

GLENCORE COAL PTY LTD

Submission to the National Competition Council

Applicant's response to the draft recommendation not to
declare the shipping channel service at the Port of
Newcastle

9 September 2015

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1 Introduction and executive summary

1.1 Purpose of Submission

On 30 July 2015 the National Competition Council ("NCC") issued a draft recommendation ("**Draft Recommendation**") in relation to the application by Glencore Coal Pty Ltd ("**Glencore**") dated 13 May 2015 ("**Application**"), not to recommend the declaration of the shipping channel services at the Port of Newcastle under Part IIIA of the *Competition & Consumer Act 2010 Cth* ("**CCA**").

In its Draft Recommendation, the NCC noted that the Application satisfied all but one of the criteria under section 44G(2) of the CCA, namely the requirement that access to the service promote a material increase in competition in at least one other dependent market ("**Criterion (a)**"). This submission focuses only on the NCC's consideration of Criterion (a) in its Draft Recommendation.

1.2 Executive Summary

NCC Approach to Criterion (a)

The matter concerns an application to declare the shipping services channel at the recently privatised Port of Newcastle, which channel is the only entry and exit to the world's largest coal export port, from which most of Australia's thermal coal production is exported. The New South Wales coal industry has contributed significant sunk investments in multi-billion dollar coal terminals at the Port of Newcastle and contributed to the dredging of the channel through industry levies or through express contributions required as part of building those coal terminals. This is not a matter where Glencore is seeking access to a third party's infrastructure which the third party is using to export its own products. Instead Glencore is seeking to have the recently privatised part of the coal industry's export supply chain made subject to access on reasonable terms so that in the future there will be consultation with industry before such price increases are levied and the possibility of arbitration of access terms will impose a reasonable constraint on otherwise unfettered monopoly power

In this context Glencore submits that the NCC's preliminary approach to applying Criterion (a) in the particular circumstances of this matter is not consistent with the intentions of Part IIIA and is a very dangerous precedent for future privatisations involving export supply chains. In particular the NCC appears to have been led into error by focusing on an initial price increase and the extent of that price increase compared to the overall cost of production and export of coal. Criterion (a) does not call for any analysis of the current price or future prices, against a background of the cost of production or sale price of a commodity, either explicitly or implicitly. Criterion (a) requires only that access (or increased access) to the facility materially increases competition in another market.

Impacts on Dependent Markets

Glencore submits that the NCC should reconsider its preliminary views that there is no material impact on dependent markets as the result of the unfettered ability of PNO to

increase prices and the price increases which have already occurred. The price rises already announced are material to decision making in the dependent markets as the price increases represent a significant proportion of the free cash flow of many mines (and increase the cash deficit at others by a significant proportion).

Further, Glencore believes that the price rises already announced represent only the beginning of the likely price increases that PNO will impose as it seeks to achieve its target returns in relation to the Channel services. These further increases will produce additional and more substantial adverse effects on competition in dependent markets.

Glencore submits that the NCC should more fully consider the impact on the markets associated with the maintenance and operation of existing mines and mine infrastructure and the development of new mines and mine infrastructure. A private infrastructure owner is likely to set prices at a level which will extract some of the "quasi-rent" earned by existing sunk investments in mines and mine infrastructure. By setting prices at these levels it will create disincentives and preclude future investment in new or expanded mines and mine infrastructure and in productivity measures for existing assets. This chilling in investment in mining will flow through to the other dependent markets.

Finally, Glencore submits that there are other matters to be considered when assessing Criterion (a) aside from the impact of current and future price increases arising from the infrastructure owner's essentially unfettered ability to impose price increases. In particular vertical integration issues. The NCC does not appear to have considered the issues which arise from the vertical integration of PNO with the shipping operations carried out by China Merchants, a 50% owner of PNO. Glencore submits that the NCC should do so, as that in particular affects the NCC's consideration of the impact on the shipping services market.

2 Application of legal test for Criterion (a)

2.1 The Section 44G(2)(a) Test

Section 44G(2)(a) of the CCA provides that the NCC cannot recommend that a service be declared unless it is satisfied that:

"access (or increased access) to the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service."

In considering Criterion (a), the Full Federal Court in *Sydney Airport Corporation Limited v. Australian Competition Tribunal (2006) FCAFC 146* ("**Sydney Airport FC Decision**") held that the relevant counterfactual is to compare access with no access rather than declaration with the status quo. This requires a comparison between:

- (a) the future state of competition in the dependent markets with a right or ability to use the service; and
- (b) the future state of competition in the dependent markets without any right or ability or with a restricted right or ability to use the service.

This is also referred to as "with" or "without" access test. In the *Sydney Airport FC Decision*, in applying this test the Full Federal Court held that it was consistent with the parliamentary intention and statutory interpretation of Criterion (a) and distinguished it

from the test applied by the Tribunal¹ in that matter, namely, that the question is determined by comparing a market in which the status quo prevails with a market in which declaration is granted.

The Full Court in the Sydney Airport FC Decision adopted the "with" or "without" access test, particularly as the legislation expressly stipulates whether "access or increased access" rather than whether "declaration" would promote a [material] increase in competition.

This is important because the Full Federal Court considered that being able to obtain access on reasonable terms and having the ability to have terms and conditions subject to arbitration was a mechanism to ameliorate the power of a party with market power.

