

Exclusive Dealing Notification N10000453 lodged by Gladstone Ports Corporation Ltd (GPC)

Smit Lamnalco Towage Australia Pty Ltd response to Svitzer Australia Pty Ltd's Supplementary Submission of 11 June 2018

Smit Lamnalco Towage Australia Pty Ltd (**Smit Lamnalco**) is pleased to have the opportunity to provide the Australian Competition and Consumer Commission a submission in response to the Supplementary Submission of Svitzer Australia Pty Ltd (**Svitzer**) lodged on 11 June 2018 (**Svitzer Supplementary Submission**).

The Svitzer Supplementary Submission attaches report from Synergies Economic Consulting titled '*Economic assessment of exclusive licensing of towage services at Port of Gladstone*' and dated June 2018 (**Synergies Report**).

Smit Lamnalco's response to various arguments raised in the Svitzer Supplementary Submission and Synergies Report are set out in the table below.

	Svitzer Submission	Smit Lamnalco's response
Overview		
1.	<p>Svitzer contends the Notification should be revoked because:</p> <ul style="list-style-type: none"> <i>"competition is sustainable in the Port of Gladstone as proven by the fact that the Port is one of Australia's busiest ports and there is competition and contestability in Australian ports of a comparable size to Gladstone and even at significantly smaller ports";</i> <i>competition between towage providers continues even if there is joint reliance on tugs as each provider tenders for customer contracts and maintain direct relationship with their customers;</i> <i>"the threat of entry is an effective and meaningful constraint particularly given that the costs of entry are not prohibitively high for the major towage operators and are not sunk costs;</i> 	<p>In summary, Smit Lamnalco submits that the Notification should be allowed to stand because offering an exclusive licence is likely to be the best means to ensure a competitive outcome for the rates and terms offered for towage services at Gladstone because of the substantial economies of scale and scope involved in providing harbour towage services at Gladstone.</p> <p>The arguments raised in the Svitzer Supplementary Submission and Synergies Report are not persuasive in suggesting otherwise, because:</p> <ul style="list-style-type: none"> Svitzer has not provided any factual or analytical basis to challenge the modelling provided by GPC, which clearly indicates there is insufficient forecast demand in the Port of Gladstone to viably sustain more than one towage operator; Svitzer's submission to the contrary is merely argumentative. Svitzer has not provided any evidence to support its claim that more efficient

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	<p><i>competitors and potential competitors are able to demobilise and move assets to other ports."</i></p>	<p>or competitive outcomes would be achieved through "<i>simultaneous service provision by two or more operators</i>".¹ Svitzer/Synergies have confused references to '<i>cross-hiring arrangements</i>' and '<i>subcontracting the physical delivery of services</i>' under service level agreements. For the reasons explained below, neither model is a realistic outcome at Gladstone.</p> <ul style="list-style-type: none"> • Svitzer's references to the Ports of Eden, Darwin and Fremantle are not, on close analysis, supportive of Svitzer's contentions as none of those Ports is comparable to Gladstone. Given the difference between the towage functions performed by C Class tugboats and the larger vessels undertaking the general harbour towage duties at Gladstone, it is not appropriate to rely on the C Class services arrangement between Svitzer and Total AMS at Fremantle (see Synergies Report, page 35) as a basis for inferring that a similar arrangement can be established at Gladstone. At Darwin, NT Maritime entered the port but failed to establish a viable towage business case and consequently left the port. Furthermore, Coastal Tug Barge (CTB) describes itself as "in partnership" with Svitzer, its half owner, and operates C Class Tugs.² • In its first submission, Smit Lamnalco provided cogent evidence of the substantial entry costs it incurred in Gladstone, which contradict any unsubstantiated suggestions by Svitzer/Synergies that costs of entry are not very significant. In light of those substantial entry costs, the high degree of asset specificity and a real risk of not recovering costs due to uncertainty about competition in the port, including the potential for retaliation / strategic behaviour by incumbents, any towage operator under a non-exclusive licence will face few constraints from threatened entry. • Synergies' claim (at page 53) that an operator at Gladstone could exit the

¹ Synergies Report, at page 4.

