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REVIEW OF VICTORIAN PORTS REGULATION

ISSUES PAPER

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CONTENTS

| | |
|---|-----------|
| CONTENTS | 3 |
| 1 INTRODUCTION | 6 |
| 1.1 Purpose and scope of the inquiry | 6 |
| 1.2 Objectives of the Commission | 7 |
| 1.3 Purpose of the Issues Paper and Making a Submission | 8 |
| 1.4 Review Process and Timetable | 8 |
| 1.5 Structure of this Issues Paper | 10 |
| 2 THE VICTORIAN PORTS INDUSTRY | 11 |
| 2.1 The Victorian commercial ports | 11 |
| 2.1.1 Port of Melbourne | 11 |
| 2.1.2 Port of Geelong | 12 |
| 2.1.3 Port of Portland..... | 12 |
| 2.1.4 Port of Hastings | 12 |
| 2.1.5 Activities of port managers | 13 |
| 2.2 Activity at the Victorian ports | 15 |
| 2.2.1 Use of shipping channels – shipping movements | 15 |
| 2.2.2 Use of berth services – cargo throughput by port | 16 |
| 2.2.3 Container throughput at the port of Melbourne | 17 |
| 2.2.4 Market shares of other cargoes..... | 18 |
| 2.3 Movements in prescribed prices and sources of revenue | 19 |
| 2.3.1 Real price trends | 19 |
| 2.3.2 Selected benchmarks | 20 |
| 2.3.3 Sources of revenue | 23 |
| 2.4 Service quality and efficiency | 24 |
| 2.4.1 Proportion of vessels delayed from the scheduled berthing time or advised arrival time | 24 |

| | | |
|----------|---|-----------|
| 2.4.2 | Berth utilisation | 25 |
| 2.4.3 | Average ship turnaround time | 26 |
| 3 | REGULATORY CONTEXT..... | 28 |
| 3.1 | Prescribed services, related services & excluded services | 28 |
| 3.2 | The price monitoring framework | 30 |
| 3.2.1 | Transparency..... | 30 |
| 3.2.2 | Information reporting & publication..... | 31 |
| 3.2.3 | POMC-specific elements, pricing principles and pricing policy statement | 33 |
| 3.2.4 | Complaint handling..... | 34 |
| 3.2.5 | Inquiries and investigations | 34 |
| 3.2.6 | Principles governing the reimposition of price controls | 35 |
| 3.3 | Channel access framework | 36 |
| 3.3.1 | Declaration of shipping channels | 36 |
| 3.3.2 | Obligations of an access provider | 36 |
| 3.3.3 | Access disputes..... | 37 |
| 3.4 | 2004 Port Regulation Review | 37 |
| 3.4.1 | Effectiveness of existing regulation | 38 |
| 3.4.2 | Market Power Analysis | 38 |
| 3.4.3 | The Commission's 2004 Conclusions on the Need for Regulation ... | 40 |
| 3.4.4 | The Form of Regulation..... | 41 |
| 4 | PRINCIPLES RELEVANT TO THE REVIEW | 44 |
| 4.1 | The Competition and Infrastructure Reform Agreement (CIRA) | 44 |
| 4.2 | Is Price Regulation Necessary? | 45 |
| 4.2.1 | General considerations..... | 45 |
| 4.2.2 | Benefits of regulation..... | 46 |
| 4.2.3 | Costs of regulation..... | 46 |
| 4.2.4 | Interaction between price regulation and the national access framework | 47 |

| | | |
|------------|---|-----------|
| 4.3 | Forms of regulation | 48 |
| 4.3.1 | Options for price regulation | 48 |
| 4.3.2 | Considerations regarding light versus heavy handed regulation | 50 |
| 4.3.3 | Effective state based access regimes | 53 |
| 5 | ISSUES FOR THE REVIEW..... | 55 |
| 5.1 | Questions about the Commission’s proposed approach | 55 |
| 5.2 | Key questions to be addressed in the Review | 55 |
| 5.3 | Market power and market developments | 56 |
| 5.4 | Questions about the benefits and costs of regulation | 57 |
| 5.5 | Questions about the adequacy of the existing framework | 57 |
| | APPENDIX A – CPA CLAUSE 6 PRINCIPLES | 59 |

The Essential Services Commission (**Commission**) is the independent economic regulator in Victoria. The Commission regulates a number of industries, including water utilities, energy retailers, ports and rail infrastructure and export grain handling services, among others. The Commission's role differs for each regulated industry but generally involves the economic regulation of prices, service standards, and market conduct and in some cases, consumer protection.

The Commission is responsible for economic regulation of the port sector under the *Port Services Act 1995 (PSA)*. The PSA establishes an economic regulation framework that applies to Victoria's commercial seaports of Melbourne, Geelong, Portland and Hastings. This regulatory framework was established in the mid-1990s in the context of the privatisation of the ports of Portland and Geelong, and the structural reform of the statutory corporations that manage the port of Melbourne and the channels of Port Phillip Bay.

The ports regulation framework identifies certain port infrastructure services such as the provision of shipping channels, berth services, cargo marshalling areas and short-term storage adjacent to berths as "prescribed services" which are subject to price regulation by the Commission under the *Essential Services Commission Act 2001 (ESC Act)*. The Commission has exercised its price regulation powers in respect of prescribed services by establishing a price monitoring regime.

There is also an access regime for shipping channels in the PSA, but no shipping channels have been declared to date, and the access regime is inactive.

For the purpose of undertaking its regulatory roles, the Commission has regulatory powers to issue licences and establish licence conditions; establish standards and conditions of service and supply; issue guidelines; obtain information; and conduct inquiries into the ports industry.

1.1 Purpose and scope of the inquiry

Under section 53 of the PSA, the Commission is required to conduct and complete a review of the regulation of prescribed port services by June 2009. The purpose of the current Review is to meet this requirement.

The Review will determine whether the arrangements currently in place for the regulation of prices in the ports sector continue to be appropriate and, if not, how they might best be amended to meet the objectives of both the ESC Act and the PSA. This includes considering whether regulation of each port continues to be necessary, and if so the appropriate form of regulation. The Commission is also required under s53 of the PSA to report on any transitional issues that arise in relation to any recommended changes to regulation.

Under the National Reform Agenda, the Victorian Government is committed to seek certification of the channel access regime in 2009². In the expectation that this will be of assistance to the Government, the Commission plans to consider whether the channel access regime should be retained, and if so, whether any changes would be required to enable it to be certified as an effective state-based access regime. This Issues Paper has been framed to encompass consideration of the channel access regime for this reason. By doing so, the Commission anticipates being able to provide timely advice to the Government in relation to the channel access regime prior to the Government seeking certification of the regime. Accordingly, if the Commission receives terms of reference in relation to reviewing the channel access regime, and the timeframes in that terms of reference permit, it will combine that reference within the scope of the current Review.

1.2 Objectives of the Commission

In carrying out the review the Commission will have regard to its statutory objectives.

Sections 48(a) and 48(b) of the PSA provide that the Commission's objectives in relation to the port industry in a commercial trading port are:

- (i) to promote competition in the regulated industry; and*
- (ii) to protect the interests of users of Prescribed Services by ensuring that prescribed prices are fair and reasonable whilst having regard to the level of competition in, and efficiency of, the regulated industry.*

The Commission's general regulatory objectives are set out in section 8 of the ESC Act:

- (1) In performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers.*
- (2) Without derogating from subsection (1), in performing its functions and exercising its powers in relation to essential services, the Commission must in seeking to achieve the objective specified in subsection (1) have regard to the price, quality and reliability of essential services.*

Section 8A of the ESC Act states that in seeking to achieve these general objectives, the Commission must have regard to the following matters to the extent that they are relevant in any particular case:

- (a) to facilitate efficiency in regulated industries and the incentives for efficient long-term investment;*
- (b) to facilitate the financial viability of regulated industries;*
- (c) to ensure that the misuse of monopoly or non-transitory market power is prevented;*
- (d) to facilitate effective competition and promote competitive market conduct;*

² 'COAG National Reform Agenda: Competition Reform April 2007', p.43

- (e) *to ensure that regulatory decision making has regard to the relevant health, safety, environmental and social legislation applying to the regulated industry;*
- (f) *to ensure that users and consumers (including low-income or vulnerable customers) benefit from the gains from competition and efficiency; and*
- (g) *to promote consistency in regulation between States and on a national basis.*

The Commission must have regard to its general statutory objectives in a manner which it considers best achieves the objectives stated in the PSA.

1.3 Purpose of the Issues Paper and Making a Submission

This Issues Paper identifies issues about which the Commission is particularly interested to obtain comment or information.

Stakeholders are invited to make submissions on any issue raised in this paper, or any other issue considered to be relevant under the review. The questions that are asked in this Issues Paper are a guide only, and are not intended to limit or dictate the matters that may be addressed in submissions.

Submissions in response to this Issues Paper must be made by 11 February 2009 and can be sent electronically to: Ports.Consultations@esc.vic.gov.au, by fax (03-9651 3688) or by mail to:

Ports Regulation Review 2008-09
Essential Services Commission
Level 2, 35 Spring Street
Melbourne VIC 3000

The Commission will make submissions available to the public on its website, with the exception of any commercially confidential or sensitive information which has been identified as such in the submission. Please direct any queries about this Issues Paper to Patrick Ho on 9651 3770, or Michael Cunningham on 9651 0247.

1.4 Review Process and Timetable

Section 53(5) of the PSA states that the inquiry into port prescribed services regulation must be conducted in accordance with Part 5 of the ESC Act. Section 43 provides:

- (1) *Subject to this Act, the Commission may conduct an inquiry in such a manner as the Commission considers appropriate.*
- (2) *In conducting an inquiry, the Commission is not bound by rules or practice as to evidence but may inform itself in relation to any matter in such manner as the Commission considers appropriate.*

- (3) *The Commission may receive written submissions or statements.*
- (4) *The Commission—*
 - (a) *must hold at least one public hearing; and*
 - (b) *has a discretion as to whether any person may appear before the Commission in person or be represented by another person.*
- (5) *The Commission may determine that a hearing or a part of a hearing be held in private if it is satisfied that—*
 - (a) *it would be in the public interest; or*
 - (b) *the evidence is of a confidential or commercially-sensitive nature.*
- (6) *In conducting an inquiry the Commission may:*
 - (a) *consult with any person that it considers appropriate;*
 - (b) *hold public seminars and conduct workshops; and*
 - (c) *establish working groups and task forces.*

The Commission will primarily conduct the review by seeking written submissions from parties, and may also commission expert reports. Consultation will include one public hearing, the agenda for the public hearings will provide for the Commission to clarify the points or positions made in submissions, and to seek further information from parties that would help the Commission to evaluate the arguments and/or observations made. Other meetings or consultations with stakeholders may be used where this is considered to assist the Commission in its task.

A public hearing will be held in Melbourne at the Commission's offices (or Auditorium) on 3 March 2009. Parties intending to participate in the hearing are invited to RSVP by 18 February 2009. Although this is preferred, it is not mandatory to RSVP.

The following timetable has been established for this review:

- Submissions Due: 11 February 2009
- Public Hearing, Melbourne: 3 March 2009
- Draft Report: early April 2009
- Submission on draft report: four weeks from Draft Report
- Final Report: end June.

1.5 Structure of this Issues Paper

The next section of this Issues Paper begins by providing background on the Victorian ports industry. It describes the industry and the nature of port services. Current trade activity, future plans and investment activities are outlined, along with prescribed prices and sources of revenue. The section also provides some preliminary benchmark data on port charges, productivity and service quality.

Section 3 of the paper provides information on the ports regulation framework and other comparative regulatory regimes. Thus section 3.1 describes the coverage of regulation, in terms of prescribed services and related services, and those services that are excluded from regulation. Section 3.2 then describes the price monitoring framework, and section 3.3 outlines the statutory framework for the regulation of access to shipping channels. Section 3.4 summarises the issues addressed in the 2004 review of port regulation.

Section 4 of the paper sets out the economic principles that the Commission believes should underpin the review. Section 4.1 outlines wider regulatory developments, notably the Competition and Infrastructure Reform Agreement. Section 4.2 considers the issues relevant to the assessment of whether continued price regulation is required. Section 4.3 then sets out the issues that need to be addressed in determining the appropriate form of regulation (if continued regulation is required).

Section 5 summarises the issues that need to be addressed by the review, and draws together the questions on which stakeholder views are welcomed.

2 | THE VICTORIAN PORTS INDUSTRY

This chapter provides a general overview of the Victorian commercial ports activities which involves:

- a discussion of the ports which are subject to this Review and the role of the corporations that manage these ports (section 2.1), and
- a presentation of relevant background information on the port and prescribed services covered by this review (sections 2.2 to 2.4).

2.1 The Victorian commercial ports

The commercial trading ports are key engines for Victoria's economic growth. At the simplest level, ports provide for the transfer of cargoes or passengers between ships and the land. They are critical transfer points in Victoria's overall transport network and are a part of a regional and global transport system which needs to operate efficiently for the benefit of the Victorian and Australian economies.² Victoria has four commercial ports, at Melbourne, Geelong, Portland and Hastings.

2.1.1 Port of Melbourne

The port of Melbourne is owned by the Port of Melbourne Corporation (**PoMC**), a statutory corporation established under Part 2, Division 1 of the PSA. It has 34 commercial berths, over 500 hectares of land, and manages all of the shipping channels serving the port, including the channels at the entrance to Port Phillip Bay.³ The port of Melbourne handles \$75 billion in international and coastal trade each year and contributes more than \$2.5 billion every year to the Victorian economy.⁴

The port of Melbourne handles a broad range of cargoes. It is Australia's largest container port, handling 38 per cent⁵ of Australia's container trade. There are international container terminals in Swanson Dock and coastal container terminals at Webb Dock.

The major classes of non-containerised cargo handled at the port include motor vehicles; liquid bulk products such as petroleum products and chemicals; and dry bulk products such as grain, gypsum, timber, paper and cement. Motor vehicle

² Department of Infrastructure (2004). Victorian Ports Strategic Framework, November, p.4.

³ <http://www.portofmelbourne.com.au/business/aboutport/whodoeswhat.asp>, accessed on 24 November 2008.

⁴ <http://www.transport.vic.gov.au/Doi/Internet/Freight.nsf/AllDocs/89050061DB069A00CA256FF00235DDC?OpenDocument>, accessed on 24 November 2008.