2.2 NCC's approach in Draft Recommendation

The NCC stated in its Draft Recommendation that while there could be some circumstances that could lead to a material increase in competition in dependent markets, the increase in charges by PNO cannot be demonstrated in the present circumstances to be likely to cause such an increase. The NCC not only refrained from undertaking a detailed counterfactual analysis of the relevant markets, but the limited analysis it did carry out was not conducted on the basis of the "with" or "without" declaration counterfactual. The NCC reasoned that the insignificant proportion of the navigation service charges to the overall FOB coal production costs prevented it from giving any close consideration to how competition would be affected in each of the dependent markets identified by Glencore.

In Glencore's respectful submission, there are a number of issues with the NCC's approach to determining Criterion (a) in the Draft Recommendation. The Draft Recommendation focuses on the impact of the single price increase which PNO has imposed and the relatively small proportion of overall cost that the charges for the navigation service represent.

However, Glencore's application was not based upon a single price increase, but the unfettered ability of PNO as the monopoly bottleneck infrastructure owner to *increase charges in the future* because it has the ability and incentive to do so to recover the very high price it paid for the Port Assets from the State of New South Wales and whether access or increased access on reasonable terms would materially increase competition in dependent markets.

The Sydney Airport Decision is an important precedent for Criterion (a) and offers a number of important findings that are particularly relevant for Glencore's Application and which Glencore believes the NCC should attach greater significance to in finally determining satisfaction of Criterion (a).

2.3 NCC approach in Sydney Airport Decision

Glencore notes that the NCC's focus on the proportion of navigation service charges to overall costs was the same approach adopted by the NCC in relation to Criterion (a) in its initial recommendation in the Sydney Airport Decision to not declare. The argument also being that the airside service charges in that application represented a small portion of the overall costs, making any impact on competition unclear:

"For criterion (a) to be met, the Council needed to be satisfied that declaration would promote competition in the relevant passenger or freight domestic air

¹ Virgin Blue Airlines Pty Limited [2005] ACompT 5 ("**Tribunal Decision**").

*transport markets. In particular, the Council considered that SACL's incentive to exercise market power by increasing prices for the airside service was likely to be constrained by SACL's desire to increase passenger traffic to maximise revenue from retail concessions and the threat of re-regulation. **Furthermore the Council considered airside service charges were only a small contributor to the overall costs of air travel and it was unclear that SACL's proposed charges would advantage some airlines over others so as to risk limiting downstream competition.***

While SACL's ability and incentive to exercise market power was not considered to be completely hindered, the Council was not satisfied that the impact of such a tempered exercise of market power on competition in the dependent markets would adversely affect competition to a material degree. The Council therefore considered that criterion (a) was not met."²

2.4 Tribunal in Sydney Airport Decision

The NCC's initial approach was in considerable contrast with the approach of both the Tribunal and Full Federal Court which, while adopting different counterfactual approaches, determined Criterion (a) was satisfied by focusing on the monopolistic characteristics of the relevant infrastructure as well as any relevant constraints on the monopoly power of the service provider.

The Tribunal's decision looked at promotion of competition by reference to whether the conduct of the service provider (or monopolist) would, in the absence of any other competitive constraints, be constrained by declaration such that a more competitive environment would result. The Tribunal disagreed with the NCC and considered that the manner in which the service charges were imposed and the lack of consultation in changing them also pointed to the service provider's unconstrained monopoly power. The Tribunal also had specific regard to the privatization of the airport and the incentives of the monopoly service provider to derive revenue from the charges (our emphasis below):

*The critical issue in assessing whether increased access would promote competition in the dependent market was **whether there would be an enhancement of the competitive environment, and a greater opportunity for the implementation of competitive conduct in the dependent market.** This assessment involved comparing the future with declaration against the future without declaration, that is, a comparison of the factual and counterfactual*

*One of the principal issues canvassed in the proceeding was **whether SACL had misused its monopoly power in such a manner as warranted the conclusion that there had been, and would continue to be in the absence of declaration of the Airside Service, an effect on competition in the dependent market.** When we refer to a misuse of monopoly power, we are referring to an exercise of power in a manner which would not occur in a competitive environment.*

*One of the principal issues canvassed in the proceeding was **whether SACL had misused its monopoly power in such a manner as warranted the conclusion that there had been, and would continue to be in the absence of declaration of the Airside Service, an effect on competition in the dependent market.** When we*

² See http://ncc.gov.au/pre-2004-application/application_by_virgin_blue_airlines_for_declaration_of_the_airside_services.

refer to a misuse of monopoly power, we are referring to an exercise of power in a manner which would not occur in a competitive environment.

We are satisfied that SACL has misused its monopoly power in the past, and that, unless the Airside Service is declared, competition in the dependent market will continue to be affected.

In particular, we are satisfied that SACL has misused its monopoly power by the manner in which, and the reasons for which, it changed the basis for its charge for providing the Airside Service in July 2003 from an aircraft's maximum take-off weight ("MTOW") basis to a charge on a per-passenger basis ("known as the Domestic PSC"). This change adversely affected low cost carriers such as Virgin Blue as against full service airlines such as Qantas.

Further, the evidence disclosed that SACL chose a passenger-based charge "because Qantas preferred it." At the time the basis for this charge was altered, SACL knew that it would impact more adversely on Virgin Blue than on Qantas.