² "Coastal Tug Barge ...CTB operates in collaboration with the Darwin Port Corporation and in partnership with one of the world's most powerful tug corporations, Svitzer." see <http://coastaltugandbarge.com.au/about-ctb/>

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		<p>port with minimal costs, and shift its tugs elsewhere in Australia, is also unsubstantiated and should be rejected. Svitzer/Synergies ignores the LNG specific set up costs incurred to provide LNG towage at Gladstone and has not identified any other Australian port where such a move could be made with minimal cost, or likely demand for the tugs to be utilised or a viable business case.</p>
Cross-hiring and sub-contracting arrangements		
2.	<p>Cross-hiring of tugs</p> <p>The Synergies Report argues that '<i>[t]he PwC report does not take into consideration opportunities for cross-hiring between tug providers in a port.</i>' (Synergies Report, at page 34).</p> <p>The Synergies Report describes '<i>cross-hiring arrangements</i>' in the following terms:</p> <p><i>'Each operator maintains its own commercial relationship with its customers, and operators compete with each other for those customers. The arrangements are confined to agreements for the physical delivery of those services, and are used to manage "overflow" conditions in which it is efficient for a firm to assign a towage job to a competitor - the competing firms do not jointly perform jobs.'</i> (Synergies Report, at page 34).</p>	<p>Smit Lamnalco contends that PwC was correct not to consider cross hiring as a viable option at Gladstone.</p> <p>There is inconsistency between the Svitzer Supplementary Submission and the Synergies Report in terms of how they reference '<i>cross-hiring arrangements</i>' and '<i>subcontracting the physical delivery of services</i>' under service level agreements.</p> <p><i>Sub-contract arrangements</i> of this kind have emerged at the Ports of Brisbane, Botany, Melbourne and Newcastle, as a consequence of the fact that two physical operators at those ports were unsustainable (See Svitzer Supplementary Submission, page 6).</p> <p>Under a sub-contracting arrangement, an operator (that has no towage fleet situated at the port), sub-contracts performance of tug jobs for its remaining customers to the operator that has the only tug fleet at the port. Under such an arrangement, both operators may compete for towage contracts, but the service is delivered by one operator.</p> <p>A '<i>cross-hiring arrangement</i>', by contrast, would involve two towage operators both operating towage vessels at a port who may agree to share towage assets from time to time. This could assist, for example, for large vessels requiring additional tugs, however it still leads to vessel underutilisation and has not generally been adopted.</p> <p>Smit Lamnalco is not aware of any cross-hiring arrangements which have been agreed or are in place between towage competitors at any Australian port in recent memory. When Smit Lamnalco's predecessor, PB Towage, previously approached Svitzer to seek its participation in a sustainable cross-hire arrangement in Newcastle, Melbourne, Brisbane and Port Botany, to supplement their dual operation in place at</p>

