

# Port of Melbourne – Market Rent Inquiry 2020

**Public report**

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This report sets out the Essential Services Commission’s findings of our inquiry under section 53 of the Port Management Act 1995 (Vic). It excludes or redacts any material that is confidential or commercially sensitive in nature.

# Summary

## **We have completed our first inquiry into port rents**

This report sets out the Essential Services Commission's (commission's) findings of our inquiry into port rents and associated payments under section 53 of the Port Management Act 1995 (Port Management Act). Our inquiry covers activities over the period from 1 November 2016 to 31 October 2019.

The Port Management Act sets out the steps for our inquiry:

- Whether the Port of Melbourne has power in the market for access to leased Port of Melbourne land that it may exercise in relation to the process for the setting or reviewing of rents or associated payments payable by its tenants.
- If we find the Port of Melbourne has power, whether the Port of Melbourne has exercised that power in a way that has the effect of causing material detriment to the long-term interests of Victorian consumers.
- Subject to a finding of power causing material detriment, formulate recommendations to the Assistant Treasurer about whether the provision of access to port land by means of an applicable lease should be subject to economic regulation and, if so, the form of the economic regulation.

A summary of key findings is set out below.

## **The Port of Melbourne has power in the process for setting or reviewing rents**

For the purpose of our inquiry power has its natural meaning; that is, the ability to do something in a particular way. The Port of Melbourne is the only possible supplier of land in the relevant market, which the Port Management Act defines as the market for access to leased Port of Melbourne land by means of an applicable lease. In this market, the Port of Melbourne is a monopoly provider. This provides the underlying source of the Port of Melbourne's power in relation to the process for setting or reviewing rents and associated payments.

## **The Port of Melbourne's power has not been effectively constrained by the market**

We considered possible constraints on the Port of Melbourne's exercise of its power. While the Port of Melbourne's power is not unconstrained, which reflects a mix of market characteristics and legislative and contractual arrangements, we consider it retains a significant degree of control in relation to setting and reviewing rents.

Most existing tenants have limited ability to switch or credibly threaten to switch to non-port land. Many tenants are 'locked in' to the Port of Melbourne due to significant sunk costs, and long lead

times and large investments needed to explore and secure alternatives. Particularly for stevedore tenants, there is no suitable alternative provider of equivalent access to land for supplying Australia's second largest city, or to facilitate exports. These factors limit the bargaining power of tenants.

Competitive constraints may exist in some downstream markets. However even if a tenant is a price taker and therefore needs to absorb cost increases, rents are generally small relative to a tenant's costs or profits. This means rents would have to increase substantially before any such constraint became effective in terms of constraining the Port of Melbourne's power.<sup>1</sup>

### **Legislation, Port Concession Deed and other contractual arrangements are also limited in constraining the Port of Melbourne's power**

During the port privatisation process, economic regulation was considered as an option to constrain the Port of Melbourne's power over land rents. The Victorian Government proposed a regulatory framework which included the requirement for the Port of Melbourne to offer a market rent review mechanism with a dispute resolution process, and a periodic review by the commission on whether the Port of Melbourne has misused its power.

Ultimately, the Victorian Parliament amended the Port Management Act which established the role of the commission in the sector. The Victorian Government (through its administrative body, the Port Lessor) also entered into an agreement with the Port of Melbourne through the Port Concession Deed (port deed). Among other things, the port deed sets out the Port of Melbourne's responsibilities in conducting market rent reviews.

We consider the port deed (including its reasonable market rent requirements) and other relevant contractual arrangements do not prevent the Port of Melbourne exercising its power.

In terms of the port deed, we consider it provides some potential constraints but its effectiveness is reduced because it:

- Has not been made available to tenants or prospective tenants. While key clauses are designed to protect the interests of tenants, they are either unaware of their existence or uncertain about how they operate. This appears to undermine a key purpose of the port deed, and therefore does not operate to constrain the Port of Melbourne's power in an effective manner.
- Expressly permits the Port of Melbourne to include ratchet clauses, which, when combined with fixed annual rent escalations, may result in an ongoing upward rent bias for future rent

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<sup>1</sup> In theory, increases in rent may affect a tenant's ability to compete in the market in which it operates. This could lead to reduced throughput for the Port. In this way, competition in downstream markets can be a constraint on rent increases.

reviews. This reduces the ability of a regular review process to bring rents into line with market or efficient rates.

- Does not impose restrictions on the Port of Melbourne's power to set and review associated payments, such as management or other fees which may be set without reference to their costs, effectively leading to increased rental costs for tenants.

In respect of a market rent review under a port lease, a tenant or the Port of Melbourne can refer the matter to independent rent determination. The Port of Melbourne cited this process as an important safety net for tenants. However, this process is only available for a market rent review that is due under an existing lease and not for setting a commencing rent under a new port lease.

Further, we found that, for leases where a market rent review was undertaken during the inquiry period, only a small sample of those leases were referred to an independent valuer for rent determination. Some tenants noted costs and uncertainty as reasons for not pursuing independent determinations. We also consider that the Port of Melbourne's lack of willingness to share rent and port information and related valuation data contributes to the ineffectiveness of these constraints.

### **The Port of Melbourne's behaviour provides evidence that it has exercised its power**

We engaged with the Port of Melbourne and its tenants throughout the review. We have been provided with volumes of information, much of which is confidential, which indicates dissatisfaction amongst tenants about the Port of Melbourne's negotiation processes and the outcomes and impacts of its approach (for new leases and for market rent reviews).

We also note that our inquiry was conducted while some port lease negotiations were outstanding. Some of those tenants did not want to risk prejudicing their negotiations or damaging their relationship with the Port of Melbourne by making a public submission to our inquiry.

We have received evidence of deferred investment and impacts on tenant ability to lock in new customer contracts because of the rent setting process adopted by the Port of Melbourne.

The commission also engaged HWL Ebsworth Lawyers (HWL Ebsworth) to undertake an in-depth review of Port of Melbourne management communications, board papers, and draft and final contracts related to 24 of 57 new lease negotiations or market rent reviews conducted during the inquiry period. The review also included four new lease negotiations started but not yet completed.

We found many examples of the Port of Melbourne using a broad range of negotiation strategies and processes to drive higher rent outcomes.

Some of the strategies adopted by the Port of Melbourne are common in lease negotiations in competitive markets. While these strategies may be acceptable in these markets, they are not always appropriate in a monopoly market where tenants at the port face significant barriers in pursuing and securing alternative suppliers of suitable land.

Examples of how the Port of Melbourne has exercised its power include:

- Failing to inform tenants of the negotiation processes to be followed, or key provisions in the port deed. We found the Port of Melbourne does not provide tenants or prospective tenants sufficient information about the process for setting and reviewing rents under a new port lease. While the Port of Melbourne has said negotiation processes are well known, tenants refer to unclear processes and a lack of visibility about what is included in the port deed. HWL Ebsworth advise us that the Port of Melbourne would be permitted to disclose certain clauses to enable it to perform its obligations under the deed.
- Refusing to share valuation advice with tenants. We do not consider it is reasonable for the Port of Melbourne to withhold valuation information in a monopoly environment where the Port of Melbourne has significant power over the processes for setting and negotiating rents. While the Port of Melbourne has argued that this is standard industry practice, we understand it is now common for parties to share this information in competitive leasing markets.
- Making insufficient adjustments in the process for reviewing and setting rents to reflect the different permitted land uses at the port.
- Reinforcing the strategies above, the Port of Melbourne strategically sequences market rent reviews to its benefit by targeting certain high valuation agreements to negotiate first, rather than progress reviews in parallel. The port has then placed excessive weight on the outcomes of these higher value sites to flow rents to lower value land uses (resulting in rents not being at their efficient levels).

More detail on these, and other strategies adopted by the Port of Melbourne are provided in Chapter 4 (which focuses on negotiation processes) and Chapter 5 (which focuses on rent outcomes).

In this paper, we make observations about the strategies adopted by the Port of Melbourne and whether they are likely to result in rents reflecting efficient levels, consistent with those that would be found in workably competitive land rental markets. Rents that are higher than their efficient level can be one indicator of material detriment, which we explore in Chapter 6.

### **Port rents have grown strongly**

Rents have grown strongly since privatisation of the port. From a sample of new agreements following market rent reviews, we found examples of rents more than doubling. One agreement led to rents increasing threefold. Analysis by the Australian Competition and Consumer Commission has shown that the average rent per square metre at the Port of Melbourne (for stevedores) is significantly higher than the other major ports across Australia and also increased relatively strongly over the period from 2017-18 to 2018-19.

In 2015-16, the Port of Melbourne generated income of \$53.8 million from rents and licence fees.<sup>2</sup> By 2018-19, 'property revenue' earned by the Port of Melbourne was \$193.7million.<sup>3</sup>

We understand that there was a general acceptance from stakeholders that rents prior to privatisation were too low and would need to increase over time. However, we consider the prevalence of rent increases rising by more than double are significant, and unlikely to match stakeholder expectations. They are also likely to reflect the impacts of the Port of Melbourne exercising its monopoly power during the inquiry period.

We reviewed a sample of outcomes of the market rent review process where independent valuations or tenant valuations were used. In all cases, the Port of Melbourne's starting point for negotiations are substantially higher compared to independent third-party valuations, and any valuations commissioned by tenants. This is important in the context of the information advantages and strategies of the Port of Melbourne, noted above.

### **The Port of Melbourne's exercise of its power has caused material detriment**

Many of the Port of Melbourne's behaviours contributed to a lack of transparency and information asymmetry for tenants, hampering their ability to negotiate with the Port of Melbourne on an equal basis during the inquiry period. This constrained tenants from countering other strategies used by the Port of Melbourne to increase rents or associated payments.

Our analysis of rents paid by tenants indicates the Port of Melbourne has not sufficiently considered the different characteristics of land at the port, which would be necessary to arrive at efficient rent levels.

Further, the Port of Melbourne has used its power derived from asymmetric knowledge of rents (in part derived from keeping its valuations confidential and prohibiting tenants from sharing information about their agreements) and its control of the market rent review process to sequence reviews to its advantage. We received submissions from tenants noting that they were at an information disadvantage, limiting their ability to influence processes and rent outcomes.

As a result, we consider agreements made during the inquiry period will reflect gains from the Port of Melbourne's exercise of monopoly power. Accordingly, rents will not be at an efficient level causing material detriment to tenants and ultimately to the long-term interests of Victorian consumers. Tenants also cited non-price (non-rent) matters such as higher negotiation costs due to the negotiation practices adopted by the Port of Melbourne.

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<sup>2</sup> Port of Melbourne Corporation 2016, Annual Report 2015-16, 2016, p.69

<sup>3</sup> Lonsdale Finance Pty Ltd, Listing prospectus 10 September 2019, p.161

Demonstrating broader harm, we received feedback from some tenants that higher rents are being passed on to their customers (we acknowledge the extent of pass-through will vary, depending on the market the tenant is competing in). We also found specific examples where, due to the protracted and uncertain negotiation processes adopted by the Port of Melbourne, tenant investment had been deferred with impacts also on the ability to lock in new customer contracts. We considered the impacts on households and businesses relying on imports or exporting through the port.

### **Further economic regulation is justified to ensure there is mitigation of the ability of the Port to exercise power through rent seeking**

Given we have found material detriment, we must make recommendations to the Assistant Treasurer about whether economic regulation should be applied, and, if so, the form of economic regulation that should apply.

We recommend that economic regulation apply, but in the form of a relatively light touch approach. We recommend an enhanced negotiate-mediate-arbitrate framework independently overseen by the commission.

The aim is to improve commercial negotiations with tenants by clarifying processes and responsibilities, mandating a freer flow of information, and enabling access to independent private arbitration for new leases as well as market rent reviews. We consider this is a proportionate response (say, relative to full price regulation) to address the deficiencies we have identified.

If the Victorian Government accepts our recommendations, legislative change will be required. Therefore we propose in the short term government, the Port Lessor and the Port of Melbourne should work with the commission to implement a transitional approach to new arrangements by making incremental improvements to transparency and processes. In part, this could be achieved initially by publicly disclosing clauses of the port deed relevant to the processes for reviewing and establishing rents at the port.

# 1. Introduction

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. We also summarise key legislative, regulatory, and contractual arrangements relevant to our inquiry.

## 1.1. Our task

We were assigned several regulatory roles in 2016 when legislation was passed to enable 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 and associated payments at the Port of Melbourne (also referred to as a market rent inquiry or inquiry in this paper).<sup>4</sup>

Our task and the required process in undertaking a market rent inquiry is set out in section 53 of the Port Management Act 1995 (Port Management Act, provided at Appendix A). This is our first inquiry under this section and the focus is on activities occurring from 1 November 2016 to 31 October 2019.<sup>5</sup> The relevant market for our inquiry is the market for access to leased land in the Port of Melbourne by means of an 'applicable lease'.<sup>6 7</sup>

The Port Management Act prescribes three steps for us to consider. The second and third steps cannot be undertaken unless the prior step results in the commission making the requisite finding.

### First step – Power

Our first task is to make a finding about whether the Port of Melbourne has power in the market for access to leased Port of Melbourne land that it may exercise in relation to the process for setting or reviewing rents. For the purpose of our inquiry power has its natural meaning; that is, the ability to do something in a particular way. Chapter 3 sets out our framework for assessing whether the Port of Melbourne has power and our findings.

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<sup>4</sup> Section 53(1)(a) of the Port Management Act 1995 (Vic) 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'.

<sup>5</sup> As per section 53(5) of Port Management Act 1995 (Vic). Any rents set or reviewed during this period are relevant to our inquiry, including rents agreed before the commencement of our inquiry period.

<sup>6</sup> Port Management Act 1995 (Vic), s 53(5).

<sup>7</sup> An 'applicable lease' is a lease or sublease granted by the port lessee (Lonsdale Asset Property Pty Limited ACN 614 295 582, as trustee for the Lonsdale Asset Property Trust ABN 99 381 517 446 ) or the port of Melbourne operator (Port of Melbourne Operations Pty Limited ACN 610 925 178, as trustee for the Port of Melbourne Unit Trust (ABN 83 751 315 034)). See definitions in section 53(5) of Port Management Act 1995 (Vic).

## Second step – Effect of exercise of power

If we find the Port of Melbourne has power, our second task is to assess whether there is material detriment due to the exercise of power in the inquiry period. We assess the exercise of power in Chapter 4 (covering power in the context of negotiation processes) and Chapter 5 (covering power in relation to rent outcomes). Any detriment must not be trivial, transitory or immaterial, and must apply to the interests of consumers as a whole. We address detriment in Chapter 6.

## Third step – Recommendations

Our third task is to formulate recommendations to the Assistant Treasurer about whether the provision of access to port land by means of an applicable lease should be subject to economic regulation and, if so, the form of the economic regulation. The commission has no jurisdiction to undertake this third task unless it has made a finding of material detriment (second step).

We are not constrained about the form of economic regulation which we can recommend. However, we are guided by the objectives of the Port Management Act and the Essential Services Commission Act 2001 (Vic) (ESC Act). Findings at the first two steps are also relevant considerations for the commission in assessing the nature of any regulation that we recommend. Our recommendations are discussed in Chapter 7.

## Other matters we must have regard to

In conducting our inquiry, the Port Management Act requires us to have regard to:

- the processes used by the Port of Melbourne to establish or review rents or associated payments (however described) payable under an applicable lease
- the Port of Melbourne's compliance with processes required by 'head leases' or other arrangements made by them in connection with the head lease (for example, arrangements with the State of Victoria as the land owner).
- 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.<sup>8</sup>

The commission is required in this inquiry to have regard to its objective under the ESC Act when undertaking this review. The ESC Act specifies the objective of the commission when performing

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<sup>8</sup> Port Management Act 1995 (Vic), s 53(3).

its functions and exercising its powers is to promote the long term interests of Victorian consumers.<sup>9</sup>

We must conduct our inquiry in accordance with part 5 of the ESC Act and may collect information and documents under our compulsory information gathering powers as per section 37 of the ESC Act. For more detail on the statutory requirements for our inquiry see Appendix B.

## **1.2. 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 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. Our inquiry is limited to applicable leases only. We have not examined the Port of Melbourne lease.

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

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<sup>9</sup> Essential Services Commission Act 2001 (Vic), section 8.

