructure assets in its own right, or contract with other infrastructure owners for use of their assets. Under the proposed

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<sup>1</sup> Specifically port capacity; however, IIPCo would provide a unified and credible indication to the below rail provider as to the timing, location and quantum of future rail investment

architecture, either IIPCo would own PWCS outright (to the extent that this is possible) or PWCS would be required to implement the directions of IIPCo in relation to key operational matters under a firm, long-term management agreement. Similarly, under this type of industry architecture, NCIG would be subject to the directions of IIPCo in relation to key operational matters (or alternatively, NCIG could be completely folded in to PWCS).

Exhibit 6

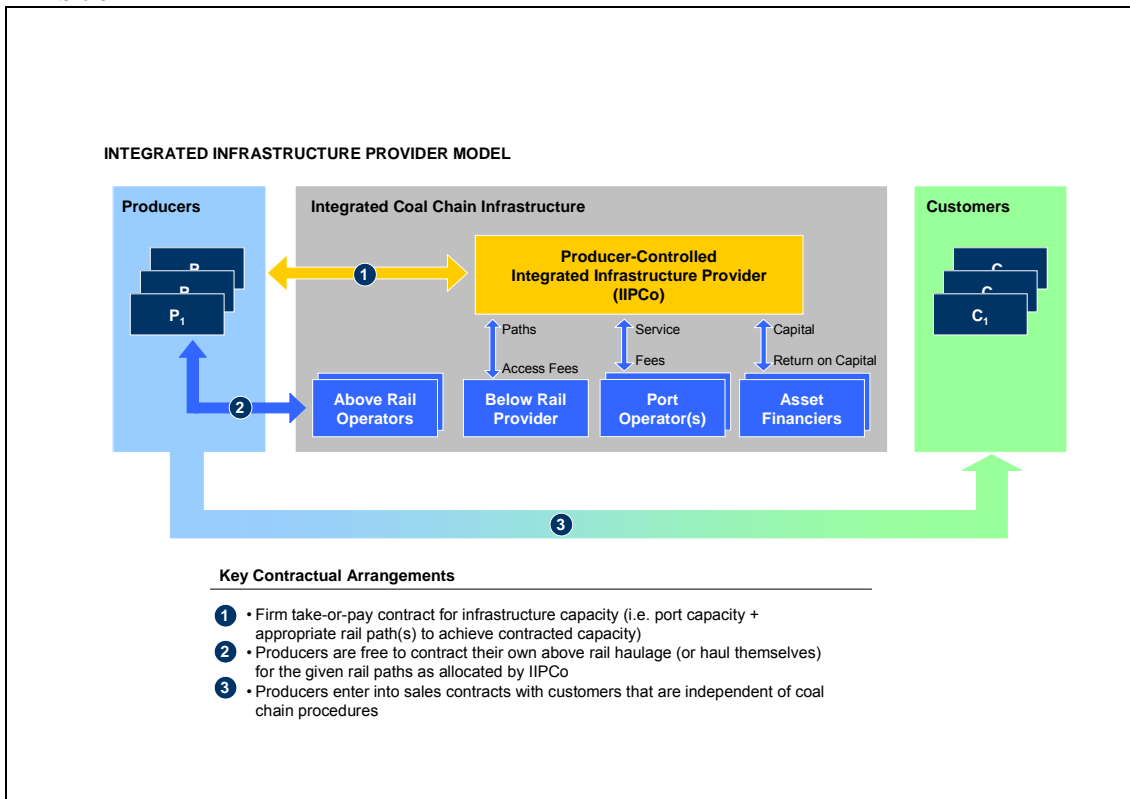
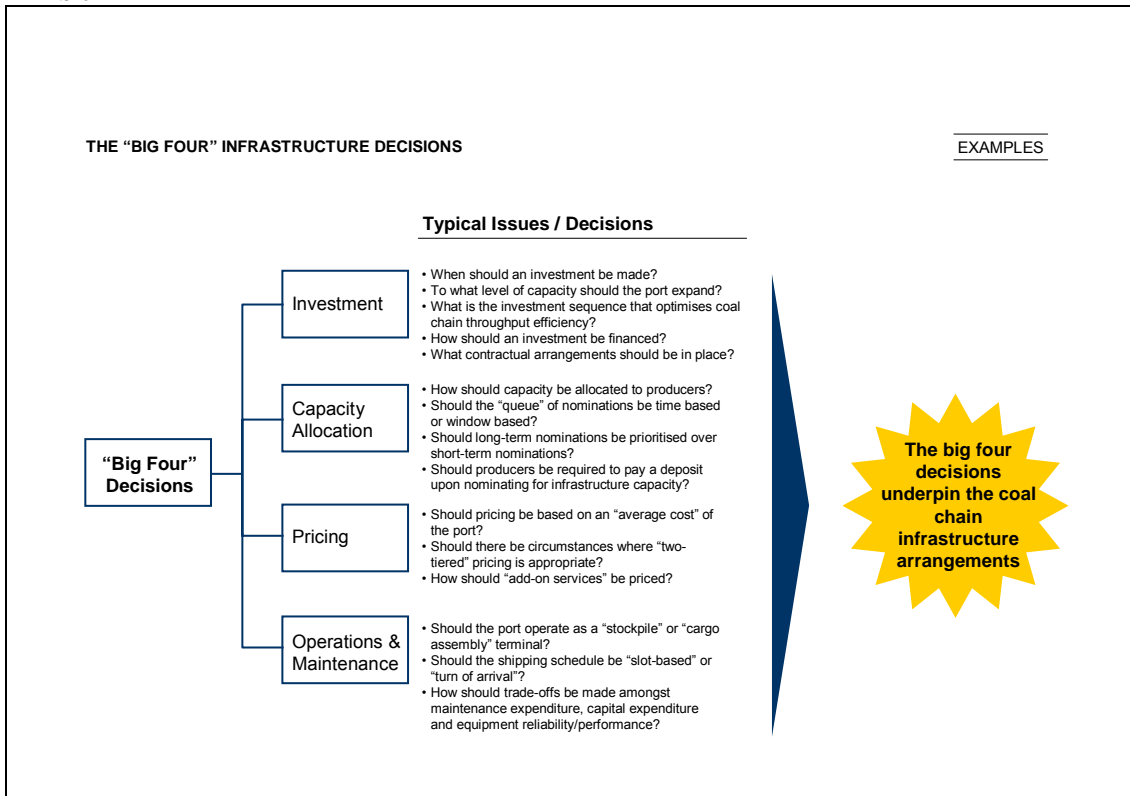
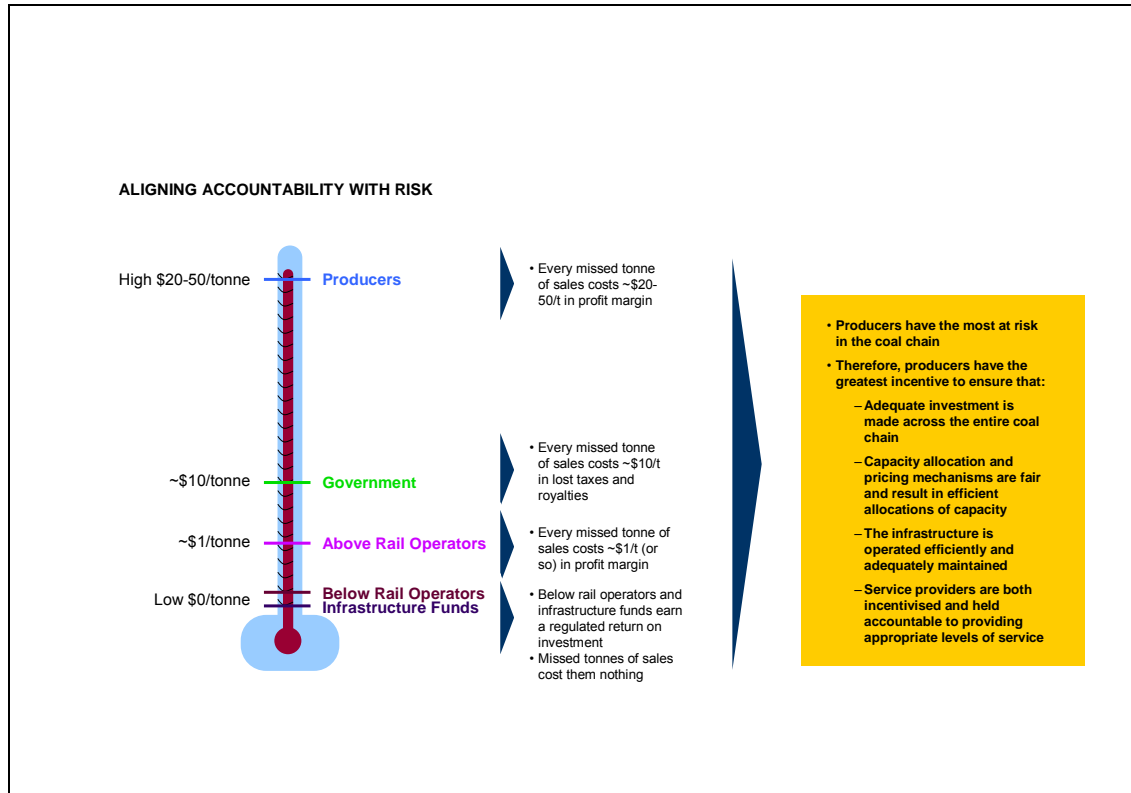


