

Port of Melbourne
Corporation



**Response to the Essential Services Commission's
Review of Victorian Ports Regulation
April 2009 Draft Report**

May 2009

Classification: Commercial-in-Confidence

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1 Introduction

Port of Melbourne Corporation (PoMC) is pleased to provide this submission in response to the draft report by the Essential Services Commission (ESC) released on 30 April 2009.

The primary purpose of the draft report is to meet the ESC's obligation under s53 of the Ports Services Act 1995 (PSA) to make a recommendation to the Minister as to whether or not "prescribed services" are to be subject to price regulation and the form of that price regulation.

In addition, following the Ministerial reference pursuant to s41 of the Essential Services Commission Act on 29 January 2009, as part of this review the ESC is required to:

- have regard to the principles outlined in clauses 4.1 and 4.2 of the Competition Infrastructure Reform Agreement (the CIRA);
- assess whether the channel access regime in Part 3 Division 4 of the PSA (PSA Channel Access Regime) is "necessary in order to ensure competition or competitive tension in upstream and/or downstream markets";
- assess whether in its current form the PSA Channel Access Regime is able to be certified by the National Competition Council (NCC)¹ (if the ESC considers there is net benefit from continuing this regime); and
- take note of recent amendments to the ESC Act in particular the insertion of Part 3A² and the implications of this for the design and assessment of access regimes.

¹ The Minister's letter refers to certification by the NCC but the NCC does not actually certify state access regimes. It is the Commonwealth Treasurer who makes certification decisions – the NCC merely makes a recommendation to the Commonwealth Treasurer.

² Part 3A was inserted in 2008 to reflect amendments to Part IIIA of the Trade Practices Act agreed as part of the National Reform Agenda.

2 The Essential Services Commission's Conclusions

The ESC has reached the following preliminary conclusions and made the following recommendations in its draft report:

1. The ESC has concluded that PoMC has market power in relation to containerised trades and motor vehicles and retains the potential to exercise this market power. This finding is fundamental to most of the ESC's other conclusions and recommendations. PoMC does not concur with the ESC's conclusion on the issue of market power: refer section 4 below and Dr Rhonda Smith's expert economic opinion in Attachment 2.
2. The ESC has concluded that PoMC's statutory objectives in the PSA do not provide sufficient guidance to PoMC "to seek a commercial return while not exploiting monopoly powers" as referred to in relation to clause 4.2(c) of the Competition Infrastructure Reform Agreement (CIRA). The ESC has recommended that these statutory objectives, in combination with price regulation under the PSA, would satisfy clause 4.2(c) of the CIRA. This recommendation is dependent on the ESC's analysis of market power which PoMC believes is not correct and is addressed in Dr Smith's expert economic opinion.
3. On the basis of its conclusion that PoMC has market power in relation to containerised trades and motor vehicles, and notwithstanding statements by the ESC that there has been no evidence that PoMC has exercised any such market power, the ESC has recommended that price regulation under the PSA continue for the following "prescribed services":
 - "providing berths, wharves and cargo marshalling areas and short term storage in relation to container or motor vehicle cargoes within the port or port waters of Melbourne or Hastings"; and
 - "providing shipping channel services (for all ships) in those channels serving the port of Melbourne, including the "shared channels" with respect to ships bound for either the ports of Melbourne or Geelong".

In light of Dr Smith's comments on the ESC's analysis of market power, and the issues raised in sections 5 and 6 below, PoMC believes there is no proper basis for making this recommendation.

4. The ESC's recommended form of price regulation for these "prescribed services" under the PSA is to continue the current "price monitoring framework" which requires PoMC to comply with pricing principles set by the ESC. However, the ESC proposes two key differences:
 - the removal of the ESC's powers to initiate reviews and impose heavier regulation (to be replaced by the ESC simply bringing concerns to the attention of the Government); and
 - the inclusion of more intrusive principles for asset revaluation, assessing rates of return and how PoMC sets prices.

In light of Dr Smith's comments on the ESC's analysis of market power, and the issues raised in sections 5 and 6 below, PoMC believes there is no proper basis for recommending this form of regulation.

5. The ESC has recommended that the shared channels be declared under the PSA Channels Access Regime in order to ensure competition or competitive tension in upstream and/or downstream markets on the basis that PoMC's control of the shared channels gives it scope to impede competition in upstream or downstream markets, notwithstanding statements by the ESC that there has been no evidence that PoMC has exercised any market power in relation to the shared channels. PoMC's view is that this recommendation is not correct: refer section 7 below.
6. The ESC has concluded that the PSA Channel Access Regime is capable of certification in its current form. This conclusion does not address the more important issue of whether, if an access regime is required, Part IIIA would be a more appropriate form of access regulation, given that one of the aims of the National Reform Agenda is to simplify regulation and reduce compliance costs.

3 Port of Melbourne Corporation's Position

In responding to the ESC's draft report, PoMC does not believe that the ESC has properly taken into account the following relevant matters:

- In assessing market power, the ESC has not properly taken into account the distinction between the port of Melbourne and PoMC and the position of PoMC within the supply chain. As explained in PoMC's original submission to the ESC, when these matters are taken into account, it is evident that PoMC does not enjoy substantial market power so there is no proper basis for recommending regulation pursuant to a s53 review or a clause 4.1(a) CIRA review.
- PoMC suggests the ESC has not properly taken into account the cost and broader impact of on-going price regulation under the PSA and its impact on investment. In particular, it is misleading to characterise this regime as "light-handed price monitoring". The requirement to comply with pricing principles set by the ESC and in particular the proposed principles for asset revaluation, assessing rates of return etc is heavy-handed. It diminishes PoMC's ability to respond in an innovative manner to the changing commercial environment and to fulfill a broader role beyond the port gate. Given that PoMC's Port Development Strategy will involve significant on-going investment, price regulation will increasingly affect PoMC's flexibility with respect to alternative funding models and thus jeopardise PoMC's ability to deliver that necessary investment. By not taking these matters into account PoMC is concerned that the ESC is significantly understating the very real cost of ongoing regulation.
- With the release of the Victorian Transport Plan and Freight Futures (Victorian Freight Network Strategy), the Victorian Government has given consideration to the role of ports to facilitate, participate in and invest in the broader supply chain. In embracing this, PoMC is acutely aware of the need to retain the flexibility to work with other

