Statement of Issues

23 February 2017

South32 – proposed acquisition of Metropolitan

Purpose

1. South32 Limited (**South32**) proposes to acquire Metropolitan Collieries Pty Ltd (**Metropolitan**), an Australian subsidiary of Peabody Energy Corporation (**Peabody**). Metropolitan owns the Metropolitan mine and an associated 16.67 per cent interest in Port Kembla Coal Terminal Limited. Both South32 and Metropolitan supply metallurgical coal (also known as coking coal) from the Illawarra region to Australian customers.

2. This Statement of Issues:

   - gives the Australian Competition and Consumer Commission's (**ACCC**'s) preliminary views on competition issues arising from the proposed acquisition
   - identifies areas of further inquiry
   - invites interested parties to submit comments and information to assist our assessment of the issues.

Overview of ACCC's preliminary views

3. The legal test which the ACCC applies in considering the proposed acquisition is in section 50 of the *Competition and Consumer Act 2010* (**the Act**). Section 50 prohibits acquisitions that would have the effect, or be likely to have the effect, of substantially lessening competition in any market.

4. The ACCC divides its preliminary views into three categories, 'issues of concern', 'issues that may raise concerns' and 'issues unlikely to raise concerns'. In this Statement of Issues, the ACCC has identified one issue that may raise concerns and one issue that is unlikely to raise concerns.

Issue that may raise concerns

5. Australian customers of coking coal appear to benefit from competition between South32 and Metropolitan. The proposed acquisition would remove this competitive rivalry and, in the medium term, is expected to result in a single

supplier of material volumes of coking coal from the Illawarra region, which is the closest source of coking coal to Australian customers. The ACCC's preliminary view is that this may substantially lessen competition in the supply of coking coal to Australian customers.

6. If the ACCC's further investigations show that:

   - there is competitive rivalry between South32 and Metropolitan; and
   - the supply of coking coal from the Bowen Basin (to Australian customers) is not a close constraint on South32 and Metropolitan

   then the ACCC considers that the proposed acquisition is likely to substantially lessen competition.

Issue that is unlikely to raise concerns

7. The proposed acquisition appears unlikely to increase the risk that South32 would be able to foreclose current or potential rival coal producers from the Port Kembla Coal Terminal. Accordingly, the ACCC's preliminary view is that South32's acquisition of a 16.67 per cent interest in the Port Kembla Coal Terminal Limited, as a result of the proposed acquisition, is unlikely to raise competition concerns.

Making a submission

8. The ACCC is seeking submissions from interested parties, particularly on the following key issues:

   - substitutability of different grades of coking coal in determining blends of coal suitable for coke production and steel manufacturing
   - substitutability of Illawarra sourced coking coal with coking coal available in other regions in terms of technical and physical properties
   - likely cost to Australian steelmakers in sourcing large quantities of coking coal from the Bowen Basin, including transportation costs, capital costs associated with any necessary infrastructure upgrade and other potential costs.

9. Detailed discussion of these and other issues, along with specific questions, is contained in this Statement of Issues.

10. Interested parties should provide submissions by no later than 5pm on Friday 10 March 2017. Responses may be emailed to mergers@accc.gov.au with the title: *Submission re: South32 – Metropolitan (attention Elizabeth Elias/Shantanu Govil)*. If you would like to discuss the matter with ACCC officers over the telephone or in person, or have any questions about this Statement of Issues, please contact Shantanu Govil on 03 9290 6922 or Elizabeth Elias on 02 6243 1104.

11. The ACCC anticipates making a final decision on 6 April 2017. However, this timeline can change. To keep abreast of possible changes in relation to timing

and to find relevant documents, interested parties should visit the Mergers Register on the ACCC's website at www.accc.gov.au/mergersregister.