SACL submitted that the Domestic PSC encouraged a more efficient use of the services and facilities provided at Sydney Airport than did the former MTOW-based charge, and that efficient pricing principles warranted the use of a Domestic PSC. We have rejected this submission. We are satisfied that efficient pricing of the Airside Service required consideration of the underlying cost drivers of that Service by reference to the nature of the aircraft using the Service, rather than by reference to the number of passengers travelling in such aircraft.

*A number of issues were raised in relation to the level of revenue SACL would be able to derive in the future. We are satisfied that, in the light of the history of the development of the Domestic PSC and the manner in which SACL is contemplating imposing further charges, **these revenue issues are likely to be resolved by SACL exercising monopoly power to impose upon the airlines a level of revenue growth which would not be open to it in a competitive environment.** While these issues are outstanding, and where the airlines have no recourse to independent arbitration and determination, **there remains the opportunity for SACL to impose higher and additional charges upon the airlines which would be unlikely to be accepted in a more competitive environment.**³*

(emphasis added).

2.5 Full Federal Court in Sydney Airport FC Decision

The Full Federal Court focussed on the natural monopoly characteristics of the infrastructure providing the service. In accepting that Criterion (a) had been satisfied it held:

"Virgin submitted that, on its alternative construction, which we favour, it is clear that s 44H(4)(a) would be satisfied...because (as substantially found by the tribunal) (a) Sydney Airport is a natural monopoly and SACL exerts monopoly power; (b) the airside service is a necessary input for effective competition in the dependent market; (c) neither Bankstown or Richmond Airport could provide the service; and (d) the parent company of SACL had the first right of refusal to build and operate any second major airport within 100 km of the Sydney central business district.

³ At [12] to [16] of Tribunal Decision.

Further, there was no real debate among the experts before the tribunal that, given the strategic nature of Sydney as Australia's largest city and a significant gateway to international air travel, access to Sydney Airport is essential to compete in the domestic air passenger market.

In these circumstances, there appears little doubt that on Virgin's alternative arguments s 44H(4)(a) must have been satisfied here.⁴

Glencore believes that the Channel Services to the Port of Newcastle are of a similar strategic nature and essential input as Sydney Airport. This is because the Port of Newcastle is the world's and Australia's largest coal export port and that therefore access to the Port is essential for competition in dependent markets.

3 Impact on Dependent Markets

3.1 Glencore approach

In its Application, Glencore suggested that declaration of the Channel Services would materially increase competition in a number of dependent markets namely:

- (c) a coal export market;
- (d) a market for the financing of coal mining projects in the Hunter Valley (including the expansion of existing projects);
- (e) markets for the acquisition and disposal of exploration and/or mining authorities;
- (f) markets for the provision of infrastructure connected with the mining operations including rail, road, power and water;
- (g) a market for services such as geographical and drilling services, construction, operation and maintenance; and
- (h) markets for the provision of shipping services, including shipping agents and vessel operators.

3.2 NCC approach

The NCC's approach on dependent markets in the Draft Recommendation is less than clear.

The NCC expressed concerns as to whether these markets are broader geographically than the Hunter Valley region. Glencore would submit that in some cases this cannot be the case – for example mines and mining tenements are defined by a physical location, as is mining infrastructure. Other services are likely to be relatively localised, for example construction services.

The NCC indicated that, in any event, it did not believe that competition would be increased materially because of the small impact that the initial cost increase would have on coal mining operations compared to the total exported coal price. Glencore does not believe that is the correct test. The test is whether declaration of the Channel Services would materially increase competition in at least one of these dependent markets. Access to a monopoly bottleneck is likely to increase competition materially in each of the

⁴ At [91] to [92] of Sydney Airport FC Decision.

dependent markets. This is the case because access to that bottleneck is a material input for each of those dependent markets either directly or indirectly.

Second, as stressed at numerous points in this submission, there is no sound reason to focus only on the initial price increase. When looking at the impact on dependent markets, relevant question is the ability of PNO to price in an unfettered way. The manner in which price increases occur can illustrate the ability of an asset owner to price in an unfettered way. Assessing what has occurred to date, the Channel access fees were increased without consultation and apply in a discriminatory manner to larger coal vessels that are more efficient and service only certain types of ports.

3.3 Financing of coal mining operations

Finally, the NCC discounted there being a financing market for coal mining operations or infrastructure in the Hunter Valley. The relevant coal mining operations are in the Hunter Valley. The operators in the Hunter Valley export through the Channel, using the same defined set of infrastructure. This group of operators have no other economic means of export other than through the Port of Newcastle. In respect of those mining operations, and the other infrastructure operations which rely upon those mining operations for their income, there are a range of financial institutions willing to finance those operations and expansion of those operations. Given the common risks associated with the Hunter Valley infrastructure, potential financiers will regard those potential borrowers as subject to the same risks. Financiers will look in the aggregate at their exposure to common risks, such as the availability of export through the Hunter Valley coal chain. This approach of financiers effectively creates a market for the finite aggregate exposure to such risks to which financiers are willing to be exposed.

In relation to the financing of the relevant parties, declaration of the Channel Services would decrease risks associated with future price increases that would remove the profit margin of those mines and make them uneconomic and therefore also unbankable. A decrease in risk creates an increase in the funds available for financing projects exposed to the same risk. If Glencore is correct that the relevant test is in relation to PNO to price in an unfettered way, then Glencore believes that the test is satisfied in relation to this market, particularly given the NCC's statement at paragraph 4.40 as follows:

The Council also acknowledges that, theoretically, an increase in the risk associated with Hunter Valley coal projects could increase the cost of finance for those projects. This could raise barriers to entry for new entrants (or to expansion for existing producers, which may have an effect on competition that could be improved via declaration.