parties and potentially entertain investment models that differ from those traditionally undertaken. With this focus on efficiency and integration of the broader supply chain (consistent with the requirements for PoMC under the PSA), it is likely that the traditional boundaries in terms of both physical definition and cash flows will be less defined. The retention of strict definitions of asset classes and a strict structure of pricing thereon, as is the case under the price regulation model currently in existence, will not be beneficial in expanding beyond the current traditional models. In fact, it can be said with some confidence that the retention of price regulation in this future of expanding focus for the ports will not enhance competition.

- PoMC is of the view that the ESC has not properly taken into account the requirements of the CIRA and in particular the intent behind clause 4.1(a) of the CIRA given the context of the National Reform Agenda. As the ESC has not properly considered the role of PoMC in the supply chain and its legal relationships, the ESC has not established how regulating PoMC would deliver any benefit to users of the Port of Melbourne. As such, PoMC forms the view that the ESC has overstated the benefits of regulation.
- In relation to the shared channels, the ESC has not established how declaring the shared channels so as to activate the PSA Channel Access Regime would ensure competition or competitive tension in upstream and/or downstream markets. As such, PoMC believes the ESC's recommendation has not satisfied the test set out in the Ministerial reference.
- Further, whilst acknowledging that the more light-handed national access regime in Part IIIA may well deter PoMC from misusing any market power in relation to shared channels, the ESC has not considered whether (if an access regime is required) declaration under Part IIIA would be a more appropriate form of access regulation, particularly in light of the Sydney Airport experience³ given that one of the aims of the National Reform Agenda is to simplify regulation and reduce compliance costs

These high level points are discussed in more detail in this submission.

In addition, detailed comments on points of inaccuracy have been included in Attachment 1 to this submission.

³ The ESC has discussed in some detail the price monitoring regime for airports but omitted to mention that in reality disputes about airport pricing and access terms have either been resolved commercially or, in the case of Sydney Airport, by declaration under Part IIIA. Following declaration of airside services at Sydney Airport under Part IIIA, Virgin Blue initiated an arbitration by the ACCC which resulted in the parties reaching commercial agreement – which is exactly the type of outcome the National Reform Agenda is seeking to achieve.

4 Does Port of Melbourne Corporation have Market Power

The ESC has concluded that PoMC has market power in relation to containerised trades and motor vehicles and that PoMC retains the potential to exercise this market power, although the ESC acknowledges that the evidence available to it does not support a conclusion that PoMC has actually exercised any such market power. As stated on page 119:

“...at this stage, there is insufficient evidence to adequately support a conclusion that PoMC has exercised substantial market power during the price monitoring period with respect to its overall levels of prices and profits.”

It is not evident that there has been substantive assessment undertaken by the ESC and little is presented by way of supporting evidence for its conclusion on the issue of whether or not PoMC has market power.

Of particular note to PoMC, the ESC would appear not to have properly taken into account the distinction between the port of Melbourne and PoMC and the position of PoMC within the supply chain. As explained in PoMC’s original submission to the ESC, when these are taken into account, it is clear that PoMC does not enjoy substantial market power at the port so there is no basis for regulation.

The ESC says at page 116 that:

“...recent published economic and econometric analysis of Australia’s east coast container ports suggests that while the PoMC has substantial market power, that market power is not being exercised, and part of the reason may be the influence of economic regulation, among other things.”

PoMC feels that this statement is not valid. Case law such as *AGL v ACCC No3 [2003] FCA 1525* demonstrate the errors that can be made attempting to rely on such modelling to establish market power. The ESC itself acknowledges qualifications to such modelling (refer page 118 of the draft report).

This type of modelling is unlikely to be accepted as proof of market power. The only thing established by the material relied on by the ESC is that there is no evidence of market power being exercised. It cannot be concluded that this is due to the current form of regulation – it could equally well be due to a lack of market power or no incentive to exercise any market power or the effectiveness of the statutory objectives in the PSA.

PoMC is also concerned that the ESC has dismissed the role of the statutory objectives in the PSA⁴ without supporting analysis, simply stating at page 134:

“The Commission is not satisfied that in itself this statutory objective is sufficient to guide the PoMC towards setting access charges in such a way that seeks a commercial return only while not exploiting any monopoly powers.”

PoMC has commissioned an economic expert, Dr Rhonda Smith, to comment on the ESC’s approach to the assessment of market power and the material on which it has based its assessment. Dr Smith’s report is attached as Attachment 2.

Dr Smith’s report supports PoMC’s view that:

- the ESC’s finding on market power is not justified;
- the ESC has underestimated the significance of the constraints on PoMC; and
- there is no proper basis for recommending regulation pursuant to a s53 review or a clause 4.1(a) CIRA review.

5 Impact of PSA Price Regulation Regime

PoMC is of the view that the ESC has not properly taken into account the cost of on-going price regulation under the PSA and its impact on investment.

The cost of regulation is not simply the administrative burden of information reporting to ESC so it can publish its annual monitoring report. This aspect of the PSA regime has little cost in terms of administrative burden but equally has little value (the reality is that there is no real need for it).

However, it may be misleading to characterise the current regime as “light-handed price monitoring”. As discussed in PoMC’s original submission, the requirement to comply with pricing principles set by the ESC diminishes PoMC’s ability to respond in an innovative manner to the changing commercial environment and to fulfill a broader role beyond the port gate. This is the real cost of regulation.

The proposed principles for asset revaluation, assessing rates of return etc make the impact of regulation even heavier than the current position. PoMC believes that the ESC should have considered this issue in its draft report. The ESC would appear to justify its recommendations on the basis that the PSA regime is not as heavy handed as other possible forms of price regulation.

