# CORRECTED VERSION

# PORT OF MELBOURNE SELECT COMMITTEE

## Inquiry into the proposed lease of the port of Melbourne

Melbourne — 8 September 2015

Members

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| Mr Gordon Rich-Phillips — Chair | Mr Craig Ondarchie |
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| Mr Greg Barber | Ms Harriet Shing |
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Secretary: Mr Keir Delaney

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Witnesses

Mr David Martine, secretary,

Mr David Webster, deputy secretary, and

Mr Nick Rizos, director, port transaction unit, Department of Treasury and Finance;

Mr Anthony Burgess, chief executive officer, Flagstaff Partners; and

Mr Julian Peck, managing director, Morgan Stanley.

**The CHAIR** — I declare open the Legislative Council Port of Melbourne Select Committee public hearing. This hearing is in relation to the inquiry into the proposed lease of the port of Melbourne. All mobile telephones should now be turned to silent. I welcome Mr David Martine, the Secretary of the Department of Treasury and Finance; Mr David Webster, the deputy secretary; Mr Nick Rizos, director, port transaction unit; Mr Tony Burgess from Flagstaff Partners; and Mr Julian Peck from Morgan Stanley. I thank you all for making yourselves available this morning.

The committee does not require witnesses to be sworn, but questions must be answered fully, accurately and truthfully. Witnesses found to be giving false or misleading evidence may be in contempt of Parliament and subject to penalty. All evidence taken at this hearing is protected by parliamentary privilege as provided by the Constitution Act 1975 and further subject to the provisions of the Legislative Council standing orders. Therefore the information you give today is protected by law; however, any comments repeated outside this hearing may not be protected. All evidence is being recorded, and you will be provided with a proof version of the transcript in the next couple of days.

We have allowed 60 minutes for this session, and to ensure that there is sufficient time for questions, I would ask you to keep your presentation relatively short. Mr Martine, I now invite you to make an open presentation.

**Mr MARTINE** — Thank you, Chair, and thank you for the opportunity to present to the committee this morning on the proposed lease of the port of Melbourne. I note the department has separately provided to the committee the whole-of-government submission outlining the transaction structure and addressing each of the terms of reference. We have also now provided to the committee a slide presentation. I will talk through the first two slides providing an overview of the proposed lease transaction, and we may refer to the supplementary slides later in the session as we endeavour to answer the committee's questions.

If you turn to the slide marked no. 2 at the bottom of the page, Victoria's population is estimated to reach 10 million by the year 2051. This population growth will feed demand for goods and services and ultimately trade growth. Increasing container trade and trade more broadly needs to be accommodated to support this population growth and anticipated demand. The port of Melbourne is Australia's premier port, and retaining Victoria's status as the freight and logistics capital of Australia is a key objective for the lease transaction.

The Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Bill 2015 establishes the Victorian Transport Fund and directs proceeds into the VTF. As required by the bill, these proceeds will be used for the level crossings removal program and other infrastructure projects such as public transport, roads, rail, the movement of freight or ports. The government is making the port's commercial operations available on the basis of a 50-year lease, with the legislation providing for an option of a 20-year extension under regulation. A future government can extend the lease term for up to 20 years, and whether the government chooses to exercise that option will be up to the government of the day. Any extended lease term will need to be negotiated with the leaseholder at the time. The 50-year lease will be structured in such a way that the leaseholder will be encouraged to maximise container throughput at the port of Melbourne. As a consequence, the port of Melbourne will be the state's only international container port for a considerable period into the future.

However, at some stage during the term of the lease, Victoria is likely to need a second container port. The lease does not rule out a second container port. There are no restrictions on the state developing a second port, and the lease does not confer on the successful bidder any rights to develop a second port. There are no non-complete clauses for containers, a port monopoly is not being created and compensation is not a given in the event that a second port is operational during the term of the lease. The port growth regime is only triggered if a future government builds a second port before it is needed. The state does expect a complementary second port to be operational before the end of the port of Melbourne lease. The state will fully control any new state-sponsored port and will have full control of the impacts that the second port will have on the port of Melbourne.

The port's assets, liabilities, people and functions are to be separated into two ongoing entities. The bill before Parliament authorises and facilitates leasing land and disposing of other assets of the Port of Melbourne Corporation and transferring responsibility for the port's commercial operations to the leaseholder. Port land will remain owned by the state. Port of Melbourne Corporation employees will be treated fairly and equitably. Transferring staff will be offered no less favourable terms of employment, and employees remaining with the state will continue to have the benefits of the terms and conditions of their current employment.

If you just turn to slide marked no. 3, planning and environment approvals will not change. The Victorian and commonwealth governments retain responsibility for regulating the port's safety, security and environmental functions. All existing statutory planning standards will continue to apply. The state will continue to be responsible for the harbourmaster, safe navigation in Port Phillip Bay, dangerous goods, oversight, waterside emergency management, marine pollution response and towage regulation. Public access to walkways and bike paths for locals', visitors' and neighbours' use will be maintained, and the iconic Station Pier will remain in public hands.

Strengthened economic regulation will protect users and reinforce the port's premier port status. Non-rent port charges will be regulated by the Essential Services Commission, so the reality is that the regulation will be broader and more stringent than is the case today, and indeed more so than at any other container ports in Australia. The legislation protects port users by imposing a CPI price cap on port charges for at least 15 years. No other port has this level of price regulation.