### **1.3. 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 oversees the Port of Melbourne's compliance with its contractual and legislative obligations.

### **1.4. Overview of key contractual arrangements**

#### **Port Concession Deed**

The Port Concession Deed (port deed) is the confidential agreement between the Victorian Government (and administered by the Port Lessor) and the Port of Melbourne that sets out the responsibilities of each party on a range of matters. The relevant provisions relating to setting and reviewing rents are set out in clauses 18 and 19 of the port deed (see Appendix C).

In high level terms the port deed requires the Port of Melbourne to offer a port tenant a reasonable market rent, and a market rent review every five years for leases of more than eight years. It also provides the right for parties to seek an independent valuer to determine the reasonable market rent for a market rent review. The port deed also sets out several circumstances in which the reasonable market rent provisions of the port deed do not apply.

The assessment of reasonable market rent needs to consider a range of factors. The reasonable market rent definition in the Port of Melbourne's standard lease is provided at Appendix D.<sup>10</sup> It indicates that the assessment of reasonable market rent needs to consider factors such as the condition of the land, the location and area of the land, proximity to relevant facilities and transport, the permitted use of the land, the whole term of the lease (excluding options) and rents of comparable land or premises.

#### **Port Head Lease and Port Sublease**

The Port Head Lease and the Port Sublease are the contracts between the Port of Melbourne and the Port Lessor created during the transfer of the port's operations. The relevant processes for setting and reviewing rents are set out in the Port Head Lease and Port Sublease. The most relevant clauses for our inquiry are those requiring the Port of Melbourne to ensure that pending rent reviews are undertaken and completed 'as soon as reasonably practicable' after the lease commencement date.<sup>11</sup> Pending rent reviews are outstanding market rent reviews under the

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<sup>10</sup> Note that the Port of Melbourne provided us with permission to publish the reasonable market rent definition included in its standard lease.

<sup>11</sup> The lease commencement date refers to the commencement time of the Port Head Lease and the Port Sublease.

existing tenant leases that had not been initiated or completed as at the lease commencement date.

## Port leases

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. New leases and new rents are negotiated and set according to the Port of Melbourne's new standard approach and processes it requires and has implemented from 1 November 2016. Reviews of rents under new and existing port leases are undertaken according to a process specified for market rent reviews in these agreements, in which both parties either negotiate and agree the rent or refer this 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 started, the activities carried out on the relevant land during the lease, and the type of land to which the lease is associated. The Port of Melbourne administers around 120 leases with an average term of around 25 years. While some leases are short term, others extend to over 50 years.<sup>12</sup>

### 1.5. 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.

Containers are the main type of cargo to pass through the port, with more than 3.0 million handled in 2018-19.<sup>13</sup> They are handled by one of three international container terminal operators:

- DP World Australia – operates at Swanson Dock West
- Patrick Container Terminals – operates at Swanson Dock East
- Victoria International Container Terminal (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

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<sup>12</sup> 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.

<sup>13</sup> Port of Melbourne, Historical trade data, accessed 24 February 2020, <https://www.portofmelbourne.com/about-us/trade-statistics/historical-trade-data/>.

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.

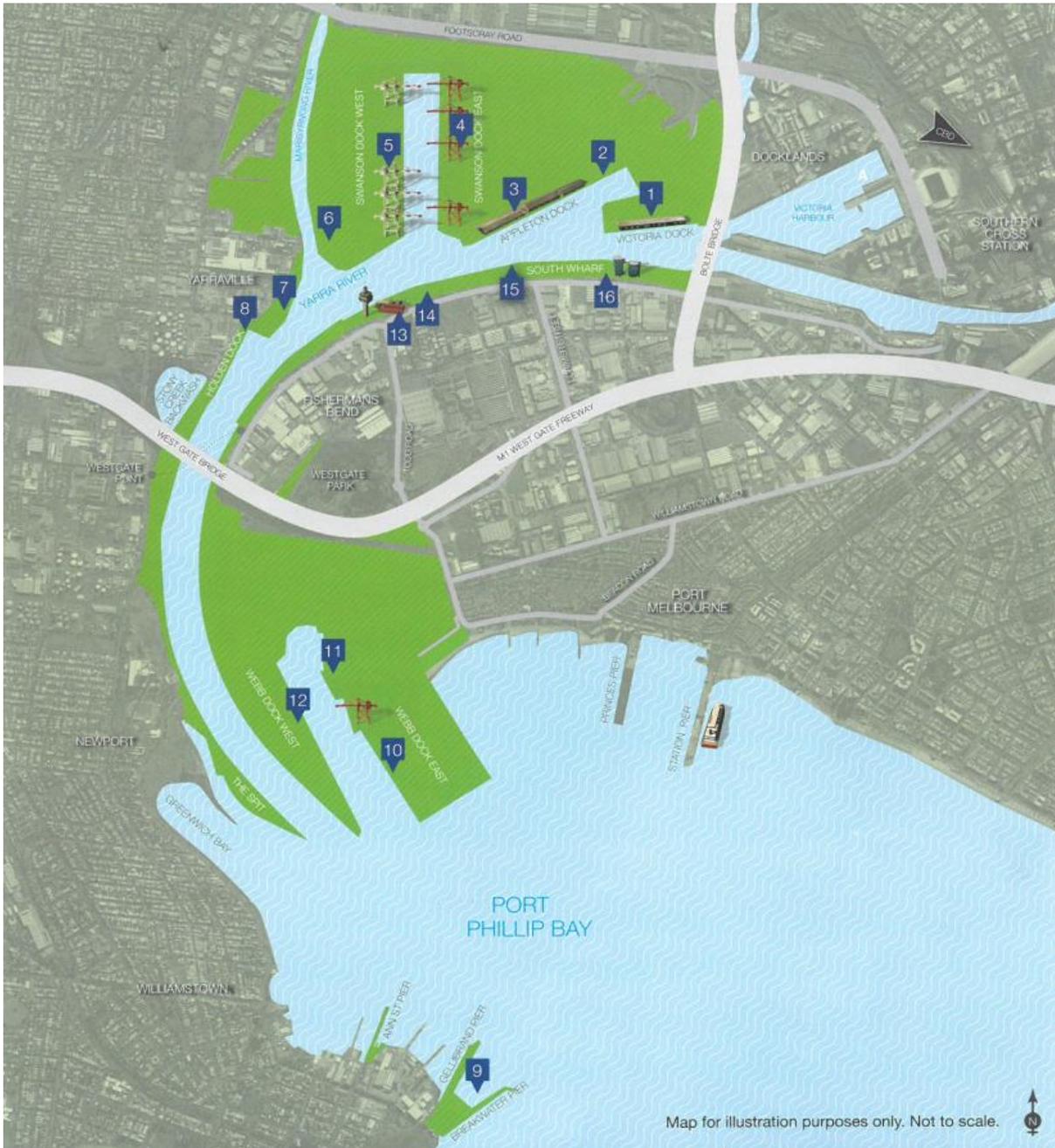
The Port of Melbourne derives a significant share of its total revenue from land rents. This share has increased since the Lonsdale Consortium was granted a 50 year lease in 2016. In 2015-16, rents and licence fees comprised 14 per cent of the Port of Melbourne's total revenue (that is, \$53.8 million of \$394.2 million).<sup>14</sup> By 2018-19, 'property revenue' was almost 29 per of the Port of Melbourne's total income (that is, \$193.7million of \$672.5million).<sup>15</sup>

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<sup>14</sup> Port of Melbourne Corporation 2016, Annual Report 2015-16, 2016, p.69.

<sup>15</sup> Lonsdale Finance Pty Ltd, Listing prospectus 10 September 2019, p.161.

**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

## 2. The commission's approach to the inquiry

The commission's inquiry provided many opportunities for stakeholders to contribute. The manner of our engagement was guided by our obligations under Part 5 of the Essential Services Commission Act 2001 (Vic). We have considered all information submitted by stakeholders during our inquiry in developing our findings and recommendations.

### 2.1. Key steps in our process

#### Scope and process paper – September 2019

We released a scope and process paper in September 2019, setting out key issues and our proposed approach to the inquiry. We invited stakeholders to comment and received 12 submissions (some of which were provided on a confidential basis). All public submissions are available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

We also conducted a number of 'drop-in sessions' in November 2019 where stakeholders raised key issues, or provided information to support the information provided in their submissions. The information provided to us in these sessions was also confidential.

#### Interim report – March 2020

We indicated in the scope and process paper that we would release a draft report in January 2020 and hold a public forum in February 2020. This was not possible due to the volume of confidential information we received. The relevance and importance of key documents were unknown at the time we commenced the inquiry. As such, the type, and timing, of our approach changed.

We released an interim report in March 2020, in place of a draft report, to outline our interim views and the range of stakeholder views received to that point. We also invited stakeholders to provide written submissions addressing any issues in our interim report, or any other information relevant to our inquiry.

Following the release of our interim report, we held a public forum on 31 March 2020 where we explained our interim views and provided an opportunity for stakeholders to ask us questions and provide feedback. The Port of Melbourne also presented and provided their views at the public forum. We received six submissions from tenants, and two submissions from the Port of Melbourne (one confidential) in response to our interim report (non-confidential submissions are on our website).

## Provisional conclusions – June 2020

The commission provided the Port of Melbourne a copy of our provisional conclusions on 4 June 2020. We invited the Port of Melbourne to provide a written response to the provisional conclusions by 12 June 2020.

Commission staff met with the Port of Melbourne on 5 June to present our provisional conclusions, and to hear the Port's initial views. Subsequently, we agreed to the Port of Melbourne's request that we extend the deadline for their submission. We extended the deadline to 17 June 2020.

We received the Port of Melbourne's written submission to our provisional conclusions on 17 June 2020. On 19 June, the Port of Melbourne presented to the commission on its response. We also received an addendum to the Port of Melbourne's written submission on 3 July 2020.

All information provided by the Port of Melbourne was taken into account by the commission in reaching our inquiry findings and recommendations.

## Other interactions with the Port of Melbourne

The commission engaged with the Port of Melbourne regularly throughout our inquiry. In addition to the above, we note there were several meetings to discuss our inquiry and information relevant to it, and many emails to provide and clarify information.

On 17 January 2020, we issued the Port of Melbourne a request under our compulsory information gathering powers seeking copies of all documents and communications necessary for us to conduct our inquiry.<sup>16</sup> Among other things, we requested a sample of new leases and market rent reviews conducted. We sought detailed communications in respect of these leases and reviews, including correspondence between the Port of Melbourne and each of the relevant tenants, copies of the proposed and final agreements, external valuation reports, expert rent determinations and other documents and information relating to independent valuations and the timing of negotiations.

We also requested the Port of Melbourne provide us with copies of the clauses in the Port Concession Deed, the Port Head 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 material provided to staff and board members relating to the process for setting and reviewing rents.

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<sup>16</sup> Notice issued by the commission under section 37 of the ESC Act.

## We requested information from the Port Lessor

We served the Port Lessor with a notice under our compulsory information gathering powers, requesting copies of the clauses in the port deed, the Port Head Lease, the Port Sublease and other documents relevant to the setting and reviewing of rents at the Port of Melbourne.<sup>17</sup>

### 2.2. Legal review

Our review was informed by a substantial body of work done by a team in the property law division of HWL Ebsworth. This work was headed by a senior property partner of HWL Ebsworth with over 20 years' experience in property law matters, including in commercial and industrial leasing.

HWL Ebsworth provided advice to the commission following its review of material we received from the Port of Melbourne over the course of our inquiry, including leases it provided to us in response to our request for information under our compulsory information gathering powers. The lease sample comprised eight out of the 24 new leases (33 per cent) negotiated by the Port of Melbourne in the inquiry period, 16 out of 33 market rent reviews (48 per cent) completed by the Port of Melbourne during this period, and four new lease negotiations that were initiated but not yet concluded.<sup>18</sup>

In total, their review covered thousands of pages of documents and information provided by the Port of Melbourne. HWL Ebsworth considered:

- how the Port of Melbourne has approached setting and reviewing rents
- whether the Port of Melbourne has exercised power in these processes
- whether the Port of Melbourne has complied with its obligations, including contractual arrangements, while engaging in these processes.

HWL Ebsworth provided the commission with a 123-page report covering its review of leases (confidential Attachment 1).<sup>19</sup> The report focuses on the processes used by the Port of Melbourne in relation to the lease sample for the setting and reviewing rents. The report also considers how these processes took into account the requirements for setting and reviewing rents for leased port

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<sup>17</sup> Notice issued by the commission under section 37 of the ESC Act.

<sup>18</sup> We called for information and documents in relation to 10 out of the 24 new leases established at the port during the inquiry period, however at our meeting with the Port of Melbourne on 23 January 2020, they indicated that 2 of these had been negotiated before the inquiry period. This was confirmed and the review of new leases was reduced to 8 new leases.

<sup>19</sup> HWL Ebsworth Lawyers, Essential Services Commission, Port of Melbourne Market Rent Inquiry 2020, High-level summary report of port leases, 14 April 2020.

land specified in the port deed. These are two of the matters the Port Management Act requires the commission to have regard to in undertaking this inquiry.<sup>20</sup>

HWL Ebsworth also provided the commission with advice on the lease negotiation framework that applies at the port, the processes followed by the Port of Melbourne, and their key observations relating to the setting or reviewing of rents at the port for the sample of leases reviewed (confidential Attachment 2).<sup>21</sup>

Both reports set out above informed the provisional conclusions the commission provided to the Port of Melbourne on 4 June 2020.

HWL Ebsworth also prepared a response to a document prepared for the Port of Melbourne by its lawyers (King & Wood Mallesons submission), and provided by the Port of Melbourne as part of a confidential submission made in June 2020<sup>22</sup> describing what they consider to be usual market practice for negotiating industrial leases (the HWL Ebsworth response is provided at confidential Attachment 3).<sup>23</sup>

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<sup>20</sup> Port Management Act 1995 (Vic), s 53(3)(a) and (b).

<sup>21</sup> HWL Ebsworth Lawyers, Essential Services Commission, Port of Melbourne Market Rent Inquiry 2020, Advice to the Essential Services Commission relating to the processes and observations, 30 April 2020.

<sup>22</sup> Confidential submission by Port of Melbourne Pty Ltd response dated June 2020, to Essential Services Commission summary of provisions commission conclusions dated 4 June 2020, Attachment 2 – King & Wood Mallesons, 16 June 2020.

<sup>23</sup> HWL Ebsworth Lawyers, Memo to the Essential Services Commission re. HWLE response to submissions by King & Wood Mallesons, 29 June 2020.

## 3. Assessing the Port of Melbourne's power

The first matter we address is whether the Port of Melbourne has power in the process for setting or reviewing rents. In our interim report, our view was that the Port of Melbourne has power that it may exercise. In this chapter, we outline how we have assessed power and the views we received from submissions to the interim report. We explain why we maintain our finding that the Port of Melbourne has such power.

### 3.1. Our framework for assessing power

The definition we have adopted for power is its natural meaning; that is, the ability to do something in a particular way. In the context of our inquiry, it is power that the Port of Melbourne may exercise in the relevant market; that is, the market for access to leased Port of Melbourne land by means of an applicable lease.<sup>24</sup> We have considered the Port of Melbourne's power over:

- setting or reviewing rents
- setting the terms and conditions of leases and licences
- the processes for negotiating new leases or changes in rents, or terms and conditions
- the information available and to be made available to existing or prospective tenants relevant to such negotiation.<sup>25</sup>

A reference to *process for setting or reviewing rents or associated payments* in this paper must be interpreted as including all the elements above.

For clarity, we did not assess the market in terms of sections 46 or 46A of the Competition and Consumer Act 2010 (Cth). These are concerned with the misuse of market power and the substantial lessening of competition that can result. As well as being outside the scope of our inquiry, we do not have the legislative authority to consider or to apply these tests.

In effect, we must examine and make a finding about whether the Port of Melbourne can materially set its own processes. Logically this is less likely if head leases, operative legal arrangements and

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<sup>24</sup> This is defined in section 53 of the Port Management Act and differs from market definitions applicable in other acts such as the Competition and Consumer Act 2010 (Cth).