Confidentiality of submissions

12. The ACCC will not publish submissions regarding the proposed acquisition. We will not disclose submissions to third parties (except our advisors/consultants) unless compelled by law (for example, under freedom of information legislation or during court proceedings) or in accordance with s155AAA of the *Competition and Consumer Act 2010*. Where the ACCC is required to disclose confidential information, the ACCC will notify you in advance where possible so that you may have an opportunity to be heard. Therefore, if the information provided to the ACCC is of a confidential nature, please indicate as such. Our *Informal Merger Review Process Guidelines* contain more information on confidentiality.

About ACCC 'Statements of Issues'

13. A Statement of Issues published by the ACCC is not a final decision about a proposed acquisition, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.

14. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is also intended to provide the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

Timeline

Date	Event
2 December 2016	ACCC commenced review of the proposed acquisition
23 February 2017	ACCC publication of Statement of Issues
10 March 2017	Deadline for submissions from interested parties in response to this Statement of Issues
6 April 2017	Proposed date for ACCC final decision

The parties

The acquirer – South32

15. South32 is a global metals and mining firm which operates in Australia, Southern Africa and South America. South32 is listed on the Australian Securities Exchange. Until 2015, South32 was part of the BHP Billiton Group. South32 has interests in supply of nickel, zinc, aluminium, manganese, silver, lead and coal.

16. Relevantly, South32 operates two coal mines, the Appin and Dendrobium mines in the Illawarra region of NSW, which primarily produce coking coal. South32 also operates coal preparation plants at Westcliff and Dendrobium. South32 produced approximately 7 million tonnes of coking coal in Australia in the 2015-16 financial year. Approximately 70-80 per cent of the coking coal produced by South32 is exported.

17. South32 currently has a 16.67 per cent interest in Port Kembla Coal Terminal Limited. South32 also manages the Port Kembla Coal Terminal, on behalf of the consortium of coal producers which owns the facility through Port Kembla Coal Terminal Limited.

The target – Metropolitan

18. Metropolitan is a wholly-owned subsidiary of Peabody, the world's largest privately owned coal company. Metropolitan owns the Metropolitan mine, located in Helensburgh in the Illawarra region of NSW. The Metropolitan mine produces coking coal and, in 2015, produced approximately 1.9 million tonnes.

19. Just over half the coal produced at the Metropolitan mine is exported, primarily to Asia. The remainder of the coal produced at the Metropolitan mine is supplied to Australian customers such as BlueScope Steel Limited (**BlueScope**) and Arrium Limited (**Arrium**).

20. Metropolitan's domestic sales are largely for semi hard coking coal.

21. Metropolitan also has a 16.67 per cent interest in Port Kembla Coal Terminal Limited.

Other industry participants

Other Illawarra coal producers

22. In addition to the merger parties, there is currently one other producer of material quantities of coking coal in the Illawarra region.

23. Glencore owns the Tahmoor mine which operates in the Bulli coal seam in the Illawarra region of NSW. The Tahmoor mine principally produces coking coal but some steaming coal is also produced. Its annual production is approximately 1.8 million tonnes.

24. Glencore announced on 1 June 2016 that it plans to close the Tahmoor mine by early 2019.[1]

25. There is one other producer of coking coal in the Illawarra region, Wollongong Coal, however Wollongong Coal only produces small quantities of coking coal.

[1] http://www.tahmoorcoal.com.au/EN/Documents/160601%20-%20Tahmoor%20mine%20closure%20-%20media%20statement.pdf

Australian customers of coking coal

26. There are two domestic customers of coking coal in Australia, BlueScope and Arrium.

BlueScope Steel Limited

27. BlueScope operates the Port Kembla Steelworks in the Illawarra region of NSW, which is the largest steelworks in Australia. BlueScope manufactures approximately 2.6 million tonnes of crude steel from its steelworks in the Illawarra. BlueScope manufactures approximately 1.65 million tonnes of coke per annum, some of which it sells as a standalone product.

28. BlueScope currently sources all its coking coal from the Illawarra region. BlueScope purchases coking coal from the South32, Metropolitan and Tahmoor mines. BlueScope has previously sourced small quantities of coking coal from the Hunter Valley.

