Port of Newcastle

Assessment of revocation application by Port of Newcastle Operations Pty Ltd

Prepared on behalf of Glencore Coal Pty Ltd

4 February 2019

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Executive Summary

Synergies has been instructed by Glencore to provide a report which responds to the NCC's Statement of Preliminary Views ('NCC's preliminary view') on revocation of the declaration in relation to the use of the defined service ('Service' which largely comprises the shipping channels)at the Port of Newcastle that was released on 19 December 2018.

In support of its application for revocation of the declaration, PNO contends that two of the declaration criteria established in s 44CA of the *Competition and Consumer Act 2010* (Cth) (CCA) – criterion (a) and (d) – are no longer satisfied with respect to the Service.

The NCC's preliminary view accepts that criterion (a) and (d) are not satisfied. The Council considers that declaration would not have any appreciable effect in promoting the economically efficient operation of, use of, or investment in the infrastructure by which the Service is provided.[1] The NCC therefore proposes to recommend to the designated Minister that the declaration be revoked. [2]

We have reviewed the NCC's preliminary view on criterion (a) and (d), against our earlier evidence submitted to the NCC, as well as other stakeholder submissions and relevant regulatory precedent. We disagree with the NCC's assessment based on several key aspects (without limiting the other matters raised by Glencore in its previous and current submissions).

First, in relation to criterion (a), the NCC has not properly considered the manner in which and extent to which PNO will be incentivised to maximise profits in a future without declaration. As a consequence, the NCC has not adequately assessed the risk associated with the strong likelihood that substantially higher port charges will materially reduce the investment incentives for coal tenement buyers in the Newcastle catchment region and impact adversely on competition in the coal tenements market. The NCC's views are contrary to those expressed by the ACCC in its public commentary on the NCC's draft recommendation and its conclusion is contrary to the views expressed by the Queensland Competition Authority (QCA) in relation to its assessment of the continuation of the declaration of the Dalrymple Bay Coal Terminal (DBCT).

Further, we consider that the NCC has placed insufficient weight on the ACCC's recently published arbitration determination in the Glencore-PNO access dispute matter when assessing the risk that materially higher prices will most likely prevail in an unconstrained environment. While Synergies accepts that the ACCC's Determination is

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1 NCC (2018), Revocation of the declaration of the shipping channel service at the Port of Newcastle, Statement of Preliminary Views, 19 December 2018, p.80.

2 NCC (2018), p.80.

not a single definitive view of what constitutes 'reasonable' terms and conditions, the ACCC is the statutory body under the CCA tasked with making such determinations; and at the very least, the determination demonstrates that the mere availability of access to arbitration provides the very real prospect of lower, more cost reflective, prices being achieved in a future where the status quo of declaration applies relative to the situation where revocation applies. This is particularly the case given the NCC's acknowledgement that, in the absence of declaration, PNO is an unregulated bottleneck facility.

Second, the NCC's assessment of criterion (a) effectively means it does not recognise any additional public benefits under criterion (d). Where the NCC considers there is no material competition benefits in a future with declaration, the NCC concludes that there will be no derived efficiency gains or other public benefits either. The NCC's views are contrary to the submissions of the New South Wales (NSW) industry body, the NSW Minerals Council, and other coal exporters. More substantively, irrespective of competition impacts in dependent markets, continued declaration will facilitate increased investment and output from the Hunter Valley and this outcome advances the public interest in the context of the CCA objectives.

The inevitable consequence of higher port charges for the coal industry means that prospective bidders for coal tenements are less likely to purchase tenement rights or if they do so will pay lower prices because they assess that their expected returns will be lower in the face of rising costs (port charges) which cannot be mitigated. Most of the impact would be reflected in a transfer of resource rents from the sellers of coal tenements and ultimately the State of NSW to shareholders in the Port of Newcastle. There is also likely to be a reduction in coal output from the Hunter Valley relative to what would occur in the absence of the revocation over the longer term.

For these reasons, we do not consider that the NCC's preliminary view appropriately demonstrates why declaration does not satisfy the legislative criteria. Rather, the legislative criteria (following amendments) relevant to establishing declaration remain satisfied and that revocation is likely to lead to a material loss of competition in at least one of the dependent markets, namely the market for coal tenements. This market is critical for ensuring future coal reserves are well placed to meet demand. Any loss of competition in this market is likely to result in adverse effects including weakened incentives for investment and lower coal resource values. We also maintain that declaration is in the public interest.

Our assessment of criterion (a) and (d) is well aligned with recent regulatory precedent set by the QCA in its draft recommendation to continue declaration of the DBCT in

Queensland.[3] This decision is relevant as it considers the same legislative criteria and similar issues in similar dependent markets (i.e. coal tenements) to those being assessed by the NCC. While both regulatory decisions consider very similar issues, the regulators have reached very different conclusions. The QCA's conclusion to recommend ongoing declaration of DBCT is consistent with Synergies' arguments for ongoing declaration at the Port of Newcastle.

[3] See QCA (2018), Draft recommendation – Part C: DBCT declaration review, December 2018. The QCA released its Draft recommendation on 18 December 2018. A copy is available at http://www.qca.org.au/Other-Sectors/Access/To/Infrastructure/DeclarationReviews/In-Progress/2020-Declaration-Review

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Contents

1 Introduction

1.1 Background and instructions

Synergies Economic Consulting (Synergies) is assisting Glencore Coal Pty Ltd (Glencore) in its response to the preliminary views of the National Competition Council (NCC) on the application submitted by Port of Newcastle Operations Pty Limited (PNO) to the NCC on 2 July 2018. The application is for the declaration made by the Australian Competition Tribunal on 16 June 2016 of the declared Service at the Port of Newcastle to be revoked pursuant to s 44J of the Competition and Consumer Act 2010 (Cth) (CCA).

The declared Service is specified as follows:

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

and is declared for the period to 7 July 2031.

In support of its application, PNO submitted that two of the declaration criteria established in s 44CA – criterion (a) and (d) - were no longer satisfied with respect to the Service.

Synergies' reports of 8 August 2018 (2018a[4]) and 5 October 2018 (2018b[5]) to the NCC responded to PNO's initial application and its further claims by presenting evidence that demonstrated criterion (a) and (d) were satisfied. Synergies submitted that:

- revocation will lead to a material loss in competition in at least one dependent market, namely the coal tenements market (thereby satisfying criterion (a)); and
- there are public benefits associated with declaration and a range of public detriments should revocation occur (thereby satisfying criterion (d)).

The NCC released its Statement of Preliminary Views on 19 December 2018 which concluded that criterion (a) and (d) are not satisfied and therefore proposes to recommend to the designated Minister that the Declaration be revoked.[6]

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[4] A copy of this report is available at http://ncc.gov.au/images/uploads/Glencore_Coal_Pty_Ltd_-_Synergies_Report_-_8_August_2018.pdf

[5] A copy of this report is available at Annexure C of Glencore's submission at http://ncc.gov.au/images/uploads/Glencore_Coal_Pty_Ltd,_5_October_2018_(PDF,_2.17MB).pdf

[6] NCC (2018), pp.79-80.

Synergies disagrees with the NCC's preliminary view and maintains that continued declaration satisfies criterion (a) and (d) and is consistent with the objects of Part IIIA. This report sets out where we consider the NCC has not had sufficient regard for the competitive harm and public interest losses resulting from revocation.

Our response to the NCC's preliminary view also takes into account recent regulatory precedent set by the Queensland Competition Authority (QCA), which is, at present, reviewing the existing declaration of the Dalrymple Bay Coal Terminal (DBCT).[7] The QCA's draft recommendation to maintain the DBCT declaration is relevant as it considers many of the issues considered by the NCC. The QCA's draft recommendation and reasons are consistent with the arguments raised by Synergies in this and earlier reports.

1.2 Report structure

Synergies has adopted the following structure for this report:

- Section 2 - sets out our response to the NCC's preliminary view on criterion (a) in which we show that the NCC has not properly considered the extent to which PNO will be incentivised to increase prices in order to maximise profits, and therefore that revocation will reduce investment incentives for coal tenement buyers in the Newcastle catchment region;
- Section 3 - presents our response to the NCC's preliminary view on criterion (d) where we consider the NCC does not appropriately recognise the possibility that, in a future absent declaration, there can be adverse efficiency effects even if there were no adverse competition effects as the NCC contends; and
- Section 4 - discusses how continued declaration is consistent with the objects of Part IIIA.

7 See QCA (2018), Draft recommendation – Part C: DBCT declaration review, December 2018. The QCA releases its Draft recommendation on 18 December 2018. A copy is available at http://www.qca.org.au/Other-Sectors/Access/To/Infrastructure/DeclarationReviews/In-Progress/2020-Declaration-Review

2 Response to NCC assessment of criterion (a)

2.1 Summary

This section presents Synergies' response to the NCC's preliminary view on criterion (a).

The NCC is not satisfied that increased access to the declared Service, on reasonable terms and conditions, as a result of a declaration would promote a material increase in competition in any dependent market.[8]

Synergies disagrees with the NCC's preliminary findings. Our earlier reports (2018a), (2018b) focussed on the competition losses that will arise in the dependent coal tenements market in the Newcastle catchment.

We maintain our view that by reducing competition materially in the coal tenements market, revocation of the declaration is inconsistent with the objects of Part IIIA and the broader objective of the CCA which is, in part, to enhance the welfare of Australians through the promotion of competition.[9]

The NCC's conclusions materially turn on its view that Service fees are a very small proportion of the cost of coal and that the commercially rational Service charge increases (without declaration) are unlikely to be a significant cost component.[10] Synergies considers that the NCC's assessment has not properly considered the manner in which and extent to which PNO will be incentivised to increase prices in order to maximise profits absent the declaration remaining in place. As a result, the NCC has not considered the strong likelihood that *substantially* higher port charges will materially reduce the investment incentives for coal tenement buyers in the Newcastle catchment region.

Similar to investors in the residential housing market, prospective bidders for coal tenements are less likely to purchase tenement rights when they assess that their expected returns will be materially lower in the face of rising costs which cannot be mitigated. This in turn most likely means a material loss in competition in the coal tenements markets and less efficient outcomes for existing tenement holders where coal resource values are reduced. Much of the impact would be reflected in a transfer of resource rents from the sellers of coal tenements and ultimately the State of NSW to

8 NCC (2018), p.64.

9 The object of the CCA is set out in Part I, section 2.

10 NCC (2018), p.42.

shareholders in the Port of Newcastle.[11] There is also likely to be a reduction in investment and coal production relative to what would occur in the absence of the revocation over the longer term.

This view is consistent with recent findings of the Queensland Competition Authority (QCA) in respect of the impact of declaration of the Dalrymple Bay Coal Terminal (DBCT) on competition in the coal tenements market in central Queensland. The QCA conducted a detailed and thorough review to provide advice and assistance on criterion (a). As a result, the QCA considers that:[12]

> Criterion (a) is satisfied.
>
> DBCT Management has an ability and incentive to exercise market power, such that in the absence of declaration, efficient entry to the coal tenements market would be discouraged and there will be a material impact on competition in that market.
>
> Access (or increased access) to the DBCT service on reasonable terms and conditions as a result of declaration would promote a material increase in competition in the coal tenements market.

A summary of the contrasting positions of the NCC and the QCA on criterion (a) is presented in the table below.