3.4 Competition issues

On 4 September 2015, the Chairman of the Australian Competition and Consumer Commission ("ACCC"), Rod Sims, stated in his speech '*Competition key to restoring Australia's productivity*':

Access regulation of monopoly infrastructure

The last area I would like to address today is access regulation of monopoly infrastructure.

This is an area of particular concern to the ACCC because natural monopoly infrastructure can act as a bottleneck in the supply chain, hindering competition and productivity in upstream and downstream markets.

As I have just mentioned, I am concerned about the selling of monopoly or near monopoly assets without appropriate access and/or pricing controls in place. When privatised, such assets will result in the transfer of market power to private hands.

It concerns me when the argument is made that economic regulation is not required for such assets because any monopolistic pricing amounts to a pure transfer of economic rents between parties within the supply chain.

On this issue, the Productivity Commission noted in its 2013 inquiry into the National Access Regime that the transfer of economic rents between parties within a commodity export supply chain could occur without any impact on the supply decisions of existing suppliers.

This seems to suggest that policy makers should pay no attention to the ability of a bottleneck monopolist to extract rents from upstream or downstream firms in a commodity export supply chain.

I take a different view.

To produce or extract an important commodity like coal requires a major sunk investment in mining equipment and infrastructure. These sunk investments give rise to what are known as “quasi-rents” which are subject to the threat of hold-up.

The threat of expropriation of rents by a monopoly service provider in such a situation does not merely result in a pure transfer. Rather, the threat of such expropriation can limit future investment and innovation by the upstream firms.

What miner would invest in reducing its extraction costs if it knew that the lower extraction costs would simply be met by higher transportation charges? More generally, what miner would invest in its mines knowing that the benefits of that investment could be expropriated by a monopoly somewhere else in the supply chain?

This effect is, of course, not just limited to mining. The threat of expropriation of rents by a monopoly service provider may also discourage Australian farmers from investing in, for example, farm machinery or new seed technologies.

This is an illustration of a more general point that should be more widely recognised. Monopolies can be harmful in that they can limit investment and innovation in upstream or downstream industries.

Monopolies, therefore, generally require effective economic regulation.

The ACCC Chairman has issued a clear statement of the issues that Glencore and the Hunter Valley coal industry face in the absence of declaration of the Channel Services. The issue that coal producers in the Hunter Valley face is also distinguished from the issues faced in the Pilbara in Western Australia. The Channel provides the only access to the stranded infrastructure services where users to existing long term take or pay contracts and therefore have no other commercial access options.

4 Impacts of recent Channel price increases

4.1 The Channel is the only shipping access to the Port of Newcastle

For the purposes of Part IIIA, the relevant issue is the unfettered ability of PNO to control access to the Channel and impose charges on access to Channel Services at the Port of Newcastle. The Hunter Valley coal producers have no alternative route to export their coal and therefore coal buyers have no choice but to pay the charges imposed by PNO to use the Port of Newcastle.

The Channel is a classic bottleneck. Coal vessels cannot access the infrastructure in the Port of Newcastle except by accessing the Channel to the Port. This infrastructure includes coal terminals such as the terminal owned by Newcastle Coal Infrastructure Group ("NCIG") and the Port Waratah Coal Services Terminal ("PWCS"). Coal producers have long term coal take or pay contracts for coal loading at these terminals. Coal producers also have long term take or pay contracts with above rail operators such as Pacific National and Aurzion for rail coal haulage and long term take or pay access contracts for access to rail infrastructure into the Port with Australian Rail Track Corporation ("ARTC"). Even if there was an alternative port from which Hunter Valley coal producers could ship their coal (which there is not), the costs of breaking these long term contracts would prevent the Hunter Valley coal producers using any such alternative.

4.2 Impact on coal producers

Glencore strongly believes that the NCC's Draft Recommendation, in focussing on the current increase by PNO being 1% of the total delivered cost of coal from the Hunter Valley, does not give sufficient weight to the impact of the cost increase to mining operations in the Hunter Valley. Coal producers are operating on minimal margins and in some cases are loss making at the current time.

Glencore believes that it was more appropriate for the NCC to look at the actual costs involved and operating margins of Hunter Valley Coal Mines at present, rather than the exported coal prices which PNO considered. The current and more importantly future price increases by PNO will have a material impact on the coal industry generally in the Hunter Valley and not just "high cost" mines. Glencore's factual assessment of the Hunter Valley coal export industry (from its experience as the region's largest coal miner) is that it shows that approximately 30% of the regions 33 coal mines are currently operating at zero or negative cash margin and are therefore at risk of closure. A further 30% of mines are making a cash margin of less than USD5/t. Overall the average cash margin being generated by all Hunter Valley exporters is in the order of USD6.4/t. The outlook for coal prices is forecasted by many analysts to remain weak for at least the next two years. In those circumstances, Newcastle export growth projections have been cut from 7.3% p.a. in the period 2000 to 2015 to just 1.3% per annum for the period 2015 to 2030. This analysis is based on information which is highly confidential to Glencore but Glencore is willing to make further details available for review by an NCC representative on a confidential basis.

PNO has suggested that the price increase was a mere transfer of a small component of the total cost of production to PNO. However, in reality, the increase reflects the ability of PNO as an infrastructure monopolist to extract a profit margin from the Hunter Valley coal producers. This ability to extract such a profit clearly impacts the incentives and risks of producing coal in the Hunter Valley. In turn this therefore does have a material impact on all dependent markets.

