Flinders Ports
SOUTH AUSTRALIA

Essential Services Commission of South Australia

Ports Price Review:

Discussion Paper No. 1

Should Price Regulation Continue?

Flinders Ports Response

March 2003

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EXECUTIVE SUMMARY

Background

Following the sale of the Ports Corp SA business to Flinders Ports, the SA Government Minister for Government Enterprises made a First Pricing Determination under the Maritime Services (Access) Act 2000 (the MSA Act). This provided for the regulation of prices for Essential Maritime Services supplied by the Regulated Operator (Flinders Ports) for the initial period after privatisation. The regulatory mechanism has been administered by the South Australian Independent Industry Regulator, subsequently known as the Essential Services Commission of South Australia (ESCOSA).

In addition to the price regulation under the First Pricing Determination, a Ports Price Review is required under section 7 of the MSA Act. The details of the planned review are set out in the open letter from the Independent Industry Regulator dated 29 August 2002. The letter defines the process as considering the 'IF' of price regulation – ie. is price regulation needed? – and the 'HOW' – if so, how should it be done. Since logically the 'HOW' will follow the 'IF', the initial task for ESCOSA will be to assess the desirability of continuing price regulation.

In November 2002, ESCOSA issued a discussion paper, in which it invited submissions from interested parties in relation to a range of issues that it considered relevant to the review. This short paper summarises the argument of Flinders Ports' response to that invitation: the arguments summarised here will be explored in more detail in the full submission.

Principles of Good Regulation

General principles of efficient regulation are contained in the Competition Principles Agreement which was endorsed by the Council of Australian Governments in 1995. These principles are that:

1. the burden of proof that regulation is necessary remains with the proponents of regulatory change;
2. regulatory change should be the minimum required to achieve the desired outcomes;
3. regulation should be designed to have minimal impact on competition;
4. regulation should have clearly identifiable outcomes and should be performance based rather than prescriptive;
5. regulatory measures should be compatible with relevant international standards or practices;
6. regulation should not restrict trade; and
7. regulatory oversight should be reviewed at least every 10 years to assess whether continued regulation is needed.

Flinders Ports believes that these principles – and particularly principles 1 to 4 - provide useful guidance for the assessment of the desirability of continuing price regulation of the port sector in South Australia. (

The costs and risks of regulatory intervention in price setting are being increasingly recognised. The Productivity Commission has drawn attention to many of these in its recent report on the National Access Regime, highlighting in particular the potential threat to future investment of excessive intervention. Other recent reviews, including the Parer report on the regulation of the electricity industry, have arrived at similar conclusions. Emerging as central themes are:

Materiality — As regulatory intervention has significant costs, it should only take place if the market imperfections it is intended to address are substantial

Proportionality — The nature of the regulatory response should be carefully calibrated to ensure that it is proportionate to the consequences of any potential abuse of market power.

These considerations were influential in the decision of the Commonwealth Government to remove the price-capping regime in the airports sector. They are at least as relevant to the South Australian port sector.

Flinders Ports view is that port prices should not be regulated unless there is a demonstrable and imminent risk that, in the absence of such regulation, prices would be set and sustained at a level that reflects the abuse of substantial market power.

This is not the case in the port sector in the South Australia for two main reasons:

- The basic infrastructure services that we provide are subject to market pressure from a variety of sources, and our behaviour reflects the effectiveness of these pressures in ensuring that we perform efficiently and price appropriately.
- If opportunities to extract excess profits in the short term do exist, taking advantage of these opportunities would be detrimental to our long-term commercial interests, as reflected in our business principles and operating objectives

Service Definition

The Discussion Paper specifically seeks comment on the extent and definition of the services that should be covered by price regulation.

If price regulation is to continue, the appropriate starting point for this assessment is the notion of essential infrastructure facilities as defined in Competition Principles Agreement. If this suggestion is accepted, then the range of services to which price regulation should be applied is that delivered by means of essential infrastructure facilities. Which would be uneconomical to duplicate, where access is necessary to permit effective competition in a downstream or upstream market and where market power exists. This test would include maritime access to the ports using navigation channels. It may also include the use of berths and wharves for cargo handling operations.

However, the definition would clearly exclude services, such as mooring and pilotage, that are not inextricably tied to the provision of essential infrastructure facilities. It would also exclude services that are provided by means of facilities that could be readily replicated at another location. Generally, the storage of cargoes within the port, either in open areas or in covered sheds, would fall into this category, since port users could use off-wharf facilities instead without incurring unreasonable costs. However, the provision of space in order to marshal cargoes on the wharf for imminent loading or immediately after discharge, where this can reasonably by considered an integral part of the loading or discharge operation, could justifiably be included within the scope of a regulated service.