Exhibit 7



A producer controlled IIPCo is the best way to align accountability for the operation of the coal chain with risk in a multi-user system. Producers have the most at risk when sales are lost; therefore producers have the greatest incentive to perform across the dimensions of balanced investment, optimal maintenance schedules and optimal operational modes. The relative incentives to perform are compared in Exhibit 8.

**Exhibit 8**



There are many issues to resolve regarding the ownership and operation of such an Integrated Infrastructure Provider: governance, the commercial arrangements amongst the parties and operational principles (including those associated with train scheduling) are a few of the key ones. This paper does not intend to address the details of all issues that need to be resolved in moving to an IIPCo architecture – this should be done by a working group of a broad range of stakeholders. This paper intends to address only a selected number of dimensions of how an IIPCo could be owned and operated, and generally at a high-level.

Governance of the IIPCo will be of particular interest to all producers and other stakeholders. While this paper does not seek to detail the specific governance framework for IIPCo, one way to achieve alignment between industry risk and industry accountability would be to have each producer's IIPCo representation determined by its share of industry throughput. For example, a producer that has a 10% share of industry throughput would have 10% of the IIPCo ownership representation. Ownership of IIPCo could translate into Board representation, as it does at PWCS.

As with PWCS, the governance rules would need to address the approval thresholds required for particular categories of decision (i.e. majority, super-majority and unanimous decision matters), with those thresholds designed to provide minority shareholders in IIPCo with appropriate input into the outcome of significant proposals affecting IIPCo.

Although IIPCo would be the “brains trust” of the Hunter Valley coal chain infrastructure, it need not control the day-to-day implementation of the IIPCo operational plan. It would be anticipated that the IIPCo plan would be implemented by a number of specialist service providers. For example, above-rail service providers could implement the IIPCo train schedule on IIPCo’s behalf; PWCS and/or NCIG could implement the port operations and maintenance that are required in the IIPCo plan; the HVCCLT (or a similar body) could be retained by IIPCo to help develop its short-term and long-term master plan.

What IIPCo could not delegate, however, is accountability for identifying and then fulfilling the need for port and rail infrastructure to support the growth initiatives of Hunter Valley coal producers.

IIPCo would have the responsibility for ensuring that the contractual terms set between the service provider and IIPCo define an appropriate set of performance measures and service levels. It is envisaged that IIPCo would retain appropriately qualified managerial and specialist staff for the purpose of overseeing the performance of each service provider, and other functions associated with IIPCo's decision-making processes.



## **2.2 A Long Term Commercial Framework is Critical in Facilitating Growth in Industry Employment and Ensuring a Minimal Queue**

No industry architecture can be defined without a clear understanding of the arrangements that provide the “rules” of how the industry players will work together. These rules need to be clearly defined in an LTCF and understood by all industry stakeholders. These elements of the LTCF need also to be reflected in revised user agreements and other contracts between industry players.

Currently, the commercial practices that characterise the industry are stifling growth, resulting in sales being lost to alternative coal export operations around the world (as illustrated by Newcastle’s reduction in market share shown in Exhibit 3). An LTCF that is fair, transparent and provides certainty needs to be well-defined and well-understood by all industry stakeholders.

This section describes the principles of the proposed LTCF and discusses the importance of such a framework in supporting sustainable growth and ensuring a minimal queue.

### ***Principles of the Long Term Commercial Framework***

The LTCF needs to provide certainty to all stakeholders. Without certainty over infrastructure capacity, coal producers are constrained in making investments in mine expansions. Without certainty over demand for infrastructure capacity from producers, infrastructure providers will tend to under-invest in rail and port capacity. Without certainty over the volume that the coal chain can deliver, there can be no mechanism that ensures that allocated port capacity will be in line with real coal chain capacity - this will result in continued ship queues off the Newcastle coast.