⁵ <http://www.portofmelbourne.com.au/business/aboutport/>, accessed on 24 November 2008.

terminals are at Webb Dock and liquid bulk facilities are in Yarraville, Coode Island and Williamstown. Dry bulk facilities are at Yarraville, Fisherman's Bend and Appleton Dock, and break bulk facilities are at Webb Dock and Appleton Dock.

Most of the major terminals at the port are subject to long-term lease, although these operate alongside unleased multi-purpose common-user berths. Major tenants at the port include DP World, Patrick Stevedores (a subsidiary of Asciano), Toll Shipping, ANL, Exxon Mobil, Melbourne Cement Facilities and Terminals Australia.

The port of Melbourne also caters for cruise shipping at Station Pier. Approximately 60 passenger cruise ships call at the port each year in addition to the daily service by the Spirit of Tasmania.

2.1.2 Port of Geelong

The port of Geelong is situated in the city of Geelong at the head of Corio Bay. It has 14 berths at seven terminals and is served by a dedicated 32.5 km one-way shipping channel. The port is privately owned by the Port of Geelong Unit Trust⁶ (comprising Asciano Limited, the Australian Infrastructure Fund and Deutsche Bank) and is operated by Patrick Ports, a subsidiary of Asciano. The shipping channels are managed by the Victorian Regional Channels Authority (**VRCA**). The port handles 25 per cent of Victoria's overseas exports⁷.

Major users of the port include Shell (at Corio) and Alcoa (at Point Henry), for liquid bulk products and alumina. There are common user berths in Corio Quay and Lascelles Wharf which handle a range of cargoes including woodchips, logs and fertiliser. GrainCorp owns its own berth facilities at the port for grain and woodchips.

2.1.3 Port of Portland

The port of Portland in western Victoria is privately owned by the Port of Portland Pty Ltd (**PoPL**) (50% owned by the Australian Infrastructure Fund, and 50% by its unlisted affiliate, the Utilities Trust of Australia⁸). It is a natural deep-water port with six berths; one of which is under long-term lease to Alcoa. The port primarily handles bulk commodities, such as woodchips, grain, mineral sands, alumina, fertiliser and livestock. It is currently building new facilities to accommodate an increase in woodchip volumes.

2.1.4 Port of Hastings

The port of Hastings in Western Port Bay is owned by the Port of Hastings Corporation (**PoHC**), a statutory corporation established under Division 1A in Part

⁶ <http://www.hfm.com.au/assets/seaports/geelong/>. Australian Infrastructure Fund holds a 35% interest.

⁷ VRCA Annual Report 2007-08, p.8.

⁸ http://www.portofportland.com.au/index.php?option=com_content&task=view&id=68&Itemid=85.

2 of the PSA. Patrick Ports Hastings, a division of Asciano, manages the port under a Port Management Agreement with PoHC. PoHC retains responsibility for planning future port infrastructure requirements, and is currently planning future developments, of which the first stage is for additional berths for bulk and break bulk cargoes.

The port of Hastings has five berths at three separate locations; Long Island Point, Crib Point and Stony Point. The main products handled are petroleum products (exports of crude oil and LPG and imports of refined products) and steel.

2.1.5 Activities of port managers

Although port authorities differ widely in the range of services and facilities they provide, a key element common to all port authorities is the provision and management of the basic infrastructure such as facilities for the berthing of ships and loading cargo; as well as navigation infrastructure, such as shipping channels, to provide for the safe access of ships to the berths. Harbour masters employed by the ports are responsible for directing shipping movements within the port waters. These services are “prescribed services” within the regulatory framework (which is described in the following section).

Ports also provide land in the vicinity of the berths on which cargoes can be assembled for loading or placed temporarily following discharge, as well as road and rail access and other services within the port environs.

In addition, many port authorities provide complementary infrastructure and superstructure, such as cargo storage facilities or specialised cargo handling equipment. PoMC’s statutory role encompasses facilitating trade and enhancing the efficiency of the land-side interface of the port. Some ports may also provide services within the port such as pilotage, towage, mooring or ship repair (see Table 2.1), but in Victorian ports, for the most part, these activities are carried out by other service providers. Table 2.1 summarises the main port service providers in Victoria.

Table 2.1 **Providers of infrastructure and other services – Victorian ports**

| <i>Services</i> | <i>Melbourne</i> | <i>Geelong</i> | <i>Portland</i> | <i>Hastings</i> |
|---|---|--|-------------------|-------------------------------------|
| Development/Management of Channels | PoMC | VRCA | PoPL ^b | Patrick Ports Hastings ^b |
| Development/Management of Berths & Cargo Marshalling Infrastructure | PoMC | GeelongPort, GrainCorp ^a | PoPL | Patrick Ports Hastings ^c |
| Pilotage | Port Phillip Sea Pilots Pty Ltd | Port Phillip Sea Pilots Pty Ltd | PoPL | Port Phillip Sea Pilots Pty Ltd |
| Towage | Svitzer Australasia, PB Towage | Svitzer Australasia | PoPL | Svitzer Australasia |
| Mooring | Melbourne Port Services, Skilled Maritime Services | Svitzer, L.W. Marine Services, Corio Bay Shipping Services (vessels at anchor), Victorian Marine Services. | PoPL | L.W. Marine Services |
| Stevedoring | Patrick Stevedores, DP World, P&O Automotive & General Stevedoring, ANS | P&O Ports, Patrick Bulk & General Ports Stevedoring (Geelong) | P&O Ports, PoPL | Patrick Stevedores WesternPort |

^a Note that the Commonwealth Government owns and operates the Port Wilson Explosives Pier.

^b Delegated under contract with the VRCA.

^c Patrick operates the port of Hastings under a management contract (PMA) to PoHC.

Source: Victorian port operators

2.2 Activity at the Victorian ports

This section presents summary information on the levels of trade activity and usage of prescribed services at each of the ports. Such information is relevant to a number of questions being addressed by the review, including assessment of the extent of competition between ports.

The information below describes:

- the use of shipping channels at each port
- the trade throughput at each port
- the container throughput at the port of Melbourne
- the market shares of non-container trades.

2.2.1 Use of shipping channels – shipping movements

Table 2.2 presents data on the number of ship visits to each port. In 2007-08, there were 4,599 ship visits in total, with almost 80 per cent of ship visits at the port of Melbourne.

Ship visits increased between 2003-04 and 2007-08 by an average 1.5 per cent per annum, although there is variation from year to year. Most of this increase has been at the port of Melbourne, where ship visits increased at 2.3 per cent per annum over the period. At the regional ports, the number of ship visits has been relatively static and in some cases decreased. This may have been affected by recent poor grain harvests.

Table 2.2 **Number of ship visits by port**

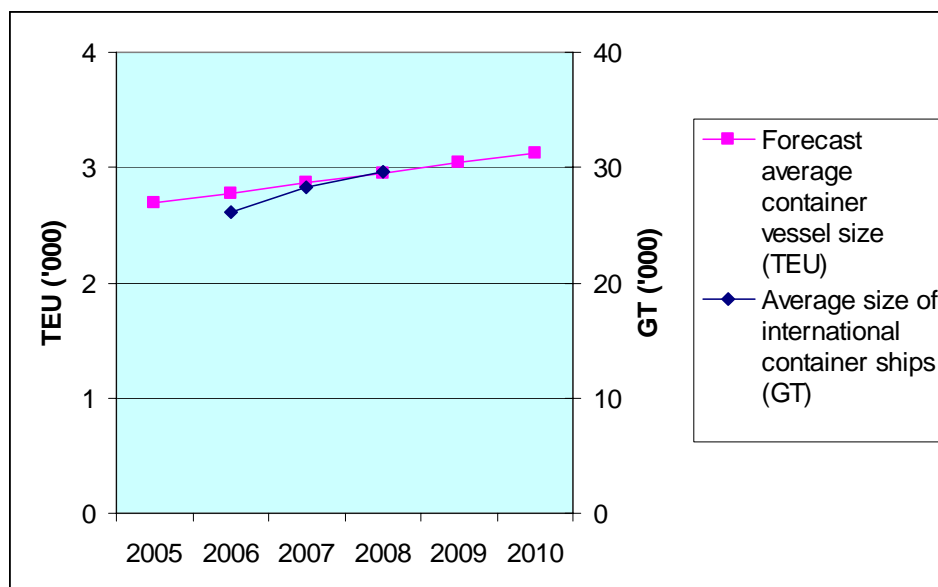
| <i>Year ending June</i> | <i>2004</i> | <i>2005</i> | <i>2006</i> | <i>2007</i> | <i>2008</i> | <i>4-year average change (%)</i> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|----------------------------------|
| Melbourne | 3,268 | 3,411 | 3,543 | 3,524 | 3,580 | 2.3 |
| Geelong | 527 | 558 | 545 | 478 | 540 | 0.6 |
| Portland | 331 | 336 | 450 | 261 | 279 | -4.2 |
| Hastings | 202 | 203 | 178 | 183 | 200 | -0.2 |
| Total | 4,328 | 4,508 | 4,716 | 4,446 | 4,599 | 1.5 |

Source: Victorian port operators.

At the port of Melbourne cargo volumes (discussed below) have increased faster than the number of ship visits because of the trend to larger vessels. Figure 2.1 shows the average vessel size for container ships visiting the port of Melbourne, and forecast average vessel size.

Another indication of the increase in ship sizes is the proportion of ships visiting the port of Melbourne that have a draft¹⁰ greater than 12.1m, which has almost doubled in the last four years, from just over 6 per cent in 2004-05 to 12 per cent in 2007-08.¹¹

Figure 2.1 **Average size of container ships visiting the port of Melbourne**



Source: Meyrick and Associates (2006), 'Benefit Cost Analysis and Economic Assessment'; in chapter 16 of PoMC (2006) 'Supplementary Environmental Effects Statement: Channel Deepening Project'.

2.2.2 Use of berth services – cargo throughput by port

Table 2.3 presents data on the growth in cargo throughput at each port. The average growth in total cargo throughput at all ports over the five year period from 2003-04 to 2007-08 was 1.0 per cent per annum. However, the port of Melbourne was the only port to experience growth over this period, with an average growth rate of 3.7 per cent per annum. The combined throughput of the regional ports decreased from 18.1 million tonnes in 2003-04 to 15.8 million tonnes in 2007-08, an average annual rate of decline of 3.4 per cent per annum.

This growth in cargo throughput at the port of Melbourne was mainly due to strong growth in containerised cargo (on the basis of mass tonnes this increased at an

¹⁰ The draft of a ship is the vertical distance between the waterline and the bottom of the hull (the keel). Maximum summer draft is the maximum height taking into account the worst-case scenario of weather conditions.

¹¹ Source: PoMC.

average rate of 5.9 per cent per annum over the same period) and motor vehicles (which increased at an average rate of 14.3 per cent per annum over this period). Excluding containers and vehicles, the port of Melbourne's other cargoes decreased by an average 1.2 per cent per annum over the five year period to 2007-08.

Table 2.3 Cargo throughput by port ('000 mass tonnes)

| <i>Year ending June</i> | <i>2004</i> | <i>2005</i> | <i>2006</i> | <i>2007</i> | <i>2008</i> | <i>4-year average change (%)</i> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|----------------------------------|
| Melbourne | | | | | | |
| Containers | 16,800 | 18,370 | 18,552 | 19,744 | 21,092 | 5.9 |
| Vehicles | 450 | 593 | 605 | 677 | 768 | 14.3 |
| Other | 9,400 | 9,345 | 8,604 | 9,095 | 8,962 | -1.2 |
| Sub-total | 26,650 | 28,308 | 27,761 | 29,515 | 30,822 | 3.7 |
| Geelong | 9,740 | 10,043 | 9,435 | 9,859 | 9,555 | -0.5 |
| Portland | 3,798 | 3,645 | 3,513 | 3,044 | 3,258 | -3.8 |
| Hastings | 4,572 | 3,512 | 3,083 | 3,250 | 2,954 | -10.3 |
| Total | 44,760 | 45,507 | 43,754 | 45,668 | 46,589 | 1.0 |

Source: Victorian port operators.

2.2.3 Container throughput at the port of Melbourne

The port of Melbourne is the only Victorian port that handles large volumes of containers¹². In the 2004 Port Review the Commission indicated that there is some potential for competition with interstate container ports through land-bridging or transhipment of containers.

Table 2.4 shows the shares of container trades originating from and destined to several Australian markets that were handled through the port of Melbourne in 2003-04 to 2007-08. These shares are based on the throughput of containers measured in mass tonnes.

Over the five year period, the Port of Melbourne's share of total container trade to and from:

- Victoria increased from 94 per cent to 97 per cent
- Tasmania increased from 33 per cent to 52 per cent
- South Australia increased from 28 per cent to 34 per cent
- New South Wales and ACT increased from 6 per cent to 8 per cent
- all other states and territories combined remained at 3 per cent.

¹² The ports of Geelong and Portland handle a small quantity of container trade.

Over the same period, the port of Melbourne's share of Australia's total container trade increased from 34 per cent to 35 per cent. The reason that its Australia-wide share increased more slowly than its shares of some of the individual states is due to the relatively strong economic growth occurring in states such as Queensland.

Table 2.4 **Port of Melbourne share in container trade by state**

| <i>Year ending June</i> | <i>Export origin</i> | | <i>Import destination</i> | | <i>Total container trade</i> | |
|-----------------------------|----------------------|-------------------------|---------------------------|-------------------------|------------------------------|-------------------------|
| | <i>2004</i> | <i>2008^a</i> | <i>2004</i> | <i>2008^a</i> | <i>2004</i> | <i>2008^a</i> |
| Victoria | 90.2 | 94.7 | 96.8 | 99.4 | 93.8 | 96.5 |
| Tasmania | 36.0 | 55.3 | 21.2 | 25.0 | 33.1 | 52.3 |
| South Australia | 24.9 | 33.2 | 35.5 | 38.1 | 28.1 | 34.0 |
| NSW & ACT | 12.6 | 12.1 | 0.2 | 0.3 | 6.1 | 7.7 |
| Other Australia | 2.7 | 3.6 | 4.4 | 2.7 | 3.4 | 3.4 |
| - Total | 32.0 | 33.7 | 36.7 | 37.3 | 34.2 | 34.8 |

^a Using preliminary data.