Arrium

29. Arrium Limited (**Arrium**) operates the OneSteel Whyalla Steelworks (located in South Australia). Arrium makes finished and semi-finished steel products.

30. Arrium sources a significant proportion of its coking coal from the Illawarra region, acquiring coal from both South32 and Metropolitan. Arrium has also sourced coking coal from elsewhere, mainly from the Hunter Valley and Queensland. All of the coal acquired by Arrium is shipped to the OneSteel steelworks in Whyalla.

31. Arrium was placed into voluntary administration on 7 April 2016 and is currently subject to a deed of company arrangement.

Industry background

32. Australia accounts for approximately 60 per cent of global coking coal exports and produced an estimated 188 million tonnes in the 2015-16 financial year.

33. A vast majority (95 per cent) of the coking coal produced in Australia is exported to international customers, including to China, Japan, South Korea, Europe and India.

34. Coking coal in Australia is predominantly produced in the Bowen Basin in Queensland and in the Illawarra region in NSW. Small quantities of semi soft coking coal are also available in the Hunter Valley in NSW.

35. Coking coal is categorised into grades based on its chemical composition. High quality and more expensive coking coals are characterised by higher levels of volatile matter, carbon, rank and plasticity. Coking coal grades, in order of quality, include: premium hard coking coal, hard coking coal, semi hard coking coal, semi soft coking coal and pulverised coal injection coal.

36. To produce coke, steelmakers use a blend of coals from different sources, with a blend likely to include both higher quality and lower quality grades. Steelmakers will typically blend coals from a variety of sources to obtain a blend of coal that

will make a target quality of coke as economically as possible. Coke quality and yield, as well as the delivered cost of the coal and the cost of disposing of unwanted material will all be taken into account by a steelmaker in determining the optimal mix of coals.

The proposed transaction

37. On 3 November 2016, South32 announced its proposal to acquire Metropolitan from Peabody for $US200 million. South32 intends to purchase 100 per cent of the shares of Metropolitan which owns the Metropolitan coal mine and a 16.67 per cent interest in Port Kembla Coal Terminal Limited.

Areas of overlap

38. South32 and Metropolitan are the two largest producers of coking coal in the Illawarra region and two of the largest suppliers of coking coal to the two Australian steelmakers.

39. While South32 and Metropolitan sell different grades of coal, the ACCC understands that premium hard coking coal from South32 and hard coking coal from Metropolitan are substitutable to an extent. The ACCC also understands that semi hard coking coal produced by Metropolitan can be an alternative coking coal feedstock, capable of displacing a proportion of the hard coking coal used in a steelmaker's blast furnace. The degree of this substitutability is an issue the ACCC is exploring further.

Future with and without the acquisition

40. Section 50 of the Act prohibits acquisitions that would have the effect or be likely to have the effect of substantially lessening competition in a market. In assessing a proposed acquisition pursuant to section 50 of the Act, the ACCC considers the effects of the acquisition by comparing the likely future competitive environment post-acquisition if the acquisition proceeds (the "with" position) to the likely future competitive environment if the acquisition does not proceed (the "without" position) to determine whether the proposed acquisition is likely to substantially lessen competition in any relevant market.

41. On the basis of the information currently available, the ACCC considers the likely competitive environment if the acquisition does not proceed will involve South32 and Metropolitan continuing to compete with each other, with Metropolitan under the ownership of Peabody or an alternative owner.

Previous ACCC decisions

42. The ACCC has previously considered acquisitions involving an aggregation in coal production. The most recent is the ACCC's review of Glencore International's acquisition of Xstrata plc in 2012. In that review, the ACCC considered a number of product markets were relevant to the proposed acquisition including in relation to seaborne coal, a market for thermal coal and a market for coking coal. In that review, the ACCC considered the impact of the acquisition on both the Australian and the global markets for the affected products.

43. The ACCC notes previous acquisitions considered by the ACCC involving coking coal production did not involve significant overlap in the supply of coking coal to domestic customers.