The port also has frozen prices on loaded international container export charges, and these charges will be progressively reduced by 2.5 per cent annually for the next four years. The government will give effect to this decision through a pricing order. This means that by the year 2020 we expect that loaded international container export charges will be 22 per cent lower than equivalent import charges. Rents are already effectively regulated by lease contracts, which are commercially negotiated between the stevedores and the port, like any landlord-tenant agreement. This contract has independent evaluation provisions if there is a dispute. With the proposed economic regulatory regime the government is seeking to ensure that port users and Victorian consumers are safeguarded from unexpected price increases and that the port of Melbourne continues to support the long-term competitiveness of the Victorian economy while providing the leaseholder with regulatory certainty.

In conclusion, the port of Melbourne is the biggest container and cargo port in the country, visited by more than 3000 ships each year. A central focus in implementing the transaction is optimising the state's overall long-term economic objective while balancing flexibility, capacity growth incentives, efficiency, economic competitiveness and the response by the investor market. Key features of the transaction's design which demonstrate this balance include a 50-year lease that reflects the need for longer term strategic flexibility compared to achieving more up-front value through a longer, less flexible arrangement — for example, say, 99 years; strengthening the proposed economic regulatory regime to facilitate low-cost port access pricing through a focus on efficient costs and capital investment compared to a private sector bidding market preference for obviously less regulation; establishing a port growth regime to align the interests of the state, leaseholder and the entire supply chain in an efficient and timely development of port of Melbourne container capacity; and, finally, setting up a transaction design which is neutral to a second container port location and enables the state to determine if and when a second container port capacity is developed.

Thank you, Chair, for the opportunity to present here this morning, and we certainly welcome the committee's questions.

**The CHAIR** — Thank you, Mr Martine. Firstly, on behalf of the committee, thank you for the whole-of-government submission, which we received last Friday. I know we have also received correspondence from you in respect of a range of documents the committee was seeking access to as part of its inquiry, primarily lease-related documents, pricing order documents et cetera. Obviously they have not been provided to this point. The committee of course reserves its right to subpoena those documents if it sees fit, but obviously the intent of this committee is to conduct this inquiry as expeditiously as possible, which we understand is the government's desire. Obviously if the department can facilitate the provision of those documents without us needing to go down the formal path of subpoenaing them, that would assist our deliberations.

**Mr MARTINE** — Chair, if I could perhaps respond to that, we have endeavoured in the submission to try to provide the committee with as much as information as we can. We certainly understand that the committee is interested in the pricing order, and we will endeavour to provide that to the committee as soon as possible. In terms of the transaction documents, which it is probably fair to say are still evolving documents, we certainly need to be careful about some of the commercial-in-confidence issues. At the committee's discretion, one option may be whether the committee might want an in camera discussion around the actual transaction documents. The joint financial advisers would be in a good position to talk through our financial documents and all the structure and perhaps go into a little bit more detail. But certainly on the pricing order we will endeavour to get that to the committee as soon as practicably possible.

**The CHAIR** — Thank you, Mr Martine. I would like to ask you firstly about the recent negotiations between the Port of Melbourne Corporation and DP World in respect of rents, and you touched on rents briefly in your opening statement. Can you inform the committee what role the Department of Treasury and Finance played in those negotiations, either directly or behind the scenes, with the Port of Melbourne Corporation?

**Mr MARTINE** — Essentially the negotiations are part of the normal commercial relationship between the port and DP World, but I might get Mr Webster to go through a little bit more detail.

**Mr WEBSTER** — Thank you, David. As the secretary was saying, the rental negotiations were seen as business as usual conducted and led by the Port of Melbourne. There were discussions between Treasury staff and the Port of Melbourne with respect to the negotiations, and there was various guidance around timing and how to take the process forward. Treasury was in the room, but, as I was saying, it was led by the Port of Melbourne as part of business as usual.

**The CHAIR** — It has been reported that the starting point for the DP negotiations was around the $16 per metre rental, with a proposal from the Port of Melbourne to increase that to $120 a square metre, and then ultimately landing pretty much back where you started at $20 a square metre. What role did Treasury play or what advice and guidance did Treasury have in getting that outcome that went from a low base to a very high base and ultimately back pretty much to a low base?

**Mr WEBSTER** — The Port of Melbourne considered the terms of the lease, which had a market rent review mechanism in there, which is standard in these types of clauses across the country. The view of the board and the Port of Melbourne was that the appropriate place, in terms of what was market rent, was the most recent rental outcome, which was at VICT, which was the $120 a square metre. We would expect Port of Melbourne to seek the best outcome for the state and for its shareholder. Based on the evidence which was in front of it, which was a recently completed transaction, I think it was entirely appropriate to go out there with an initial rent indication of $120 a square metre. The lease provisions have in there effectively an independent determination if they are in dispute, and that played out.

**The CHAIR** — Was that played out with Treasury's assistance or purely by the negotiation between DP and the port?

**Mr WEBSTER** — There were no directions from Treasury in respect of the rental outcome, although there were discussions in terms of the strategy that they were going to adopt.

**The CHAIR** — Is it merely coincidence that that resolution was reached the day before the legislation for the port sale reached the Legislative Council?

