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Registrar

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No. NSD 1141 of 2016

Federal Court of Australia

District Registry: New South Wales

Division: General

Port of Newcastle Operations Pty Ltd ACN 165 332 990
Applicant

The Australian Competition Tribunal and others named in the schedule
Respondents

ACCC'S OUTLINE OF SUBMISSIONS

A. BACKGROUND

1. The fourth respondent (**ACCC**) is an independent statutory authority established by s. 6A of the *Competition and Consumer Act* 2010 (Cth) (**Act**).

2. The ACCC made an application to be joined as a party to this proceeding, and was added as the fourth respondent on 18 October 2016. On the same date, the Commonwealth was added as the third respondent.

3. The ACCC's submissions reflect its position, not that of the Commonwealth.

4. The ACCC does not make submissions regarding 'Issue 1'[1] in the decision of the Australian Competition Tribunal which is under review and the issues raised in the applicant's (**PNO's**) originating application. Those issues concern the expression "*access (or increased access)*" which appears within criterion (a),[2] including whether or not *Sydney Airport Corporation v. Australian Competition Tribunal*[3] (**Sydney Airport FC**) was correctly decided and was

[1] *Application by Glencore Coal Pty Ltd* [2016] ACompT 6 (**Tribunal's reasons**), Part A, tab 3 at [35(1)] and [53]-[121].
[2] See s. 44H(4)(a) of the Act.
[3] (2006) 155 FCR 124.

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correctly interpreted and applied by the Tribunal in the present case, and those concerning criterion (f).

5. 'Issue 2'[4] in the Tribunal's decision addressed the second respondent's (**Glencore's**) alternative contention, which the Tribunal described as being advanced on the basis that Glencore accepted that it has access (in a conventional sense) to the Service because PNO does provide that access to shippers on the terms PNO has fixed.[5] Glencore had submitted that, on this alternative contention, criterion (a) is satisfied on the basis that *increased* access to the Service would promote a material increase in competition in a dependent market.[6]

6. The Tribunal concluded in relation to Issue 2 that, if it were wrong about the correct approach to criterion (a), it would not be satisfied that increased access would promote a material increase in competition in the coal export market. If that market would not be promoted in that way, it follows that the other four dependent markets would also not be promoted with a material increase in competition in any of them.[7]

7. Issue 2 is the subject of Glencore's notice of contention dated 4 August 2016.[8]

8. The ACCC's submissions concern Issue 2, which may determine the outcome of this proceeding[9] if the Court were to conclude that *Sydney Airport FC* was not correctly decided, or was not correctly interpreted or applied by the Tribunal in the present case.

B. ERRORS BY THE TRIBUNAL IN RELATION TO ISSUE 2

Overview

9. In addressing Issue 2, it is submitted that the Tribunal made two errors. First, and most critically, it did not construe the concept of "*promote a material increase in competition*" in criterion (a) as involving the creation of appropriate conditions or an environment for improving competition from what it would otherwise be in each of the relevant dependent markets, but instead concentrated the enquiry upon whether PNO's future pricing behaviour would have the short run effect of reducing coal production from the Hunter Valley.

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[4] Tribunal's reasons at [35(2)] and [122]-[157].

[5] Tribunal's reasons at [122].

[6] Tribunal's reasons at [35(2)].

[7] Tribunal's reasons at [157].

[8] Part A, tab 9.

[9] On remitter to the Tribunal, since, in the event that the Court determines Issue 1 in PNO's favour, PNO seeks orders setting aside the Tribunal's decision and remitting the matter to the Tribunal for it to be determined according to law.

10. Second, the Tribunal reasoned that PNO's market power would be constrained by an incentive to maintain levels of coal production from the Hunter Valley, which failed to take into account that PNO could, without affecting levels of coal production, price discriminate or increase prices in an environment of rising coal prices.

