



Port of Melbourne – Market Rent Inquiry 2020

Interim Report

20 March 2020



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Summary

We are conducting an inquiry into whether the Port of Melbourne has power in setting and reviewing land rents and associated payments and whether this could cause material detriment to Victorian consumers.

This is the first of our market rent inquiries and covers the period 1 November 2016 to 31 October 2019.¹ We will consider whether the Port of Melbourne has:

- power in relation to the process for setting and reviewing land rents and associated payments²
- exercised that power in a way that causes material detriment to the long term interests of Victorian consumers.

If we find the Port of Melbourne's use of that power has caused material detriment, we are required to make recommendations on possible economic regulation to the Assistant Treasurer.

In undertaking our inquiry, as per section 53(3) of the Port Management Act 1995, we are to consider the:

- Port of Melbourne's processes used to set and review land rents
- Port of Melbourne's compliance with processes to set and review rents required under relevant contractual arrangements
- extent to which the land rents paid are ultimately passed through to Victorian consumers.

We are to conduct our inquiry in accordance with part 5 of the Essential Services Commission Act 2001 and may collect information or documents as per section 37 of that Act (see Appendix B).

As the 'port licence holder' and landlord, the Port of Melbourne controls the leasing of land at the port to tenants, who pay rent in exchange for use of the land to conduct their operations.

The terms and structures of tenants' leases can vary significantly according to when the lease was entered into, the activities carried out on the relevant land during the lease and the type of land to which the lease is associated.

¹ As per section 53(5) of Port Management Act 1995.

² Section 53(1)(a) refers to 'the process for the setting or reviewing of rents or associated payments (however described) payable by a tenant under an applicable lease'. For brevity, in this document we refer to this as the 'process for setting and reviewing rents'.

We have a framework for assessing power and material detriment

We are assessing the extent to which the Port of Melbourne has power to set and review land rents, including any market, contractual and legislative constraints available to countervail these powers.

For our inquiry, power has its natural meaning, the ability to do or act.

Market constraints on the Port of Melbourne's power may include tenants' ability to substitute to alternative land and counter by extracting concessions on their rents and lease terms and conditions.

The main contractual constraint relevant to our inquiry is the Port Concession Deed (port deed) – the confidential agreement between the Victorian Government and the Port of Melbourne regulating key aspects of the private operation of the port of Melbourne. This includes clauses setting out processes and criteria for how rents may be set and reviewed.

The Port of Melbourne may also face some legislative constraints in the Competition and Consumer Act 2010 (Cth), Retail Leases Act 2003 (Retail Leases Act) and the Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act 2016.

If we find the Port of Melbourne has power to set and review rents that cannot be countervailed, we will examine whether this has been exercised in a way that has or could cause material detriment to the long term interests of Victorian consumers.

We will assess material detriment according to whether the Port of Melbourne's exercise of power in setting and reviewing rents has led to higher prices, reduced access or reduced efficiency.

The Port of Melbourne has power in setting and reviewing rents

The Port of Melbourne is a monopoly provider of port land and potentially has power when setting and negotiating rents with tenants. We have found only minimal constraints on the Port of Melbourne's ability to use this power.

There appears to be weak market constraints on the Port of Melbourne's power in setting and reviewing rents. Most tenants appear to have limited ability to credibly threaten to switch to non-port land.

There also appears to be minimal legislative constraint on the Port of Melbourne's power because relevant Acts seem to have limited application to the setting of port rents and access to port land or would only apply to a small number of tenants' leases.

The efficacy of any countervailing power anticipated by the port deed is also limited by its confidentiality. Its provisions are unknown to tenants creating asymmetry in information and negotiations.

There also appears to be no market, contractual or legislative constraints on the Port of Melbourne's power to:

- withhold land to reduce supply and increase aggregate rents
- control negotiation timelines to suit their commercial interests
- impose management or other fees.

Our interim view is therefore that the Port of Melbourne has power in setting and reviewing rents and that there is currently limited countervailing market, contractual or legislative power available to tenants to constrain this power.

Stakeholders have concerns with rent levels and the Port of Melbourne's negotiation approach

Given the confidentiality of the port deed, tenants were unable to comment on whether the Port of Melbourne adhered to the rent setting and review process this document describes.

In the Port of Melbourne's view, tenants are broadly familiar with its rent setting and review process.

Yet, from consultation to date, information provided to the commission suggests that many tenants have no effective knowledge of the relevant rent-related provisions in the port deed or the Port of Melbourne's own processes, criteria and timelines for setting and reviewing rents.

An information asymmetry is therefore created between the Port of Melbourne, which is fully aware of the rent-related requirements in the port deed as well as its own processes and requirements, and its tenants, which are not.

This information asymmetry is likely to advantage the negotiating position of the Port of Melbourne relative to tenants. The port deed is therefore a potential source of power for the Port of Melbourne. We were not able to find any requirement in legislation or elsewhere for the relevant parts of the port deed to be made public or directly available to tenants and prospective tenants. This creates a significant risk the Port of Melbourne could exploit its knowledge of the actual rent constraints in the port deed to their advantage. The lack of transparency about the Port of Melbourne's own processes and criteria for setting and reviewing rents, including the intended timing of those processes, is also a potential source of power for the Port of Melbourne in these processes.

Tenants are concerned with the rent levels the Port of Melbourne sets, particularly in relation to its escalation approach and its use of ratchet clauses (that prevent rents from decreasing).

Some tenants questioned whether the Port of Melbourne was ignoring provisions of the Retail Leases Act, particularly in its use of ratchet clauses.

A number of tenants raised concerns with the Port of Melbourne's use of term sheets (which they believe would lock in terms and conditions) and characterised their negotiation approach as 'take it-or-leave-it'.

We are presently corroborating the views of stakeholders with the primary documents (including leases) and correspondence we have obtained.

The information provided by the Port of Melbourne and tenants has been very helpful to our understanding of rent negotiations, the various interpretations and concessions made by the respective parties and how access to land is managed at the port. We welcome further feedback to assist us with this task.

We will assess material detriment in terms of efficiency

Rents should be at the long term efficient level which results from a competitive process. Rents below this level may constrain the Port of Melbourne's investment and result in excessive demand for port leases leading to the inefficient allocation of land. While rents above this level may cause material detriment to Victorian consumers.

Most tenants have told us higher rents would likely result in negative consequences for their business and/or customers.

Some tenants claimed they would be able to pass-through higher rents, leading to higher prices. While others said they would not be able to do so and this would have other impacts on consumers (tenants exiting markets and reductions in quality).

A number of tenants reported the Port of Melbourne's negotiation approach results in additional transaction costs. These costs add to the burden associated with rents and are also relevant in considering pass-through and material detriment.

If we do find that the Port of Melbourne is exercising its powers to set and review rents in a way that has the effect of causing material detriment to the long term interests of Victorian consumers, we can make recommendations for regulatory reform. Any recommendations around regulatory reform will be assessed against a set of criteria we have previously used to guide regulatory settings – transparency, effectiveness, proportionality and accountability.

Relevantly, the Port of Melbourne is aware the commission has a market rent inquiry role and could make recommendations on whether rent setting or reviewing should be subject to economic regulation. So, the Port of Melbourne may refrain from using its power. Our monitoring may therefore be a viable substitute for more stringent economic regulation.

The repercussions of the Port of Melbourne's use of its power in the market for setting rents and providing access to port land and implications for the long term interests of Victorian consumers, is our further focus as we progress the inquiry.

Inquiry timelines and submitting feedback

This report provides a further opportunity for us to engage with stakeholders and receive their feedback. We are also holding a public forum. Following this, we will carefully consider the feedback provided and release our final report.

Table 1.1 gives an indicative timeline for the inquiry. This timeline has been modified since our scope and process paper was released. More detail is provided in section 1.5.

Our charter of consultation and regulatory practice has further information on the principles that guide our approach to consultation.³

Table 1.1: Indicative timeline

Activity	Indicative timeline
Released scope and process paper	26 September 2019
Release interim report	20 March 2020
Hold public forum	31 March 2020
Deadline for submissions on interim report	16 April 2020
Deliver final report to Minister*	30 April 2020
Release final report [#]	After Minister has made publicly available

* As per section 45(5) and 45(6) of the Essential Services Commission Act 2001, after receiving the final report the Minister must make the report publicly available, within 7 days if Parliament is sitting, or within 30 days if Parliament is not sitting.

[#] As per section 45(7) of the Essential Services Commission Act 2001, the commission must make the final report publicly available after the Minister has received and made the final report publicly available.

Send us your feedback by 16 April 2020

We want to hear your views on how effectively the land rental market at the Port of Melbourne is working. We encourage you to provide written submissions addressing any issues in this report or any other information you consider relevant to the inquiry. This may include suggestions on our framework and commentary on our understanding of the Port of Melbourne's power in the land rental market.

³ ESC, Stakeholder Engagement Framework: Charter of Consultation and Regulatory Practice, 2018, available at: <https://www.esc.vic.gov.au/about-us/how-we-regulate/stakeholder-engagement-framework>

While all information is welcome, submissions need only address those issues or questions you feel are relevant to your experience in the land rental market at the Port of Melbourne.

E-mail and mail

We invite written submissions on the interim report by **Thursday, 16 April 2020**. You may email your submission to transport@esc.vic.gov.au or send submissions by mail marked:

Attention: Price Monitoring and Regulation Division – Transport
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Engage Victoria

Written submissions can also be made via Engage Victoria. To view our Engage Victoria page and information on how to make a submission, please visit Engage Victoria at:

Website: <https://engage.vic.gov.au/>

Publication of submissions

We treat all submissions as public information unless the submitter has asked us to treat some or all of a submission as confidential or commercially sensitive. Please clearly specify any information that you **do not** want to be made public.⁴

Come to our Public Forum on 31 March 2020

We are holding a public forum at **10am on Tuesday, 31 March 2020**, for stakeholders to meet and share their views. All are welcome to attend.