**Mr WEBSTER** — I could not comment on that.

**The CHAIR** — How was the resolution reached between DP World and the Port of Melbourne from the $120 at VICT, as you have outlined, getting back to the $20?

**Mr WEBSTER** — As you would expect there was a series of offers and counteroffers, and ultimately the Port of Melbourne and DP World reached a consensus opinion based on offer and counteroffer.

**The CHAIR** — What advice or what view did Treasury put to the Port of Melbourne in those negotiations?

**Mr WEBSTER** — In terms of where Port of Melbourne was counteroffering, they discussed that with Treasury.

**The CHAIR** — What advice did Treasury give to the Port of Melbourne or what view did Treasury put to the Port of Melbourne?

**Mr WEBSTER** — There were no directions from Treasury to the Port of Melbourne in terms of particular outcomes.

**The CHAIR** — Did Treasury put a view to Port of Melbourne?

**Mr WEBSTER** — Views in terms of whether what the Port of Melbourne was doing appeared in the shareholder's interest: yes.

**The CHAIR** — And what were the shareholder's interests at that time?

**Mr WEBSTER** — The shareholder's interest balances a number of things, which include overall economic outcome to the state, not just the rental outcome.

**The CHAIR** — Did the shareholder's interest encompass the pending sale of the port of Melbourne and the pending consideration by Parliament of the legislation?

**Mr WEBSTER** — I think that question is best directed to the Port of Melbourne, as they were leading the negotiations.

**The CHAIR** — You indicated, if I understand correctly, that Treasury expressed a view to the Port of Melbourne having regard to the shareholder's interests, so I am asking: which particular interests of the shareholder did Treasury have regard to in putting a view to the Port of Melbourne? Was it the consideration of the pending sale?

**Mr WEBSTER** — I think from the outset of the transaction the long-term overall economic impact on the state has been the overriding priority for how the transaction is structured.

**Mr MARTINE** — Just to add to Mr Webster's comments, essentially our role would really be no different whether there is legislation on the proposal to lease the port of Melbourne. As you may be aware, we have an important shareholder role that we exercise and assist the government in exercising, so for a significant transaction such as this one by the Port of Melbourne, if that was occurring last year or the year before, as the shareholder representatives we would certainly take a keen interest in that.

**The CHAIR** — Can I ask one final question on this matter? What impact would increasing the rent at the DP World terminal to $120 per square metre have on the valuation of the port versus the $16 that is currently being paid?

**Mr WEBSTER** — I might actually hand that over to Nick just to talk around the significance of the rental charges and the overall revenue stream of the port of Melbourne to put into context the relative sizes of the revenues.

**Mr RIZOS** — Chair, are you happy for me to address that question?

**The CHAIR** — Thank you.

**Mr RIZOS** — To put rent into context, our submission talks a little bit about the extent of the economic regulatory framework. In that section of our submission we discussed the relativities. It is important to note that 86 per cent of the port's revenue will be captured by the economic regulatory framework, so that effectively allows approximately 14 per cent of the port's revenue that relates to rent. In the context of the question that was asked specifically — —

**The CHAIR** — But presumably if you increase rents by a factor of 8, that revenue which is not captured would become a much larger proportion of the total revenue.

**Mr RIZOS** — By definition, if you were to do that, that would be the case. I think the important point here is that we are not in a position to, nor should we — and I am sure the financial advisers may express a view as well — speculate on valuation in the middle of a transaction. That is not the appropriate thing to do at this stage, so we need to be a little bit circumspect in how far we go in that regard.

**The CHAIR** — I ask the question this way: would higher revenue equal higher value?

**Mr WEBSTER** — If I can pick up an earlier point, neither the state nor the Port of Melbourne can unilaterally impose rents on stevedores. There is a dispute mechanism in there which has a view towards market rent reviews. The Port of Melbourne cannot pick an arbitrary number and impose it on the stevedores without the stevedores having the right to seek an independent market rent review.

**Mr MULINO** — Firstly, thank you for your very detailed submission that was provided to us last week, and thank you for your presentation today. Could I just ask you to step us through the port growth regime?

**Mr WEBSTER** — I will pick up on that, and then I will hand over to Julian. We believe that the port growth regime creates the best overall economic outcome for the state. There are three key elements to it. First, we believe it is in the state's interest that the private sector is not disincentivised from developing the port of Melbourne to its natural capacity of 7 to 8 million TEUs. Developing the port of Melbourne further is the lowest cost outcome for the state and consumers and exporters. Expanding the port of Melbourne would be much less expensive than greenfield capacity at a second port, and the total supply chain cost from the port of Melbourne, given the supply chain is centred in and around the port of Melbourne, will be less expensive than a new second port which is located further away from metropolitan Melbourne.

Secondly, the state retains complete flexibility as to the location, the timing and the staging of the capacity and the ultimate capacity of the second port. As the secretary alluded to earlier, the port of Melbourne leaseholder has no rights in respect of developing a second port.

Third, the port growth regime allows the bidders to price the port of Melbourne assuming that the government will deliver the second port in the way it is most likely to do so. We believe that the benefits to the state in terms of pricing certainty outweigh any benefits that might accrue from not having a port growth regime in place.