It is a material issue for all Hunter Valley coal miners for a monopoly infrastructure owner like PNO to be able to extract the small profit margin currently obtained from these mining operations and likely to be obtained in the medium term. It is not an economically rational approach to allow monopoly infrastructure owners to continually increase access prices to seek to claim super profits at the expense of productive industries.

5 Future Channel price increases

5.1 The ability for PNO to increase prices for access to the Channel Services

Glencore believes that when considering Criterion (a), the focus should not be on the amount that the charge in dispute represents or what the impact a singular charge will have but rather, the relevant considerations are much broader and include scrutinising the ability of the service provider to impose such charges, the opportunities of service users to engage in meaningful negotiation with the provider and the underlying cost drivers for the charges.

Glencore notes that it wrote to PNO seeking details in relation to the underlying cost drivers for the navigation service charges. PNO failed to provide supporting details of the basis upon which increases to navigation service charges were calculated. A copy of PNO's letter to Glencore dated 19 December 2014 is attached to Synergies Report attached to this submission.

5.2 NCC Draft Recommendation

The Draft Recommendation states that while there could be some circumstances that could lead to a material increase in competition in dependent markets, the increase in charges by the infrastructure owner, PNO, cannot be demonstrated in the present circumstances to be likely to cause such an increase. However, Glencore's Application was not based upon that single price increase, but the unfettered ability of PNO as the monopoly bottleneck infrastructure owner to increase charges in the future. As noted above, it has the ability and incentive to do so.

The NCC stated:

"4.21 For instance it is conceivable that, in the absence of declared access, the pricing increases imposed by PNO, and the largely unfettered ability of PNO to impose future price increases, will impact competition in a number of markets associated with the production and sale of coal for export from the Port of Newcastle [our emphasis]. This may occur because increases in charges for the service will add to the costs of producers, potentially making operations unprofitable, particularly for higher cost mines. This may lead to producers ceasing mining operations (either outright or by putting mines into care and maintenance), or cancelling or postponing mine expansions. It may contribute to making coal sourced from the Hunter Valley less competitive in global markets. These effects would also flow through to other markets related to the production and sale of coal from the Hunter Valley, including infrastructure services, specialist mining services and the acquisition of mining authorities. Declaration, and increased access to the service by way of 'reasonable' terms and conditions, could mitigate these effects, constraining PNO's ability to impose 'unreasonable' prices and providing certainty over future pricing decisions. These outcomes would enhance the conditions for competition in respect of the production and sale of coal, and in respect of the various other markets associated with that activity. Increased

access could therefore promote a material increase in competition in various dependent markets, and criterion (a) could be satisfied.

4.22 *While such a scenario is conceivable, in the Council's view it cannot be demonstrated in the present circumstances.*

4.23 *Critically, the Council considers that the charges for the service represent only a very small component of the overall cost of the production and sale of coal for export from the Hunter Valley. The price increases imposed by PNO necessarily represent a still smaller proportion of this cost. While producers are undoubtedly sensitive to the charges, it is difficult to conclude that changes to those charges would have a material impact on decisions that would affect competition in any relevant market. Consequently, it is difficult to conclude that increased access to the service would materially promote competition in a relevant market."*

We do not believe that the NCC's preliminary analysis fully addresses the impact of the current and likely future price increases by PNO on the Hunter Valley coal industry. We believe that the better approach, looking at the overall circumstances and reflective of the Application, is to look at the likely increases by PNO over time.

5.3 Likely PNO pricing strategy

The Draft Recommendation took a very benign view of PNO's likely future price approach and considered that it would not be inclined to price the services so as to drive coal companies out of business. The NCC noted PNO had not declined access to date. The NCC also stated that PNO was not vertically integrated. Glencore believes that this analysis is unusual. It is too simplistic an analysis of an infrastructure owner's incentives. PNO has every incentive to increase prices. As has been pointed out by the ACCC Chairman, the sunk investments in existing mines and mine infrastructure give rise to "quasi-rents". Given the sunk investments in existing mines and mine infrastructure, those existing assets will continue to be operated so long as they generate some cash from their operations. This means that there is considerable scope for a monopolist to raise its prices before the existing operations would be the subject of closure. However, to the extent that prices are raised – and certainly in any scenario in which prices are raised to the extent that this impacts on the ability of infrastructure and mine asset owners to achieve a return on capital rather than an operating cash surplus – this will preclude any further investment in, development or expansion of mines or mining infrastructure. Therefore, to the extent that the NCC applies a test based on whether existing coal mines and mine infrastructure are likely to be driven out of business, it may be allowing PNO to raise prices to an extent which will preclude investment in new or expanded mines, investment in coal handling infrastructure, or investment by existing mines in measures to increase profitability. Given that new or expanded production is likely to be incremental to existing production, the profits which can be extracted from increasing prices in respect of the existing volumes of coal production are likely to greatly outweigh the profits which will be generated by holding prices lower to incentivise new throughput and production. It would therefore seem likely that it will be in the interests of an unregulated infrastructure owner in the position of PNO to follow this course of action.

