Relevance for revocation application of ACCC's determination

A report for Port of Newcastle Operations

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Disclaimer

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1. Introduction

This report has been prepared for Port of Newcastle Operations Pty Ltd (PNO), the provider of a range of port-related services at the port of Newcastle. PNO has made an application[1] to the National Competition Council (the Council, or NCC) seeking its recommendation that the declaration of 'the relevant service'[2] provided by PNO be revoked.

This report should be read in conjunction with two earlier reports[3] we prepared for PNO. Unless otherwise indicated, terms defined in our earlier reports apply equally in this report.

Our two earlier reports addressed, respectively:

- the effect of declaration on incentives to invest in coal mines; and
- the effect of declaration on competition for coal authorities.

We concluded in our earlier reports that declaration is unlikely to have a discernible effect on either incentives to invest in coal mines or competition for coal authorities.

The Australian Competition and Consumer Commission (ACCC) has since publicly released its final determination[4] and associated statement of reasons[5] in relation to the access dispute between Glencore Coal Assets Australia Pty Ltd (Glencore) and Port of Newcastle Operations Pty Ltd (Port of Newcastle).

The Council has sought the views of interested parties as to whether it should have regard to the ACCC's final determination and, if so, how it should have regard to that determination.

PNO has asked us to prepare this report, addressing:

- whether the ACCC's final determination is relevant to the conclusions drawn in our earlier reports; and
- the issues raised in submissions by Glencore, Yancoal, and Newcastle Coal Infrastructure Group, to the extent that they are relevant to the question asked by the Council.

The remainder of this report is structured as follows:

- section 2 summarises the key elements of the ACCC's final determination;
- section 3 discusses whether the ACCC's final determination is relevant to incentives to invest in coal mines, including the issues raised in submissions on those incentives; and
- section 4 discusses whether the ACCC's final determination is relevant to the competition for coal authorities.

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[1] PNO, *Application for revocation of declaration*, July 2018

[2] The relevant service is defined as: 'The provision of the right to access and use the shipping channels (including berths next to wharves as part of the channels) at the Port [of Newcastle], by which vessels may enter a Port precinct and load and unload at relevant terminals located within the Port precinct and then depart the Port precinct.' See: PNO, *Application for revocation of declaration*, July 2018, p 3.

[3] HoustonKemp, *Effect of declaration on incentives to invest in coal mines*, A report for Port of Newcastle Operations, 14 September 2018; and HoustonKemp, *Effect of declaration on competition for coal authorities*, A report for Port of Newcastle Operations, 24 September 2014.

[4] ACCC, *Access dispute between Glencore Coal Assets Australia Pty Ltd and Port of Newcastle Operations Pty Ltd, Final Determination under section 44V*, 18 September 2018 (ACCC's final determination).

[5] ACCC, *Access dispute between Glencore Coal Assets Australia Pty Ltd and Port of Newcastle Operations Pty Ltd, Final Determination: Statement of Reasons*, 18 September 2018 (ACCC's statement of reasons)

2. Relevance of ACCC's determination

This section summarises the key elements of the ACCC's final determination.

2.1 Pre-existing arrangements

PNO applies two main charges for coal vessels using its facilities, ie:[6]

- a navigation service charge, being a dollar per gross tonne charge levied on each vessel at time of port entry, based on the gross tonnage of the vessel; and
- a wharfage charge, which is a dollar per revenue tonne[7] charge for non-containerised freight loaded onto each vessel.

PNO determines its cost of service, including an appropriate return on its capital, with reference to a conventional building block model so that the prices it sets generate revenue that is no more than its estimated maximum allowed revenue.[8]

Charges at the Port of Newcastle are subject to a price monitoring scheme as specified in Part 6 of the Ports and Maritime Administration Act (PAMA Act). The objective of the price monitoring scheme is to:

> …promote the economically efficient operation of, use of and investment in major port facilities in the State by monitoring the prices port operators charge users of those facilities, so as to promote a competitive commercial environment in port operations.

The price monitoring scheme requires PNO:[9]

- to publish its relevant charges on its website;
- to give prior notice to any proposed changes to both the Minister and on its website;
- to provide the relevant Minister with an annual report on:
  - its prices, including amount of variation and reasons for changes; and
  - any other relevant information required by the Minister.

The Minister may refer any identified pricing concerns to the Independent Pricing and Regulatory Tribunal (IPART) for its review and investigation. Alternatively, IPART can also request the Minster to refer a matter to it, which may arise if IPART receives complaints in relation to PNO's charges.