Prematurely disrupting the supply chain and building the extensive port and landside infrastructure ahead of actual need is not in the state's interest, not in business's interest and not in the consumers' interest. In the absence of a port growth-type regime, bidders will factor in the risk of a second container port being sponsored by the state earlier than required or bigger than required. A port growth regime provides bidders with confidence that the state is likely to be mindful of the economic outcomes of the second port on overall state port capacity.

The state is likely to want that cheaper port of Melbourne brownfield capacity is maximised before building an expensive second port with the extensive landside infrastructure associated with that. By aligning the incentives of the port of Melbourne leaseholder and the state, the state will benefit in two ways. First, higher up-front proceeds from the lease as the bidders can efficiently price the risk of the state developing a second port ahead of need and be more confident in paying for the growth potential at the port of Melbourne. They will not price in the risk of the state acting in a way it is unlikely to do so. Second, the leaseholder and tenants of the port, including stevedores, are actually incentivised to invest during the term of the lease. In the absence of a port growth regime, there is a potential disincentive there of the risk of the state building a competing second port. Bidders do not face the risk of a loss of investment and pricing that in, if the state acts in a way it is unlikely to do so.

The DTF and the JFA have considered a number of alternative approaches to align the interests of the state and the port of Melbourne leasehold on port capacity. The proposed port growth regime compensates the port of Melbourne leaseholder for international container trade actually diverted from the port of Melbourne to a state-sponsored second port. The key elements are: during the lease term the state sponsored a competing international container port; compensation will only be payable based on actual volumes diverted to the state's second port; compensation is only payable for international container trade which is diverted, not for any other trade, such as break bulk.

The port of Melbourne volumes which will attract compensation will be competitively bid and will be capped at less than the natural capacity of port of Melbourne, creating effectively a first loss or an excess-type position for the leaseholder. Again, there is strict criteria to be satisfied before the leaseholder becomes eligible for compensation. That is outlined at page 28 of the submission and slide 13.

Any compensation payments will be made annually over the remaining life of the lease, based on the volume of the international container trade actually diverted. I make the point that the state has total control over when compensation is paid, whether compensation is paid and, if so, how much. The state decides when and where to build a second port and what capacity each stage will be.

To put this into context, in 2015 the revenue of the port of Melbourne was about $368 million. Various press speculation on the potential costs of a second port have started at $12 billion, excluding potential for significant rail and landside costs. Should any compensation actually be required for diverted trade, the state will be receiving revenues from that diverted trade at the second port, which is expected to more or less offset the compensation payable.

Just in summary, the port growth regime allows risk to be priced in the most overall economically advantageous way. It does not fetter any rights of the state to build a second port whenever it wants and wherever it wants. The port growth regime does not disincentivise the leaseholder from investing in lowest cost incremental capacity at the port of Melbourne for the expected benefit of Victoria, and the value of the impact on the price is expected to be greater than any benefits that might arise for the state if the regime was not in place.

At that point I might hand over to Julian to talk through some of the detail.

**Mr PECK** — Could we go to slide 11? I might just lead off here and, Tony, please chip in. I think what we are trying to illustrate with slide 11 is the point that David has made around timing and staging of a new state-sponsored port. Effectively that grey shaded area, if you will, is the point of overlap, and that is completely within the state's control. I think the other key message on this chart is that on any analysis a new greenfield port that is built further away at current construction costs is going to be more expensive than that port of Melbourne capacity you see there that could be developed through. It is in the state's best economic interest that that existing capacity is fully utilised for as long as possible. That is going to deliver the lowest overall supply chain cost to users.

You will see in the submission there is a chart there showing the distribution of containers, which are basically centred around port of Melbourne, which goes to the supply chain point. Really what we are looking to do is ensure that that risk that the private sector might think is greater than that grey area that might disincentivise them from investing or might under price, the asset is effectively providing a form of insurance so that they behave appropriately, both in terms of initial valuation and ongoing investment.

**Mr BURGESS** — The other key point that we would make referring to that page 11 is that there is a lot more capacity at the port of Melbourne post the current port capacity project, which will go to about 5 million TEUs. Ultimately the capacity, based on technical advice, is 7 to 8 million TEUs. Basically what we want in the interests of the state in leasing the port is to have the successful leaseholder value the ability to continue to grow the capacity of the port that growth being the lowest cost growth and the lowest cost supply chain solution, so in the interests of the state as a whole and all users of the port; and once it is the leaseholder, during the term of the lease to actually invest the dollars along the way to actually implement the increased capacity.

We know the port capacity project is costing something in the order of $1.6 billion for the port and on the landside for the relevant tenants. These increments in capacity in the future will probably cost in the order of those sort of dollars. Clearly neither the leaseholder nor the stevedores would willingly undertake investment of billions of dollars if they felt there was a real risk that the state would potentially strand that capacity by effectively sponsoring a second port sooner than is required or to a greater capacity than is required.

Effectively this regime is designed really to make sure we get the best possible value now, reflecting the growth capacity in the port, and incentivise the leaseholder and the tenants at the port to undertake the necessary investment over the next 50 years to ensure that the lowest cost port capacity and the lowest supply chain cost associated with that is actually put in place for the benefit of the state of Victoria. That is the driving rationale here, while at the same time allowing the state the unfettered right to build the second port where it wants, when it wants, to the size it decides. We believe we have achieved the objective of getting the best economic outcome for the state while preserving the state's strategic flexibility.