Market definition

44. The ACCC's starting point for delineating relevant markets is to identify the products actually or potentially supplied by the merger parties. The ACCC then considers what other products constitute sufficiently close substitutes to provide a significant source of constraint on the acquirer (i.e. South32) following the proposed acquisition.

45. The ACCC is continuing to consider the boundaries of the relevant market(s) affected by the proposed acquisition. The ACCC notes that market definition depends on the specific facts and circumstances of each particular merger, and current evidence from market participants is critical. Decisions relating to market definitions in previous, albeit similar, merger inquiries may therefore provide only limited guidance.

46. The ACCC's preliminary views on the product and geographical dimensions of the relevant market are set out below.

Product dimension

47. As noted above, South32 and Metropolitan are suppliers of coking coal. South32 predominantly blends the production from its Illawarra mines and sells the blend as premium hard coking coal. Metropolitan sells hard coking coal (all of which is exported), and semi hard coking coal and pulverised coal injection coal which is sold to both domestic and export customers.

48. The ACCC's preliminary view is that there is a degree of substitutability between the various grades and sources of coking coal. The ACCC understands it is typical for producers of coke and steel to blend coals from various sources to produce coke with the desired physical and chemical characteristics. The ACCC also understands that it is possible to use coals from different sources and in different combinations to deliver the required coke quality characteristics. However, the physical and technical attributes of different coking coals limit the ability of steel mills to directly substitute one grade of coking coal for another. Even coals of the same grade but from different coal seams can have different technical characteristics which may limit the extent of direct substitutability. However, in cases where two types of coal are not directly substitutable, the two types of coal could form part of two different blends that are substitutable.

49. While semi hard coking coal can replace a certain volume of hard coking coal in an overall blend of coals used by a steel mill, only a proportion of hard coking coal can be displaced without affecting the performance of the blast furnace and the efficiency of iron production. Poorer quality coals also lead to higher levels of impurities, such as ash, resulting in lower yield and higher disposal costs for the steelmaker.

50. The ACCC also understands that there are costs to customers in switching suppliers of coking coal, particularly if a substantial portion of the coking coal purchases are being substituted. These costs may include costs associated with testing, configuring and re-designing a coking coal blend. However the ACCC's

preliminary view is that these transition costs are unlikely to be material in the context of a significant supply commitment.

51. The ACCC is continuing to consider the appropriate product dimension in this case and how limitations on substitution may be relevant to the ACCC's competition assessment. The ACCC notes that there are different opinions on the level of substitution between different sources of coal and the extent to which one or more coal sources can be substituted in a blend. Given the commercial sensitivity of steelmakers' coal blends, and the consequent information asymmetry between coal producers and steel mills, differences in views as to the substitutability may be inevitable.

52. Issues relating to the product dimension of the market are explored further under the 'issue of concern' heading below.

Geographical dimension

53. The ACCC recognises that coking coal is a globally traded commodity and that contractual prices for the supply of coking coal are typically linked to international indices or spot prices. While there is clear competition between coking coal producers on a global basis, this does not preclude there also being narrower geographic market(s) within Australia for supply to domestic customers which are relevant to the competition assessment.

54. While prices are linked to international pricing benchmarks, the final agreed pricing mechanism is typically a global benchmark price plus or minus a certain amount. That final price will be agreed by reference to the technical and physical properties of the coal (relative to the characteristics of certain benchmark coal) and the bargaining power of the contracting parties. The bargaining power of each party will reflect the alternative options for supply or purchase available to that counterparty.

55. In an export-focussed industry, where there are competing local suppliers, the price for Australian customers is likely to be equivalent or close to export price parity. If domestic prices decreased below export price parity, the domestic suppliers would switch more volume to exports. On the other hand, if domestic prices increased above export price parity, the domestic suppliers would compete to supply that Australian customer (as there would be higher returns than for exporting), until the price returned to close to export price parity. Market feedback indicates that Australian customers' prices for coking coal are currently set by reference to international benchmarks and where the coal producer avoids the cost of transporting the coal to the port and loading the coal ready for export (which is the case for BlueScope), a rebate will be paid.