⁴ Which have recently been amended (commencing 13 May 2009) to include a new obligation on PoMC to carry out its statutory function in a manner that has regard to the benefits of increased competition between persons and bodies that provide services related to the operation of the Port of Melbourne (s13(2)(da)) and a new Part 6B which requires PoMC to prepare and submit to the Minister a 4 yearly Port Development Strategy in accordance with guidelines issued by the Minister.

Further, there is no assessment of the impact of regulatory risk. The proposed principles for asset revaluation, assessing rates of return etc and the extent of the ESC's powers with respect to "prescribed services" under the ESC Act have the potential to significantly increase the regulatory risks involved for PoMC.

The Ministerial direction requires the ESC to take note of recent amendments to the ESC Act in particular the insertion of Part 3A of the ESC Act. Section 35C of the ESC Act (which forms part of Part 3A) requires that pricing principles for regulated access prices should, amongst other things, "include a return on investment commensurate with the regulatory and commercial risks involved".

The High Court in *EAPL v ACCC* [2007] HCA 44 at paragraph 50 reinforced the need for certainty so not to deter investment:

"The greater the degree of uncertainty and unpredictability in the regulatory process, the greater will be the perceived risk of investment. The greater the perceived risk of investment, the higher will be the returns sought."

It is not evident that the ESC has dealt with the issue that increased regulatory risk will deter necessary ongoing investment and require higher returns, which is the fundamental concern of the National Reform Agenda.

6 CIRA Obligations and the National Reform Agenda

The regulatory landscape has changed significantly since the PSA was introduced in 1995 and since the ESC's 2004 report pursuant to section 53 of the PSA, on which the ESC has heavily relied in this draft report.

The rationale for regulation is the public interest in ensuring that effective competition can take place in markets that are dependent on monopoly facilities. However, the inherent risk in regulation is that it will impede the incentives to invest in necessary infrastructure, which is contrary to the public interest. The challenge of Government is to balance these two public interest concerns.

The concern about impeding investment formed a key theme underlying the CIRA which formed part of the National Reform Agenda to which all Australian Governments committed themselves in 2006. The fundamental aim of the National Reform Agenda was expressed to be:

"to reduce regulatory uncertainty and compliance costs for owners, users and investors in significant infrastructure and to support the efficient use of national infrastructure".

One of the key commitments in the CIRA was for each State / Territory to review the regulation of its ports to determine if regulation is warranted. The context behind this was the 2005 report by the Prime Minister's Exports and Infrastructure Taskforce, which was established to identify bottlenecks of a physical or regulatory kind that may impede the full realisation of Australia's export opportunities.

The resulting principle reflected in clause 4.1(a) of the CIRA was that ports should be regulated only if there is a “**clear need**” for regulation in order to promote competition in a dependent market or prevent the misuse of market power.

The issue of market power is addressed above.

In relation to the issue of promoting competition, one of the findings of the NSW CIRA review (at page 3) was that:

“Port corporation charges are a relatively small component of total costs. Port corporation prices are too small to materially affect up and downstream competition, either adversely or positively.”

Whilst the ESC has acknowledged the fact that PoMC’s charges are a very small component of total costs, this significance of this point in light of the CIRA commitments has not been addressed by the ESC – namely that (even if market power in theory exists) there cannot be a clear need for regulation if prices are too small to materially affect up and downstream competition, either adversely or positively.

In terms of the costs and benefits of regulation, given the point made above, PoMC believes the ESC has overstated the benefits of regulation. It would appear to have not taken into consideration the fact that the benefit of regulating PoMC pricing will not flow directly to the logistics providers, freight owners and buyers it cites as beneficiaries of regulation (as they do not have direct legal relationships with the PoMC).

It is PoMC’s opinion that the ESC has also understated the costs of regulation by assuming the only cost is the administrative compliance burden, with no mention of the impact on investment and efficiency as discussed above.

Finally, as noted by the COAG Reform Council in its March 2009 report on the progress made by jurisdictions in implementing their CIRA commitments (at page 59-60):

“The original objective of this review requirement being placed in the CIRA followed from COAG’s in principle agreement in June 2005 to a ‘simpler and consistent national system of regulation for ports and export-related infrastructure’. This was a key principle agreed to in CIRA. As such, the Council considers the question of whether jurisdictions are collectively moving toward a simpler and more consistent national system of ports regulation to be very important. The Council is continuing to assess jurisdictions’ reports and progress towards achieving COAG’s intent in this area, and will be in a position to report on this in its next report on the infrastructure regulation reform agenda.”

Based on the information in the draft report, PoMC are of the opinion that the ESC’s recommendations run counter to the principle of a simpler and nationally consistent approach to regulation of ports.

7 Shared Channels

The ESC has concluded that shared channels are “monopoly bottleneck facilities” giving PoMC scope to impede competition in upstream or downstream markets. On that basis, the ESC considers that the PSA Channel Access Regime should be activated and combined with

specific pricing principles that apply to shared channels under the price monitoring framework.

However, the ESC has not established how declaring the shared channels so as to activate the PSA Channel Access Regime would ensure competition or competitive tension in upstream and / or downstream markets. For example, unlike the approach taken by the courts and the Competition Tribunal, having formed a view on market power, the ESC has presented no analysis of whether there is any incentive to use market power, nor how the PSA Channel Access Regime would change current outcomes. If it would not change current outcomes, then PoMC believes there is no basis for a finding that it is necessary, as required by the Ministerial reference.

Further, whilst acknowledging that the combination of the more light-handed national access regime in Part IIIA and s46 of the TPA may well deter PoMC from misusing any market power in relation to shared channels, the ESC has not addressed whether (if an access regime is required) Part IIIA would be a more appropriate form of access regulation, particularly in light of the Sydney Airport experience, given that one of the aims of the National Reform Agenda is to simplify regulation and reduce compliance costs.