Proper construction of criterion (a)

11. Competition, in the context of the Act, is conceived to be a process, rather than a static state of affairs, and is understood to refer to the nature and extent of rivalry in a given market.[10]

12. In considering the meaning of competition there is a distinction between, on the one hand, the process of competition and, on the other, the extent of competition, which is the outcome of that process.[11]

13. In economics, the word 'competition' (as a process) has many meanings. Stigler's well-known definition is "*rivalry between individuals (or groups or nations) and it arises whenever two or more parties strive for something that all cannot gain*". Under this definition, competition refers to behaviour, and especially to patterns of business behaviour. Relevantly, it relates to behaviour that may affect the price or quality or conditions of sale of goods or services exchanged in the relevant market. Hence competition may be described as rivalry that amounts to a process that leads to an increase in economic efficiency.[12]

14. The extent or state of competition in a market is the result of internal and external factors which bear upon the nature and extent of the rivalry.[13]

15. The concept of "*promoting*" competition in the criterion does not correspond to measuring quantifiable increases in competition or the state of competition, but expresses a more flexible idea of creating the conditions or environment for improving competition from what it would be otherwise.[14] A leading statement of this principle is found in *Sydney Airports Corporation*:[15]

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[10] *Re Queensland Co-operative Milling Association Ltd* (1976) 25 FLR 169 at 189-90; *Re Virgin Blue Airlines Pty Ltd* (2005) 195 FLR 242 at [145]; *Adamson v. West Perth Football Club (Incorporated)* (1979) 39 FLR 199 at 224-5; *Outboard Marine Australia Pty Ltd v. Hecar Investments No. 6 Pty Ltd* (1982) 66 FLR 120 at 123-4 per Bowen CJ and Fisher J; *Universal Music Australia Pty Ltd v. Australian Competition and Consumer Commission* (2003) 131 FCR 529 at [242] per Wilcox, French and Gyles JJ; *Australian Competition and Consumer Commission v. Cement Australia Pty Ltd* (2013) 310 ALR 165 at [3013].

[11] *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1049].

[12] *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1050].

[13] *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1051].

[14] *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10 at [106]-[107]; *Re Duke Eastern Gas Pipeline Pty Ltd* (2001) 162 FLR 1 at [75]; *Re Services Sydney Pty Ltd* (2005) 227 ALR 140 at [132]; *Re Virgin Blue Airlines Pty Ltd*

> *"The Tribunal does not consider that the notion of 'promoting' competition in s 44H(4)(a) requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of 'promoting' competition in s 44H(4)(a) involves the idea of* ***creating the conditions or environment for improving competition from what it would be otherwise****. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.*
>
> *We have reached this conclusion having had regard, in particular, to the two stage process of the Pt IIIA access regime. The purpose of an access declaration is to unlock a bottleneck so that competition can be promoted in a market other than the market for the service. The emphasis is on 'access' which leads us to the view that s 44H(4)(a) is concerned with the fostering of competition, that is to say it is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the Tribunal considers that the promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial."* (emphasis added)

16. Put another way, the enquiry emphasises evaluative or qualitative judgments about the future conditions and environment for competition, and is not confined to quantitative effects.[16]

17. The criterion is forward looking,[17] involving a comparison of the future state of competition in each of two scenarios – sometimes described as the 'with or without' test,[18] or the "*factual*" and the "*counterfactual*".[19]

18. A similar "*factual*" and "*counterfactual*" analysis is adopted for ss 45, 47 and 50 of the Act – in that context the enquiry focuses upon the *future* state of competition with and without the proposed conduct or acquisition.[20] The existing state of competition in the market may be relevant to establishing the likely future state of competition in the market without the

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(2005) 195 FLR 242 at [146]; *Telstra Corporation Ltd v. Australian Competition Tribunal* (2009) 175 FCR 201 at [224]-[225]; *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1060].

[15] *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10 at [106]-[107].

[16] See *Australian Competition and Consumer Commission v. Australian Medical Association Western Australia Branch Inc* (2003) 199 ALR 423 at [339], in the context of substantially lessening competition, referring to *Eastern Express Pty Ltd v. General Newspapers Pty Ltd* (1991) 30 FCR 385 at 421 and Donald and Heydon, *Trade Practices Law*, vol. 1, p. 42; *Universal Music Australia Pty Ltd v. Australian Competition and Consumer Commission* (2003) 131 FCR 529 at [242] per Wilcox, French and Gyles JJ.