The public forum will be held at:

Harbour Kitchen

Waterfront Side, Ground Floor NAB Building, 800 Bourke St, Docklands VIC 3008

Meet and speak with us in person

Want to discuss your views in person? **Please feel free to contact us by e-mail at transport@esc.vic.gov.au, or by phone on (+61 3) 9032 1300 or 1300 664 969.**

⁴ <https://www.esc.vic.gov.au/about-us/our-submission-policy>

1. Introduction

We are conducting an inquiry into whether the Port of Melbourne has any power in setting and reviewing its land rents and whether this could cause material detriment.

As the 'port licence holder' and landlord, the Port of Melbourne controls the leasing of land at the port to tenants, who pay rent in exchange for use of the land to conduct their operations.

The terms and structures of the different leases with the Port of Melbourne can vary according to when a lease was established and the type of land it is associated with.

This chapter outlines our role in the market rent inquiry and provides an overview of the main stakeholders in the land rental market at the Port of Melbourne.

1.1. What have we been asked to do?

We were assigned several regulatory roles in 2016, when legislation was passed for the Port of Melbourne's commercial operations to be leased to a private operator. This included a role in conducting periodic inquiries into the setting and reviewing of land rents at the Port of Melbourne.

Under section 53(1) of the Port Management Act 1995 (Port Management Act, see Appendix A) we will consider whether the Port of Melbourne has:

- power in relation to the process for setting and reviewing land rents and associated payments⁵
- exercised that power in a way that causes material detriment to the long term interests of Victorian consumers.

If we find the Port of Melbourne's use of that power has caused material detriment, we are required to make recommendations on possible economic regulation to the Assistant Treasurer.

In undertaking our inquiry, as per section 53(3) of the Port Management Act, we are to consider the:

- Port of Melbourne's processes used to set and review land rents
- Port of Melbourne's compliance with the processes to set and review rents under relevant contractual arrangements

⁵ Section 53(1)(a) refers to 'the process for the setting or reviewing of rents or associated payments (however described) payable by a tenant under an applicable lease'. For brevity, in this document we refer to this as the 'process for setting and reviewing rents'.

- extent to which the land rents paid are ultimately passed through to Victorian consumers.

We are to conduct our inquiry in accordance with part 5 of the Essential Services Commission Act 2001 (ESC Act) and may collect information or documents as per section 37 of that Act (see Appendix B).

This is the first of our market rent inquiries and covers the period 1 November 2016 to 31 October 2019.⁶ This inquiry covers behaviours across that period not just leases entered into or extended during that period. As a result, any land rents set or reviewed during this period are relevant to our inquiry. This includes any land rents that relate to contracts entered into before the inquiry period.

1.2. Who is the port licence holder?

In 2016, the government awarded a 50 year lease for the commercial operations of the Port of Melbourne to the Lonsdale Consortium comprising the Future Fund, Queensland Investment Corporation (QIC), Global Infrastructure Partners (GIP) and Ontario Municipal Employees Retirement Scheme (OMERS).

The Lonsdale Consortium commenced operations and became the 'port licence holder' on 1 November 2016. As the port licence holder, it is responsible for:

- operation of wharves and berths (excluding Station Pier and West Finger Pier)
- maintenance and operation of shipping channels
- management of approximately 500 hectares of land (mainly used for commercial purposes).

The port licence holder also holds the functions of the port lessee and the Port of Melbourne operator as defined in the Port Management Act. It chose to use the Port of Melbourne name for its operations. We shall therefore refer to the port licence holder, the port lessee and the Port of Melbourne operator as the Port of Melbourne for the purposes of this inquiry.

Although land at the port remains in state ownership, the Port of Melbourne is the relevant 'landlord' for the purposes of this inquiry. As the landlord, it controls the leasing of land at the port to 'tenants', who pay rent in exchange for use of the land to conduct their operations.

For clarity, the Port Management Act makes a distinction between a 'Port of Melbourne lease' and an 'applicable lease'. A Port of Melbourne lease refers to the 50 year lease granted by the Victorian Government to the Lonsdale Consortium and an applicable lease is a lease between the Port of Melbourne and a tenant (see Appendix A for the Port Management Act definitions). Our inquiry is limited to applicable leases only. We will not examine the Port of Melbourne lease.

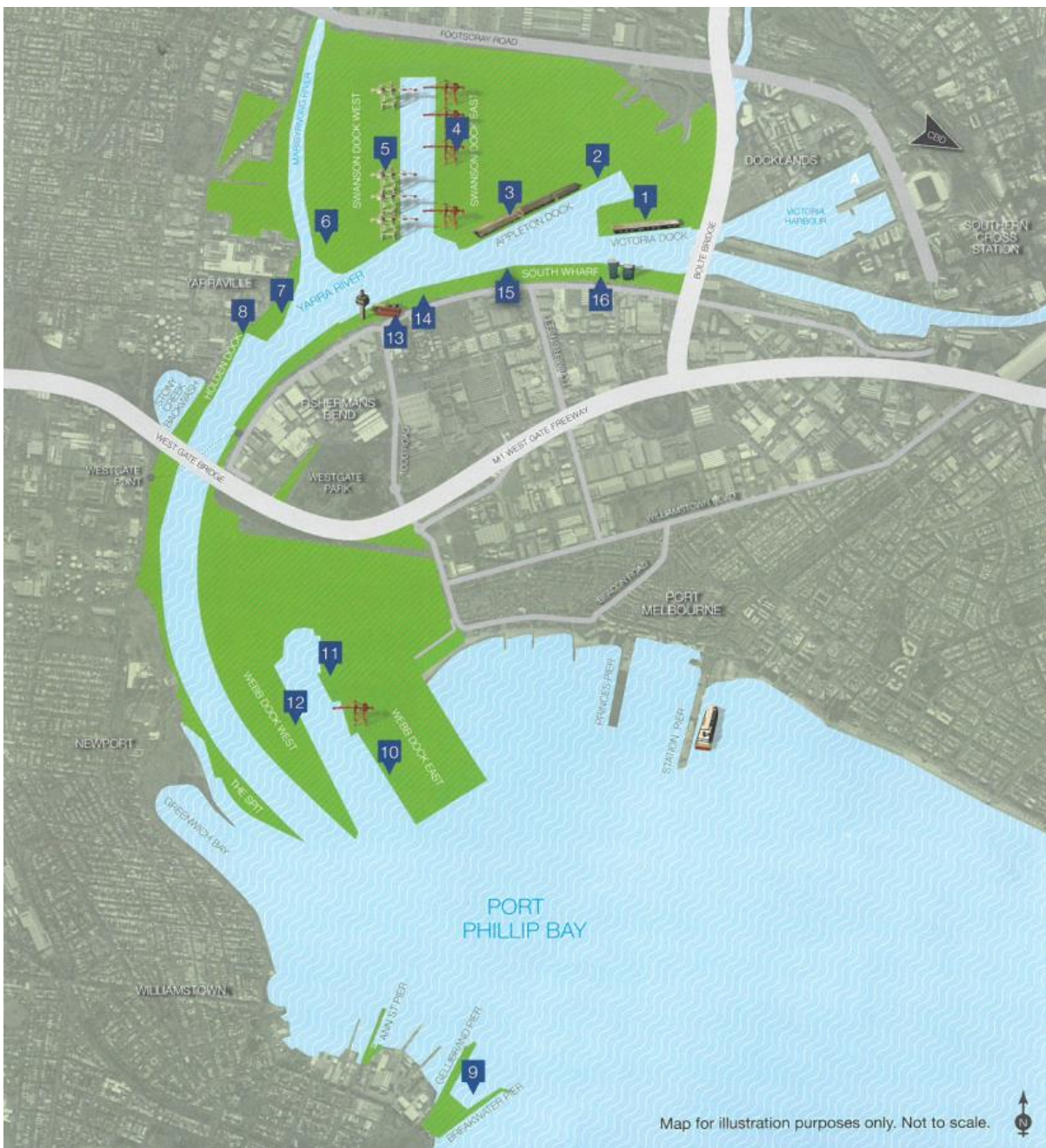
⁶ As per section 53(5) of Port Management Act.

While the Port Management Act defines an applicable lease as a sublease (or a sublease of a sublease), we will refer to it as a lease for the purposes of this inquiry.

1.3. Who are the main operators at the Port of Melbourne?

The Port of Melbourne is Australia's largest container, automotive and general cargo port. It is Victoria's only port to handle containers. It also handles a variety of non-containerised cargoes, across its 35 commercial berths, jetties and piers in nine separate port precincts. Figure 1.1 identifies the land (in shaded green) and key precincts (numbered) of the port.

Figure 1.1 Port of Melbourne land and port precincts



1. 24 Victoria Dock	7. 5&6 Yarraville Berth	13. Port Education Centre
2. F Appleton Dock	8. Holden Dock	14. 33 South Wharf
3. B-E Appleton Dock	9. Gellibrand & Breakwater Pier	15. 27-31 South Wharf
4. 1-4 Swanson Dock East	10. 4-5 Webb Dock East	16. 26 South Wharf
5. 1-4 Swanson Dock West	11. 1-2 Webb Dock East	
6. No. 1 Maribyrnong	12. 1-3 Webb Dock West	

Source: Fishermans Bend planning review - Hearing document 332 - Port of Melbourne site visit materials, p. 2

Containers are the main type of cargo to pass through the port, with more than 3.0 million handled in 2018-19.⁷ They are handled by one of three terminal operators:

- DP World Australia – operates at Swanson Dock West
- Patrick Container Terminals – operates at Swanson Dock East
- Victorian International Container Terminal Limited (VICT) – operates at Webb Dock East.

Motor vehicles also account for a significant share of cargo at the port, with over 312,000 vehicles handled in 2018-19. They are handled by the Melbourne International RoRo & Automotive Terminal (MIRRAT) that operates the specially designed Roll-on/Roll-off (RoRo) terminal at Webb Dock West.

Other terminals or precincts at the port are managed by operators for general cargo and dry and liquid bulk cargo. Some of these terminals are multipurpose and handle a variety of non-containerised pack types and break bulk, while others are specialised and handle dry cargo or bulk liquids.

1.4. How does land rental at the Port of Melbourne work?

Each tenant has a lease with the Port of Melbourne that specifies the rent to be paid and the terms under which the land is to be accessed and used. These are set and reviewed according to a process in which both parties either negotiate or refer to an independent party for determination (should they not be able to negotiate an agreement).