PNO has already raised its prices, notwithstanding that there have already been significant increases in volumes which have significantly raised its revenues, and given its relatively fixed cost structure raised its unit profits. It is likely it will continue to do so to ensure that the returns to its shareholders provide an appropriate return on the initial

high purchase price. For example Hastings Infrastructure Fund has an expected rate of return of 10 per cent from its assets.⁵

5.4 IPART regime

The NCC has found in its Draft Recommendation that PNO effectively has an unfettered pricing power in relation to access to the Channel but PNO has stated that this is not a concern given IPART's oversight role. Glencore does not believe that the possible threat of IPART review constitutes a material protection for Channel users. Only the NSW Government may trigger an IPART review. Access seekers and users of the Channel Services themselves could not seek redress through IPART. It is not known to Glencore what statements may have been made by the NSW Government or its advisers to PNO at the time of the privatisation of the Channel, but the NSW Government may at least have given indications of the levels of price increases that could be imposed without triggering an IPART review. It would certainly have increased the potential revenue available to the NSW Government from the sale of the Channel if NSW Government had been able to indicate an acceptable level of future price increases to bidders as part of the privatisation process.

6 Likely future increases to the navigation service charge

6.1 PNO's target revenue

Glencore, through the Economic Consulting Firm Synergies, has calculated that based on various conservative estimates of the cost base being used by PNO, that it will seek to recover at least an additional (in addition to the recent \$20m increase) amount between \$60m per year and up to \$180m per year, representing even on PNO's calculations between 3-6% of the total exported coal price.

As can be seen from the projections set out in the table below, Synergies' analysis indicates that, in order to earn a commercial return on its investment, PNO may therefore seek additional increases in navigation services charges beyond those implemented in its first year of ownership and in the range of 70-84% in future years.

According to Synergies' assessment, if PNO were to seek full recovery of its published value of its trade assets of \$2.398bn, it is possible that it may seek additional increases in navigation services of up to 211% in subsequent years.

The below table is extracted from the Synergies analysis which appears as an Annexure to this submission. The assumptions and basis for the calculations are set out in greater detail in the analysis.

Table 1 2015/16 Annual Allowable Revenues

	Scenario Description	2015/16 AAR	2015/16 Allowable NSC charge ¹	% increase from current NSC
Base case	Current estimated revenue	\$111,201,486	\$84,121,301	
Scenario 1	Asset Value at PNO's stated trade asset value of \$2.398b Channel life at 98 years	\$268,566,009	\$241,485,325	187%
Scenario 2	Asset Value at PNO's stated trade asset value of \$2.398b All asset lives at maximum of 50 years	\$288,438,024	\$261,357,840	211%
Scenario 3	Asset Value at PNO's purchase price of \$1.75b	\$170,404,974	\$143,324,790	70%

⁵ This 10% return is referred to on the Hastings Infrastructure Fund website.; <https://www.hastingsinfra.com/equity/tif/>

	Scenario Description	2015/16 AAR	2015/16 Allowable NSC charge ¹	% increase from current NSC
Scenario 4	Channel life at 98 years Asset Value at PNO's purchase price of \$1.75b All asset lives at maximum of 50 years	\$181,911,882	\$154,831,698	84%

¹ Allowable NSC charge is determined by deducting current revenue from other charges from the total assessed ARR for 2015/16. This assumes that price increases would most likely to be applied to the NSC charge component, which is largely paid by the coal industry.

Source: Synergies

6.2 Future implications of the navigation service charge

It is instructive to repeat the observations of Dr Yeates in context of the additional data outlined above.

While, in Dr Yeates' view, the navigation service charge represents just less than 1% of the FOB cost of export coal, it is likely to represent between 3 to 6% of the total exported coal price in the near future. Given that the majority of the mines in the Hunter Valley are operating at zero to negligible profit margins, the impact of the unregulated navigation service charge, whether as a less than 1% proportion or as a 3-6% component of the total cost, will certainly add to the costs of producers, making operations further unprofitable and may lead to producers ceasing mining operations and/or cancelling or postponing mine expansions.

Such an impact will most certainly have flow on effects in each of the Dependent Markets given the inter-dependence of upstream and downstream operations in the coal supply chain and the services markets which support this supply chain. Declaration of the shipping Channel service would result in transparency, certainty and a right to negotiate the navigation service charges such that, producers will be able to operate in improved and competitive conditions. Declaration and access on reasonable terms would further improve the conditions for competition in the Dependent Markets and in particular the market for financing of coal mining projects as well as the shipping services market.

Glencore does not believe that Criterion (a) should require that dire circumstances, such as the ceasing of mining operations, need transpire before it can be said that declaration of the service will result in a material increase in competition in a relevant market. The foreseeability of such circumstances, coupled with the likelihood of an increase in competition, demonstrates satisfaction of Criterion (a). This is consistent with the reasoning adopted by the Tribunal and Federal Court in previous decisions which consider section 44G(2)(a) of the CCA.

7 Non-pricing considerations

7.1 Ability to arbitrate

In the Sydney Airport Decision, in considering the future with declaration, the Tribunal discussed the need to assess what impact the opportunity for arbitration would have, and found that, where no effective dispute resolution was available to the parties, arbitration under declaration would result in a more competitive environment in satisfaction of criterion (a):

"In the factual SACL will be constrained from misusing its monopoly power in the future because commercial negotiations will be conducted with the knowledge that, in default of agreement, independent arbitration is available." [516]

"If declaration is made, the environment for the promotion of competition is enhanced in the dependent market because there will be an opportunity for all the matters to which we have referred to be resolved by means of independent arbitration, more in line with what would be expected in a competitive environment." [521]

Glencore notes that in the NCC Draft Recommendation at 3.13 the NCC stated:

"In the Council's view it is reasonable to assume that were the shipping Channel service declared, the actuality or threat of the ACCC determining shipping channel service prices as part of an access dispute will result in prices that are "reasonable" and in greater certainty as to how prices are determined. By "reasonable" prices the Council means prices consistent with those that might result from arbitration of a relevant access dispute."