**Mr PECK** — I think that ongoing capital expenditure — just to finish a couple of key points — would be covered by the regulatory regime, so clearly that is within the net of the regulatory regime and that cost will be amortised over growing volumes. That will ensure the lowest cost capacity. Just over the page, on page 12, I think an important point that both Tony and I have probably touched on is that this regime only operates where the state has actually built a state-sponsored port and has, if you like, diverted containers to itself.

The state will be receiving revenue, which is that top red line. You see that it is actually paying our way on this regime. It is because it is taking that revenue away from the port of Melbourne, the concession that was let hopefully in 2016, and therefore it has funding in hand to make those payments. It is highly unlikely that the state is going to be out of pocket. If I can use an analogy, if you had a single shareholder of both ports and they brought in a new port and they were diverting trade to their new port, they would be driving revenue through the new port capacity. They would be eroding, if you will, slightly their existing port capacity. The net position of all that is much the same as would be achieved under this regime. We are not creating artificial devices or poison pills in the structure.

Finally I would say — Tony, I will just lead off here, and then please jump in again — the chart on page 13 is intended to summarise a series of gates that any party would have to pass through in order to qualify for any compensation. It is only international container trade; it is only going to be a capacity limit that we will define through a contest, and that is the best way to get the right risk and return for the state and value for the state; it is only if it is a state-sponsored facility, so if the private sector builds it, that is great, fantastic; compliant with transaction documentation obligations, so if the leaseholder is not in compliance with their lease, no payments; and the state, importantly, will have a device to say, 'If you're not investing and I as a state wish to invest, here is a notice. If you don't respond, then all bets are off'. There is a series of charts and gates that you would have to go through here in order to actually qualify for anything.

**Mr BURGESS** — In summary, the leaseholder is going to bear all the commercial risks. The only risk really the leaseholder cannot control is the state deciding for whatever reasons in the future that it wants to build a second port sooner than required and larger than required. That is something that a private leaseholder, he or she, cannot control. But of course the state is in control of its destiny in that respect.

**Mr BARBER** — My question for Treasury is: what advice have you given the government as to the economic benefits that will appear as a result of privatising the port? That is to say, what will a private investor do that the publicly owned port of Melbourne cannot or will not do?

**Mr WEBSTER** — In terms of the advice to government, we have thought very long and hard about the future regulatory regime, the incentives that that actually creates for investment in the port and the certainty that gives to the whole supply chain as far as further investment goes. So in terms of both strengthening and deepening the regulatory regime, we believe that creates the right incentives to stevedores to get the supply chain confidence in investing in the port of Melbourne. I think DP World signing up for a 50-year lease is evidence of people voting with their feet.

In terms of taking the transaction further, the reinvestment of those proceeds via the transport fund into a variety of infrastructure programs, including the level crossings and other infrastructure, obviously has flow-on economic benefits to the state.

**Mr MARTINE** — If I can just add to Mr Webster's comments, essentially it is an opportunity for the state to better leverage the state's balance sheet by, in a sense, recycling the assets into other assets. The commonwealth currently has a 15 per cent incentive payment on offer, so that effectively means that whatever we ultimately lease the port of Melbourne for, we will receive 15 per cent in two instalments, which is not an insignificant amount of money that is available. One of the key benefits here is leveraging the state's current balance sheet to enable those funds to be recycled into, as Mr Webster indicated, other infrastructure projects along with receiving the incentive payment from the commonwealth.

**Mr BARBER** — I understand that last bit. I did not hear anything that said a private port will necessarily be run better than a public port could be or should be, in terms of the advice you gave to government.

**Mr WEBSTER** — In terms of the philosophical benefits of privatisation, I think that is beyond the advice which we have been asked for.

**Mr BARBER** — Thank you. New topic: what tangible steps have you made in terms of the government's plan B — that is, to sell the port under the State Owned Enterprises Act?

**Mr WEBSTER** — In terms of the ability to transact under contractual mechanism, effectively legislation remains the preferred option. We believe that gives the optimal outcome for the longer term interests of the state. In terms of a contractual route, effectively a combination of the State Owned Enterprises Act and other levers would mean that a lot of the obligations which legislation would place on the leaseholder would have to be retrofitted and would place similar or analogous controls via way of contract. There has been initial thinking done in terms of how that would be constructed.

**Mr BARBER** — So just initial thinking, no tangible steps beyond that?

**Mr WEBSTER** — Initial thinking in terms of setting out a process for a potential transaction, but plan A is via legislation.

**Mr BARBER** — Thank you. New topic, and this is my last one: coming back to what you said — that really it is just a balance sheet thing plus Joe Hockey's 15 per cent and that the main benefit is the money that then gets spent on the level crossings — in terms of that level crossings portfolio, which I think is 50 crossings costing around $6.5 billion, what work have you done to demonstrate the financial and economic benefits of that portfolio of works? Has there been a business case, is it a gateway, is treated as high-risk, high-value — what work has Treasury done around that job of work?

**Mr MARTINE** — The work is underway on the 50 level crossings. There is a number that have been already announced, and business cases are being finalised for those. From memory, I think the government's indicative costing for the full 50 was $5 billion to $6 billion over an eight-year period, with an intention, I think the government indicated in the budget, of completing around 20 in first four years. Certainly that work is underway, but there have already been announcements for I cannot remember exactly the number of level crossings, but that work is certainly being completed on those.