The terms and structures of tenants' leases can vary significantly according to when the lease was entered into, the activities carried out on the relevant land during the lease and the type of land to

⁷ Port of Melbourne, Historical trade data, sourced from <https://www.portofmelbourne.com/about-us/trade-statistics/historical-trade-data/> (accessed 24 February 2020).

which the lease is associated with. The Port of Melbourne administers around 120 leases with an average term of around 25 years. While some are short term, others extend to over 50 years.⁸

The Port of Melbourne derives a significant share of its total revenue from land rents. This share has increased since the Lonsdale Consortium was granted a 50 year lease in 2016. In 2015-16, rents and licence fees comprised 14 per cent of the port's total revenue.⁹ While in 2018-19, 'property revenue' was almost 29 per cent of the Port of Melbourne's total income.¹⁰

1.5. We have adapted our inquiry to accommodate the information we have received

We indicated in the scope and process paper released on 26 September 2019, that we would release a draft report in January 2020 and hold a public forum in February 2020. This has not been possible, due to the volume of confidential information we have received. We obtained much of this confidential information via compulsory information requests issued under section 37 of the ESC Act (see section 2.2. and Appendix C for an outline of the information we obtained) which has added to the timelines of our inquiry.

We are unable to reveal the full details of the confidential information we have received in this report. It has become apparent during the course of our inquiry how important much of that information is in the setting and reviewing of land rents at the Port of Melbourne. For instance, the relevance and importance of key documents were unknown at the time we commenced the inquiry. Indeed, we were unaware of their existence. As such, the type, and timing, of our report has changed.

We have released this interim report, in place of a draft report, to outline our interim views to date and the range of stakeholder views we have received so far. These views are interim only, as we have not been able to complete our analysis on some important parts of the information we have only recently received. However, our final views and recommendations will be included in our final report, which is due to be delivered to the Assistant Treasurer by 30 April 2020 (any confidential or

⁸ Source: Data provided to the Commission by the Port of Melbourne.

A significant number of mostly small tenants are in overholding arrangements, with their leases effectively continuing on a monthly basis.

⁹ Port of Melbourne Corporation 2016, *Annual Report 2015-16*, p.69

¹⁰ Lonsdale Finance Pty Ltd, *Listing prospectus 10 September 2019*, p.161

commercially-sensitive information will be provided for the Assistant Treasurer only, it will not be included in the final report we ultimately publish).¹¹

We welcome further feedback on the views in this interim report and would encourage stakeholders to make submissions to this interim report.

¹¹ As per section 45(2) of the ESC Act, the commission must divide the final report into a document containing confidential or commercially sensitive information and another document containing the rest of the report.

2. Our framework

We are assessing the extent to which the Port of Melbourne has power to set and review land rents, subject to market, contractual and legislative constraints.

For our inquiry, power has its natural meaning, the ability to do or act.

Market constraints on the Port of Melbourne's power may include tenants' ability to substitute to alternative land and counter by extracting concessions on their rents and lease terms and conditions.

The main contractual constraint relevant to our inquiry is contained in the Port Concession Deed – the confidential agreement between the Victorian Government and the Port of Melbourne. This includes clauses setting out processes and criteria for how rents may be set and reviewed.

The Port of Melbourne may also face some legislative constraints in the Competition and Consumer Act 2010 (Cth), Retail Leases Act 2003 and the Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act 2016.

Should we find the Port of Melbourne has power that cannot be countervailed, we will examine whether this has been exercised in a way that has or could cause material detriment to the long term interests of Victorian consumers.

We will assess material detriment according to whether the Port of Melbourne's exercise of power in setting and reviewing rents has led to higher prices, reduced access or reduced efficiency.

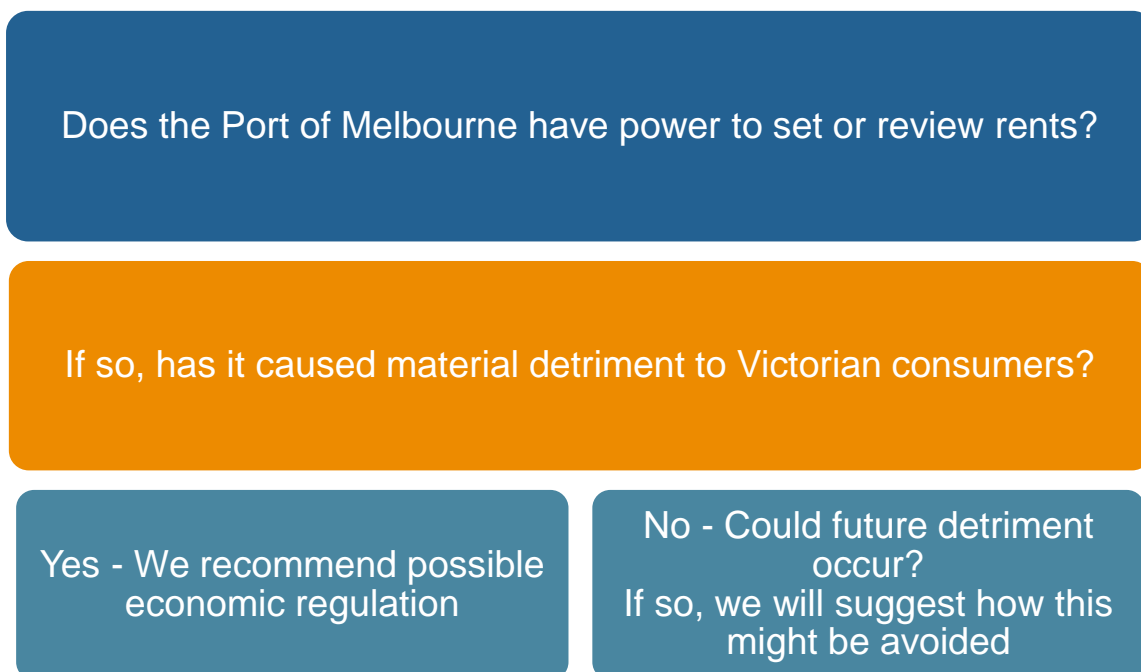
This chapter sets out the framework for our inquiry into rents at the Port of Melbourne.

There are two key questions our inquiry is seeking to address (as shown in Figure 2.1):

- Does the Port of Melbourne have the power to set or review rents?
- If so, has the Port of Melbourne used this power in a way that has caused material detriment to the long term interests of Victorian consumers?

If we should find material detriment, we are to make recommendations on possible economic regulation to the Assistant Treasurer. We will also make suggestions on how potential material detriment might be avoided.

Figure 2.1 – The key questions of our inquiry



2.1. Does the Port of Melbourne have power?

To assess the Port of Melbourne’s power, we have examined the arrangements under which rents are set and reviewed. We will then base our assessment on the extent to which the Port of Melbourne has discretion in controlling these arrangements in the relevant market.

In undertaking this assessment, we note:

- ‘relevant market’ is a defined term in the Port Management Act¹², and is limited to leased Port of Melbourne land
- the Port of Melbourne is the only possible supplier of land in the relevant market.

Defining power

For this inquiry, power has its natural meaning, the legal ability, capacity or authority to do or act.¹³ The Port of Melbourne may have power over:

- setting prices for leases or licences (rent and associated payments)

¹² Section 53 (5) of the Port Management Act defines the relevant market as ‘the market for access to leased port of Melbourne land by means of an applicable lease.’

¹³ The Macquarie dictionary defines power as the ability to do or act; capability of doing or effecting something.

- setting terms and conditions that are applicable to leases and licences
- providing processes for negotiating new or changes in prices or terms and conditions of leases or licences
- providing information ('the rules of the game') to enable efficient and effective negotiation of new or changes in prices or terms and conditions of leases or licences.

Constraints on the Port

While the Port of Melbourne is the only supplier of land in the relevant market, there are some constraints on its power in setting and reviewing rents. These include:

- market constraints
- legislative constraints
- contractual constraints.

Market constraints

Market constraints include:

- **Substitution** – The availability and possibility for tenants to switch to alternatives. This may include Australian ports or other industrial land.
 - This may represent a constraint on the Port of Melbourne's power if tenants can switch to alternatives such as utilising land and domestic transport at other Australian ports or other sites.
- **Countervailing power** – The ability of tenants to resist the Port of Melbourne's control in some way, such as extracting concessions on their rents, or on the terms and conditions of their leases.
 - This may represent a constraint on the Port of Melbourne's power if tenants are able to respond.
- **Barriers to entry** – Any physical, regulatory or economic constraints that prevent other entities from offering land at the port precinct.
 - This is not a constraint on the Port of Melbourne's power. No other entities have entry rights to this market, as the Port of Melbourne has the sole licence to operate and lease land at the port precinct.

Legislative constraints

Legislative constraints that may apply to the Port of Melbourne include both federal and state based legislation including:

- **Competition and Consumer Act 2010 (Cth)** – regulates the relationships between suppliers, wholesalers, retailers, and consumers. Its predominant purpose is to enhance the welfare and protection of Australian consumers by promoting fair trading and competition, through the provision of consumer protections. It may have limited application to rent setting at the Port of Melbourne.
- **Retail Leases Act 2003** – designed to provide protection to ‘retail’ tenants from unfair commercial lease dealings and imposes a number of legislative constraints and responsibilities on landlord in respect of their dealings with tenants. The Retail Leases Act 2003 (Retail Leases Act) is widely regarded as being ‘tenant friendly’ and plays an integral role regulating the retail leasing behaviours in Victoria. Similar legislation can be found in most Australia states. The Act applies to ‘retail premises’ (as defined in the Retail Leases Act) but excludes some premises and businesses. It is likely to only apply to a very small number of leases at the Port of Melbourne and as such may have limited application.
- **Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction Act) 2016 (DVI Act)** – gives effect to the leasing of the Port of Melbourne’s commercial operations in 2016. The Act may in some instances expand the power of the Port of Melbourne by allowing it to charge tenants some fees (for the consideration of the grant of a lease) that are considered to be additional to the rents that tenants pay (an example of an associated payment).