Table 1 Criterion (a) assessment NCC vs QCA

Factor	NCC (PoN revocation)	QCA (DBCT declaration review)
That access (or increased access) promotes a material increase in competition in at least one market, other than the market for the service	Criterion (a) is not satisfied for PoN	Criterion (a) is satisfied for DBCT
Pricing objective	Insufficient constraint on incentive of PNO to earn monopoly profits	Insufficient constraint on incentive of DBCT to maximise its profits
Constraints on ability and incentive to exercise market power: with or without declaration		
• Countervailing power of users	Users of the port are not an effective constraint as they have no effective alternative to the Service	There is a substantial cost difference in exporting coal through other coal terminals compared to DBCT; therefore both existing and new entrants would have no countervailing power in a future without declaration

11 Such a material transfer in economic rents from miners to PNO is contrary to the public interest. Without these rents, miners will be less willing to undertake exploration activities. See section 4.4 of Synergies' 8 August 2018 report. This issue is discussed in section 3.5 of this report.

12 QCA (2018), p.5.

Factor		NCC (PoN revocation)	QCA (DBCT declaration review)
•	Competition from other facilities	The presence of Port Botany places some constraint on PNO, but only for users for which it may be commercially viable (only for containerised freight)	Other coal export terminals are not close substitutes and hence would not act as a competitive constraint on DBCT
•	Lease arrangements	Lease arrangements may allow for some influence by the State but are costly and would not adequately limit any effects on competition from PNO's actions	The lease arrangement does not appear to be a mechanism that would constrain DBCT from exercising market power in a future without declaration
•	Vertical integration	PNO is not vertically integrated into any dependent market therefore has no incentive to discriminate in favour of any related operation(s) in dependent markets	Despite DBCT not being vertically integrated it would still have the ability and incentive to exert market power
•	Threat of declaration or regulation	The existing regulatory framework (PAMA Act and regulations) promotes transparency but does not provide an adequate regulatory constraint	The threat of declaration would not act as a constraint against DBCT from exercising market power in a manner such that it would adversely affect competition conditions
	Key finding	The NCC found that PNO has the ability and incentive to earn monopoly profits and did not identify any adequate constraints on PNO exercising market power	The QCA's view was that as a result of no constraints being identified DBCT would have the ability and incentive to exercise market power
Competition assessment of future with and without declaration in the coal tenements market			
•	Significance of charge	The NCC considered that current port charges were less than 1% of forecast thermal coal price, and 'commercially realistic' price increases would be small	The QCA found that coal handling charges were currently 2-3% of forecast metallurgical coal price and, absent declaration, for new users this may rise to 8-12%
•	Investment incentives	The NCC does not consider the difference in uncertainty resulting from whether the Service is declared relative to revocation to be sufficient to have a material effect on the decision whether to invest or participate in the coal tenements market	The QCA considers that the absence of the declaration will likely have a material and adverse impact on efficient investment in the coal tenements market due to the fact that the risk and uncertainty as a result of no declaration would create a barrier to efficient entry into the market (see 'impact on coal tenements dependent market for more discussion)
•	Coal resource values	The NCC noted the possibility that revoking the declaration would have the effect of a reduction in the resource values, however, this would have been already taken into account by investors as such the drop in value is likely to be minimal	Existing users would have materially more favourable access conditions than potential DBCT users in a future without declaration because existing users are protected from significantly higher access charges by existing user agreements. This would have the potential effect of discouraging future users from participants in the coal tenements market resulting in an adverse effect on competition
•	Impact on coal tenements dependent market	The NCC considered that 'commercially realistic' increases in port charges would have an immaterial effect on overall supply chain costs and thus the absence of the declaration will have no material effect on competition in the coal tenements market	The QCA found that the absence of the declaration would result in a material reduction in competition in the coal tenements market due to the ability of DBCT to: - set asymmetric terms and conditions between existing users and new entrants (coal handling

Factor	NCC (PoN revocation)	QCA (DBCT declaration review)
		charge for existing users would be far smaller than for potential users) - set prices at five-year intervals making potential DBCT users' mining operations unbankable, discouraging new entry - price discriminate between existing and potential users

Source: Synergies, based on the NCC's Preliminary View and the QCA's Draft Recommendation

While both regulatory decisions consider very similar issues, the regulators have reached very different conclusions, which appear to turn on the following factors:

- the regulator's view on the materiality of potential price increases; and
- the regulator's view on the likelihood that pricing risks for critical infrastructure may influence investment decisions in a market other than the market for the service that is being considered for declaration.

We discuss these factors in more detail in section 2.5. Despite acknowledging there is little constraint on PNO's market power, the NCC considers that PNO will most likely charge a 'commercially realistic' price (without indicating what that might be or why PNO would voluntarily charge a price below that which maximises profit) and that, even in the absence of declaration, Service charges are 'unlikely to be a significant cost component' (again, without assessing what a 'commercially realistic' price might be). Furthermore, the NCC assumes that existing and potential market participants share its benign view. The mere presence of the Glencore-PNO access dispute as well as stakeholder submissions from other coal exporters submitted to the NCC as part of this process (e.g. Yancoal, NCIG) suggests such views are not widely held by those who will be affected by such charges.

2.2 Background

Criterion (a) as set out in subsection 44CA(1) of the CCA prescribes that:

> (a) access (or increased access) to the service, on reasonable terms and conditions, as a result of declaration of 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.

This criterion is forward looking, requiring two scenarios to be considered – one in which a declaration is made and access (or increased access) to the Service is available on reasonable terms and conditions and the other in which no declaration is made.

The dependent markets that had been previously identified and accepted by the NCC were:[13]

(a) a coal export market (the coal export market);

(b) markets for the acquisition and disposal of exploration and/or mining authorities (the tenements market);

(c) markets for the provision of infrastructure connected with mining operations, including rail, road, power and water (the infrastructure market);

(d) markets for services such as geological and drilling services, construction, operation and maintenance (the specialist services market); and

(e) a market for the provision of shipping services involving shipping agents and vessel operators, of which ships exporting coal from the Port of Newcastle are a part (the bulk shipping market).

In its preliminary view, the NCC considered it appropriate to have regard to a 'container port market' as an additional discrete dependent market.[14] Synergies accepts this view and considers it uncontentious for the purpose of assessing PNO's application for revocation.

Synergies' assessment of the competition losses associated with revocation was not based on the identified separate market for container port services. We have not made any assessment of the impact of revocation on competition in this market given the limited time available to respond to the preliminary decision.

Synergies, however, notes recent comments by the CEO of PNO that it will seek to develop the container operations at the Port through the relationships of its 50% shareholder China Merchants. China Merchants has shipping container vessels in its shipping arm.[15] This has not been analysed by the NCC even though it was raised by the NCC.

2.3 Synergies' previous views on criterion (a)

Synergies (2018a) considered a future with and without declaration and submitted that:[16]

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13 NCC (2018), p.32.

14 NCC (2018), p.34.

15 Fairplay (2018), Australia's Newcastle port faces the coal conundrum, 13 April 2018. See https://fairplay.ihs.com/bulk/article/4297541/australia%E2%80%99s-newcastle-port-faces-the-coal-conundrum [accessed 1 February 2019]

16 Refer to section 2 of Synergies' report (2018a).

- in a future without declaration, there will be no effective commercial, contractual or regulatory constraint on PNO's ability to impose significant Service charge increases for coal producers;
- investors in the coal sector in the Newcastle catchment, facing a material risk of substantially higher port charges, will have a reduced incentive to invest in coal exploration and future reserves (i.e. the coal tenements market);
- investors in the coal tenements market in the Newcastle catchment often tend to be those smaller companies who are focussed on more marginal tenements (which do not attract the attention of the major producers); they have higher marginal costs and are less able to reduce their exposure to higher access charges;
- in the face of higher costs and expectations of materially lower returns, these smaller coal producers are less likely to purchase tenements and invest in coal exploration, thus lowering coal resource values as they become generally less attractive; and
- under these conditions, revocation is likely to lead to a material loss of competition in at least one of the dependent markets, namely the market for coal tenements, thus satisfying criterion (a).

Synergies (2018a) further noted that it was unable to conclude that there would be no competition effects in the other dependent markets without conducting a full assessment of each market (this was not possible due to reporting time constraints).

Synergies (2018a) also noted that the competitiveness of Newcastle's coal exporters can deteriorate and cause flow-on competition reducing effects in other dependent markets, without there being a material reduction in competition in the relevant coal export market.[17] This follows from the distinction between 'competitiveness' of a supplier (or group of suppliers) and 'competition in a market'. Even though competition in the relevant coal export market may not be materially affected by Service charge increases, the competitive constraints from other suppliers in the coal export market can mean that the competitiveness (profitability) of Newcastle's coal exporters may be adversely affected with flow-on adverse competitive effects to other dependent markets.

[17] Synergies (2018a), p.52.

2.4 NCC's preliminary view

The NCC reached a different view. It concluded that increased access, on reasonable terms and conditions, as a result of declaration will not promote a material increase in competition, in any upstream or downstream market directly.[18]

While accepting evidence that PNO has market power and that there will be insufficient constraint on its pricing behaviour in a future absent declaration, the NCC still contended that PNO would set 'commercially realistic prices', without a supporting rationale and meaningful explanation for what that meant, and accepted PNO's claims that the magnitude of Service charges, with or without declaration, would be insufficient to materially impact volumes traded through the Port, investment incentives, or otherwise competition in any dependant market.[19]

Given these reasons, the NCC's preliminary conclusion is that criterion (a) is not satisfied.

2.5 Synergies' response to the NCC's preliminary view

Synergies disagrees with the NCC's preliminary view that competition will be unaffected by a change in the status of declaration, particularly in the coal tenements market, and our supporting reasons are set out below.

In assessing criterion (a) and considering the two future scenarios (i.e. with and without declaration):

1. the NCC first considered PNO's ability and incentives to exercise market power by imposing higher prices for the Service;
2. it then considered whether such conduct would materially affect competition in any of the relevant dependent markets.

While the NCC acknowledges that that PNO has the ability and incentive to exercise market power, it has taken the view that 'commercially realistic' price increases are likely to mean that port charges remain a small component of costs. The NCC has not indicated what a 'commercially realistic' price might be, nor has it provided any justification for this view, especially in light of its finding that, in the absence of declaration, PNO will be an unregulated bottleneck facility. We discuss this in more detail in section 2.5.1 below.

18 NCC (2018), p.64.

19 NCC (2018), p.64.

Further, we disagree with the NCC that such conduct, in a future without declaration, will not have any influence on the decisions of coal producers, particularly in relation to investment in coal tenements. Revocation will result in a material loss of competition in the dependent coal tenements market, for the reasons set out in section 2.5.2 below.

2.5.1 Future with and without declaration

PNO's ability and incentive to exercise market power

The NCC reached several key conclusions in respect of PNO's incentives and, absent the declaration, its ability to exercise its market power by increasing prices for the Service, which we have summarised as follows:[20]

(a) the Port of Newcastle occupies a strategic bottleneck and has the ability and incentive to earn monopoly profits;

(b) current users of the port are not an effective constraint on PNO's market power because:

  (i) users have no alternative to using the Service;

  (ii) they have limited ability to pass on price increases; and

  (iii) demand for shipping channel Services is price inelastic.

