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# Effect of declaration on competition for coal authorities

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A report for Port of Newcastle Operations

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# Contents

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1. Introduction	1
2. Framework for market definition	3
2.1 What is a market?	3
2.2 Hypothetical monopolist test	3
3. Market for coal mining authorities	5
3.1 Geographic dimension of the market	5
3.2 Product dimension of the market	8
3.3 Conclusion	8



# 1. Introduction

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This report has been prepared for Port of Newcastle Operations Pty Ltd (PNO), the provider of a range of port-related services.

PNO has made an application<sup>1</sup> to the National Competition Council (NCC) seeking its recommendation that the declaration of certain services provided by PNO made by the Australia Competition Tribunal on 16 June 2016 be revoked, pursuant to section 44J of the *Competition and Consumer Act (Cth) 2010* (CCA). The service the subject of the application (the relevant service) is:

The provision of the right to access and use the shipping channels (including berths next to wharves as part of the channels) at the Port [of Newcastle], by which vessels may enter a Port precinct and load and unload at relevant terminals located within the Port precinct and then depart the Port precinct.

In material submitted to the NCC, both Synergies (on behalf of Glencore) and Yancoal make various representations in relation to the effect of declaration of the relevant service on the market for coal mining authorities, the geographic scope of which those parties contend should be defined by reference to the Hunter Valley.

In a letter dated 4 September 2018, the NCC requested that PNO provide additional submissions, documents and information to enable its consideration of whether it should recommend that the declaration of the shipping channel service be revoked. PNO has asked that we provide our opinion on the second of the matters on which the NCC requested further evidence from PNO – in particular:

The effect of declaration on competition in the acquisition and disposal of exploration and/or mining authorities.

The NCC's question arises in the context of criterion (a) of the declaration test set out at Part IIIA of the CCA, which requires the designated Minister to be satisfied:<sup>2</sup>

...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

For declaration to promote a material increase in competition in the market for the acquisition and disposal of exploration and/or mining authorities – to which we refer as the market for coal authorities – requires both that:

- declaration gives rise to a reduction in charges for the relevant service of sufficient magnitude so as to materially increase the incentives of parties to engage in coal mining or related activities in the Hunter Valley; and
- the geographic dimension of the market for coal authorities is limited to the Hunter Valley so that the effect identified above materially increases the level of competition in this market.

In our opinion, neither of these requirements is satisfied.

In an accompanying report, we explain that there would be no material difference in the investment incentives in new coal mining projects, with and without declaration of the relevant service.<sup>3</sup> It follows from this finding that, if there is no material change to incentives to invest in new coal mining projects, then there

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<sup>1</sup> PNO, *Application for revocation of declaration*, July 2018

<sup>2</sup> Competition and Consumer Act (Cth) 2010, section 44H(4)(a).

<sup>3</sup> HoustonKemp, *Effect of declaration of services provided at the Port of Newcastle on incentives to invest in coal mines*, 14 September 2018.

cannot be a material change to incentives to engage in the acquisition and disposal of exploration and/or mining authorities.

Nevertheless, the remainder of this report addresses scope of the market for coal authorities, with a particular focus on its geographic dimension. Our report is structured as follows:

- section 2 introduces the concept of a market and the conventional framework for defining a market; and
- section 3 identifies the boundaries of the market for coal mining authorities and concludes that it is very likely to be broader than the Hunter Valley.

## 2. Framework for market definition

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Competition takes place within markets. In this section we describe the concepts that underpin a market, and the conventional approach to defining markets.

### 2.1 What is a market?

A market is an area of close competition between firms.<sup>4</sup> Market definition involves the identification of the competitive constraints that are likely to have a material effect on a product or service (they are 'in' the market), and those that have a less immediate effect (they are 'out' of the market). However, such bright lines rarely exist in practice, and firms selling products that are outside of a market may act as a competitive constraint on those in that market, albeit to a lesser degree.

The boundaries of a market are conventionally determined by reference to four dimensions, ie:<sup>5</sup>

- the product dimension, being the goods or services supplied;
- the functional dimension, being that part of the supply chain that is the relevant arena of competition;
- the geographic dimension, being the geographic area over which the relevant products are supplied (or could be supplied); and
- the temporal dimension, being the time period over which substitution can take place.

A market encompasses the range of business activities, geographic areas and functional levels within which, if given a sufficient economic incentive, buyers would switch to a substantial extent from one source of supply to another ('demand-side' substitution), and/or sellers would switch to a substantial extent from one production plan to another ('supply-side' substitution).