Contractual constraints

The Port Concession Deed (port deed) is a confidential contract between the Port of Melbourne and the Victorian Government (administered by the Port Lessor) which sets out the responsibilities of each party, on a range of matters. Only a small number of clauses are relevant to the setting or reviewing of rents, however they hold special significance with respect to parties’ rights and obligations to one another, and to tenants.

As a legally enforceable contract with clauses relating to the rent setting and review process, the port deed may serve to countervail the Port of Melbourne’s power.

Other contractual constraints include:

- **Port Lease and Port Sublease** – Constitute contracts between the Port of Melbourne and the Port Lessor created during the transfer of the operations of the port. There may be provisions within these contracts that may represent some contractual constraint on the Port of Melbourne’s powers.
- **Existing Port Sub-Leases** – The Port of Melbourne has taken over all existing leases with tenants. These may be prescriptive and provide the Port of Melbourne with little discretion over the process of setting and reviewing rents (i.e. they are agreed lease terms, at least over the remaining life of these leases).

Box 2.1 What is the Port Lessor?

The Melbourne Port lessor is the state entity from which the Lonsdale Consortium leased the commercial operations of the Port of Melbourne for 50 years commencing on 1 November 2016.

The Port Lessor manages the Port of Melbourne's compliance with its contractual and legislative obligations.

Do these constraints prevent the Port of Melbourne from exercising power?

In assessing whether the Port of Melbourne has power in the process for setting and reviewing rents, we will consider if the market, legal and contractual constraints represent a suite of countervailing powers that may appropriately constrain these powers. If we find that any current constraints are insufficient to appropriately countervail the Port of Melbourne's powers, we will conclude that it has power that it can exercise in the process for setting and reviewing rents.

2.2. Has the Port of Melbourne's power caused material detriment?

Should we find that the Port of Melbourne has power, we will examine if there have been any harmful effects in the exercise of that power on Victorian consumers.

Defining material detriment

Material detriment is not defined in the Port Management Act. To interpret this term for our inquiry we have had regard to:

- section 48 of the Port Management Act which details the objectives for the regulation of port services; and
- sections 1 and 8A of the ESC Act which details the purpose of, and matters that, the commission must have regard to in performing its functions and exercising its powers.

We interpret material detriment to be conduct which leads to higher prices, reduced access to services and/or reduced efficiency. Given our focus on prices, access and efficiency, we will assess whether the exercise of power by the Port of Melbourne has:

- resulted in tenants paying rents that are above market rents (i.e. higher prices)
- prevented prospective tenants from accessing Port or Melbourne land (i.e. reduced access), or
- been harmful to the efficiency of tenants' operations (i.e. reduced efficiency).

Determining whether material detriment has occurred

Our assessment of the arrangements under which rents are set and reviewed will also reveal whether that power has been exercised. To determine whether that power has been exercised in a way that causes material detriment we will assess:

- the rent setting and review process (as defined in legislation and by the Port of Melbourne)¹⁴
- submissions by stakeholders and other feedback provided at one-on-one meetings with the Port of Melbourne and separately with some tenants
- information gathered using section 37 of the ESC Act
- unleased land at the Port of Melbourne
- rents, rental escalations, throughput guarantees, management fees and other associated payments.

We issued two section 37 notices to gather evidence

Our inquiry has received submissions, both written and in person, from tenants and the Port of Melbourne. We have sought corroboration of issues raised by stakeholders by obtaining primary documents from both the Port of Melbourne and the Port Lessor under section 37 of the ESC Act. Our analysis of this data and information is ongoing.

What we requested from the Port of Melbourne

To gather evidence in relation to stakeholders' views, we sought a range of documents from the Port of Melbourne.

We served the Port of Melbourne with a notice under section 37 of the ESC Act requesting copies of all documents and communications necessary for us to conduct our inquiry.

For general lease information we sought:

- a list of all leases and licences at the Port of Melbourne,
- details of each lease – including location, size of the leased land, and duration,
- details of rents and associated payments for each lease – including the annual rent, annual rent per square metre, minimum trade guarantees and annual lease management fee,
- details of annual escalations for each lease
- details relating to market rent reviews – including the timing of market rent reviews, whether it led to an independent determination process, and whether the lease includes a ratchet clause

¹⁴ As per section 53(3)(a) of the Port Management Act, we must have regard to 'the processes used to establish or review rents or associated payments payable by a tenant under an applicable lease'. We must also to have regard to the Port of Melbourne's compliance with these process (as per section 53(3)(b) of the Port Management Act).

- details of unleased land.

In addition, we requested a sample of ten new leases and a sample of 17 market rent reviews conducted. We sought detailed communications in respect of those samples, including correspondence between the Port of Melbourne and each of the relevant tenants, copies of the proposed and final agreements, valuation reports, expert rent determinations and other relevant documents and information relating to independent valuations and the timing of negotiations.¹⁵

We also requested the Port of Melbourne provide us with copies of the clauses in the Port Concession Deed, the Port Lease and Port Sublease which it considered relevant to the setting and reviewing of rents.

Finally, we sought any policies and procedures the Port of Melbourne applies in the process for setting and reviewing rents, and training material provided to staff and board members relating to the process for setting and reviewing rents.

What we requested from the Port Lessor

We served the Port Lessor with a notice under section 37 of the ESC Act, requesting copies of the clauses in the Port Concession Deed, the Port Lease, the Port Sublease and other confidential documents relevant to the setting and reviewing of rents at the Port of Melbourne.

¹⁵ Note, we selected a sample of leases based on information previously provided by the Port of Melbourne. Our reasoning behind selecting leases for our sample is detailed in Appendix C.

3. The Port of Melbourne's power in setting and reviewing rents

There are weak market constraints on the Port of Melbourne's power in setting and reviewing rents. Most tenants appear to have limited ability to credibly threaten to switch to non-port land.

There is minimal legislative constraint on the Port of Melbourne's power.

There are limited contractual constraints on the Port of Melbourne's power. The main contractual constraints are found in some provisions of the Port Concession Deed (port deed).

The confidentiality of the port deed limits its efficacy in constraining the Port of Melbourne's power. The majority of tenants are either unaware of the relevant constraint provisions in the port deed or of the existence of the port deed at all, which can lead to asymmetry in negotiations.

The port deed does not provide a constraint on the Port of Melbourne's power to:

- withhold land to reduce supply and increase aggregate rents
- control negotiation timelines to suit their commercial interests
- impose management or other fees.

Given the weak constraints, our interim view is the Port of Melbourne does have power in setting and reviewing rents.

This chapter examines constraints on the Port of Melbourne's power to set and review land rents.

3.1. Market constraints

The market in which the Port of Melbourne leases land, may impose constraints on its power to set and review land rents.

The 'relevant market', as defined in the Port Management Act, is limited to leased land within the port precinct. Within that relevant market, the Port of Melbourne is the only possible supplier of land. No other party can enter to provide land to tenants at the port. This means substitution by tenants to other suppliers within the relevant market is not possible.

While tenants cannot switch to other suppliers of land at the Port of Melbourne, they may be able to counter by leasing land (or threatening to lease land) outside of the port precinct.¹⁶ Therefore, the level of constraint that is imposed on the Port of Melbourne will depend on the ability of tenants to exercise countervailing power.

Tenants have differing degrees of countervailing power

Tenants at the Port of Melbourne can effectively be separated into two categories: those that have some ability to exercise power to resist rent increases by switching to land or credibly threatening to switch to land outside the port precinct, and those that do not.

It would appear from information we have collected so far, that the vast majority of tenants have limited ability to credibly threaten a switch to non-port land because:

- many tenants have activities that are associated with the loading and unloading of cargo which must be conducted within close proximity of wharves [this includes stevedores, automotive terminal operators, and government services (customs)]
- other tenants have activities that could potentially be switched to other ports or areas outside of the Port of Melbourne precinct but have significant investments in assets on land at the port (this includes many Coode Island tenants, logistics operators and importers/exporters)
- suppliers of infrastructure under port licences (e.g. power, water) have no option but to access land at the port.

Those tenants that have some capacity to switch, typically have minimal infrastructure in place on land at the port and do not face significant operational and cost penalties from operating in areas outside of the port. This might include, for example, open land that is used for the storage of containers.

The existence of a small number of tenants that might be able to resist rent increases is not a sufficient constraint on the Port of Melbourne's power. This is because the Port of Melbourne is not constrained to setting a single rent for all tenants. Rather, it is able to negotiate individual rates with each tenant. This means the Port of Melbourne could charge lower rents to those tenants that are able to switch and maintain higher rents for those tenants that are not able.

In conclusion, we find there are weak market constraints on the Port of Melbourne's power in relation to setting and reviewing rents.

¹⁶ .Section 53 of the Port Management Act constrains the relevant market to leased land at the Port of Melbourne, implying rents on comparable land outside the port precinct do not constrain rents within that relevant market. Nevertheless, the commission considers that in some cases it will be practical for the Port of Melbourne to have regard to rents on comparable land outside the port precinct as required by the port deed.

3.2. Legislative constraints

There is limited legislative constraint on the Port of Melbourne.

Competition and Consumer Act 2010

The Competition and Consumer Act 2010 covers the relationships between suppliers, wholesalers, retailers, and consumers. Its purpose is to enhance the welfare of Australians by promoting fair trading and competition, and through the provision of consumer protections. It may have limited application to the setting and reviewing of rents at the Port of Melbourne.

Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act

The Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction Act 2016 (DVI Act) is Victorian legislation which gave effect to the leasing of the Port of Melbourne's commercial operations in 2016.

Section 59(2)(a) of the DVI Act may be relevant to the setting of associated payments as it appears on its face to allow the Port of Melbourne to charge sums in consideration of the grant of a lease.

Retail Leases Act

The Retail Leases Act, where it applies, may limit the Port of Melbourne's power and may offer some protection to tenants in regulating rent reviews (including a market rent review). However, in practice, due to the nature and size of most port tenants, the Retail Act has limited application and is unlikely to place any restrictions on the Port of Melbourne in the vast majority of rental negotiations.

For example, ratchet clauses are rendered void by section 35(3) of the Retail Act.