[17] *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10 at [108]; *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1048].

[18] *Re Fortescue Metals Group Ltd* (2010) 242 FLR 136 at [1048].

[19] *Re Virgin Blue Airlines Pty Ltd* (2005) 195 FLR 242 at [148].

[20] *Stirling Harbour Services Pty Ltd v. Bunbury Port Authority* (2000) ATPR 41-752 at [113]; *Stirling Harbour Services Pty Ltd v. Bunbury Port Authority* (2000) ATPR 41-783 at [12] per Burchett and Hely JJ and [86] per Carr J; *Outboard Marine Australia Pty Ltd v. Hecar Investments No. 6 Pty Ltd* (1982) 66 FLR 120 at 124 per Bowen CJ and Fisher J.

conduct or acquisition, but this is not always the case because the enquiry is forward looking.[21]

19. In making judgments about the future conditions and environment for competition the enquiries required by Part IIIA (including criterion (a)) necessarily look to an extended period into the future. The decision to declare a service under Part IIIA must hold good for the whole of the period of the declaration.[22]

20. Barriers to entry connote the existence of market power because significant barriers to entry afford an opportunity for a firm to sustainably raise prices without losing customers.

First Error: Short Run Effect of Reducing Coal Production

21. The Tribunal did not consider the idea of creating the conditions or environment for improving competition in its conclusions in relation to Issue 2, notwithstanding some reference to the concept in its consideration of Issue 1.[23] Instead the Tribunal focused attention on the short term static quantitative effects of PNO's pricing on volumes of coal production as an indicator of changes in competition.

22. The Tribunal also found the letter from Synergies Economic Consulting of 1 September 2015 to be of little use,[24] the Tribunal observing that it constituted an attempt to estimate the additional charges which PNO may seek to impose (above the recent current increase) based on PNO's target rate of return and cost base. The Tribunal concluded that that exercise did not assist because it proceeded on the basis of *no analysis of the impact of a price rise on coal export volumes*. Either a price rise would have an impact on coal export volumes, in which case the estimates were of questionable value, or it would not, in which case the claim of any competitive impact was seen to be empty.[25]

23. This view of the matter – that the claim of any competitive impact of a price rise is 'seen to be empty' if that price rise would have no impact on coal export volumes – equates the competitive impact of a potential price rise with the impact of that price rise on coal export volumes. To do so circumscribes the 'with or without' test so that it is a short-term

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[21] *Stirling Harbour Services Pty Ltd v. Bunbury Port Authority* (2000) ATPR 41-752 at [113]; *Stirling Harbour Services Pty Ltd v. Bunbury Port Authority* (2000) ATPR 41-783 at [12] per Burchett and Hely JJ.

[22] *Pilbara Infrastructure Pty Ltd v. Australian Competition Tribunal* (2012) 246 CLR 379 at [99] per French CJ, Gummow, Hayne, Crennan, Kiefel and Bell JJ.

[23] Tribunal's reasons at [107] (in the context of identifying dependent markets) and [114].

[24] Comprehensive Reference Index (**CRI**), Part C, tab 31A.

[25] Tribunal's reasons at [137].

quantitative assessment only, downplaying or ignoring qualitative judgments about long-run effects.

24. The Tribunal gave little if any weight to dynamic efficiency and incentives to invest in the medium to long term. First, the Tribunal erred in rejecting, or giving no weight to, the evidence of Dr Bishop of RBB Economics[26] regarding dampening incentives to invest in the medium to long term, including the dynamic adverse consequence on competition of blunting investment in expanded production capacity, on the basis that this was 'no more than a set of theoretical propositions, unsupported by data that might inform the possible magnitude of the effects claimed'.[27] This demonstrates that the Tribunal focused upon short run quantitative assessments and 'data' regarding the 'magnitude' of the immediate effects, rather than adopting an evaluative assessment of the effect of such disincentives to invest on the conditions or environment for competition on a 'with or without' test.