56. The ACCC considers that competition is necessary for customers in a region to obtain export price parity. If there is a single exporter in a region, that supplier will likely set the price to local customers to match the next best option available to the customer, which will be supply from another region. This higher price will reflect the costs that would be otherwise incurred by the customer in transporting from the other region and the capital costs associated with any additional transport infrastructure required to bring in coal from the other region.

57. If the cost to the customer of obtaining supply from another region is 5-10 per cent higher than the current cost of obtaining supply, then the ACCC considers it likely that the region will constitute its own geographic market. This approach

reflects an application of the Hypothetical Monopolist Test from the perspective of Australian customers, as set out in the ACCC's Merger Guidelines.

58. Accordingly, the ACCC is assessing:

- the additional transportation costs incurred by Australian customers in shipping coking coal from sources outside the Illawarra (including the proportion of the overall delivered price which is comprised of transportation costs)
- other costs to Australian customers of obtaining supply from alternative regions, including additional costs associated with managing the risk of a longer supply chain (for example, higher inventory costs)
- any limitations on the ability of customers to access alternatives sources of supply from alternative regions, such as capacity constraints at the necessary infrastructure and the capital costs associated with increasing the capacity of the infrastructure.

59. The ACCC's assessment of the factors set out above does not exclude the existence of a global seaborne market for coking coal. In addition to this global seaborne market, the proposed acquisition is likely to affect a narrower market for the supply of coking coal to Australian customers and suppliers in this market may be limited to coal producers in the Illawarra.

Issue that may raise concerns: reduction in competition in supply of coking coal to Australian customers

60. The ACCC's preliminary view is that Australian customers of coking coal currently benefit from local competition between the coal producers in the Illawarra region. The proposed acquisition would remove the competitive rivalry between South32 and Metropolitan and, following the expected closure of Glencore's Tahmoor mine, result in there being only one supplier of material volumes of coking coal from the Illawarra in the medium term.

61. The ACCC is therefore concerned that the proposed acquisition may allow South32 to increase the price, or otherwise lessen the terms of supply, for coal supplied to Australian customers from the Metropolitan or South32 mines.

62. In determining whether the proposed acquisition is likely to result in a substantial lessening of competition, the ACCC is considering the actual and potential competitive constraint provided by other suppliers of coking coal, including those based in the Illawarra and elsewhere in Australia.

63. The ACCC's preliminary view is that the alternative actual or potential suppliers may not provide sufficient competitive constraint on South32 post-acquisition because:

- the Illawarra region is not expected to have, in the medium to long term, other producers capable of supplying material volumes of technically substitutability coking coals

- there is significant additional cost associated with transporting substitutable coking coals from alternative sources to the Australian steelmakers as well as potential capacity constraints limiting the ability of one steelmaker to import large volumes of coal by ship.

Availability of substitutes

64. The ACCC is continuing to consider the extent to which alternative sources of coking coal are likely to provide a competitive constraint on South32 after the acquisition. In considering the extent to which alternative sources are likely to provide a competitive constraint, the ACCC considers the credibility of a potential threat by a customer to switch to rival sources and the extent to which such a threat may constrain an attempt to exercise market power by South32 post-acquisition.

Illawarra

65. The ACCC is aware of two other existing coking coal mines in the Illawarra, the Tahmoor mine operated by Glencore and Wollongong Coal's mine in the Southern Coalfields Region of NSW.

66. Glencore announced in June 2016 that it will close its Tahmoor mine, citing low world coal prices as the reason for its closure. The ACCC is not aware of any announcement by Glencore that its intentions have changed and while coal prices have increased since Glencore's announcement, the ACCC does not expect the Tahmoor mine would continue to produce coal in the medium term.

67. The ACCC understands that Wollongong Coal is producing only small quantities of coking coal, which would likely limit customers' ability to switch away from South32 to Wollongong Coal post-acquisition. Market inquiries also suggest that the properties of the coal currently produced from the Wollongong Coal mine may limit its suitability (for use in material volumes) for coke production. The ACCC further understands that any expansion or changes in Wollongong Coal's operations are subject to a number of regulatory approvals, including in relation to the environmental impact of its operations. Accordingly, the likelihood of coal production from Wollongong Coal providing an effective constraint on South32 post acquisition appears small.

