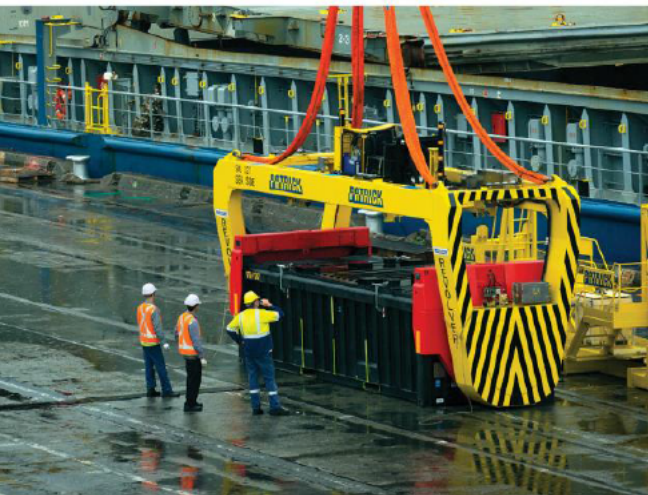




Submission to the Inquiry into the Proposed Lease of the Port Of Melbourne

September 2015



TOP **50**
ASX LISTED
COMPANY

OVER **8,800**
PEOPLE ACROSS AUSTRALIA
AND NEW ZEALAND

AS AT
30 JUNE 2014 **\$4 billion**
BILLION REVENUE

Executive Summary

Asciano supports the privatisation of the Port of Melbourne and believes there will be significant benefit for Victoria from the level crossing grade separation project for which a large part of the proceeds will be used. However, we do believe that improvements can be made to the process without impacting either the timing of the sale or the proceeds from the sale.

Competition concerns & market power

A key concern is the ability of the port operator to exercise its substantial market power which will distort competition and undermine supply chain efficiency. The Lease Act¹ includes a regulatory regime overseen by the Victorian Essential Services Commission (**ESC**) designed by the Victorian Government to deal with these competition issues. Asciano has worked with the ESC over a number of years both as an access seeker and an access provider. The ESC is a very capable organisation and, if given the appropriate regulatory framework, can be a very effective regulator and deliver pro competitive outcomes for the benefit of Victorians. We believe the regime outlined in the Lease Act does not yet allow the ESC to effectively deliver those pro competitive outcomes. However, a few simple changes can make it much more effective by:

- Including rental charges under the price cap;
- Including more detail in the legislation on the regulatory regime and a move away from reliance on Order of Council; and
- Including regulation preventing vertical integration by the privatised port operator without appropriate regulatory constraints in place.

Preclusion of ACCC Oversight

The Lease Act excludes ACCC from any oversight of the lease, financing agreements or compensation payments. This means there is no independent oversight to test whether the agreements are anti competitive. This is significantly out of step with other states' port privatisation processes and also previous transactions undertaken by the Port of Melbourne.

¹ Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Bill 2015 (the "Bill").

Asciano believes that the restriction on ACCC involvement should be removed. We understand that the Government is concerned about delays to the sale. We do not believe that allowing the ACCC to be involved in the process would cause any delay. In other port privatisations, the ACCC has met very tight timeframe to ensure that no delays have occurred.

Restriction on competition between ports

Although there is little detail available, there has been discussions of compensation being payable to the privatised Melbourne port operator if a new container port is developed and takes containers away from the Port of Melbourne.. This will provide a disincentive for future Government's to allow future port developments. Asciano believes that this compensation payment should be removed.

Asciano is supportive of the Victorian Governments privatisation of the Port of Melbourne but in order to ensure that that Victorian supply chains remain efficient and effective, a number of simple changes which will neither affect the timing nor the price of the sale should be made.

Asciano

Asciano has a material presence across Victoria and around Australia in both the ports and rail sectors. Through Pacific National, we carry 70% of Australia's intermodal freight on rail, including a significant volume of intermodal and bulk freight to and from Melbourne, and our Patrick businesses move nearly 50% of Australia's containerised imports and exports across the docks as well as significant volumes of Australia's bulk, break-bulk and automotive volumes. Our services connect Victorian importers with their markets across the state, and we also support many of Victoria's key export industries, from agriculture and food, to forestry and manufacturing.