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		<p>those ports, Svitzer refused cross hiring on each occasion.</p> <p>A long term cross-hiring arrangement between two operators looking to avoid asset overcapacity at a port would be inefficient and create risks for port users. For example, the customers requiring LNG towage at the Port of Gladstone have significantly high safety and operating standards that must be satisfied by any LNG towage operators at the Port. A cross-hiring arrangement would raise significant concerns for those LNG customers, as they must be fully satisfied with the safety and operational record and capability of all parties to the arrangement.</p>
3.	<p>Entry based on sub-contracting to one operator</p> <p>Svitzer submits that '<i>competition between towage providers continues even if there is joint reliance on tugs as each provider tenders for customer contracts and maintain direct relationships with their customers</i>'. (Svitzer Supplementary Submission, at page 1)</p> <p>Svitzer refer to the Port of Brisbane and Port of Newcastle as examples where ports of comparable size to the Port of Gladstone can support more than one towage operator.</p> <p><i>'Port of Brisbane - the Port is currently served by SMIT and Svitzer...SMIT has not exited the port as claimed by GPC. Rather, it has entered into a service level agreement with Svitzer until 2020 pursuant to which Svitzer provides the physical towage operations. SMIT, however, continues to vigorously compete and contract directly with customers, providing a strong constraint on Svitzer.'</i> (Svitzer Supplementary Submission, at page 6)</p> <p><i>'Port of Newcastle - SMIT and Svitzer compete at this port, with a service level agreement pursuant to which Svitzer provides the physical towage service while SMIT directly compete for customers and maintains direct relationships with them.'</i> (Svitzer Supplementary Submission, at page 6)</p> <p><i>'The service level agreements between SMIT and Svitzer also demonstrate how market participants can resolve issues around</i></p>	<p>PwC was correct not to entertain or model Svitzer's sub-contract model as a realistic scenario for towage service delivery at the Port of Gladstone.</p> <p>Smit Lamnalco agreed to subcontract towage jobs to Svitzer in Brisbane, Melbourne, Botany and Newcastle as a means to maintain a presence in those ports and continue servicing its network customers. The decision was taken because, despite Smit Lamnalco's best efforts and pursuing all available efficiencies, demand in the ports did not support two operators on a sustainable basis.</p> <p>Furthermore, Svitzer's use of multi-port rebates for major customers made it extremely difficult for a new towage operator to successfully compete on rates at any single port. As result, after acquiring PB Towage, Smit Lamnalco ceased all physical operations in those ports and leased its tugs to Svitzer.</p> <p>Whilst the sub-contracting arrangement has proven beneficial to support the continuing participation of two established operators in 4 harbour ports, Smit Lamnalco is not aware of any towage operator who would be likely to enter a port such as Gladstone, based on securing a sub-contract arrangement with another towage operator at the port. Indeed, it would be difficult to see any significant upside to entry or benefit to a customer where the proposition is simply on-selling the services of a competitor.</p> <p>Based on its experience with sub-contracting arrangements, Smit Lamnalco considers it highly unlikely that the prospect of entering into a sub-contracting arrangement with another operator at a port would encourage a bidder for a non-exclusive licence.</p>

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	<i>optimal utilisation of towage vessels and efficiency while preserving vigorous competition for customer contracts.</i> (Svitzer Supplementary Submission, at page 6)	On the basis of the above, Smit Lamnalco's experience at the Ports of Brisbane, Melbourne, Botany and Newcastle does not support any of Svitzer's contentions on this issue.
4.	The Synergies Report notes that 'Svitzer advises that cross-hiring arrangements are common in Europe.' (Synergies Report, page 34)	Smit Lamnalco is not in a position to respond to this argument from Svitzer/Synergies, as they have not identified any ports in Europe where a cross-hiring arrangement is in place.
Comparison between Port of Gladstone and the Ports of Fremantle and Eden		
5.	<p>As noted above, Svitzer refers to the Ports of Fremantle and Eden as example of ports where multiple towage operators compare for a comparable or lesser number of tug jobs than at Gladstone. In relation to each of these Ports, Svitzer submits that:</p> <p><i>'Port of Fremantle - the port had half the number of tug jobs but a comparable number of vessel calls to Gladstone, but sustains three competing towage C operators, including Total AMS, Mackenzie Marine and Towage (MMT), and Svitzer...Svitzer and MMT operate two C Class tugboats each and Total AMS operates three.'</i> (Svitzer Supplementary Submission, at page 1)</p> <p><i>'at the Port of Eden, which recorded 95 vessel calls in 2016/17, Svitzer was the only provider until 2016 when Pacific Tug entered after winning a contract from the Eden chip mill.'</i> (Svitzer Supplementary Submission, at page 1)</p> <p>In relation to the Port of Fremantle, the Synergies Report also identifies that <i>'an allocation of overflow work occurs in other Australia towage markets, including in the provision of C Class towage services at the Port of Fremantle, where towage services are from time to time, sub-contracted between Svitzer and Total AMS. This example is testament, in itself, to such a competitive port model</i></p>	<p>Smit Lamnalco does not consider the Port of Fremantle and Port of Eden to be sufficiently similar to the Port of Gladstone to justify the comparison asserted by Svitzer and Synergies.</p> <p>The nature of the Ports of Fremantle and Eden are such that the tug job requirements at those ports are very different to the tug job requirements at the Port of Gladstone. Further details are provided under the relevant headings below.</p> <p>Port of Fremantle</p> <p>The Synergies Report is incorrect in identifying that C Class towage services are <i>'essentially the same'</i> as the harbour towage services provided by Smit Lamnalco at the Port of Gladstone. C Class tugboats cannot be used to perform general harbour towage duties at the Port of Gladstone, in any circumstances, due to the environmental conditions at the Port.</p> <p>C Class tugboats are of a much smaller size, compared to those deployed at the Port of Gladstone. Due to their smaller size, C Class tug boats are used by operators, such as Total AMS, in areas of the Port of Fremantle that are not subject to strong currents and weather constraints. C Class tugboats are not suitable for the general harbour towage duties undertaken by larger vessels, as identified in the relevant specifications set out on page 83 of the Fremantle Port Information Guide.³ Those specifications identify that a C Class tugboat has a bollard pull of "10T @ 100%</p>