25. Second, the arguments concerning uncertainty in relation to PNO's future charging increases were dealt with summarily,[28] without conducting a 'with or without' test comparing the two future scenarios in each of the relevant dependent markets, without reference to whether or not increased access to the Service would reduce or remove that uncertainty, and without consideration of whether or not such a reduction or removal would create or enhance the conditions or environment for improving competition.

Second Error: The Incentive not to reduce coal production

26. The shipping channels at the Port are a natural "*bottleneck*" monopoly so that the shipping channels are the only commercially viable option for the export of seaborne coal from the Hunter Valley region.[29]

27. Until May 2014, the Port was operated by the State of NSW.[30] In May 2014, the joint venture parents of PNO, Hasting Funds Management and China Merchants Group, entered into a long term lease arrangement with the State of NSW for the privatisation of the Port assets, including the shipping channels, that is the Service, generating gross proceeds of some A$1.75B to the State of NSW.[31]

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[26] CRI, Part C, tab 31B1.

[27] Tribunal's reasons at [143]-[144].

[28] Tribunal's reasons at [156].

[29] National Competition Council "*Declaration of the shipping channel service at the Port of Newcastle – Final Recommendation*" (2 November 2015) (**NCC Final Recommendation**) at [4.89]; Tribunal's reasons at [7].

[30] Tribunal's reasons at [10].

[31] Tribunal's reasons at [12].

28. In the case of PNO, the ultimate customers are the mines who made their investments during the period in which the Port was government owned. During that period, it was implicit that the government – as owner of the Port – would not exercise market power and extract the value of those investments by raising port charges. The miners could therefore invest in good faith in developing their mines, creating substantial economic value. Now, as a result of privatisation, that constraint has been removed.[32] Absent declaration of the Service, PNO has essentially unfettered pricing ability.[33]

29. Even though the charge for Port services is currently small as a proportion of the total supply chain costs,[34] there is no guarantee that it will remain small in the future.

30. Assuming PNO has an incentive to exercise its market power,[35] the Tribunal ought to have held that access or increased access would enhance the conditions or environment for improving competition in dependent markets because commercial negotiations would then be conducted with the knowledge that, in default of agreement, independent arbitration is available.[36]

31. Instead the Tribunal reasoned as follows:[37]

> "*... there is a practical constraint on PNO of ensuring that coal producers continue to supply into a highly competitive market. That is, if price rises imposed by PNO made some coal producers uncompetitive globally, and led to some operations ceasing in the Hunter Valley, this could reduce volumes and revenues for PNO. While it is possible that this may not constrain PNO if other producers remained that could absorb the price increases, it is more likely that PNO would have an incentive to maximise the flow of coal through the Port so as to capture as much of the benefits from this coal export market as possible. Consequently, it does not necessary [sic] follow from an ability to increase prices that there will be a* ***reduction in coal production that impacts competition*** *in the coal export market because PNO has the commercial motivation to ensure that the Service supports the ongoing coal export market and its expansion.*" (emphasis added)

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[32] See Malbon, Justin, (1998), *"Gaining balance on the regulatory tightrope"*, in 'Who benefits from privatisation?' (London, Routledge) at p. 13; Marsden, John, (1998), *"Reforming Public Enterprises: Case Studies: Australia"* (OECD Public Management Service) at pp. 3-4.

[33] Tribunal's reasons at [133], [135], [138] and, in particular, [145] where the Tribunal described the charges for the Service, if not subject to declaration, as *"largely unconstrained"*.

[34] NCC Final Recommendation at [4.96]-[4.99]; Tribunal's reasons at [156].

[35] See the Tribunal's reasons at [135].

[36] See *Re Virgin Blue Airlines Pty Ltd* (2005) 195 FLR 242 at [516].

[37] Tribunal's reasons at [155]. See also the Tribunal's reasons at [137] where, as noted above, the Tribunal critiqued the report of Synergies Economic Consulting (1 September 2015, CRI, Part C, tab 31A) on the basis that either "*a price rise would have an impact on coal export volumes, in which case the estimates are of questionable value, or it would not, in which case the claim of any competitive impact is seen to be empty*".