8 Process and Final Recommendations

PoMC's understanding is that the Government will make a decision both on whether there should be on-going regulation of "prescribed services" and on whether the PSA Channel Access Regime should be activated following publication of the ESC's final report and having regard to the CIRA principles.

The bottom line is that, in light of the CIRA, the default position should be no regulation unless a convincing case for regulation has been demonstrated.

The ESC's draft report has established is that there is no evidence of any misuse of market power and no evidence that regulation will have any impact on upstream or downstream competition. PoMC does not believe this is enough to show a clear need for regulation.

Further, there does not appear to be consideration of the impact of regulation on investment and efficiency. PoMC has raised its concerns about on-going regulation diminishing PoMC's ability to respond in an innovative manner to the changing commercial environment and to fulfill a broader role beyond the port gate. This is particularly important as "Freight Futures" envisages PoMC becoming more actively involved in the efficiency of the freight network in and out of the port.

In relation to shared channels, the test set out in the Ministerial reference (namely whether the PSA Channel Access Regime is "necessary in order to ensure competition or competitive tension in upstream and / or downstream markets") has not been met.

Response to the ESC – Review of Victorian Ports Regulation

In addition to the concerns that PoMC has raised in the body of its response, the following detailed comments are supplied with reference to specific comments in the ESC's Draft Report.

1. PoMC is concerned about the reference to draught constraints for "all vessels" rather than "container vessels" as a relevant measure used by the ESC (refer pages 50 and 57). This was raised in a letter to the Commission on 19 February this year following the issue of the Ports Monitoring Report. The CEO of the ESC acknowledged the concerns in his response dated 4 March.
2. The calculation of the "Real Price Increase" (pages 54 and 117) is driven by the additional CDP levy which was introduced to recover the Channel Deepening Project. PoMC believes it is misleading to incorporate this in a base price increase calculation as this has been clearly described by PoMC in all its communications as a cost recovery charge.
3. Service quality indicator (page 57) – PoMC expresses concern that this is not an appropriate measure and could lead to results that are misleading. The calculation of this measure as stated *"is to combine total of the % of ships draught constrained and the % of ships delayed from their scheduled berthing time. Increases in this composite service quality indicator therefore represent deteriorating service quality"*.
 - 3.1 As discussed above the measure of percentage of ships draught constrained is based on "all vessels" not just containerised vessels which PoMC has stated is a more suitable measure.
 - 3.2 The measure of the percentage of ships delayed is not within the control of PoMC. As stated in the PoMC submission, stevedoring services provided at the international container terminals in the Port of Melbourne are provided by independent third parties. PoMC has a commercial landlord – tenant relationship with these parties but is not involved in, and unable to influence, their daily activities with regard to berthing schedules.

PoMC does not believe that drawing any conclusions from the Service Quality Indicator as presented is valid. The fact that PoMC has undertaken the Channel Deepening Project is a strong indicator in itself of the focus the organisation has on service delivery.
4. Motor vehicle trade (page 91): PoMC believe motor vehicle trade is subject to strong competition and could potentially transfer to another port as was achieved in Sydney where Motor Vehicles were transferred from Port Jackson to Port Kembla. The infrastructure required in establishing a motor vehicle berth does not require substantial investment; the only requirement is the availability of land and access to and from it. It is worth considering whether the ESC would contemplate recommending price regulation for this market if this trade was transferred to another Victorian port.
5. PoMC suggests that the reference to concerns about access to common user berths and pilotage services be removed from page 109. The concerns about common user berth access was based on reviews of other jurisdictions. PoMC is not aware of any concerns raised in relation to

access to this service and would question the inclusion in the report. In relation to the pilotage services the report (page 109 section 7.8.2) refers to a concern raised by SAL at the public hearing about pilotage charges (which is not a service provided by PoMC). Again PoMC is not aware of any issues raised in relation to this and ask that it be excluded in this report.

6. It is stated in the Draft report that the charter of PoMC (effectively the PSA) does not meet the requirements of CIRA on its own and needs the PMD to further support this. PoMC disputes this and believes the CIRA requirements are met through the PSA. The ESC has not detailed any inconsistencies.
7. Section 10 – pages 136 – 147: The draft ESC report provides an analysis of various theoretical valuation approaches for regulated assets. The analysis provided is not conclusive and does not provide a clear, unambiguous recommendation.

PoMC as a stand alone entity is subject to the full suite of Australian Accounting Standards and the government financial directives. These are applied fully and the organisation is audited annually for compliance. These standards and directives provide a clear approach for valuation of assets. They ensure that assets are recorded at their fair market value and provide an appropriate base for the determination of pricing where an organisation is required to generate a rate of return on its asset base.

Attempts to introduce another form of asset valuation will add complexity, confusion and further cost of compliance. No comments have been made in the draft report or in the submissions made publically available as to why any change is warranted or as to why the current approach is not meeting its requirements. The addition of yet further regulatory impost would be a significant concern for PoMC.

PoMC does concur that for valuing channel assets (where PoMC is required to use the discounted cashflow method) that the “line in the sand” approach is required to avoid the circularity involved – this is consistent with the approach that has been applied to this point. However, PoMC feels that the draft report is inconsistent in recommending the “line in the sand” approach for channels and at the same time amending this for the “old” channels (pre 1996) and requiring these be set at zero value. No rationale has been provided to support this.

Further, we note that from the completion of the CDP in late 2009, PoMC will have a channel that is no longer distinguishable as the old channel and the new channel; they will be the same enhanced asset. To continue to treat the old asset and the new asset separately for pricing purposes will contradict with the treatment of the channels for accounting purposes and for physical asset maintenance purposes.