68. The ACCC is not aware of any other suppliers of coking coal in the Illawarra. The ACCC is, however, aware of a potential new entrant in the Illawarra, Hume Coal, which is considered in the 'Barriers to entry' section below.

Hunter Valley

69. The ACCC is aware that coal sourced from the Hunter Valley is used in coking coal blends in steelmaking operations in Australia. Market inquiries indicate that both semi soft coking coal and pulverised coal injection coal have been sourced from the Hunter Valley for use in coke and steel production.

70. However the ACCC understands that coal produced in the Hunter Valley has limited coking properties and therefore the proportion of Hunter Valley coal which can be used in the blend for the coke ovens is very limited.

71. Therefore, the ACCC's preliminary view is that coal supplied from the Hunter Valley is unlikely to provide a competitive constraint to South32 after the acquisition.

Bowen Basin

72. The ACCC's preliminary view is that there are a number of coking coal mines in the Bowen Basin which can supply coking coal with similar chemical and physical properties to the coking coal supplied by South32 and Metropolitan. The ACCC is investigating the extent to which the availability of coking coal from the Bowen Basin is likely to act as an effective competitive constraint on South32 post-acquisition.

73. The ACCC's preliminary view is that Bowen Basin coking coal is likely to be the next best option for Australian steelmakers after Illawarra sourced coking coal. The ACCC considers that, post-acquisition, South32 may be able to increase prices charged to Australian customers up to the delivered price of substitutable coals from the Bowen Basin (including the additional transport/infrastructure costs), as it would not face significant local competition. As noted in the market definition section, if the price of this next best option (after factoring in transport costs and any capital costs associated with adapting infrastructure to allow for the required volumes of imports) is less than 5 to 10 per cent higher than current prices paid by Australian customers, then the ACCC considers it likely that Bowen Basin providers would constrain South32 post-acquisition. If the delivered price of Bowen Basin coal is more than 5 to 10 per cent higher than the prices currently paid by Australian customers, then Bowen Basin coal is unlikely to be an effective competitive constraint on South32 after the acquisition, making it more likely that the acquisition will raise competition concerns.

74. The ACCC is continuing to consider the landed cost of coking coal from the Bowen Basin. Market inquiries to date suggest that the landed price may be significantly higher than the price of coal obtained from the Illawarra because of the following factors:

- a material increase in transportation costs. Factors that may influence transport costs include:

    a. the volume of the coal shipped and in particular the size of the vessel employed

    b. the number of deliveries and journeys required

    c. whether Australian cabotage laws apply and the availability of vessels meeting Australian cabotage requirements. The ACCC understands that Australian cabotage laws may not apply where certain size vessels (for example, Cape vessels) are employed

- capital costs associated with expanding a customer's infrastructure (for example, handling berth) necessary to receive sufficient volume of coal by ship

- longer supply chain may require steelmakers to hold additional inventory to mitigate the risk of delays which will affect their working capital.

75. In relation to transportation costs, BlueScope would incur significantly higher freight logistics costs to ship coal from the Bowen Basin via the Queensland coal exporting ports to its steel mill at Port Kembla compared to the costs associated with the supply of coal from South32 and Metropolitan's mines in the Illawarra to its steelworks at Port Kembla. Market inquiries indicate that the cost of transporting coal from the Bowen Basin to Port Kembla is likely to be between $US10-15 per tonne.

76. The ACCC also understands that the freight costs which would be incurred by Arrium to transport material volumes of coal from the Bowen Basin to its steelworks at Whyalla would be materially higher than the costs which Arrium incurs in transporting material volumes of coal from Port Kembla to Whyalla. The distance and therefore journey time from the coal ports in Queensland to Whyalla is approximately double the distance and journey time from Port Kembla to Whyalla. This increased journey time would reduce the number of voyages a single vessel is able to make in a year, with consequent implications for the number of vessels which need to be employed from the spot shipping market as well as possible increased inventory costs.