Asciano is the Port of Melbourne's biggest tenant. We provide stevedoring and road and rail logistics services through our lease holdings at the Port of Melbourne.

The Issues

Asciano supports the privatisation of the Port of Melbourne and believes there will be significant benefit for Victoria from the level crossing grade separation project for which a large part of the proceeds will be used. However, we do have concerns about the way in which the Victorian Government is proposing to privatise the port. Our key concerns are:

- The ability of the port operator to exercise its substantial market power which will distort competition and undermine supply chain efficiency;
- Preclusion of ACCC scrutiny of the competition implications of the privatisation process; and
- Compensation arrangements that may deter future Governments from developing a competitive container port.

We believe that these issues can be addressed with reasonably minor amendments to the current legislation which would have minimal impact on the sale timing or on the proceeds from the sale.

Competition Concerns & Market Power

The ESC, the Victorian state competition regulator, has rightly concluded that the Port of Melbourne Corporation currently has substantial market power because of the lack of viable substitutes, lack of countervailing power held by customers (including tenants) and height of barriers to entry.²

As a result of these market power issues, the recent Harper Competition Policy Review Final Report specifically recognised the importance of establishing adequate competition oversight prior to privatisation of government owned assets. In relation to port privatisation, Harper concluded:

Significant reform of ports has been achieved, which has benefited users. Nonetheless, various participants in many of the port services chains have significant market power. Regulators and regulatory frameworks need to

² ESC Review Of Victorian Ports Regulation Final Report June 2014.

recognise this, including through the application of pricing oversight and, if necessary, price regulation.

Leasing costs at ports subject to price regulation should aim to reflect the opportunity cost of the land and not the ability to extract monopoly rents. The latter represents an inefficient tax on consumers and business.

As with other privatisations, port privatisations should be undertaken within a regulatory framework that promotes competition and prevents monopoly pricing, even though this may result in a lower sale price.”³

This market power residing with a privatised port operator raises two major concerns monopoly pricing and vertical integration.

Monopoly pricing

The privatised port owners have the incentive to monopoly price especially where any potential marginal competition from other ports has been prevented. This incentive to monopoly price is exacerbated by the high prices being paid by the successful bidders.

Rental charges at the ports have been significantly increased in the years prior to privatisation, thus maximising the sale price. For example, in the three years prior to privatisation rents increased at Patrick’s Brisbane Container terminal by 128%. The Port of Melbourne had proposed an unprecedented increase to DP World of over 700%. Whilst it appears this issue may have been resolved between DP World and the PoMC, it remains an issue for Patrick. It also demonstrates what can happen in future if the market power of the PoMC is not constrained in any way with regard to rents.

There are three areas that the port operator can increase prices:

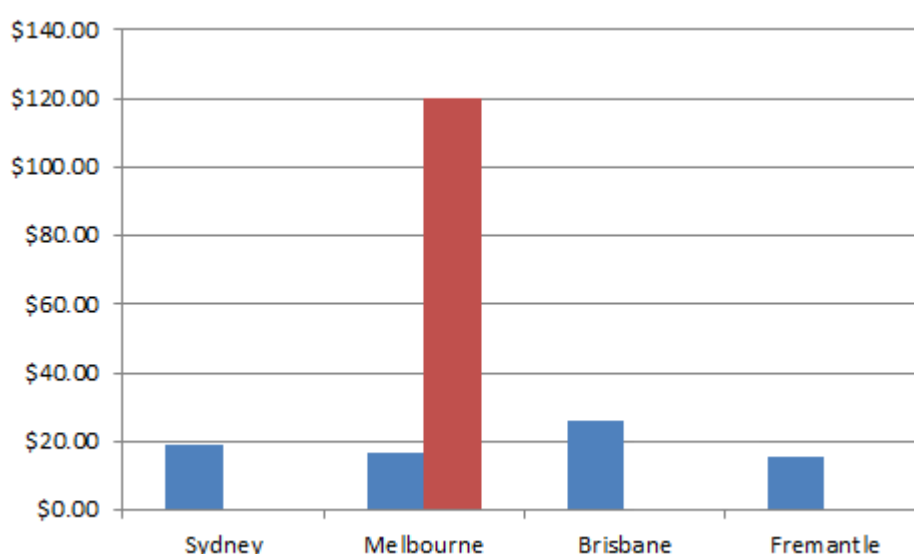
- **Terminal Rent:** When stevedores such as Patrick are within leases there are some constraints on port owner pricing through market review clauses and dispute resolution in leases. However, there are no protections against rent increases when out of lease. In addition, the privatised operator will seek to interpret aggressively any price increase clauses in current leases as has happened at Melbourne.