Source: BITRE unpublished data.

2.2.4 Market shares of other cargoes

In the non-container (and non-motor vehicle) trades the Commission has previously noted that there is some potential for competition between the Victorian ports. Figure 2.5 presents the volumes and market shares in non-container trade of the Victorian ports.

Melbourne continues to have the largest shares in break bulk and dry bulk, while Geelong maintains the largest share in liquid bulk, with over half of all liquid bulk trade.

Break bulk trade at all of the Victorian ports increased at an average rate of 2.5 per cent per annum over the period from 2003-04 to 2007-08. The most significant change in market share was Portland's, which decreased from 18.3 per cent in 2003-04 to 11.9 per cent in 2007-08. This appears to be due in part to a significant reduction in logs. By contrast the port of Hastings benefited from increased steel volumes.

Dry bulk trade over all the Victorian ports increased at an average rate of 1.5 per cent per annum between 2003-04 and 2007-08, notwithstanding the drought conditions affecting the latter year. Geelong increased its share of dry bulk from 22.9 per cent to 29.1 per cent over this period, which appears to be largely due to an increase in fertiliser trade at the port.

In liquid bulk, there was a significant decline in total throughput over the same period, averaging 4.5 per cent per annum. The port of Hastings' share dropped from 23.4 per cent to 14.0 per cent over this period, and represented the main

source of the decline. This appears to be due to decreased production from the Bass Strait oil and gas fields.

Table 2.5 **Victorian ports non-container trade**

| | <i>Throughput ('000 tonnes)</i> | | <i>4-year avg. change (%)</i> | <i>Share (%)</i> | |
|-------------------------------|---------------------------------|----------------|-----------------------------------|------------------|----------------|
| | <i>2003-04</i> | <i>2007-08</i> | | <i>2003-04</i> | <i>2007-08</i> |
| <i>Break bulk^a</i> | | | | | |
| Melbourne | 1,450 | 1,667 | 3.5 | 42.5 | 44.2 |
| Geelong | 394 | 491 | 5.7 | 11.6 | 13.0 |
| Portland | 625 | 448 | -8.0 | 18.3 | 11.9 |
| Hastings | 941 | 1,164 | 5.5 | 27.6 | 30.9 |
| Sub-total | 3,410 | 3,770 | 2.5 | 100.0 | 100.0 |
| <i>Dry bulk</i> | | | | | |
| Melbourne | 3,600 | 3,065 | -3.9 | 41.6 | 37.6 |
| Geelong | 1,982 | 2,372 | 4.6 | 22.9 | 29.1 |
| Portland | 3,053 | 2,705 | -3.0 | 35.3 | 33.2 |
| Hastings | 25 | - | -100.0 | 0.3 | - |
| Sub-total | 8,660 | 8,142 | 1.5 | 100.0 | 100.0 |
| <i>Liquid bulk</i> | | | | | |
| Melbourne | 4,350 | 4,231 | -0.7 | 28.2 | 33.0 |
| Geelong | 7,364 | 6,692 | -2.4 | 47.7 | 52.2 |
| Portland | 120 | 105 | -3.3 | 0.8 | 0.8 |
| Hastings | 3,606 | 1,790 | -16.1 | 23.4 | 14.0 |
| Sub-total | 15,440 | 12,818 | -4.5 | 100.0 | 100.0 |
| Grand Total | 27,510 | 24,730 | -2.6 | | |

^a Excludes motor vehicles.

Source: Victorian port operators.

2.3 Movements in prescribed prices and sources of revenue

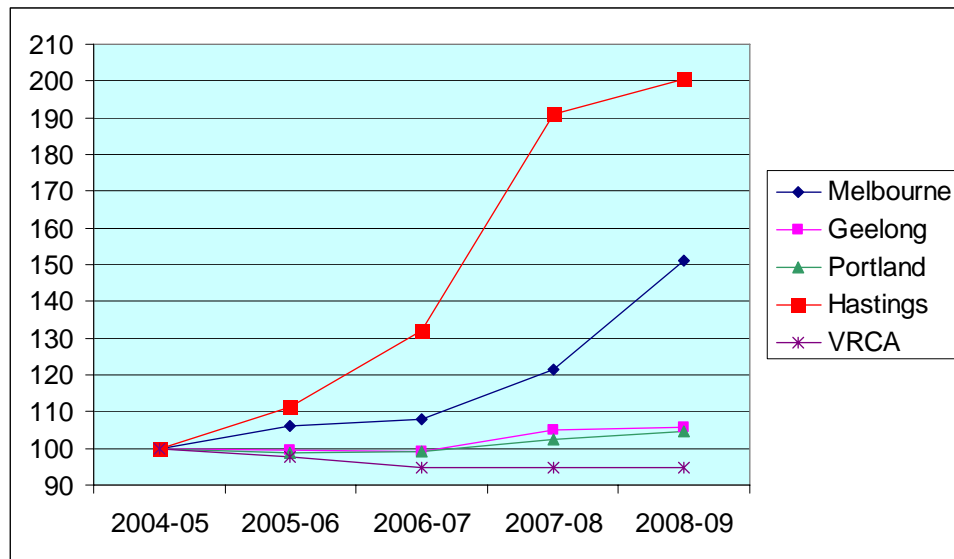
Under the present price monitoring framework the Commission monitors movements in port prices. This section presents summary information on average movements in prescribed prices at each of the Victorian ports, as well as identifying some price benchmarks, and examining changes in the structure of port charges.

2.3.1 Real price trends

Figure 2.2 presents the estimated index of reference prices for each of the Victorian ports over the period 2004-05 to 2008-09. The 2008-09 prices are based

on published prices applying from 1 July 2008 to the date of publication of this Issues Paper. (Note that these prices may be subject to change during the remainder of the 2008-09 financial year).

Figure 2.2 **Estimated index of reference prices by port^{ab}**



^a The average increase in reference prices in each year is estimated by weighting individual price increases by billing units from the previous year.

^b Hastings estimates are based only on time-of-use and flag-fall charges.

Data source: Victorian port operators.

2.3.2 Selected benchmarks

There are a number of benchmarks of port prices in Australia. The ones below have been sourced from the Bureau of Infrastructure, Transport and Regional Economics' (BITRE) publication *Waterline*, which contains its port interface cost index, and from a benchmarking study of Australian ports by Meyrick and Associates.¹³

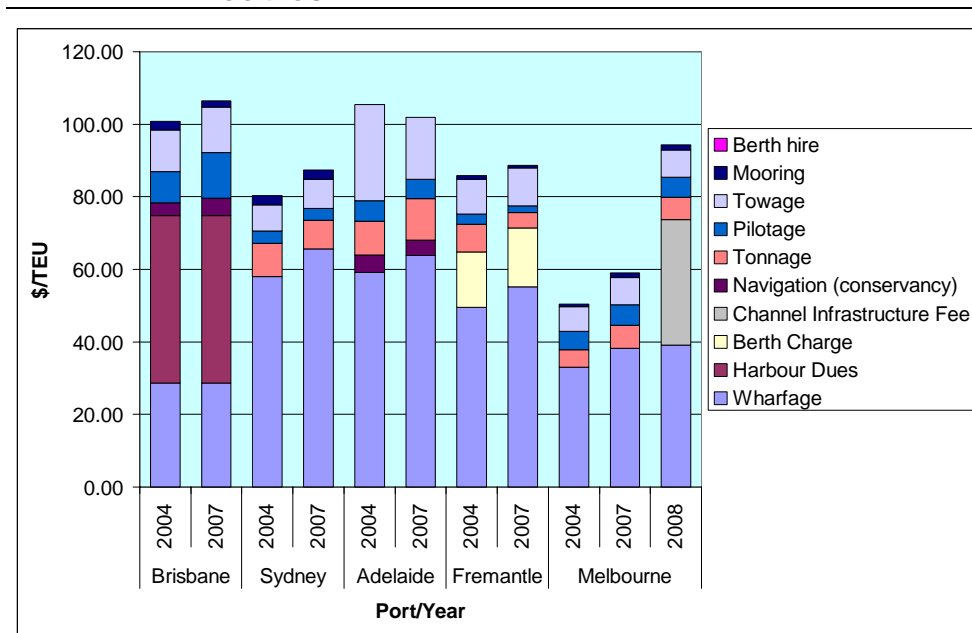
Containerised

Figure 2.3 shows the costs to port users (for containerised freight only) on a per TEU basis, at each of the five major Australian container ports from 2004 to 2007 based on BITRE data. The diagram shows the components of the costs, and includes port authority charges, as well as certain service charges such as mooring, towage and pilotage.

¹³ Meyrick and Associates (2007) *Benchmarking of Port Prices in Australia*, final report prepared for Essential Services Commission of South Australia

In 2004 and 2007, the port of Melbourne was the lowest cost port, with total port interface charges averaging less than \$60 per TEU, compared to over \$80 per TEU at Port Botany and Fremantle. With the introduction of the channel Infrastructure Fee in April 2008, which is designed to recoup the costs of the channel deepening project, the total port interface costs at the port of Melbourne are estimated to have increased to over \$90 per TEU. Although a direct comparison is not available at present, this increase may now mean that the port of Melbourne will have higher total interface costs than Port Botany and Fremantle, while remaining lower than the ports of Brisbane and Adelaide.

Figure 2.3 **Costs per TEU – major Australian container terminals 2004-08^a**



^a Wharfage and tonnage fees for 2008 taken from PoMC reference tariff schedule effective 1 July 2008. 2007 pilotage, towing and mooring fees and size of ship visits used to estimate 2008 costs.

Data source: BITRE

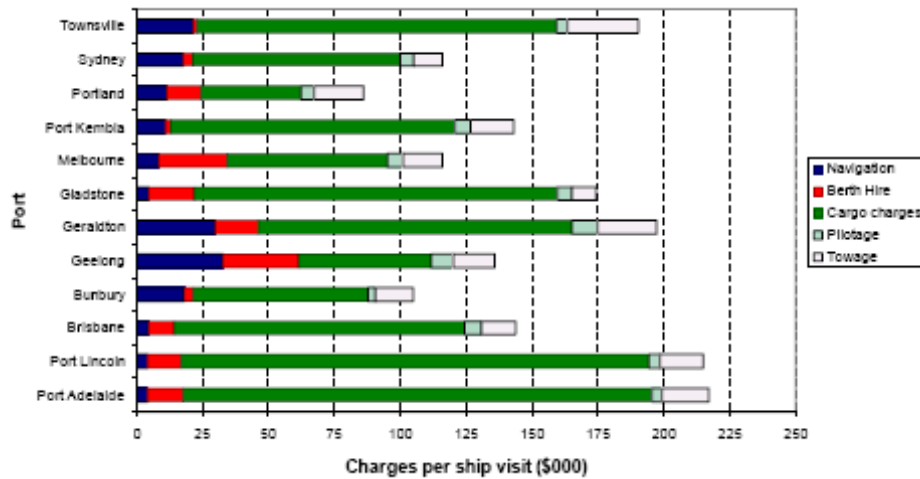
Non-containerised

Some selected benchmarks for non-containerised freight have been drawn from the Meyrick report previously mentioned. Figure 2.4 shows benchmarks of typical costs per vessel for liquid bulk vessels across a range of Australian ports (including three of the Victorian ports) and Figure 2.5 reproduces the cost benchmarks for vessels carrying motor vehicles at different Australian ports.¹⁴

¹⁴ The charges of each port have been weighted with respect to composition of trade and size of ships visiting the port.

With regard to liquid bulk, these benchmarks suggest that at the ports of Melbourne and Geelong, the port authority charges (i.e. navigation, berth hire and cargo charges) per visit for a tanker would cost in the range of around \$95,000 to \$110,000. This cost range is comparable to Sydney and Port Kembla, slightly lower than the port of Brisbane and significantly lower than at Port Adelaide.

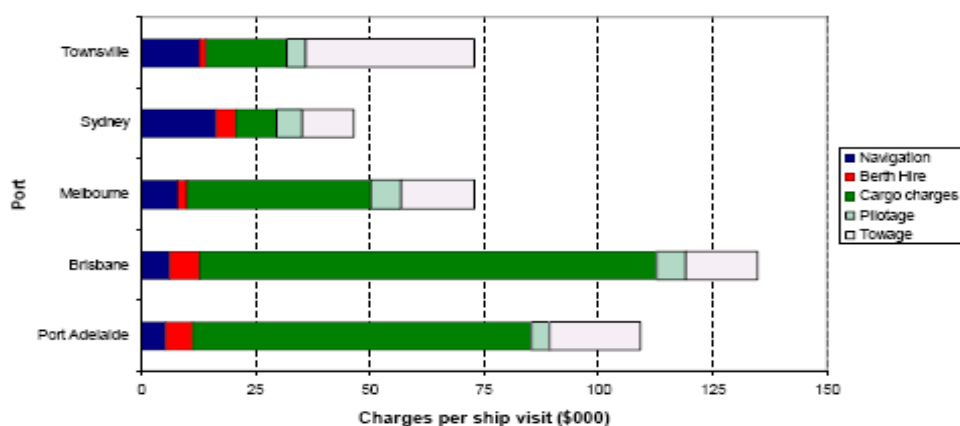
Figure 2.4 **Liquid bulk vessel costs per visit**



Data source: Meyrick and Associates 2007, *Benchmarking of Port Prices in Australia*, final report prepared for Essential Services Commission of South Australia.

For ships carrying motor vehicles, Figure 2.5 shows the estimated typical cost of port authority charges (i.e. navigation, berth hire and cargo charges) is around \$50,000 per ship visit at the port of Melbourne. This is significantly higher than for Sydney or Townsville but considerably lower than for Brisbane and Adelaide.

Figure 2.5 Motor vehicles vessel costs per visit



Data source: Meyrick and Associates 2007, *Benchmarking of Port Prices in Australia*, final report prepared for Essential Services Commission of South Australia.

2.3.3 Sources of revenue

This section examines how the structure of revenues and prices has changed at the Victorian ports since price monitoring was introduced.

At the ports of Geelong and Portland the relative importance of cargo-based charges has increased as a source of prescribed revenue, while the port of Hastings has increased its reliance on ship-based charges (see Table 2.6). The mix of port charges remained relatively constant for the port of Melbourne. However, the introduction of the cargo-based Infrastructure Fee in April 2008 (which is only partially reflected in the average figures for 2007-08) will imply a significant shift toward cargo-based charges once it has fully flowed through into annual results.

