Newcastle Coal Infrastructure Group

Submission in response to NCC Statement of Preliminary Views

Revocation Application for the Port of Newcastle shipping channel service

4 February 2019

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1 Executive summary

1 Newcastle Coal Infrastructure Group (**NCIG**) welcomes the opportunity to respond to the National Competition Council's (**NCC**) Statement of Preliminary Views (**Preliminary Views**) in connection with the NCC's consideration of the application from Port of Newcastle Operations Pty Ltd (**PNO**) seeking revocation of the declaration of the shipping channel service at the Port of Newcastle.

2 NCIG agrees with many of the conclusions reached by the NCC in its Preliminary Views.

3 In particular, NCIG agrees with the NCC that PNO:

(a) occupies a bottleneck position in the Hunter Valley export coal supply chain;

(b) is capable of servicing total foreseeable demand with its existing facilities; and

(c) in the absence of declaration, will have pricing power that is not able to be constrained by suppliers of other services, actions of its customers or any other regulation.

4 In short, the NCC has found that PNO is a natural monopoly and will be constrained in its future pricing only by its incentive to maximise profits - i.e. the only likely cap on future price increases is the level at which pricing for the Service so materially impacts on terminal throughput that an increase would result in a loss of overall profits. While NCIG agrees with this conclusion of the NCC, which is well supported by the relevant evidence, it is also the reason why NCIG maintains its strong opposition to any revocation of declaration.

5 NCIG remains concerned that the NCC has neither fully considered nor properly had regard to the likely implications of this unconstrained monopoly pricing by PNO on the Hunter Valley coal chain and competition in relevant dependent markets over time. The NCC's Preliminary Views in this respect are internally inconsistent, in that the NCC agrees with PNO that PNO has no material ability to price discriminate among users, but then fails to recognise that this means that monopoly pricing by PNO will inevitably lead to a reduction in volumes of coal exported through the port over time.

6 The NCC's Preliminary Views appear to be heavily shaped by the following central findings, which are either flawed or unsupported by evidence:

(a) that the service fees currently account for a "*very small component*" of the cost of coal of the "*average Hunter Valley coal miner*";

(b) that PNO has an incentive to maximise volumes handled through the terminal, as opposed to its overall profit; and

(c) that as the coal tenement market is derivative of the coal market, there cannot be any material adverse effect in that market if the primary coal market remains competitive.

7 NCIG submits that when these matters are assessed having proper regard to the evidence the NCC should conclude that criteria (a) and (d) continue to be satisfied in respect of the Service. This is particularly the case given that the NCC has discretion as to whether or not to make a recommendation to the minister in response to a request for revocation of declaration, and should have regards to the interest in maintaining consistency in regulation in circumstances where there has been no material change in market circumstances.

Pricing as a 'small component' of downstream pricing

8 The NCC in its Preliminary Views finds that the service fees currently account for a "*very small component*" of the cost of coal. This finding underpins the NCC's conclusion that monopoly pricing by PNO would not lead to a loss of coal export volumes.

9 To reach this conclusion, the NCC appears to rely upon an estimate provided by PNO of the margins earned by the "*average Hunter Valley coal miner*". However, this average margin figure is irrelevant to analysing the impact of price increases on demand for the service. What is relevant to an analysis of the impact on volumes of increases in costs is the profitability of *marginal* production, not average production. In a commodity market such as coal where there are large number of potential development opportunities and projects with a wide range of costs, the profitability of marginal producers will inevitably be very small or close to zero and will be materially affected by monopoly pricing of services by owners of bottleneck infrastructure.

PNO incentive is to profit maximise (not to maximise volumes)

10 The NCC appears to erroneously conclude that PNO has an incentive "*to maximise the volume of coal flowing through the Port*". This is incorrect. PNO has an incentive to maximise its overall **profit**, not its volume. PNO will readily accept lower volumes if doing so results in a greater profit from higher margins from servicing its remaining volume. Where the NCC has recognised that demand for the service is relatively price inelastic,[1] it is clear that the profit achieved by an increase in price on the remaining majority of tonnes will be far greater than the revenue lost by a decrease in volumes.