³ The Fremantle Port Information Guide (2018) is available at: <http://www.fremantleports.com.au/SiteCollectionDocuments/Port%20Information%20Guide.pdf>.

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	<p><i>working sustainably over an extended period of time.'</i> (Synergies Report, at page 35)</p> <p>The Synergies Report also states that '<i>the C Class services at Fremantle are essentially the same service as that which is licensed exclusively at the Port of Gladstone for the harbour towage services.'</i> (Synergies Report, at page 47)</p>	<p>MCR", compared with the bollard pull of ">60T @ MCR" and ">35T @ MCR" for A and B Class tugboats, respectively.</p> <p>The fact that Svitzer occasionally engages a C Class tugboat from Total AMS is, therefore, not comparable to a situation where two towage operators, with a similar number of tugs that are of a similar size, are cooperating under a cross-hire arrangement.</p> <p>Port of Eden</p> <p>Eden is a much smaller port than Gladstone, has different physical features and does not include the LNG trade. Unlike the Port of Fremantle, the Port of Eden involves two towage operators, namely Svitzer and Pacific Tug, competing on the basis of the same service offering. After 18 months, it remains unclear whether the entry by Pacific Tug into Eden Port is profitable and sustainable. Svitzer has provided no evidence to suggest it is viable.</p> <p>Furthermore, there only appears to be approximately 210 jobs per annum at the Port of Eden. Therefore, given both operators operate 2 tug boats, a lines boat and pilot boat, it must be the case that both operators are incurring significant losses.</p>
Sunk and overhead costs associated with providing towage services		
6.	<p>Sunk costs are not material</p> <p>Svitzer submits that '[a]n incumbent towage provider at the Port of Gladstone is likely to be constrained by the threat of new entry as a towage service provider's primarily capital cost is not sunk. This is explored in details in the Synergies report which finds that:</p> <ul style="list-style-type: none"> • if operations at one port prove unprofitable, a towage operator's assets can be readily deployed to another port. The major capital costs incurred in entering a port are therefore substantially recoverable on exit; • as the primary capital costs of entry are not sunk, entry and 	<p>These claims are theoretical, overstated and have not been substantiated.</p> <p>Svitzer and Synergies' argument that tugboats are highly mobile does not address the issue of whether on exiting the port of Gladstone, an operator could reasonably expect to deploy those tugs elsewhere in Australia on a sustainable and profitable basis.</p> <p>The tugs required at Gladstone have a large bollard capacity and would only be suitable to service other large shipping ports, such as Newcastle. However, this port is already fully serviced. No examples of actual redeployment opportunities are identified by Svitzer or Synergies.</p>