8. PoMC has provided detail to the ESC to further explain the question raised by the users of the Geelong Channels (and included in the ESC draft report) in relation to the one cent levy. The rationale for this charge is fully supported and is consistent with the pricing principles of the framework under which PoMC operates. PoMC as the responsible entity for the channels under the PSA believes that it is both necessary and responsible to ensure the safety of all port users is enhanced. Given the nature of the channel approaches, all users of the Port of Geelong must use the shared channel to transit the heads. This area of navigation requires extreme care and whilst the likelihood of casualty may be considered reasonably low, the consequence would be considered high and would have considerable implications for the operations of the ports of both Geelong and Melbourne.

Through significant dredging works of the access channel and the Entrance, the CDP will make access through this area safer and will allow larger vessels to transit to the ports of both Geelong and Melbourne. It will also allow the maximum draught vessels of 11.7 metres into Geelong to transit the Entrance unaffected by tidal conditions. Additional investments have been made to compliment existing navigational services and infrastructure that will contribute further to the safety of navigation and assist transit through the entrance. On this basis, charges have been applied to vessels that will derive a benefit from the CDP works in terms of capacity and safety of navigation.

Port of Melbourne Corporation**Expert Economic Comment****Dr. Rhonda L. Smith**

1. I am a Senior Lecturer in the Economics Department at the University of Melbourne. My Curriculum Vitae is provided as Addendum 1.
2. As part of its review of the regulation of Victorian ports, the Essential Services Commission (ESC) has produced a draft report. I have been asked by the Port of Melbourne Corporation (PoMC) to review the draft with respect to the findings in relation to market power. As a consequence, my comments relate only to chapter 7 of the ESC's draft. In addition, I have been instructed not to consider the issue of shared channels.
3. The PoMC operates subject to the Victorian Port Services Act 1995 which, inter alia, provides for:
 - i. a price regulation regime for 'prescribed services', defined to include shipping channels, berth services, and short term storage or cargo marshalling facilities;
 - ii. third party access via an established access regime for 'declared' shipping channels – although currently the shipping channels of Port Phillip Bay are not declared.
4. The approach of the ESC in chapter 7 of its draft is to test whether the PoMC has substantial market power and second to inquire whether it has sufficient incentive to exercise that market power. Even if PoMC possesses substantial market power and is found to have an incentive to exercise that power, a relevant consideration is the benefits from regulation via increased competition and any practical issues in regulating PoMC.

Market Definition

5. In its Draft, the ESC narrows its market definition from that of its 2004 Review on the grounds that '...at the present time the lack of fast and highly efficient long-distance freight rail services implies limited scope for substitution' (between capital city ports), that is, switching costs would be relatively high. Consequently, it found that the Port of Melbourne is relatively isolated. Thus, the ESC defines the relevant geographic dimension of the market as either a Melbourne market or a Victorian market. The market is then divided into sub-markets based on cargo 'pack' types because these are transported differently, use specialised shipping and require specialised land-side port

infrastructure. Whilst not necessarily agreeing with this market definition,¹ I will assume that it is applicable for the present. However, consideration needs to be given to whether these geographic boundaries are likely to change in future and what significance this has for the competitive constraints on PoMC and not just after it occurs but currently.

Market Power

6. In its review in 2004, the ESC concluded that PoMC possessed substantial market power in relation to container and motor vehicle cargoes. It comes to the same conclusion in its draft report.
7. When considering whether a firm has a substantial degree of market power one is seeking to identify whether the firm concerned has the ability to influence market outcomes, that is, an ability to act somewhat independent of market forces or competitive constraints. As the ESC correctly identifies, market power may be exercised directly via pricing or indirectly by reduced service, less innovation and the like.
8. Competition, that is, the absence of substantial market power, is valued because generally competition results in efficient market outcomes. Thus,

‘Through competition, firms and institutions become more efficient, innovative and flexible. Consumers have greater choice and possibly lower prices. Competition is also a means of enhancing community welfare by promoting a more efficient use of resources, thus providing greater returns to producers and higher real wages.’²

This is reflected in the ESC’s observation that

‘...whether there is cause for concern about the degree of market power depends on the effectiveness of competition in deterring the potential economic efficiency losses that can result from the exercise of market power.’³

9. Substantial market power will only exist where a firm is relatively unconstrained either by competition or by other factors which cause it to behave as though the

¹ A concern that arises in this context is the risk that a relevant constraint on the conduct of PoMC may be overlooked. As discussed later in this report, key drivers of the business decisions of PoMC are economies of scale and quality of service to shipping lines. Given the commonality of infrastructure supplied by PoMC, as distinct from that supplied by stevedores, it is doubtful whether PoMC could, or has sufficient information, to discriminate in the quality of service provided between ships carrying contestable and non contestable cargoes or in relation to fees charged (it simply does not know the origin/destination of the cargoes passing through the port). If this is the case, in my opinion, it is inappropriate to segment the market based on cargo types, especially when the market has been defined more broadly.

² Graeme Samuel, Association of Australian Ports and Maritime authorities, Biennial conference, 11 October 2006, p5.

³ ESC, Draft, p.79.

market were competitive. To establish whether a firm possesses substantial market power, structural characteristics of the market (such as market share and market concentration; barriers to entry; and countervailing power) must be considered. Importantly, however, relationships between a firm and its customers, a firm and its suppliers, or with other relevant entities may impose constraints such that even with no current rivals in the same geographic area, high barriers to entry and no countervailing power, it would be concluded that the firm concerned did not possess substantial market power or, if it did, it would have no incentive to exercise it.

10. In order to assess market power it is important to identify clearly:

- i. where the alleged market power may be located in the range of activities undertaken by the firm under investigation. The PoMC's role is to provide physical infrastructure for ships to enter and load/unload freight in the Port of Melbourne. It is generally not directly involved in the provision of port services to ships or the movement and storage of freight at the port. There is an important distinction between PoMC and the Port of Melbourne.⁴ PoMC charges shipping lines a fee to cover the capital cost of infrastructure and maintenance. Its relationship with stevedores and others who supply port services is as a landlord. It supplies services that are an input into, or are complementary with, those supplied by others.
- ii. relationships that have a significant impact on the efficiency and viability of the business. As a supplier of infrastructure, as the ESC observes, PoMC engages in a business in which there are significant economies of scale which must be exploited if the business is to operate efficiently. The ESC concludes that this is a significant barrier to entry but fails to consider the implications of the need to expand the business to achieve these economies, especially as additional investment in infrastructure occurs. Conversely, it needs to avoid contraction of the business. I shall return to this issue below;
- iii. the validity in drawing conclusions from historical data – see paragraph 12 (iii) below.