11 In the absence of any effective commercial or regulatory constraint, PNO will have an incentive to increase its charges to the profit-maximising monopoly price. In analysing arguments raised in respect to potential hold-up, the NCC agreed with PNO's submissions that it had no material ability to price discriminate among users. However, the NCC did not have regard to this finding in assessing the likely impact of monopoly pricing on volumes. With no ability to easily price discriminate among users, profit maximising pricing by a monopoly such as PNO will *inevitably* involve pricing in a way that causes demand for the service to be lower than it would otherwise.

Analysis of dependent markets

12 The NCC did analyse the effect of declaration on competition in the tenements market in the Newcastle Catchment area. However, the NCC also stated that it considered this market to be "*derivative*" of the broader coal export market, potentially implying that no effect on competition could be seen to arise if competition in the coal export market was not also affected. NCIG strongly disagrees with that assertion.

13 There are distinct geological, commercial and regulatory conditions which mean that the market for investment in tenements in the Newcastle Catchment area is distinct from investment in coal mines elsewhere in Australia or globally. Consistent with this, there are a large number of coal miners that operate exclusively or predominately in this region. To suggest that competition in the market for tenements in this region could not be impacted if competition in global coal markets is inconsistent with a proper understanding of these distinct markets.

Conclusion

14 NCIG considers that these are errors in the NCC's Preliminary Views. The NCC's conclusions on these points lead it to wrongly conclude that criteria (a) and (d) for declaration are not satisfied. Specifically:

(a) with respect to criterion (a), PNO's incentive to maximise profits (and not volume) will inevitably lead it to price at a level which has a disproportionate impact on new entrants as well as smaller coal miners with a portfolio of more marginal tenements, thereby distorting competition in the related coal export and Newcastle Catchment tenement markets;

(b) with respect to criterion (d), in the absence of declaration PNO's pricing is likely to be at a level that will result in lower coal volumes being produced in and exported from the Hunter Valley, which means that declaration will be of significant public benefit by

[1] NCC Preliminary Views, 6.27

maintaining these production volumes (and resulting employment, coal royalties and wider contribution to economic activity) as well as the competitive conditions for new entrant, smaller and marginal coal producers.

15 The outcome of the current revocation application is likely to have far-reaching, and long-term implications for participants across the Hunter Valley coal supply chain. Glencore commenced its initial application for declaration in May 2015 and has expended substantial resources since then in continuing to pursue declaration. If PNO's current application for revocation is successful, there is a small prospect of any other party going through the costly and time consuming process of applying for declaration.

16 Because of the long-term impact of the NCC's decision, NCIG submits that it is critically important for the NCC to properly assess the impact of its finding that PNO will operate as an unconstrained natural monopoly in the absence of declaration and the true magnitude of pricing increases that it will be profitable for PNO to pursue in the absence of declaration. In doing so, NCIG submits that PNO will inevitably price its services in a way that is to the detriment of competition in dependent markets, existing and future coal producers and the economy more broadly.

17 NCIG submits that the NCC, when the likely magnitude of profit maximising price increases is understood, should consider the criteria for declaration as being satisfied, and reject PNO's application for revocation of the existing declaration.

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2 Criterion (a) – promotion of competition

(a) Identification of dependent markets

18 In its Preliminary Views, the NCC considered the following dependent markets:

(a) the coal export market;

(b) the tenements market; and

(c) the container port market.[2]

19 NCIG agrees that these are relevant dependent markets for the purpose of the present application. NCIG also remains of the view that the other two dependent markets described at paragraph 6.60 of the NCC's preliminary views (the infrastructure market and the specialist services market) are distinct dependent markets, although it acknowledges that there are unlikely to be competitive impacts in these markets that are distinct from those in the three markets analysed by the NCC.

20 However, the NCC also stated that "*The Council remains of the view that the tenements market is a derivative of the coal export market but considers it appropriate to examine the tenements market in greater detail given the submissions received.*" If the NCC means by this that a competitive effect in the tenements market can only arise if there is also an effect in the coal export market, NCIG disagrees. As described in more detail in a number of previous submissions to the NCC,[3] there are distinct geological, commercial and regulatory conditions which mean that the market for investment in tenements in the Newcastle Catchment area is distinct from investment in coal mines elsewhere in Australia or globally.