**Mr BARBER** — Just the final bit: in terms of those business cases that are underway, what are the monetised benefits that you are uncovering for level crossing removal, and can you give us a hint as to the kind of benefit-cost ratio that might appear?

**Mr WEBSTER** — I do not have the numbers in front of me aggregating all of the individual business cases that have been done to date. There is a program-level business case which looks at the entire program of 50 and will look at the aggregate benefits and costs of the program in total. That is in development.

**Mr MARTINE** — If I can just add, certainly a key metric that stays in my mind is that a number of level crossing gates remain down for something like 40 minutes during peak hours. These are major arterial roads, so that does create quite a significant drag on traffic flows, a drag on productivity et cetera. Some of these are quite significant projects to undertake to actually improve that traffic flow and reduce congestion on some of these major arterials.

**Mr BARBER** — I am keen to learn, Chair, how the benefits are monetised, so if we can get some more information on that down the line, that would be very helpful.

**The CHAIR** — That might be something we can come back to.

**Mr MARTINE** — Yes, we can take that on notice and seek to provide the committee with some more information

**The CHAIR** — If you can provide some more information on notice, that would be appreciated. Thank you, Mr Martine.

**Mr PURCELL** — Back to the regional growth regime, I am interested in the capacity issue, how the regime will work and how you actually determine capacity.

**Mr MARTINE** — I might get Mr Rizos to run through how that will work in practice. I guess the main point to mention up-front, and we covered this in the hearing a few weeks ago, is that it will be biddable issue, so we will be sitting down and getting the proponents to actually bid for some of these arrangements to maximise the value to the state — but I will just get Mr Rizos to run through some of the detail.

**Mr RIZOS** — We are confident that the port can get to somewhere in the order of 7 million to 8 million TEU, because as David alluded to earlier, the port growth regime is premised on the ability to get to 7 million or 8 million TEU. There are a number of documents in the public domain. I draw your attention to the port of Melbourne website, which has two documents — a 2006 document and a 2009 document — that clearly articulate the port's ability to get to in the order of 7 million to 8 million TEU. So we are confident. We have also had work performed in the confidential setting of the data room that provides us with sufficient confidence that that is achievable. From that perspective we are in no doubt that the port can achieve a 7 million to 8 million TEUs outcome. I also note that the Port of Melbourne, represented by the CEO, will be speaking after us this morning, and he may also be able to shed some additional light on that.

**Mr WEBSTER** — In terms of the overlap with the port growth regime, I would redraw your attention to the 'use it or lose it' notice clause in there. Effectively what that is set up to do is if the port of Melbourne is say, for example, at 5 million TEUs and is not expanding and there is a need for additional container capacity for the state, the state can effectively put the Port of Melbourne on notice that, 'We believe the state needs more port capacity, and if you do not deliver that port capacity, the state has the right to deliver that capacity which is needed, and if you have not built it and we do that, then that does not attract the port growth regime compensation'. So there is an inbuilt protection there if the Port of Melbourne does not deliver future capacity as expected.

**Mr PURCELL** — If I could, through the Chair, the Port of Melbourne basically said that the volume through the port grows with the population. We have currently got 2.5 million containers, approximately, through the port, with a population of 4 million. If we go to 7.5, we are talking about a population of 12 million. What work is being done to make certain that you can actually get in and out of the port rather than just have capacity, so that the production that currently comes from the Riverina and other parts, even of South Australia, does not go to other ports so that we could finish up with capacity in the port but no way of getting it in there so the port could still have capacity but the state is actually being negatively impacted because goods are going to other ports, particularly Botany?

**Mr WEBSTER** — I will initially touch on that and then pass across to Nick. Effectively the state has that issue regardless of whether the port is in private hands or in state hands. In terms of managing the landside transportation logistics, effectively nothing changes by way of the transaction. The port expansion regime is subject to the same environmental controls. There is an extensive consultation mechanism in there through port capacity plans and ongoing dialogue with the state. The state will have to respond to the growing freight task throughout the state, regardless of who owns the port or who leases the port longer term. Nick, did you want to elucidate on that?

**Mr RIZOS** — Yes. As Mr Webster alluded to, the strategy in terms of the way we have set up the transaction is to ensure that the state retains as much strategic flexibility as possible, and that goes to landside infrastructure and investment as well. There is nothing that constrains or commits the state in relation to landside investment outside the port gate. Importantly, the state will be in an active relationship with the port of Melbourne operator for the duration of the 50 years. We will have in place port development strategies and port development plans that will be considered at five-yearly intervals, it is proposed, between the state and the port operator. They are geared towards ensuring that the state has absolute visibility on demand projections, as perceived by the port and as considered by the state, and also how capacity will be provided to meet that projected demand over the journey.

I think as per one of the graphs that was presented earlier, demand projections vary from time to time, so projections that were set two or three years ago are likely to be out of date, and they move from time to time as we would expect. So what we have done is design a framework that provides the state with sufficient visibility to engage in appropriate planning outcomes for the state and ensure that the scenario that Mr Purcell alluded to is not possible and frankly that the state can manage that outcome.