11. In considering the competition between capital city ports for containerised cargo, based on its 2004 review, the ESC finds that the majority of containers and motor vehicles pass through the port nearest their source in the case of exports and their final destination in the case of imports. It refers to 13% of PoMC's container traffic originating from southern NSW and SA⁵ and concludes that this contestable cargo is a relatively small proportion of the total. Further, it finds that 96% of the traffic through the port has its origin or destination in Victoria. More generally, it refers to a finding that the elasticity of substitution between capital city ports is extremely low. This low

⁴ PoMC, Response to the ESC Ports Regulation Review Issues Paper, p.10.

⁵ ESC, Draft, p.86.

level of substitutability between ports is attributed to the cost of land transport between container ports.

12. I make a number of observations in relation to the ESC's conclusion that substitution is low:

- i. whether 13% is a relatively low level of contestable cargo depends primarily on its impact on profitability (or some other measure of performance, which for PoMC would be efficiency). This will be determined by the impact of the loss of 13% of container freight on the unit costs of PoMC and would reflect the significant economies of scale associated with infrastructure services observed by the ESC, as well as the perception of shipping lines about the desirability of the Port of Melbourne as a destination;
- ii. the estimate of contestable container cargo is said to relate to southern NSW and South Australia⁶ but there is no reference to northern Victoria or to Tasmania.

*'The Port of Melbourne's catchment is the whole of South Eastern Australia, including southern New South Wales, South Australia and especially Tasmania. It's a chicken-and-egg situation – ships call here (Melbourne) because this is where the cargo is, and the cargo is here because there are ships available to carry it. ..There is a kind of mutual dependency, but this relationship fails if one side is unable to keep up its part of the bargain...If the range of shipping services is incomplete or insufficient, the importers and exporters of cargo will look elsewhere.'*⁷

This suggests that the ESC's figure of 10% may underestimate the extent of contestable cargo, possibly quite significantly.

- iii. the use of the term 'substitution' is instructive. An assessment in relation to market definition or market power considers not only actual substitution, that is historical experience, but the potential for substitution if market power is exercised, for example via a price increase of say 5%, and hence the term 'substitutability' is used. If a market is operating relatively competitively,⁸ firms position themselves in response to this and little substitution may be observed. The significance is that if one looks at historical data and there has been no price event (or reduction in efficiency) that causes customers or alternative potential suppliers to reconsider their arrangements then the substitution actually occurring is likely to be low and possibly somewhat

⁶ ESC, Draft, p.86.

⁷ Victorian Freight and Logistics Council, *The Common Sense of Channel Deeping*, 2008, p.2.

⁸ As PoMC is currently subject to price regulation it can be assumed that its prices are competitive.

random.⁹ Thus, what is relevant is to consider what the extent of the response would be if PoMC were to raise its prices by 5% (or possibly more relevantly, reduce the quality of its infrastructure service by the equivalent of a 5% price increase) – a critical loss analysis is required.

- iv. not only does the problem identified in (iii) above arise in relation to the elasticity estimates, but elasticities are typically measured as the response in the relevant variable to a 1% price change. For most commercial purposes responding to a 1% price change will be insignificant given the costs of management time and the like. This is the reason why the SSNIP test, for example assumes a 5% price increase.¹⁰
- v. the ESC concludes that the additional cost of land transport largely precludes substitutability between ports. I assume that the major component of land transport is the transfer of containers to rail (or road) and that delays in delivery of imported cargos are much more significant for costs than shipping charges. No doubt, if PoMC were to attempt to exercise market power by poor service, this would provide an incentive to increase the speed and efficiency of land transport from alternative ports to customers. More significant, however, are the longer term implications of such inefficiencies. In the short term port users may be locked into a particular port, but this is not true in the long run. In discussing the implications of less efficient port operations, the Victorian Transport Association Priority Report states:

‘...industry and jobs will gradually move interstate to where port access is not a barrier to vital international trade...Employment could be radically affected if our largest companies re-allocate their resources and establish distribution centres in states other than Victoria.’¹¹

13. The ESC then finds that ‘...there are potentially large barriers to new entry for the provision of containerised port services, given the economies of scale involved and the availability of sufficient land and land transport to provide these services.’
However, in relation to motor vehicles, it finds that barriers to entry are relatively

⁹ Thus, when considering the pattern of motor vehicle exports, for example, typically exports and imports are despatched and received via the nearest port to production/consumption. However, should the relative efficiency of ports (or other factors such as ship sizes or government policy in relation to ports, as with Glebe Island and Port Kemble) alter, users will adjust, although that adjustment may take some time.

¹⁰ SSNIP refers to a small but significant, non transitory increase in price. Similarly, in Safeway, the Court considered whether Safeway possessed substantial market power in part based on its ability to raise prices by 5% above the competitive level without losing so much business that the increase was unprofitable.

¹¹ VTA Priority Report 33, January/February 2008. Comments made in the context of the channel deepening project. Similarly, the Victorian Freight and Logistics Council, *The Common Sense of Channel Deepening*, 2008, states that ‘Over time businesses will drift to the most convenient, cost-effective location – meaning a loss of economic activity and community wealth for Victoria.’ (p.4)

low.¹² This should remove any concern of the ESC that PoMC has substantial market power in relation to motor vehicles as any exercise of market power could be expected to translate into entry, loss of business and profits if barriers to entry are low. However, the ESC seems still to consider that there may be a market power issue in relation to motor vehicles and supports this with an observation that ‘vehicle charges’ are substantially higher at the Port of Melbourne than at Port Botany.¹³ Presumably ‘vehicle charges’ refers to all vehicle charges and mostly they are determined not by the PoMC but by the stevedores. More information would be necessary before any conclusion concerning PoMC’s market power could be drawn from this observation, including an inquiry as to the accuracy and comparability of the figures.