Table 2.6 Sources of prescribed revenues (%)

| | Melbourne | | Geelong ^a | | Portland | | Hastings | |
|---------------------|-----------|------|----------------------|------|----------|------|----------|------|
| | 2004 | 2008 | 2004 | 2008 | 2004 | 2008 | 2004 | 2008 |
| Ship-based charges | 19 | 17 | 26 | 21 | 34 | 33 | 41 | 56 |
| Time-of-use charges | 2 | 2 | 49 | 49 | 31 | 27 | 0 | 0 |
| Cargo-based charges | 79 | 81 | 25 | 30 | 35 | 40 | 59 | 44 |

^a Using actual VRCA revenue from prescribed services, and estimated VRCA revenue from prescribed services in 2003-04 based on proportion of revenue attributable to prescribed services in 2004-05.

Source: Victorian port operators.

2.4 Service quality and efficiency

Indicators of the quality of service and efficiency are relevant to a price monitoring regime, since these indicators may deteriorate in circumstances where market power is exercised, and improve where competition is more effective. However, it is important to note that the performance statistics provided are not directly comparable across port operators, due to differences in geographic location, port infrastructure and the types of cargoes handled. Therefore, emphasis is given to trends in these measures for each port.

The measures of port service quality and efficiency monitored by the Commission include:

- the proportion of vessels delayed from the scheduled berthing time or advised arrival time
- berth utilisation, and
- average ship turnaround time.

2.4.1 Proportion of vessels delayed from the scheduled berthing time or advised arrival time

Figure 2.6 shows trends in vessel delays for PoMC and POPL. These two ports have reported their percentage of vessel delays in each year, but the ports of Geelong and Hastings have each reported that vessel delays were either zero or not available in each year. For this reason the latter two ports are not included in Figure 2.6.

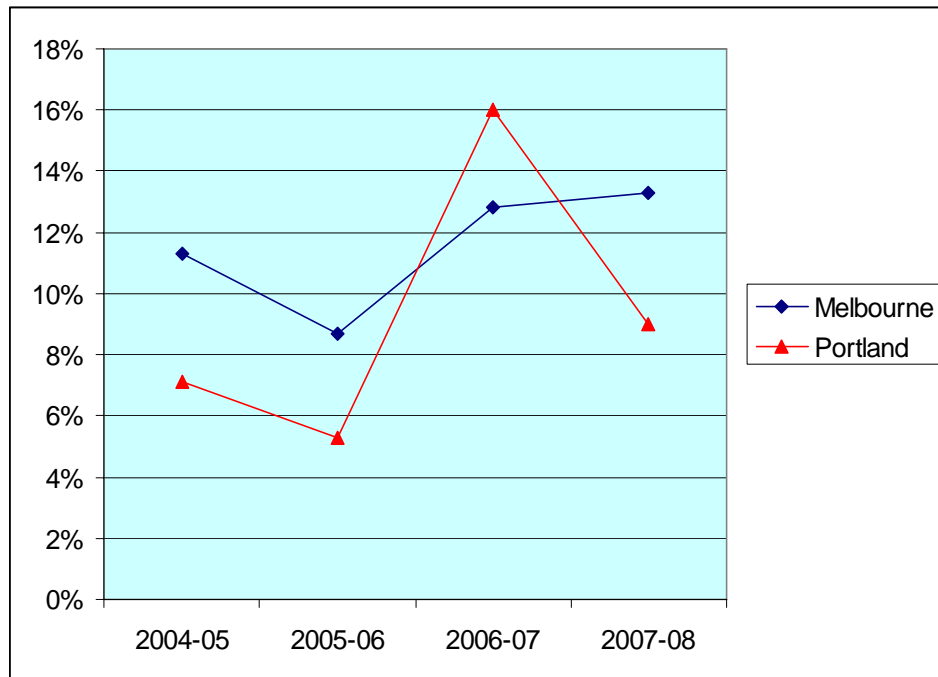
Proportion of vessels delayed from the scheduled berthing time or advised arrival time has increased at both the ports of Melbourne and Portland over the last three years.

PoMC has a vessel delay target of less than 4 per cent for 'on window' (scheduled arrival of vessel) and less than 15 per cent for 'off window' (unscheduled arrival of vessel) for 2008-09, and 4 per cent and 11 per cent respectively from 2009-10 onwards.¹⁵ In 2007-08, 3 per cent of container ships were delayed 'on window' and 22 per cent were delayed 'off window'.¹⁶ This suggests that PoMC's 'off window' performance is significantly outside its target range.

¹⁵ PoMC Annual report 2007-08, p.87.

¹⁶ Ibid.

Figure 2.6 **Proportion of vessels delayed from the scheduled berthing time or advised arrival time**

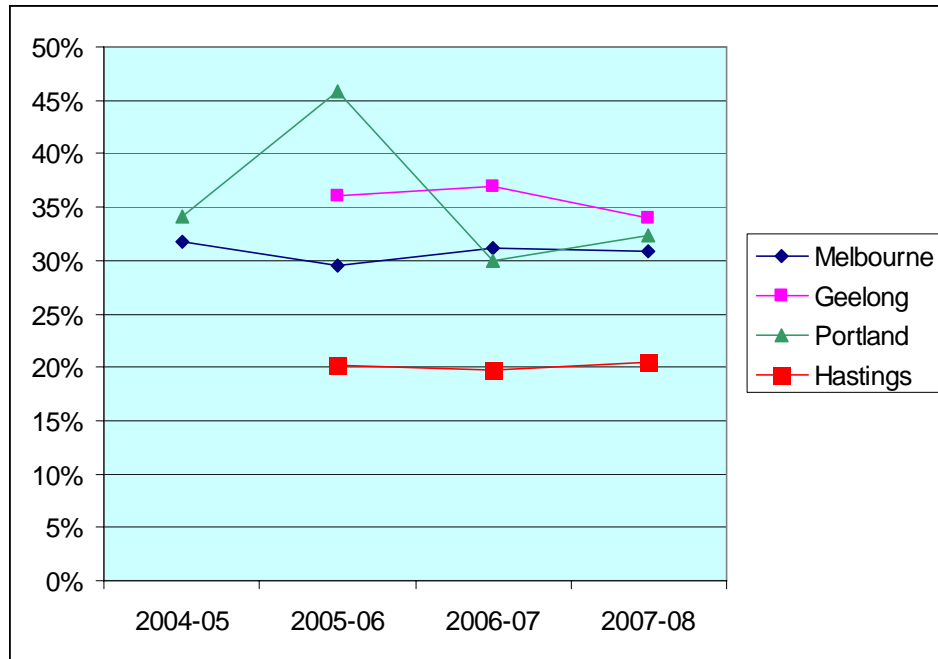


Data source: Victorian port operators.

2.4.2 Berth utilisation

Figure 2.7 shows the trends in berth utilisation for the Victorian ports. The graph shows that berth utilisation at the Victorian ports has been relatively stable over the last three years, except for a spike in berth utilisation for the port of Portland in 2005-06.

Figure 2.7 **Berth utilisation**



^a Berth utilisation unavailable for Geelong and Hastings for 2004-05.

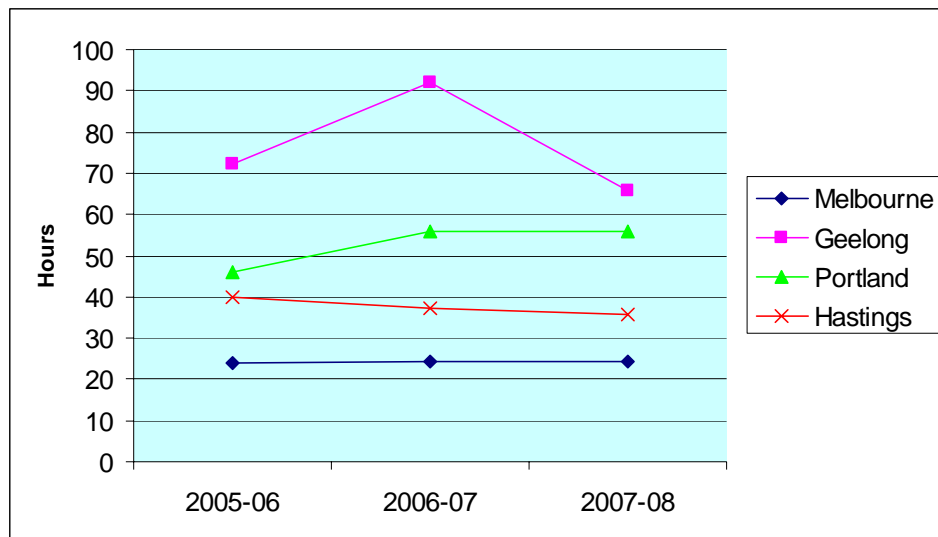
Data source: Victorian port operators.

2.4.3 Average ship turnaround time

A third measure of service quality and efficiency is average ship turnaround time, shown in Figure 2.8. Again, ship turnaround time depends on many factors, such as the type of cargo, and hence the variations between ports cannot be taken as an indicator of comparative service standards. Trends in the measures can provide useful information, but will also be affected by changes in the types of cargoes handled by a port.

Average ship turnaround time at Melbourne has remained relatively constant from 2005-06 to 2007-08, while at Hastings it has decreased slightly. At Geelong the turnaround time increased sharply in 2006-07, but decreased even more sharply in 2007-08. The port of Portland has had a significant increase in average ship turnaround time from 2005-06 to 2007-08.

Figure 2.8 **Average ship turnaround time (hours)**



Data source: Victorian port operators.

3 REGULATORY CONTEXT

This section of the paper provides an overview of the regulatory context within which the current review is taking place. There are two main elements to the economic regulatory framework applying to the ports:

- Certain port services are subject to the Commission's price regulation powers in the ESC Act. These services are designated as "prescribed services" in the PSA, and the Commission has exercised its price regulation powers in respect of prescribed services by establishing a price monitoring regime through its 2005 Price Monitoring Determination (**PMD**).
- Division 4 of Part 3 of the PSA establishes an access regime for shipping channels which provides potential users with the right to gain access to declared shipping channels and provides the Commission with powers to make determinations with respect to access disputes (including with respect to prices). This regime only applies to channels declared by Order of the Governor-in-Council, and since no channels have been declared to date, the access regime has not been activated.

Section 3.1 describes the coverage of the two elements, in terms of the services which are covered (or potentially covered) by price regulation, namely prescribed and related services, and those which are not, namely excluded services and excluded contracts. The following sections describe the current price monitoring framework (section 3.2) and the Channel Access Framework (section 3.3). Section 3.4 describes the regulatory issues addressed by the Commission in the 2004 review of port regulation and the Commission's determinations on key issues.

3.1 Prescribed services, related services & excluded services

Prescribed Services

Prescribed services are subject to the price monitoring regime. They are defined in Section 49(c) of the PSA as including:

- the provision of channels for use by shipping
- the provision of berths, buoys or dolphins in connection with the berthing of vessels in the ports of Melbourne, Geelong, Portland and Hastings
- the provision of short-term storage or cargo marshalling facilities in connection with the loading or unloading of vessels at berths, buoys or dolphins in the ports of Melbourne, Geelong, Portland and Hastings.

Channel Services cover the service of providing shipping channels, including the dredging of channels to maintain their depths, the installation and maintenance of associated navigation aids, and provision of the shipping control services associated with the role of the harbour master.

Berth Services include the services of providing berths and other moorings (i.e. buoys and dolphins), and of providing short-term storage and cargo marshalling areas directly behind the berths (i.e. the second and third of the prescribed services listed above). These are closely related because short-term storage and cargo marshalling areas are essential to the efficient functioning of the berths, and are essentially an extension of the berths themselves. The Commission's view is that berth services do not include warehousing and longer term distribution centres within the precincts of each commercial trading port which potentially compete with similar facilities at a range of other locations. This is because the regulatory scheme in the PSA was not intended to regulate contestable services. Berth services include those provided to passenger cruise ships (e.g. at Station Pier).

The prices charged for prescribed services are referred to as "prescribed prices" (s49(b) of the PSA) over which the Commission has regulatory powers pursuant to s32(1) of the ESC Act.

Related Services

The Commission can, at its discretion, take into account the costs of providing "related services" when making determinations. Thus Section 54(4) of the PSA provides:

The Commission may, when making a determination in relation to prescribed services in a commercial trading port, have regard to the costs associated with any service related to the prescribed services if—

- (a) the related service is necessary or essential to the provision of prescribed services; and*
- (b) the related service cannot readily be provided by another provider; and*
- (c) it is not feasible to charge a separate price for the related service.*

Excluded services

Under Clause 2.3.1 of the PMD the Commission can exclude specific prescribed services from regulatory oversight:

If the Commission is satisfied that it would promote the Objectives if the provision of a specific service (which would otherwise fall within the definition of Prescribed Service) be excluded from the operation of this Price Monitoring Determination, it may notify the relevant Provider of Prescribed Services in writing.

Excluded contracts

Certain contracts in place prior to the enactment of the PSA have been defined as excluded contracts. They are excluded from the regulatory framework under Clause 2.2.3 of the PMD:

For the purposes of this Price Monitoring Determination, Prescribed Prices include prices charged for the provision of, or in connection with, Prescribed Services and Related Services under (a) existing contracts (as described in clause 2.2.2); and (b) contracts entered into under clause 2.2.1, but do not include prices charged under Excluded Contracts.

The Statement of Purpose and Reasons to the PMD elaborates:

Under the existing scheme for regulating prices of prescribed services, certain contracts in place prior to enactment of the PSA have been treated as exempt contracts, and thereby excluded from the regulatory framework. Clauses 2.2.3 and 3.4.1(a)(iii) provide for such contracts to continue to be excluded from the regulatory framework.

Table 6 in the Statement of Purpose and Reasons provides a list of excluded contracts for each of the Victorian ports.

3.2 The price monitoring framework

The main elements of the price monitoring framework provided by the PMD include:

- a requirement for ports to maintain a published set of reference tariffs
- a requirement for Port of Melbourne Corporation (**PoMC**) to comply with pricing principles contained in the PMD and to prepare and publish a Pricing Policy Statement
- clear requirements on the provision of information to the Commission to support its monitoring role
- the publication of an annual monitoring report by the Commission
- a credible threat of the application of more prescriptive regulation if market power is misused
- a scheduled review after five years to determine whether the prices monitoring framework is delivering the objectives of the ESC Act and the PSA.