IPART has the power to conduct investigations and make reports on any matter with respect to pricing, industry or competition that is referred to it by the Minister.

2.2 ACCC's final determination

The ACCC's recently published final determination applies to the terms and conditions of access:[10]

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[6] Port of Newcastle Operations Pty Ltd, *Port of Newcastle Schedule of Service Charges – Effective from 1 January 2018*, p 4, https://www.portofnewcastle.com.au/Resources/Documents/Port-of-Newcastle-Schedule-of-Port-Pricing-2018.pdf. There are also site occupation fess and ship utility fees, which are currently levied on non-coal carrying vessels only

[7] One revenue tonne is one tonne of freight or one cubic metre/kilolitre, whichever gives the largest number units.

[8] Port of Newcastle Operations Pty Ltd, *Submission in Response to Glencore's Application to the National Competition Council*, 18 June 2015, p 21.

[9] Ports and Maritime Administration Act 1995, Part 6

[10] ACCC, Final Determination, 18 September 2018, p 2.

> a. where Glencore, either directly or by agent, charters a vessel to enter the Port precinct and load Glencore coal, and
>
> b. where Glencore makes a representation to PNO of the kind referred to in section 48(4)(b) of the Ports and Maritime Administration Act 1995 (the PMAA) that it has the functions of the owner of a vessel, or accepts the obligation to exercise those functions, in order to enter the Port precinct and load Glencore coal.

The determination does not apply to:[11]

> a. the terms and conditions of access to apply in respect of vessels carrying coal that have not been chartered by Glencore or in respect of which Glencore has not made a representation of the kind referred to in section 48(4)(b) of the PMAA
>
> b. terms and conditions of access for vessels other than those calling at the coal terminals at the Port, and
>
> c. any charges imposed by PNO other than the Navigation Service Charge and the Wharfage Charge.

The ACCC used a building block framework to derive its estimate of the maximum allowable revenue for the relevant services provided by PNO.[12] Broadly, this method estimates the cost of providing the service over a specified time period, including an appropriate rate of return. From those estimated costs a maximum allowable revenue is derived in relation to the forward-looking pricing period, which is then divided by forecast volumes to calculate charges sufficient to recover that maximum allowable revenue.[13]

2.2.1 Wharfage charge

PNO's current wharfage charge is $0.0746 per revenue tonne.[14] The ACCC recorded the agreement of the parties that the wharfage charge should be maintained at $0.0746, and indexed on 1 January each year by the change in the consumer price index (CPI) for Sydney.[15]

2.2.2 Navigation service charge

PNO's current navigation service charge is $0.7553 per vessel gross tonne.[16] The ACCC's final determination sets the initial navigation service charge to $0.6075 per vessel gross tonne, which amounts to a discount of around 20 per cent on its current charge.[17] This charge is to be reviewed annually based on:[18]

- updated forecast volumes for the coming year; and
- adjustments for any material change event, ie, a change in law that increases costs such that it would cause an increase in charges of more than 2.5 per cent.

The final determination also puts in place a 'true up' mechanism to adjust for any under or over recovery of revenue, and the pass through of Force Majeure Events or costs of more than $1 million.[19]

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[11] ACCC, Final Determination, 18 September 2018, p 2.

[12] ACCC, Statement of reasons, 18 September 2018, p 141.

[13] ACCC, Statement of reasons, 18 September 2018, p 32.

[14] Port of Newcastle Operations Pty Ltd, *Application for Revocation of Declaration*, 2 July 2018, p 18

[15] ACCC, Statement of reasons, 18 September 2018, pp 177 – 178.

[16] Port of Newcastle Operations Pty Ltd, *Port of Newcastle Schedule of Service Charges – Effective from 1 January 2018*, p 4

[17] ACCC, Statement of reasons, 18 September 2018, p 178.

[18] ACCC, Statement of reasons, 18 September 2018, pp 178 – 179.

[19] ACCC, Final Determination, 18 September 2018, pp 3 – 4

The ACCC's final determination provides for five yearly reviews of the navigation service charge applicable for Glencore, at which time the inputs into the building block model would be subject to review. [20]

2.3 Effect of the ACCC's determination

The essential outcomes of the ACCC's final determination for charges payable by vessels meeting the requirements set out in section 2.2, as compared with the pre-existing arrangements, are that:

- the same wharfage charge applies, being $0.0746 per tonne of coal; and
- the navigation service charge reduces, from $0.7553 to $0.6075 per gross tonne.