<sup>25</sup> These aspects are an integral part of the process for setting or reviewing the amounts of rents or associated payments, and directly influence the amount of rents or associated payments payable for leases or licences. For example, the size, the term, the purpose for which the relevant land can be used, the matters to be had regard to in setting or reviewing rents or associated payments (including arrangements for improvements), and termination rights will all affect the rent and associated payments ultimately payable for that land.

laws give the Port of Melbourne little or no discretion. Conversely, if there is considerable discretion, there will be power.

### **3.2. The source of the Port of Melbourne's power**

The Port of Melbourne is the only possible supplier of land in the relevant market for our inquiry; that is, the market for access to leased Port of Melbourne land by means of an applicable lease. Therefore in this market, the Port of Melbourne is a monopoly provider. This provides the underlying source of the Port of Melbourne's power.

### **3.3. Identifying constraints on power**

We considered possible constraints that may limit the Port of Melbourne's exercise of its power. While the Port of Melbourne's power is not unconstrained reflecting a mix of market characteristics and legislative and contractual arrangements, we consider it retains a significant degree of control in relation to the processes it adopts for setting or reviewing rents.

Tenants agreed with the commission's preliminary view in our interim report that the Port of Melbourne has power that it may exercise. The Port of Melbourne argued there were constraints on its scope to exercise power. This is discussed further below.

#### **Market constraints**

Most tenants have limited ability to switch or credibly threaten to switch to non-port land. Many tenants are 'locked in' to the Port of Melbourne due to significant sunk costs, and long lead times and large investments needed to explore and secure alternatives. Particularly for stevedore tenants, there is no suitable alternative provider that provides equivalent access to land goods for supplying Australia's second largest city, or to facilitate exports. These factors limit the bargaining power of most tenants.

In its response to our interim report, the Port of Melbourne argued there were constraints on its scope to exercise market power for those leases where:

- there are direct substitutes for some port land uses outside of the port area
- for land uses involving stevedoring services for dry bulk, liquid bulk, Bass Strait trades and break bulk due to competitive market constraints arising in the tenant's market
- large tenants involved in international container and motor vehicle stevedoring have strong countervailing powers.

The Port of Melbourne further noted that regardless of market constraints, in practice, the port deed requires that leases provide access to independent valuers to determine the reasonable market rent, if required.

We address these points below.

### **Substitute land**

The Port of Melbourne suggests there is viable non-port land for all uses apart from stevedoring services and some intermodal services (these services require wharf access). The Port of Melbourne suggests non-port land rents will provide an effective constraint for port land rentals because if the Port of Melbourne raised rents above this level, the tenant would relocate.

We agree with the Port of Melbourne that there is potential for substitute land to act as a market constraint. However, we consider that many of its tenants who do not require wharf access have limited non-port land options.

This is because many other tenants will either:

- not have readily available land options in areas in close proximity to the Port of Melbourne, or
- have made significant financial investments on Port of Melbourne land, which could not be re-used on any alternative land (sunk costs).

For those tenants that have invested on Port of Melbourne land, moving from the Port of Melbourne could also involve significant additional costs including new investment and relocation costs, and costs of cleaning up sites so the land could be re-leased.<sup>26</sup>

The effect of these tenant investments is that in comparing offers to move to non-port land, the tenants would have to consider the additional costs of re-locating their operations, including forgoing returns on existing sunk assets (or investments already made) and incurring new investment expenditure on the new site, plus any higher costs for their customers that could reduce their business.<sup>27</sup> This will open a material gap between otherwise comparable rents offered by non-port land suppliers and the rents able to be charged by the Port of Melbourne.

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<sup>26</sup> The Victorian Government considered a proposal to re-locate Coode Island tenants to Point Lillias, near Geelong, in the mid-1990s, but was not proceeded with due to the cost and environmental impact. See Senate Environment, Communications, Information Technology and the Arts Committees, Commonwealth Environment Powers, accessed 11 August 2020,

[https://www.aph.gov.au/parliamentary\\_business/committees/senate/environment\\_and\\_communications/completed\\_inquiries/1999-02/enviropowers/report/c04](https://www.aph.gov.au/parliamentary_business/committees/senate/environment_and_communications/completed_inquiries/1999-02/enviropowers/report/c04).

<sup>27</sup> That is, a tenant would compare:

- the present value of returns earned on the current site which equals expected revenues, less rents payable to the Port of Melbourne, less other cash costs
- The present value of returns earned at another site which equals expected revenues, less rents payable to another landlord less the full investment costs of the new site. There may be additional costs of relocating operations and expected revenues may also reduce if downstream customers switch to other suppliers or have reduced willingness to pay due to higher transport costs.

Users that are likely to have significant sunk assets at the Port of Melbourne or limited suitable alternative land include utilities, liquid bulk, dry bulk and logistics suppliers.

Based on our analysis of information provided to us by the Port of Melbourne, we consider a significant majority of tenants by share of port area or annual rent payments (in the order of 90 per cent) have little to no economically viable option but to negotiate solely with the Port of Melbourne, thereby limiting their bargaining power.

### **Competitive constraints arising in downstream markets**

The Port of Melbourne contended that competition in downstream markets can constrain its ability to charge higher rentals. It reasoned that:<sup>28</sup>

‘The constraint arises from a tenant or its customers being a price taker in the market in which it operates. In these circumstances, increases in rent above a reasonable market rate may not be able to be passed on to the tenant’s customers, and may affect the tenant’s ability to compete in the provision of services in that market. This would not be in the commercial interests of PoM and so becomes an effective constraint on rent increases above a reasonable market rate.’

We agree with the Port of Melbourne that such a constraint may exist in principle, and its power is not completely unfettered. Whether it constrains in practice is a factual matter that depends on the market price of the output and the costs of the tenant and its users.

Other evidence indicates downstream market constraints are of limited practical relevance. Rents are currently quite small relative to the tenant’s revenues, profits, or the value of goods being shipped. This means that rents may be able to increase substantially before any such constraint became material in terms of the ability to materially limit the Port of Melbourne’s power.<sup>29</sup>

Contrary to the Port of Melbourne’s submission noted above, we consider it does not necessarily follow that competition in downstream markets can constrain its ability to charge higher rentals, even if tenants are price takers that cannot pass through higher rents to end consumers.<sup>30</sup>

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<sup>28</sup> Port of Melbourne, Market Rent Inquiry 2020 Interim Report, Port of Melbourne Submission, April 2020, p. 13.

<sup>29</sup> For example, a recent estimate relating to one exported agricultural product, skim milk powder, which is transported through the Port of Melbourne, has transport costs including port charges estimated at 14 per cent of the value of output. See Agrifutures, The Impact of Freight Costs on Australian Farms, May 2019, pp. 39-40.

<sup>30</sup> For example, in commodity markets suppliers typically receive the world price less the costs of transport, which includes port costs. As increases in tenant costs cannot be passed through to end consumers, the result of higher rents would be lower payments to those who ship through the port. A constraint on higher charges would then only arise to the extent that the returns available to shippers must be sufficient to permit continued supply.

The Port of Melbourne further argues that for stevedoring services, the commission should consider the markets in which each service is operating to determine the extent of competition for stevedoring services. It argues there are constraints due to potential competition from other Victorian ports in relation to dry bulk cargo, liquid bulk cargo, Bass Strait trades and break bulk cargo.

We acknowledge that the Port of Melbourne has provided some examples where downstream constraints have led to negotiations and different agreements being struck. However, our analysis of rents paid by tenants on Port of Melbourne land does not generally indicate that the Port of Melbourne acknowledges the different constraints of such tenants by offering different rents (this is explained further in Chapter 5).

Most tenants pay rentals that are very similar, on average, to those paid for international container stevedores at the port. Evidence provided to the commission by liquid bulk tenants indicates the Port of Melbourne is seeking similar rentals in negotiations for new leases.

### **Countervailing power of international container stevedores**

The Port of Melbourne argues that for international container stevedores, increasing competition via the introduction of a third stevedore is a constraint on rent increases. Given that the Port of Melbourne is the supplier of land to all three competing stevedores, it is difficult to see how this could form any kind of constraint on the Port of Melbourne.

As a general proposition, the pass through of higher input costs is greater where all firms are subject to the same input cost increase. So more competition via a new entrant also facing the higher rent costs, would seem to pose little constraint on the Port of Melbourne itself.<sup>31</sup>

With respect to motor vehicle imports, on the basis of the evidence provided, we see little prospect that the trade could relocate to Geelong or Hastings within a reasonable timeframe if rental costs at the Port of Melbourne increased.<sup>32</sup> We note the Port of Melbourne considered these ports were a constraint on its power.

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<sup>31</sup> Moreover, many theoretical models indicate that pass through of industry-wide cost changes increases with the intensity of competition. See RBB Economics, *Cost pass-through: theory, measurement, and potential policy implications A Report prepared for the Office of Fair Trading*, 2014, pp. 4-5.

<sup>32</sup> The Australian Competition and Consumer Commission's (ACCC) competition assessment with respect to Melbourne International RoRo and Auto Terminal's acquisition of the rights to be the sole provider of roll-on/roll-off services at the Port of Melbourne suggested that: 'The Port Capacity Project will result in the terminal operator of the WDW Terminal controlling a monopoly asset, which will give it market power in respect of that asset (irrespective of who the successful bidder is).' ACCC, Public Competition Assessment: 21 July 2014, accessed 11 August 2020, <https://www.accc.gov.au/system/files/public-registers/documents/MER14%2B7895.pdf>.

## Contractual constraints on rent

The Port of Melbourne suggests that the port deed provides a constraint on leases entered into from 2016. This is because, amongst other things, it contains a provision that obliges the Port of Melbourne to include a market rent review clause with the ability for a tenant to refer a market rent review for independent determination where the parties cannot agree on the market rent for the relevant period. For leases agreed prior to 2016, there was also a market rent review clause, which was of a substantially similar form to that operating in current lease agreements.

Later in the chapter, we highlight factors that explain our view that the contractual constraints are not sufficient to avoid a conclusion that the Port of Melbourne has power in the setting and reviewing of rents.

## Legislative constraints

During the port privatisation process, economic regulation was considered as an option to constrain the Port of Melbourne's power over land rents. The Victorian Government implemented a regulatory framework which included the requirement for the Port of Melbourne to offer a market rent review mechanism with a dispute resolution process, and a periodic review by the commission on whether the Port of Melbourne has misused its market power. Generally (and as discussed further below) we find these have had little impact on constraining the Port of Melbourne's power.

Other legislative constraints that may apply to the Port of Melbourne include both federal and state legislation such as:

- **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. We note the Competition and Consumer Act 2010 would only apply if rent setting had the effect of substantially lessening competition in a market. This would only restrain the Port of Melbourne from increasing prices in very limited circumstances, that is, where this could be shown to cause a substantial lessening of competition.
- **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 behaviour in Victoria. Similar legislation can be found in most Australian states. The Act applies to 'retail premises' (as defined in the Retail Leases Act). 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. We have seen evidence that the Port of Melbourne has required tenants to warrant that the Retail Leases Act does not apply, sometimes in circumstances where arguably that Act could apply.

- **Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction Act) 2016** – 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). The Act does not appear to create any additional constraints on the Port of Melbourne’s behaviour.

Our interim report noted the Port of Melbourne would be aware of our monitoring role and that we could make recommendations to the Assistant Treasurer on whether rent setting or reviewing should be subject to economic regulation. This is not likely to mean the Port of Melbourne does not have power, as our role does not specifically affect the Port of Melbourne’s power. It may, however, mean the Port of Melbourne refrains from using its power.

### Contractual constraints

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

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.

We consider the port deed provides some potential constraints, but its effectiveness is reduced because it:

- Has not been made available to tenants or prospective tenants. While key clauses are designed to protect the interests of tenants, they are either unaware of their existence or uncertain about how they operate. This appears to undermine a key purpose of the port deed, and therefore does not operate to constrain the Port of Melbourne’s power in an effective manner.
- Expressly permits the Port of Melbourne to include ratchet clauses, which, when combined with fixed annual rent escalations, may result in an ongoing upward rent bias for future rent reviews. This reduces the ability of a regular review process to bring rents into line with market or efficient rates.
- Does not impose restrictions on the Port of Melbourne's power to set and review associated payments, such as management or other fees which may be set without reference to their costs, effectively leading to increased rental costs for tenants.

In respect of a market rent review under a port lease, a tenant or the Port of Melbourne can refer the matter to independent rent determination. The Port of Melbourne cited this process as an

important safety net for tenants. However, this process is only available for a market rent review that is due under an existing lease and not for setting a commencing rent under a new port lease.

Further, we found that, for leases where a market rent review was undertaken during the inquiry period, only a small sample of those leases were referred to an independent valuer for rent determination. Some tenants noted costs and uncertainty as reasons for not pursuing independent determinations. We also consider that the Port of Melbourne's lack of willingness to share rent and port information, and related valuation data contributes to the ineffectiveness of these constraints.

### **Other potential sources of power**

We have identified a number of other potential sources of power for the Port of Melbourne. These are summarised below:

- **To withhold land supply** – The Port of Melbourne may 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 could increase aggregate rents. However, to the extent the Port of Melbourne is able to discriminate between tenants by offering differing rents, we recognise that withholding supply may not be a profit-maximising strategy.
- **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.

### **3.4. Conclusion – The Port of Melbourne has power in the process for setting and reviewing land rents**

The Port of Melbourne holds monopoly power in relation to leased land in the port. This is because the Port of Melbourne is the only supplier of leased land in the port. This creates a strong presumption that it will have power with respect to many or all tenants. We further considered constraints on that power. We found that:

1. There are only weak market constraints on the Port of Melbourne's 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. This gives them limited countervailing power. We consider only a small number of existing tenants could viably operate on land outside the port precinct.
2. There is minimal constraint on the Port of Melbourne from ports-specific or competition legislation. This includes our observation that the commission's role to conduct a market rent

review every five years has been insufficient in constraining the Port of Melbourne's power to date.

3. There are 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. We consider there is also imprecision with the reasonable market rent provision, and it includes a range of exceptions. The ability to impose annual escalations and ratchet clauses also creates a risk that the Port of Melbourne could charge rents above reasonable market rent across the escalation period which would not be corrected after a market rent review (ratchet clauses and escalations are discussed further in Chapter 5). The port deed also does not provide a constraint to other potential sources of power for the Port of Melbourne including:
  - withholding land to reduce supply and increase aggregate rents
  - withholding information regarding occupancy costs payable by other tenants at the port
  - controlling negotiation timelines to suit their commercial interests
  - imposing management or other fees unrelated to costs.

These factors put the Port of Melbourne in a position of significant power in relation to tenants in the port which it can use to its commercial advantage, including in relation to the processes for setting and reviewing of rents for leased land in the port.

## 4. Exercise of power in negotiation processes

This chapter considers the Port of Melbourne's exercise of power in the negotiation processes for reviewing or setting rents under new leases or at market rent reviews. We cover the governing arrangements for these processes, and the approach taken by the Port of Melbourne.

As well as our own review, this chapter is informed by work undertaken by HWL Ebsworth, described in Chapter 2 (Section 2.2). The chapter concludes with our finding that the approaches of the Port of Melbourne outlined below demonstrate it has exercised its power in the inquiry period in relation to negotiation processes.<sup>33</sup>

### 4.1. Framework to guide processes for setting and reviewing rents

The key documents that describe and set out the processes the Port of Melbourne is to follow when setting and reviewing rents are:

- Port of Melbourne internal documents setting out its internal processes, approach and negotiation strategies. These are predominantly set out in:
  - the Port of Melbourne's workflow charts for new leases and market rent reviews respectively, which describe the key steps in the Port of Melbourne's processes for negotiating a new lease or a market rent review, the roles and responsibilities of different Port of Melbourne parties for each step, and the party responsible to approve each step (these flowcharts contain no timelines)
  - individual new lease negotiation and individual market rent review strategies approved by the Port of Melbourne board for each pending new lease or market rent review negotiation
  - broader port rental market and lease negotiation approaches and strategies approved by the Port of Melbourne board.
- For market rent reviews – the rent review clauses set out in existing lease agreements (providing key steps and timelines to apply to a market rent review)
- Clauses 18 and 19 of the port deed.

Below, we cover processes relating to new leases and then those applying to market rent reviews.

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<sup>33</sup> In reviewing the exercise of power we consider the context for the behaviour, such as the scope for negotiation and the information and options available to tenants, including in comparison to competitive leasing markets.