(c) other potential constraints are not sufficient to constrain PNO's market power:

  (i) PNO does not have an incentive to discriminate in favour of any particular operation that would result in reduced volumes;

  (ii) the existing regulatory framework (PAMA Act and regulations) promotes transparency but does not constrain charges, and is not an effective substitute for access regulation;

  (iii) lease arrangements may allow for some influence by the State but are costly and would not limit any effects on competition from PNO's actions; and

(d) given the lack of constraints on PNO's market power, terms and conditions of access are likely to be more favourable to users in a future with declaration.

Synergies agrees with the NCC's conclusions that PNO has market power and has a commercial incentive to use its market power in order to earn monopoly profits.

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[20] NCC (2018), pp.25-29.

Relevance of market power to assessment of criterion (a)

The NCC has noted: "The market power of the service provider is relevant to the assessment of criterion (a) insofar as it is part of the Council's assessment of the ability and incentive of the service provider to adversely affect competition in a dependent market."[21] We consider that the NCC's reference to an incentive to adversely affect competition in a dependent market is not a necessary requirement. The service provider does not need to have an incentive to affect competition, but rather only needs to have the incentive to maximise profit, with a consequential impact on competition.

Synergies has previously established[22] and the NCC appears to have accepted, that PNO has a clear incentive to use its market power to charge a price that extracts monopoly rents from users of the facility (as Glencore has previously submitted that PNO had already begun doing[23]). As is discussed in further detail below, the extent to which PNO will be able to use its market power to increase prices will depend on the limited responsiveness of demand to price increases and the threat of more stringent regulation. Neither of these pose credible constraints on PNO's exercise of market power in a future without declaration.

Further, as noted above, PNO is acutely aware that the coal sector has only a limited life and is actively planning for the development of additional trades. This is a key factor driving PNO's proposed development of a container terminal at the Port.[24] PNO's commercial imperative to foster the development of additional trades to provide a 'life after coal', together with the container vessels shipping business of its 50% shareholder China Merchants, further complicates any assessment of PNO's incentives. PNO has many opportunities to provide advantages to its shareholder, including reduced wharfage or reductions in other port related charges.

Applying this correct interpretation to criterion (a), PNO's pursuit of these commercial objectives has the clear potential to have consequential impacts on competition in dependent markets.

21 NCC (2018), p.31.

22 See section 2.3.1 of Synergies 8 August 2018 report.

23 Glencore (2018), Submission to the National Competition Council in response to the application by Port of Newcastle Pty Ltd for revocation of declaration of the shipping channel service at the Port of Newcastle, 8 August 2018, p.16.

24 Newcastle Herald (2017), Life after coal, 20 December 2017. See https://www.theherald.com.au/story/5132103/life-after-coal-leadership-needed-for-a-fair-transition/ [accessed 1 February 2019]

Potential outcomes of PNO's exercise of market power absent declaration

While the NCC accepts that PNO has market power, the NCC's assessment about the manner in which and extent to which PNO will exercise this power absent the declaration appears to assume that PNO will adopt a very restrained approach, although the NCC does not support this assumption with an attempt to identify what that price might be or provide a credible commercial rationale for why PNO would apply it. In this regard, the NCC considers that:[25]

- the commercially rational price increases which may be imposed by PNO in the future without declaration remain unlikely to be a significant cost component or driver of profitability in the coal export market; and
- it is more likely that PNO will be incentivised to maximise the volume of coal passing through the Port, rather than set prices at a level that materially reduces coal throughput.

We disagree with both of these conclusions, for the reasons set out below.

In considering the future without declaration, the NCC has stated that it considers that Service charge increases to commercially realistic levels would remain a small proportion of costs.[26] This appears to reflect the NCC's view that estimates of the potential Service charge calculated under a building block methodology, such as PNO's submission to the ACCC of \$1.36/GT or Synergies' estimate of \$1.64/GT, provide an indication of the prices that might be considered commercially feasible in the future without declaration.[27]

However, the NCC does not appear to have considered the extent to which higher price increases may also be commercially feasible. For example, the PNO submitted charge of \$1.36/GT was developed for the purpose of an ACCC arbitration and, as noted by the NCC[28], the actuality and/or threat of arbitration increases the incentive and likelihood for PNO to provide 'reasonable terms and conditions'. Therefore, it cannot be assumed that this reflects the price that may be sought by PNO in the absence of the declaration. Further, absent the declaration, there is no requirement for PNO to calculate prices according to a building block methodology, and even if there was such a constraint, there

25 NCC (2018), p.42.

26 NCC (2018), p.54.

27 NCC (2018), p.41-42.

28 NCC (2018), p.30.

would be no limitation on the parameter values PNO could adopt which would justify increases in charges for the Service.

It is therefore important to consider what characterises a commercially feasible charge. In this regard, we note that the NCC has described a commercially realistic charge to be one that is set at a level that is not above the profit maximising level.[29] We agree with this view. However, we note that the NCC has not sought to make any assessment of what the profit maximising price might be, after having regard to the factors that would constrain PNO's market power.

Absent declaration, the only factor that will effectively constrain PNO's incentives to increase prices is the responsiveness of volumes; that is, price will increase towards a level at which demand is no longer inelastic such that volumes are materially affected. In this respect it is a basic economic condition that a monopolist will set prices based on the elastic part of the demand function that it faces.[30] Although the simple monopoly textbook model may not exactly apply, the basic principle of increasing prices if demand is inelastic should not be controversial – a monopolist will generally not know that it has maximised profit until it increases price to the point where demand is affected.

The main constraint may be the potential for regulatory intervention if very large price increases were sustained, but the nature of and prospect of such regulatory intervention is highly uncertain and most likely would entail a considerable time lag entailing economic damage in the meantime. Indeed, if the NCC's approach to date is maintained, then such a constraint is likely to be weak.

Synergies previously examined PNO's profit incentives by modelling revenue and volume scenarios under different port price levels of: (1) no increase in prices, (2) a \$1.50/t price increase; and (3) a \$3/t increase.[31] The results showed even if price increases were to result in a 25% reduction in long term volumes, as is possible with a \$3/t price increase and assuming low coal prices, PNO's revenue could still be increased substantially (our modelling estimated a substantial increase in revenues from a baseline of \$65.3 million to a projected revenue level of \$321.1 million).

While our previous submission demonstrated that a \$3/t price increase would have a strongly positive impact on PNO profits (even factoring in potential declines in volume), we had not sought to quantify the ultimate binding constraint on PNO in terms of the

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29 NCC (2018), p.42.

30 For a discussion of monopoly behaviour over time, see Dennis W. Carlton and Jeffrey M. Perloff (2005), Modern Industrial Organization, p.94.

31 Synergies (2018a), p.29.

highest profit maximising price that could theoretically prevail in a future absent declaration.

Given the NCC effectively equates a commercially realistic price to be somewhere below the profit maximising level, we have extended our previous assessment by considering much higher price increases in order to provide an indicative assessment of where the profit maximising price level might lie.

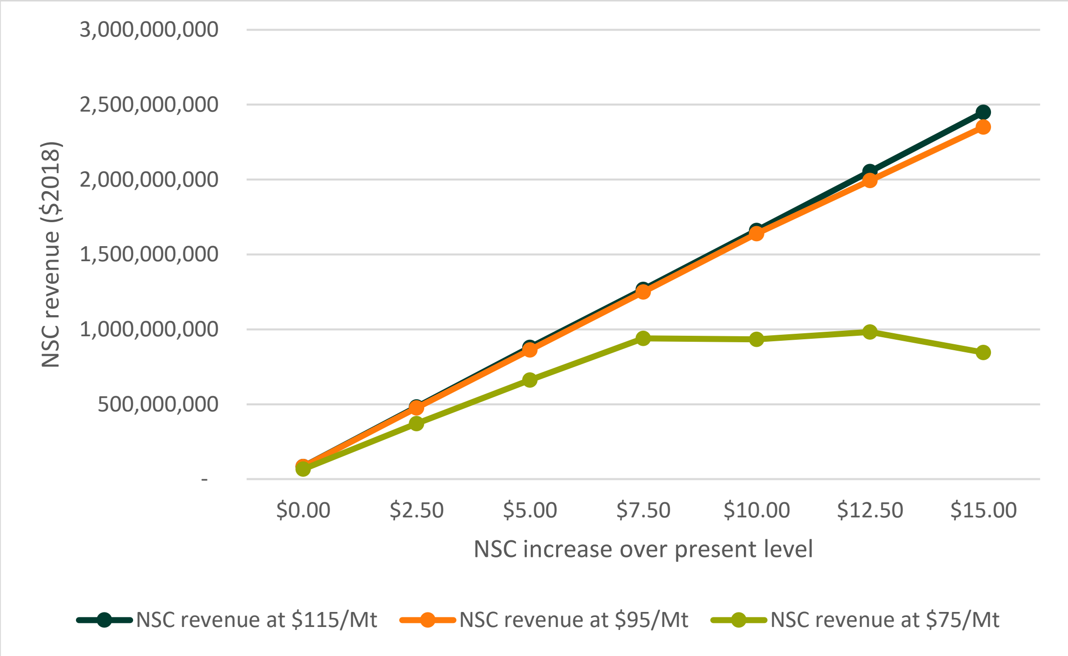
The conventional approach to assessing the profit maximising price is to apply relevant demand elasticities to equate marginal cost and marginal revenue for a series of prices. Here, we do not have information available that would enable this calculation to be performed. Instead, in order to obtain an estimate of the indicative magnitude of a profit maximising price, we have undertaken a high level assessment based on the Wood Mackenzie data utilised in our previous submissions.

The assumed incremental increase in the Navigation Service Charge (NSC) has been added to the total cash cost for each mine as measured by Wood Mackenzie. This allows us to ascertain the threshold coal price at which a given coal operation is expected to be priced out of the market. We have then added up the total coal volume (across all producers) that is expected to be produced at that price, in order to determine the relevant quantity for the revenue calculation. The estimated revenue from the NSC is then derived as this expected quantity multiplied by the total NSC (the base NSC of $0.53 plus the modelled increase).

Clearly, the profit maximising price for the Service will vary over time as coal prices, exchange rates and production change. Nevertheless, this approach, whilst static in nature, provides an indication of the likely magnitude of the profit maximising price for the Service.

Figure 1 shows that the point at which each of the identified NSC increases ranging between a $2.50/t increase up to a $15/t increase is expected to lead to an increase in revenue (which, for PNO, broadly equates to profit given an environment of mostly fixed costs), at prevailing coal prices of AU$75/t, AU$95t, and at AU$115/t.

Figure 1 Profit maximising scenarios under various coal prices and Navigation Service Charge (NSC) increases



Source: Synergies

The figure shows, under a low coal price assumption of AU$75/t, port charge increases only cease to be profitable at around $12.50/t, the point at which profits start to decline. At this price level, port charges are approximately 17 per cent of the coal price. At higher coal prices, the profit maximising port charge will be substantially higher again as is clearly shown in the figure.

It is not our intention to suggest that PNO will levy charges for the Service at the profit maximising price. Moreover, whilst the precise value of the profit maximising price may be debated, it is clearly significantly higher than the values we used in our earlier analysis and presumably significantly exceeds the "commercially realistic" price that has underpinned the NCC's analysis. In our view, it highlights that it is inappropriate to rely upon an unspecified "commercially realistic" price to underpin analysis of the adverse competition and public interest impacts of revocation of the declaration.