The following outlines the principles of the proposed LTCF grouped into the “big four” decisions that are central to determining the ability of the coal chain to cater for growth in an efficient, effective manner:

#### **1. Investments —**

- All future port and rail infrastructure capacity expansions will be underwritten by firm, long-term take-or-pay contracts that are entered into by infrastructure providers with coal producers before expansions take place
- New and incumbent producers will have equal opportunity to contract for new or expanded infrastructure capacity
- The integrated infrastructure provider will need to have a Masterplan in place that indicates the likely sequence, timeframe and cost for various expansion options.

- IIPCo will also need to have a defined set of industry agreed rules that provide guidance on when, and to what extent, an expansion opportunity is deemed economic and may progress to the next level of project planning or implementation. Such agreements exist at open access ports such as DBCT, and would be refined as the IIPCo concept is documented. One key principle would be that no investment would proceed unless a certain (agreed) proportion of its capacity is contracted for at least the first 10 years.

## 2. Capacity Allocation —

- Capacity will be allocated under firm, take-or-pay contracts. Once capacity has been allocated to a producer, it must be delivered upon in full by the infrastructure provider
  - Expanded mine capacity (by existing or new producers) will not be able to “crowd out” the fixed volume take-or-pay contractual agreements between incumbent producers and infrastructure providers
  - Thus, even if the port reaches a point where no further expansions are economically feasible, the expansion aspirations of new or incumbent producers cannot be used to squeeze the entitlements of existing port users
- The capacity allocations under the take-or-pay contracts between producers and infrastructure providers will be tradeable by producers to ensure efficient use of scarce infrastructure capacity
- Capacity will be allocated by a pre-defined and transparent allocation protocol that prioritises longer-term commitments to capacity over shorter-term nominations for capacity.
  - Capacity would be allocated on the basis of renewable (evergreen) 10 year contracts, but we would suggest that shorter-term contracts be available, as well. An incumbent producer having a mine with, for example, 5 years of mine life remaining should be allowed to match their infrastructure allocation with their remaining mine life (but would not be offered a renewable option).
  - The precise structure of the contracts, and their prioritisation would need to be agreed amongst producers.

- Producers (existing and new) will be required to commit to contracts for new capacity approximately three years in advance of their requirement for coal chain capacity (with the exception of transitional arrangements for 2009 and 2010). Assuming appropriate master plans are in place for the coal chain, this should provide adequate lead-time for investment in port and (above- and below-) rail capacity.
- Port capacity will be based on a “standard unit” of capacity that takes into account the time that port equipment is utilised. Producers who utilise port services inefficiently are effectively reducing the capacity available for other producers, and it would be unfair not to recognise this in the commercial arrangements

### **3. Pricing —**

- The LTCF will incorporate a pricing policy that is fair and provides the appropriate commercial drivers to encourage the efficient use of available infrastructure
- A port pricing structure that is “flat” (i.e. a single price for all producers) is likely – although there may be times when the industry deems a two-tiered or “user-pays” pricing structure more appropriate. It is inherently difficult, however, to differentially price individual “tiers” of capacity, as often a significant investment at one stage opens up subsequent lower-cost expansions
- If the IIPCo were to pursue the development of a new port facility independent of the NCIG/PWCS terminals, then it might be appropriate to consider a different pricing approach for that facility. Given that the combined capacity of PWCS and NCIG is 180mtpa (or more) this is not likely to be a consideration for some time.

### **4. Operations and Maintenance —**

- The LTCF will stipulate that infrastructure operations and maintenance should optimise coal chain throughput efficiency