## 4.2. Processes for negotiating new leases (setting new rents)

The Port of Melbourne introduced a new approach for negotiating new leases from 1 November 2016 – the date from which it became the landlord of all leased land at the port.

A key feature of this new approach is that the following commercial terms would apply to all new leases:

- a market rent, market rent review and ratchet clauses
- guaranteed annual rent increases of [redacted] per cent or [redacted] per cent, whichever is the greater (achieved by the Port of Melbourne standard lease agreement requiring the rent to increase by the annual rent increase amount the day before a market rent review)
- minimum trade guarantees (where relevant)
- payment of annual lease management fees, often up to [redacted] per cent of the rent payable
- new leases to be concluded on the terms and conditions set out in the Port of Melbourne's new standard lease agreement.

We note that some of the above terms (such as the inclusion of ratchet clauses and payment of minimum trade guarantees) were also found in the port leases with the Victorian government prior to the privatisation of the port.

These terms have been presented to tenants or prospective tenants by the Port of Melbourne as applying to all leases negotiated from 1 November 2016, and on the basis that they are part of the standard commercial requirements of the Port of Melbourne in its leasing transactions.<sup>34</sup> They apply to new tenants, and to existing port tenants (which represent most cases) when the existing tenant's lease is about to expire, and the existing tenant has expressed an interest in negotiating another lease to enable the tenant to remain at the port.

They also apply to existing tenants that exercise their options or rights to be granted a new lease or to extend the term of an existing lease but noting that this may be precluded by the terms of the relevant lease. Where this latter circumstance arose for two new lease negotiations we reviewed, the Port of Melbourne sought the consent of the existing tenant to conclude its standard lease agreement acknowledging that the terms and conditions could be changed to ensure they were substantially similar to the terms and conditions of the existing lease.

The Port of Melbourne has indicated to existing tenants (including those that exercise options to renew or extend leases) that due to the privatisation of the port, from 1 November 2016 the Port

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<sup>34</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

must enter into its own leases with tenants. Further, the Port of Melbourne requires tenants to negotiate a new lease under its new leasing approach and standard lease agreement.<sup>35</sup>

The Port of Melbourne's lease approach and standard lease agreement is a 'new' development at the port. Existing tenants negotiating a new lease only became aware of these requirements when they initiated a new lease negotiation. Several issues with the Port of Melbourne's approach and processes relating to new leases were identified during the inquiry period. These are covered below.

### **Tenants expressed dissatisfaction with the Port of Melbourne's proposed terms for new leases**

Several tenants expressed dissatisfaction with the Port of Melbourne's proposals for new leases, including rents and the inclusion of a ratchet clause. Tenants described being 'taken aback' with terms that are 'not commercial and (with) increase(s) not justified', or terms that are 'outrageous and out of step with market reality', and 'significant and in my experience not normal.'<sup>36</sup>

The proposal to levy annual lease management fees was also raised by some tenants as being out of line with historical arrangements at the port. These fees were therefore seen as a significant new impost on existing tenants negotiating a new lease. These are discussed further in Chapter 5.

### **Processes for negotiating a new lease are not clear, leading to delays in agreements**

The Port of Melbourne has internal documents which guide its new lease negotiations. However, it does not publish information that sets out key steps, processes and timelines that are to apply to new lease negotiations, for the benefit of tenants.

This has created significant uncertainty for tenants negotiating a new lease and provided the Port of Melbourne with power in the processes for setting and reviewing rents.

One tenant expressed that there had been '... a tremendous amount of delay and uncertainty from the Port of Melbourne in relation to its direction for proposing the new lease and that it had taken months to get an offer from the Port...'.<sup>37</sup> A number of tenants raised issues about the lack of information and transparency in the lease negotiation process and the uncertainty as a result.

Many pointed to long timelines to negotiate new leases. The time taken to negotiate the new leases reviewed for the inquiry period ranged from six to 33 months. Some new lease negotiations,

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<sup>35</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>36</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>37</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

already underway for periods of more than 21 months, had still not been concluded by the end of the inquiry period.

The Port of Melbourne has noted that reaching agreement on complex lease terms can take time.<sup>38</sup>

We agree that complex lease negotiations can take time and acknowledge it requires agreement from both parties. However, we have observed protracted negotiation timeframes for a number of tenancies, some of which may not have led to efficient outcomes.

Key matters contributing to extended timelines included protracted negotiations on commercial terms, the terms and conditions of the Port of Melbourne's new standard lease agreement, and delays in the Port of Melbourne making offers once existing tenants had initiated the process to negotiate a new lease. HWL Ebsworth advised us that a reasonable time to negotiate a commercial lease is approximately six months, well below that experienced by some port tenants (see Appendix E).

### **Lack of clear processes for tenants has enabled the Port of Melbourne to use its power**

The lack of clear negotiation processes has also enabled the Port of Melbourne to exercise a range of other strategies that demonstrate the exercise of power with tenants. Our review has found examples including:

- delaying new lease negotiations to the point that an existing tenant has no commercial option but to accept the Port of Melbourne's lease terms<sup>39</sup>
- using board approval dates and processes, of which tenants are unaware, to successfully pressure tenants into making key decisions on very short notice (that is, a few days) if the tenant required the new lease to be concluded before expiration of the existing lease<sup>40</sup>
- at a very late stage in the new lease negotiation, noting intent to put a new lease opportunity out to market if the tenant does not agree to the Port of Melbourne's new lease proposals<sup>41</sup>
- stating no agreement would be reached if the Port of Melbourne new lease proposal was not accepted by the existing tenant.<sup>42</sup>

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<sup>38</sup> Confidential submission by Port of Melbourne, Market Rent Inquiry 2020 Summary of provisional commission conclusions, Port of Melbourne Submission, June 2020, p 22.

<sup>39</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>40</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>41</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>42</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

## Retrospective commencement dates for new leases

The Port of Melbourne also proposed, for an existing lease expiring in five years' time (the end of June 2022) that as a condition of securing a new lease a retrospective commencement date would need to apply (of 1 December 2017).

This was proposed so the Port of Melbourne could take advantage of its proposed new commercial lease terms (particularly the [redacted] per cent minimum annual rent increase guarantee). This would produce higher rent outcomes than it could otherwise achieve if it allowed the existing lease to run its course and was therefore required to negotiate a reasonable market rent at lease expiry.<sup>43</sup> (We note that the retrospective commencement date was not part of the final rental agreement.)

The Port of Melbourne through a King & Wood Mallesons submission<sup>44</sup> indicated that [redacted].

We note there is no issue with applying retrospective commencement dates in this way in competitive leasing markets. However, the Port of Melbourne has not addressed the specific issue raised by the commission – that in some instances the Port of Melbourne has sought to apply a retrospective commencement date before expiry of a currently effective lease.<sup>45</sup> We consider this is inappropriate given the Port of Melbourne has substantial power in the negotiating process.

The lack of clear and binding processes for negotiating new leases is providing significant uncertainty and preventing tenants from being able to engage in timely, efficient, least cost new lease negotiations. The lack of clear processes and binding timelines for negotiating a new lease has also enabled the Port of Melbourne to strategically time lease negotiations to ensure the Port of Melbourne can generate the maximum uplift of rent possible at the port. This is addressed in Chapter 5.

## The Port of Melbourne used terms sheets to its advantage

The Port of Melbourne exercised its power over lease negotiations by often only providing the full terms of the standard lease once a terms sheet with all key commercial terms was agreed. By adopting this approach, tenants were often forced to agree to headline commercial terms while costly provisions were not revealed until the standard lease was provided.

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<sup>43</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

<sup>44</sup> Confidential submission by Port of Melbourne Pty Ltd response dated June 2020, to Essential Services Commission summary of provisions commission conclusions dated 4 June 2020, Attachment 2 – King & Wood Mallesons, 16 June 2020.

<sup>45</sup> HWL Ebsworth Commercial Leasing Practice Advice – see confidential attachment 2.

We noted that some tenants had raised concerns that they were unsure whether the terms sheets were binding in our interim report. In response the Port of Melbourne noted that:<sup>46</sup>

‘The signing of a Principal Terms Sheet signals a commitment by both parties to negotiate the terms of the lease, consistent with the commercial parameters set out in the Heads of Agreement. While the signing of a Principal Terms Sheet is an indication of intent, it does not prevent a prospective tenant from choosing to not sign the legal agreement, at a future time.

In addition, the Principal Terms Sheet is non-binding, and expressly provides that it is subject to board approval from both parties.’

We accept the terms sheets were non-binding.

Our review of documents revealed that in most lease negotiations the Port of Melbourne was the only party to sign the terms sheet, while only sometimes was it signed by both parties. This seems to suggest that there is some uncertainty on the part of tenants in regard to the nature of terms sheets.

We were also able to substantiate tenant claims that the Port of Melbourne refused to proceed to subsequent stages of lease negotiation without a signed terms sheet. For example, in lease negotiations with one tenant, the Port of Melbourne refused to meet without the tenant agreeing to a number of terms. They included costly provisions such as environmental clauses.

### **The Port of Melbourne has withheld valuation information, adding to information asymmetry for tenants**

There is currently no reliable and up to date information readily available about the market for leased land in the port that can assist parties with negotiating a new lease with the Port of Melbourne. This creates a significant imbalance of power in favour of the Port of Melbourne in new lease negotiations, relative to tenants or prospective tenants.

Information about the on port rental market is a key input to enable a party to form a view about the market rent for leased land in the port. Where there is no substitute land available outside of the port, on port rental market information is the most important set of information required to enable any party to meaningfully engage with the Port of Melbourne in a rent negotiation.

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<sup>46</sup> Port of Melbourne, submission to the Essential Services Commission paper 2020, Port of Melbourne – Market Rent Inquiry 2020: Interim Report, April 2020, p. 20.

The rental market at the port is unique, complex and difficult to navigate. Rents and other terms under leases are also constantly changing.<sup>47</sup> For a party to knowledgeably negotiate, they should have access to the same market information as the Port of Melbourne. This includes access to the valuation information relied on by the Port of Melbourne to make a rent proposal, as well as broader market information to enable evaluation of the Port of Melbourne's rent proposal.<sup>48</sup>

This information is currently held exclusively by the Port of Melbourne and the single external valuer it uses for all its lease negotiations. Any requests by tenants to provide this information have been refused. The basis provided by the Port of Melbourne for this includes that:

- it is against the Port of Melbourne's policy to disclose such information
- it does not consider itself legally obliged to disclose such information
- it is not standard commercial procedure for a party to disclose such information within its possession to the other party.<sup>49</sup>

Tenants also cannot share their specific lease information with other tenants, because of confidentiality obligations imposed in their lease agreement.

This means that the Port of Melbourne effectively controls on port rental market information.

The Port of Melbourne [*redacted*].

We note that tenants and their valuers have the same information asymmetry, in that they have no access to reliable, up to date on port market information. Any information provided by the Port of Melbourne to an independent valuer is also provided on a confidential basis and not available to tenants or their valuers. Anecdotal sharing of information between tenants is also not considered a reliable source of up to date on port market information that should be relied on for negotiation.

The Port of Melbourne, through the King & Wood Mallesons Submission,<sup>50</sup> states that [*redacted*].

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<sup>47</sup> For example, during the inquiry period 24 new leases and 33 market rent reviews were completed by the Port of Melbourne. A further 11 market rent reviews were due in 2019 but had not yet commenced. A number of new lease negotiations were also underway.

<sup>48</sup> The on port rental market information that is likely to be relevant to enable a party to engage meaningfully in a new lease negotiation includes information about the different land uses (hierarchy of land uses), different ranges of rents that apply to each land use (hierarchy of rents), key attributes that differentiate land uses and rents at the port (and where applicable that differentiate leased premises falling within a specific category of land use), the land use category that applies to the premise that is the subject of the negotiations, rents or rent ranges that apply to that category of land use, and where the Port of Melbourne relies on comparative information from other categories of land uses to inform its rent offer, similar information in relation to those categories of land.

<sup>49</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1 – p. 25.

<sup>50</sup> Confidential submission by Port of Melbourne Pty Ltd response dated June 2020, to Essential Services Commission summary of provisions commission conclusions dated 4 June 2020, Attachment 2 – King & Wood Mallesons, 16 June 2020.

HWL Ebsworth advised that it was not uncommon for new lease negotiations or market rent review clauses in Victorian leases to not compel the parties to share valuation information.<sup>51</sup> However, it is now common to find commercial leases in Victoria that do require the parties to share valuation information.<sup>52</sup>

Irrespective of what might or might not be common in competitive commercial leasing markets, we consider that it is unreasonable for the Port of Melbourne to withhold valuation information, given that the Port of Melbourne is a monopoly provider of the port land.

The Port of Melbourne's actions in controlling and preventing disclosure of relevant on-port market information appears contrary to the intent of the port deed and international best practice principles that guide rent negotiations. It has become apparent that most of the tenants of port leased land we consulted were either unaware of the existence of clauses 18 and 19 of the port concession deed (deed) or uncertain about the proper operation and effect of those provisions.

We note the Port of Melbourne supports a view that the market rent for leased land at the port should be determined in accordance with internationally accepted processes and principles used for market rent negotiations.<sup>53</sup> This is embedded in the definition of a market rent from the International Valuation Standard Council and adopted by the Australian Property Institute:<sup>54</sup>

'The estimated amount for which an interest in real property should be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'

This definition sets the benchmark which the valuation industry and commercial leasing sectors generally use to guide market rent valuations and negotiations. A key principle embedded in this benchmark is that parties should act knowledgeably, prudently and without compulsion.

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<sup>51</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1 – p. 25.

<sup>52</sup> *ibid.*

<sup>53</sup> Confidential submission by Port of Melbourne Pty Ltd response dated June 2020, to Essential Services Commission summary of provisions commission conclusions dated 4 June 2020, Attachment 3, p. 2.

<sup>54</sup> The Port of Melbourne and its external valuer use this definition for purposes of setting and reviewing rents at the port. All market rent assessments and valuations prepared for the Port of Melbourne for these purposes, and made available to the commission during this inquiry, use this definition as the basis for preparing rent assessments and valuations to be used by the Port to inform its negotiations for setting and reviewing rents at the port.

Clause 18.1 of the port deed adopts the same approach for determining the reasonable market rent in new lease negotiations captured by clause 18 and 19 of the port deed, whilst specifically mentioning matters to have regard to when determining a reasonable market rent.<sup>55</sup>

These arrangements recognize that a level of information should be reasonably accessible and available to the parties negotiating a new lease to enable each party to form a view about what might constitute a reasonable market rent for lease port land, and to engage in an informed, prudent and willing lease negotiation.

### **The Port of Melbourne delays the provision of standard terms and conditions of leases**

The Port of Melbourne's standard lease agreement is not publicly available. It is also only usually provided in new lease negotiations after the commercial terms have been agreed.

The new standard lease agreement contains important non-rent related terms and conditions of lease, many of which have significant legal, financial and risk implications.<sup>56</sup> These terms and conditions can significantly influence decisions to enter into leases and terms included in the lease.

The commission considers the Port of Melbourne's approach places the tenant at significant disadvantage and does not facilitate informed and efficient lease negotiations. Several tenants have reported their dissatisfaction with this practice to us during our inquiry.

### **No external mechanism to resolve disputes arising in new lease negotiations**

We note that during the inquiry period the overwhelming majority of new lease negotiations were with existing tenants.<sup>57</sup> There is currently no external mechanism available to existing tenants or other parties to have any disputes arising during a new lease negotiation resolved independently (including through the independent determination processes under the port deed).

The lack of such a mechanism creates a significant imbalance of power in favour of the Port of Melbourne in new lease negotiations. We consider that such a mechanism is desirable given the examples of the exercise of its power noted above. Existing tenants currently have very little available to them to countervail this power.

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<sup>55</sup> Clause 18(c)(vi) of the port deed [*redacted*].

<sup>56</sup> Examples of such terms and conditions include terms relevant for market rent reviews (particularly terms that propose to reduce or prevent any benefit from a market rent review accruing to a tenant) obligations at expiry (e.g. removal of tenant goods), removal of Landlord notified improvements, rights of the landlord to require surrender of the premises on limited notice, environmental reporting and clean up obligations, terms and conditions of renewals and options for further leases, length of notification periods, and circumstances for and obligations on default and termination of the lease.