### 2.2 Hypothetical monopolist test

The generally accepted framework for defining markets is the 'hypothetical monopolist test', which involves the systematic application of a process that:<sup>6</sup>

- commences with the narrowest reasonable market definition, taking into account the purpose at hand;
- determines whether a hypothetical monopolist in the candidate market is closely constrained by supply from outside the market – if it is then the next step is applied, otherwise the market is taken to have been defined; and
- expands the market to include the close constraints on the hypothetical monopolist and goes back to the previous step.

The hypothetical monopolist test is primarily a method for organising thinking. In some circumstances it may be possible for the examination of whether a hypothetical monopolist is closely constrained to be undertaken quantitatively, by assessing whether a hypothetical monopolist that controlled all sales within the candidate market could profitably impose a small but significant and non-transitory increase in price (SSNIP) of five to ten per cent.

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<sup>4</sup> *Re QCMA (1976) APR 40-012*, p 22.

<sup>5</sup> ACCC, *Merger Guidelines*, 2008, p 13, para 4.8.

<sup>6</sup> ACCC, *Merger Guidelines*, 2008, p 15, paras 4.19-4.21.

The hypothetical monopolist test is complete and the market is taken to have been defined if the SSNIP is profitable, thereby signifying that no further products or additional sources of supply are sufficiently close substitutes to be in the market.

## 3. Market for coal mining authorities

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In defining the boundaries of the market for coal authorities, the principal matter of disagreement relates to the geographic dimension of that market. In this section we set out the basis for our opinion that:

- the geographic dimension of the coal mining authorities market is likely to extend beyond the Hunter Valley; and
- that the product dimension of the market encompasses the rights to explore a specific coal deposit, but the degree of substitution between one mining authority and another does not turn on any delineation between the type of coal produced.

This section does not address the functional and temporal dimensions of this market, which are not in dispute.

### 3.1 Geographic dimension of the market

In its final determination on the application for declaration of the shipping channel service at the Port of Newcastle, the NCC highlighted that the market for coal mining authorities may have a geographic scope extending beyond the Hunter Valley because:<sup>7</sup>

...parties seeking coal mining authorities may likewise be able to consider different locations (for instance, coal regions located in the Hunter Valley in NSW or coal mining regions in Queensland), thus expanding the field of substitutes.

We agree with the NCC that the scope of the market for coal authorities most likely extends beyond the Hunter Valley.

The basis for this conclusion is readily apparent when set in the context of the hypothetical monopolist test framework. A hypothetical monopolist seller of coal authorities in the Hunter Valley would not profitably be able to impose increases in price. The buyers of these authorities are investors who face a vast array of choices about where to acquire the rights to potential resources. There are no special circumstances prevailing in the Hunter Valley that would imply investors could not substitute towards opportunities in other areas, such as central Queensland or elsewhere.

Our reasoning is supported by that of the Australian Competition Tribunal in Fortescue Metals, which found that the market for the purchase and sale of tenements extended beyond the Pilbara region:<sup>8</sup>

Examining a map of tenements in the Pilbara, it is obvious that tenement purchasers (whether outright or partial purchasers) have not confined themselves to buying tenements around a specific railway line. This provides strong evidence that a monopoly seller of tenements around a specific line could not profitably apply a price increase because buyers would substitute to other tenements. Further, a monopsony buyer of tenements around a specific line could not profitably decrease price because sellers would easily find a purchaser outside this geographical area. The consequence of the geographic scope of the market for tenements being likely to extend beyond the Hay Point catchment (to, say, Central Queensland) is that the actions of DBCTM at Hay Point are unlikely to be material to this broader market for tenements.

The consequence of the geographic scope of the market for coal authorities being likely to extend beyond the Hunter Valley is that the actions of PNO at the Port of Newcastle are very unlikely to be material to this

<sup>7</sup> National Competition Council, *Final recommendation: Declaration of the shipping channel service at the Port of Newcastle*, 2 November 2015, p 32.

<sup>8</sup> Australian Competition Tribunal, *In the matter of Fortescue Metals Group Limited [2010] ACompT 2*, 30 June 2010, p 258, paras 1118-1119.



broader market for coal authorities. It follows that the market for coal authorities is not a dependent market in which declaration of the shipping channel service would promote a material increase in competition.

By contrast, Synergies (on behalf of Glencore) and Yancoal contend that the relevant market for coal mining authorities involves a much narrower geographic scope. We summarise these contentions and the basis for them below.