3.2.1 Transparency

Within the price monitoring framework it is an objective of the Commission to facilitate commercial negotiation and competition. It does this by:

- ensuring that port users have adequate information for the purposes of negotiating access to prescribed services, through the obligations imposed on port operators to publish reference tariffs, and in the case of PoMC, its Pricing Policy Statement, as well as the Commission's monitoring reports
- providing port industry participants with information about the regulatory framework, and
- wherever relevant and practicable, encouraging port users and port operators to seek to resolve matters of dispute through commercial negotiation.

Thus a key element of the framework is transparency. Transparency is provided through the publication of reference tariffs by port operators together with the publication of monitoring reports by the Commission (discussed in the following section).

Regulated port operators are required to publish a Reference Tariff Schedule for prescribed services by the end of May each year (clause 2.1.1(a) of the PMD) for application for the financial year commencing 1 July of that year. A port operator can meet this obligation by publishing its Reference Tariff Schedule on its website (clause 2.1.2). Providers of prescribed services must also provide the Commission with a copy of their Reference Tariff Schedule for the following financial year (clause 2.1.1(b)). The Reference Tariff Schedule can be varied during the financial year, but the port operator must give port users and the Commission 60 days notice (clause 2.4.2).

The Reference Tariff Schedule is a “standing offer” of the terms and conditions upon which prescribed services will be provided (see clause 2.1.6). The Reference Tariff Schedule must be made freely available to all actual and potential port users (clause 2.1.3). A port operator is not required to obtain the approval of the Commission when establishing its Reference Tariff Schedule (clause 2.1.1(b)).

The Reference Tariff Schedule must clearly indicate the services to which each tariff relates, and any applicable standards of service (clause 2.1.4). Clause 2.1.5 requires that the Reference Tariff Schedule not include fees for services that are not prescribed services or related services (as defined). This prohibits “bundling” of prescribed and non-prescribed services. In addition, there is a requirement (clause 2.1.5(b)) for the “ring fencing” of charges that come under the channel access regime, to ensure that they are distinguishable from charges for other prescribed services and non-prescribed services.

While the Reference Tariff Schedule forms a “standing offer”, there is nothing to prevent port operators from negotiating different pricing arrangements with individual users where such arrangements are to the satisfaction of both parties (clause 2.2.1).

3.2.2 Information reporting & publication

Port operators are required to provide a range of information to the Commission. The information is used by the Commission to monitor the provision of prescribed services and related services.

Information disclosure by port operators

The main information requirements include:

- Financial statements for prescribed services, including revenues, operating costs and profits, assets and liabilities, capital expenditure and expenditure on related services (clause 3.2.2). The information must be accompanied by a Director’s Responsibility Statement, or if the Commission allows, certified by a competent officer of the regulated entity (clause 3.2.4(a)) and an audit statement must be provided to the Commission with the financial statements (clause 3.2.4(b)). A full

- and detailed statement of the accounting principles and policies used to prepare the regulatory financial statements should also be provided (clause 3.2.4(c)).
- Separate financial statements must be provided for prescribed channels, other prescribed services and non-prescribed services, and the whole of business of the port operator (clause 3.2.1). A cost allocation statement must also be provided which details how costs and assets have been allocated between these services (clause 3.3). The cost allocation principles must conform to the methodology set out in clause 3.3.2 (and under clause 3.3.5 the Commission can reject a cost allocation statement that does not follow these requirements).
 - Port charges and levels of demand for each of the prescribed port services (clause 3.4.1(a)).
 - Indicators of service quality and productivity relating to the provision of prescribed services (clause 3.4.1(c)).
 - Other statistical information to support the Commission's market and statistical analysis (clause 3.4.1(b)).

This information is to be provided annually to the Commission by each port operator, no later than four calendar months after the end of the financial year (clauses 3.2.4(d) and 3.3.4). The Reference Tariff Schedule must also be provided to the Commission by the end of May each year, as described in section 3.2.1 above.

In addition, subsection 56(3) of the PSA requires the provider of prescribed services to make financial and business records available to the Commission when required to do so by notice in writing given by the Commission.

Information Reporting by the Commission

The Commission publishes an annual Monitoring Report that provides information about the provision of prescribed services at each of the Victorian commercial ports (clause 4.1.1). The purpose of the Ports Monitoring Report is to present information on the economic performance of Victoria's ports. The publication of these reports supports the Commission's objective of facilitating commercial negotiation and competition by making information publicly available that will be relevant to port industry participants, for example, when they are negotiating the terms and conditions of obtaining access to prescribed services. It also contains the information that is relevant to the effectiveness of the regulatory framework in meeting the Commission's statutory objectives established in section 48 of the PSA¹⁶.

Annual Monitoring Reports also contain some of the information that the Commission considers relevant to its monitoring of prescribed prices at regulated ports (clause 4.1.2). The 2005/6 report included information on port activity, changes to the levels and structure of port charges, service quality indicators, findings of customer satisfaction surveys, and selected financial performance and productivity indicators.

¹⁶ ESC, Feb 2007, Ports Monitoring Report 2005-06, p.6

Delays in the provision of some of the required audited information have meant that the Monitoring Report for 2006/7 has not yet been published. The same format will be used in a combined 2006/7 and 2007/8 Monitoring Report, to be published in early 2009.

3.2.3 POMC-specific elements, pricing principles and pricing policy statement

In the 2004 review of regulation of Victorian ports, the Commission determined that PoMC held substantial market power in its core container and motor vehicle trades. As a consequence, the Commission determined that effective price monitoring required clear regulatory principles that make clear to all stakeholders what pricing conduct is acceptable and what is unacceptable.

To this end, clauses 5.2 and 5.3 of the PMD set out the principles which are to guide the PoMC when setting prescribed prices. The pricing principles state that PoMC's prescribed prices:

- should generate expected revenue that is sufficient to meet the expected efficient long-run costs of providing the prescribed services, including a return on assets (appropriately defined and valued) commensurate with the risks involved
- should not provide a sustained level of revenue that is significantly above that which would be or would have been sufficient to meet the efficient long-run costs of providing the prescribed services, including a return on assets (appropriately defined and valued) commensurate with the risks involved
- should not be structured to advantage the operations of PoMC over those of a competitor in a related market, except on the basis of costs of supply
- should not discriminate between users of equivalent ("like for like") services where those users compete in a related market, other than on the basis of differences in the costs of supply
- may reflect efficient forms of price discrimination as follows:
 - multi-part pricing and price discrimination should be employed when these will promote efficient outcomes, and
 - the expected revenue raised from the prices applying to a particular service should be no lower than the forward-looking avoidable cost of providing that service and no higher than that required to support the provision of that service on a stand-alone basis.

In addition, the PoMC is required to have regard to the following pricing principles when setting prescribed prices for the use of Shared Channels¹⁷:

- charges for use of a Shared Channel should generate expected revenue equal to the specific costs of providing the Shared Channel and a reasonable allocation of common costs (including an appropriate return on capital)

¹⁷ The Shared Channels are defined as the shipping channels at the entrance to Port Phillip Bay that are required to be used by all ships visiting either the port of Melbourne or the port of Geelong.

- the rules by which common costs are allocated should be reasonable, the allocation basis verifiable, and the rules consistently applied
- the cost of improvements to a Shared Channel that can be demonstrated to benefit only the users of one port should be borne by users of that port, and
- except insofar as the application of paragraph (c) requires, charges for use of a Shared Channel should not discriminate between users on the basis of port or berth that will be used by the vessel, except on the basis of cost.

Under the PMD, PoMC was also required to prepare a Pricing Policy Statement which remains in force over the five year regulatory period. In preparing the Pricing Policy Statement, PoMC was required to consult with port users and the Commission.

PoMC's Pricing Policy Statement¹⁸ explains how the reference tariffs have and will be calculated, and how the pricing principles (set out in clause 5.2 of the PMD) and the additional pricing principles specific to Shared Channels (in clause 5.3.1 of the PMD) have been complied with, as well as how other relevant economic principles have been applied. The Pricing Policy Statement also explains the pricing strategy during the regulatory period (as required by clause 6.2.3 of the PMD), and how this corresponds with PoMC's business plans, and how the costs of major investments are to be recovered.

3.2.4 Complaint handling

Under the PMD, the Commission is not required to investigate complaints or to take action in relation to complaints. However, the Statement of Purpose and Reasons to the PMD sets out the proposed complaint handling process. Because it does not wish to intervene in matters that would normally be subject to commercial negotiation or commercial dispute resolution processes, the Commission refers complaints to the relevant port operator in the first instance. The Commission would only investigate a complaint if:

- it is of sufficient weight or substance, and
- the parties have exhausted normal avenues of commercial resolution, and
- it is likely that a regulated port or channel operator has significantly misused its market power.

All complaints are noted by the Commission, and statistical information about complaints is included in the reports published by the Commission.

3.2.5 Inquiries and investigations

An important element of the price monitoring framework is the Commission's ability to undertake inquiries and the possibility of reversion to a more prescriptive form of regulation.

¹⁸ Available at: <http://www.esc.vic.gov.au/NR/exeres/220A5919-09F5-4B8E-B0D6-9203D770970F.htm>

Section 7 of the PMD provides that, within the five-year regulatory period, the Commission can initiate an inquiry into any matter relating to the supply of prescribed services (clause 7.1.1). For example, it may inquire into whether a port or ports have significantly misused market power, or whether the price monitoring regime is effectively meeting the Commission's statutory objectives (clause 7.1.3). Such an inquiry can be confined to a particular port, prescribed service or issue, depending on the nature and extent of the identified problem.

The Statement of Purpose and Reasons to the PMD indicates that the Commission will use its powers of inquiry sparingly. Consistent with the Commission's monitoring role, the inquiry power is intended to be used only in unusual circumstances, where the Commission has significant concerns with regard to the market conduct of a regulated port or ports under the price monitoring regime. For example, it is not intended that inquiries will need to be conducted unless there is evidence to suggest that the regulated port or channel operator has significantly misused its market power.

3.2.6 Principles governing the reimposition of price controls

If an inquiry finds that there has been significant misuse of market power, or the price monitoring framework is not effectively meeting the Commission's statutory objectives, the Commission may amend the PMD – e.g. by reintroducing price controls for one or more ports, or in another way that the Commission feels is appropriate to ensure that the objectives of the PSA and the ESC Act are met (clause 7.2.1 of the PMD).

To ensure that the risk of re-introduction of prescriptive regulation does not act as a deterrent to efficient investment, clarity is needed regarding the regulatory treatment of investments undertaken during the price monitoring period. Section 8 of the PMD is intended to provide such clarity.

The PMD contains specific commitments regarding investments that have been prudently and efficiently undertaken during the price monitoring period. It also provides assurance that investments undertaken following an appropriate rigorous and open evaluation process, and executed consistently with that evaluation, would be regarded as prudent in the event of the re-imposition of price controls.

In particular, the Commission is committed to adopting the actual cost of investment as the relevant asset value for inclusion in the Regulatory Asset Base, provided the investment was used to provide prescribed and related services and was prudently made. The PMD states that the Commission will accept that an investment has prudently been made if it is satisfied that the project has:

- been the subject of a detailed cost-benefit assessment by reference to the Victorian Government's procedures for reviewing major capital project,
- the assessment demonstrated net economic benefits, and included analysis of the financial costs and benefits for the Provider of Prescribed Services,
- been implemented in accordance with projections (that were considered for the purposes of the cost-benefit analysis referred to above), and

- where there has been a significant deviation from the cost that was projected in the original cost benefit analysis, that all appropriate project and risk management processes were put in place and adhered to (clause 8.2.3).

3.3 Channel access framework

Under paragraph 49(c)(i) of the PSA, the provision of channels for use by shipping is a prescribed service. Therefore the prices charged for the provision of these services are prescribed prices and subject to regulation by the Commission through the price monitoring framework described above.

In addition, Division 4 of Part 3 of the PSA establishes the Channels Access Regime, which applies to channels declared by the Governor in Council by Order to be prescribed channels. However to date no channels have been declared, so that the only aspect of the channels access regime that is operational is the price regulation of channel access charges. Notwithstanding that there are no declared shipping channels at present, the Commission has released a Guideline on how it would conduct the process of determining an access dispute (were a channel to be declared and an access dispute arise).¹⁹

3.3.1 Declaration of shipping channels

In its 2003 Inquiry into Port Channel Access in Victoria, the Commission examined the market power of channel operators and the effectiveness of the access regime relating to the channels in Victoria²⁰. The Commission recommended that the access regime should be retained and implemented through:

- declaration of provision of channel services in Port Phillip Bay for use by commercial shipping in the waters serving the ports of Melbourne and Geelong (and possible declaration of Westernport and Portland channels), and
- application to the National Competition Council (**NCC**) for certification as an effective State-based regime under the Competition Principles Agreement (**CPA**).

Following further consideration during the 2004 Review of Regulation of the Victorian Ports, the Commission recommended that only the channels serving the ports of Melbourne and Geelong be declared²¹.

3.3.2 Obligations of an access provider

Section 59 of the PSA sets out the access obligations of channel operators in the event of declaration of channel services. Under this section, the channel operator would be required to:

- provide access on fair and reasonable terms and conditions

¹⁹ <http://www.esc.vic.gov.au/NR/exeres/E99347BD-44D1-4965-A458-34EA4325FF10.htm>

²⁰ ESC, May 2003, "Inquiry into Port Channel Access in Victoria: Final Report"

²¹ ESC, June 2004, 'Regulation of the Victorian Ports: Final Report' p91.

- use all reasonable endeavours to meet the requirements of a person seeking access to prescribed channels (an “Access Seeker”), and
- make a formal proposal of terms and conditions within 30 business days of receiving a request for access, or within such reasonable lesser period as is fixed by the Commission.

The PSA also provides that a channel operator or any other person having access to a prescribed channel must not hinder access to the prescribed channel by an Access User²².

3.3.3 Access disputes

Sections 60 and 61 of the PSA give an Access Seeker the right to request a determination from the Commission on the terms and conditions on which access is to be provided. The role of the Commission in making determinations on disputes over access to prescribed channels would be additional to the Commission’s price monitoring role.