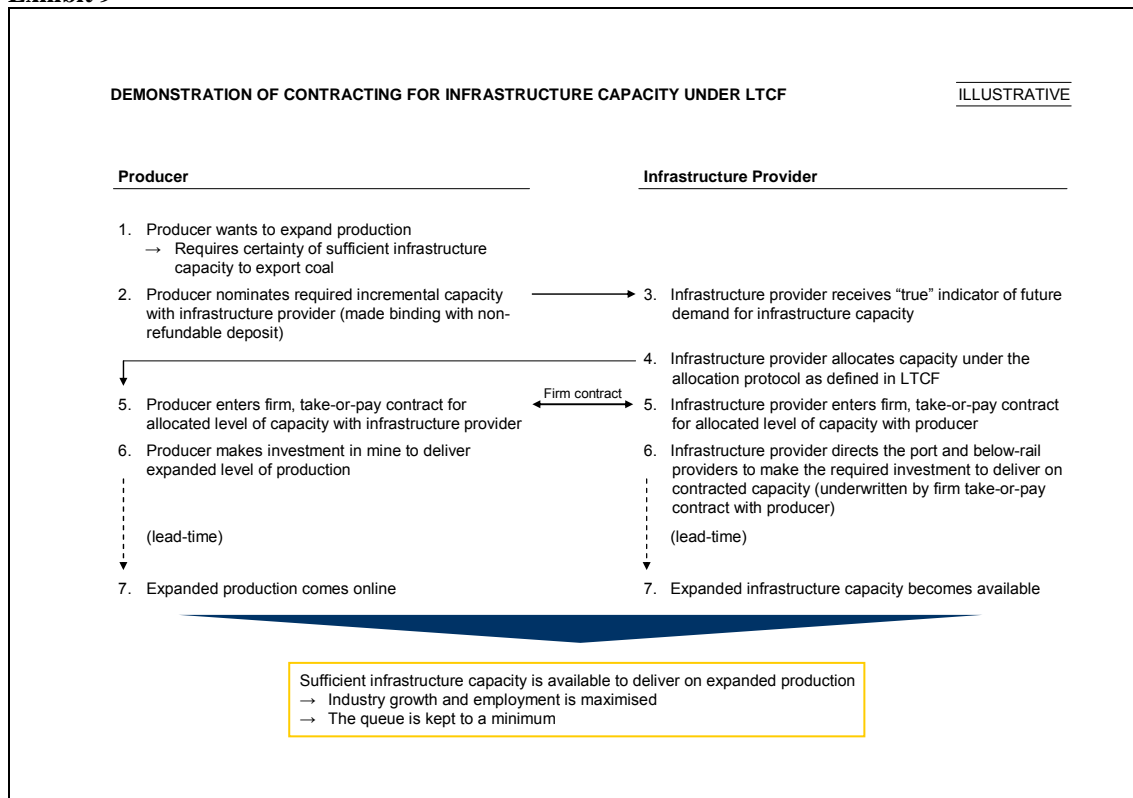
By way of example, Exhibit 9 demonstrates how infrastructure capacity would be contracted for under the proposed LTCF. It shows how the producer gains certainty over future infrastructure allocations – which allow it to invest in the mine, while the infrastructure provider gains certainty over future demand for infrastructure capacity. The investment in infrastructure is underwritten by the producer by way of a firm, take-or-pay contract. This ensures that the infrastructure provider will make the necessary investment to ensure that sufficient capacity is available to deliver on the expanded production: industry growth and employment is maximised and the queue is kept to a minimum.

It will be the role of the IIPCo, and all the producers that own and govern it, to decide when there are simply no more feasible (economic) expansions at its existing facilities. At this point, the IIPCo might be evaluating alternative options, such as new port locations. If the potential growth options of the existing PWCS and NCIG terminal locations are maximised, the Hunter valley coal industry might reach 180 million tonnes per annum or more before hitting its infrastructure capacity. Given the 2007 system throughput of 85 million tonnes, this allows for very significant growth before the industry is again constrained.

The principles of the LTCF will need to be fleshed out in detail, agreed by coal chain participants and reflected in the relevant industry user agreements. The principles here are intended to provide a framework to begin such discussions, not stifle the options to be considered.

Of course, the agreed LTCF will need to comply with the Trade Practices Act, and may require formal authorisation, as have other agreements amongst industry participants.

**Exhibit 9**



*A Long Term Commercial Framework is Critical to Facilitate Industry Growth*

The proposed LTCF is critical to ensure sustainable industry growth over the long-term. An LTCF designed with the principles above offers the best chance of addressing the issues facing the Hunter Valley coal industry. That is:

- Coal producers will gain certainty over future rail or port entitlements. This will facilitate greater investment at the mine since producers will know for certain (at the time of investment) how much infrastructure capacity they will be entitled to in the future
- Allocated infrastructure capacity will remain in line with real coal chain capacity – minimising queues and eliminating the need for stop-gap CBS-type systems that scale back producers’ capacity entitlements
  - Under the status quo, there is no link between port capacity and rail capacity. Port capacity is allocated based on an estimate of what the rail can deliver; above rail operators invest in rolling stock based on their estimates of what the port can ship; and below rail infrastructure providers invest based on public forecasts of demand. It is not surprising that under this set of commercial practices coal chain capacity becomes misaligned and queues form. Only when demand indicators are backed by firm, take-or-pay contracts can they be considered to be “true” indicators of demand upon which investments should be made (underwritten by take-or-pay contracts)

Exhibit 10 makes the key comparisons between the practices that currently characterise the Hunter Valley coal chain with those that are being proposed in the LTCF.