### 3.1.1 Synergies' contentions

Synergies submits that the relevant market for coal mining authorities is limited to regions within the Hunter Valley from which prospective mines could use the Port of Newcastle.<sup>9</sup>

Synergies observes that mining exploration permits apply to a particular mineral deposit at a specific location in New South Wales and cannot be used to explore in other locations. It concludes that:<sup>10</sup>

In effect this means that, irrespective of the options that buyers of exploration rights might have, the sellers of those rights are restricted in terms of the locations for the rights.

Synergies also notes its disagreement with the NCC's earlier consideration of this issue on the basis that it did not take into account differences in the type and quality of coal and the relevance of logistics infrastructure:<sup>11</sup>

...the NCC's final recommendation did not consider in any detail the aspects of this market, such as the differences in coal types or quality (i.e. thermal coal is predominantly mined in NSW while coking coal is predominantly mined in Queensland) and it did not consider the extent to which access to and cost of logistics infrastructure influences the extent to which buyers will see tenements in different regions as direct substitutes (noting that the most substantial thermal coal deposits in Queensland are located in the Surat and Galilee basins, which have limited, if any, existing available transport infrastructure).

Synergies proposes that the scope of the geographic dimension of the relevant market can be identified through use of a 'hypothetical monopsonist test', in which it posits a single buyer of coal authorities in the Hunter Valley. Synergies concludes that this single buyer would profitably be able to reduce prices for coal authorities:<sup>12</sup>

As the tenements are specific to defined locations in NSW, and, if developed, would have no option but to export via the Port of Newcastle, the seller would not have options to supply tenements except to that single buyer. Therefore, it follows that a monopsony buyer of tenements linked to the Port of Newcastle catchment could profitably reduce the prices paid for those tenements.

We disagree with Synergies' analysis and conclusion on this point.

The essential error in the reasoning put forward by Synergies makes is to assume away the prospect of alternative buyers of coal authorities – from outside the Hunter Valley – competing with its hypothetical, Hunter Valley-based monopsonist. Coal authorities have a fundamental value given expectations of the price of coal and the costs of its extraction. If a hypothetical monopsonist for coal authorities in the Hunter Valley were to attempt to force prices for coal authorities below their fundamental value, its position would quickly be competed away by buyers from outside the Hunter Valley seeking the potential arbitrage opportunity created by that action.

This is consistent with the findings in the Fortescue Metals case quoted above, in which the Tribunal observed that sellers would 'easily find a purchaser outside this geographical area'.

<sup>9</sup> Synergies, *Assessment of revocation application by Port of Newcastle Operations*, 8 August 2018, pp 44-45.

<sup>10</sup> Synergies, *Assessment of revocation application by Port of Newcastle Operations*, 8 August 2018, p 44.

<sup>11</sup> Synergies, *Assessment of revocation application by Port of Newcastle Operations*, 8 August 2018, p 44.

<sup>12</sup> Synergies, *Assessment of revocation application by Port of Newcastle Operations*, 8 August 2018, p 45.

Synergies attempts to distinguish the Fortescue Metals case from the circumstances at the Port of Newcastle by suggesting that:<sup>13</sup>

At the time of that decision, there was no third party access available to existing rail lines, and there was therefore likely to be no perceived advantage in being in close proximity to an existing rail line. As the Tribunal noted, the declaration application under consideration related only to the BHP Billiton rail lines, and that many of the Pilbara tenements would have effective substitutes available to them in the form of alternative rail lines (including both existing and planned rail lines). This contrasts with the tenements in the Newcastle catchment area, which have access to no existing or planned substitute to the Port of Newcastle.

In our opinion, Synergies' observations have no relevance in distinguishing the Fortescue Metals matter from the circumstances at the Port of Newcastle. The observations made by the Tribunal about the availability of alternative infrastructure options have no obvious bearing on its finding as to the hypothetical monopsonist and were not mentioned by the Tribunal in that context.

Further, there is no reason to assume that there would be any link between the availability of alternative infrastructure options and the effect of declaration on competition. The availability of alternative infrastructure options, as compared with only one such option, may increase the fundamental value of coal authorities by reducing the expected cost of sending coal to market. However, this possibility neither increases nor decreases the scope for potential buyers to compete with a hypothetical monopsonist of coal authorities in the Hunter Valley.

We note for completeness that, even if it were the case that a hypothetical monopsonist – perhaps operating globally – could materially reduce the prices of coal authorities in the Hunter Valley, the basis for any promotion to competition in the market for such coal authorities that Synergies contends would arise from declaration of the relevant service remains unclear.