77. The ACCC is continuing to consider possible capacity constraints associated with existing infrastructure which may limit the ability of a customer to receive material volumes of coal by ship. To the extent that there are existing constraints, the ACCC considers it appropriate to consider the capital costs associated with an extension and upgrade to existing facilities to enable the customer to receive the relevant volumes of coal by ship.

78. In addition to transportation and possible capital costs associated with infrastructure upgrade, the ACCC considers it appropriate to consider any holding or inventory costs associated with a longer supply chain and potentially receiving fewer (but larger) deliveries. The ACCC is continuing to obtain information on such costs.

79. Market inquiries also suggest that in comparing the delivered price of coal likely to be paid by the steelmakers, it may be important to consider the likelihood of a discount or premium (relative to the relevant benchmark) being applied to the rival coal source as this will influence the overall delivered price of the coal. For example, a semi hard coking coal sourced from a particular mine in the Bowen Basin may be priced at a relatively cheaper level to the Metropolitan semi hard coking coal potentially resulting in a similar or potentially even lower delivered price. However, market inquiries suggest that coal which is cheaper due to its chemical and physical attributes may perform less effectively in the coke ovens. Accordingly, adjustments for performance, as well as any consequent adjustments to the blend to ensure compatible coal is employed, would also need to be taken into account in comparing the delivered price for such coal. The ACCC notes that the vast majority of coking coal from the Bowen Basin is exported to international customers and that coal producers in the Bowen Basin would have not have an incentive to supply Australian customers unless they are able to sell the coal at a margin that is as at least equal to that which can be achieved on the global market.

80. The ACCC notes that the significance of the incremental transport costs for customers depends on the underlying price paid for the coal (free on board or FOB equivalent). The price of coking coal has fluctuated significantly in the past 12 months and there are varying forecasts as to price levels in the next 12

months. The ACCC's preliminary view is that it is appropriate to consider the materiality of the incremental transport costs against the long term average price for coking coal.

81. The ACCC understands that long term contracts may prevent price rises and provide a degree of protection for Australian customers. While the existence of such a contract would prevent South32 from raising the price of coal produced in its Illawarra mines up to the delivered price of Bowen Basin coal, it would not prevent South32 from increasing the price of coal produced from the Metropolitan mine up to the level prescribed in a long term contract. The existence of a long term contract would also not protect a customer from the cost impacts associated with any decision by South32 to discontinue the supply of semi hard coking coal from the Metropolitan mine post-acquisition (discussed below).

Blending synergies and potential impact on Australian customers

82. The ACCC considers that, post-acquisition, South32 would appear to have an incentive to blend the coal produced from the Metropolitan mine with the premium hard coking coal produced from South32's Illawarra mines. A blend of South32's premium hard coking coal and Metropolitan's semi hard coking coal is likely to achieve a higher price than would be achieved selling the two coals separately.

83. Australian customers have raised concerns that if South32 were to pursue such a strategy and discontinue the supply of the semi hard coking coal currently provided by Metropolitan, customers would be forced to either purchase higher priced hard coking coal from South32 and/or source semi hard coking coal from other regions at a significantly higher landed cost. The ACCC is continuing to consider this issue and the extent to which coal producers' blending strategies are influenced by competition.

Barriers to entry and expansion

84. The ACCC takes the view that new entry must be timely, likely and sufficient in scope to be considered a constraint. In assessing the likelihood of new entry, the ACCC takes into account the likely cost and profitability of entering the market, particularly the sunk costs and time associated with commencing mining operations.

85. The ACCC's preliminary view is the entry of a new coal producer in the Illawarra capable of supplying a material volume of substitute coal is unlikely in the short to medium term having regard to:

- the existence of significant sunk costs in commencing mining operations, which increases the risk of, and the cost associated with, failed entry. The high risk and costs associated with failed entry are likely to deter new entry

- the need to obtain the regulatory approvals, particularly environmental approvals, which can be time consuming. The Illawarra coal seams are located close to national parks and the Sydney water catchment area which increases the complexity of obtaining the regulatory approvals.