**Exhibit 10**

<b>COMPARISON OF CURRENT COMMERCIAL PRACTICES WITH PROPOSED LTCF</b>			
	<b>Current Practices</b>	<b>Proposed LTCF</b>	<b>Comments</b>
<b>1</b> Firm, enforceable take-or-pay contracts between port services provider and producers?	X	✓	Under the provisions of the Kooragang leases between PWCS and the NPC, firm take-or-pay contracts for capacity cannot be entered into with producers
<b>2</b> Firm, enforceable take-or-pay contracts between above rail providers and producers?	X	✓	The lack of certainty over port capacity has made it impossible for above rail providers to deliver on their contracts. This has reduced the incentive for producers to contract for above rail services – some opting to not contract for rail at all
<b>3</b> Port expansion decisions based on true indications of demand as determined by firm, take-or-pay contracts entered into prior to investment?	X	✓	Port expansion decisions are currently based on nominations that were made in a process whereby producers incurred no penalty for overbidding. Under such a process it is rational to overbid to capture a free call option on expansion capacity
<b>4</b> Below rail expansion decisions based on true indications of demand as determined by firm, take-or-pay contracts entered into prior to investment?	X	✓	Below rail investments are currently made based on public and internal forecasts of coal demand out of the Hunter Valley. No account of how much capacity producers are willing to contract for is made prior to investment

\* \* \*

The proposed IIPCo architecture aligns accountability of key industry decisions with those who have the most at risk: the producers. The proposed LTCF is the framework for how the IIPCo operates; it ensures the certainty that is critical for the facilitation of future sustainable growth.

While the LTCF could be implemented as a stand-alone framework independent of the IIPCo architecture, this would not solve a number of the major issues that are currently facing the Hunter Valley coal industry. Implementing an LTCF in the current industry structure would enhance certainty for producers and infrastructure providers, but it does not address the significant risk of misalignment across the coal chain. For example, implementing a new commercial framework in the current structure would continue to leave industry participants vulnerable to a mismatch between rail and port capacity. Only an IIPCo-type architecture will align accountability with risk to ensure that future investment across the coal chain is balanced.

Exhibit 11 illustrates the essential differences between the current industry architecture and commercial practices with the proposed IIPCo architecture operating under the proposed LTCF. IIPCo would become a “one-stop shop” to contract for

port and below rail capacity – driving alignment across the coal chain. The producer-controlled IIPCo would be responsible for making key investment decisions, and would then be entitled to require those decisions to be implemented under its long-term management/service agreements with the port and below rail providers; a responsibility that producers are the most well-positioned to bear. Finally, IIPCo would enter into firm take-or-pay contacts with producers for capacity under an LTCF.

#### Exhibit 11

<b>INTEGRATED INFRASTRUCTURE PROVIDER VS CURRENT ARRANGEMENTS: ESSENTIAL DIFFERENCES</b>	
<u>Current Arrangements</u>	<u>Integrated Infrastructure Provider</u>
<ul style="list-style-type: none"> <li>• Producers contract individually for port services (with PWCS or NCIG) and for rail services (with PN or QR) –Likely to result in mismatches</li> </ul>	<p>The IIPCo becomes a “one-stop shop” for producers to contract with for capacity that allows their coal to be hauled “from load-out to ship”; the IIPCo is, in turn, a single buyer of port and below rail services</p>
<ul style="list-style-type: none"> <li>• Suppliers of port and rail services separately drive investment, maintenance and operational decision-making</li> </ul>	<p>The IIPCo drives critical decision-making with suppliers of below rail and port services delivering against agreed investment plans and service standards; producers still need to match with above-rail services</p>
<ul style="list-style-type: none"> <li>• No efficient long-term commercial framework is in place for the allocation and contracting of port capacity at PWCS</li> </ul>	<p>Contracting between producers and the IIPCo would be carried out under an agreed LTCF, consisting of firm take-or-pay contracts, a defined allocation protocol and agreed pricing arrangements</p>