The other thing we are providing for in the context of the transaction is we are ensuring that the rail option is preserved. We consider that to be a significant strategic outcome that the state wants to ensure it preserves, so we are protecting rail corridors and we are ensuring that a rail option is considered by bidders as part of the bidding process.

**Mr PURCELL** — Through the Chair, I would just like to challenge one part of that. The issue is that if it was still in state hands, the state has the option of building a second port and using a second port even though capacity exists in the port of Melbourne, whereas we are taking that away under this because we are saying even if you have capacity and you cannot use it for whatever reason, you cannot build another port and take the income out of it without compensating the port of Melbourne, so it does actually make a difference.

**Mr WEBSTER** — The state has the unfettered right to build a second port whenever it wants, wherever it wants and how big it wants — —

**Mr PURCELL** — And to pay compensation.

**Mr WEBSTER** — To pay compensation. Again to put it into context, last year the port of Melbourne revenues — revenues, not profit — were $358 million. Landside costs of, sorry — —

Hastings has been estimated at $12 billion-plus, excluding the extensive landside infrastructure that will be required for that, so that gives you some feel for what sort of numbers we are talking about.

**Mr MARTINE** — If I can just add to Mr Webster's answer, I think one of the important points here is in that scenario the state would then be collecting the revenue stream, so in a sense what would effectively be happening is the bidder who originally paid for that revenue stream upfront, are receiving back that component of what they paid because we as a state are then going to collect that revenue stream over a period of time. I think that is an important point to think about in terms of the term 'compensation'. It is a bit like a component of a refund for what they actually previously paid for, which was a revenue stream that we are taking away, because we are now going to collect that revenue stream.

**Mr PECK** — If I can add just a couple of observations, it is not unusual that transport capacity today does not exist for potential transport volumes in 30 years time, because the state will build it when it is actually required. If you look at overseas examples, there are old ports in Europe that are up river, if you will, which is like in our bay if I can use that analogy, that are much busier, and international container ports that have the same issue, and they work through it over time. This is not a unique issue in terms of supply chain development over time around a trade centre. There are far more congested trade centres in other markets offshore, and the same issues apply, and governments and industry work together to get to the right solution.

**Mr ONDARCHIE** — Thank you. Julian, I want to talk about the economic benefit to the state in terms of value uplift of selling the port as a monopoly underwritten by compensation. Would you like to share your view about what the value of that is potentially? Not in terms of an actual number, but in having compensation around this.

**Mr PECK** — Obviously it would not be in the public interest for me to speculate on valuation, which you understand, but I think the difficulty the private sector has with this sort of issue — and hence the regime that has been proposed — is the inability to value sovereign risk.

If I wanted to look at another industry to draw an analogy, if you look at wind farm investment in Australia in the last few years, it has been particularly problematic. Every time there is a review of the RET scheme wind farm investment stops. It has a chilling effect because private sector cannot hedge sovereign risk, it cannot lay it off to someone else; the only thing the private sector can do in the face of that sort of risk is simply to not invest, and that is what will happen.

So what we are trying to achieve for the state here is the right balance of value upfront, because business can value the port with confidence. They are not held to hold 100 cents on the dollar, as the gents have explained; there is a first loss concept in here, so we are not providing a 100 cents in the dollar insurance policy here. What it does do, critically, is provide confidence that the state understands this issue, that the state effectively does not have a windfall gain where someone might pay upfront and then that effectively gives the state incentive to build over the top without any consequence.

We have looked at different models for this, but we think this is the best model, where all of the risks of developing and managing a port are with the private sector, with the one exception that we are looking at here, which is a state-driven change in market share that the private sector would just find it very difficult to price. So there is confidence around the cash-flow forecast, there is confidence around discount rate, and you can look at those things in different ways, and investors will run different scenarios here, but I would stress, and I think Tony would echo this, that upfront proceeds are only part of the rationale here. The bigger saving, frankly, if you run a valuation model is if the state gets the benefit of ongoing investment in low-cost brownfield capacity of port of Melbourne and the state defers a greenfield port that might cost 12 billion according to KPMG by 10 years. That value to the state far outweighs the upfront proceeds.

**Mr BURGESS** — In summary, I think really that the regime is designed to ensure that the interests of the private leaseholder align with the interests of the state, because if you go to that diagram on page 11, if the state retained ownership of port of Melbourne it would be adding capacity over the next 50 years ahead of the second port.

**Mr ONDARCHIE** — Yes, I understand.

**Mr BURGESS** — All we are trying to do in the lease transaction is to ensure that the private leaseholder behaves in the way that the state requires them to behave.

**Mr ONDARCHIE** — So the compensation, in a sense, is almost like a bit of a warranty or guarantee that you are going to hold to your word, and if you change your mind that there will be some sort of compensation paid back to the initial investor, or whoever owns it at the time?

**Mr MARTINE** — Yes.

**Mr PECK** — Yes.

**Mr ONDARCHIE** — So in a sense is the compensation almost a bit of a repayment for the extra value that they paid at the front end?

**Mr PECK** — You could look at it in that way, but I think the use of the guarantee I would qualify that in that — and David might want to chip in here — all the state is doing is guaranteeing the opportunity. It is not guaranteeing the capacity is going to be developed — —

**Mr ONDARCHIE** — No. But it is bringing the value upfront though, isn't it?

**Mr PECK** — It is guaranteeing the opportunity to have it, and they should price it efficiently.

**Mr BURGESS** — Two elements of it: some of the value upfront and also an encouragement to undertake the billions of dollars of investment in new capacity, additional capacity along the way.