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	<p><i>exit into the towage services market at a particular port can more readily occur;</i></p> <ul style="list-style-type: none"> <i>an analysis of the costs of entering and exiting the Gladstone towage service market, and strategies for entry, shows that there are no material barriers to entry. While the costs are no insignificant, they are not prohibitive for the major towage operators'. (Svitzer Supplementary Submission, at page 8)</i> <p>The Synergies Report states that the '<i>[w]hat matters from the perspective of sunk costs is whether, in the event that entry is unsuccessful, a loss will be able to be averted through the alternative deployment of the tug at another port or, at worst, on the disposal (whether by sale or lease) of surplus tugs.</i>' (Synergies Report, at page 51)</p> <p>Synergies concludes that '<i>towage service assets (essentially tug boats) are highly mobile so their owners may move them to other markets or sell them. Therefore, although the costs of market entry are not insignificant, most of those costs are not sunk because they can be recovered on exit.</i>' (Synergies Report, at page 60)</p>	<p>Nor is it realistic for Synergies to claim (at page 6), without any evidence, that a second operator at Gladstone could feasibly recover its sunk costs by returning the tugs to the manufacturer (in Europe) or undertaking salvage, offshore support or tug and barge operations.</p> <p>Smit Lamnalco is not aware how the tugs from the Port of Gladstone could be "<i>readily deployed to another port</i>", as submitted by Svitzer, to avoid their capital and establishment costs being sunk and not recoverable.</p> <p><i>Smit Lamnalco's investment in LNG tugboats at Gladstone</i></p> <p>As outlined on pages 4-5 of Smit Lamnalco's initial submission⁴, the LNG tugboats commissioned for Gladstone were designed in close conjunction with GPC, MSQ and the LNG shipping lines to meet the specific LNG towage requirements for the Port of Gladstone. This included equipping these LNG tugboats with a larger bollard pull than the harbour tugs and gas detectors and gas-type dampeners on all air inlets and outlets. Smit Lamnalco also invested in training specialist crews for these LNG tugboats in the operational and safety requirements of GPC and the surrounding LNG terminals.</p> <p>The Synergies claim (p38) that entry at Gladstone may be viable with second hand tugs appears to be mere speculation, and is contrary to Smit Lamnalco's experience and evidence of entry costs.</p> <p><i>The role of uncertainty for potential entrants</i></p> <p>The arguments raised by Svitzer and Synergies are presented from the perspective of a towage provider with existing investments in towage assets capable of serving the Port of Gladstone.</p> <p>A robust analysis of the costs of entering the market for supplying towage services at Gladstone requires an assessment of the costs of entry faced by a new entrant that</p>

⁴ Smit Lamnalco, Public Register version submission to ACCC regarding Exclusive Dealing Notification N10000453 lodged by Gladstone Ports Corporation, 6 April 2018 (Smit Lamnalco 6 April Submission).