32. This reasoning rests on a premise that PNO's incentive to maximise the flow of coal through the Port constrained it from increasing prices, where such an increase would otherwise be likely to reduce coal production and impact competition. This fails to recognise that a monopolist can increase prices so as to harm the conditions or environment for competition notwithstanding that coal production levels do not immediately fall.

33. The Tribunal's approach does not properly consider the question of price discrimination nor allow for the consequences of increases in the world price for coal. These matters were raised on the material before the Tribunal and are directly relevant to the proper application of the "with or without" test that is required to be carried out for each dependent market.

34. If PNO cannot price discriminate, an attempt to increase its profits by raising its charges for Port services will normally result in a reduction in demand for Port services in the medium to long term.[38] In these circumstances, PNO will face a trade-off between price and volume. An attempt to maximise profits by raising prices will result in a reduction in coal mined for export in the mid to long term.

35. However, PNO may be able to price discriminate, and this is recognised both by the NCC[39] and the miners.[40] For example, PNO could charge each mine a different price for the use of Port services. If it is able to do this effectively, PNO could achieve an outcome in which there is no reduction in volume notwithstanding that it has materially increased prices to some mines. However, it is incorrect to conclude, as the Tribunal has implicitly done, that because there is no prima facie reduction in volume, there is no detrimental impact on competition.

36. This can be illustrated using the following scenarios.

37. Suppose that each Hunter Valley coal mine has some constant variable cost of extraction, which can be expressed in dollars per tonne of coal, up to some capacity limit (the maximum amount of coal that can be extracted per year).[41]

38. The following table sets out hypothetical figures for four coal mines, labelled A, B, C and D. The variable cost, capacity, and fixed cost of each mine is as set out in the table below. A

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[38] This follows under the normal economic assumption that the demand for port services is "downward sloping". It is theoretically possible that a port is able to increase prices over some range without having a material effect on demand for port services. However, a profit-maximising port would continue to increase prices beyond this range to the point where there arises a material reduction in demand for port services.

[39] NCC Final Recommendation at [4.93].

[40] Submission by The Bloomfield Group (16 June 2015, CRI, Part C, tab 12) at p.3.

[41] In practice the cost of extraction is not likely to be strictly constant – instead, it is likely that the higher the rate of extraction of the coal mine the higher the cost of extraction. Nevertheless, the assumption of constant costs of extraction is a good place to start.

further assumption is made that the fixed cost reflects the sunk costs of the investment in developing the mine. Finally, assume that the current world price for seaborne coal is $50/tonne.

Mine	Variable Cost ($/t)	Capacity (mt/annum)	Fixed costs ($m/annum)
A	$10	50	1000
B	$20	100	2000
C	$30	30	500
D	$40	10	70

39. In the first scenario assume that PNO is unable to price discriminate – that is, PNO must charge the same price for Port services to each mine – and that the charge is currently set as a flat fee of $2 per tonne of coal shipped. At this price all of the mines choose to produce at their capacity. The total volume of production is 190 mt/annum, and each mine is profitable.

40. Now assume that the Service is not declared and PNO seeks to set Port charges in a manner which maximises its overall profit. If PNO increases the charge to more than $10/tonne the smallest miner (mine D) is no longer covering its variable costs and will choose to shut down. This reduces the volume of coal shipped through the Port to 180 mt/annum. However, it can be profitable for PNO to reduce the volume of coal shipped if this reduction is offset by increasing charges on the remaining volume. In fact, if PNO is unable to price discriminate, its profit is maximised with a charge of (just under) $30/tonne. At this price mines C and D cease to produce, reducing the throughput to 150 mt/annum. But the foregone volume on these mines is made up by higher charges on the remaining volume.

41. This scenario illustrates that, in the case where PNO is *unable* to price discriminate, it will typically have an incentive to choose a price which balances a reduction in volume against an increase in the price. Relative to a future where the Service is declared, PNO's incentives are likely to result in some reduction in the volume of throughput, and potentially some reduction in the number of suppliers in the upstream market.