**Mr ONDARCHIE** — I understand with the drivers are.

**Mr MARTINE** — But I think in terms of terminology, I think refund is actually a better term than compensation. Because in a sense as you indicated, they have paid for that revenue stream upfront. The state is then made a decision along the way to divert capacity. In a sense, the state would then be refunding the money that they paid upfront for that revenue stream — —

**Mr ONDARCHIE** — For that extra value.

**Mr MARTINE** — because the state will now be collecting that value through its own revenue stream from the new port.

**Mr ONDARCHIE** — That is a good point you make, David, but, Julian, something you just said in evidence earlier — that bidders do not face the loss of investment if the state decides to do so in terms of a second container port — —

**Mr PECK** — Bidders do not face the loss?

**Mr ONDARCHIE** — You said bidders do not face the loss of investment if the state decides to do so in terms of a second container port.

**Mr PECK** — They would have some loss, yes.

**Mr ONDARCHIE** — What happens if it is a private container port that is developed, not a state-owned or state contributed development?

**Mr MARTINE** — No compensation.

**Mr PECK** — No compensation.

**Mr ONDARCHIE** — No compensation?

**Mr MARTINE** — No. That is like any business. They also have a risk another private sector competitor might enter a market and compete, and you can never insure against that. That is just part of the normal business transaction, so there is no arrangement whatsoever for if a private provider built a port.

**Mr ONDARCHIE** — Do you estimate that will diminish the front-end value knowing that then?

**Mr WEBSTER** — Given the significant cost of developing a private second port, we believe that bidders can rationally price in that risk and give an efficient price for that risk.

**Mr PECK** — There is a private port inside Port Phillip Bay now. They could go and build a container terminal. You know the private sector can compete in that regard, and the state has no financial involvement in that outcome.

**Ms SHING** — Thank you, gentlemen, I will be very quick. Thank you for your submission and for providing the additional detail both through the slides and your contributions today. I note that in the overall submission there are numerous references to the duration of the lease, and the way in which that has been considered as compared with other jurisdictions. I would just like to understand as best we can with the time available what the rationale is for 50 years as being the proposed lease term when compared with the 40 year period that was earlier discussed, and what that delivers in terms of benefits.

**Mr MARTINE** — I might just get Mr Burgess to run through that.

**Mr BURGESS** — I can take that. In determining the appropriate lease term for a port such as the port of Melbourne there are three key factors. The first one is what is the natural capacity of the port and how long, given expected trade growth, will it take to get there? That is point one, and within that how long do you really require the investment in that extra capacity that you need for the landlord and the tenants, the stevedores, to actually get a return on that investment? That is bucket one. That really drives what we might call the minimum length of lease term.

On the other hand we know that during the next decades the port of Melbourne will reach capacity, and there will be a need for a second port. The question is at what point does a second port get built, and how are the capacity additions in that second port staged, and ultimately is that second port going to be a complete replacement of the port of Melbourne or complementary? The third element in this is the alternative use and value of the land at the port of Melbourne. As you know, the history of ports is that they move downriver and then ultimately go somewhere else.

When we look at this in the context of the port of Melbourne, under the coalition I think there was a marker down for 40 years, and I think that had reference to a KPMG report that has been released publicly in a redacted form, but which indicated a 30 to 40-year recommended term. That was premised on two things. It was premised first on capacity of around 5 million TEUs and also a growth rate in international container trade of 4.8 per cent per annum.

The subsequent work we have done in conjunction with the Port of Melbourne Corporation indicates that capacity is probably more likely to be 7 to 8 million TEUs, and that probably gives you another 10 years at least. In addition to that, if you look at the growth rate in international container trade, since the GFC, it has actually run at 2 per cent per annum. That is a long way short of 4.8 per cent. Now, the experts — and there are as many experts as you want to consult — are saying we are going forward on a multidecade basis, at a growth rate of perhaps 3.5 to 4 per cent.

So if you actually take the higher capacity that we believe exists at the port of Melbourne on the one hand and the likely lower growth in container trade, that comfortably gets us to a position of saying 50 years is an appropriate term, while retaining the State’s flexibility. That gives enough time for the leaseholder and the tenants to invest in that additional capacity to take it from 5 to 7 or 8 million TEUs on the one hand, while leaving the state with complete flexibility to decide what it wants to do on a second port, how big it wants to make a second port and also the flexibility to actually convert the port of Melbourne land into urban use. That is how we have balanced the factors to come to that.

**Ms SHING** — So it is a refinement of projections that has resulted in the 10-year difference between the 40 and the 50.

**Mr BURGESS** — Capacity and growth projections.

**Ms SHING** — Yes. Thank you.

**The CHAIR** — Thank you, Mr Burgess. Gentlemen, thank you very much for your time this morning. Obviously the committee will have follow-up matters to pursue with you, and it is the committee's intention to undertake a further hearing at the end of the inquiry after we have heard from third-party witnesses. So we will hear from the Department of Treasury and Finance again, but we appreciate your input and involvement this morning, and we look forward to further interactions over the course of the inquiry.

**Witnesses withdrew.**