³ Competition Policy Review Final Report March 2015 p 208.

- **Port Charges** are applied by the port to shipping lines and include ship based charges (eg tonnage, pilotage, towage) and cargo based fees (eg wharfage charges, harbour dues).
- **New Charges:** The port operator may introduce new charges for example surcharges for new infrastructure investments, or unbundle current services. These charges may be directed at either shipping lines or stevedores. The current regime does not address this concern in any way.

The Port of Melbourne's proposal to DP World of a rent of \$120 per m² was unprecedented and out of proportion with other capital city ports, including those already privatised. DP World had estimated that the rental increase would add \$80 per container passing through the Port of Melbourne. Currently the stevedore container charge at Melbourne is around \$220 per container. These charges would be levied by the stevedore on the shipping lines and landside operators and will be passed down the supply chain impacting Victoria's competitiveness.

Current Rents \$ per m² at Capital Container Ports vs PoM proposal



We are heartened by reports that the Victorian Government has taken a much more sensible approach than that initially proposed by the Port of Melbourne. We understand from reports that DP World has negotiated a deal with the Port of Melbourne for rent much lower than that originally proposed. However, we understand that this still includes significant rental increases of around 125% by 2023. Based on the reported information, DP World does not have protection from the introduction of new charges or significant

rental increases post 2023. Asciano is seeking to start negotiations with the Port of Melbourne.

Vertically integrated monopolist

Even if companies currently active at Melbourne Port are excluded from the lease process, the privatised port operator may seek to expand its services downstream into stevedoring – especially if looking to become more profitable to improve returns on the likely high prices paid for the port. A vertically integrated port provider would have the incentive to prefer its own related stevedore and could do this through discriminatory pricing, planning and operational decisions. This would undermine effective competition in stevedoring resulting in poorer economic outcomes. It is important to recognise that vertical integration can occur via both organic and inorganic (ie through acquisition) means. While the ACCC would have the ability to intervene in future on non organic vertical integration it would not be able to address organic vertical integration such as the Flinders Ports example discussed below.

A good example of the impact of vertical integration is Flinders Ports who operates seven Ports at Port Adelaide, Port Lincoln, Port Pirie, Thevenard, Port Giles, Wallaroo and Klein Port.

They are not only the port operator but also an active stevedore through the wholly owned Flinders Logistics which offers a full range of stevedoring service across bulk export and import, container services and general cargo. To win customers at Port Adelaide, Patrick needs services from Flinders Ports who at the same time are trying to win the same customer. On several occasions a key factor in Patrick losing tenders was the cost and conditions imposed by Flinders Ports. We are aware that Qube has been experiencing similar problems. This type of unconstrained vertical integration undermines the competitive process and, ultimately, the efficiency of the supply chains.

The Victorian Government's response does not address the issues

The Lease Act⁴ includes a regulatory regime overseen by the ESC designed by the Victorian Government to deal with any competition issues. Asciano has worked with the

⁴ Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Bill 2015 (the "Bill").

ESC over a number of years both as an access seeker and an access provider. The ESC is a very capable organisation and if given the appropriate regulatory framework can be a very effective regulator and deliver pro competitive outcomes for the benefit of Victorians.

We believe the current regime outlined in the lease does not yet allow the ESC to effectively deliver those pro competitive outcomes. However, a few simple changes can make it much more effective.

The regulation in the Lease Act covers port charges but not rental charges or new charges which will be unregulated. This lack of coverage of rent undermines any benefits the regulatory regime will deliver as the Port Operator will still be able to monopoly price, but this pricing behaviour will be concentrated on rent and new charges. Port users, and ultimately exporters and consumers, will still be impacted by monopoly pricing. The privatised port corporation will be more likely to target unregulated revenues (rent) than those covered by the limited regulation.