<sup>57</sup> The Port of Melbourne advised commission staff that it requires all existing tenants that hold an option to renew or extend an existing lease, to negotiate and conclude a new lease on the Port of Melbourne's standard lease terms. Tenant submissions have also referred to this requirement.

### **4.3. Processes for reviewing rents (market rent reviews)**

The process for undertaking a market rent review is set out in an existing tenant lease. This process applies to all port tenants holding existing leases, regardless of when the lease was concluded, provided the lease allows for a market rent review.

As noted in Chapter 3, the commission considers that the market rent review mechanism and the ability for parties to seek independent determination, can be ineffective when used in the context of a monopoly provider of leased land.

#### **The Port of Melbourne controls the timing of market rent reviews**

Lease agreements at the port generally allow only the Port of Melbourne to initiate a market rent review. There is no time limit by which the Port of Melbourne must initiate a market rent review.

As with new lease negotiations, this enables the Port of Melbourne to strategically time the initiation of market rent reviews to ensure that it can generate the maximum uplift of rent possible at the port (discussed further in Chapter 5). This also means that the Port of Melbourne can initiate a market rent review some years after it is due, in some cases up to two or three years after the scheduled date. This is considered by many tenants to be unfair and unreasonable.<sup>58</sup>

We acknowledge the Port of Melbourne was obliged under the Port Lease Transaction to undertake and complete outstanding market rent reviews as soon as reasonably practicable after the port privatisation transaction. This however, created significant uncertainty for tenants. It also presents significant challenges for valuers when market rent reviews are initiated some years after the actual rent review date.

This is particularly the case at the port because of the nature of leases at the port and the challenges tenants face with being able to access reliable information about the on-port rent market. This includes historic rent information and information about developments at the port (such as the Port Capacity Project) that have had a significant impact on the port rental market.

We are advised by HWL Ebsworth that it is common for commercial leases to impose a time limit by which a party can initiate a market rent review after the relevant market rent review date has passed (usually no later than six to 12 months after the market rent review date). Such a mechanism better balances the interests of both parties in a market rent review and is intended to address issues related to uncertainty and perceived inequity.

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<sup>58</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

As noted earlier, the Port of Melbourne includes a ratchet clause in its standard form lease. This can constrain rents from falling, even when rents may be higher than their efficient level.

### **Like those negotiating new leases, tenants also face an information asymmetry in market rent reviews due to the lack of on port rental market information**

As with existing tenants negotiating new leases, tenants engaging in market rent reviews are unable to easily access reliable and up to date information about the market for leased land in the port. This precludes them from being able to meaningfully engage with the Port of Melbourne in market rent review negotiations.

As with new lease negotiations, the Port of Melbourne has refused requests from several port tenants to disclose the valuation advice provided to it by the port valuer and other relevant market information within its possession required to facilitate a meaningful and informed rent negotiation. This approach is inconsistent with the valuation principle discussed above that parties should act knowledgeably.

#### **4.4. Conclusion – the Port of Melbourne has exercised its power in the negotiation processes for setting and reviewing rents**

Many of the Port of Melbourne's behaviours as outlined above contributed to a lack of transparency and information asymmetry for tenants, hampering their ability to effectively and knowledgeably negotiate with the Port of Melbourne during the inquiry period. We consider these examples reflect an exercise of the Port of Melbourne's power in the process for reviewing or setting rents.

The commission has also made some observations about compliance by the Port of Melbourne with clause 18 and 19 of the port deed during the inquiry period. These are expanded upon at Appendix F. These include observations about the role of the Port Lessor in ensuring that the Port of Melbourne complies with its obligations under clause 18 and 19 of the port deed.

## 5. Exercise of power in rent outcomes

This chapter focuses on the strategies adopted by the Port of Melbourne in relation to rent outcomes during the inquiry period. Like Chapter 4, our analysis was supported by HWL Ebsworth's review of documents including a sample of leases provided to us by the Port of Melbourne.

Our inquiry has found the Port of Melbourne adopts a range of strategies that taken together, we consider has contributed to significant increases in rent outcomes in the inquiry period.

As well as further demonstrating the exercise of its power, the effectiveness of the strategies outlined below leverage from the information asymmetry and uncertainty fostered by the Port of Melbourne as identified in Chapter 4. The chapter concludes that the strategies adopted by the Port of Melbourne have contributed to rents being above efficient levels.

### Efficient rents

In this chapter, we make observations about the strategies adopted by the Port of Melbourne and whether they are likely to result in rents reflecting efficient levels, consistent with those that would be found in workably competitive land rental markets. Rents that are higher than their efficient level can be one indicator of material detriment, which we explore further in Chapter 6.

As well as many well-informed tenants, in workably competitive land rental markets there would be a number of possible suppliers of suitable land so each supplier faces a degree of rivalry.<sup>59</sup> While suppliers may have some discretion over rents, none would have a substantial degree of market power – so rents will settle towards their efficient level.

Despite the application of a reasonable market rent provision in the port deed, rents may still rise above their efficient level. This could be due to the Port of Melbourne being the sole provider of leased land at the port, combined with significant barriers for tenants to access substitute alternative land, or information asymmetry arising from the inability of tenants to access reliable, up to date on-port market information to inform rent negotiations. For the same reasons, outcomes for other lease negotiations may similarly not reflect efficient rent levels.

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<sup>59</sup> 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.

## **5.1. The Port of Melbourne’s valuation and rent negotiation process focuses on referencing rents to those set for prime port land**

During our review, we found that Port of Melbourne management were required by its board to ensure that the rents for large international container terminal stevedores were used as a market reference point for all rent reviews.<sup>60</sup> We note there is a hierarchy of land uses and valuations for land at the Port of Melbourne with stevedores (especially international container terminal stevedores) at the apex. The service provided by these stevedores necessarily requires them to have direct access to prime land at the port.<sup>61</sup>

The value of land that enables the provision of international container stevedoring is higher than the value of other land at the port. The Port of Melbourne acknowledges that international container stevedoring land could be of higher value given ‘...the significantly higher utility resulting from these operations’.<sup>62</sup>

In a workably competitive market for non-international container stevedore land, these rents appropriate for international container stevedores could not be persistently applied to other tenants. It would therefore be an exercise of power if the Port of Melbourne were able to implement and then sustain rents for other land based on (or not adequately differentiated from) international container stevedore rents.

## **5.2. The Port of Melbourne has not always sufficiently adjusted rents to reflect permitted land use**

We have found that the Port of Melbourne in setting rents has had insufficient regard for the different uses of the land at the port. This is in part due to the confidentiality of the port deed. If tenants were fully aware of the port deed requirements they would be in a better position to negotiate.

We have identified examples where the Port of Melbourne has flowed higher value rents for higher value land – predominantly international container stevedores – across different land uses. These examples are set out at Appendix G, which also includes a brief description of the tenant’s

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<sup>60</sup> This information was included in documents provided to us in response to our section 37 information request under the ESC Act, to the Port of Melbourne.

<sup>61</sup> Factors influencing the value of land include water depth in channels and at berth, coastal geography, inland geography, tidal range and other factors.

<sup>62</sup> Port of Melbourne, submission to the Essential Services Commission paper ‘Port of Melbourne market rent inquiry 2020 interim report’, April 2020, p. 14. The Port of Melbourne refers to international container and motor vehicle stevedoring. While it refers to the higher utility of these operations, it argues rents at the port are constrained by long-term leases, market testing of rental rates, countervailing powers of large tenants and the requirement for access to independent valuation within the port deed.

business which forms the basis for their location at the port. As described in Appendix G, the target tenants' business operations and intended use of land are different to those of international container stevedores.

Another reason for concern regarding the use of benchmarks without adjustment is that many lease transactions involve land leasing but also other arrangements. We agree with a submission by a valuer to the interim report which noted that:

'...the typical circumstances where lease agreements relating to Port land are not independent of other parallel agreements between the same parties...there are associated and simultaneous commercial agreements dealing with various port operations.'

The implication of these arrangements is that the rent negotiated is not a true market rent that would be derived in a workably competitive market.

A key example of this are leases that include concessions for high value activities, which necessarily increase the value to tenants. These actions result in a situation where the rent included in the benchmark is inflated because it does not simply reflect the value of the land, and reflects the power of the Port of Melbourne in the market for leased land at the port.

Reflecting the above, we consider there will be rents that for a number of lease negotiations is too high for the intended use and is unlikely to be achievable in a workably competitive market. That is, the strategies adopted by the Port of Melbourne means rents will be above an efficient level.

The Port of Melbourne's approach could also be considered as contrary to the intent of the port deed, noting matters such as [redacted] are matters the Port of Melbourne must consider under clause 18(1)(c) of the port deed (see Appendix F for more information on our views on the Port of Melbourne's compliance with the port deed).

### **There is evidence rents have converged to stevedore rates**

The Port of Melbourne suggests a narrow gap in rents across their different tenants implies it has limited power in setting stevedore rents.<sup>63</sup> In our view, the narrow gap implies the Port of Melbourne has power in the non-international container stevedore rent market and has exercised that power to raise rents for these tenants closer to those for international container stevedores.

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<sup>63</sup> Port of Melbourne, submission to the Essential Services Commission paper 'Port of Melbourne market rent inquiry 2020 interim report', April 2020, p. 14.

Non-international container stevedore rents have been rising towards international container stevedore rents rather than other way around, as may occur if the Port of Melbourne had limited power in setting and reviewing non-international container stevedore rents.

Figure 5.1 plots the rent outcomes for the negotiations identified in Appendix G where we consider the Port of Melbourne has effectively sought to apply unadjusted international container stevedore rent levels to non-international container stevedores. This strategy has pushed non-stevedore land rents towards stevedore rents (in this case towards the red line in the chart below).

**Figure 5.1 The development of selected non-stevedore rents v stevedore rents (\$/m<sup>2</sup>)**

[REDACTED]

### **5.3. The Port of Melbourne typically adopts a 'stretch range' rent to start negotiations**

The Port of Melbourne typically informs each lease negotiation with advice from their external valuer. Partly reflecting the considerable uncertainties inherent in such valuations, the Port of Melbourne's external valuer typically presents various ranges for the expected rent – a low rent range, a 'market rent' range and a high rent range, sometimes called a 'stretch range'.

The approach to valuations described above (with a focus on prime land) informs the range the Port of Melbourne adopts in its negotiations with tenants.

The Port of Melbourne would often commence negotiations with a tenant by offering the stretch range rent, with a view that the tenant would ultimately negotiate the Port of Melbourne down.

However, in one new lease negotiation we reviewed, the Port of Melbourne commenced negotiations at a rent level that exceeded the stretch range.<sup>64</sup> This negotiation was concluded at

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<sup>64</sup> See HWL Ebsworth Process Review Report at confidential Attachment 1.

the commencing rent proposed by the Port of Melbourne, which was a rent well above what the Port of Melbourne's external valuer considered a reasonable market rent.

We also found in some other cases that the rent agreed by parties would be a rate which is lower than the stretch rent, but higher than the 'market rent range' assessed by the Port of Melbourne's valuer.

### Data on valuations and negotiation outcomes

In support of its approach, the Port of Melbourne submitted data summarising the differences between its 'negotiation range' and rent outcomes for several market rent reviews, and new leases conducted during the inquiry period.<sup>65</sup> We verified the negotiation range for each outcome is based on information on a likely rent range provided by the Port of Melbourne's external valuer and consistent with information submitted to the Port of Melbourne board.

The Port of Melbourne contends its data demonstrate that:

- no rent outcomes exceeded the valuation range provided by its external valuer
- many outcomes were agreed under commercial negotiations with tenants at or below the bottom of the valuation range
- the majority of market rent reviews were negotiated without either party needing to exercise their rights to independent determination as per the conditions within individual lease agreements.<sup>66</sup>

Figure 5.2 compares the valuation ranges with rent outcomes for tenants that underwent market rent reviews during the inquiry period. It largely replicates a similar figure the Port of Melbourne provided to the commission (in response to our provisional conclusions) with the following modifications to:

- include an indicative estimate of the initial valuation suggested by the tenant (where we have that information)<sup>67</sup>

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<sup>65</sup> Confidential submission by Port of Melbourne, Market Rent Inquiry 2020 Summary of provisional commission conclusions, Port of Melbourne Submission, June 2020, pp. 5 and 13.

Port of Melbourne Submission to Summary of provisional commission conclusions – Addendum, 3 July 2020, p. 3.

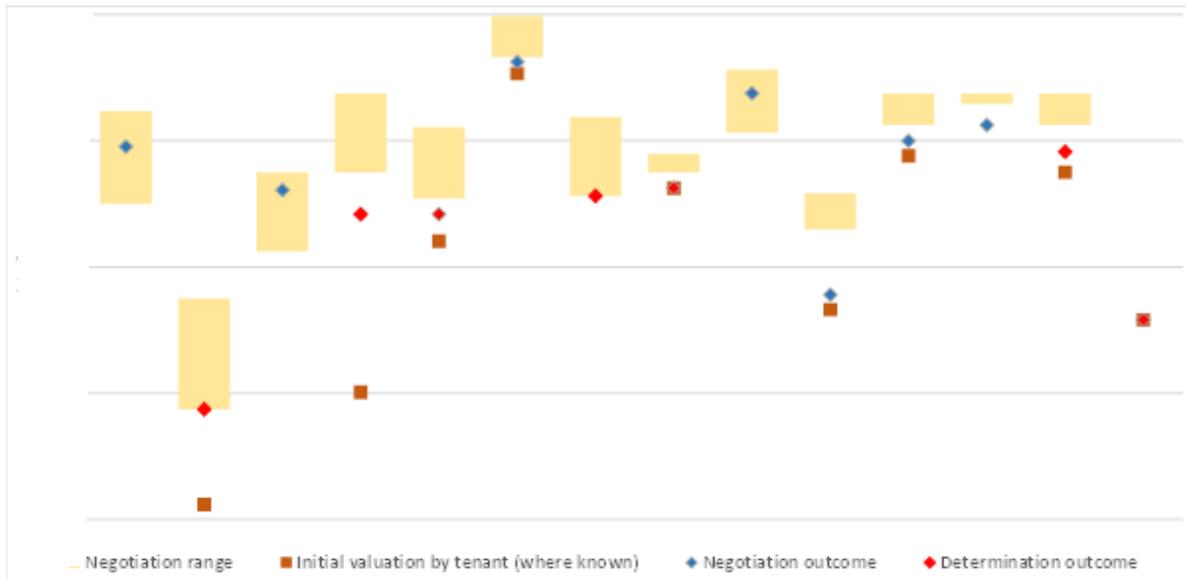
<sup>66</sup> Confidential submission by Port of Melbourne, Market Rent Inquiry 2020 Summary of provisional commission conclusions, Port of Melbourne Submission, June 2020, p. 13.

Port of Melbourne Submission to Summary of provisional commission conclusions – Addendum, 3 July 2020, p. 3.

<sup>67</sup> This information has been compiled from an analysis of correspondence between the tenant and the Port of Melbourne. An initial valuation estimate from the tenant is not available for all leases included in the chart.

- distinguish rent outcomes that were commercially agreed from those that were resolved by independent determination.

**Figure 5.2 Sample of market rent review outcomes for market rent reviews (\$ per m<sup>2</sup>)**



Source: Compiled from information provided by the Port of Melbourne in submissions and under section 37 of the Essential Services Commission Act. This includes 'Figure 1 Outcomes compared to valuation ranges for MRRs during the review period' that was included in:

- Confidential submission by Port of Melbourne, Market Rent Inquiry 2020 Summary of provisional commission conclusions, Port of Melbourne Submission, June 2020, page 13
- Port of Melbourne Submission to Summary of provisional commission conclusions – Addendum, 3 July 2020, page 3

In our view (and noting the subjectivity of valuation processes) the most significant takeout from the data above is that all independent determinations were either at the bottom of or below the lowest point in the Port of Melbourne's valuation range. We also note that most negotiated outcomes also generated outcomes below the Port of Melbourne's original negotiation range.

This suggests that the valuations relied on and approach adopted by the Port of Melbourne in rent negotiations are consistently pitched at rent levels that are above rent levels determined by independent valuers.