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		<p>does not have existing towage assets. New entrants of this nature face greater uncertainty on the return on their substantial upfront investment in acquiring towage assets. For example, the terms of the contract and its duration will not be known to a potential new entrant.</p> <p>This uncertainty, and the existence of economies of scale in combination with sunk costs, will result in a lower likelihood of entry, and therefore less constraints on competition. In overlooking the forward-looking, incremental risks of potential entrants, the Synergies report has overstated the likely state of competition under a non-exclusive licence. Further, the Synergies report understates the extent of competition for an exclusive licence, with the consequence that it has exaggerated the extent of competition under a non-exclusive licence and compared that exaggerated state to an understated state of competition under the exclusive licence.</p>
	<p>Overhead costs can be spread across other operations</p> <p>The Synergies Reports states that the PwC Report 'assumes that a second towage operator would need to replicate the allocated shore-side overhead footprint of the incumbent in whole or to a degree. This may be a reasonable assumption for a greenfields towage entrant. However, an established towage operator would be able to leverage other operations to cluster its overhead footprint. An example would be Svitzer's ability to rationalise its indirect labour in Gladstone with its other operations in Brisbane and Newcastle.' (Synergies Report, at page 39)</p>	<p>Svitzer is the only example of a towage operator that is able to leverage its other operations around Australia. Established towage operators with the ability to spread their costs broadly across their Australia-wide operations are able to leverage this by submitting a competitive bid for an exclusive licence at the Port of Gladstone.</p>
<p>Barriers to entry and the degree of competition at other Australian ports</p>		
7.	<p>Synergies submits that '<i>although most Australian ports are at present served by a single service provider, in last decade, in particular, there has been a number of entries and exits in the provision of harbour towage in specific Australian ports.</i>' (Synergies Report, at page 5)</p>	<p>This statement from Synergies is misleading as the fact that there have been entries and exits actually shows a lack of sustainable competition where there is more than one operator. The threat of new entry is only credible if that entry is of a sustainable effective competitor. If it were otherwise, a surviving towage provider could impose monopoly pricing once all other competing providers have exited the market.</p> <p>This is consistent with the PC Report, where the Productivity Commission considered the relevant question to be whether two towage providers will be sustainable in the</p>

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		long term. ⁵
8.	<p>Synergies submits that '<i>if one firm entered the market and the subsequent competition led to the exit of one of the firms, then customers not only will have benefited from the competition while it existed - they would continue to benefit because their discovery of efficient prices and services will maintain pressure on the remaining firm to perform (or itself risk new entry)</i>'. (Synergies Report, at page 9)</p> <p>Synergies also submits that '<i>there is no question that a towage provider's incentives to improve efficiency will be sharper in an environment where an operator's relative efficiency is consistently tested in the market</i>'. (Synergies Report, at page 41)</p> <p>Synergies then conclude that '<i>in the absence of exclusivity, it will be the threat of entry that will constrain the incumbent's pricing</i>.' (Synergies Report, at page 79)</p>	<p>Synergies' argument ignores the significant barriers to entry that face a potential new entrant to the market for supplying towage services. Specifically, the Synergies Report ignores the details of the economies of scale at the Port of Gladstone presented in the Smit Lamnalco 6 April 2018 Submission.</p> <p>As identified in the Smit Lamnalco 6 April 2018 Submission, Smit Lamnalco made a substantial investment in acquiring port-specific assets, training, support systems and the overall establishment of its towage operations at Gladstone.⁶ This illustrates the significant capital investment required to enter the market, which is relevant to determining the profitability of a new entrant supplying towage services at the Port of Gladstone.⁷</p> <p>In other words, a tenuous entry threat created by a non-exclusive licence would be unlikely to offer any material competitive constraint to the incumbent. As a result, an exclusive licence is unlikely to materially lessen the competitive tension for customers at the Port of Gladstone.</p> <p>It is far preferable to improve the chance for competitive tension by awarding an exclusive licence. When the exclusive licence is re-tendered sufficient protections will be in place to underpin investment by a single operator.</p> <p>In focusing on sunk costs and transient new entry, the submissions from Synergies also ignore strategic barriers that exist and limit the contestability of towage services at Australian Ports. 'Strategic barriers' are those that arise because of actions or threatened actions by incumbents that deter new entry.⁸ A relevant example is</p>

⁵ PC Report, at [77].

⁶ Smit Lamnalco 6 April 2018 Submission, at [25].

⁷ The ACCC's *Merger Guidelines* state that '[t]he likelihood of entry generally depends on the profitability of entering the market. The ACCC will assess whether a new entrant could expect to make a commercial return on its investment' (at [7.24]).

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		Svitzer's practice of offering rebates to multi-port customers which a single port operator cannot match.