In order to estimate the effect of the reduced navigation service charge on the cost of exporting Glencore coal from the Port of Newcastle, we assume that the relevant vessel has a gross tonnage of 58,000 and will be loading 92,500 tonnes of coal.[21] Under these assumptions, the vessel would pay:

- $51,235 of port charges under the current charges, or around 55 cents per tonne of coal exported; and
- $42,663 of port charges under those prices determined by the ACCC, or around 46 cents per tonne of coal exported.

The magnitude of this differential means that the ACCC's determination reduces the navigation charge payable by around nine cents per tonne of coal exported – as summarised in Table 1. By way of ready comparison, the nine cents per tonne price differential represents:

- between 0.1 to 0.2 per cent of the total price of coal, assuming a world price of around $50 to $100 per tonne; and
- a total sum of around $8,500 per cargo, for which (adopting the same $50 to $100 range for coal prices) the market value is likely to range between $4.65 million and $9.25 million.

Although the price effect of the ACCC's determination will vary depending on the size of the particular vessel used to transport coal, we expect that the magnitude of the difference in price would remain in the range of nine cents per tonne of exported coal.

Since competition between sellers and buyers take place in global market(s) for seaborne coal, there is no economic basis to conclude that the whole or even the larger part of this reduction in transport costs will be retained by one or other party competing in these markets.

Rather, standard economic principles dictate that the benefit of such a transport cost reduction will be shared between participants in the supply chain, eg, coal buyers, the coal producer and shippers, in proportions that will be determined by the relative elasticities of supply and demand in the relevant market(s). Beyond the 'in principle' observation that it is extremely unlikely that all of the benefit could fall to one or other party, we are not aware of any empirical evidence that would enable such an assessment readily to be made.

[20] ACCC, Final Determination, 18 September 2018, p 3.

[21] These are assumptions are consistent with those used by PNO to calculate estimated cost of Newcastle Coal. Port of Newcastle Operations Pty Ltd, *Application for Revocation of Declaration*, 2 July 2018, p 26.

Table 1: Change in navigation and wharfage charges payable for 58,000 gross tonne vessel, loaded with 92,500 tonnes of coal

	Current charges	ACCC determination
Wharfage charge	$0.0746 per tonne of coal	$0.0746 per tonne of coal
Navigation service charge	$0.7553 per gross tonne of vessel	$0.6075 per gross tonne of vessel
Total charge	$51,235	$42,663
Charge per tonne of coal	$0.55 per tonne	$0.46 per tonne
Total difference in charge	$8,572	
Market value of coal	$4.625 million to $9,250 million	
Change in charges as a percentage of market value	0.1 to 0.2 per cent	

3. Incentives to invest in coal mines

In this section we discuss whether the ACCC's final determination is relevant to incentives to invest in coal mines, including the issues raised in submissions on those incentives.

3.1 Conclusions from our earlier report

In our earlier report assessing the effect of declaration on incentives to invest in coal mines, our analysis focused on two potential effects of the declaration being revoked, as raised by the ACCC, ie, whether:[22]

- increases in prices for the service may lead to reduced output in dependent markets, and potentially the exit of firms from those markets; and
- investments made in relation to use of the service may be subject to hold-up, ie, the threat that once an investment is made, the service provider will seek to change the terms and conditions, including price, in its favour – fearing this outcome, customers will be reluctant to invest, or will make less desirable investment decisions.

We concluded that the incentive for a firm to invest in developing or expanding a coal mine depends on the expected returns of the mining project over its life, and the degree of risk arising in relation to those returns. The incentive increases if either:

- there is a higher expected return, with the same level of risk; or
- there is a lower level of risk, with the same level of expected return.

On the first of these considerations, we concluded that the expected return from mining investments will not be discernibly different with and without declaration because:[23]

> - it cannot be assumed that the terms of access to the relevant service will be any more favourable for any user or group of users with declaration than without;
> - port charges are only a very small part of the cost of supplying coal, and so any reduction in them arising from declaration is unlikely to have a discernible effect on the expected return from investing in new mines; and
> - investors of coal mines will not face any risk of 'hold up' because PNO cannot set its terms and conditions of service so as to discriminate between one mine and another.

On the second consideration, we concluded that the risk of investing in coal mines will not be discernibly different with and without declaration because:[24]

> - port charges are only a very small part of the cost of supplying coal, and so any increase in the level of uncertainty over such charges could only have a similarly sized effect; and
> - the risks to the returns from investing in coal mines are subject to vastly greater sources of uncertainty, such as the variation in the price that investors may receive for their coal.