#### **5.4. The Port of Melbourne has introduced management fees, which do not appear to be linked to its costs**

Management fees are included in the Port of Melbourne's standard lease document. Although the rate imposed can vary across tenants, it ranges from [redacted] per cent of rent revenue.<sup>68</sup>

We note that most port leases prior to privatisation allowed for the Port Lessor to recover management fees as part of the building outgoings payable under the relevant port lease. However, we found that the Port Lessor on most occasions did not enforce this provision. After privatisation, the Port of Melbourne elected to enforce payment of management fees, and keep it as a standard commercial requirement of the Port of Melbourne for new port leases.

Tenants submitted the Port of Melbourne does not justify either the imposition or the rate of management fees. Moreover, nothing in the primary documents we have viewed discusses the rationale for management fees or explains their level in particular leases, across all leases or as a cost category for the overall business. We note the Port of Melbourne estimates the costs it incurs in managing its land property portfolio are around [redacted] per cent of rent revenue.<sup>69</sup>

We have observed a number of instances in primary documents provided by the Port of Melbourne to us that show when challenged by tenants on the proposed management fees, it simply reduced the rate as a negotiating point. This behaviour suggests management fees are another component of the rent and up for negotiation as part of lease negotiations. Reducing the level of the management fee, instead of lowering the rent, also preserves the precedent component of rent for subsequent lease negotiations.

The rapid increases in rent levels since the Port Lease Transaction means management fees now apply to a higher base rent, resulting in tenants' aggregate costs associated with access to land at the Port of Melbourne rising sharply over the inquiry period.

The Port of Melbourne has contended the recovery of property management expenses falls within the usual commercial constraints on prices. This contention fails to appreciate that management fees cannot be considered in isolation.

From a tenant's perspective, the viability of leasing Port of Melbourne land will depend (among other things) on the total costs (including rent and associated payments) of that access. Therefore,

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<sup>68</sup> Port of Melbourne, submission to the Essential Services Commission paper 'Port of Melbourne market rent inquiry 2020 interim report', April 2020, p. 18.

<sup>69</sup> Port of Melbourne, submission to the Essential Services Commission paper 'Port of Melbourne market rent inquiry 2020 interim report', April 2020, p. 19.

the tenant will likely view management fees as simply a fixed component of the rent in the sense that it cannot do anything to alter or reduce that cost – short of not leasing the land or leasing less land. In this sense, management fees are effectively a component of rent.

Reflecting the above factors, we regard management fees to be a component of rent, albeit calculated differently to the other rent components. It is likely tenants would also consider them as such; that is a cost consequent on leasing land at the port.

It appears the Port of Melbourne has little or no constraints on its ability to charge management fees to tenants. Instead, the imposition of management fees and the sharp rise in associated revenue is evidence of an exercise of power.

## **5.5. The Port of Melbourne’s use of ratchet clauses can add to the escalation of rents**

As noted in Chapter 4 the Port of Melbourne includes a ‘ratchet clause’ in its standard form lease, meaning they are in most, if not virtually all, finalised tenant leases. While allowable under the port deed, we note that ratchet clauses prevent a rent from decreasing at a market rent review to a level below that prevailing immediately prior to the review. This can constrain rents from falling, even when rents may be higher than their efficient level. We also note that ratchet clauses were part of the port leases that the tenants entered into with the State Government prior to privatisation.

We have concluded that the inclusion of ratchet clauses in leases has not materially impacted tenants during this inquiry period. However, they reflect an exercise of power and can be used to contribute to an upward spiral in rents particularly when used in combination with the Port of Melbourne’s minimum annual rent increase of the consumer price index plus [redacted] or [redacted] per cent, whichever is greater.

We have reviewed a range of primary documents relating to the setting and reviewing of rents conducted over the inquiry period and have not found any justification of the escalation approach applied by the Port of Melbourne.

The combined impact of ratchet clauses and the [redacted] annual escalations is likely to be more evident in future rent setting processes at the port, where the market rent may potentially fall below the rent payable in the preceding year but would be prevented by the ratchet clause from decreasing under the port lease. Given the coronavirus pandemic, there is a possibility that market rents may fall during the next inquiry period.

Further, we note that the port deed obliges the Port of Melbourne to [redacted]. This suggests that the port deed recognises that some benefit from a market rent review will accrue to a tenant. But the ability of the Port of Melbourne to include a ratchet clause in leases reduces the ability of a regular review process to bring rents into line with market or efficient rates.

As noted earlier in this report, the Port of Melbourne has argued the port deed offers effective contractual constraints on its power in relation to the setting and reviewing of rents at the port. However, we argue that such constraint is diminished to a certain extent by the provisions of the port deed which expressly permit the Port of Melbourne to include ratchet clauses in new port leases.

#### **Ratchet clauses, escalation, and associated payments (excluding management fees)**

The annual escalation of rents combined with ratchet clauses can push and sustain rents above efficient levels. Along with the ability of the Port of Melbourne to charge tenants other fees, not directly linked to its costs, this could result in inefficient costs being incurred by tenants in future regulatory periods.

We have concluded that overall, the use of ratchet clauses has not materially impacted tenants in the inquiry period but may cause material detriment to tenants in future inquiry periods. Appendix H includes more detail on our findings in relation to ratchet clauses and escalation, and associated payments (minimum trade guarantees and land tax).

### **5.6. The Port of Melbourne has sequenced negotiations to its advantage**

After the Port of Melbourne's commercial operations were leased in 2016, there were a number of market rent reviews that had not yet been initiated, despite being well past the market review date in the relevant lease contract. It appears these market rent reviews had been put on hold while the Port Lease Transaction was in the process of being implemented.

We understand that there were resourcing issues through the period that the Port Lease Transaction was under consideration and that these persisted beyond that time. The Port of Melbourne advised that the prioritisation of pending market rent reviews had regard to organisational capability, size and significance of the lease, and other factors.<sup>70</sup> These considerations are likely to have impacted the timeline for addressing the backlog.

However, we have found examples in the Port of Melbourne's board papers that there are other reasons for the sequencing of the rent review process that are at least additional to those acknowledged in the Port's submission. In particular, the board minutes explicitly point to the strategic value of stevedore rents and the need to sequence rents by focusing on high valuations early, rather than to progress reviews in parallel. For example, in the market rent review process

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<sup>70</sup> Confidential Port of Melbourne, Market Rent Inquiry 2020 Summary of provisional commission conclusions, Port of Melbourne Submission, June 2020, p. 29.

for one tenant, the Port of Melbourne internal strategy plan stated that it was strategically prudent for it to [redacted]. The strategic sequencing of rent reviews reinforces the other strategies adopted by the Port of Melbourne noted above, including insufficient adjustments to take into account the characteristics of different land at the port.

Information supporting our views above in relation to the strategic sequencing of market rent reviews is provided at Appendix I.

## **5.7. The Port of Melbourne is recycling monopoly outcomes**

We consider the tactics adopted by the Port of Melbourne as described earlier in this chapter and in Chapter 4 (which foster information asymmetries and uncertainty over the negotiation process for tenants) has resulted in rents that are above efficient levels.

As noted above, the main approach the Port of Melbourne uses to inform rents is to benchmark rents against other on-port rent outcomes. The rents it uses as benchmarks do not account for monopoly returns, including those that arise from insufficient differentiation that would account for the different uses of leased land.

The port deed constraints on valuation do not appear to rule out ongoing land revaluation with reference to other port tenants. Any framework that allows rents for a port lease to be set with reference to other rents for leases also on port land may facilitate monopoly returns. As the Australian Competition and Consumer Commission noted, revaluing land to take account of other rents at the Port of Melbourne ‘...is inappropriate as it would lead to a continuing upward spiral in prices.’<sup>71</sup>

As a result, we expect rents at the port to persist above levels that would occur in workably competitive markets and include monopoly returns. Given the lack of effective constraints and valuers’ almost universal application of on-port benchmarks in setting and reviewing rents, the inclusion of monopoly returns has contributed to rents being above efficient levels.

## **5.8. Rents at the Port of Melbourne have increased significantly**

From a sample of new agreements following market rent reviews, we found examples of rents more than doubling in the inquiry period. One agreement led to rents increasing threefold. The

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<sup>71</sup> Australian Competition and Consumer Commission submission to the inquiry into the proposed lease of the Port of Melbourne, September 2015, p. 9.

increases in rents in the sample of leases reviewed by HWL Ebsworth is provided at Annexure C of confidential Attachment 2.

We noted earlier that in 2015-16, rents and licence fees comprised 14 per cent of the port's total revenue (or \$53.8 million of \$394.2 million).<sup>72</sup> By 2018-19, 'property revenue' was almost 29 per cent of the Port of Melbourne's total income (or \$193.7million of \$672.5m).<sup>73</sup> We understand growth in rent and associated income has increased for various reasons.<sup>74</sup>

Although we do not have specific data to confirm, many tenants have acknowledged their rents were 'below market rates' prior to the Port Lease Transaction. This means there has been a degree of 'catch-up' in the rents since the Port Lease Transaction, as the Port of Melbourne has:

- transformed management of its land portfolio and conduct in rent negotiations to more commercial settings
- increased its target return required on leased land
- unwound any public interest component previously embedded in rents.

Despite general tenant acceptance that rent increases were necessary, many felt that the rate of increase over recent years was too rapid.

Analysis by the Australian Competition and Consumer Commission has shown that the average rent per square metre for the three international container stevedore tenants at the Port of Melbourne is significantly higher than the other major ports across Australia and also increased relatively strongly over the period from 2017-18 to 2018-19 (Figure 5.3). This rapid increase was an issue raised by stevedores in the Port Pricing and Access Review (PPAR) commissioned by the Victorian Minister for Freight and Ports.

A common theme raised by the stevedores in the PPAR was the impact of rapid recent increases in land rentals on their cost base and the need to increase landside charges, at least in part, to recover these costs.<sup>75</sup>

While there are questions over the level and increase of international container stevedore rents at the Port of Melbourne, perhaps more concerning (from an efficiency perspective) is the use of

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<sup>72</sup> Port of Melbourne Corporation 2016, Annual Report 2015-16, p.69

<sup>73</sup> Lonsdale Finance Pty Ltd, Listing prospectus 10 September 2019, p.161

<sup>74</sup> As well as increase in rent levels, it also will reflect factors such as growing activity at the port, and the Port Capacity Project.

<sup>75</sup> Victorian Department of Transport, Independent review of the Victorian Ports System: Discussion Paper, July 2020, p. 39.

some international container stevedores as a benchmark in setting rents for other tenants at the Port of Melbourne, as discussed above.

**Figure 5.3 Average rent per square metre, 2017-18 to 2018-19**



Source: ACCC analysis of container stevedores' submissions to the monitoring regime. Deflator series derived from the ABS CPI (cat. no. 6401.0, tables 1 and 2, Index Numbers; All Groups CPI; Australia). Base year for ACCC deflator series: 2018-19.

Note: Average port rents per square metre calculated by dividing the sum of total fixed and variable port rents in a given container port by total leased areas designated for international container terminals. Excludes lease outgoing costs. Vertical axis of chart intentionally left blank.

ACCC, Container stevedoring monitoring report 2018-19, October 2019, p. 71.

## **5.9. Conclusion – the Port of Melbourne has exercised its power in the processes for setting and reviewing rents**

The Port of Melbourne has adopted a range of strategies that taken together, reflect an approach to inflate rent outcomes. Tactics such as starting negotiations at a stretch rate, and sequencing market rent reviews to maximise rent outcomes, leverage from the information asymmetries and uncertainty faced by tenants, as discussed in Chapter 4. This resulted in an inflation of rents across the port during the inquiry period. Further, the behaviours adopted by the Port of Melbourne given its status as a monopoly provider will mean that prices or rents for some tenants subject to new leases and market rent review in the inquiry period are inefficiently high.

## 6. Assessing material detriment

As set out in earlier sections, our inquiry has found:

- The Port of Melbourne has power in the relevant market (that is, leased Port of Melbourne land), as the only supplier of land in this market and many of its tenants have no commercially viable option but to negotiate with the Port of Melbourne.
- The Port of Melbourne has exercised its power in the relevant market in terms of the rents it has set and in its conduct in negotiations with tenants.

In this Chapter, we set out our views that:

- Tenants experience material detriment that flows from the Port of Melbourne's exercise of power. Material detriment to consumers is experienced via the pass through of effects that are directly experienced by tenants, to the tenant's customers and then onto consumers (covering households and businesses).
- The pass through of material detriments from tenants to consumers will occur in the long term, although the effects are less readily apparent in the shorter term.

### 6.1. Our framework for assessing 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
- section 48A of the Port of Melbourne Act which requires the commission to have regard to sections 1, 8 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 consider that material detriment is a concept that includes factors related to economic efficiency, which influences the long term interests of Victorian consumers.

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'*

Our powers and functions are regulated by the ESC Act. The purpose of the ESC Act is to enable the commission to perform all regulatory and advisory functions in a manner that provides incentives for dynamic, productive and allocative efficiency and promotes the long term interests of

Victorian consumers.<sup>76</sup> Our objective under the ESC Act is to promote the long term interests of Victorian consumers, having regard to the price, quality and reliability of essential services.<sup>77</sup>

We must also have regard to other matters to the extent they are relevant. This includes efficiency in the relevant industry, incentives for long term investment, the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries, the costs and benefits of regulation and any matter specified in the empowering instrument (including relevant legislation).<sup>78</sup>

Section 48A of the Port Management Act requires us, in addition to the objectives and matters outlined above, to have regard for the objectives set out in section 48 of the Port Management Act. While some objectives only apply to prescribed services, the objectives largely mirror the efficiency objectives of the ESC Act.<sup>79</sup>

Our assessment of detriment focuses on aspects related to efficiency. But it is not the only factor. Expressed in terms used in the ESC Act, if the rent is the price of a lease, its terms and conditions are aspects of the 'quality' of the service provided. The security of tenure (including the duration and termination or renewal provisions) is part of the 'reliability' of that service, and the available information and processes are part of the efficiency of delivery of the service.

Since price, quality, reliability and efficiency are all concerns of the commission when assessing the interests of consumers, they are also relevant considerations in an inquiry that considers the way that power has been exercised and the outcomes or resulting detriment from use of power.

We are also required under section 53(3)(c) of the Port Management Act to have regard to the extent to which rents may (emphasis added) be passed through the supply chain. That is, how rents paid by a tenant may be passed through to users of services provided by the tenant, to other customers, and ultimately to consumers. Harm to tenants through higher than efficient rents would be expected to create detriment to the long-term interests of consumers if they were passed through in higher prices, reduced competition, or reduced quality, reliability, or efficiency.

For us to make recommendations on any new form of economic regulation, any detriment must not be trivial, transitory, or immaterial. It must apply to the interests of consumers as a whole.

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<sup>76</sup> Essential Services Commission Act 2001 (Vic), s 1.

<sup>77</sup> Essential Services Commission Act 2001 (Vic), s 8.

<sup>78</sup> Essential Services Commission Act 2001 (Vic), s 8A.

At the time of making a finding, the effect of material detriment must have occurred and be continuing, must be currently occurring or must necessarily arise. It is possible to find an effect of material detriment that occurs outside the inquiry period if the exercise of power occurred in the inquiry period, the detriment will necessarily arise and there is a causal connection.

The Port of Melbourne submitted that to demonstrate a finding of material detriment to the long term interests of Victorian consumers, we would need to consider factors such as the size of the excessive rental level against a competitive rental benchmark, the relative contribution of the tenant to the Victorian economy, and the extent to which the activities of the tenant has a wide impact within the Victorian economy.

We do not accept the Port of Melbourne's contentions, noting there is no obligation on us to undertake the kinds of analysis it proposes. Further, we note benchmarking studies have limitations given the difficulties in identifying suitable competitive benchmarks due to differences in the locational characteristics of alternative land, and the need to adjust for any monopoly rent components for comparable ports in Australia. We also note tenants can experience detriment that is not directly related to the level of rents.

## **6.2. Detriment to port tenants**

We conclude that the effect of material detriment has occurred and is continuing to occur in relation to tenants as:

- there is no publicly available clearly articulated and binding process for negotiating new leases
- tenants have no access to reliable, up to date on-port rental market information to be able to determine the market rent for land in the port and to engage in rent negotiation on an informed basis consistent with internationally and locally accepted practices and principles
- rents for some tenants subject to new leases and market rent review in the inquiry period are inefficiently high
- higher negotiation costs have arisen than what would occur in a better functioning system (with examples of negotiation processes running for as long as three years)
- we have been provided with specific examples of deferred tenant investment, and a reduced ability to lock in contracts with new customers due to uncertainty around tenure.