### 3.1.2 Yancoal's contentions

Yancoal contends that the market for coal authorities is limited to the Hunter Valley due to:<sup>14</sup>

- differences in infrastructure costs and different regulatory environments for mining development and approvals between regions; and
- the ability for Hunter Valley coal producers to redeploy existing take-or-pay contracts for railway and terminal capacity, and existing staff, between mines.

In our opinion, neither of these factors suggest a narrow geographic market for coal authorities.

We noted above that differences in infrastructure costs and regulatory environments may affect the value of coal authorities but have no effect on the substitutability of any particular coal authority with any other.

The second contention suggests that existing Hunter Valley coal producers do not regard coal authorities in other regions to be substitutable with those in the Hunter Valley because the latter can be developed into mines with strong cost synergies with their existing mines. This contention turns on an unstated assumption that coal miners typically enter into contracting and staffing arrangements that exceed the requirements of their existing mines, such that they must acquire new local mining authorities in order to spread these fixed costs more thinly.

Such an assumption is implausible over the medium to long term timeframe in which coal authorities are acquired and developed. Rather, coal miners typically hold portfolios of rail and terminal contracts that provide them with options to maintain their level of contract exposure – in relation to the output from one or more mines – or reduce it over time. Similarly, staffing levels at coal miners in the Hunter Valley are not fixed

<sup>13</sup> Synergies, *Assessment of revocation application by Port of Newcastle Operations*, 8 August 2018, p 45.

<sup>14</sup> Yancoal, *Submission on revocation application for the Port of Newcastle shipping channel service*, 8 August 2018, pp 11-12. Yancoal also sets out a fourth contention relating to the types and qualities of coal, which we discuss in section 3.2 below.

but may vary up or down based on requirements. This suggests that, over any reasonable time period, these factors are not strong synergies and do not constrain substitution of coal authorities between regions to the material degree asserted by Yancoal.

### 3.2 Product dimension of the market

In our opinion, the product dimension of the market encompasses the rights to explore a specific coal deposit, but may not extend to authorities to explore for or develop other types of mineral deposit.

Yancoal contends that the market for coal authorities is distinct from that for non-coal mineral authorities.<sup>15</sup> We agree that this is reasonable distinction. Buyers of coal authorities are likely to be distinct from those seeking to purchase authorities in relation to other minerals and would not generally regard them as substitutable.

In contrast, Synergies states that the product dimension for the market should be described as:

...the rights to explore a specific coal deposit, with different markets existing for predominantly thermal and predominantly coking coal deposits.

In a similar vein, Yancoal notes that the geographic market may be narrow due to differences in the type and quality of coal mined between the Hunter Valley and other regions of Australia, such as central Queensland.

We disagree that there is likely to be a good basis to distinguish markets for authorities of different types and qualities of coal. For this to be a valid distinction, one would have to assume that the buyers of authorities for different types and qualities of coal were distinct and would not regard them as substitutable.

In contrast, we observe that the major miners in the Hunter Valley are broadly the same as those in central Queensland. Further, many mines in both regions produce a mix of thermal and coking coal. This suggests that the expertise and equipment required to mine (and presumably, to explore for) thermal and coking coal are broadly similar.

The fact that there may be separate product markets for thermal and coking coal has no bearing on this assessment, since the fundamental value of authorities arises from expectations of the price of coal and the costs of its extraction. However, these factors are quite separate from the expertise and equipment necessary to explore for and extract the coal deposits themselves.

### 3.3 Conclusion

For the reasons we explain above, the coal mining authorities' markets defined by Yancoal and Synergies (on behalf of Glencore) are not valid. Further, in an accompanying report,<sup>16</sup> we explain that there would be no material difference in the investment incentives in new coal mining projects (at any stage of their development), with and without declaration of the relevant service.

It follows that declaration of the relevant service would not have any material effect on competition in any market for mining authorities because:

- declaration would not materially increase the incentives of parties to invest in coal mining, and so to acquire mining authorities in the Hunter Valley; and
- the geographic dimension of the market for coal authorities extends beyond the Hunter Valley, and so any effect on investment incentives would be immaterial relative to the size of that market.

<sup>15</sup> Yancoal, *Submission on revocation application for the Port of Newcastle shipping channel service*, 8 August 2018, p 11.

<sup>16</sup> HoustonKemp, *Effect of declaration of services provided at the Port of Newcastle on incentives to invest in coal mines*, 14 September 2018.



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