14. Finally, the ESC considers the issue of countervailing power and whether customers impose such a constraint on PoMC that it could be said not to possess substantial market power absent close rivals and with high barriers to entry.
15. Countervailing power is the ability of a customer (or customers) to by-pass a firm should it attempt to exercise market power. Absent alternative suppliers, generally this means:
 - i. vertically integrating to self supply;
 - ii. sponsoring a third party entrant; or
 - iii. importing the service.
16. The ESC concludes that the demand for port infrastructure services is highly inelastic and users are unlikely to respond to any exercise of market power because these costs are a small proportion of total costs.¹⁴ Consequently, users of port infrastructure services lack countervailing power.
17. Shipping lines are the direct customer of the PoMC, that is, they are the users of the infrastructure services supplied by PoMC, although others such as importers and exporters are indirectly affected by port charges. Consequently, this lack of responsiveness could be because port charges are passed on by shipping lines and so are spread across all of their customers and so are a very small proportion of the total cost of shipping imports and exports. Given this, any competition between ports is likely to be based on service, including speedy turnaround and should be the focus of the market power inquiry. So the relevant question to ask when considering countervailing power is the ability of shipping lines to bypass PoMC if the Port of Melbourne is not an efficient port in terms of service.

¹² ESC, Draft, p. 92.

¹³ ESC, Draft, p.92.

¹⁴ ESC, Draft, p.90.

18. The ESC concludes that shipping lines go where the cargo is.¹⁵ However, I assume that the costs of the shipping lines are determined primarily by the efficiency of their operations and this means that minimising the time in port is critical to containing costs. To this end, shipping lines are seeking to reduce the number of ports they visit, leaving users of shipping to bear consequent inefficiencies in the distribution of their cargoes from the ports.¹⁶ More importantly, in seeking efficiencies, bigger ships are being used and this means less frequent calls and it limits the ability to enter some ports. Thus, as early as 2002, the OECD observed that:

*'It is possible that maintaining the capacity utilisation of such large vessels will require greater organisation of shipping networks around a hub-and-spoke structure...relatively few ports can handle such ships, leading to a concentration of major services to a limited number of major ports, implying an increase in feeder and transshipment services to other terminals.'*¹⁷

And

*'...ships have become progressively larger, not only because of trade demands but because of the same rule that applies to most things: economies of scale. The largest container ships have doubled in size in just the last ten years.'*¹⁸

On 20 May 2009, for example, MSC Mediterranean Shipping Company announced *'...further rationalisation of its service pattern from the Far East to the Mediterranean and Europe in order to reduce surplus capacity and to match existing and anticipated cargo volumes.'*¹⁹

19. The ability of shipping lines to reconfigure ports of call are not restricted by sunk costs incurred in relation to particular ports. As the ACCC notes:

*'Barriers to switching between trade routes (for container shipping lines) did not appear high. Market inquiries revealed that vessels are often redeployed between trade routes: that is, vessels can enter and exit trade routes with minimal sunk costs.'*²⁰

¹⁵ ESC, Draft, p.89.

¹⁶ 'If the range of shipping services is incomplete or insufficient, the importers and exporters of cargo will look elsewhere. Ports and their surrounding communities in Europe, Asia and North and South America have already found this, to their cost.' Victorian Freight and Logistics Council, *The Common Sense Guide To Channel Deepening*, 2008, p.2.

¹⁷ OECD, *Competition Policy in Liner Shipping: Final Report*, April 2002, paragraph 25; available at www.oecd.org/dataoecd/13/46/2553902.pdf.

¹⁸ Victorian Freight and Logistics Council, *The Common Sense Guide To Channel Deepening*, 2008, p.2

¹⁹ <http://seanews.info/press/press.asp?pressID=1003950>

²⁰ ACCC, public competition assessment in relation to the acquisition of P70 Nedlloyd by Moller-Maersk, September 2005.

Similarly,

*'Entry into any particular Australian liner trade is not costless nor without risk, but the level of sunk costs may be quite low as vessels are not generally specialised for a trade and can be shifted from one trade to another.'*²¹

20. For a country as small as Australia this means that for most of the shipping lines, the likelihood is that over time they will visit some ports less frequently and possibly not at all. This likelihood has major implications for the conduct of suppliers of port infrastructure services to those shipping lines: it constrains them to act competitively. Ports that would otherwise possibly be viewed as in separate markets, become competitors to retain shipping lines in future. To ensure (or hope to ensure) continued use by shipping lines, bodies such as PoMC must be highly efficient in the supply of port services. Even if it were concluded that PoMC possessed substantial market power, it would be against its own long term interests to exercise it by offering poor service if it believes, that shipping lines will make calls to fewer Australian ports in future.

21. The significance of this can be illustrated by reference to the channel deepening project. Giving evidence to the House of Representatives Standing Committee on Transport and Regional Services, Mr Tim Blood, MD of P&O Ports stated:

*'Ships are already altering their whole cargo patterns because of the limitations in Melbourne. That has been happening for the last three or four year, and it is going to get worse. Shipping lines the world over are consolidating. There will be further consolidations. Vessel sizes are increasing. Ports must be capable of dealing with those deeper draft vessels.'*²²

Incentive to exercise market power

22. The second step in the process that the ESC is required to undertake involves considering whether, if PoMC, possesses substantial market power, it has an incentive to exercise it.

23. There are three significant economic reasons why it would not have such an incentive:

- i. the infrastructure service business that PoMC is engaged in offers very substantial economies of scale. This means that growing the business of the port reduces the unit costs incurred in the supply of infrastructure and losing business through the port raises the unit cost of supply;

²¹ ACCC, Report on Part X of the TPA, July, 2004, p.44.