Taking these observations together, we further concluded that there would be no discernible difference in the investment incentives in new coal mines with and without declaration of the relevant service.

[22] Letter from Rod Sims to Richard Home, 8 August 2018, p 5.

[23] HoustonKemp, *Effect of declaration on incentives to invest in coal mines*, A report for Port of Newcastle Operations, 14 September 2018, p 2.

[24] *Ibid*.

3.2 Stakeholder contentions

In our earlier report, we noted that total port charges amount to around one per cent of the profit earned from supplying coal and have amounted to less than 1.5 per cent of the price of thermal coal since 1991.

We also noted that the risk of a hold-up problem may only arise if PNO was able to increase the price of its service to each mine individually. We stated that PNO does not have the systematic ability to identify the source of coal at the time the coal is loaded on to each ship, and so cannot set charges so as to discriminate on a mine-by-mine basis.

Stakeholder submissions make two broad responses to these observations, which we address in light of the ACCC's determination.

3.2.1 Port charges contended to be material for higher cost, planned and prospective mines

In response to our analysis, some submissions noted that the profitability of the 'average' or low cost mine is not relevant and that, rather, the relevant consideration is the significance of port charges for higher cost, and planned and prospective mines.

Synergies Economic Consulting (Synergies) contends that, although higher port charges may not influence production decisions for lowest cost mines, it could influence higher cost mines since the relevant consideration is that of more marginal producers. Synergies further contends that planned and prospective coal mines are likely to be more marginal mines, either in terms of coal quality or costs.

Newcastle Coal Infrastructure Group, Yancoal and Glencore similarly contend that port costs are material, particularly for marginal mines, and higher port charges could alter a miner's investment decision process.

We agree that in assessing the criterion (a) competition test it is relevant to consider the likely effect on port charges resulting from declaration on the decisions of any marginal, higher cost mines that would be in production. Any effect on port charges resulting from declaration is much less likely to alter decisions made by average or low-cost mines and so to affect competition in any derivative market.

However, consistent with this same proposition it is not the level of port charges (as a proportion of mine profits or anticipated mine profits) that is relevant for any such marginal or higher cost mine but, rather, the effect on any such marginal mines of:

- any difference in port charges with and without declaration of the relevant service; but
- adjusted downward to reflect the proportion of any reduction in port charges that would be captured by coal producers, since any reduction would be shared by others along the supply chain.

The analysis we present in section two shows that the ACCC's determination amounts to a reduction in port costs of around nine cents per tonne of coal exported. Assuming such a reduction in port charges was eventually to apply more broadly to other users – rather than only to vessels meeting the conditions that need to be satisfied by Glencore in order to come within the scope of the determination – this would represent around 0.1 to 0.2 per cent of the total price of coal.

Of this amount, some of the benefit of this price reduction will be captured by other participants along the supply chain. Certainly, not all of it will be retained by coal producers.

To the extent that the ACCC's determination is relevant or should be regarded, in our opinion it demonstrates that declaration could only have an immaterial effect on the anticipated return on mines in the event of a potential reduction in port charges. In other words, if a change in port charges that represents 0.1 to 0.2 per cent of the price of coal was taken to be the likely consequence of declaration, this would have an immaterial effect on the incentives to invest in coal mines.

3.2.2 Hold-up problem is a key risk

In response to our analysis of the contended hold-up problem, some submissions noted that PNO's commercial objective is to maximise its profits and not the volume of coal exported through the Port of Newcastle.

In other words, absent declaration, PNO could use its monopoly power to raise prices substantially, even if the consequence was some reductions in coal export volumes. Yancoal submitted that PNO could raise prices to all users, which would cause an investment hold-up to marginal miners. Glencore also contends that PNO can identify the source of coal loaded onto vessels and notes that it already discriminates its charges by vessel type.

The problem with these contentions is that they each assume that PNO has unfettered ability to raise charges, without any apprehension of existing or potential future regulatory mechanisms being brought to bear on such conduct. Such an assumption is highly unrealistic and would be an unsafe basis on which to assess the state of competition in dependent markets without declaration.[25]

Further, PNO does not have visibility of the source of coal prior to or during the loading of cargo onto the ship. Although it has visibility after the ship has left the port, this information cannot be used for navigation service charge pricing, as the invoice is sent before the ship leaves the port. It follows that PNO does not have the ability to set the navigation service charge by reference to the source of coal.