21 Consistent with this, there are a large number of coal producers that are solely or principally based in Newcastle Catchment area, including Whitehaven Coal, Malabar Coal, NuCoal Resources, Bloomfield Group, Centennial Coal and Australian Pacific Coal. In other words, the

[2] NCC, Preliminary Views, 6.74

[3] NCC, Preliminary Views, 6.129 – 6.136

market participants are a much narrower group than the market participants in export coal markets.

22 Based on the clear evidence, NCIG submits that the NCC must recognise that there is a distinct market for coal tenements in the Newcastle Catchment area, which would be likely to be impacted by the actions of PNO and irrespective of the effect of conduct on the global coal market.

23 This conclusion is consistent with the draft decision of the QCA in December 2018, in the context of its review of the declaration of the Dalrymple Bay Coal Terminal under the certified Queensland access regime, that there is a distinct geographic market for tenements in the Hay Point catchment area in Queensland.[4] This conclusion was supported by an independent expert report commissioned by the QCA in that review.[5]

(b) Analysis of likely market conditions in the absence of declaration

24 NCIG agrees with a large number of factual conclusions expressed by the NCC in its Preliminary Views. In particular, NCIG agrees that:

(a) PNO "*has an incentive to maximise profits… occupies a bottleneck position in the Hunter Valley export coal supply chain*… and *may therefore have both the ability and incentive to earn monopoly profits by denying access to the service, significantly increasing charges for the service"*;[6]

(b) *"current users of the Port are not an effective constraint."* on the market power of PNO "*because they have no effective alternative to using the Service, limited ability to pass on increases in Service access charges, and the demand for the shipping channel service is relatively price inelastic*";[7]

(c) if the service is not declared, NSW regulations and provisions in the lease between the State of NSW and PNO provide, respectively, only "*some very limited constraint on PNO's behaviour*" and "*for some influence over PNO by the State*", but the extent of constraint and influence falls well short of that which would result from declaration under the National Access Regime;[8]

(d) terms of access as a result of declaration "*are likely to be more favourable for users of the Service than those which would be set by PNO in the absence of Declaration*;[9]

(e) *"the Port could meet the total foreseeable demand in the market in the Relevant Term and at the least cost compared to any two or more facilities"*;[10] and

(f) *"the Service is a bottleneck monopoly in the coal export market."*[11]

25 In short, these conclusions amount to a finding that PNO, in the absence of declaration, will operate as an unconstrained natural monopoly, with the ability and incentive to engage in monopoly pricing.

[4] QCA, Draft Recommendation, Part C: Declaration Review, December 2018

[5] Balance, DBCTM Declaration Review, Independent Opinion for Queensland Competition Authority, 31 August 2018

[6] NCC, Preliminary Views, 6.26

[7] NCC, Preliminary Views, 6.27

[8] NCC, Preliminary Views, 6.41 and 6.43

[9] NCC, Preliminary Views, 6.49

[10] NCC, Preliminary Views, 7.7

[11] NCC, Preliminary Views, 10.4

26 The effects of monopoly pricing are well understood, and were analysed by the Productivity Commission in the context of its 2013 review of the National Access Regime.[12] Consistent with the standard economic analysis of monopoly pricing, the Productivity Commission identified that pricing by a natural monopoly will inevitably be higher, and demand for the relevant services will be lower, than that which can be expected under an effective access regime.[13] This analysis is equally applicable whether or not the owner of the natural monopoly infrastructure is vertically integrated.