Thus Commission would have the power to determine access disputes in circumstances where:

- the Access Seeker cannot agree to the terms and conditions of access offered by the channel operator, or the channel operator has not made a formal offer to the Access Seeker as required under paragraph 59(2)(b) of the PSA and Part 3 of the Channel Access Guideline (section 60).
- an Access User’s reasonable right of access to a prescribed channel has been hindered by the channel operator or another party (section 61).

When making a determination of this kind, the Commission must have regard to the factors specified in PSA and any other factors that the Commission considers relevant. In addition the Commission must consider the matters specified in paragraphs (i) and (j) of clause 6(4) of the CPA.

In addition, subsection 60(4) of the PSA provides that the Commission must not make a determination if it considers that doing so would substantially impede the existing right of access of another person, unless that person has been given an opportunity to make a submission to the Commission in respect of the matter.

3.4 2004 Port Regulation Review

Under s53 of the PSA, the Commission is required to periodically review the regulatory regime and make recommendations to Government on whether continued regulation of prescribed prices is appropriate, and if so the form of economic regulation to be adopted. The second of these scheduled inquiries was completed in 2004.

In that review the Commission:

²² “Access User” is a party with a legitimate right of access.

- considered whether continued price regulation of each of the prescribed port services was appropriate and recommended that harbour towage and the connection of electricity and water services to ships should cease to be prescribed services, and
- considered the appropriate form of regulation and recommended a change from “building block” price regulation to a price monitoring regime.

The review included consideration of the channel access regime as mentioned in section 3.3.1 above.

The approach taken by the Commission to the last review and its conclusions are relevant matters for the present review and are briefly summarised below.

3.4.1 Effectiveness of existing regulation

In the 2004 review the Commission examined the effectiveness of regulation over the preceding regulatory period. It considered that the price-cap arrangements that were put in place following the 1999 review had generally worked well by delivering real reductions in Port of Melbourne charges²³. While PoMC’s profitability had declined, this did not appear to be due to an excessively tight constraint on prescribed prices because revenue had exceeded the forecast used at the time prices were set, but costs had escalated more rapidly²⁴.

Nevertheless, the 2004 inquiry gave emphasis to the assessment of market power and concluded that a lighter handed form of regulation would be more effective going forward²⁵.

3.4.2 Market Power Analysis

The ACCC has defined market power as “the ability of a firm or firms profitably to divert prices, quality, variety, service or innovation from their competitive levels for a significant period of time”.²⁶ Market power is “substantial” when its use would have a substantive economic impact that would be felt over an extended period.

The first task for the Commission was to assess whether the providers of port services had substantial market power, and whether the exercise of this market power was otherwise constrained. The Commission used three broad indicators in forming a judgement on whether substantial market power existed in a particular market²⁷:

- key features of the market structure, such as the existence and number of competitors, the extent of barriers to entry of new firms, the availability of

²³ ESC, June 2004, Op cit, p.46

²⁴ ESC, Ibid, p.47

²⁵ ESC, Ibid p.47

²⁶ ACCC, June 1999, ‘Merger Guidelines’, p.23

²⁷ ESC, June 2004, Op cit, p.51

substitutes for the products of the industry, and the degree of concentration on the buying side of the market.

- active rivalry between service providers that extends to all aspects of price and service offered to consumers.
- a comparison of market outcomes with those expected from a workably competitive market. However, where a market has been the subject of price regulation, this aspect of the market may provide little guidance in regard to the existence of substantial market power, as outcomes are constrained by the pricing rules set by the regulator.

Conclusions on market power in 2004 review

In the 2004 Review, the Commission concluded that PoMC retained substantial market power in its core container and motor vehicle trades²⁸. These trades represented over 80% of the port's wharfage revenue at that time.

The Commission considered that while there appeared to be increasing scope for competition from interstate container terminals, the extent of competition at that time could not in itself be considered to impose an effective constraint on the PoMC's pricing behaviour. Furthermore, there were high barriers to the entry of new container terminals, and while the countervailing power of shipping lines and stevedores was substantial, the ability to pass costs through to cargo owners tended to mitigate the effects of this countervailing power²⁹.

On the other hand, the Commission considered that the regional ports had only limited market power, except in certain bulk trades³⁰. Their core trades of dry bulk and general cargoes were generally contestable between ports because they were sourced from or destined for areas that can competitively access alternative ports. Market power situations were largely confined to major "captive" users - for example the Alcoa aluminium smelters, the Shell refinery at Geelong, and the BHP Steel rolling mill at Hastings (now Bluescope Steel). These "captive" users were usually protected by long-term agreements with the ports (e.g. Alcoa), ownership of relevant berthing facilities (e.g. Bluescope Steel) or in some cases industry specific legislation³¹. Exceptions, such as the Shell refinery at Geelong, nevertheless appeared to have feasible alternative options (e.g. the development of a private terminal, or transportation of oil via the W.A.G. Pipeline).

Ports operate in a business-to-business trading environment, and many of their customers are well-informed and powerful. International shipping lines, principal tenants and major bulk customers in particular appear to be in a position to exercise significant countervailing power. But this power is unevenly spread amongst the customer base, and in many cases was – at least in the short term – limited by the absence of a credible alternative.

²⁸ ESC, *Ibid*, p72

²⁹ ESC, *Ibid*, p73

³⁰ ESC, *Ibid*, p73

³¹ e.g. see *Western Port Development Act 1967*, Parts III and IV

In the review, the Commission found that the threat of new entry, typically in the form of an existing port beginning to play a role in the shipping of a type of cargo in which it had not previously been involved, was credible with respect to some trades, and there were important instances of where such entry has in fact taken place. However, there were a number of trade segments – primarily containers, cars and crude oil in Melbourne – in which the threat of new entry was unlikely to be a significant consideration³².

The Commission also considered whether competition between the regional ports may have been affected by cross-ownership/control³³. For example, the Australian Infrastructure Fund (**AIF**) had a significant interest in both the Geelong and Portland ports, and Toll Holdings operated both the ports of Geelong and Hastings. However, given the minority position of AIF in the port of Geelong, and the scope for the new PoHC to undertake developments at the port of Hastings separately from the facilities now managed by Asciano, these circumstances were not considered to effectively limit competition between the ports.

The Commission identified several important developments that were increasing the degree of competition in the ports sector³⁴. Among these, the ongoing improvements in the interstate freight rail network were important, together with overall improvements in logistics efficiency. These developments were being given further stimulus through the emergence of integrated logistics service providers. The Commission also considered it significant that key competitors to the port of Melbourne, such as the ports of Adelaide and Geelong, were privately owned, relatively efficient and vigorous competitors.

The overall rate of growth of seaborne trade was also found to be important, as well as the greater rationalization of services among shipping lines.

3.4.3 The Commission's 2004 Conclusions on the Need for Regulation

Price regulation

In light of the substantial market power of PoMC the Commission recommended that its shipping channel and berth services should remain prescribed services³⁵. For the regional ports, the Commission considered that there was a case for deregulation of berth services. However the Commission identified some uncertainty as to the extent of residual market power in relation to some “captive” trades, and as a result considered that berth services at the regional ports should continue to be prescribed services³⁶. The Commission also noted that it would give further consideration to whether regional ports should be fully deregulated at the next review of port regulation. In the interim, the Commission recommended that

³² ESC, Op.cit., p73

³³ ESC, Ibid, p73

³⁴ ESC, Ibid, p73

³⁵ ESC, Ibid, p98

³⁶ ESC, Ibid, p99

the provision of berth and shipping channel services by these port entities should continue to be prescribed services as a transitional step to deregulation³⁷.

Access Regulation - Channels

In considering the need for access regulation, the Commission was of the view that the channel access regime should be retained. However, the Commission considered that channels should be declared only where there is an identified benefit that would be provided by the access regime. On this basis the Commission considered that it would be appropriate to declare only the shipping channels of Port Phillip Bay and its entrance³⁸.

The exclusion of the channels serving the ports of Portland and Hastings from the declaration was intended to ensure that regulation was not applied to situations where there is not a clear benefit. However the Commission noted that these channels could be declared at any time should a benefit to the declaration be identified at a future time.

Access Regulation – Berth Services

The Commission also considered whether it would be appropriate to extend access regulation into the provision of key port infrastructure by PoMC. However, as no specific concerns had arisen with respect to the conduct of PoMC in relation to access, the Commission did not propose that access obligations should be applied to berths and marshalling areas at that time. However, the Commission recommended that this matter be kept under review³⁹.

3.4.4 The Form of Regulation

Consideration of the appropriate form of regulation involves weighing the benefits against the costs of alternative regulatory forms. The Commission considered that, as a general rule, the more substantial is market power, the more likely that “heavier handed” forms of regulation would be applicable, and vice versa. Hence the market power assessment discussed above was also directly relevant to the preferred form of regulation.

Although the Commission found substantial market power in core sectors of the market, it considered that even in these sectors there was a significant competitive fringe which was contestable with interstate ports, and some important developments that were increasing the degree of contestability over time. These and other factors, such as the degree of countervailing power of major port users, while insufficient in themselves to prevent the misuse of market power by the port, were nevertheless regarded as pertinent to:

- the minimum regulatory response necessary to protect port users from misuse of market power; and

³⁷ ESC, *Ibid*, p5

³⁸ ESC, *Ibid*, p91

³⁹ ESC, *Ibid*, p05

- the form of regulation most conducive to promoting competition.

Given the differences in market power between PoMC and the regional ports, the Commission considered that complete consistency of regulatory treatment between the major and minor Victorian ports would require a degree of regulation of the regional ports which would not be warranted. Its recommended monitoring approach was designed to achieve a significant degree of regulatory consistency between the ports, while also reflecting the differences in market power between PoMC and the regional ports.

The key considerations that informed the Commission’s conclusions in relation to the proposed regulatory framework included⁴⁰:

- Preference for market solutions.
- Proportionality. Promotion and protection of competition. Consistency.
- Balancing short and long term benefits to consumers.

Form of Price Regulation of Channel and Berth Services

The Commission’s preferred approach to the regulation of prescribed prices for the provision of channel services and berth services was a price monitoring framework supported by appropriate information disclosure requirements and a clearly enunciated threat of re-regulation in the event that the systematic misuse of market power becomes evident.

The recommended disclosure requirements included a requirement to maintain a published set of Reference Tariffs, and clear requirements on the provision of information to the Commission to support its monitoring role.

The recommended approach to establishing a credible threat of the application of more prescriptive regulation if market power is misused had a “dual form”, including an ability by the government or the Commission to initiate inquiries within the regulatory period if there were concerns that market power had been misused, and a scheduled review after five years to determine whether the price monitoring framework was delivering the objectives of the ESC Act and the PSA.

Certain additional regulatory requirements were recommended to apply to PoMC berth and channel services, because of PoMC’s greater market power. PoMC was required to comply with the pricing principles stated in section 3.2.3 above. In addition, PoMC was required to prepare a public Pricing Policy Statement which specified the economic rationale and principles that would govern its pricing strategy and approach. The Commission expected that the approach to pricing established by PoMC under the Pricing Policy Statement would be consistent with overarching pricing principles established by the Commission. The regional ports and VRCA were not required to prepare a Pricing Policy Statement.

The Commission also indicated that, if it were called upon to arbitrate a channel access dispute under the channel access regime, it would not proceed to make a determination if the dispute related to the price of access if the channel operator

⁴⁰ ESC, *Ibid*, pp104 to 105

were offering access at prices contained in a Reference Tariff, unless the Commission was first satisfied that the prices contained in the Reference Tariff did not comply with the pricing principles.

4 | PRINCIPLES RELEVANT TO THE REVIEW

This section sets out the principles that will guide the Commission's assessment of the key issues that need to be addressed in the review.

Firstly, section 4.1 sets out the nationally agreed principles governing the regulation of ports. Then section 4.2 outlines the Commission's proposed approach to addressing the question of coverage – that is, whether regulation should be applied and if so to what services. This includes consideration of questions such as:

- What are the benefits of regulation, in terms of constraining the abuse of market power? How should market power be assessed?
- What are the costs of regulation in terms of compliance costs and distortion to commercial negotiations and decisions?

Section 4.3 outlines the proposed approach to the question: if regulation is appropriate, what form should it take? This includes questions such as:

- Should regulation be heavy or light handed?
- Should it comprise price regulation, price monitoring and/or application of access regime(s)?
- What would be required for the access regime to be certified as effective?

4.1 The Competition and Infrastructure Reform Agreement (CIRA)

In February 2006, COAG agreed to establish a simpler and consistent national approach to economic regulation of significant infrastructure in its Competition and Infrastructure Reform Agreement (**CIRA**).⁴¹

The parties agreed that in the first instance, the terms and conditions of third party access should be commercially agreed between the access seeker and the access provider. The introduction of price monitoring for services provided by means of significant infrastructure facilities should be considered, where this would improve the level of price transparency, as a first step where price regulation may be required, or when scaling back from more intrusive regulation.⁴²

In relation to ports, the parties agreed that ports should only be subject to economic regulation where a clear need for it exists in the promotion of competition

⁴¹ Clause 2.1

⁴² Clauses 2.2 and 2.3

in upstream or downstream markets or to prevent the misuse of market power⁴³. Where regulation of ports is warranted, it should conform to a consistent national approach based on the following principles⁴⁴:

- wherever possible, third party access to services provided by means of ports and related infrastructure facilities should be on the basis of terms and conditions agreed between the operator of the facility and the person seeking access
- where possible, commercial outcomes should be promoted by establishing a competitive market framework that allows competition in and entry to port and related infrastructure services, including stevedoring, in preference to economic regulation
- where regulatory oversight of prices is warranted pursuant to clause 2.3, this should be undertaken by an independent body which publishes relevant information, and
- where access regimes are required, and to maximize consistency, those regimes should be certified in accordance with the TPA and the CPA.