The very fact that PNO tariffs are set with reference to a regulatory style, building block approach underlines that it has an incentive to pay attention to the price setting framework and assumptions that would likely apply if it were regulated. PNO's incentive to conduct itself having regard to the likely outcome if it was regulated is an entirely rational response to its presumptive desire to avoid the significant costs of any such regulatory intervention.

The subtlety and sophistication of such incentives appear to have been overlooked by submissions contending that the 'without declaration' circumstance involves an unfettered ability of PNO to conduct itself without regard to these existing and potential constraints. We explained in section 2 the nature and extent of existing regulatory mechanisms applying to services provided by PNO.

In our opinion, there is no reasonable basis on which to conclude that PNO has an unfettered ability or the incentive to exercise its monopoly power by either substantially increasing its prices or by setting charges so as to discriminate on a mine-by-mine basis.

3.2.3 Uncertainty in future port charges is a key risk

We concluded in our earlier report that the risk of investing will not be discernibly different with and without declaration. In addition to port charges only representing a very small part of the cost of supplying coal, we also conclude that there are other, vastly greater sources of uncertainty associated with investing in a coal mine, such as changes in coal prices, freight costs and exchange rates.

Yancoal contends that many of these sources of uncertainty are different from the uncertainty of future port changes because:

(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);

[25] Yancoal's contention is that raising charges by a sufficient extent that a marginal mine no longer produces is a form of hold-up. This appears to conflate the economic concept of upward sloping supply curves – which cause one mine always to be 'marginal' – with the mine-specific phenomenon of hold-up, which involves action directed at a particular counter-party in circumstances where its option to respond have become limited. These economic concepts are not the same.

(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;

Yancoal also noted that PNO has the ability to reset prices every year to a level that maximises its profits, but coal miners have high sunk costs and cannot easily exit the market. Several submissions also noted that uncertainty regarding future port prices would also reduce investors' willingness to invest in coal mines in the Newcastle catchment area.

In our opinion, there is no economic basis for these contentions. For example:

- there is no intrinsic reason why a user cannot seek to enter into a long term agreement with PNO as to the future arrangements for its port charges; and
- there is no economic basis on which to suggest that coal price freight rates and foreign exchange rates exhibit a stronger 'tendency towards the mean' than port charges; and
- the immaterial magnitude of the difference in port charges with and without declaration means that any uncertainty remains immaterial.

On these considerations, there is no basis on which to vary our previously expressed conclusion that declaration will not have a material effect on the degree of certainty of future port charges.

3.3 ACCC determination reinforces our conclusion

Notwithstanding the above, if the ACCC's final determination is considered to be relevant, it reinforces our earlier conclusion that declaration will not have a material effect on the incentive to invest in coal mines because:

- the difference in port charges with and without declaration can reasonably be expected to be immaterial;
- a significant proportion of the benefit of any such difference will be captured by coal buyers or other parties involved in the transport of coal from the producer's to the buyer's location;
- a change in port cost representing 0.1 or 0.2 per cent of coal prices is extremely unlikely to have a material effect on the returns on investment in mining projects, even before discounting this amount to account for the proportion that will be captured by coal buyers;
- PNO does not have an unfettered ability or the incentive to exercise its monopoly power, and so differences in future port charges with and without declaration are likely to have an immaterial effect on:
  - returns on investment in mining; and so
  - the incentive to invest in coal mining.

4. Competition for coal authorities

In this section we discuss whether the ACCC's final determination is relevant to competition for coal authorities.

4.1 Conclusions from our earlier report

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

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

In our earlier report, we explain that there would be no material difference in the investment incentives in new coal mining projects, with and without declaration of the relevant service. It follows that, if there is no material change to incentives to invest in new coal mining projects, then there cannot be a material change to incentives to engage in the acquisition and disposal of exploration and/or mining authorities.

We also concluded that the geographic dimension of the coal mining authority is likely to extend beyond the Hunter Valley. The consequence of a geographic dimension that extends beyond the Hunter Valley is that the actions of PNO at the Port of Newcastle are even less likely to be material when assessed by reference to the broader market of coal mining authorities.

4.2 ACCC determination reinforces our conclusion

The ACCC's final determination reinforces our earlier conclusion that declaration will not affect competition for coal authorities, because:

- as discussed in section 3, it reinforces that there would be no material difference in the investment incentives in new coal mining projects, with and without declaration of the relevant service; and
- it is not relevant to the geographic dimension of the coal mining authority, and so does not change our conclusion that the market likely extends beyond the Hunter Valley.

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