Notwithstanding that, in our 8 August report, we clearly demonstrated how PNO's profit objective is best achieved through increasing port charges, and accepting any consequential impact on volume,[32] the NCC has based its assessment on the presumption that PNO will set prices with the objective of avoiding any material loss in coal volumes. For example, the NCC states that "The Council notes that it is possible

[32] Synergies (2018a), p.16-32.

that reducing coal volumes through the Port may not diminish PNO's profitability if other users of the Service increase their volumes sufficiently to compensate for lost coal volumes. However, considering PNO's ongoing reliance on coal export revenues, the Council does not consider this likely."[33] The NCC does not appear to have considered the extent to which the profit impact of lost coal volumes will be compensated by the profit impact of higher prices for the remaining coal volumes.

In this regard, it seems as if the NCC does not recognise the standard economic proposition that profit maximisation for an entity with market power always means higher prices, from the exercise of that market power, with either some reduction in volume or in extreme cases no impact on volumes. This is a basic economic feature of a monopoly situation including where there is excess capacity. It means that PNO is very unlikely to maximise profit without there being a reduction in volume (as it is reductions in volume that ultimately constrain profit maximising price increases).

For these reasons, we consider that the NCC's reliance on Service charges remaining a small cost component in the absence of the declaration is not consistent with the behaviour that can be expected from a profit maximising monopolist, which is a characterisation of the commercial environment that the NCC accepts. Instead, the NCC appears to be relying on PNO 'doing the right thing', rather than acting in accordance with its commercial objectives. Considering a range of potential pricing outcomes that more accurately reflects PNO's commercial objectives is fundamental in an assessment of the degree of harm that may arise in dependent markets in a future without declaration.

We observe that the QCA, in its declaration review of DBCT, similarly concluded that DBCT Management has a profit maximising objective.[34] However, in considering the potential consequences of DBCT acting in accordance with its profit maximising objective, the QCA explicitly assessed the factors that will ultimately constrain DBCT's pricing – in this case the costs that users would incur if using the WICET facility. In this context, the QCA estimated that:[35]

- in a future with declaration (i.e. status quo):
  - the coal handling charges that apply when the DBCT service is declared would represent about 2 to 3 per cent of the forecast metallurgical coal prices until 2035;

33 NCC (2018), p.42.

34 QCA (2018), p.70.

35 QCA (2018), pp.83-85.

- for mines in the Goonyella system, the average supply chain cost to access WICET[36] is at least $26 per tonne, which is more than double the supply chain cost to access DBCT at $11 per tonne. This results in an estimated cost difference between accessing WICET and DBCT of at least $15 per tonne;

- in a future without declaration:
  - the coal handling charge at DBCT for potential entrants would likely go up from the current $5 per tonne (that incumbents would pay) by an additional at least $15 per tonne to at least $20 per tonne, such that the cost of accessing DBCT for entrants would be about the same as accessing WICET, all other things being equal;
  - a coal handling charge at this level for potential entrants would represent at least 8 to 12 per cent of the forecast metallurgical coal prices in a future without declaration;
  - this would be at least four times the 2 to 3 per cent of metallurgical coal price that existing users would pay as a coal handling charge.

The QCA then assessed the potential competition impacts with and without declaration, assuming such prices were applied, and found that declaration would promote competition in the coal tenements market.

We consider that the NCC should similarly make an explicit assessment of the range of prices that could potentially be applied by PNO given its commercial objectives and constraints, and then assess the potential competition impacts having regard to possible application of such prices. It is only against the backdrop of such an analysis can an assessment of future “commercially realistic” prices (absent declaration) be made. Synergies submits that this represents feasible and reasonable analysis that should be undertaken given the importance of the matter to the assessment of the revocation application and the national significance of the facility.

Application of access on ‘reasonable’ terms and conditions and relevance of ACCC arbitration determination

Synergies presented evidence (2018a) that where declaration of the Service continues, market participants will be assured that access to the port will be made available on reasonable terms and conditions for the term of the declaration (to July 2031), with this right supported by a legal right of access and opportunity to seek arbitration in the event

[36] WICET is not subject to the same access arrangements that apply to DBCT. Terms and conditions of access to WICET are set out in WICET’s Terminal Access Policy.

of a dispute.[37] This was further acknowledged by Synergies (2018b), pre-dating the decision to, and public release of, the ACCC's Arbitration Determination, in which Synergies noted that the ACCC's decision should provide some important guidance on efficiency issues and whether declaration would have any impact on investment.[38]

The NCC's preliminary view does not consider it necessary or appropriate to form a concluded view as to whether the terms set in the ACCC Determination are 'reasonable terms and conditions as a result of declaration'.[39] The NCC further noted that the Determination '…reflects the ACCC's appraisal of reasonable terms and conditions for Glencore and PNO at a point in time and…[is] an example of the type of decision that can result from an arbitration…'.[40] In so doing, the NCC indicated that it has not treated the Determination as a definitive statement of what reasonable terms and conditions are.[41]

Synergies accepts the NCC's preliminary view that the ACCC's arbitration Determination does not represent the single definitive view of what constitutes 'reasonable' terms and conditions, particularly noting that aspects of the ACCC's Determination are subject to legal appeal by PNO (largely relating to whether or not PNO can include channel dredging expenditure by exporters or the coal terminals in its asset base) and Glencore (largely on the basis that the ACCC was led into error by accepting PNO's arguments on rock density and therefore dredging costs in the channel) and reasonable minds may differ on specific parameter estimates. However, we consider that the ACCC's Determination is important in providing all stakeholders with a guide as to what a reasonable price for the Service may be and how it may be determined having regard to the detailed assessment of the individual parameters that the ACCC undertook. Particularly important is the ACCC's view that the reasonable price for the Service is significantly lower than the price currently being applied by PNO.

In its approach to assessing criterion (a), Synergies considers that the NCC has placed insufficient weight on the ACCC's Determination in the context of considering the risk that PNO will exercise its market power to set prices that are above a reasonable level. Indeed, based on the Determination, it appears that PNO has already done so.

37 Synergies (2018a), p.11.

38 Synergies (2018b), p.21. This report will be cited as "Synergies (2018b)" in all subsequent references contained in this current report.

39 NCC (2018), p.18.

40 NCC (2018), p.18.

41 NCC (2018), pp.18,19-20.

At the very least, the Determination demonstrates that the mere presence of declaration and access to arbitration provides the very real prospect of lower, more cost reflective, prices being achieved in a future where the status quo of declaration applies relative to the situation where revocation applies.

Extent of Glencore advantage due to arbitration outcome

Irrespective of the outcome of PNO's revocation application, Glencore will have the benefit of an arbitrated outcome on its Service charge, giving it certainty over the pricing methodology to be used to calculate the charge.

Synergies notes that the NCC is not satisfied that Glencore will gain a competitive advantage as a result of the ACCC's arbitrated terms. The NCC further considered that any advantage that did exist would remain in the future with and without declaration, and even if it did exist, the advantage is too small to make a material difference to the state of competition in any market. The NCC concluded that were this a material concern, more market participants would have sought rectification through arbitration.[42]

Synergies disagrees with the NCC's conclusions on this point. The view that the advantage that Glencore will only gain a small advantage (if any) from an arbitrated outcome in a future without declaration rests entirely on the NCC's benign view of the extent to which PNO will take advantage of its market power, discussed above. In particular, the NCC provides no credible commercial rationale why PNO would limit its price increases to the extent the NCC assumes.

Further, Synergies considers that the absence of more ACCC arbitrations from other coal producers in the Newcastle catchment is not a sufficient basis to indicate evidence that other market participants do not consider this to be a material concern. While no other party has applied for arbitration to date, this does not provide any guidance as to the future as the ACCC arbitration Determination was only handed down in late 2018.

Lodging a dispute with the ACCC for arbitration is not costless, and some producers may be willing to accept some price 'premium' in order to avoid this process, particularly while the outcome of the current dispute is not yet settled. For so long as the declaration remains in place, users have the option of seeking arbitration if the 'premium' becomes unacceptably high. Recognising this, we consider that PNO is less likely to seek further aggressive price increases while the declaration remains in place, as it will be acutely aware of the likely price reduction that will apply if users choose to seek arbitration.

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42 NCC (2018), p.56.

Conclusions

The NCC's preliminary view assumes PNO will adopt a very restrained approach in setting prices in a future without declaration. The NCC indicates that PNO will adopt a price that is 'commercially realistic' without any assessment of what that means or at which price level a commercially realistic price is expected to prevail. Our analysis suggests that PNO has the ability and incentive to increase prices significantly before the detrimental impact on volumes means that further price rises will not be profitable.

Despite clear and unequivocal evidence of PNO's profit maximising motive, the NCC has advocated that declaration be revoked. While Synergies accepts that the presence of market power is not, by itself, a sufficient determinative factor to meet the necessary threshold for criterion (a) to be satisfied, it does raise practical concerns for users of the declared Service that the only credible constraint that currently exists (as attested to in the recent ACCC arbitrated outcome in Glencore-PNO access dispute in which the ACCC has set a lower Service charge to that currently imposed by PNO) will be removed should the NCC's recommendation be endorsed by the Minister. To rely on PNO to apply prices that are 'commercially realistic' has insufficient regard to PNO's past pricing behaviour and its commercial incentive to maximise profit.

The NCC's preliminary assessment of competition impacts associated with changes in the status of declaration is examined in section 2.5.2 below.

2.5.2 Impact of declaration on competition in coal tenements market

Synergies presented evidence (2018a)[43] that revocation will result in a material loss of competition in the coal tenements market, as it will weaken investment incentives and lower coal resource values. This is because a future without declaration will result in a higher cost and risk profile for new and prospective coal miners in the Newcastle catchment. As the economic viability of new mines deteriorates, this will most likely reduce the incentives of miners to invest in tenement rights. We consider that this will be likely to have a material adverse impact on effective competition in the tenements market. It will also entail a transfer of resource rents from tenement sellers including the State of NSW to the shareholders of the Port of Newcastle.

The NCC reached a different view, concluding that competition in the tenements market would remain effective irrespective of the declaration. This view was based on the following reasons:

[43] See section 3.3.3 of Synergies 8 August 2018 report.

- while acknowledging that the tenements market is likely to be characterised by higher costs and risks than may be present for existing mines, the NCC considered that Service charges would be a small component of coal costs and, even absent declaration, would have a minimal impact on the profitability of coal exports;
- consistent with this view, the NCC considered that:
  - any uncertainty about Service charges is likely to be relatively small compared to other risks, including coal prices, labour costs and taxes; and
  - any advantage enjoyed by Glencore as a result of its arbitrated terms would be too small to make a material difference to the state of competition in the tenements market;
- the NCC did not receive any submissions to provide evidence of the vulnerability of small mining participants in the tenements market.

We respond to these points below.

Materiality of Service charge in tenements market

Synergies' (2018a) and (2018b) presented evidence about the importance of port charges to investment incentives in the coal tenements market.[44] The possibility of higher port charges is an important risk factor when making a decision about whether to invest in exploration or development. Coal producers will base their decisions on their assessment of many factors, including the price that they anticipate PNO will apply.