3.3. Contractual constraints

As part of its agreement to accept the 50 year lease for commercial operations in 2016, the Port of Melbourne entered into the Port Concession Deed (port deed) with the Port Lessor, to contractually govern the relationship between the parties for the private operation of the port.¹⁷

The port deed includes a number of clauses relevant to the setting and reviewing of rents by the Port of Melbourne.

¹⁷ For brevity, we have only referred to the Port of Melbourne and the Port Lessor, however, we note there are four signatories to the Port Concession Deed

There may also be contractual constraints on the Port of Melbourne from its Port Lease and the Port Sublease agreements with the Government. We are still assessing the implications of these documents and how they have been interpreted and applied, particularly by the Port of Melbourne.

3.4. Assessment of contractual constraints

Blanket Confidentiality of Port Concession Deed

The Port Concession Deed is not transparent and hinders negotiation

Despite setting out how rents are to be set and reviewed, the port deed remains confidential between the State Government (through the Port Lessor) and the Port of Melbourne. As a result, there is an information asymmetry between the Port of Melbourne, which is fully aware of the rent-related requirements in the port deed, and its tenants, which are effectively unaware.

From our consultation to date, it is apparent tenants have no effective knowledge of the relevant rent-related provisions in the port deed. While some tenants told us they were aware of its existence, they have not sighted, or been provided with, relevant extracts.

Our preliminary view is that this lack of transparency creates an information asymmetry that advantages the negotiating position of the Port of Melbourne relative to tenants. The port deed is therefore a potential source of power for the Port of Melbourne. We were not able to find any requirement in legislation or elsewhere for the relevant parts of the port deed to be made public or directly available to tenants and prospective tenants. This creates an opportunity for the Port of Melbourne to use its knowledge of the processes and criteria for setting and reviewing rents specified in the port deed to their advantage. The potential implications of such information asymmetry include:

- **Tenants are not able to respond to non-compliance** – Should the Port of Melbourne not comply with requirements of the port deed, tenants and prospective tenants are not able to seek compliance or seek enforcement of the port deed (with the Port Lessor or otherwise). If tenants were aware of the requirements, they would be able to require that the Port of Melbourne should act as specified in the port deed.
- **Potential for misinterpretation of compliance** – The Port of Melbourne could include a contract term in a lease to comply with a particular requirement of the port deed without advising tenants that its inclusion simply reflects such compliance. Tenants, unaware of the requirements in the port deed, could misinterpret the inclusion of such a contract term as a concession by the Port of Melbourne. This may make the rent offer appear more attractive to the tenant; whereas the Port of Melbourne is merely acting as required by the port deed.

The confidential status of the provisions of the port deed relevant to the setting and reviewing of rents limits its efficacy in countervailing any monopoly power the Port of Melbourne may have. This

is because prospective and current tenants are unaware of the obligations imposed on the Port of Melbourne under the port deed and the rights it may afford tenants.

Our preliminary view is that this is a failure in the rent setting and reviewing regime, as the Port of Melbourne could use it to its commercial advantage, which would be to the disadvantage of its tenants.

Controls on other uses of power

We have identified a number of other sources of power for the Port of Melbourne that are not constrained by either the market, legislation or the port deed. These sources of power include:

- **To withhold land supply** – The Port of Melbourne is able to reduce the effective supply of land by not making certain land available for rent. Given the weak market constraints on the Port of Melbourne’s behaviour and the lack of restrictions in the port deed, such a strategy will likely increase aggregate rents.
- **Control negotiation timelines** – The Port of Melbourne has power regarding the timing of rent negotiations. Depending on its commercial interests, this could involve imposing tight turnaround times on tenants, taking an extended time to respond to tenants or delaying progress of negotiations to the next stage.
- **Imposition of management or other fees** – The Port of Melbourne is able to charge other fees associated with renting land at the port. For example, the Port of Melbourne could add management or other fees (including setting the amount of these fees) as an additional charge.

In conclusion, our interim view is that the Port of Melbourne has power in setting and reviewing rents and that there is currently limited countervailing market, contractual or legislative power available to tenants to constrain this power.

3.5. Interim conclusion – The Port of Melbourne has power to set and review land rents and associated payments

The Port of Melbourne is a monopoly provider of port land and therefore has power when setting and negotiating rents with tenants. Our interim view is that there are only minimal constraints on the Port of Melbourne’s ability to use this power.

There appears to be weak market constraints on the Port of Melbourne’s power, with tenants unable to exercise countervailing power. Most tenants have a strong business imperative to operate on port land with limited scope to switch, or threaten to switch, to non-port land. We consider only a small number of existing tenants could viably operate on land outside the port precinct.

There also appears to be limited contractual constraints on the Port of Melbourne's power. The port deed does provide some potential constraint, but its efficacy is reduced because its provisions are unknown to tenants creating an asymmetry of information in negotiations.

There also appears to be no constraints on other potential sources of power for the Port of Melbourne including:

- withholding land to reduce supply and increase aggregate rents
- controlling negotiation timelines to suit their commercial interests
- imposing management or other fees

There appears to be minimal constraint on the Port of Melbourne from existing legislation.

Overall, it seems that the Port of Melbourne has power in the process for the setting and review of rents and associated payments, and that there is currently limited countervailing market, contractual and legislative power available to tenants to constrain this power. Our interim view is therefore the Port of Melbourne has significant power in relation to the setting and reviewing of rents.

However, the Port of Melbourne is aware that the commission has a market rent inquiry role and could make recommendations to the Assistant Treasurer on whether rent setting or reviewing should be subject to economic regulation. Given this possibility, the Port of Melbourne may refrain from using its power. Our monitoring role may therefore be a viable substitute for more stringent economic regulation.

The question of whether the Port of Melbourne has exercised its power and the implications for material detriment to the long-term interests of Victorian consumers are key focus areas for the next stage of our inquiry and final report.

Our assessment has led to our interim view that the Port of Melbourne has power in the setting and reviewing of rents.

We invite stakeholders' submissions on this view.

4. What stakeholders have told us

We have received feedback from the Port of Melbourne and a number of tenants.

In the Port of Melbourne's view, tenants are broadly familiar with the rent setting and review process.

Tenants are concerned with the rent levels the Port of Melbourne sets, particularly in relation to its escalation approach and its use of ratchet clauses (that prevent rents from decreasing).

A number of tenants noted the Port of Melbourne's use of term sheets (which they believe would lock in terms and conditions) and characterised their negotiation approach as 'take it-or-leave-it'.

Some tenants questioned whether the Port of Melbourne was ignoring provisions of the Retail Leases Act 2003, particularly in its use of ratchet clauses.

We are presently corroborating the views of stakeholders with the primary documents and correspondence we have obtained. We welcome further feedback to assist us with this task.

This chapter examines feedback from tenants and presents our interim views on the possible harmful effects of the Port of Melbourne's exercise of power as expressed by stakeholders. These views are based on the information we have received to date from written submissions and meetings with stakeholders.

We are not yet in a position to conclude that there are any harmful effects or whether any possible harmful effects constitute material detriment to the long term interests of Victorian consumers. Assessing pass-through and material detriment will be a focus of our final report.

4.1. Feedback on Scope and Process Paper

We released a Scope and Process Paper on 26 September 2019 seeking feedback on our proposed approaches to likely key issues for the inquiry.

Twelve submissions were received including from:

- the Port of Melbourne, whose behaviour is the subject of the inquiry
- stevedores
- peak bodies – Chemistry Australia and Victorian Farmers Federation
- port tenants.

Most submissions from tenants were commercially sensitive and confidential. Public submissions are available on the commission's website.

We also conducted a number of ‘drop-in sessions’ where stakeholders made direct representations about relevant issues and/or supported information in their submissions. The information provided in these sessions was also confidential.

4.2. The Port of Melbourne’s views

The Port of Melbourne provided a submission in response to our scope and process paper. They were generally supportive of the framework proposed and commented on a number of key issues.

The Port of Melbourne supported the main factors we identified as relevant for assessing power including barriers to entry, countervailing power and substitutes. It characterised most tenants as large businesses of significant size and commercial significance, and with strong bargaining power.

The Port of Melbourne noted that it may be relevant to consider product and geographic dimensions of the market (when defining the relevant market for this inquiry) and, in particular, the availability of substitute land in other ports. Some tenants may have specific operational reasons for accessing leased Port of Melbourne land (with limited substitutes) while others may value proximity to the port for commercial reasons (with potentially many substitutes).

The Port of Melbourne noted the port deed is an important part of the regulatory environment as it sets out the requirements around new leases and for market rent reviews. It claimed it must abide by the relevant rent setting and review procedures in the port deed.

The Port of Melbourne noted that, although the port deed is confidential, the rent-related parts are based on an established negotiate-arbitrate model that has long been in place in Australian landlord ports. As a result, it considers that port tenants and the industry more broadly are familiar with the process for setting and reviewing rents.

The Port of Melbourne also claimed individual lease agreements provide sufficient readily available information on setting and reviewing rents.

We are currently reviewing documentary information around a number of rent negotiations and market rent reviews conducted within the inquiry period to assess whether the Port of Melbourne has complied with the rent-related provisions of the port deed.

We invite stakeholder submissions on the Port of Melbourne’s views.

4.3. Feedback from tenants

We received a number of submissions from tenants and other stakeholders. Much of the detail was commercially sensitive and thus confidential. We have aggregated the feedback into a number of emerging themes which are summarised in the following sections.

4. What stakeholders have told us

4.4. Concerns with rent levels

No explanation of rent levels

A number of tenants indicated the Port of Melbourne does not provide their basis for the rental level or provide independent valuation reports on market rents to tenants in negotiations. Tenants claimed this makes it harder for them to assess the basis for the rent claimed by the Port of Melbourne.

Rents on land outside the port

Some tenants suggested the Port of Melbourne should consider rents on land outside the port as a relevant factor in setting rents on land inside the port. Others posited that including land outside the port decreased the risk of monopoly returns (from other port leases) being flowed across the port precinct more broadly. Some tenants argued that land outside the port was a viable substitute as they could actually re-locate to such land without materially impacting their operating models.