The CIRA includes an agreement to allow for competition in the provision of port and port related infrastructure facility services, unless a transparent public review indicates that the benefits of restricting competition outweighs the costs to the community.⁴⁵ Each of the signatories to CIRA were required to review the regulation of ports and port authorities, handling and storage facility operations at significant ports to ensure they are consistent with the above principles.⁴⁶ The review of regulation of Victorian ports completed by the Commission in June 2004 satisfied the latter commitment.⁴⁷

4.2 Is Price Regulation Necessary?

4.2.1 General considerations

One purpose of this Review is to consider whether the prescribed port services should remain subject to price regulation. Regulation should only be applied where there is a convincing case that it is necessary, such that the benefits of regulation can be reasonably expected to outweigh the costs. Section 33(4) of the ESC Act requires that the Commission, before making any price determination, must ensure that:

⁴³ Clause 4.1(a)

⁴⁴ Clause 4.1(b)

⁴⁵ Clause 4.2

⁴⁶ Clause 4.3

⁴⁷ Minister for Finance, WorkCover and the TAC, 'Review of Port Planning Terms of Reference', 25/7/2007. At: <http://www.esc.vic.gov.au/public/Ports/Consultations/Port+planning+and+its+impact+on+c+ompetition+review/Port+planning+and+its+impact+on+competition.htm>

- (a) *the expected costs of the proposed regulation do not exceed the expected benefits, and*
- (b) *the determination takes into account and clearly articulates any trade-offs between costs and service standards.*

The benefits of regulation are largely associated with preventing the misuse of substantial market power. However regulation also imposes costs on the community. The potential costs of regulation are likely to be relatively high where there is scope for greater competition that could be deterred by the impact of regulation on prices, or where there is potential for investment that may be impeded or delayed by certain forms of regulation.

Ultimately a recommendation to continue with price regulation requires a judgment to be made on whether the costs and risks associated with any likely market failure that might arise in the absence of regulation would exceed the costs of regulation and the risks of regulatory failure under continued regulation.

4.2.2 Benefits of regulation

Whether there are benefits from economic regulation of port services will depend on whether the providers of port services have substantial market power, and whether the exercise of this market power is not otherwise constrained. Such market power, if unchecked, may result in prices that are excessive due to inefficient costs or excessive profit taking, which could lead to a loss of economic efficiency. Additionally, in vertically integrated industries, market power may be used to distort competition in upstream or downstream industries.

As discussed above, the Commission uses three broad indicators in forming a judgement on whether substantial market power exists in a particular market:

- key features of the market structure
- the extent of active rivalry between service providers
- a comparison of market outcomes with those expected from a workably competitive market.

The case for regulation will depend on the degree of market power that can be exercised, and on the magnitude of the economic consequences that would flow from a misuse of that market power. The economic consequences of a misuse of market power will be more serious if the industry comprises a large share of the national economy, is essential to other significant industries or involves actions that lead to major distortions in the pattern of demand.

4.2.3 Costs of regulation

In its Review of the National Access Regime, the Productivity Commission identified five potential costs of economic regulation.⁴⁸

⁴⁸ Productivity Commission, September 2001, Review of the National Access Regime, Inquiry Report,

- administrative costs for Government and compliance costs for business
- constraints on the scope for infrastructure providers to deliver and price their services efficiently
- reduced incentives to invest in infrastructure facilities
- inefficient investment in related markets
- wasteful strategic behaviour by both service providers and access seekers.

Moreover price signals can be important in promoting dynamic efficiency, and in encouraging new entry into markets⁴⁹. In certain circumstances the promotion of competition requires that prices be allowed to rise to a level at which potential profits encourage companies to take the risk of entering new markets. Regulation to eliminate above normal profits in these circumstances may have the effect of discouraging competition, with possible implications for the achievement greater economic efficiency in the longer term.

4.2.4 Interaction between price regulation and the national access framework

The case for price regulation of services provided by essential infrastructure facilities may also depend on whether those facilities would fall within the ambit of the national access framework. This is especially the case with regard to services that might be covered by third party access regulation.

The owner/operators of facilities that are eligible to be covered under the national access framework typically have substantial market power due to the “monopoly bottleneck” characteristics of such infrastructure, and are able to affect competition in a related market. The relevant related market is typically one where the owner/operator of the essential facility competes with other suppliers in that related market – i.e. there is vertical integration. Access to the essential facility on reasonable commercial terms is important to maintaining a level playing field for competition in the related market.

Access regulation may therefore be necessary to ensure that users of significant infrastructure facilities are able to obtain access to these services on fair and reasonable terms and conditions. Without such regulation, these service providers could deny or restrict access to their facilities, or charge monopoly or discriminatory prices, to restrict competition in upstream or downstream markets.

The CPA and Part IIIA of the TPA provide a national framework for the regulation of access to significant infrastructure facilities. The criteria for assessing whether certain facilities are “significant infrastructure facilities” which can be subject to access regulation are outlined in clause 6 of the CPA and Part IIIA of the TPA. The key criteria may be summarised as follows:

- the relevant service provided by the facilities falls within the definition of “service” in Section 44(b) of the TPA

⁴⁹ ESC, June 2004, Op cit, p49.

- it is “significant” to the State economy
- it would not be commercially feasible to duplicate the facilities
- access to the service promotes competition in an upstream or downstream market, and
- access to the service is in the public interest.

Third party access regulation can apply to facilities that meet these criteria. Thus, if the channel access regime is to be retained, it should only apply to shipping channels that meet these criteria. Likewise if third party access regulation were to be applied to berth services, these criteria would need to be satisfied with respect to those services.

4.3 Forms of regulation

4.3.1 Options for price regulation

There are a wide range of different forms that economic regulation can take. These vary in terms of the extent to which the regulator seeks to intervene in pricing (and consequent profit outcomes), the extent of information required by the regulator and the compliance costs involved. Different forms of regulation are often characterised as “light-handed” or “heavy-handed”, according to the degree to which they vary in these aspects.

The range of possible forms of regulation includes:

- methods of price control such as rate of return regulation, price cap or incentive regulation, and
- lighter forms of regulation such as price monitoring, pricing principles and threshold schemes.

Access regulation under the national access framework in Australia is also usually characterised as light-handed, involving negotiate-arbitrate arrangements and access undertakings. However, a number of industry-specific access codes, such as in gas and electricity distribution, have price control frameworks more characteristic of “heavy handed” regulation.

Price control methods

Rate of return regulation places specific bounds on prices and profitability by allowing the regulated business to recover its costs, including a rate of return on capital. Rate of return regulation is demanding in terms of the information required, the frequency of rate hearings, high compliance costs, and poor efficiency incentives.

CPI-X price cap regulation has been widely implemented within Australia. CPI-X sets a limit on the weighted average increase in prices that is allowed each year for a defined regulatory period – typically three to five years. This form of regulation is intended to provide strong incentives for the regulated business to make efficiency improvements, since the business is able to retain the cost savings achieved, at

least within the regulatory period (and beyond if efficiency carry-overs are incorporated into the regime).

A variety of approaches can be used to set X for the regulatory period. The building blocks approach establishes a revenue requirement which covers the cost of service (including a return on capital as measured by the regulatory asset base). Alternatively, Total Factor Productivity (**TFP**) techniques can be used. These set X on the basis of historical analysis of productivity growth. Yet another option is to index X to the movement in prices of comparable services (such as the prices charged by similar companies).

TFP or other index approaches can be combined with a building block approach to determine (or re-determine) the initial level of prices for the regulatory period (termed Po). Alternatively, a legacy pricing approach starts from existing prices, and applies an indexed-based price cap to determine the allowed level of future prices.

Frontier methods of setting price caps involve either data envelop analysis (**DEA**) or stochastic frontier analysis (**SFA**). These approaches identify the “efficiency frontier” from the performance of the firms in the sample. The efficiency frontier is then used as a yardstick against which to compare the performance of each regulated business.

Econometric benchmarking is another method of comparing the efficiency performance of a sample of regulated businesses. Often the efficiency benchmarking is used to determine target efficiency improvements which are applied to the operating and capital components of a building block approach.

Price regulation arrangements often involve scrutiny (or guidance) of pricing structures. They are also usually accompanied by some form of monitoring of the quality of service and may incorporate explicit incentives for improved service quality.

Lighter handed forms of price regulation

Price monitoring involves the regulator in monitoring prices, profits and service quality over time. Protection from market power operates through the threat of further regulatory action. Price monitoring allows greater scope for commercial negotiation. However, the threat of future regulatory must be credible if the regime is to be effective.

Pricing principles involve the regulator specifying qualitative principles with which prices must comply. They can be used in conjunction with other regulatory arrangements, such as price caps, price monitoring, or negotiate-arbitrate models.

A threshold approach to regulation has been developed within New Zealand. Price, quality or profit-based “thresholds” are established, together with a periodic review of whether the thresholds have been complied with. A breach of the threshold triggers a regulatory investigation into whether the business should be subject to price regulation.

Access regulation

The regulation of access prices under the Australian national access framework is based on a negotiate/arbitrate model for infrastructure that is “declared” as essential for access purposes, or is subject to an access undertaking, a state-based access regime, or to an industry-specific code such as those used in the energy infrastructure industries.

Within a negotiate/arbitrate model, negotiations between an access seekers and an access provider may take place within established pricing bounds, typically a lower bound of incremental cost and an upper bound of stand-alone cost. The emphasis is on commercial negotiation, but the regulator can be called upon to arbitrate in the event that negotiations fail. This model is intended to minimise regulatory involvement. However, the regime can involve heavy compliance costs if the parties rely on arbitration to determine pricing outcomes,

As an alternative to declaration, service providers can submit an access undertaking for approval by the relevant state regulator or the ACCC. The undertaking is developed by the service provider and specifies the terms and conditions of access, including principles for determining access and in some cases indicative prices for a representative service.

The NCC has recently introduced a “light regulation” framework for certain gas pipelines which combines characteristics of the undertaking and negotiate/arbitrate models described above. In this model, the undertaking contains non-price terms and conditions, with prices subject to the negotiate/arbitrate model.⁵⁰

4.3.2 Considerations regarding light versus heavy handed regulation

In assessing the appropriate regulatory approach to apply, a fundamental trade-off exists between minimising the effects of market power and providing the regulated business with the appropriate incentives to enhance efficiency and service quality. The choice between more or less light-handed approaches amounts to a decision on what kind of arrangement will achieve this most effectively. As a general rule, the more substantial is market power, the more likely that “heavier handed” forms of regulation would be applicable, and vice versa. Where there is some competition in the industry, the risks of regulatory failure are exacerbated, and “lighter handed” forms of regulation are generally more appropriate.

NERA identified the key characteristics that indicate when lighter-handed forms of regulation are likely to be appropriate⁵¹. These concern the extent of market power that exists given the particular market circumstances of the industry or market segment, institutional dynamics, dynamic considerations and procedural considerations.

⁵⁰ NCC (August 2008) ‘Exposure draft of the Guide to the Council’s role in light regulation determinations’

⁵¹ NERA, March 2004, Alternative approaches to light-handed regulation, p57

Market Circumstances and Extent of Market Power

Market circumstances, in terms of the structure of the market, dictate the extent of market power, and the risk of that market power being exercised. The extent of actual and potential competition constitutes the most immediate constraint, with the extent of countervailing buyer power and the size of the regulated entity forming important additional considerations. The scope for a business to engage in efficient price discrimination must also be considered – particularly if the market structure is such that large classes of users would be excluded in the absence of price discrimination with resultant inefficiencies. Finally, the vertical structure of the market must be examined. If significant vertical integration is present, this increases the potential efficiency loss from the exercise of market power as it impacts on more than one market.

Institutional Dynamics

The second characteristic is the institutional dynamics of the sector. Ultimately, most lighter-handed regulatory schemes operate upon the threat of more comprehensive regulation. The power of this sanction can be substantially enhanced if a framework exhibits clear regulatory pricing principles and the open, transparent and consistent implementation of those principles. A criticism of some light-handed regimes is the perceived lack of such a threat.

Market Dynamics

The third characteristic recognises that the industries under consideration are normally characterised by investments that have no alternative purpose and which exhibit decreasing costs over their useful lives. Taking account of these dynamic considerations by recognising and minimising inefficiencies in relation to long-term investments is a key element of sound regulatory design. Arguably the best way to achieve an efficient level of investment is to formulate clear regulatory principles, and administer those principles openly, transparently and, most importantly, consistently. There is no compelling reason to prefer any particular form of regulation in this respect. However, the framework ultimately implemented must accurately reflect the position in the spectrum of market development that the industry currently sits, and the regulator must refrain from opportunistic behaviour in order to ensure dynamic efficiency in the longer-term.

Procedural Considerations

The fourth characteristic reflects the fact that once the general regulatory framework has been decided upon, a procedural decision must be made regarding the extent to which the details or bounds of that regulatory framework are made explicit at the outset. A trade-off often exists between pro-actively establishing the details, versus waiting for issues to arise and then responding to them on a case-by-case basis. Whilst pro-active clarification will entail an initial cost, the re-active option will often incur even greater costs.

Application to ports in the 2004 Review

In its previous review of port regulation, the Commission drew on the above considerations and developed the assessment framework outlined in Section 3.4.4 above. Under this framework the key considerations that informed the

Commission's conclusions in relation to the proposed regulatory framework included the following⁵²:

- Preference for market solutions. Where it can be effective, a regulatory framework in which the regulator's role is by exception (such as a complaints-based, dispute resolution, or monitoring role), is to be preferred to a prescriptive regulatory model. The key proviso is effectiveness, as reactive forms of regulation can become either heavy handed or ineffective where there is a high degree of market power.
- Proportionality. The regulatory framework should ensure that the extent to which management behaviour is constrained is proportional to the likely economic or social harm that would flow from the market failure that it seeks to address. In the Victorian ports sector, the social costs of divergences from pricing efficiency are likely to be modest, suggesting that emphasis should be given to "light handed" forms of regulation.
- Promotion and protection of competition. In a sector where there is some competition, and potential for increased competition, it is important that the regulatory framework should provide scope and incentive for pro-active competitive conduct by the regulated firm, and not stifle innovation.
- Consistency. Consistency is an important consideration in determining whether to adopt a similar regulatory model for all of the Victorian ports, notwithstanding potential differences in market power. Also relevant are developments in the regulation of other Australian ports, and the major airports, as well as the interstate rail network.
- Balancing short and long term benefits to consumers. "Lighter handed" forms of regulation place less emphasis on reducing or removing economic rents, and more emphasis on reducing efficiency losses arising from distorted incentives to invest or adopt competitive strategies. The form of price regulation should strike an effective balance between protecting users from monopolistic pricing, and facilitating efficient investment in port infrastructure.