### **6.3. Material detriment to the long term interests of Victorian consumers**

To determine the magnitude of pass through from tenants to Victorian consumers in the short run is a complex task. Business costs are affected by a range of different factors, and rents and other port costs are a small component of total costs.<sup>80</sup> Further, land rents are a fixed cost.

Nonetheless, even if one observes little short term effect from higher rents or costs, we must consider the 'long term' interests of Victorian consumers. This includes allowance for time for tenants to adjust to the change in outcomes, to make investment decisions and to implement growth, and entry or exit strategies.<sup>81</sup> We consider that material detriment in the form of higher rents or costs felt by tenants (that are not solely exporters) will be passed through to those tenants' customers, downstream users and ultimately, in the longer term, to Victorian consumers.

As required by the Port Management Act, we have had regard to the extent to which any rents or associated payments 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.

Table 6.1 lists a range of different tenants of the port and the way that tenant may pass on costs to consumers. The level of competition in and structure of a tenant's downstream market is the major factor in how detriment will be experienced by consumers. Two circumstances become evident.

The first identifies where there is limited competition in downstream markets or where all competitors face a similar increase in costs. In this case, Victorian consumers would experience detriment from higher prices.

The stevedoring industry is the main example in this category as all competitors are experiencing a similar increase in costs.

Demonstrating broader harm, a common theme raised by the stevedores in the Victorian Government's Port Pricing and Access Review was the impact of rapid recent increases in land rentals on their cost base and the need to increase landside charges, at least in part, to recover these costs.<sup>82</sup>

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<sup>80</sup> Noting that if an exporter's transport costs rise excessively they may shift production to another product (that can be transported through another port, or even to air freight) and as a consequence, also reducing efficiency.

<sup>81</sup> Australian Competition Tribunal, Re Seven Network Limited (No 4) [2004] ACompT 11 (23 December 2004).

<sup>82</sup> Victorian Department of Transport, Independent review of the Victorian Ports System: Discussion Paper, July 2020, p. 39.

The second scenario relates to sectors where a tenant’s competitors do not face a similar change in costs. While there is less ability to directly pass these costs on, Victorian consumers are likely to face detriment in the longer term because tenants will substitute to other (less productive) factors of production or eventually they may exit the market. Consumers ultimately face the costs of these scenarios. It is likely that most of the Port of Melbourne’s tenants fall in this category.

**Table 6.1** Overview of tenant types

TYPE OF USER	EXAMPLE	DIRECT DOWNSTREAM USERS	DIRECTLY AFFECTS VICTORIAN CONSUMERS IF PASS THROUGH OCCURS?	KEY FACTORS WHICH DETERMINE PASS THROUGH	OTHER ECONOMIC IMPACTS
Stevedore	DP World, Patrick, VICT	<ul style="list-style-type: none"> <li>Shipping lines, transport operators</li> </ul>	Yes (imports)	<ul style="list-style-type: none"> <li>All stevedores affected</li> <li>Moderate competition</li> </ul>	Risk of exit/reduced competition
			No (exports)		
Logistics / Warehousing / storage	Salta Qube	<ul style="list-style-type: none"> <li>Stevedores, transport operators, cargo owners</li> </ul>	Yes (imports)	<ul style="list-style-type: none"> <li>Firms compete with others not subject to higher rentals</li> </ul>	Risk of exit/reduced competition
			No (exports)		
Exporter – competes on world markets	Emerald Grain	<ul style="list-style-type: none"> <li>Overseas manufacturers/consumers</li> </ul>	No (harms producers)	<ul style="list-style-type: none"> <li>Firms compete with others not subject to higher rentals</li> </ul>	Losses to Victorian producers
Exporter – competes in Australian domestic markets	Coode island tenants	<ul style="list-style-type: none"> <li>Chemical manufacturers</li> </ul>	No (harms producers)	<ul style="list-style-type: none"> <li>Firms compete with others not subject to higher rentals</li> </ul>	Losses to Victorian producers
Importer – inputs	Coode Island tenants RORO/PDI Mobil	<ul style="list-style-type: none"> <li>Chemical manufacturers</li> <li>Car manufacturers</li> <li>Oil refinery</li> </ul>	Yes	<ul style="list-style-type: none"> <li>Firms compete with others not subject to higher rentals</li> </ul>	Risk of exit/reduced competition

TYPE OF USER	EXAMPLE	DIRECT DOWNSTREAM USERS	DIRECTLY AFFECTS VICTORIAN CONSUMERS IF PASS THROUGH OCCURS?	KEY FACTORS WHICH DETERMINE PASS THROUGH	OTHER ECONOMIC IMPACTS
Utilities suppliers	Ecogen	<ul style="list-style-type: none"> <li>Energy retailers</li> </ul>	Yes	<ul style="list-style-type: none"> <li>Firms compete with others not subject to higher rentals</li> </ul>	Risk of exit/reduced competition

Tenants who made submissions to our inquiry argue that material detriment to consumers has occurred or will occur from the pass through of higher rents or of other costs. An overview of tenant views (expressed in confidential submissions) is provided at Appendix J. We note (some de-identified) comments from tenants below:

‘The economic incidence of higher rents will flow through to the entire economy and may have an adverse impact in terms of the contraction in state GSP.’

Any misuse of market power will create ‘...inefficient costs that ultimately have to be passed through the supply chain leading to increases downstream to business input costs and costs to consumers of the end products...many manufacturers are trade exposed and increased costs have the potential to reduce competitiveness and threaten the viability of those operations.’

In a public submission to our scope and process paper, the Victorian Farmers’ Federation highlighted the effects of higher rentals on its members:

‘All these costs are eventually passed back to famers. 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... Thus, Victorian grain farmers bear the significant costs in moving grain from the farm to a FOB position without any ability or power to negotiate better terms.’<sup>83</sup>

#### **6.4. Conclusion – the Port of Melbourne has exercised its power, that had the outcome of material detriment**

Material detriment to the long-term interests of Victorian consumers flows from the lack of publicly available, clearly articulated and binding processes for new lease negotiations, the inability of tenants to access reliable up to date information about the rental market at the port to evaluate and counter rent proposals made by the Port of Melbourne, higher than efficient rents paid by tenants, higher negotiation costs being incurred by tenants than would be expected in an efficient negotiation process, and in investment by tenants that is foregone or delayed as a result of the Port of Melbourne exercising bargaining power.

We have found that the pass through of inefficiencies from tenants to consumers is expected in the long term, although the effects will be harder to observe in the shorter term because land rents are a fixed cost. Stevedores have noted they are passing on rent increases to their customers.

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<sup>83</sup> Victorian Farmers Federation, submission to the Essential Services Commission paper ‘Port of Melbourne market rent inquiry 2020: scoping paper’, October 2019, p.1.

## 7. Recommendations

We have concluded that the Port of Melbourne has power and has exercised this power in a way that causes material detriment to the long-term interests of Victorian consumers. As a consequence under section 53(1)(b) of the Port Management Act, we are required to make recommendations to the Assistant Treasurer 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.

### 7.1. Deciding on the need for economic regulation and its form

#### Economic regulation is not defined in the Port Management Act

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.<sup>84</sup>

Economic regulation need not be in the form of direct regulation of prices or quality. Regulation can 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 (on price, quality or both) that would have occurred had the market been subject to those tensions.

Ultimately, the effectiveness of economic regulation depends on the institutions and rules that facilitate it. Throughout Australia and internationally, economic regulators have been established at arms-length from the day-to-day operations of government. Theory and experience shows that such independence has been a central design feature in upholding confidence in those areas of the economy — that is, confidence by consumers, incumbent businesses and new entrants. Economic regulation provides this confidence by creating a stable and predictable environment.

An expanded discussion on our views on what is economic regulation is available on our website at <https://www.esc.vic.gov.au/sites/default/files/documents/What-Is-Economic-Regulation.pdf>

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<sup>84</sup> 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.

## Criteria for assessing regulatory recommendations

We have previously developed a set of criteria to determine suitable regulatory approaches in ports.<sup>85</sup> 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:

- **Transparency:** are the objectives and operation of the regulatory framework clear?
- **Effectiveness:** is the framework appropriately addressing the regulatory problem?
- **Proportionality:** are the elements of the framework proportional to the nature of the regulatory problem, including the obligations placed on the Port of Melbourne by the framework?
- **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 of options. As a general proposition, solutions that are most cost effective given the likely size of any detriment should be preferred.

An illustrative summary of possible regulatory options is provided in Box 7.1.

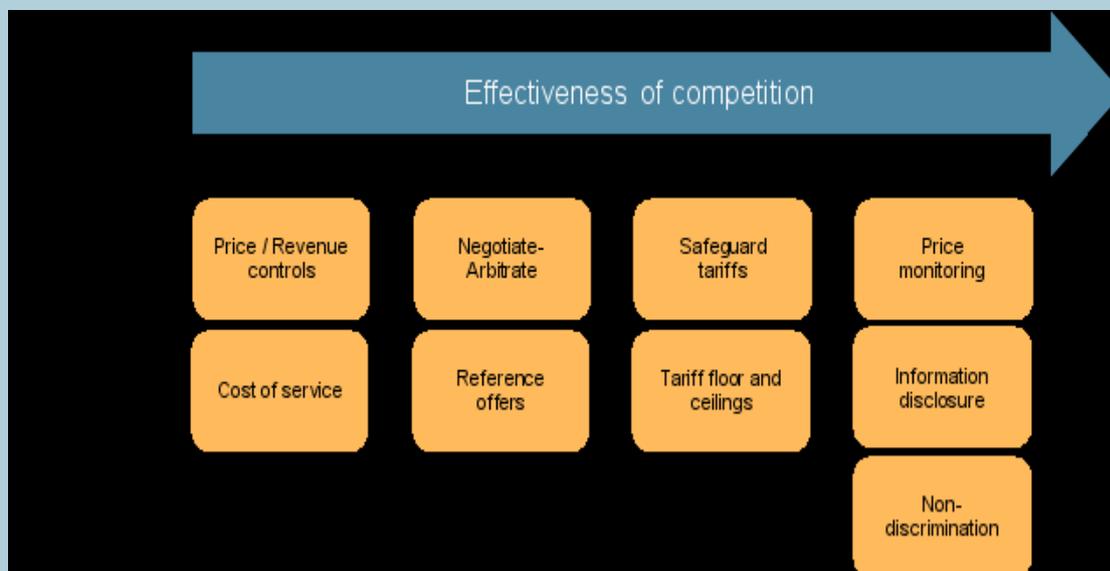
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<sup>85</sup> Essential Services Commission, Review of Victorian Ports Regulation, Final report, June 2014, p. 70. These criteria were also set out in our Interim Report (page 31) and referenced in the Victorian Guide to Regulation (2014, section 1.2) as four of the eight key characteristics of a good regulatory system.

### Box 7.1 Scope of possible approaches

The figure below shows the spectrum of possible regulatory approaches, defined here by differing responses to degree of competition and market power that is evident.

Figure 1: Economic regulation options



The options on the left-hand side of the diagram are more appropriate for natural monopolies. Price controls or cost-of-service regulation are common applications of such controls used in Australia for energy and water networks.

The options towards the middle of the spectrum reflect firms that may have power are also 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 regime 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.

This type of regulation is closest to the current form of regulation applied to the Port of Melbourne's supply of land. However, it is a weaker version as 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. Nor, is it overseen by an independent body.

For markets that are closer to being competitive, regulation is commonly more light-handed. 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.

### **Consideration of a 'no change' option**

We considered leaving the current regulatory framework unchanged. This approach would leave it open to the Port of Melbourne (and potentially the Port Lessor) to address the issues raised in this inquiry.

We find that consideration of the 'no change' option scores poorly against our assessment criteria set out above. This is because efficacy of the current framework relies on either:

- the Port of Melbourne being subject to sufficient competitive pressure to prevent it from exercising power leading to material detriment to the long term of Victorian consumers or
- the threat of regulation incentivising the Port of Melbourne to operate as though it were subject to sufficient competitive pressure.

We have not seen evidence to suggest there will be significant changes in the Port of Melbourne's future behaviour to address the issues identified by this inquiry in the absence of establishing a more formalised regulatory framework. While the Port of Melbourne has said negotiation processes are well known, many of the tenants we engaged with highlighted their concerns about unclear processes and a lack of visibility about what is included in the port deed. Indeed, we have been provided with volumes of information, much of which is confidential, which indicates dissatisfaction among tenants about the Port of Melbourne's negotiation processes and the outcomes and impacts of its approach to negotiations (for new leases and for market rent reviews).

A continuation of the current approach is not in the long term interest of Victorian consumers.

### **We have considered a range of possible economic regulatory options**

We have considered a range of regulatory options for economic regulation spanning the spectrum set out in Table 7.1. We have considered each of the options separately for the purposes of illustrating their respective benefits. We recognise some of the specific measures recommended could apply in combination.

**Table 7.1 Regulatory options considered**

No.	Option	Description	Assessment against criteria
1	<b>Incremental improvements to current framework</b>	<ul style="list-style-type: none"> <li>• Changes that may be unilaterally implemented by the Port of Melbourne or with the agreement of the Port Lessor to improve the current framework.</li> <li>○ Greater disclosure of information: including relevant sections of the port deed, as well as valuation information relevant to the assessment of market rents.</li> <li>○ Improving negotiation processes: Through the development of a robust and transparent negotiation protocol setting out the processes to be followed for negotiation of port leases and rent reviews with the port tenants.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Effectiveness:</b> Would address some problems, but possibly limited due to lack of oversight / accountability</li> <li>• <b>Proportionate:</b> The response is likely to be insufficient to address the problems identified</li> <li>• <b>Transparent:</b> Likely to be some improvement, but limited due to lack of oversight</li> <li>• <b>Accountability:</b> Likely to be some improvement, but limited due to lack of oversight</li> </ul>
2	<b>A formal rent monitoring regime</b>	<ul style="list-style-type: none"> <li>• Develop a formal, transparent methodology that the Port of Melbourne should follow in setting land rentals and extend section 49I of the Port Management Act to include compliance with this methodology in the Commissioner's periodic compliance reviews.</li> <li>• Reporting by an independent regulator of compliance with methodology and market outcomes.</li> <li>• In addition, the complaints process in section 49Q of the Port Management Act would be extended to cover land rental. This will provide tenants with another avenue to resolve disputes. Triggers for initiating the complaints process would need to be identified.</li> <li>• This approach is consistent with the existing framework for regulating prescribed services (as per section 49(1) of the Port Management Act) and could specify a clearer process for negotiating land rentals with tenants and greater guidance on pricing.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Effectiveness:</b> Likely to be some improvement, but will depend on the frequency and depth of reviews, and the clarity of how the Port of Melbourne could demonstrate compliance</li> <li>• <b>Proportionate:</b> Consistent with prescribed services, and a balanced response to the problems identified</li> <li>• <b>Transparent:</b> Material improvement</li> <li>• <b>Accountability:</b> Improvement</li> </ul>
3	<b>An enhanced negotiate-arbitrate framework</b>	<ul style="list-style-type: none"> <li>• Retains the preference for commercial negotiation of rents.</li> <li>• Aims to reduce the mismatch in bargaining power between the Port of Melbourne and tenants by, for instance, increasing transparency in negotiation processes over new leases, improving information disclosure, and providing guidance on specific lease clauses, combined with a credible threat of arbitration to resolve rent-related disputes.</li> <li>• Expand the types of issues that can go to independent arbitration to include non-price issues and extend beyond matters of property valuation.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Effectiveness:</b> Significant improvement in tenant bargaining position for new leases</li> <li>• <b>Proportionate:</b> Proportional to the nature of the regulatory problem identified. Transparency and negotiation guidelines help to address bargaining imbalances, respects primacy of commercial negotiation and allows flexibility. Reactive arbitration process keeps costs low.</li> <li>• <b>Transparent:</b> Material improvement</li> </ul>

No.	Option	Description	Assessment against criteria
			<ul style="list-style-type: none"> <li>• <b>Accountability:</b> Material improvement</li> </ul>
4	<b>Cost-based price controls</b>	<ul style="list-style-type: none"> <li>• Setting a cap on the maximum revenue that the Port of Melbourne can earn, or the maximum price that the Port of Melbourne can charge tenants, for a specified period.</li> <li>• Revenue or price caps are typically set using a building block or other type of cost model and smoothed over the regulatory period using a “CPI-X” approach.</li> <li>• This approach provides the strongest control on the exercise of power.</li> <li>• Depending on how it was to be implemented, it could involve significant changes to the existing agreements between tenants and the Port of Melbourne, and significant regulatory costs for the Port of Melbourne and Commission.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Effectiveness:</b> Directly addresses market power issues</li> <li>• <b>Proportionate:</b> A disproportionate response to the level of material harm identified at this stage. Significant increase in regulatory costs; difficult to implement given complexity in determining land rents and (potentially) unwinding existing contracts</li> <li>• <b>Transparent:</b> Material improvement</li> <li>• <b>Accountability:</b> Material improvement</li> </ul>

### An enhanced negotiate-arbitrate framework represents an appropriate balance

Our key criteria are that regulation should be transparent, effective at addressing the problems identified, proportionate to the degree of problem identified, and create clear accountabilities for the regulator and regulated entities.