Aggressive annual escalation

The tenants we have consulted with are largely of the view that the Port of Melbourne approach to annual rent escalation is not justified. A number of tenants noted the annual escalation approach used by the Port of Melbourne (higher of CPI+X% or 4%)¹⁸ was in excess of the escalation used in comparable leases of non-port land. Some tenants suggested escalation pegged at CPI would likely be more appropriate.

Ratchet clauses

Most tenants we have heard from regard ratchet clauses as unfair and have artificially increased rents.

4.5. Tenants feedback on other potential sources of power

As we identified in chapter 3, the Port of Melbourne has other sources of power that are not constrained by either the market or the port deed, which tenants have commented on.

¹⁸ CPI means the Consumer Price Index

Withholding land

Some tenants informed us of vacant land sites at the port precinct and were concerned this would increase rents. The Port of Melbourne noted these sites had been advertised, yet some are still vacant as they have been unable to get tenants.

Control of negotiation timelines

A number of tenants suggested that the Port of Melbourne used negotiation timelines to tip the balance of power around negotiations further in their favour. They claim the Port of Melbourne would do this by:

- imposing tight turnaround timelines
- often not responding in a timely manner to tenants' issues or questions
- delaying progress to the next negotiation stage or otherwise intentionally dragging out negotiations unnecessarily
- approaching some tenants up to 24 months before their current lease expired, which tenants regarded as an inordinately long time relative to the time spent negotiating most commercial leases and signals a long and expensive negotiation.

Controlling timelines in these ways could increase tenants' operational costs (especially for many small tenants). It may also increase uncertainty for tenants in planning customer offers or investments.

Imposition of management or other fees

Some tenants have noted the Port of Melbourne has imposed a management fee on top of the rent they are charged. This fee does not appear to have been applied to all tenants. Tenants told us the Port of Melbourne has provided no justification for the application of a management fee, nor the amount of the fee imposed.

4.6. Tenants views on the Port of Melbourne's negotiation approach

A number of tenants raised concerns with the way the Port of Melbourne negotiates leases.

Use of term sheets

Many tenants noted the Port of Melbourne's use of term sheets, which it has often presented early in negotiations. Term sheets provide minimum detail about the lease contract but include the key commercial terms of the proposed lease including the commencing rent, rent reviews, duration of the term and the permitted use. Some tenants claimed that they were told that progress to further negotiation, including around the detail of the proposed terms and conditions, was dependent on

signing the term sheet. These tenants believed this would mean locking in the rent amount before a proper understanding of the overall impact of the proposed terms and conditions.

Take-it-or-leave-it basis

A number of tenants reported that the Port of Melbourne offered contracts on what they characterised as a 'take-it-or-leave-it' basis (although the Port of Melbourne may not have used these precise words). These tenants were concerned that this approach was designed to minimise scope for negotiation around clauses that tenants found unfair.

4.7. Concerns with applicability of Retail Leases Act

As noted in chapter 3, the Retail Leases Act is unlikely to constrain the Port of Melbourne in most rent negotiations, as it has limited application to port tenants.

A number of tenants questioned whether the Retail Leases Act applied to their particular lease. Their concerns centred around the Port of Melbourne appearing to ignore provisions in cases where the Retail Leases Act might apply. In particular, the Port of Melbourne's use of ratchet clauses, which are not permitted for leases governed by the Retail Leases Act.

4.8. We are corroborating tenant's views

On the basis of the information provided by tenants, there may be instances where the Port of Melbourne has exercised power in setting and reviewing rents which has caused or could cause material detriment. In some cases, the Port of Melbourne may not have (fully) complied with the requirements of the port deed. We are not yet in a position to conclude whether this has occurred.

While we have met with and received information from the Port of Melbourne, we have not fully tested with them, the claims made by tenants. As with any stakeholder, the Port of Melbourne will have the opportunity to provide submissions responding to issues raised in this interim report. We will carefully consider the port's responses, and any further information we receive from tenants or other parties, before finalising our report.

If the Port of Melbourne makes a submission, it would be helpful if it could outline how it considers it complies with the rent setting and review processes that stem from the port deed, as well as its own internal governance arrangements for establishing new leases and setting and reviewing rents.

Tenants are welcome to provide new and/or further supporting information on the issues outlined above. Any representations made can remain confidential if commercially sensitive.

We are currently reviewing an extensive range of primary documents relating to a sample of rent negotiations and market rent reviews. A critical focus of this review is to assess whether the claims

made by tenants are reasonably based and, if available, to identify independent documentary evidence which may corroborate this.

We encourage tenants and stakeholders to make submissions to this interim report, attend our public forum or contact us directly, should they wish to share their views or elaborate on any of the issues raised in this report.

We invite stakeholder submissions on the views expressed in our interim report.

5. Next steps

Rents should be at the long term efficient level which results from a competitive process. While rents below this level may constrain the Port of Melbourne's investment, rents above that level may cause material detriment to Victorian consumers.

Most tenants have told us higher rents would likely result in negative consequences for their business and/or customers.

Some tenants claimed they would be able to pass-through higher rents, leading to higher prices. While others said they would not be able to do so and this would have other impacts on consumers (tenants exiting markets and reductions in quality).

A number of tenants reported the Port of Melbourne's negotiation approach results in additional transaction costs. These costs add to the burden associated with rents and are also relevant in considering pass-through and material detriment.

Any recommendations around regulatory reform would be assessed against a set of criteria we have previously used to guide regulatory settings – transparency, effectiveness, proportionality and accountability.

This chapter sets out our next steps in examining the concept of material detriment and how we might assess some key aspects for the next stage of our inquiry and final report. It also sets out possible options for economic regulation, should we ultimately conclude in our inquiry that the Port of Melbourne has exercised its power in a way that causes material detriment.

5.1. Material detriment

As noted in chapter 2, we interpret material detriment to be conduct that leads to higher prices, reduced access to services and/or reduced efficiency. This interpretation is guided by the purpose and objectives of section 48 of the Port Management Act and sections 1 and 8A of the ESC Act.

Section 48 (1) (a) of the Port Management Act lists the following objective:

‘to promote efficient use of, and investment in, the provision of prescribed services for the long-term interests of users and Victorian consumers’

Rents that were set at a level that constrained the port from investing in both new and maintenance capital works would not accord with promoting efficient investment, as described in the objective. Similarly, prices that were set so low that they prevented re-allocation of the land to higher-valued uses would not result in efficient use of the land.

The ESC Act also contains objectives that require us to focus on efficiency in the relevant industry and incentives for long term investment. In our view, such objectives are promoted by efficient rents, consistent with those that would be found in competitive land rental markets.¹⁹

Since the Lonsdale Consortium was granted a 50 year lease, the Port of Melbourne has increased rents, both in amount and as a share of its overall income.

Tenants shared with us that their forward business plans anticipated an increase in per square metre rent charges for upcoming lease renewals. This was because they agreed legacy rents were often below market rates

Conceptually, increasing rents towards more efficient levels would enhance economic efficiency across the port value chain and ultimately enhance economic outcomes for Victorian consumers in the long run. It is only where rents are increased above efficient levels that material detriment to Victorian consumers might arise.

Long term aspect of material detriment

We are required to consider the long term in assessing material detriment for our inquiry. This requirement recognises that the impact of rents that are too high or too low, can take some time to flow through the port value chain from tenants, to customers of tenants and ultimately to end consumers.

Although the behaviours that are within scope are those within the inquiry period, there is no constraint on the timing of when material detriment may occur. Different classes of tenants and their customers will have different responses to higher rents. For example, a tenant might absorb higher rents in the short term, but change its investment decisions that are contingent on rents in the longer term.

Pass-through of higher rents

We are required under section 53(3)(c) of the Port Management Act to have regard to the extent to which rents are passed through. That is, how rents paid by a tenant may be passed through to

¹⁹ The notion of competitive here refers to concepts of effective or workable competition rather than perfect competition, which is only a theoretical concept. Workable and effective competition concepts are discussed by the Australian Competition Tribunal in *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT 2 (27 May 2009), and it concludes that:

“[48]...In the Tribunal’s view a market is sufficiently competitive if the market experiences at least a reasonable degree of rivalry between firms each of which suffers some constraint in their use of market power from competitors (actual and potential) and from customers. The criteria for such competition are structural (a sufficient number of sellers, few inhibitions on entry and expansion), conduct-based (eg no collusion between firms, no exclusionary or predatory tactics) and performance-based (eg firms should be efficient, prices should reflect costs and be responsive to changing market forces).”

users of services provided by the tenant, to those users' customers, and ultimately to Victorian consumers.

Tenants presented a wide range of views on their ability to pass-through higher rents to their customers. Some suggested pass-through of higher rents was inevitable with price-related consequences for Victorian consumers. Others suggested rent pass-through was not viable and that various other consumer detriments would likely emerge such as:

- tenants exiting from Victorian markets
- reduced quality
- loss of competitiveness
- reduced employment
- lower Gross State Product for Victoria.

The differing views of tenants is not surprising, as textbook economics suggests that the extent of pass through of higher input costs depends on a range of factors.

For example, tenants that operate in downstream markets that are competitive and in circumstances where their competitors are not affected by similar cost increases will have very little ability to pass through higher rentals. This might be relevant to exporters operating at the Port of Melbourne. However, in competitive markets where all suppliers face a very similar increase in costs, a high degree of pass through to consumers would be expected. This might be relevant to importers of goods that are primarily consumed in the Melbourne area.²⁰ More generally, pass-through will depend on factors including:

- the competitiveness of the industry in which the tenant operates; as well as the industry competitiveness of downstream customers
- whether the cost increase applies to just the tenant, or other firms the tenant competes with
- whether the tenant is an importer or exporter
- whether the tenant competes in domestic or international (competitive) markets.

Tenant views on pass-through

Most tenants we have consulted with for our inquiry have told us higher rents would likely result in negative consequences for their business and/or customers. Some comments from public submissions on pass-through and the broader economic consequences of higher rents are provided below.

²⁰ That is, so that all of the goods that are consumed in the Melbourne area are likely to be imported through the Port of Melbourne.