In considering the relative significance of port charges, the NCC has had regard to PNO's submission that Service charges are a small proportion of the cost of coal and has concluded that Service charge increases (to a commercially realistic level) would remain a small component of costs and would have a small impact on the profitability of exporting coal.[45]

However, in making this assessment, not only has the NCC adopted a benign view of the potential increase in Service charges absent declaration (as discussed above), the NCC does not appear to have taken into consideration that PNO's assessment of the Service charges and producer margins was **based on the costs borne by the lowest cost Hunter Valley coal producer**.[46] (PNO's assessment concluded that an average Hunter Valley coal miner bears cash costs of \$43.02/t, earning a margin of \$45.39/t at a coal price of \$88.42/t.)

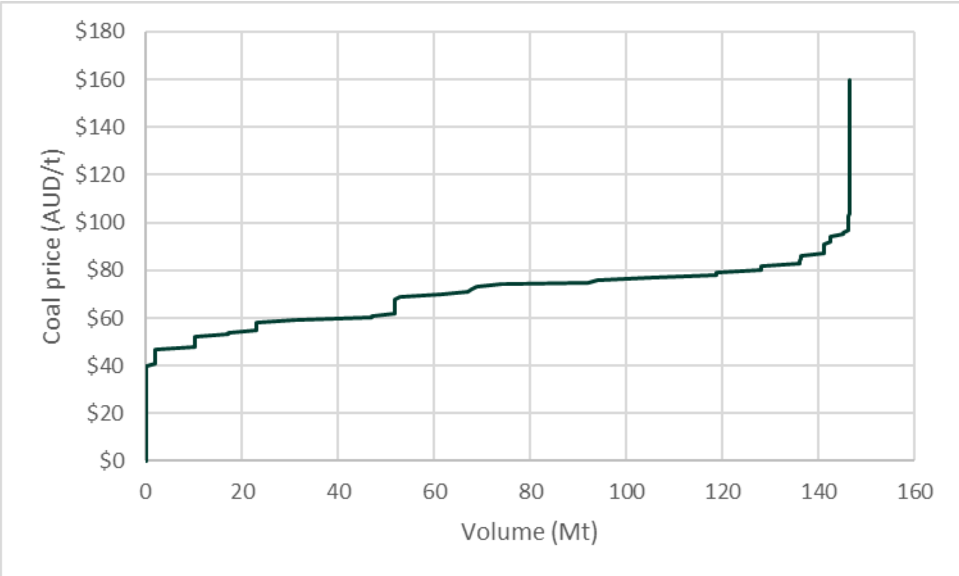
44 Synergies (2018a), p.59, (2018b), p.16.

45 NCC (2018), p.54.

46 This was demonstrated in Synergies (2018a), p.59 and Synergies (2018b), p.16

It is true that for the lowest cost mines, higher port charges may not influence production decisions. For the reasons outlined above, PNO's profit maximising price is very likely to affect marginal mines – the mines in the Hunter Valley with the highest operating costs and lowest margins. In this regard, our previous analysis (re-produced in Figure 2 below) indicates that there are numerous existing mines with cash costs above AU$80/t.[47]

Figure 2 Port of Newcastle thermal coal supply curve – existing projects (2018, AU$/t)



Source: Wood Mackenzie, Synergies analysis

Moreover, for future coal mines (those that are, in effect, sub-marginal today), the impacts can be expected to be more significant. The key consideration for demand in the tenements market relates to the expected costs and margins applicable to planned and prospective mines, that are, at present, by definition, sub-marginal. Margins for new coal developments are much thinner than for operating mines, and the risk of a significant increase in Service charges is likely to be material for such projects. As we have previously explained:[48]

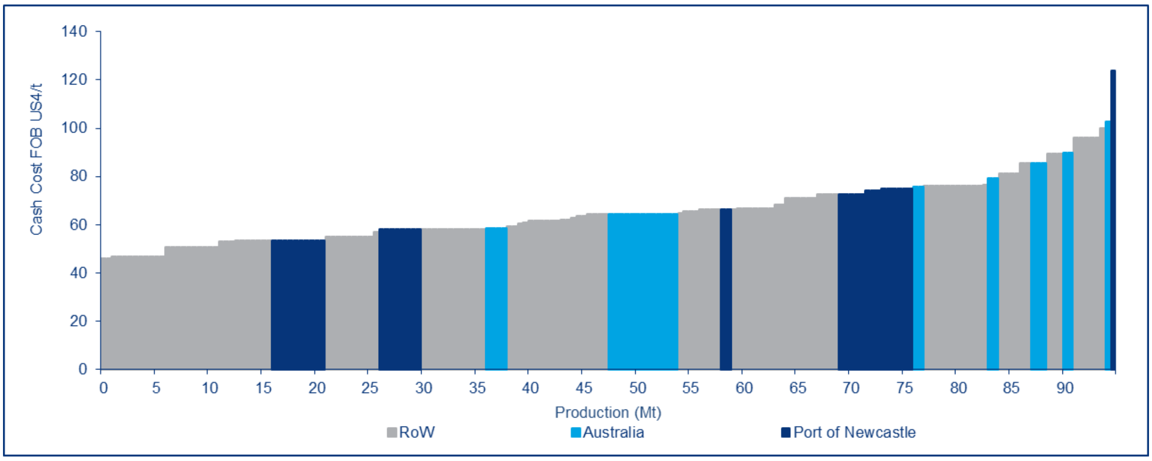
> Wood Mackenzie also maintains cost curves for known, but yet to be developed, projects. Wood Mackenzie estimates that, in 2025, the cash cost for several of these projects will range from US$70-75/t or AU$95-100/t (2018$s) as shown in Figure 19 [reproduced below at Figure 3]. Given a coal price forecast in 2025 of US$75/t

47 Price and cash cost data from Wood Mackenzie are expressed in US$. We have converted these values to AU$ using an exchange rate of 0.74 US$/AU$, which is consistent with the exchange rate at the end of July 2018.

48 Synergies (2018a), p.60.

(2018$s),[49] these projects would have a cash margin of less than $US5/t to contribute to the capital costs of the projects, which is less than NERA's estimate of capital costs of US$7.2/t. In this context, the perceived risk of a change in input cost of up to $2/t would appear likely to have a material impact on whether or not these projects will be considered viable.

Figure 3 Global Seaborne Energy Adjusted (6,322) New Thermal Coal Projects FOB supply curve (2018, US$/t, nominal) in 2025



Source: Wood Mackenzie

Having regard to:

- the costs and margins applicable to new mine developments; and
- the full range of Service price outcomes that can be anticipated in an unregulated environment given PNO's ability and incentive to increase prices;

the NCC's conclusion that the possible change in Service charge is too small to have a material impact on expected investment returns for new mine developments is based on irrelevant information and accordingly is not reasonable.

Synergies therefore considers that the NCC, in examining the impact of competition on the tenements market, has placed undue weight on PNO's claim that port charges will be relatively insignificant to the overall cost structure of coal exports, even in a future without declaration. Despite acknowledging PNO's clear profit maximising pricing incentives and lack of constraint in a future without declaration (but to a more limited extent than the Synergies assessment), the NCC's preliminary view that competition is unaffected by the declaration status relies too heavily on this determinative assumption.

[49] Wood Mackenzie forecast for 'FOB Newcastle @ 6,000 kcal/kg NAR, market'

Put another way, it is very unlikely that PNO will maximise profits without adversely affecting competition in the tenements market.

Significance of Service charge risk relative to other risks

The NCC has concluded that coal producers and exporters face significant uncertainty resulting from the magnitude and timing of potential future changes for a number of factors, including coal prices, labour costs and taxes. Compared to these other factors, the NCC considers that any uncertainty about Service charges is likely to be relatively small, and the reduction in uncertainty resulting from declaration of the Service is so small that it is not likely to promote a material increase in competition in the export coal market.

Synergies disagrees with the NCC's conclusions for two reasons:

- first, the NCC's view on the significance of the risk reflects its benign view of the potential price increases that may occur absent declaration (as discussed above), which we have shown is not consistent with profit maximising incentives and which is unlikely to be shared by all potential investors in the tenements market; and

- second, the NCC's view does not adequately distinguish between those risk factors that are able to be mitigated for or entail some upside potential, and those other risks which cannot be mitigated or which do not entail upside potential.

In a future without declaration, Synergies maintains that PNO's unfettered ability and clear incentive to impose significantly higher charges at any point in time will result in a material loss of competition in the coal tenements market, primarily because of investors' concerns over the prospect of higher costs, which will reduce the economic viability of new and prospective mining developments. Absent declaration, PNO's unfettered ability to price the use of the channel empowers it to appropriate much of the economic rent that would otherwise incentivise mine investment.

The issue of risk and its impact on competition in the tenements market is largely a matter of whether or not the costs imposed by that risk can be mitigated and also whether there is any upside potential to offset downside risk. Risk in a relevant economic sense is defined as an expected value i.e. the probability of an outcome multiplied by the impact if the outcome is realised and a range (the latter informing possible impact).[50]

[50] Black, J., (2010) The Role of Risk in Regulatory Processes, in Baldwin, R., M. Cave and M. Lodge, The Oxford Handbook of Regulation, Oxford University Press, p. 310: "*Risk is conventionally measured to be probability × impact (Knight 1921; Fischoff, Watson and Hope, 1984).*"

Where there are several possible outcomes, the expected value is the sum of the probabilities of each outcome multiplied by the value (positive or negative) associated with each outcome. Where the range of credible alternatives is wide, parties may place greater weight on worst case scenarios when assessing the desirability of investing in the Hunter Valley relative to alternative investment opportunities.[51]

Where risks cannot be mitigated or entail no meaningful upside potential and so reduce the expected economic viability of new mining ventures, then this will result in reduced demand for, and competition for, mining tenements. Where risks are able to be mitigated or are characterised by some offsetting upside potential, then any competition losses that arise should be less significant.

The risk of PNO increasing prices in a future without declaration is highly likely (insofar as it will occur, the size and timing of the increase is far less certain). The main problem with risk arises where there is no offsetting upside potential. In this case there is most likely to be a Service charge increase that does not entail any offsetting benefit for a user. This contrasts with other risks, such as coal price changes, where there is scope to manage that risk (e.g. through hedging arrangements) and the risk involves both upside and downside changes.

The NCC's view does not adequately distinguish between those risk factors that are able to be mitigated for or entail some upside potential, and those other risks which cannot be mitigated or which do not entail upside potential. This is consistent with evidence submitted by Yancoal to the NCC which notes that:[52]

> In respect of the report from HoustonKemp Report, Yancoal considers its reasoning and conclusions deeply flawed as:
>
> …
>
> (e) It simply ignores that volatility in coal prices, freight rates or foreign exchange rates are completely different to the uncertainty of future channel charges in terms of their impact on investment decisions, as:
>
> (i) volatility of coal prices, freight rates and foreign exchange rates are things that coal producers can predict and have the potential to mitigate (whether through hedging or fixed price contracting);

51 This is consistent with the economic literature associated with loss aversion, see for example Kahneman and Tversky (1979), Benartzi and Thaler (1995) and Rothschild and Stiglitz (1970).

52 Yancoal (2018), Further submission on revocation application for the Port of Newcastle Shipping Channel Service, 5 October 2018, p.6.