In balancing these considerations in 2004, the Commission came to the view that a "light handed" form of regulation would be appropriate for the Victorian ports, and would be sufficient to meet the Commission's objectives⁵³.

For the purpose of this Review, the Commission will use the principles above to assess whether there is market power, the risks of market power being misused over the next period and hence whether lighter handed or heavier handed regulation is warranted. In doing so the Commission will consider the conduct of the ports over the past regulatory period, including compliance with applicable pricing principles and the Pricing Policy Statement of PoMC, as well as the other matters listed in the PMD.

⁵² ESC, *Ibid*, pp104 to 105

⁵³ ESC, *Ibid*, p7.

4.3.3 Effective state based access regimes

The CIRA includes an agreement that all state-based access regimes must be submitted for certification in accordance with the TPA and the CPA by 2010.⁵⁴

Therefore if the channel access regime is to be retained, the Commission also needs to consider whether the existing channel access regime would meet the requirements for an effective state-based access regime, and if not, what changes to the regime might be necessary for certification. The requirements for certification are provided in Annex A.

The NCC has published guidelines on the matters it will consider when making recommendations on the effectiveness of access regimes.⁵⁵ The following requirements are particularly relevant to the access regime for port channels:

- The negotiation and dispute resolution frameworks must be well specified, and dispute resolution should be by an independent arbitrator.
- Regulatory accounts should be maintained for the services under the access regime that are separate from other services that are not subject to the access regime. This requires appropriate cost allocation principles.
- Where vertical integration issues arise, appropriate competitive neutrality provisions should apply, such as the “prohibition of anti-competitive price discrimination between affiliated users and third party access seekers operating in the same market.”⁵⁶
- The framework should appropriately address market power asymmetries that could reduce the effectiveness of a pure negotiate/arbitrate framework. In particular, price outcomes should “ultimately fall within an efficient range and are structured to eliminate opportunities for excessive profits, overcapitalisation and inefficient operating practices.”⁵⁷ To achieve this, the negotiate/arbitrate framework may need to be supplemented by price regulation in situations where there would be a substantial imbalance in negotiating positions of the access provider and access seeker.
- Any price regulation should be by an independent regulator.
- The negotiate-arbitrate framework and any price regulation arrangements should facilitate efficient price discrimination between users.
- There must be credible enforcement mechanisms.

In 1997 the NCC reviewed the channel access framework in the PSA and expressed the view that these arrangements constituted an effective access regime. Although the PSA has been amended since, most of the non-price aspects of the access regime remain unchanged. As part of the Review, the Commission

⁵⁴ Clause 2.9

⁵⁵ NCC, February 2003, ‘The National Access Regime: A Guide to Part IIIA of the TPA Part C: Certification of Access Regime’.

⁵⁶ NCC, *Ibid*, p.71

⁵⁷ NCC, *Ibid*, p.58

will consider whether the elements of the channel access regime continue to provide a suitable framework for an effective access regime.

There are a number of subjects on which the Commission is seeking comment on. These include:

- the suitability of the Commission's proposed approach to considering the questions as to whether regulation should continue and if so in what form
- stakeholder views on the questions to be addressed in the Review
- market information relevant to the assessment of market power
- stakeholder views about specific benefits and costs of regulation
- stakeholder views about how effective the current regulatory regime has been, and on the adequacy of specific elements of the existing regulatory framework.

In each case, stakeholder responses should provide information and arguments supporting the views presented in response to these questions.

5.1 Questions about the Commission's proposed approach

The Commission seeks stakeholder views on the principles and approaches that it has proposed to take and have regard to in the review, as set out in chapter 4.

1. ***Is the Commission's proposed approach of focussing on whether the benefits of regulation exceed the costs appropriate? Is its proposed approach to assessing these benefits and costs appropriate?***
2. ***Is the Commission's emphasis on the question of market power and its approach to assessing market power appropriate?***
3. ***Has the Commission adequately identified the alternative forms of regulation? Are the principles proposed by the Commission for assessing the form of regulation appropriate?***

5.2 Key questions to be addressed in the Review

The Commission seeks stakeholder views on the matters on which it must make recommendations in the Review.

4. ***Should the existing prescribed services continue to be subject to regulation? Berth services? Channel services?***
5. ***To which Victorian ports should regulation continue to apply?***
6. ***If any services should continue to be regulated, what form of price regulation should apply? For example, should price monitoring continue,***

or should there be price controls or some other form of price regulation? If so, what form of price regulation?

- 7. Are some channels “monopoly bottleneck facilities”? For example, are the Shared Channels at the entrance of Port Phillip Bay facilities of this kind? Should any of the Victorian shipping channels be subject to the channel access regime?***
- 8. Does the existence of a price monitoring regime make the channel access regime unnecessary? If so, which is preferred? Should access regulation apply to berth services?***
- 9. Would the access regime for shipping channels meet the requirements for certification as an effective access regime?***

5.3 Market power and market developments

The Commission invites stakeholder views on whether the Victorian port operators have substantial market power. This question is relevant to both the application of regulation and the form it should take.

- 10. Is there substantial market power in the provision of any berth services? Does PoMC continue to enjoy substantial market power in vehicle and container trade? Have the core trades of the regional ports (dry bulk and general cargoes) remained contestable?***
- 11. Is there substantial market power in the provision of any channel services?***

The Commission also has questions about market developments that may be relevant to its assessment of market power. Comment is sought on the following questions.

- 12. Has the structure of the market for port services changed in material respects since the previous review? Has competition between ports increased or decreased for any types of cargoes?***
- 13. To what extent has the pricing behaviour of the ports been constrained by competition between ports, or countervailing power of shipping lines?***
- 14. What changes have there been in cross ownership and control of ports or port terminals, and what influence has this had on the degree of competition in port services?***
- 15. Have any changes have occurred in the logistics chain to affect competition in the ports sector?***
- 16. How has the level of seaborne trade changed since the last review? What are the future prospects for growth? How does this affect competition between the ports, if at all? How does it affect their market power?***

5.4 Questions about the benefits and costs of regulation

The Commission must consider the benefits and the costs of the regulatory recommendations it makes. Stakeholder views are therefore sought in relation to the benefits and costs of regulation under the present regulatory framework especially. Questions include the following.

- 17. What compliance costs have been imposed on port providers by the price monitoring regime? Have the compliance costs been unduly high? Are they commensurate with the extent of market power and with the potential economic cost of the abuse of that market power?**
- 18. Has the presence of the regime affected the decisions of port service providers in terms of investment or port planning?**
- 19. Does the price monitoring regime inhibit commercial flexibility in price negotiations?**
- 20. What potential is there for future increased competition in port services? Would this potential be impeded by the presence of the price monitoring regime?**
- 21. Do the social benefits of the current regulatory regime exceed the social costs (i.e. the combined costs to all parties including long-term costs)?**

5.5 Questions about the adequacy of the existing framework

The Commission intends to make an assessment of how effective the current regulatory regime has been over the last regulatory period. This will inform its recommendations with respect to the appropriate regulatory framework over the next period. Some of the relevant issues in this assessment will be as follows.

- 22. Have the ports exercised market power with respect to any trades over the last three years since price monitoring was introduced?**
- 23. If so, does this warrant the re-imposition of price controls? And should these controls apply to certain ports or services, or more broadly to prescribed port services?**
- 24. Has PoMC complied with the pricing principles? Has it complied with its Pricing Policy Statement?**
- 25. Have there been issues of competitive non-neutrality (one port user advantaged over another)?**
- 26. Does the regime provide an appropriate level of transparency? Has the price monitoring regime provided effective protection against undesirable forms of price discrimination?**
- 27. Are the additional compliance and disclosure requirements for PoMC (i.e. the pricing principles and the Pricing Policy Statement) appropriate?**
- 28. Is the Commission's approach to complaint handling appropriate?**

29. Are the prescribed services defined adequately?

In its 2007-08 financial accounts PoMC has substantially increased the carrying value of its fixed assets (in accordance with the applicable accounting policies and principles outlined in its Annual Report). This raises the possibility that PoMC may, in future, increase its port prices in order to achieve a target rate of return on its re-valued asset base.

30. Are asset revaluations a legitimate basis for raising prices within the ports price monitoring framework? What principles should guide asset valuation for pricing purposes?

- 6.(1) Subject to subclause (2), the Commonwealth will put forward legislation to establish a regime for third party access to services provided by means of significant infrastructure facilities where:
- (a) it would not be economically feasible to duplicate the facility;
 - (b) access to the service is necessary in order to permit effective competition in a downstream or upstream market;
 - (c) the facility is of national significance having regard to the size of the facility, its importance to constitutional trade or commerce or its importance to the national economy; and
 - (d) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist.
- (2) The regime to be established by Commonwealth legislation is not intended to cover a service provided by means of a facility where the State or Territory Party in whose jurisdiction the facility is situated has in place an access regime which covers the facility and conforms to the principles set out in this clause unless:
- (a) the Council determines that the regime is ineffective having regard to the influence of the facility beyond the jurisdictional boundary of the State or Territory; or
 - (b) substantial difficulties arise from the facility being situated in more than one jurisdiction.
- (3) For a State or Territory access regime to conform to the principles set out in this clause, it should:
- (a) apply to services provided by means of significant infrastructure facilities where:
 - (i) it would not be economically feasible to duplicate the facility;
 - (ii) access to the service is necessary in order to permit effective competition in a downstream or upstream market; and
 - (iii) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist; and
 - (b) reasonably incorporate each of the principles referred to in subclause (4) and (except for an access regime for: electricity or gas that is

developed in accordance with the Australian Energy Market Agreement; or the Tarcoola to Darwin railway) subclause (5).

There may be a range of approaches available to a State or Territory Party to incorporate each principle. Provided the approach adopted in a State or Territory access regime represents a reasonable approach to the incorporation of a principle in subclause (4) or (5), the regime can be taken to have reasonably incorporated that principle for the purposes of paragraph (b).

- (3A) In assessing whether a State or Territory access regime is an effective access regime under the Trade Practices Act 1974, the assessing body:
- (a) should, as required by the Trade Practices Act 1974, and subject to section 44DA, not consider any matters other than the relevant principles in this Agreement. Matters which should not be considered include the outcome of any arbitration, or any decision, made under the access regime; and
 - (b) should recognise that, as provided by subsection 44DA(2) of the Trade Practices Act 1974, an access regime may contain other matters that are not inconsistent with the relevant principles in this Agreement.
- (4) A State or Territory access regime should incorporate the following principles:
- (a) Wherever possible third party access to a service provided by means of a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access.
 - (b) Where such agreement cannot be reached, Governments should establish a right for persons to negotiate access to a service provided by means of a facility.
 - (c) Any right to negotiate access should provide for an enforcement process.
 - (d) Any right to negotiate access should include a date after which the right would lapse unless reviewed and subsequently extended; however, existing contractual rights and obligations should not be automatically revoked.
 - (e) The owner of a facility that is used to provide a service should use all reasonable endeavours to accommodate the requirements of persons seeking access.
 - (f) Access to a service for persons seeking access need not be on exactly the same terms and conditions.
 - (g) Where the owner and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so.

- (h) The decisions of the dispute resolution body should bind the parties; however, rights of appeal under existing legislative provisions should be preserved.
- (i) In deciding on the terms and conditions for access, the dispute resolution body should take into account:
 - (i) the owner's legitimate business interests and investment in the facility;
 - (ii) the costs to the owner of providing access, including any costs of extending the facility but not costs associated with losses arising from increased competition in upstream or downstream markets;
 - (iii) the economic value to the owner of any additional investment that the person seeking access or the owner has agreed to undertake;
 - (iv) the interests of all persons holding contracts for use of the facility;
 - (v) firm and binding contractual obligations of the owner or other persons (or both) already using the facility;
 - (vi) the operational and technical requirements necessary for the safe and reliable operation of the facility;
 - (vii) the economically efficient operation of the facility; and
 - (viii) the benefit to the public from having competitive markets.
- (j) The owner may be required to extend, or to permit extension of, the facility that is used to provide a service if necessary but this would be subject to:
 - (i) such extension being technically and economically feasible and consistent with the safe and reliable operation of the facility;
 - (ii) the owner's legitimate business interests in the facility being protected; and
 - (iii) the terms of access for the third party taking into account the costs borne by the parties for the extension and the economic benefits to the parties resulting from the extension.
- (k) If there has been a material change in circumstances, the parties should be able to apply for a revocation or modification of the access arrangement which was made at the conclusion of the dispute resolution process.
- (l) The dispute resolution body should only impede the existing right of a person to use a facility where the dispute resolution body has considered whether there is a case for compensation of that person and, if appropriate, determined such compensation.
- (m) The owner or user of a service shall not engage in conduct for the purpose of hindering access to that service by another person.

- (n) Separate accounting arrangements should be required for the elements of a business which are covered by the access regime.
 - (o) The dispute resolution body, or relevant authority where provided for under specific legislation, should have access to financial statements and other accounting information pertaining to a service.
 - (p) Where more than one State or Territory access regime applies to a service, those regimes should be consistent and, by means of vested jurisdiction or other cooperative legislative scheme, provide for a single process for persons to seek access to the service, a single body to resolve disputes about any aspect of access and a single forum for enforcement of access arrangements.
- (5) A State, Territory or Commonwealth access regime (except for an access regime for: electricity or gas that is developed in accordance with the Australian Energy Market Agreement; or the Tarcoola to Darwin railway) should incorporate the following principles:
- (a) Objects clauses that promote the economically efficient use of, operation and investment in, significant infrastructure thereby promoting effective competition in upstream or downstream markets.
 - (b) Regulated access prices should be set so as to:
 - (i) generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services and include a return on investment commensurate with the regulatory and commercial risks involved;
 - (ii) allow multi-part pricing and price discrimination when it aids efficiency;
 - (iii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher; and
 - (iv) provide incentives to reduce costs or otherwise improve productivity.
 - (c) Where merits review of decisions is provided, the review will be limited to the information submitted to the original decision-maker except that the review body:
 - (i) may request new information where it considers that it would be assisted by the introduction of such information;
 - (ii) may allow new information where it considers that it could not have reasonably been made available to the original decision-maker; and

- (iii) should have regard to the policies and guidelines of the original decision-maker (if any) that are relevant to the decision under review.