42. However, the NCC recognised that it is likely that PNO can engage in some degree of price discrimination.[42] Therefore consider a further scenario in which PNO can price discriminate in some way. For example, suppose that PNO can set a different price for coal which is

[42] NCC Final Recommendation, [4.93].

shipped from the two largest mines (A and B in this example), compared to the smaller mines (C and D). (This might be because the larger miners use larger ships, for example). In this case PNO could increase its profitability by charging mines A and B just under $30/tonne, while charging a *lower* price to mines C and D (just under $20/tonne). With this charge mine C remains in operation, so the overall volume of throughput is increased, to 180 mt/annum, which increases the profit to PNO. Price discrimination allows PNO to increase throughput and, at the same time, to increase its profits. However, the mines are not covering their total costs – PNO has, in effect, expropriated some of the value of their investments.

43. From the perspective of PNO, the ideal situation is one in which PNO is able to perfectly price discriminate - that is, to charge each mine a different price.[43] In this example, PNO can theoretically maximise its profit by charging a price (just under) $40/tonne for mine A, $30/t for mine B, $20/t for mine C and $10/t for mine D. At this price each of the mines is on the verge of shutting down but continues to mine the maximum amount of coal available to it. Therefore the total volume of coal exported is also maximised at 190 mt/annum.

44. The above scenarios illustrate that, where PNO is able to price discriminate, it will usually be profitable for it to do so, since price discrimination allows PNO to raise prices without sacrificing volume. If it is able to price discriminate, even if imperfectly, it will likely be profit maximising to price in such a way as to maintain throughput through the Port, and to keep all of the existing mines in operation, despite substantial increases in prices. At the same time, in seeking to maximise its profits through price discrimination, PNO will extract some or all of the profit that the mines expect to be able to recover as a result of their investments.

45. The threat of future expropriation of some of the profits of miners by PNO is likely to have a dampening or chilling effect on future investment in the Hunter Valley coal mines which in turn is damaging to the conditions and environment for competition in one or more of the dependent markets.

46. Further, even putting price discrimination by PNO to one side, if the world price for coal increases from $50/t to $60/t, PNO can increase the price for Port services to all the miners by $10/t without affecting throughput. If the mines made their original investment in the expectation that they would be able to earn a positive cash-flow at times of higher coal prices in order to recover the costs of that investment, that expectation has proved to be unfounded.

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[43] Perfect price discrimination is seldom feasible in practice - as it requires a high level of information about the production costs or demand facing upstream or downstream customers.

47. Absent regulated access, there appear to be few limits on the ability of PNO to raise the charge for Port services. In the absence of any pricing restraint, the customers of the Service face a problem: any investments they make in reliance on the Service are subject to the threat of hold-up – the threat that once the investment is made the monopoly service provider will seek to change the terms and conditions in its favour. Fearing this outcome, the customers will be reluctant to invest, or will make less desirable investments. The harm to the competitive environment from the exercise of market power is the potential chilling effect on investment by customers who are dependent upon a service provided by a firm with market power.[44]

Dated: 9 November 2016

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[44] The potential for market power to have a chilling effect on sunk investments is recognised in competition analysis e.g. Bishop, (10 September 2015, CRI, Part C, tab 31B1) "*An Economic Assessment of NCC's Draft Recommendation not to declare the Shipping Channel at the Port of Newcastle*" at pp.6-10; ACCC, (2013) "*Productivity Commission review of the national access regime: ACCC submission to the Issues Paper*" at pp.80-81; NCC, (2012) "*Moomba to Sydney pipeline system: Revocation applications under the national Gas Code: final recommendations*" at p.21.

Schedule

No. NSD 1147 of 2016

Federal Court of Australia

District Registry: New South Wales

Division: General

Respondents

Second Respondent:	Glencore Coal Pty Ltd ACN 082 271 930
Third Respondent:	Commonwealth of Australia
Fourth Respondent:	Australian Competition and Consumer Commission