The detail of the regulatory regime is not contained in the Lease Act and the Government retains significant flexibility in implementing the regulatory approach which they can use in negotiations with bidders. This creates significant uncertainty for port users. We understand that more detail on the pricing regime may be released prior to the lease process being finalised.

The Government has been highlighting that the regulatory regime includes:

- prices to be set clearly against established economic principles and a deemed asset base; and
- overriding CPI price cap for at least 15 years.

However, the legislation only sets up that the Governor in Council on the recommendation of the ESC Minister can make an Order that implements the regulatory regime. There is little or no detail of the regime in the legislation.

The legislation says that the Order MAY include setting an initial asset base but this sits amongst a menu of other options including weaker approaches such as price monitoring. The CPI cap is not detailed in the regime and presumably will be a contractual cap between the Government and the bidder.

The legislative approach of relying on Orders to deliver the regulatory regime affords the Government flexibility in what they negotiate with the bidder but also the ability to change

the regime easily in future through orders and not legislation. This does not provide certainty for port users.

Asciano believes that some simple changes to the ESC regime could significantly improve its effectiveness. These changes, namely: an increase in codification of the regime in legislation and a movement away from relying on Orders; the inclusion of rents under the proposed price cap; and limitation on the vertical integration by the port operator without appropriate regulatory constraints being put in place.

Preclusion of ACCC Oversight

The Lease Act excludes ACCC from any oversight of the lease, financing agreements or compensation payments. This means there is no independent oversight to test whether the agreements are anti competitive.

This is significantly out of step with other states port privatisation processes and also previous transactions undertaken by the Port of Melbourne. The Port privatisations in Sydney, Brisbane, Newcastle and the current privatisation in the Northern Territory all included ACCC oversight. This was often achieved not through legislation but through a bidding requirement that ACCC approval was required.

The ACCC was involved via a bidding requirement in the leasing of the automotive terminal to MIRRAT by the Port of Melbourne. MIRRAT eventually submitted an access undertaking to the ACCC which covered amongst other things: access conditions, price control, ring fencing, operational issues such as Berthing Allocation, Performance KPIs, and audit and compliance.

Asciano believes that the restriction on ACCC involvement should be removed. By removing these restrictions, the ACCC will not be regulating the port, more assessing whether given the regulatory regime there are any particular competition concerns with particular bidders. As discussed above this is the process that most other jurisdictions have followed and the way the general economy is regulated and which has delivered significant productivity benefits since the reforms in the 1980s. We understand that the Government is concerned about delays to the sale given they are looking to invest the proceeds in a number of projects, including level crossing grade separations. We do not believe that allowing the ACCC to be involved in the process would cause any delay. In other Port privatisations, the ACCC has met very tight timeframes to ensure that no delays have occurred with the sale process.

Restriction on Competition Between Ports

In other jurisdictions, to maximise sale revenue, the structure of previous port sale processes have prevented future competition between ports. For example, Port Kembla and Sydney were sold as a bundle and there are reported restrictions on the Port of Newcastle developing a container terminal.

The choice of ports is not an option for all commodities and is dependent on the nature of the product and its proximity to the ports. As such, competition between ports may currently be on the margins. However, port privatisation structures are potentially restricting competition between ports for several decades and longer. In this timeframe market conditions may be very different due to technological and demographic changes.

Although there is little detail available, there has been discussions of compensation being payable to the privatised Melbourne port operator if a new port is developed and takes container traffic away from the Port of Melbourne.. This will provide a disincentive for future Governments to allow future port developments. Asciano believes that this compensation payment should be removed.

A Way Forward

Asciano is supportive of the Victorian Government's privatisation of the Port of Melbourne. However, in order to ensure that effective regulation is in place so that Victorian supply chains remain efficient and effective, a number of simple changes which will neither affect the timing nor the price of the sale should be made by:

- Including retail charges under the price cap;
- Including more detail about the regulatory regime and a move away from reliance on Orders of Council;
- Removing the restriction on the ACCC reviewing any competition issues with individual bidders;
- Including in the legislation provisions preventing vertical integration by the privatised port operator without appropriate regulatory constraints; and
- Removing the compensation payment for the privatised port operator if another container port is developed.



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