²² House of Representatives Standing Committee on Transport and Regional Services, Inquiry into the integration of regional rail and road networks in Australia and their interface with the ports, Hansard Transcript, 21 November 2005.

- ii. ongoing efforts to increase the efficiency of shipping lines, including rationalising the number of ports of call, is driving competition between ports, even if those ports would not otherwise have been regarded as being in close competition. Not only must a port be efficient to retain shipping lines, it also needs increasing volumes of cargo, especially as ships increase in size to justify the extra infrastructure required by the shipping lines. This suggests that responding to the requirements of customers (specifically the shipping lines) will be a key influence on the way the PoMC does business and responding to those requirements is likely to drive dynamic efficiency at the port. The significance of this is demonstrated by the enormous expense of channel deepening being undertaken in the Port of Melbourne;
 - iii. the ability in the longer term of port users to relocate their distribution activities (see paragraph 12 above).
24. There are significant non economic factors also that deter any conduct by PoMC that will reduce the efficiency of operation of the port:
- i. section 13 of the Port Services Act 1995 in effect requires the PoMC to operate efficiently because it must ‘promote and market the port of Melbourne’ (13 (f) and it must facilitate development of the port (13 (a)-(e).
- In addition, amendments to the Port Services Act 1995 which commenced on 13 May 2009 include a new obligation to carry out its statutory functions in a manner that has regard to the benefits of increased competition between persons and bodies that provide services related to the operation of the port of Melbourne (13(2)(da)) and a new Part 6B which requires PoMC to prepare and submit to the Minister a 4 yearly Port Development Strategy which includes projections of trade through the port, current and projected land use requirements, current and projected infrastructure requirements for land and water in the port, current and projected transport infrastructure requirements for land and water in the port and any other matters specified in guidelines issued by the Minister.
- ii. exposure to the risk of more heavy handed regulation. The potential already exists for a third party, dissatisfied with the terms under which services are supplied to seek a declaration of some or all of the infrastructure services supplied by PoMC under Part IIIA of the Trade Practices Act. This carries with it the threat of arbitration in relation to fees by the ACCC should the service be declared and the parties fail to agree on fees.
25. In determining whether a firm possesses substantial market power and is exercising it, it is useful to consider the way in which the firm sets its prices. To the extent that

prices are set to cover costs, including a normal rate of return on capital, the firm is not charging supra-competitive prices.

Effect

26. Any form of regulatory intervention should be based on an assessment of the benefits that regulation can be expected to deliver against the costs (administrative, enforcement and compliance).
27. Assuming that the aim of continued regulation of PoMC is to encourage competition between ports, this is unlikely to happen because, as the ESC observes, port charges are small share of the total cost of loading and unloading and shipping of cargo. Other costs such as stevedoring are far more significant. The key to competition between ports is non price competition, namely relative efficiency.
28. Further, to the extent that the ESC concludes that some of PoMC's services should remain regulated while for others this is not justified, there is likely to be a significant cost, including on others besides the PoMC, in obtaining the data necessary to apply regulatory controls and in monitoring compliance.

Conclusion

29. In my opinion, having considered the approach adopted by the ESC and the evidence that it uses, its finding that PoMC has substantial market power in the supply of certain port infrastructure services does not seem justified.
30. In coming to its conclusion about market power, the ESC has, in my opinion, underestimated the significance of the following in constraining PoMC to act in a competitive manner:
 - i. the changes occurring in shipping arrangements that are forcing different capital city ports to compete with one another in the hope of retaining enough shipping in the long term to remain efficient and profitable;
 - ii. the statutory role of the PoMC under the PSA;
 - iii. the risk of regulation under Part IIIA of the Trade Practices Act.

CURRICULUM VITAE**Rhonda Smith****B. Com (Hons), MA (Eco), D.Com, University of Melbourne**

Rhonda Smith is a Senior Lecturer in the Economics Department at the University of Melbourne (fractional 0.5). She is currently teaching undergraduate and postgraduate courses including Economics of the Law, Public Sector Economics, and Market Power and Competition Law (the last is taught jointly by the Law Faculty and the Economics Department). Since 1999 Dr Smith has taught the Masters course in Competition Law at the Australian National University.

From November 1995 to November 1998 Dr Smith was a Commissioner with the Australian Competition and Consumer Commission. She was appointed an Associate Commissioner of the ACCC in June 1999 but resigned from the ACCC in December 1999.

During 2000 Dr Smith resumed consulting, mainly in relation to competition matters, both to regulatory bodies and to major businesses. She also provides training sessions in economics relevant for competition analysis to the ACCC staff. In 2007-2008 Dr Smith undertook consulting on behalf of the Asian Development Bank in Papua New Guinea and in the Cook Islands.

She was a member of the Federal Government's Copyright Law Reform Committee from 1995 to 1998. In April 2001 she was appointed a member of the Copyright Tribunal and this appointment has been renewed subsequently. She is a member of the Advisory Board of the Intellectual Property Research Institute of Australia and a research fellow with IPRIA.

She is a lay member of the High court of New Zealand and was re-appointed to this position in March 2009.

Prior to November 1995 Dr Smith held a senior lectureship in the Economics Department at Melbourne University. Areas of research interest include industrial organisation, agricultural economics, demography, the economics of immigration and the interface of law and economics (especially in relation to trade practices and intellectual property).

Between 1988 and November 1995 Dr Smith also worked as a consultant economist, mainly in the trade practices and pricing areas. She acted as an expert witness and adviser to many large Australian companies and to the former Trade Practices Commission and the Prices Surveillance Authority. In addition, she worked as an industry analyst with a major information company with responsibilities in relation to agricultural and food industries.

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Other Positions

Advisory Board Intellectual Property Research Institute of Australia.

Advisory Board, Centre for Regulation and Market Analysis, University of South Australia