Chemistry Australia

‘Given Victoria’s chemical manufacturers are trade-exposed, increased costs have the potential to reduce competitiveness, threatening the viability of those operations.’²¹

Victorian Farmers Federation

“All these costs are eventually passed back to farmers. Farmers are characterized as price takers in a grain export market dominated by few, generally less than 10, multi-national trading companies whose balance sheets and global reach enable them to exert significant market power.”²²

Impacts on efficiency

Some tenants have suggested the Port of Melbourne may be using its power in ways that reduce efficiency for tenants or prospective tenants.

Victoria International Container Terminal raise a number of efficiency-related issues including that it must lease a container park at Webb Dock even though it is not required in their operating model.

Victorian Farmers Federation argue that the Port of Melbourne enforces maximum lease terms of 20 years which is less than the life span of much of the infrastructure that tenants, which can potentially up to 50 years. They argue that the continued operation of the Melbourne grain terminal is essential for Victoria and so the lease terms should be extended and not hindered by Port of Melbourne internal policy around optimal lease duration.

Transaction costs

The inquiry is not solely focussed on the impact of rent levels or increases in rent. Section 53(3)(a) of the Port Management Act requires us to have regard to the processes used to establish or review rents or associated payments. A number of tenants have generally reported that the approach adopted by the Port of Melbourne in negotiating rents increases costs for tenants (see chapter 4 for more detail). These costs add to the burden associated with land rents and therefore are a relevant factor in considering material detriment.

A number of tenants reported difficulties negotiating renewals of leases. This was said to create uncertainty about lease tenure; especially if their own downstream customers were on fixed or CPI-escalating contracts. Tenants also found it difficult to prudently plan capital expenditures in the face

²¹ Chemistry Australia submission, Port of Melbourne Market rent enquiry 2020, paragraph 12.

²² Victorian Farmers Federation, Port of Melbourne Market rent enquiry 2020, page 3.

of uncertainty about lease tenure and customers. These costs would also be relevant to the consideration of material detriment.

5.2. Recommendations around economic regulation

If we find the Port of Melbourne has exercised its power in a way that causes material detriment to the long term interests of Victorian consumers, we are required to make recommendations to the Assistant Treasurer on possible economic regulation (see section 53(1)(b) of the Port Management Act).

Economic regulation

Economic regulation is not a defined term in the Port Management Act. It is ordinarily taken to mean a form of regulation that applies to the supply or acquisition of goods and services, including their price or quality, with the intention of preventing the exercise of market power held by a firm or firms, or otherwise correcting a market failure. At its core, economic regulation focuses on the pursuit of economic efficiency.²³

Economic regulation need not be about the regulation of prices or quality. Regulation can also focus on enabling markets to work more effectively. That is, where competitive tension is weak or absent, economic regulation can guide service providers towards outcomes (in terms of price, quality or both) that would have occurred had the market been subject to those tensions.

When economic regulation is likely to be recommended

Even if we were to ultimately find material detriment, we may not necessarily recommend economic regulation be applied. This might arise where (for example) it is not proportionate to the harm or future harm caused, for example, if:

- amendments to existing processes would better address the identified problems
- non-compliance is not systemic and the Port of Melbourne has made steps to redress any problems (and/or compensate affected parties).

If material detriment should be found, and a proportionate remedy is required, the question then turns to which types of regulation could proportionately address the concerns.

²³ See Albon and Decker, *International Insights for the Better Economic Regulation of Infrastructure*, Working Paper No. 10, March 2015, Australian Competition and Consumer Commission (ACCC)/Australian Energy Regulator (AER) Working Paper Series, p.11 for a discussion of economic regulation.

Guidelines for assessing regulatory recommendations

We have previously developed a set of criteria to determine suitable regulatory approaches in ports.²⁴ Although these criteria did not relate to land rentals specifically, we consider that the criteria we proposed remain pertinent to how we would consider and develop any recommendations on possible economic regulation. The criteria are:

1. **Transparency** – are the objectives and operation of the current regulatory framework clear?
2. **Effectiveness** – is the framework appropriately addressing the regulatory problem?
3. **Proportionality** – are the elements of the framework proportional to the nature of the regulatory problem, including the obligations placed the Port of Melbourne under the framework?
4. **Accountability** – does the framework provide robust governance arrangements, which ensure the integrity of the regime's operation?

Scope of possible approaches

Section 53(2) of the Port Management Act makes clear that price regulation is only one of many forms of regulation that we can recommend.

Economic regulation can be thought of as a spectrum from more, to less constraint on the operations of a regulated entity. Figure 5.1 shows how this spectrum can be represented; the spectrum here is defined by differing responses to degree of competition that is evident.

The options on the left-hand side of the spectrum are more appropriate for monopolies. Price controls or cost-of-service regulation (potentially using a building block approach) are common applications of such controls in use in Australia. For example, the Victorian water businesses we regulate use a building block approach.

The options more towards the middle of the spectrum reflect that firms may have market power but also be subject to some competitive constraints that mean negotiated solutions can be pursued, usually with some oversight or recourse to independent decision-making.

Negotiated access regimes are a common form of this kind of regulation. For example, the Victorian rail access regime²⁵ and the National Access Regime (Part IIIA of the Competition and Consumer Act) facilitate commercial negotiations with an independent regulator as an arbitrator. These regimes are usually accompanied by a requirement to offer reference tariffs and other forms of information to promote commercial negotiations.

²⁴ Essential Services Commission, Review of Victorian Ports Regulation, Final report, June 2014, page 70.

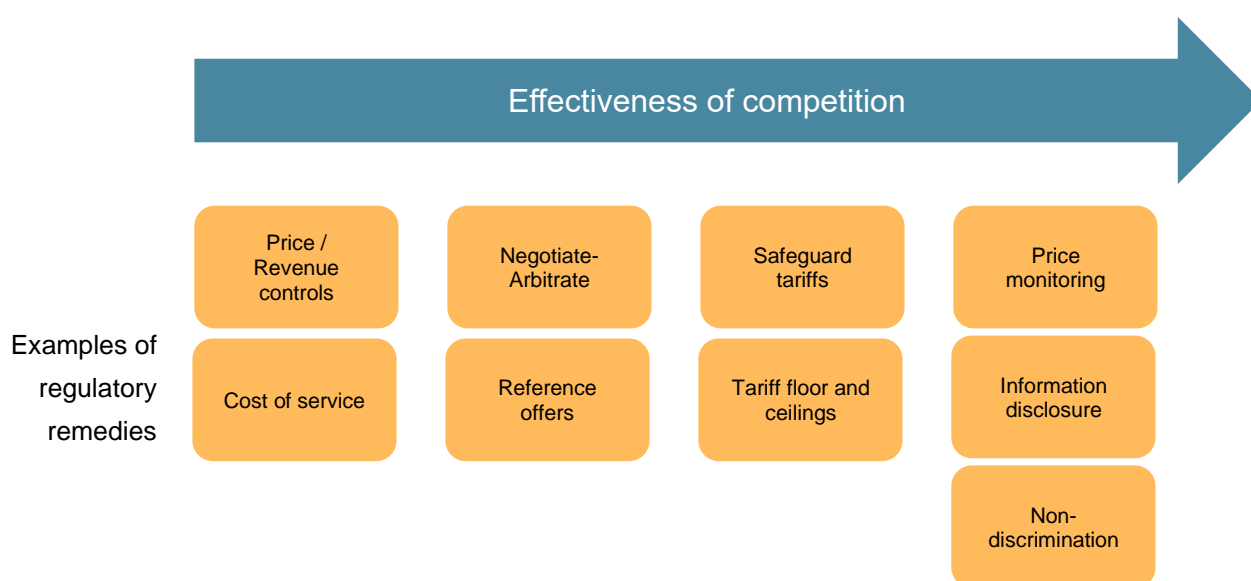
²⁵ In 2005 the Government enacted a Victorian Rail Access Regime contained in Part 2A of the Rail Corporations Act 1996. This required the provision of reference offers containing indicative terms and conditions and the right to access arbitration.

This type of regulation is closest to the current form of regulation applied to the Port of Melbourne's supply of land. However, there are no specific requirements for the Port of Melbourne to provide information to facilitate negotiations and no defined negotiating timeframes which is common in many access regimes.

For markets that are closer to being competitive, regulation is of a more light-handed variety. This can include safeguard tariffs or price floors and ceilings; which provide for the regulated firm to have a degree of pricing flexibility within certain bounds.

Other possibilities include price monitoring, requirements to disclose information on prices and performance, or obligations to not discriminate between users.

Figure 5.1 Economic regulation options



This is a non-exhaustive list of possible remedies, and not all would be suitable to apply to the lease of land at a port. However, it serves to illustrate that a wide range of regulatory approaches could be recommended to improve outcomes in the market for port land, if we find the Port of Melbourne has exercised power in a way that causes material detriment for Victorian consumers.

Confidentiality of the port deed

It has become apparent through the course of the inquiry that the confidentiality of the port deed has the potential to significantly hinder effective negotiation between the Port of Melbourne and its tenants. We are of the interim view that the sections of the port deed that purport to constrain the Port of Melbourne's power with respect to rents should be made publicly available. Currently, tenants have limited knowledge of the constraints imposed in the port deed, and the limitations on those constraints.

We have presented a range of options for economic regulation. In considering economic regulation we weigh the costs against the benefits.

We invite stakeholder submissions on the regulatory options we could recommend if we are to find the Port of Melbourne has exercised power in a way that causes material detriment.