(ii) coal prices, freight rates and foreign exchange rates are generally cyclical such that they will 'turn' over the life of the project if they are initially adverse;

whereas the likely increases in pricing by PNO are something that (in the absence of declaration) cannot be estimated or mitigated and are highly unlikely to ever be reversed.

We note that QCA also considered such a distinction to be an important one when assessing the impact of risk associated with increased pricing uncertainty and its impact on competition in the coal tenements market. It concluded that:[53]

> To summarise, the QCA's view is that in a future without declaration, access seekers would face the risk of negotiating access in an environment where DBCT Management would have the discretion to set access terms and conditions, the risk of paying a materially higher access charge reflecting the cost of accessing WICET as well as the uncertainty as to whether and when they would obtain access to the terminal. This risk would be unmanageable and fundamental, considering the essential nature of the DBCT service for mining operations in the Goonyella system, and is over and above the normal uncertainties miners would face in conducting their operations.

We consider that, similar to DBCT, the risk of significant increases in Service charges at Port of Newcastle will be perceived by investors to be both unmanageable and fundamental, as well as being over and above the normal uncertainties that miners face in conducting their operations. As coal producers do not have access to an alternative port, apart from the option of reducing production, there is no way for them to mitigate the risk of increased port charges.

The risk is unmanageable because it cannot be mitigated and it is a one sided downside risk for users of the Service.

Impact of Service charge risk on incentive to invest in mine exploration and development

Given its view that the risk associated with increases in Service charges is insignificant (discussed above), the NCC has taken the view that declaration status will have no impact on investor incentives to invest in mine exploration and development.

However, if it is accepted that the risk associated with increases in Service charges may be significant for the reasons discussed above, then we consider that this would

[53] QCA (2018), p.71.

necessarily alter the NCC's assessment of the implications that revocation may have on incentives to invest.

The economic rent that a coal tenement buyer expects to earn from its investment is a major factor in its investment decision. Without these rents, miners cannot justify making the necessary investment to undertake mining exploration activities.

This is consistent with economic literature on exhaustible resources and expectations of future economic rents (marginal profits) in decisions by resource owners about if and when to draw out deposits. For instance, Solow notes that:[54]

> A resource deposit draws its market value, ultimately, from the prospect of extraction and sale. In the meanwhile, its owner, like the owner of every capital asset, is asking: What have you done for me lately? The only way that a resource deposit in the ground and left in the ground can produce a current return for its owner is by appreciating in value…Since resource deposits have the peculiar property that they yield no dividend so long as they stay in the ground, in equilibrium the value of a resource deposit must be growing at a rate equal to the rate of interest. Since the value of a deposit is also the present value of future sales from it, after deduction of extraction costs, resource owners must expect the net price of the ore to be increasing exponentially at a rate equal to the rate of interest. If the mining industry is competitive, net price stands for market price minus marginal extraction cost for a ton of ore. If the industry operates under constant costs, that is just market price net of unit extraction costs, or the profit margin. If the industry is more or less monopolistic, as is frequently the case in extractive industry, it is the marginal profit – marginal revenue less marginal cost – that has to be growing, and expected to grow, proportionally like the rate of interest.

To the extent that potential higher port charges add to expected marginal costs and therefore squeeze the marginal profit expectations of tenement owners (assuming all other things remain equal), this will discourage mineral extraction and delay investment decisions.

Where PNO is able to substantially increase prices, much of the impact would be reflected in a transfer of resource rents from the sellers of coal tenements and ultimately the State of NSW when it sells new coal tenements (from lower tenement values) to PNO

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54 Robert M. Solow (1974), The Economics of Resources or the Resources of Economics, published in the American Economic Review, Vol. 64, No.2 Papers and Proceedings of the Eighty-Sixth Annual Meeting of the American Economic Association, May 1974, pp.1-14. In practice, the value of tenements will also be affected by expectations of factors such as productivity enhancements enabling extraction costs to be reduced and future demand.

shareholders (as a result of higher Service charges).[55] There is also likely to be a reduction in coal exploration investment and in coal production relative to what would occur in the absence of the revocation over the longer term. Synergies (2018a) previously demonstrated that that the transfer of economic rents from coal producers to PNO would be avoided through continued declaration.[56]

Synergies presented evidence (2018a) which demonstrated that it is the smaller coal producers that typically participate in the coal tenements market. Over time the deposits which are being explored and developed have a tendency to be further away from the port (i.e. in the Gunnedah Basin), such that infrastructure costs are anticipated to become more and more important to the prospect of tenements being developed into producing mines, and hence to the valuation of those tenements.

Where economic rents in coal production are transferred to PNO in the form of higher prices, this will ultimately lead to reduced competition and consolidation in the market for coal tenements as smaller coal producers have less available financial resources to invest in coal exploration. The expectation of lower returns will lower the attractiveness of coal tenements which will ultimately lower coal resource values in the Newcastle catchment as explained above.

With respect to its assessment about the competitive impacts in the coal tenements market of increased risk from higher port charges, the NCC noted an absence of submissions from small mining participants as an indicator of there being no evidence about the vulnerability of market participants to PNO's pricing behaviour.[57]

Synergies maintains that the absence of submissions about pricing uncertainty by tenement buyers or prospective bidders is not a reasonable basis to infer evidence of a position one way or the other. Clearly existing coal producers (other than Glencore) have indicated the importance of the issue, and the fact that smaller miners typically invest in coal tenements is an established characteristic of the mining industry. Further, as we have previously submitted, such evidence may not even exist as it is unrealistic to expect that a coal tenement buyer would be willing to disclose its capacity to purchase tenements at a higher price.

Extent of Glencore advantage due to arbitration outcome

As discussed in section 2.5.1, given the existence of its arbitration outcome, Glencore will not be subject to the same risk of Service charge increases as will other coal producers

55 See section 3.5 of this report.

56 Synergies (2018a), p.82.

57 NCC (2018), p.53.

over the term that the arbitrated outcome applies. The NCC's view that this benefit will be limited depends entirely on its benign view of the potential pricing outcomes that may occur absent declaration. If the full range of potential pricing outcomes is considered, it becomes apparent that Glencore's pricing advantage may indeed be significant, leading to a distinct advantage over other coal producers in coal exploration and future mine development. This comparative disadvantage for smaller companies is likely to lead to further consolidation and less rigorous competition in the coal tenements market.[58]

We note that this concern has been raised in other evidence provided to the NCC in which Yancoal, for example, considered there will be a distortion in a number of dependent markets if the declaration is revoked, as it is likely that Glencore will have the benefit of the ACCC's arbitrated terms.[59] Yancoal further argue that this effect would make coal authorities more valuable to Glencore and place Glencore in an advantageous position compared to other potential acquirers in the tenements market. Synergies agrees with this proposition as a matter of economic and commercial reality and is consistent with the likelihood of less competition in the tenements market.

Current state of competition in the tenements market

We consider that, in forming its view that competition in the tenements market will not be affected by the declaration, the NCC has had insufficient regard to the current level of competition in this market.

The NCC states that, in 2015, it considered the tenements market was and would remain effectively competitive with or without declaration of the Service. However, we note that the NCC has not undertaken any analysis on the current extent of competition in the tenements market, either in 2015 or in 2018. While the NCC has claimed that the large number of companies holding tenement licences in the Newcastle catchment supports its view that the tenements market is effectively competitive, we do not consider that this factor alone provides any robust indication on the state of competition in this market.

As we have previously submitted,[60] there are a number of factors that indicate that the tenements market is not highly competitive and which were largely not considered by the NCC. This view is supported by the NSW Government's concerns about the

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58 Synergies (2018a), p.66.

59 Yancoal (2018), Submission on revocation application for the Port of Newcastle Shipping Channel Service, 8 August 2018, pp.15-16.

60 Synergies (2018a), p.63-65.

effectiveness of existing competition in the coal tenements market and its announced reforms to the process for bidding for tenement rights aimed at improving competition.[61]

In this context, while we acknowledge that the declaration is unrelated to the proposed NSW Government reforms to the tenement bidding process, we remain of the view that a regulatory change that is expected to reduce expected returns from coal tenements is likely to adversely impact on competition in the tenements market by reducing the incentive for bidders to participate and vigorously compete in the tenements market.

Hold-up problem in the coal tenements market in a future without declaration

The NCC's preliminary view considered the issue of hold-up only in terms of the potential for PNO to hold up individual mining investments. On this basis, the NCC took the view that hold up could only occur where PNO is able to price discriminate between mines, and that the NCC was not satisfied that this was possible.

As we have discussed in previous submissions,[62] while the ability to price discriminate will assist in allowing a service provider such as PNO to increase prices in a targeted way in order to expropriate a user's profit margin after its investment is sunk, some level of profit expropriation is clearly possible through the application of general price increases. This is particularly the case for coal mines where, once investment in the mine is sunk, coal volumes (particularly for inframarginal producers) are relatively insensitive to changes in port charges.

Given this, we consider that the NCC has erred in only considering investment hold up to be a risk only if PNO is able to price discriminate.

Conclusions

The NCC's conclusion that the declaration status will not have any impact on competition in the coal tenements market rests largely on its presumption that, absent declaration, PNO can be relied upon to take a restrained approach in setting future price increases. This is not consistent with the behaviour that can be expected from a profit maximising monopolist in the circumstances considered here.

The very high likelihood that prices will rise in the absence of any credible constraints in turn puts new investments in future coal exploration and development in the Newcastle catchment region at considerable risk, and as a result will undermine competition in the coal tenements market.

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61 NSW Government (2014), Strategic Statement on NSW Coal, August 2014, p.2

62 Synergies (2018b), p.18.

3 Response to NCC assessment of criterion (d)

3.1 Summary

This section presents Synergies' response to the NCC's preliminary view on criterion (d).

The NCC is not 'positively satisfied' that a future with declaration would promote the public interest.[63] Although the NCC considers that there are some benefits and some detriments that are likely to be realised as a result of declaration, the NCC is not satisfied declaration will materially improve efficiency and welfare.[64]

Synergies disagrees with the NCC's preliminary findings and maintains its earlier position that continued declaration will promote the public interest by creating incentives for increased efficiency in supply chain infrastructure and enhancing growth in the NSW and Australian economies, thus satisfying criterion (d).[65]

This position is consistent with regulatory precedent set by the QCA in its current review of the DBCT declaration, in which the regulator considered many of the factors that the NCC also assessed, yet the QCA concluded declaration will promote the public interest:[66]

> Access as a result of declaration would create an environment for efficient investment in coal tenements markets, which would likely result in higher coal export revenues as well as would likely generate wider economic benefits to the regional and state economies, including higher coal royalties.
>
> There is no evidence to suggest that declaration will impact DBCT Management's incentives to invest in the terminal. In fact, declaration is likely to have a positive impact on the incentives to invest in DBCT as well as on the incentive to invest in the rail network and haulage facilities that service the terminal, to the extent that there is an increase in mining investment as a result of declaration.
>
> The administrative and compliance costs incurred by DBCT Management as a result of declaration are not considered excessive relative to those that may be incurred in the absence of declaration, such as to have an impact on the public interest.
>
> …

63 NCC (2018), p.79.

64 NCC (2018), p.78.

65 Synergies (2018a), p.71, pp.75-82.

66 QCA (2018), p.127.

> Having weighed all of the costs and benefits, the QCA considers that there is a net public benefit.
>
> The QCA therefore concludes that access (or increased access) to the service provided by DBCT, on reasonable terms and conditions, as a result of declaration would promote the public interest.