Pricing Structure

Traditional port charging practices are generally complex and vary greatly from port to port. The relationship between specific costs and charges is often also relatively ill-defined. There are a range of strongly held views on the appropriate structure of port tariffs but no simple solution.

The balance of Flinders Port's prices are a compromise hammered out over the years between a port and it's customers, taking into account the cost of providing the service, perceptions of ability of dedicated users to pay, acceptability to the trading community and historical and political factors. Flinders Ports believes that the current situation whilst not perfect has a number of desirable characteristics and in any case the economic benefits that flow from changing the structure are dubious and long term, but the commercial inconvenience and costs immediate and certain.

In our view, the best approach to resolving any anomalies in pricing coverage and structure is a gradualist one, involving consensual change based on bilateral negotiations between Flinders Ports and customers within a flexible time frame. This will require a degree of flexibility and commercial sensitivity that would be hard to achieve within the context of mandated regulatory prices.

Market Analysis

Structure

Competition

Flinders Ports' contention that regulation of port prices in South Australia is unnecessary is supported by analysis of the structure of the markets within which we operate. In understanding how market conditions affect our pricing behaviour, it is essential to adopt a broad view of the nature of competition in the port sector. Many of Flinders Ports' customers could easily choose to ship their cargoes through other ports: we face direct competition from ports such as Melbourne and Port Stanvac. But there are also other forces at work that can be just as powerful as, or even more powerful than, the impact of this direct competition. What matters is the impact of pricing decisions on long-term profitability.

Pricing decisions that do not take adequate account of both the competitive conditions faced by, and the logistics options available to the customer may cause a customer to become uncompetitive in an export market, or to choose to sell product domestically rather than in export markets, or to use rail transport rather than coastal shipping. In each of these cases the impact on Flinders Ports business is the same as if the customer decided to ship through Whyalla or Melbourne rather than one of Flinders Ports' ports (Flinders Ports Ports). All of these alternatives therefore represent dimensions of market pressure on our pricing policy.

Details of precisely how these competitive pressures work in the case of particular trades and customers are set out in a confidential annex to this submission.

Cost Structure

The provision of port infrastructure services in South Australia as elsewhere is characterized by high fixed costs and low variable costs. As a result, Flinders Ports' business results are very much driven by volume: there is a strong incentive to encourage and assist customers to increase the volumes that they ship through our ports. This is reflected in pricing practices: many of the commercial agreements that have been negotiated with customers provide for some form of discount or rebate when volumes exceed threshold levels.

Nature of the Customer Base

Flinders Ports' customers are rarely private individuals. In general, we deal with business clients, often with companies that are very much larger than our own. Our customer base is concentrated, and the loss of an individual customer can have a significant impact on our bottom line. Finally, in many cases, these companies have access to detailed information and analyses of the transport options that are available to them: information that we do not possess.

Taken together, these factors argue for the determination of appropriate pricing levels through a process of commercial negotiation. Expressed in formal terms, our customers are in a position to exercise considerable countervailing power, and they routinely do so. The risk that they will be subject to any significant abuse of market power is consequently minimal, and price regulation is unnecessary.

Conduct

The preceding discussion dealt, at a conceptual level, with the motivational and structural reasons why the continuation of price regulation is unnecessary for the achievement of the principle objective of the ESCOSA Act. We can also point to a substantial body of empirical evidence to support this contention.

Firstly, it is important to note that, at present, almost all the prices that are subject to regulation are in fact set at levels below those permitted under the First Pricing Determination (FPD). This is because Flinders Ports has:

- Chosen to defer implementation of the general CPI rise for 2002
- Retained or enhanced all of the discounts and rebates that were in place at the time of the sale

- Introduced a number of additional arrangements with individual customers, each of which is designed either to respond to a customer's specific business needs, to encourage them to increase the volumes that they ship through Flinders Ports, or to reward them for those greater volumes.

In practice, therefore, what generally determines the prices for regulated services is not the limits set by the FPD but the responses we have made to market pressures in the light of our long term objectives. Specific details of these responses and the reasons behind them are provided in the confidential attachment to the submission.

Importantly, we have made significant efforts to improve service quality at the same time. These service quality improvements have taken a number of forms including infrastructure development and enhanced operating performance. Once again, some of these initiatives are set out in detail in the confidential attachment.

More generally, Flinders Ports has worked hard to improve the way in which we relate to our customers, to understanding their real needs and respond to them. The outcomes from these efforts are currently being sought through a customer satisfaction survey.