Glossary

Term	Definition
CPI	Consumer Price Index
DVI Act	Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction Act
ESC Act	Essential Services Commission Act 2001
Port deed	Port Concession Deed
Port Lessor	Melbourne Port Lessor Pty Ltd, the state entity from which the Lonsdale Consortium leased the commercial operations of the Port of Melbourne for 50 years commencing on 1 November 2016.
Port Management Act	Port Management Act 1995
Port of Melbourne	Entities that hold the functions of the 'port licence holder', 'the port lessee' and the 'Port of Melbourne operator'
Retail Leases Act	Retail Lease Act 2003
VICT	Victorian International Container Terminal Limited

Appendix A – Section 53 and selected definitions of the Port Management Act

53 Conduct of inquiries

- (1) The Commission must, not later than 6 months after the end of an inquiry period—
 - (a) conduct and complete an inquiry into the following matters—
 - (i) whether a port lessee or the port of Melbourne operator has power in the relevant market that it may exercise in relation to the process for the setting or reviewing of rents or associated payments (however described) payable by a tenant under an applicable lease;
 - (ii) whether a port lessee or the port of Melbourne operator has exercised that power in a way that has the effect of causing material detriment to the long term interests of Victorian consumers (a misuse of market power); and
 - (b) if and only if the Commission finds that there has been a misuse of market power, make recommendations to the ESC Minister about whether the provision of access to port of Melbourne land by means of an applicable lease should be subject to economic regulation, and, if so, the form of the economic regulation.
- (2) For the purposes of subsection (1)(b), the form of economic regulation may include a form of price regulation.
- (3) Without limiting subsection (1), in conducting an inquiry under this section the Commission must have regard to—
 - (a) the processes used to establish or review rents or associated payments (however described) payable by a tenant under an applicable lease; and
 - (b) a port lessee's or the port of Melbourne operator's compliance with any processes for setting and reviewing rents or associated payments (however described) payable by a tenant under an applicable lease required under—
 - (i) a port of Melbourne lease; or
 - (ii) any agreement or arrangement entered into by the port lessee or the port of Melbourne operator in connection with a port of Melbourne lease; and
 - (c) the extent to which any rents or associated payments (however described) paid by a tenant under an applicable lease may be passed through by the tenant to users of services provided by the tenant, to those users' customers, and ultimately to Victorian consumers.
- (4) An inquiry under this section must be conducted in accordance with Part 5 of the **Essential Services Commission Act 2001** but section 40 of that Act does not apply in respect of that inquiry.
- (5) In this section—

applicable lease means a sublease, or a sublease of a sublease, of leased port of Melbourne land granted by a port lessee (other than to the port of Melbourne operator) or by the port of Melbourne operator;

inquiry period means any of the following—

- (a) the period of 3 years commencing on the day on which the first lease of land comprising port assets is granted to a private sector entity under section 11 of the **Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act 2016**;
- (b) the period of 5 years commencing on the day after the day on which the period referred to in paragraph (a) ends;
- (c) a period of 5 years commencing on the day after the day on which a previous 5 year period ends;

port lessee means a lessee under a port of Melbourne lease;

port of Melbourne lease has the same meaning as in section 59 of the **Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act 2016**;

relevant market means the market for access to leased port of Melbourne land by means of an applicable lease.

Selected definitions of the Port Management Act

leased port of Melbourne land means port of Melbourne land in respect of which the port of Melbourne operator holds a leasehold interest

port licence holder means the holder of a port licence

port of Melbourne operator means a person declared under section 4A to be the port of Melbourne operator

Appendix B – Section 37 and Part 5 of the Essential Services Commission Act

37 General power to obtain information and documents

- (1) If the Commission considers that it is necessary to do so for the purposes of performing its functions or exercising its powers, the Commission may require a person that the Commission has reason to believe has any relevant information or document to provide that information or document to the Commission.
- (1A) For the purposes of subsection (1), the Commission may require the person to appear before the Commission to provide the information or document.
- (2) A requirement must be made in a written notice specifying—
 - (a) the information or document required; and
 - (b) the period of time within which the requirement must be complied with; and
 - (c) the form in which the information or copy of the document is to be given to the Commission; and
 - (ca) whether or not the person is required to appear before the Commission; and
 - (d) that the requirement is made under this section.
- (3) The notice must include a copy of this Part.
- (4) A person who without lawful excuse fails to comply with any requirement made under this section in a notice given to the person is guilty of an offence.
Penalty: 120 penalty units.
- (5) It is a lawful excuse for the purposes of subsection (4) that compliance may tend to incriminate the person or make the person liable to a penalty for any other offence.
- (6) A person must not, in purported compliance with a requirement, knowingly give the Commission information that is false or misleading.
Penalty: 120 penalty units or imprisonment for 6 months.
- (7) A person must not—
 - (a) threaten, intimidate or coerce another person; or
 - (b) take, threaten to take, incite or be involved in any action that causes another person to suffer any loss, injury or disadvantage—because that other person complied, or intends to comply, with a requirement made under this section.
Penalty: 120 penalty units.
- (8) A person is not liable in any way for any loss, damage or injury suffered by another person because of the giving in good faith of any information or a document to the Commission under this section.

Part 5—Inquiries and reports

40 Inquiry by Commission

The Commission may after consultation with the Minister conduct an inquiry if the Commission considers an inquiry is necessary or desirable for the purpose of carrying out its functions.

41 Minister may refer matter for inquiry

- (1) The Commission must conduct an inquiry into any matter which the Minister by written notice refers to the Commission under this Part.
- (1A) The Minister is responsible for referring any matter to the Commission for an inquiry unless relevant legislation provides that the Minister administering the relevant legislation may refer a matter to the Commission for an inquiry.
- (1B) Before referring a matter to the Commission for an inquiry, the Minister must consult with any Minister who has responsibilities in respect of that matter.
- (2) The written notice must specify the terms of reference for the inquiry.
- (3) The Minister may—
 - (a) specify a period within which a report is to be submitted to the Minister;
 - (b) require the Commission to make a draft report publicly available or available to specified persons or bodies during the inquiry;
 - (c) require the Commission to consider specified matters;
 - (d) give the Commission specific directions in respect of the conduct of the inquiry.
- (4) The Commission must report to the Minister on the results of any inquiry.
- (5) The Minister may amend the terms of reference or extend the period within which a report is to be submitted to the Minister.

41A Minister may limit use of powers under section 37

If any inquiry is to be conducted into a matter that does not relate to a regulated industry, the Minister may give the Commission specific directions in respect of the conduct of the inquiry which limit the use of the powers conferred on the Commission under section 37 in the manner specified in the specific directions.

42 Notice of inquiry

- (1) The Commission must after notifying the Minister publish notice of an inquiry—
 - (a) in the Government Gazette; and
 - (b) in a daily newspaper generally circulating in Victoria; and
 - (c) on the internet.
- (2) The notice must specify—
 - (a) the purpose of the inquiry;
 - (b) the period during which the inquiry is to be held;

- (c) the period within which, and the form in which, members of the public may make submissions, including details of public hearings;
 - (d) the matters that the Commission would like submissions to deal with.
- (2A) The Commission may specify in the notice under subsection (2) that if a submission is not received within the period specified under subsection (2)(c), the Commission may decide not to consider the submission.
- (3) If the inquiry relates to a matter referred to the Commission by the Minister, the notice must include the terms of reference and the matters specified in section 41(3).
 - (4) The Commission must publish a further notice if the Minister amends the terms of reference or extends the period within which the report is to be submitted to the Minister.
 - (5) The Commission must send a copy of any notice published under this section to the relevant regulated entities and any person or body that the Commission considers should be notified.

43 Conduct of inquiry

- (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;
 - (c) establish working groups and task forces.

45 Reports

- (1) The Commission must submit a copy of its final report on an inquiry to the Minister.
- (2) If, in the opinion of the Commission, a final report will contain confidential or commercially-sensitive information, the Commission must divide the report into—

- (a) a document containing the confidential or commercially-sensitive information; and
 - (b) another document containing the rest of the report.
- (3) For the purposes of subsection (2), any information that the Commission may disclose under section 38 is not confidential or commercially-sensitive unless an appeal panel states that it is imposing a restriction under section 56(7)(b)(i).
 - (4) If the Commission submits a final report to the Minister in the form required by subsection (2), a reference to the final report in subsections (5), (6) and (7) is to be read as a reference to the document described in subsection (2)(b).
 - (5) The Minister must cause a copy of the final report to be laid before each House of the Parliament within 7 sitting days of the House after receiving the final report.
 - (6) The Minister must, after the final report has been laid before each House of the Parliament, or if the Parliament is not sitting, within 30 days after receiving a final report, ensure that a copy of the final report is available for public inspection.
 - (7) After the Minister has made a final report publicly available, the Commission must ensure that copies are made publicly available.

46 Special reports

- (1) If in the course of an inquiry the Commission considers that there is another matter on which the Commission should report to the Minister, the Commission may do so, in the final report or in a special report.
- (2) If the Commission prepares a special report, subsections (5), (6) and (7) of section 45 apply to the special report as if it were a final report.

Appendix C – Section 37 notices served on the Port of Melbourne and the Port Lessor

We served a section 37 notice on the Port of Melbourne

We issued a section 37 notice, under the Essential Services Commission Act 2001 to the Port of Melbourne, to obtain confidential and commercially sensitive information and documents between tenants and the Port of Melbourne. The information and documents we sought were selected to help us complete our inquiry into whether the Port of Melbourne has exercised power in setting and reviewing rents at the port of Melbourne.

How we selected leases to review

As part of the section 37 notice we selected several tenant contracts to review. To ensure a suitable cross section of tenants, we based our selection of contracts on information the Port of Melbourne had earlier provided in response to an information request.

For market rent reviews, our sample included 17 of 44 leases, which is about 39 per cent. For new leases or extensions granted we requested 10 of 24 leases, about 42 per cent.

Our selection considered the following:

- The size of the tenant – small, medium and large businesses,
- The lease term – contract lengths ranged from a few years up to over twenty years,
- New and existing leases – both existing tenant leases and new tenant leases,
- Market rent reviews – tenants in the process of going through or had just been through a market review process, and
- Long term leases due to expire soon after the review period – leases which expire within two years of the review period, these likely involved substantial tenant capital investments and the Port of Melbourne may have commenced negotiations.

In developing this information notice, we had regard to section 36A of the Essential Services Commission Act 2001. This requires us to consider the relevance of the information we seek and the estimated compliance costs.

We served a section 37 notice on the Port Lessor

In addition, we issued a second section 37 notice on the Port Lessor to obtain relevant clauses of the Port Concession Deed, head lease and sub-lease. This information is material to clearly understanding the process for setting and reviewing rents, including to tenants' rights.

It is also relevant regarding the extent of oversight on Port of Melbourne because it is required to provide the Port Lessor with certain information annually.