In Glencore's submission, it should follow from this observation that arbitration is likely to result in a material improvement in the conditions for competition in the dependent markets given that there will be an opportunity for the pricing for the service to be both more reasonable and certain, particularly in the current environment where there is no opportunity.

7.2 Misuse of monopoly power

In looking at the future state of competition in the market without declaration (i.e. the status quo), the Tribunal in the Sydney Airport Decision gave considerable weight to whether the service provider both had the capacity to misuse its monopoly power and whether it had done so. It was persuaded that the service provider had misused its monopoly power by changing the charging regime in the manner it had, knowing it would be detrimental to Virgin.

At the hearing, issues were raised in relation to the level of revenue the service provider could derive in the future, the Tribunal was persuaded that the service provider would likely use its monopoly power to impose charges to obtain a level of revenue growth that wouldn't be open to it in a competitive environment.

In the Full Federal Court, while their Honours did not consider that looking at evidence of monopolistic behaviour was relevant to the test for Criterion (a), they nevertheless found that such evidence may be relevant to the decision to declare or not declare:

*That is not to say that what has happened in relation to the service, how the provider has behaved and the degree to which it can be said that monopolistic behaviour has or has not impeded the efficient operation of the market in question may not be relevant considerations attending the making of the decision. For instance, **if it can be demonstrated that the service has been provided in a manner that can be described as fair, even-handed and in a way most likely to maximise vigorous competition in the downstream market, that may be a powerful and relevant consideration as to why no declaration should be made.** Thus, it may be that with and without declaration counterfactual (or some aspect of it) can be seen as relevant to the decision at hand. That inquiry is simply not mandated by the precondition of satisfaction in s 44H(4)(a).⁶ (emphasis added)*

We note that, given the approach of PNO and the recent increase in navigation services charges without any consultation or proper disclosure of underlying cost drivers, nor any improvements being made to the facility providing the service, the service is not being

⁶ At [85] of Tribunal Decision.

provided in a way that will maximise vigorous competition in any of the downstream markets. As the NCC has found, PNO has an unconstrained ability to increase prices and this should be an important consideration in favour of a recommendation by the NCC to declare the service.

The dependence of the coal sector on monopoly infrastructure, which it is not possible to contract to access on a long term basis, has a significant and chilling impact on coal production for export through the Port of Newcastle.

7.3 Privatisation and lack of effective regulatory regime

In the Sydney Airport FC Decision, the Full Federal Court drew attention to the Hilmer report remarks that while Part IIIA is more likely to apply to facilities traditionally owned by governments, access issues will nevertheless arise in the private sector due to the increasing trend of privatization of state assets.⁷

The Tribunal, as can be seen from the extracts above, in considering Criterion (a) gave weight to the relevance of SACL's incentive to derive return from its investment through increasing charges for the airside services.

The ACCC Chairman Rod Sims has expressed similar concerns of privatization inciting monopolistic behavior.⁸ In its submission to the Competition Policy Review Panel, the ACCC expressed the need for more effective regulation of privatized assets in light of these concerns.

The decisions of the NCC and Court consistently refer to evidence of the service provider's ability to exercise monopoly power as supportive of findings that access is likely to promote competition. In the Glencore application, the NCC acknowledges (see paragraph 4.29 of the Draft Recommendation) that the existing regulatory regime is both, unlikely to provide meaningful constraints and would fail to satisfy requirements for being an effective regime capable of certification under Part IIIA.

Given the lack of effective regulation and the absence of any mechanism by which users of the navigation service may consult or otherwise negotiate with PNO in relation to charges, it is clear that declaration would create competitive conditions by providing users with a right to negotiate and subjecting PNO to the threat of arbitration by the ACCC.

The Full Federal Court in Sydney Airport FC Decision required a monopolist to provide the service in a way that would maximise vigorous competition in a relevant dependent market in order for a finding against declaration to be likely. In the current circumstances, there is no incentive on PNO to maximise competition because it had the benefit of a commercial investment of take or pay contracts with infrastructure assets stranded in the Port confines and all that PNO is seeking to do is extract monopoly infrastructure rents. If PNO had a more benign interest it would have consulted with industry on the price increases and certainly the revaluation of assets in order to increase the cost base for the purposes of its returns is inconsistent with seeking to maximise downstream competition. Further, as Glencore has pointed out, notwithstanding what PNO claims, there have been no improvements to the service justifying the increase in charges and PNO's characterisation of the increases being less than Port Kembla does not recognise that vessel traffic in the Port of Newcastle is far greater so that overall charges recovered are far greater (also leaving aside industry contribution to the channel dredging).

⁷ At para 15 of decision.

⁸ See <http://www.afr.com/markets/commodities/energy/sims-threat-to-big-state-asset-sales-20140622-j06bb>

The Full Federal Court and Tribunal in the Sydney Airport Decision also considered the privatised status of the service facility as relevant to findings that the service provider was likely to use (and had the ability to use) its monopoly power in a manner so as to derive revenue from the privatised asset. This is clearly applicable in the Glencore application as since the \$1.75 billion acquisition on 30 May 2014, PNO in its accounts to 31 December 2014 has increased the value of its Trade Assets, being "those assets which generate revenue or the Company excluding those assets which are associated with property leasing activities" to \$2.398 billion.