In our view, Flinders Ports conduct in the marketplace provides substantive evidence to support our view that competition – broadly defined – in the port sector is effective in ensuring that Flinders Ports does not charge excessive prices for its services.

Flinders Ports Business Principles and the Objectives of Regulation

Simplistic textbook models of monopoly behaviour may provide a reasonable guide to likely behaviour given specific factors in a single time period. The reality is that Flinders Ports current short term behaviour will have consequences for outcomes in subsequent future periods. Flinders ports has a high capital investment and as a result a long term outlook. Flinders Ports' judgement is that our shareholders interests will be best served by taking the long-term view, and this is reflected in our operating principles.

This is important because, whereas the interests of suppliers and customers tend to be divergent in the short term, in the long term they tend to converge. This is evidenced by the fact that Flinders Ports' business principles are in general consistent with the objectives of the ESCOSA Act and the Maritime Services (Access) Act.

ESCOSA has as its primary objective 'the protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services'. In pursuing this objective ESCOSA is required to have regard to a number of specific considerations. Amongst these is a requirement to 'facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment'. The inclusion of this requirement embodies an implicit recognition that ESCOSA's fundamental objective of safeguarding the long-term interests of consumers requires that, amongst other things, it create the conditions in which suppliers of the services demanded by consumers can thrive.

Conversely, Flinders Ports recognises that the achievement of our goal of securing long term returns for our shareholders requires that we provide high quality, reliable service to our customers at a reasonable price. Our 2002-2007 Business Plan articulates our Business Purpose as

"To provide port related services and infrastructure to satisfy the needs of the market and to achieve or exceed shareholders' ongoing financial expectations.

This statement reflects Flinders Ports' consciousness of the causal link between meeting the needs of our customers and fulfilling the expectations of shareholders. It has been formally accepted and ratified by the Board, and provides active guidance to the management on how to conduct the business of the company. There are sound commercial reasons for pursuing this approach. If Flinders Ports relies on growing its business solely through increased sales of the basic infrastructure services that it offers, the rate of growth will be constrained at best to the natural growth of hinterland markets, plus any additional trade that can be won from other ports. Even if prices and performance are extremely competitive, the potential growth from these sources is modest. On the other hand, there is a great deal of potential for providing value-added logistics services to Flinders Ports' clients. But to persuade existing and potentially new clients to use Flinders Ports to provide these services, which they currently purchase from other providers or perform in-house, will rest in large part on the quality of the relationship that are established with them in providing basic infrastructure services. As a result, in order for Flinders Ports to achieve its business objectives, it is necessary to behave in ways that are likely to further the objectives of the ESCOSA Act.

The focus on the long-term that is shared by Flinders Ports and ESCOSA is critical to this convergence. In principle, ESCOSA could achieve lower prices for consumers in the short term by mandating a price reduction for regulated services. However, to do so would not be consistent with the focus in the ESCOSA Act on long term outcomes, since it would lead to under-investment and reductions in service quality. ESCOSA's approach to price regulation therefore reflects the need for financial sustainability of the regulated industries. Similarly, there may in principle be transient opportunities for Flinders Ports to achieve excessive profits in the short term (either by excessive pricing or reducing service quality). However to exploit these opportunities would undermine the type of relationships that we are seeking to build, and be contrary to our long-term business interests. For the reasons that were discussed previously, we think that it would also, in the medium to long term, lead to a significant decline in the volume of cargo using our ports and a consequent loss in the value of our core infrastructure assets. Because this long-term focus is likely to constrain Flinders Ports to behave – in pricing practices as well as in investment and service delivery – in a manner that is broadly consistent with the achievement of the objectives of the ESCOSA Act, we believe that the imposition of general, mandatory controls on the prices that we charge is unnecessary.

There is also theoretical and empirical evidence that price regulation brings with it significant costs and risks. In its recent report on grain handling, the Essential Services Commission of Victoria noted that:

In considering regulatory reform options it should also be noted that regulation is not without cost, both in terms of the administrative arrangements to implement the desired regulation and in terms of ongoing costs to suppliers, consumers, and others. Furthermore, excessive or untimely government intervention can stifle competition by removing the incentive for new suppliers to enter a market and for existing suppliers to contain costs and introduce innovations. (ESC, 2002)

In our view, price regulation of the South Australian port sector could be discontinued with little real risk to customers.

If Price Regulation Continues

The open letter from the Regulator[1] notes that the second stage of the review, which will be looking at the nature of regulation if it is to be continued, will be informed by some of the considerations in the first stage. We therefore felt it appropriate to address in general terms alternative approaches to price regulation, and indicate what we believe to be the implications of the preceding discussion for the form of price regulation if regulation is continued.