27 In its report, the Productivity Commission noted that the impacts on demand might be lower if the infrastructure owner is able to engage in price discrimination.[14] However, PNO has submitted that it "*is not able to set terms and conditions of access that discriminate between mines*".[15] Consistent with this submission, the NCC stated in its preliminary views that it "*is not satisfied that PNO is able to do so* [price discriminate] *to a significant extent*."[16]

28 Given its finding that PNO is an unconstrained natural monopoly, with limited ability to price discriminate, it is of some concern that the NCC made the following conclusions:

> *On the basis of the information before it, the Council considers that the commercially rational price increases which may be imposed by PNO in the future without declaration of the Service remain unlikely to be a significant cost component or driver of profitability in the coal export market in the Relevant Term.*
>
> *…*
>
> *The Council considers that, with or without declaration of the Service, PNO's commercial motivation is to ensure that the Service supports the ongoing coal export market operation and its expansion, rather than setting prices at a level that leads to a reduction of coal production (and would impact competition in the coal export market).*[17]

29 These conclusions are not consistent with the NCC's finding that, as a commercial entity, PNO will have an incentive to engage in profit maximising behaviour has a monopoly position and no effective constraints imposed on the use of that position. In the absence of an effective ability to price discriminate, a profit maximising owner of monopoly infrastructure will price in a way that causes demand for its services to be lower than they otherwise would.

30 To support its conclusion in this respect, the NCC cites an analysis provided by PNO which purports to show that "*port charges are a small component of the total delivered cost of coal, accounting for less than 1%".*[18] However this analysis is calculated by reference to estimated costs of "*the average Hunter Valley coal miner"*. This is an irrelevant reference point. In a market with an upward sloping supply curve (i.e. where suppliers have a wide range of costs and margins, for example due to different quality coal deposits, different types of coal, and differences in costs associated with underground and above-ground mining), higher prices for the service will impact the demand of *marginal* producers – those whose costs of production are closer to the long term average price they are able to achieve for their coal – and not the *average* producer.

31 It would be improper for the NCC to make a final decision on the basis of an irrelevant figure such as average costs and make the assumption that there are no long term marginal coal producers which would be affected by monopoly pricing of the service.

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[12] Productivity Commission 2013, National Access Regime, Inquiry Report no. 66, at pg 78

[13] See also Synergies, Assessment of revocation application by Port of Newcastle Operations, 8 August 2018 at 2.3.1

[14] Productivity Commission 2013, National Access Regime, Inquiry Report no. 66, at pg 79

[15] PNO Further Submission, 17 September 2018, at 3

[16] NCC, Preliminary Views, 6.117

[17] NCC, Preliminary Views, 6.96 and 6.98

[18] NCC, Preliminary Views, 6.94

32 No detailed modelling or analysis appears to have been undertaken to assess how volumes would respond to price increases and therefore the likely magnitude of price increases which it would be profitable for PNO to impose.

33 In the absence of this kind analysis or modelling NCIG submits that the NCC is not in a position to be satisfied that criterion (a) has been satisfied. To the contrary, all available evidence (as accepted by the NCC) suggest that PNO holds market power and is in a position to impose very substantial increases in the prices for the Services – including to a level at which volume decisions of marginal producers is likely to be impacted

(c) Impact of monopoly pricing on competition in dependent markets

34 PNO's future monopoly pricing will have a different impact on different types of coal producers that operate in the relevant dependent markets. Established producers with access to the highest quality and lowest cost tenements will have lower revenue as a result of higher port charges, but this is unlikely to be to the point where they cut back production from these high quality resources (although higher charges may reduce the scale and extent of their investment in future, more marginal, projects). However, new entrant coal miners, and existing miners with access to lower quality and higher cost coal resources, will be much more significantly affected.

35 As analysed in NCIG's submission of 5 October 2018,[19] the fact that monopoly pricing will have a different impact on different types of competitors is analogous to the situation analysed by the Tribunal in *Virgin Blue,* where a critical finding supporting its conclusion that criterion (a) was satisfied in that instance was that:

> *Competitors generally do not have identical cost structures, nor do they serve identical customers. Thus any particular tariff will have differential effects on different competitors compared with other tariff structures.*[20]

36 In addition, NCIG believes that it is not the case that the amendments to criterion (a) that were implemented in 2017 were designed to prevent the National Access Regime from applying to monopoly pricing by non-vertically integrated infrastructure providers such as PNO. In the Productivity Commission report that recommended these amendments, the Productivity Commission concluded that the fundamental objective of the National Access Regime was to:

> *address an enduring lack of effective competition, due to natural monopoly, in markets for infrastructure services where access is required for third parties to compete effectively in dependent markets.*
>
> …
>
> *Access regulation should cover vertically integrated and vertically separated service providers, as both can affect competition in dependent markets where they have the ability and incentive to engage in monopoly pricing of access.* [21]

37 These conditions can be expected to arise over time in the Hunter Valley in the absence of declaration. Consistent with the NCC's factual findings, PNO will have the ability and incentive to engage in monopoly pricing. This, is likely to deter investment in the Hunter Valley and distort competition in dependent markets over time. As investment by efficient, but more marginal, entities reduces, the tenements market will become more concentrated among suppliers with high quality, low cost, resources and the environment and opportunities for competition in the tenements market will materially reduce.

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[19] NCIG submission responding to PNO Further Submission, 5 October 2018, at section 3.1

[20] Application by Virgin Blue Airlines Pty Limited [2005] ACompT 5, [533]-[535]

[21] Productivity Commission 2013, National Access Regime, Inquiry Report no. 66, at pg 71

3 Criterion (d) – public interest

38 The NCC's preliminary view that criterion (d) is not satisfied rests heavily on its view that the service charges charged by PNO will not affect volumes of coal exported from the port. For example, the NCC expressed the preliminary view that:

> *On the other hand, declaration of the Service and the access regulation that follow may increase the incentives for other efficient investment to be made. By limiting the potential for PNO to set Service charges at an inefficiently high level, other entities may have a greater opportunity to invest in infrastructure which complements or is reliant on the Service. However, the Council considers that this effect is likely to be limited in this case given the magnitude of the Service charge, with or without declaration, is unlikely to impact volumes in dependent markets.*[22]

39 The NCC's preliminary view that revocation of declaration would not negatively impact economic growth was also dependent on it not being satisfied that declaration would promote a material increase in competition in any dependent market.[23]

40 As outlined above, NCIG disagrees with the NCC that the service will not be priced at a level sufficient to impact volumes of coal exported from Newcastle, or in a way that will lessen competition in dependent markets. As a result, NCIG considers that the NCC's preliminary views with respect to criterion (d) suffer from the same errors that lead it to conclude that criterion (a) would not be satisfied.

41 NCIG submits that when the impact of PNO's likely future monopoly pricing is properly analysed, the NCC should conclude that declaration would promote the public interest and, therefore, that criterion (d) is satisfied. Specifically, PNO's unconstrained monopoly pricing is likely to:

(a) reduce economic activity and employment in the Hunter Valley region, as investment in marginal coal projects is cancelled or scaled back over time;

(b) reduce demand in markets for infrastructure related to coal mining, such as rail, road, power and water;

(c) reduce demand in markets for services related to coal mining, such as construction, operation and maintenance; and

(d) lead to a reduction of allocative efficiency, arising from the deadweight loss associated with monopoly pricing.[24]

42 Once it is accepted that PNO's future monopoly pricing in the absence of declaration will result in a reduction in demand for Port of Newcastle coal tenements and investment in coal production in the Hunter Valley, it follows maintaining the declaration will create substantial public benefits through employment, economic activity and coal royalties.

43 Avoiding these negative economic effects would be in the public interest, and NCIG submits the NCC should conclude that criterion (d) is likely to be satisfied.

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[22] NCC, Preliminary Views, 9.41

[23] NCC, Preliminary Views, 9.55

[24] See analysis at Productivity Commission 2013, National Access Regime, Inquiry Report no. 66, pg 78

4 Conclusion

44 NCIG welcomes the opportunity to respond to the NCC's Preliminary Views. NCIG considers that the NCC has correctly analysed the critical importance and strong commercial position of PNO in the Hunter Valley coal supply chain and incentive to use that position for profit maximising behaviour.

45 NCIG urges the NCC to further analyse the impact of this finding. In the absence of effective regulation, PNO can be expected to take advantage of that position in a way that will negatively impact on volumes exported from the port over time and materially harm competition in dependent markets (principally in the Newcastle catchment coal tenements market). Because of this, the NCC should find that the criteria for declaration are satisfied and should not recommend that the existing declaration be revoked.