It is also worthwhile noting that the NCC's Draft Recommendation is also consistent with the position it took not to recommend declaration in the Sydney Airport Decision on the basis that any market power was constrained by SACL's need to charge competitive prices to ensure returns and also that the price increase was not significant. Neither of these points was supported by the Tribunal who, in contrast, found that any incentives tied to SACL's investment were to charge prices and create an uncompetitive environment. In Glencore's view, the very large purchase price paid for Port of Newcastle by PNO, the substantial value increase in a little over six months and the refusal to provide any analysis of the cost base upon which PNO is charging suggests that the initial price increase is just one of several to occur. The detailed Synergies analysis also supports that view.

7.4 Monopoly infrastructure and service as an essential input

The Full Federal Court noted in the Sydney Airport FC Decision that the airside services were a necessary input. This notion of access to the service being essential or necessary for effective competition in dependent markets was further explored by the Tribunal in the *Pilbara Infrastructure Decision*⁹. It was most recently observed by the NCC and the Minister in recommending certification of the Dalrymple Bay Coal Terminal ("**DBCT**") access regime in 2011. Here the NCC accepted that the DBCT exhibited natural monopoly characteristics and access to it was necessary to promote competition in the market for Queensland coal tenements and the coal export market. The Full Federal Court in the *Sydney Airport Decision* described the Airport's strategic location in Sydney and its status as a "*significant gateway to international air travel*".

Glencore previously emphasised the significance of the Port of Newcastle and the strategic location of the shipping Channel to the coal market and the national economy by reference to its contribution (thermal coal, the majority of which is exported from Newcastle). Glencore also described the physical uniqueness of the Channel and port which are quite different from the physical rail infrastructure in the Pilbara Infrastructure market.

8 Vertical integration

In addition to its views expressed in the *Pilbara Infrastructure Decision*, Glencore notes that the NCC guidelines also take into consideration the significance of vertical integration of a service provider when considering criterion (a):

"Although it is possible that criterion (a) may be satisfied where the service provider is not vertically integrated into a dependent market(s), criterion (a) will more likely be satisfied where the service provider is vertically integrated into the dependent market(s). The Federal Court stated in Sydney Airport Decision that:

⁹ Fortescue Metals Group Limited [2010] ACompT 2.

it is the very prevention of a vertically integrated organisation using its control over access to an essential facility to limit effective competition in dependent markets that is a key activity that the access regime seeks to deal. (at [45]).¹⁰

The NCC's Draft Recommendation has not taken into consideration the vertical integration of PNO via China Hastings' ownership of a bulk carrier shipping fleet (that does include coal tankers). The Draft Recommendation stated:

Not all, indeed possibly only a small subset of, price disputes or situations where prices may appear or be “excessive”, “monopolistic” or “gouging” will fall within the ambit of Part IIIA. The declaration criteria, in particular criteria (a) and (b), limit the ambit of the National Access Regime to situations where services are provided by facilities that are uneconomic to duplicate and where the price or other terms and conditions of access are such that competition is restricted in a market other than the market for the infrastructure service.

A classic example of such a situation is where a vertically integrated business controls a monopoly facility as well as competing in a dependent market which is otherwise open to competition. Where such a business tries to advantage its position in the dependent market through how it prices access to the monopoly facility, regulatory intervention may be necessary to promote competition in the dependent market.

Here there is no vertical integration between PNO's operation of the Port of Newcastle and other activities in the Hunter Valley coal chain.¹¹

It is noted that contrary to the suggestion in the draft NCC recommendation, the 50% shareholder in PNO, China Merchants does have a bulk carrier fleet which does include coal bulk carriers and therefore PNO is vertically integrated.

9 Conclusion

Glencore submits that Criterion (a) should be satisfied in this matter having regard to:

- (a) the threat of arbitration by the ACCC under declaration materially enhancing competition in the dependent markets in the absence of any effective negotiation/dispute resolution mechanism;
- (b) the unconstrained *ability* of PNO to engage in conduct that *could* hinder competition and the risks of that occurring not with a vertically integrated infrastructure operator; and
- (c) whether the infrastructure owner had and would continue (in the absence of declaration) to exercise its monopoly power in a manner which would not occur in a competitive environment.

Given:

- (i) the inability that the NCC recognizes for any party using the Channel Service to negotiate those charges (the IPART Review process can only be activated by the NSW Government);
- (ii) correspondence from PNO that it would not disclose the cost basis for the Port of Newcastle Charges;

¹⁰ See <http://ncc.gov.au/images/uploads/DERaFoDR-001.pdf> at para 3.17.

¹¹ See para 3.20 of draft recommendation.

- (iii) PNO's unfettered discretion to continue to set prices as it determines;
- (iv) the fact that there are no other practical ways to export coal from the Hunter Valley than loading it at the coal terminals for export through the Port which is not only a monopoly, but a bottleneck facility; and
- (v) PNO's investment incentives to charge at prices to recover a return on its investment (as acknowledged by PNO at pages 14 and 66 of its submission),

we believe that the NCC should find that declaration and access or increased access would result in a promotion or material increase in competition in at least one of the Dependent Markets identified by Glencore.

9 September 2015