If price regulation is required, it is most likely to achieve the ESCOSA objectives if the form of regulation:

- Maximises the scope for commercial negotiation
- Ensures incentives to invest and grow the business are protected
- Is simple and predictable in application

The recent modifications to the regulatory regime adopted for the major Australian airports was specifically designed to address a situation where the extent of market power was assessed to be modest and the risk of discouraging investment in long-lived assets high . The industry and the competitive context in which that regime has been applied is similar in many respects to that in which Flinders Ports operates. In our view, if price regulation is to be continued, the new price monitoring regime for the regulation of airport prices may provide an appropriate regulatory model.

Conclusions

Flinders Ports does not believe that future price regulation is necessary because:

- The behaviour that Flinders Ports must adopt to meet its own business objectives will in general lead to the achievement of regulatory objectives
- Flinders Ports business is subject to a variety of competitive threats, and our pricing practices demonstrate that market pressure provides an effective discipline on our pricing behaviour
- The customer base is concentrated and customers are other businesses – often large and sophisticated ones – who typically possess better information on transport alternatives available to them than Flinders Ports does, and as a result can exercise substantial countervailing power

However, if price regulation is to continue, then it is important that:

- it is confined to services that are provided by means of essential infrastructure facilities
- it disrupts as little as possible the normal commercial relationships between Flinders Ports and its customers
- it does not interfere with Flinders Ports incentives to grow the business and to invest
- it provides some scope for addressing current anomalies in price structures.

[1] Open letter from the Independent Industry Regulator dated 29 August 2002

1. INTRODUCTION

1.1 Background

The seven commercial ports of South Australia[2] were privatised in November 2001. Flinders Ports Pty Ltd purchased the business of the ports (formerly Ports Corp SA) and obtained long term leases on the land involved in core port operations.

Effective from the beginning of November 2001, the SA Government Minister for Government Enterprises made a First Pricing Determination (FPD) under the Maritime Services (Access) Act 2000 (the MSA Act). This provided for the regulation of prices for Essential Maritime Services (EMS) supplied by the Regulated Operator (Flinders Ports) for the initial period after privatisation. The regulatory mechanism was to be applied by the South Australian Independent Industry Regulator (SAIIR), subsequently known as the Essential Services Commission of South Australia (ESCOSA).

In addition to an annual process of review of pricing based on change in CPI, the FPD set a timetable for the review of the basis of pricing, and also of the regulation mechanism itself. The details of the planned review are set out in the open letter from the Independent Industry Regulator dated 29 August 2002. The letter defines the process as considering the 'IF' of price regulation – ie. is price regulation needed? – and the 'HOW' – if so, how should it be done. Since logically the 'HOW' will follow the 'IF', the initial task for SAIIR (now ESCOSA) will be to look at competition issues in relation to EMS.

A discussion paper, *Ports Price Review Discussion Paper No.1*, has been issued by ESCOSA in November 2002. ESCOSA has invited submissions from interested parties in relation to the issues raised in the paper. This submission (the Submission) comprises Flinders Ports' response to the invitation for submissions.

1.2 The regulatory framework

Price regulation in South Australian Ports is formally confined to Essential Maritime Services. These are defined in Section 4 of the MSA Act as a ‘ a maritime service consisting of-

(a) providing or allowing for access of vessels to a proclaimed port; or
(b) providing port facilities for loading or unloading vessels at a proclaimed port; or
(c) providing berths for vessels at a proclaimed port’.

Section 6 of the Act states that Essential Maritime Services are regulated under the ESC Act, hence making them subject to price regulation under the ESC Act. Section 10 of the Act also makes Essential Maritime Services, together with some other maritime services, including pilotage, subject to access regulation under the MSA Act. This is important because the provider of Essential Maritime Services would therefore be required to provide access on ‘fair commercial terms’ even if ESCOSA decided to discontinue price regulation.

[2] Proclaimed ports under the MSA Acts, being Port Adelaide, Port Giles, Wallaroo, Port Pirie, Port Lincoln, Thevenard and Ardrossan. Ardrossan is operated by AusBulk Ltd., and Flinders Ports operates all others and the Port of Klein Point.

Under the First Pricing Determination, the maximum level of certain key prices charged by Flinders Ports were set for three years. The Determination limited these prices – except for the Cargo Services Charges for grain, in which no increase is permitted during the period of the Determination – to be increased annually in line with the CPI. It is to be noted that the Pricing Determination relates to specific price elements, not directly to the services themselves. The implicit presumption is that these charges reflect payment for the provision of the essential maritime services. While this is approximately and generally true, the FPD did not establish any exact or transparent connection between the two.