The QCA's analysis and findings support the evidence presented earlier by Synergies that declaration of the PNO channel Service will promote the public interest.

3.2 Background

Criterion (d) requires as set out in subsection 44CA(1) of the CCA:

> (d) that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote the public interest.

The NCC has previously identified that the central question associated with this criterion is whether the declaration is likely to generate overall gains to the community. The NCC and the Minister may have regard to a very wide range of matters when considering this criterion. The NCC has also indicated that issues of economic efficiency and competition to be important in the context of promoting the public interest.[90] We consider that the objects of Part IIIA and the broader CCA are highly relevant to the consideration of the public interest. This is discussed in section 4 of this report.

There are also mandatory public interest considerations pursuant to s 44CA(3) of the CCA, in which the NCC must consider:

- the effect that declaring the service would have on investment in:
  - infrastructure services; and
  - markets that depend on access to the service; and
- the administrative and compliance costs that would be incurred by the provider of the service if the service is declared.

As a result of the amendments to the previous criterion (f), this is now a positive test. Under the old criterion (which was a negative formulation), the NCC found that declaration would not be contrary to the public interest, thus satisfying criterion (f).[67]

Under the amended criterion, the NCC notes that it does not call into question its conclusions on criteria. It accepts those results and inquires whether, on balance,

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[67] NCC (2015), p.53.

declaration of the service would promote the public interest giving consideration to likely flow-on effects that follow its conclusions as well as any other matters that are relevant to the public interest.

Synergies assessment of criterion (d) is consistent with this approach. We identified (2018a) the additional benefits associated with improved access based on reasonable terms and conditions (compared to access on PNO's imposed terms) and which have not already been identified in criterion (a). These additional benefits fell into two broad categories:

- the additional economic growth in the NSW and Australian economies associated with increased mining production (i.e. where increased investment attractiveness because of the declaration leads to deposits being proven and ultimately mined);[68]
- the avoided efficiency losses that would have otherwise materialised resulting from diminished competition in the tenements market leading to a deterioration in the value of tenements, including new tenements sold by the NSW Government, and reduced investment and investor confidence in mining development.

3.3 Synergies' previous views on criterion (d)

Synergies (2018a) presented evidence to indicate that there are strong efficiency benefits associated with maintaining the declaration. Access (or increased) access to the Service, based on reasonable terms and conditions resulting from continued declaration, relative to revocation, will ensure that disincentives to future investment in coal mining, exploration, development and production are not introduced. Disincentives will arise in a future absent declaration where tenements represent a less attractive investment as potential entrants anticipate reduced margins given the very high likelihood that Service charges will rise. Reduced competition will also result in lower tenement values reflecting a transfer of economic rent from tenement sellers to PNO shareholders. This will further distort the incentives for efficient investment in infrastructure. Continued declaration will avoid these disincentives, and not put at risk the economic gains associated with such investment.

Possible efficiency losses without competition losses

In light of the NCC's recommendation to have the declaration revoked, it is important to re-emphasise that efficiency losses can occur in markets without there being a material

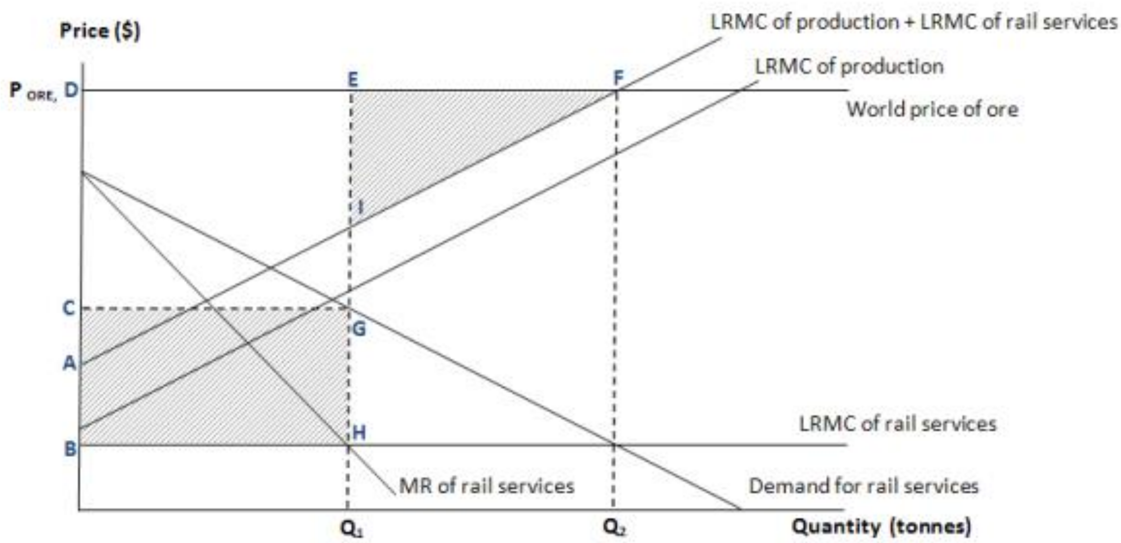
68 Synergies (2018a), p.71.

adverse impact on competition in those markets. The NCC's preliminary view does not address this point. Our key contentions are that:

- allocative economic efficiency losses can occur in markets without there being a material adverse impact on competition in those markets. This is because allocative economic efficiency effects arise wherever the pattern and associated value of economic activity differs between a status quo factual position and a counter factual position following a policy or parameter change (in this case, where the counter factual results in materially higher Service charges where declaration is revoked).
- these effects are not necessarily dependent on there being a material reduction in workable competition in any market. For example, where coal exported from the Newcastle catchment is less competitive in relevant export markets and volumes decline, there could be an efficiency loss for coal mines where the access prices exceed the efficient costs of supply through the Port of Newcastle.

We have re-produced the following figure from our earlier report (2018a) which was based on an ACCC submission to a Productivity Commission review and demonstrates that efficiency losses can arise despite no reference to competition losses necessarily occurring.

Figure 4 Efficiency losses as a result of monopoly pricing



Source: Reproduced from Synergies 8 August 2018 report at p.73. Originally sourced from ACCC (2013), Productivity Commission Review of the National Access Regime - ACCC submission to issues paper, February 2013, p.77

In presenting this diagram, the ACCC used the example of a miner exporting its output into a global market to show that there can be efficiency losses without there being reference to a material reduction in workable competition, by, for example, noting that:[69]

> Even if the railway operator is able to expropriate some or all of the miner's rents (the area ADF) without affecting the miners' marginal costs of supply (for example, by imposing a two-part tariff for rail services), there may still be negative efficiency consequences from the expropriation of the miner's economic rents. Mining exploration is inherently risky as many prospects will be found not to be viable after substantial exploration and initial development expenditures have been incurred. The economic rents made on commercially viable mines allow miners to recover losses on prospects that prove unviable and to achieve at least a commercially acceptable risk-adjusted rate of return across their entire operations (including losses on unviable prospects). Expropriation of these economic rents may discourage investments in prospecting for, and developing, new mines—with negative implications for allocative and dynamic efficiency, productivity and export earnings, and, in turn, for community welfare.

This example shows that there is no impact on the marginal cost of supply and by implication no impact on current production and so is consistent with a view that if there is no impact on current production there is no impact on competition in the market in which that production competes. However, as explained, the extraction of rents may discourage investment and subsequently production over the longer term.

Our earlier report also considered that there would also be a significant public detriment associated with a revocation of the declaration where:

- there is no other credible constraint on PNO engaging in monopoly pricing which would mean that the application of the Part IIIIA regulatory framework is redundant;
- revocation of the declaration will cause a reduction in the value of investments made by coal producers who legitimately expected that PNO's ability to engage in monopoly pricing would be constrained; and
- it establishes a precedent for undeclared ports, across Australia, to raise prices where they perceive the threat of regulation is similarly weak.

Our 5 October 2018 report also addressed specific claims from PNO that:

[69] ACCC (2013), Productivity Commission Review of the National Access Regime – ACCC submission to issues paper, February 2013, p.77.

- declaration may have a chilling effect on investment in infrastructure services. It is true that inappropriate regulatory pricing of declared services may affect investment incentives. In this regard, we have already presented evidence there is significant channel capacity such that no significant investment in channel capacity is required over the medium term. Moreover, even if any such investment is required, based on the history of channel development (which was substantially funded by users) as well as PNO's public statements regarding future investments, those future investments will most likely be required to be funded by users. This means that:
  - there is no expectation that PNO will commit its own funds to channel development for the foreseeable future, and therefore the risk that declaration will have a chilling effect on PNO's investment in the declared service is in practice very limited;
  - however, the absence of declaration may in fact have a chilling effect on investment that other parties are willing to make, both in relation to the declared service (e.g. users may be reluctant to fund capital dredging works if they consider that PNO is likely to seek to also recover the costs of such works in Service charges) and in relation to complementary infrastructure (e.g. users may be reluctant to fund complementary infrastructure if they consider that PNO may subsequently increase Service charges to expropriate profit margins);
- declaration has created significant compliance costs. In this regard, while we acknowledge that significant costs are likely to have been incurred in the Glencore-PNO arbitration, we demonstrated that many of these costs are likely to be one-off in nature and avoided in future arbitrations if the outcomes of arbitration are publicly known.

For these reasons, Synergies considered criterion (d) to be satisfied to warrant the declaration remaining in place.

3.4 NCC's preliminary view

The NCC is not 'positively satisfied' that declaration will promote the public interest, for the reasons, we have summarised below:[70]

- effect of declaration on investment in infrastructure services

[70] NCC (2018), pp.75-79.

   - while acknowledging that declaration may limit the potential for PNO to set prices at an inefficiently high level, and give users of the port services greater opportunity to invest in other mining related infrastructure, the NCC considered this effect to be limited, and given its view on the likely magnitude of the Service charge with or without declaration, would be unlikely to impact volumes in dependent markets.

- effect of declaration on investment in dependent markets
   - given its view on the likely magnitude of the Service charge with or without declaration, the NCC considered that investment incentives in dependent markets will be similar with or without declaration.

- administrative and compliance costs of declaration
   - the NCC acknowledged that in a future with declaration, the number of future disputes is uncertain, although future disputes are likely to be relatively less complex and less costly due to matters already considered in the Glencore-PNO arbitration.

- other matters the NCC considered are identified as follows:
   - *Improved efficiency* - where the NCC is not satisfied under criterion (a) that declaration will promote a material increase in competition in any dependent market, it is similarly not satisfied that declaration will improve efficiency and welfare.
   - *Transfer of surplus* – the NCC considers declaration is likely to result in more favourable terms and conditions of access for users, which would redistribute surplus from PNO to users; however it does not consider the wealth transfer effect to be sufficient to warrant continued declaration.
   - *Economic growth* – the NCC does not consider declaration will appreciably impact economic growth. The NCC did not provide further detail.

In assessing a change from the status quo of a future with declaration to a future without declaration, the NCC considers the public detriments will be minimal, noting that:

- while acknowledging the value of investment in tenements made while the declaration was in place may drop, the NCC considers the drop to be minimal (as sophisticated investors will have anticipated the risk of the declaration of being overturned);[71]

[71] NCC (2018), p.76.