In our view, there are doubts about whether approaches such as enhancements to the existing processes or price monitoring are likely to be effective in constraining an exercise of power. Such approaches would address concerns regarding the information advantages of the Port of Melbourne.

At the other end of the spectrum, we consider cost-based regulation is likely to be disproportionate to the material detriment identified at this time. We also have concerns about the practicality and proportionality of this option. These controls would undoubtedly involve significant disruption to existing landlord-tenant agreements – including some agreements where commercial leasing agreements have been struck prior to the inquiry period. Cost-based controls would also be difficult to implement given the uncertainty in identifying efficient land values that would form the basis of any cost assessment.

On balance, we consider an enhanced negotiate-arbitrate framework accompanied by greater information transparency would be most consistent with our principles. The framework would cover

not only the market rent review processes, but all negotiations related to the setting and reviewing existing of rents and associated payments.

An effective negotiate-arbitrate framework would reduce the Port of Melbourne's ability to exploit power by:

- setting out processes to be followed, as much as practicable, during negotiations with tenants over new leases and at market rent reviews, thereby helping to define expectations, responsibilities and rules of conduct
- mandating a freer flow of information that would assist negotiation and narrow differences between the parties on appropriate valuation of land and other non-price terms, and
- requiring the development and introduction of a mandatory code of conduct for leasing practices and enabling access to independent arbitration on the price and non-price terms of new leases with existing tenants, price terms in market rent reviews, and process issues arising in either new lease negotiations or market rent reviews.

Compared to direct price or revenue control regulation, we consider the primary benefits of a negotiate-arbitrate framework include:

- Tenants and prospective tenants are at the heart of the regulatory process. They are able to negotiate specific agreements that suit their particular business models, needs and risk appetites, as opposed to the services on offer being determined through a regulatory process.
- The Port of Melbourne and tenants are able to adapt flexibly to changing preferences or technological and market developments
- The framework results in a relatively lower administrative and regulatory burden. The regulation is 'reactive' rather than 'proactive' in that much of the direct regulatory costs are only incurred if and when a matter is taken to arbitration.

### **The introduction of a port leasing code of conduct**

There are many alternative forms that a negotiate-arbitrate framework can take. It can be imposed under legislation, in a prescribed code of conduct, by deemed declaration, or by regulatory involvement via a price notification and regulatory veto.

We recommend that the negotiate-arbitrate framework be implemented through a mandatory port leasing code of conduct to be effected through amendment to the Port Management Act.

The code should set out the specific standards of conduct that parties are required to comply with during negotiations and the means for dealing with disputes. The code would apply to new leases and market rent reviews.

In particular, the code could cover matter such as:

- provide that disputes in relation to lease terms are to be resolved by the following three stage regime:
  - Stage 1: negotiation between the Port of Melbourne and the relevant Port Tenant
  - Stage 2: mediation
  - Stage 3: arbitration (where an independent arbitrator would make a binding decision).
- formalise the arrangements provided in our interim solution in relation to greater information disclosure, improving negotiation processes, and potential directions on the inclusion of specific lease terms for new leases
- encourage open, honest and good faith negotiations between the parties with information sharing (subject to any legislative or contractual constraints) whereby the parties must actively attempt to negotiate in good faith in all aspects<sup>86</sup>
- include provisions specially designated for the Hazardous Bulk Liquid tenants and the treatment of their relevant leases with protection measures consistent with the port deed.

### **Strengthening dispute resolution processes**

The current process of expert determination is limited to disputes around valuations of the reasonable market rent payable consequent to a market rent review. In our view, this mechanism is not suitable to resolve disputes about land rentals that are prospectively broader than simply land valuation. This inquiry has identified that non-pricing issues related to conduct and behaviour have contributed to disputes and animosity between parties

A key purpose of the arbitration mechanism is to pose a constraint on the exercise of power during negotiations by providing a credible threat of intervention. We recommend that:

- an effective and binding commercially oriented arbitration process to resolve disputes about proposed terms and conditions of leases, rents or associated payments, and processes for negotiation, in a cost-effective and efficient manner
- setting out the principles an arbitrator would be required to have regard to when determining disputes.

### **Introduction of mediation in the first instance before arbitration**

In the event that the Port of Melbourne and a tenant (or prospective tenant) cannot agree on the terms and conditions of a lease, or rents or associated payments, either party would be allowed to

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<sup>86</sup> The obligation to act in good faith would not prevent a party from acting in his or her legitimate commercial interests.

refer the dispute to mandatory mediation in the first instance to try and resolve their dispute. This would help to reduce costs and may resolve many issues of the type identified in this inquiry.

If the parties are unable to agree to resolve their dispute following the mediation, the parties would then have the option to refer the dispute to an independent arbitrator.

### **Who should oversee the establishment of an independent arbitration framework?**

The key task for the agency overseeing the framework would be consulting on and establishing a set of principles that the independent private arbitrator will have regard to, such that matters can be resolved in an impartial, and practical manner. These could for example, include that the arbitrator considers historic, current, and proposed rent levels, land attributes, the extent of information available to the parties during negotiations, the Port of Melbourne's published negotiation processes and its and the tenant's submissions.

We anticipate the framework would provide that the independent arbitrator's determination will be final and binding on the parties, except in the case of manifest error.

For clarity, disputes which solely relate to land valuation could still involve valuation experts' reports. However, the valuer would not be appointed to provide an expert determination as per current practice, but rather represent an input for the independent arbitrator's decision making.

It is a common task for an economic regulator to oversee negotiation-arbitration frameworks, and for market participants to have confidence in the framework it is important that this role is at arm's length from day-to-day operations and administration of the relationship between the government and the port.

As such we believe the Essential Services Commission is an appropriate body to undertake the task, given we are already responsible for regulating prescribed services at the Port of Melbourne and have experience in developing negotiation-arbitration frameworks.

Government could also consider whether the Australian Competition and Consumer Commission perform the role, though the referral of the task to the Commonwealth may be more difficult to achieve. Another alternative would be to establish a new independent agency to perform the role, however, it is not clear whether the level of disputation is such to warrant the resources associated with creating a new standalone agency.

### **New regulatory framework to be forward looking**

Our proposed approach is aimed at helping to provide countervailing power in the market for rental land at the Port of Melbourne. It is not intended to resolve individual disputes or provide redress for actions undertaken within the current inquiry period.

## Shorten the review period

We recommend that the commission's next review of port market rent inquiry occur in three years' time. This is sooner than the five yearly review that we are required to undertake under section 53 of the Port Management Act. In our view, shortening the review period is appropriate to ensure that any changes in arrangements are working as intended as well as providing a credible regulatory threat to the Port of Melbourne through increased scrutiny.

## Further consultation

Legislation will need to be changed to enable the commission to undertake the roles set out in our recommendations. We would then consult on our initial views about the development of the code of conduct and the enhanced approach to negotiation-arbitration before implementation to fully develop the framework.

## 7.2. Transitional arrangement to make improvements to the current arrangements

Given it will take time to consult on, and to the develop and implement the recommended economic regulatory framework, we recommend that a series of transitional arrangements be put in place to address the immediate issues identified by this inquiry. As a guide, we suggest work on these transitional arrangements commence within three months of our inquiry report, and be completed within twelve months.

## Greater disclosure of information to improve negotiations

In general, the absence of information hinders efficient negotiations and increases negotiation costs for tenants.

The current negotiation framework, including the port deed, imposes few specific information disclosure requirements on the Port of Melbourne. We identified that the lack of disclosure has hindered effective negotiations increasing timelines and costs for tenants.

Greater information transparency should result in more relevant, timely and accessible information for tenants to inform their negotiations with the Port of Melbourne. This will allow tenants to more readily verify whether the terms offered by the Port of Melbourne are reasonable. This will help to reduce the time taken to reach a negotiated outcome, or to identify disagreements and, if required, seek independent resolution.

The port deed is an important document that sets some requirements that the Port of Melbourne must have regard to when conducting its negotiations with tenants. In our view, greater transparency on the terms of the port deed that are relevant to tenants will assist the negotiation process. Such disclosure will not, by itself, redress the bargaining disadvantages of tenants.

However, it will reduce some of the uncertainty in the negotiation process, make tenants better aware of their rights under the port deed.

We are only recommending greater transparency about the clauses of the port deed that are relevant to rental process. We recommend that:

- the Port of Melbourne and the Port Lessor publish clauses 18 and 19 of the port deed and associated definitions
- where clause 18 of the port deed applies to a new or existing Port Lease, the Port of Melbourne provide a complete copy of clause 18 of the Port deed to the prospective or existing tenant at the beginning of lease negotiations or at the beginning of a market rent review
- where clause 19 of the port deed applies to a new or existing Port Lease, the Port of Melbourne provide a complete copy of clauses 18 and 19 of the port deed to the prospective or existing tenant at the beginning of lease negotiations or at the beginning of a market rent review.

### **Improvements to the negotiating process**

We found the Port of Melbourne's specification and communication of its negotiation processes to be deficient and allowed it to exercise power in the negotiation process.

#### **Publishing a negotiation protocol**

We recommend the Port of Melbourne develop and publish a robust and transparent negotiation protocol on the processes to be followed for negotiation of new port leases and market rent reviews.

#### **Disclosure of information on valuations**

The Port of Melbourne and tenants used valuers to estimate rents for leased land based on comparable transactions. For this process to produce better outcomes, valuers must have access to relevant market information.

We have found the Port of Melbourne has access to information that may be relevant for this valuation exercise which it does not share with tenants' valuers. This includes the rents paid for comparable on-port land and the valuation advice produced by the Port of Melbourne's valuer.

We consider enhancing disclosure requirements of market rental information will allow the Port of Melbourne, tenants and their respective valuers to develop more informed views on land rent and reduce search or price discovery costs. It will also allow tenants to better understand the principles and reasoning that have informed the Port of Melbourne's rental offer, which may in turn reduce the scope for disagreements and the duration of the negotiation process.

Consistent with this view, we recommend the Port of Melbourne:

- annually publish certain information relating to prevailing and historical rents.

- upon request share the valuation reports prepared by its valuers with the relevant tenants during a market rent review or during negotiations for a new lease. Equally, tenants could be required to share their valuations with the Port of Melbourne.

### **Extend expert determination process to new leases**

Currently independent expert determination of market rents is only available for market rent reviews under existing leases. The Port of Melbourne is only required to offer tenants a reasonable market rent for a new lease. We recommend the protocol should apply to the process for establishing new leases that, in the event of negotiation failing, the commencing rent is to be determined by referring the matter to an independent expert.

### **Access to standard lease agreements and the use of terms sheets should be clarified**

In respect of new lease negotiations, we found tenants are not provided with a copy of the Port of Melbourne standard lease agreement until all commercial terms are agreed via a terms sheet.

This practice has hindered the negotiation process. In several instances, tenants have also been uncertain as to whether the terms sheet is binding and have been unable to assess the reasonableness of the conditions in the terms sheet without having an opportunity to review the lease.

We recommend that:

- the Port of Melbourne publish its standard lease on its website
- when issuing a terms sheet to a tenant, the Port of Melbourne should identify whether the terms sheet is binding or non-binding on the parties and whether executing the terms sheet is or isn't a pre-condition to seeing the full terms of a lease
- the Port of Melbourne either provide a tenant with a copy of the lease that is going to be used as the basis for negotiations at the commencement of negotiation of the terms sheet or direct the tenant to view the standard lease on the Port of Melbourne's website.

### **Some specific lease terms should be reviewed**

We identified certain terms and conditions included in lease agreements could amount to an exercise of power. To address these specific aspects, we make the following recommendations:

- Associated payments – the Port of Melbourne should only include these payments if it can separately justify the basis for any charges other than rent that it proposes to levy on tenants. It should demonstrate that these charges are used to recover the Port of Melbourne's efficient costs, and that these costs are not otherwise recovered through other charges (such as land rent). For clarity, this includes both management fees and minimum trade guarantees.

- Ratchets – the Port of Melbourne should not include ratchet clauses as a standard clause in new port leases, but such clauses could be the subject of negotiation to achieve longer leasing lengths. A more equitable outcome for both the Port of Melbourne and tenants would be the use of 'cap and collar' provisions, which would mean that the rent could not fall below an agreed level or increase above an agreed level at a market rent review.

### **Ongoing compliance monitoring by the Port Lessor should increase**

The Port Lessor should be more active in ensuring compliance by the Port of Melbourne with the relevant terms and conditions of the port deed and Port Head Lease.

We recommend that the Port Lessor:

- give consideration to the issues identified in this inquiry
- undertake periodic reviews of the Port of Melbourne's compliance with the port deed and Port Head Lease
- undertake action in the event of non-compliance.

We recommend that government impose an obligation on the Port Lessor to report biennially to Parliament on the Port of Melbourne's compliance, and any action that has been taken by the Port Lessor in the event of any non-compliance, with the relevant terms and conditions of the port deed and Port Head Lease.

# Glossary

Term	Definition
CPI	Consumer Price Index
DVI Act	Delivering Victorian Infrastructure (Port of Melbourne Lease Transaction) Act 2016
ESC Act	Essential Services Commission Act 2001
MIRRAT	Melbourne International RoRo & Automotive Terminal
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 Leases Act 2003
RoRo	Roll-on/Roll-off
VICT	Victoria 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.

# Appendix B – 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 – Clause 18 and 19 of the Port Concession Deed

[REDACTED]

## Appendix D – Reasonable market rent definition in Port of Melbourne’s standard lease contract

### 4.3 Market review

...

- (n) Without limiting clause 4.3(m), the Third Valuer must determine a “Reasonable Market Rent”, being the rent that would reasonably be expected to be realised if the Premises was offered for lease in the open market by a willing but not anxious landlord to a willing but not anxious tenant and assuming the Premises will be used for the Permitted Use, and having regard to:
  - (i) the condition that the Premises and any existing improvements are in at the time that the determination is made;
  - (ii) the location and area of the Premises and the proximity to relevant facilities and transport links;
  - (iii) the cost of reclaiming or otherwise developing the Premises (including constructing improvements) and the value of any other works to be performed or incentives offered by the Landlord;
  - (iv) the nature of the Permitted Use;
  - (v) the whole term of this lease, excluding options in favour of the Tenant; and
  - (vi) information that can reasonably be obtained about rents then applicable for tenants of the Port and tenants of comparable land or premises and the value of the Port and that comparable land or premises.<sup>[16]</sup>

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<sup>[16]</sup> Clause 4.3(n) must only be included for leases for a duration of more than 8 years (including any options to review) in accordance with clause 18.1 of the Port Concession Deed, but should otherwise not be amended or deleted in negotiations.

## Appendix E – New lease negotiation timeframes at end of inquiry period

[REDACTED]

## Appendix F – ESC observations on the Port of Melbourne’s compliance with the port deed

[REDACTED]

## Appendix G – Insufficient differentiation

[REDACTED]

## Appendix H – Other clauses that may increase tenant costs: escalations and associated payments

[REDACTED]

## Appendix I – Sequencing of negotiations

[REDACTED]

## Appendix J – Tenant views on pass through of detriment

[REDACTED]