### **3. The Proposed Redesign of the Industry Architecture will Provide Significant Economic Benefits to the Industry and NSW**

The redesign of the Hunter Valley coal industry infrastructure would not be so critical if the value at stake was not significant. There are enormous economic benefits to all stakeholders in moving to an IIPCo architecture under a clearly defined LTCF that facilitates growth and ensures a minimal queue. Maximising coal exports out of Newcastle will maximise employment for the Hunter Valley, royalties and taxes for the government and value for the coal producers. Maintaining the status quo will come at an enormous opportunity cost to NSW since the current commercial practices that characterise the industry are stifling growth.

In 2005, NCIG was awarded the right to construct and operate a third coal terminal in the port of Newcastle and, in 2007, was granted development approval to commence construction of their terminal; NCIG can build up to 66 Mtpa capacity. Assuming PWCS can expand to the order of 120 Mtpa (beyond which PWCS's expandability appears extremely limited) total industry port capacity could be in the order of 186 Mtpa.

In mid-2007, PWCS commissioned a report from independent economists *CRA International* to quantify the value that was at stake for the industry in realising its full growth potential of 186 Mtpa. The report found that there are significant economic benefits with the rapid expansion of the industry up to 186 Mtpa relative to a base case of 116 Mtpa capacity that was assumed for 2008:

- An additional 70 Mtpa of expansion capacity from 2008 to 2014 is worth approximately A\$10 billion in NSW exports in net present value terms
- An additional 30,000 new jobs would be created in NSW in port, rail and mine construction in the initial years of the expansion. Once the major construction phase is completed, employment is still projected to remain well above base case (2008) levels
- By 2015, it is projected that regional output in the Hunter Valley would be 6.1 per cent above base case levels while GSP in NSW would be 1.3 per cent above the base case in the same year. This expansion would lead to the permanent creation of 11,000 new jobs in the Hunter region

Of course, the industry is unlikely to export 116 Mt of coal in 2008, instead expecting approximately 95 Mt. This suggests that the value of the growth potential over and above current levels is even more significant.

The value at stake is enormous and is currently at significant risk of being lost out to alternative coal export operations around the world. As long as there remains uncertainty over future infrastructure capacity allocations or there is uncertainty over existing infrastructure capacity allocations, coal producers are constrained in making



significant capital investments to grow production. The economic benefits described above will be lost (at least in part) to alternative coal exporting regions and the misalignment in coal chain infrastructure will continue to cause significant queues of ships off the coast of Newcastle.

#### 4. Conclusions & Required Action

The economic benefits associated with the Hunter Valley coal industry realising its full potential are enormous: billions of dollars and thousands of jobs are at stake. The current commercial practices that characterise the industry are, however, stifling its growth – placing at risk the economic benefits described above.

This document articulates a solution that addresses the issues that are currently facing the Hunter Valley coal industry. Specifically, it outlines a proposal for the industry, with the support of the government, to move to a producer-controlled IIPCo structure that operates under an unambiguous LTCF

The redesign of the industry’s architecture proposed in this document would probably be the most significant reform the industry has ever undergone. In order to successfully achieve the goals of maximum growth, maximum employment and a minimal queue:

- The industry will need to be open to working collaboratively, acknowledging that, while there will inevitably be micro details that will cause debate amongst the producers, the “end-game” is too important and too valuable to forgo
  - Producers and other stakeholders will need to work together to create a single view on the way forward
  - The IIPCo rules/charter will need to be drafted
  - Commercial arrangements and revised user agreements will need to be drafted
- The government will need to support the industry through policy and actions that facilitate the industry achieving the proposed redesign of its architecture. The industry will not be able to achieve the discussed goals without the support of the NSW government, in particular

The industry needs to shift its focus from debates that focus on “How can I get a larger share of the pie?” to productive discussions around “How can we grow the pie?” Over the past three or four years, industry debates over allocation systems such as the CBS have focussed almost entirely on the former, at the expense of genuine industry engagement on the more important constraints to industry growth.

To facilitate long-term growth in exports and employment in the industry while maintaining a minimum queue, action needs to be taken immediately. The lead-time on investments at the mine and in infrastructure can be in the order of three or four years. The industry, with the support of the government, needs to plant the seeds today for future growth in an efficient multi-user Hunter Valley coal chain.