86. The ACCC is aware that Hume Coal[2] is a potential new entrant in the Illawarra region. Hume Coal is not expected to commence operations until at least 2021 and needs the regulatory approvals outlined above. Given the uncertainty as to the commencement date and the future ability of Hume Coal to supply Australian steelmakers, the ACCC's preliminary view is that Hume Coal is unlikely to constrain South 32 in the short to medium-term.[3]

87. As set out above, the ACCC's preliminary view is that Wollongong Coal faces some barriers to expansion due to the need to secure a number of regulatory approvals in relation to the environmental impact of the mine and Wollongong Coal's proposed plans.

The ACCC invites comments from market participants on its concerns in relation to a reduction in competition for the supply of coking coal to Australian customers. In particular market participants may wish to comment on the following:

- substitutability between different grades of coking coal, including the physical and technical characteristics that distinguish different grades of coking coal and the impact of substituting higher quality coals with lower quality coals (including its impact on coke yield, furnace and coke oven performance and waste disposal cost)
- substitutability of Illawarra sourced coking coal with coking coal available in other regions, particularly the Hunter Valley in NSW and the Bowen Basin in Queensland, as well as potential future sources of coking coal in the Illawarra
- the cost to the Australian steelmakers of obtaining coking coal from other regions, including the freight and handling costs, likelihood of any capital investment necessary to receive significant quantities from a different region or impact on working capital as a result of longer supply chains (including these costs as a proportion of total delivered price)
- likelihood and cost of importing coking coal to Australia, including transportation costs and historical examples of imports of coking coal to Australia.

Issue that is unlikely to raise concerns: access to Port Kembla Coal Terminal

88. The ACCC has considered whether the increase in South32's shareholding in the Port Kembla Coal Terminal Limited as a result of the proposed acquisition gives rise to any competition concerns. In particular, the ACCC has considered whether South32 would, post-acquisition, have the ability and incentive to foreclose current or future coal producers from access to the export facilities at the Port Kembla Coal Terminal in a way which would lessen competition in the relevant market for coal production.

89. The proposed acquisition would increase South32's shareholding in Port Kembla Coal Terminal Limited from 16.67 per cent to 33.34 per cent. If the proposed

[2] Hume Coal is a subsidiary of POSCO Australia, which in turn is wholly owned by Korean company POSCO.

[3] https://www.humecoal.com.au/project/assessment-timeline/.

acquisition proceeds, the remaining shareholders would be Glencore (33.34 per cent), Centennial Coal Company Limited (16.67 per cent) and Wollongong Coal Ltd (16.67 per cent).

90. Post-acquisition, South32 would not hold a majority interest in Port Kembla Coal Terminal Limited or a majority of the voting power at board level. While South32 would, following the proposed acquisition, have a veto power over board decisions concerning a limited range of matters (as would Glencore), none of these matters relate to the day to day operation of the facility. The ACCC has also considered whether the increase in South32's interest in the Port Kembla Coal Terminal Limited would change the incentives of South32 and the remaining shareholders (for example, increase their interdependence) in such a way that the acquisition would have an anti-competitive effect.

91. The ACCC's preliminary view is that the proposed acquisition is not likely to give South32 the ability to control the decision making of the board of Port Kembla Coal Terminal Limited and is unlikely to give rise to significant competition concerns.

ACCC's future steps

92. As noted above, the ACCC now seeks submissions from market participants on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter. Submissions are to be received by the ACCC no later than Friday 10 March 2017 and should be emailed to mergers@accc.gov.au.

93. The ACCC will finalise its view on this matter after it considers submissions invited by this Statement of Issues.

94. The ACCC intends to publicly announce its final view by Thursday 6 April 2017. However the anticipated timeline may change in line with the *Informal Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement to explain its final view.