- the NCC rejected the premise that revocation will prompt other ports to raise their prices as it does not view declaration as a relevant precedent for other ports, as according to the NCC, the circumstances applicable to the provision of port services vary significantly.[72]

Our response to these issues is provided below.

3.5 Synergies' response to the NCC's preliminary view

Criterion (a) assessment and its flow on effects dominates the NCC's assessment of criterion (d)

The NCC's assessment of criterion (a), and in particular its benign view of the extent to which Service charges may rise absent the declaration and its resulting view that the declaration status will not impact incentives to invest in coal mine developments, effectively means it does not consider it likely that there will be any additional public benefits associated with new mine development under criterion (d).

It is not possible to fully test the NCC's position that declaration will not appreciably affect economic growth as this was not explained in the Statement, nor did the NCC directly respond to evidence presented in Synergies' 8 August report that demonstrated the economic benefits that will arise in the NSW and Australian economies from stimulated investment in mining developments.[73] However, we remain of the view that, to the extent that continued declaration will avoid the creation of disincentives to investment in mine development, this will lead to economic benefits to the NSW and Australian economies.

We note that the QCA similarly recognised DBCT's importance to the Queensland economy as well as the terminal's 'substantial' contribution in facilitating that state's coal exports, royalties and employment when considering the public interest impact of declaration.[74]

Further, where the NCC considers there is no material competition benefits in a future with declaration, the NCC concludes that there will be no derived efficiency gains or other public benefits either.

Notwithstanding our respective views about the competition impacts resulting from a change in declaration and the potential stimulation of mining development, we consider

72 NCC (2018), p.79.

73 See section 4.3 of Synergies' 8 August 2018 report.

74 QCA (2018), pp.103-107.

that the NCC does not adequately recognise the possibility that, in a future absent declaration, there can be adverse efficiency effects without any commensurate, adverse competition effects (as we have outlined in section 3.3).

Other matters relevant to the criterion (d) assessment

Our examination of the other matters identified in the NCC's Statement indicates that there are two matters upon which the NCC and Synergies appear to agree in their respective assessments of the public benefits that will arise from a future with declaration: (1) that administrative and compliance costs of declaration are not deemed excessive; and (2) declaration is likely to result in a transfer of surplus from PNO to users and also to sellers of coal tenements, including the State of NSW (although, even here, given its benign view on the likely price increases that PNO may apply, the NCC does not regard wealth transfers as material).

However, in addition to not agreeing on the scope for efficiency gains as a result of continued declaration, Synergies and the NCC also disagree on the scale of public detriments that will arise if revocation occurs. In considering the impact of a change from the status quo where declaration currently applies, the NCC considered that the public detriment associated with revocation will be minimal. Given that the NCC has already acknowledged that, without declaration, PNO has the ability and incentive to significantly raise prices, this claim significantly understates the considerable risk for existing coal producers and potential, new investors from revocation.

Further, to conclude, as the NCC has done, that other ports are not watching the outcome of the current declaration process understates the strategic role of economic regulation, particularly in today's current climate around port pricing. Such a view understates the heightened public scrutiny that is taking place by other economic regulators (such as the ACCC and the QCA) around port pricing in Australia and the extent to which economic regulation is seen as a real constraint (or, as a result of this current declaration, a credible threat). While different ports will:

- interpret the threat of regulation differently, particularly in light of the threat of State based regulatory intervention;
- assess the value of their social license differently; and
- have differing levels of exposure to the risk of declaration under Part IIIA, with certain ports being unaffected by the NCC's decision,

removing the threat of declaration is likely to influence future pricing outcomes for at least some ports.

QCA has assessed that DBCT declaration satisfies criterion (d) based on the same legislative criteria examined by the NCC

The scope for a different regulatory opinion to apply in an assessment of the public benefits resulting from declaration is evidenced through the QCA's review of the DBCT declaration. The QCA considered the same legislative factors that were assessed by the NCC having regard to very similar circumstances. The QCA concluded the public interest is promoted through continued declaration of DBCT, thus satisfying criterion (d). A summary of the contrasting regulatory positions between the NCC and the QCA is presented in the table below.

Table 2 Criterion (d) assessment NCC vs QCA

Factor	NCC (PoN revocation)	QCA (DBCT declaration review)
That access on reasonable terms and conditions as a result of declaration would promote the public interest	Criterion (d) is not satisfied for PoN	Criterion (d) is satisfied for DBCT
The effect of declaration on investment in infrastructure services	Declaration may lessen PNO's incentive to invest due to limiting the returns which might otherwise have been accrued to PNO from such investment On the other hand, declaration may increase the incentives for other efficient investment to be made. 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	There is no evidence to suggest that declaration will impact DBCT Managements incentives to invest in DBCT. However, declaration is likely to promote investment in mining and in the rail network and haulage facilities and so is likely to have a positive impact on the incentives to invest in DBCT
The effect of declaration on investments in markets that depend on access to the service	Investment incentives in dependent markets will be similar with or without declaration of the Service Service charges or uncertainty around how they might change are not sufficient to materially impact investment decisions	Declaration is likely to promote investment in the market for coal tenements Absence of declaration would likely have an adverse impact on efficient investment in coal tenements market
Administrative and compliance costs of declaration	A relatively small number of access disputes are likely to arise or result in arbitration if declaration applies because uncertainty around the particulars of arbitrated access terms will continue to narrow as disputes are arbitrated (where determinations are published) and PNO is likely to be incentivised to have regard to these terms in future negotiations with access seekers to avoid arbitration. Where such disputes result in arbitration, they are likely to be less costly than the Glencore-PNO Arbitration	The administrative and compliance costs incurred by DBCT Management as a result of declaration are not excessive. It is also open for DBCT Management to submit a draft access undertaking to the QCA that includes measures to reduce its compliance costs
Other considerations		
Improved efficiency	The NCC is not satisfied that declaration will promote a material increase in competition in any dependent market and thus improve efficiency and welfare	Declaration would promote the public interest by increasing the incentive to invest in the market for coal tenements. It will otherwise have no adverse impacts on productive or allocative efficiency
Transfer of surplus (incl . Royalties)	Declaration is likely to result in terms and conditions of access (including price) that are more favourable to access seekers and, thus, would redistribute surplus from PNO to users	As declaration would promote a material increase in competition in the market for coal tenements, it will also promote the public interest because of

Factor	NCC (PoN revocation)	QCA (DBCT declaration review)
	of the Service. The wealth transfer effected by declaration will not be sufficient to have any material effect A transfer of surplus from entities operating under one taxation regimes to those operating under a different taxation regime (i.e. royalties) does not, of itself, promote the public interest	the wider economic benefits of promoting investment in that market, including higher coal royalties
Economic growth	The NCC does not consider that declaration will appreciably impact economic growth	If efficient investment in this market is deterred in the absence of declaration, there are not only foregone revenue opportunities, but the community also forgoes the wider economic benefits of maximising the value of the state's coal resources, including increased coal royalties, employment and associated regional development
May prompt other ports to raise their prices (i.e. precedent)	Declaration does not necessarily provide a relevant precedent for other ports	

Source: Synergies, based on the NCC's Preliminary View and the QCA's Draft Recommendation – table 15, p.108.

Once again, we consider that the key factor that has led to these different conclusions is the NCC's benign view of PNO's future pricing levels in an environment unconstrained by the declaration.

4 Objects of Part IIIA

4.1 NCC's preliminary view

The NCC has stated that it has had regard to the objects of Part IIIA when formulating its proposed recommendation to revoke the declaration at the Port of Newcastle.[75]

This is part of the NCC's mandatory consideration:[76]

> Section 44J of the Competition and Consumer Act 2010 (Cth) (the CCA) provides that the Council may recommend to the designated Minister that a declaration be revoked. The Council must have regard to the objects of Part IIIA of the CCA and cannot recommend revocation of a declaration unless it is satisfied that subsection 44F(1) or 44H(4) of the CCA would prevent the declaration of service from being considered, recommended or made (as applicable).

The object of the CCA is, in part, to enhance the welfare of Australians through the promotion of competition. Pursuant to s 44AA of the CCA, the objects of Part IIIA are to:[77]

> (a) promote the economically efficient operation of, and use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and
>
> (b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.

This is based on the premise that competition provides an incentive for firms to improve economic efficiency.

4.2 Synergies' response

The NCC has stated that it has had regard to the objects of Part IIIA when formulating its proposed recommendation to revoke the declaration at the Port of Newcastle.[78] However, how the NCC has applied this mandatory consideration of the Part IIIA objects clause is unclear.

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77 See s 44AA of the CCA.

78 NCC (2018), p.8.

We note that the NCC considered several submissions on how the Council should approach this consideration, including from Glencore, which in part, relied upon our earlier analysis[79] which stepped through our reasoning that showed:

- revocation is inconsistent with the Objects clause (a) as it will introduce distorting price signals for investment and dampen incentives for innovation in the dependent markets and reduce competition in dependent markets; and
- revocation is also inconsistent with Objects clause (b) because it undermines the effectiveness of Part IIIA as a credible regulatory constraint.

The NCC's preliminary view does not directly address how its revocation recommendation aligns with Part IIIA objects other than noting that: (1) there is no provision in the legislation for how this should be conducted, and (2) there is no requirement for it to consider whether there has been a material change in circumstances since the Declaration was made.[80]

Without more detail, Synergies considers that the NCC has had insufficient regard to the Objects clause. Absent the declaration, the effectiveness of Part IIIA is diminished as not only does Part IIIA fail to respond to a situation where a provider of essential bottleneck infrastructure is clearly setting prices above the efficient cost of service provision in a manner that will disincentivise the efficient use of that infrastructure, but the threat of Part IIIA applying for ports generally is considerably weakened.

This also weakens the credibility of Part IIIA for all infrastructure sectors where competition is not deemed to be a sufficient constraint on monopoly behaviour and no other regulatory tool is available or adequate to address issues of access. This is particularly disappointing given the recent ACCC Glencore-PNO arbitration which, irrespective of the final pricing outcome, demonstrates that economic regulation can deliver appropriate constraints on opportunistic, unjustified price increases arising from the exercise of market power.

Acceptance that declaration acts as a credible threat on such behaviour is consistent with the QCA's draft recommendation to continue the DBCT declaration where it noted the following:[81]

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[79] Synergies (2018a), pp.93-95.

[80] NCC (2018), p.8.

[81] QCA (2018), p.78.

> In contrast, when considering the future with declaration, the QCA Act's third party access regime provides a credible constraint on DBCT Management's exercise of market power and enables a balanced access negotiation framework.
>
> For instance, declaration under the QCA Act establishes a right for an access seeker, and an obligation on DBCT Management (as the access provider of the service), to negotiate an access agreement. This right extends to any access seeker. The QCA Act envisages that those negotiations will end in the successful conclusion of an access agreement, and if commercial negotiations fail, in arbitration by the QCA.
>
> …
>
> The QCA approves those standard terms, having regard to the factors listed in s. 138(2) of the QCA Act, which, among other things, seek to promote economically efficient outcomes in relation to essential infrastructure services, and protect the legitimate business interests of access provider, the interests of access seekers and access holders, and the public interest.

We therefore maintain revocation is inconsistent with the objects of Part IIIA, as demonstrated in this and earlier submissions, it will undermine efficient use of infrastructure and competition in dependent markets.

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