1.3 Principles of Good Regulation

General principles of efficient regulation are contained in the Competition Principles Agreement which was endorsed by the Council of Australian Governments in 1995. These principles are that:

1. the burden of proof that regulation is necessary remains with the proponents of regulatory change;
2. regulatory change should be the minimum required to achieve the desired outcomes;
3. regulation should be designed to have minimal impact on competition;
4. regulation should have clearly identifiable outcomes and should be performance based rather than prescriptive;
5. regulatory measures should be compatible with relevant international standards or practices;
6. regulation should not restrict trade; and
7. regulatory oversight should be reviewed at least every 10 years to assess whether continued regulation is needed.

Flinders Ports believes that these principles – and particularly principles 1 to 4 – provide useful guidance for the assessment of the desirability of continuing price regulation of the port sector in South Australia. Consistent with these principles, Flinders Ports' view is that prices should not be regulated unless there is a demonstrable and imminent risk that, in the absence of such regulation, prices would be set and sustained at a level that reflects the abuse of substantial market power.

This is not the case in the port sector in the South Australia for two main reasons:

- The basic infrastructure services that Flinders Ports provides are subject to market pressure from a variety of sources, and Flinders Ports' behaviour reflects the effectiveness of these pressures in ensuring that we perform efficiently and price appropriately.
- Even where short-term opportunities exist to set prices significantly above the cost of production, taking advantage of these opportunities would be detrimental to Flinders Ports' long-term commercial interests, as reflected in the company's business principles and operating objectives.

1.4 Structure of this Submission

Following this brief introduction, Section 2 deals with the specific issue of the extent and definition of the services that could be covered by price regulation. We suggest that, if price regulation is to continue, the appropriate starting point for this assessment is the notion of essential infrastructure facilities as defined in competition principles agreement. If this suggestion is accepted, then the range of services to which price regulation could be applied are those delivered by means of essential infrastructure facilities. This test would include maritime access to the ports using navigation channels. It may also include the use of berths and wharves for cargoes handling operations. It would exclude services such as mooring and pilotage, and the storage of cargo (other than the marshalling of cargoes on the wharf for imminent loading or immediately after discharge). This section also examines the structure and coverage of current charges. It acknowledges imperfections in current pricing structures, but cautions against any forced restructuring by regulatory action.

Section 3 focuses on an analysis of the structure of the markets within which Flinders Ports operate. In understanding how market conditions affect our pricing behaviour, it is essential to adopt a broad view of the nature of competition in the port sector. From a Flinders Ports point of view, what matters is the impact of pricing decisions on long-term business interests. Setting prices at too high a level may cause a customer to become uncompetitive in an export market, or to choose to sell product domestically rather than in export markets, or to use rail transport rather than coastal shipping. In each of these cases the impact on Flinders Ports business is the same as if the customer decided to ship through Port Stanvac, Whyalla or Melbourne rather than one of our ports. All of these alternatives therefore represent dimensions of market pressure on our pricing policy.

Section 3 also points out that these considerations are reflected in our pricing and other behaviour: at present almost all of Flinders Ports regulated prices are in fact set at levels below those permitted under the First Pricing Determination. Importantly, we have made significant efforts to improve service quality at the same time. In our view, our conduct in the marketplace provides substantive evidence to support the position that competition – broadly defined – in the port sector is effective in ensuring that Flinders Ports does not charge excessive prices for its services.

Section 4 sets out Flinders Ports' business principles in the context of the objectives of the ESCOSA Act and the Maritime Services (Access) Act. Our basic contention in this section is that in order for Flinders Ports to achieve our business objectives we need to behave in ways that are likely to further the objectives of these Acts. This is essentially because our focus is on building long-term relationships with our customers and to expand the range of services that we provide to them beyond basic infrastructure services. Attempts to exploit any transient opportunities that may exist to achieve excessive profits in the short term would undermine the type of relationship that we are seeking to build, and be contrary to our long-term business interests. We argue that, as a result, commercial negotiations are likely to lead to better outcomes for all parties than price regulation, and that price regulation brings with it significant costs and risks.

In Section 5 we briefly discuss the potential costs of continued price regulation. In our view, these costs are real and substantial, and clearly outweigh any potential economic benefits that could flow from continued regulation.

Section 6 looks briefly at the key principles that should be adopted if it is decided that some form of price regulation needs to be retained. While we are mindful of the fact that, at this stage of the review, ESCOSA wishes to focus only the issue of whether price regulation should continue, the open letter from the Regulator[3] notes that the second stage of the review, looking at the nature of regulation if it is to be continued, will be informed by some of the considerations in the first stage.

The principal theme of this section is that the form of regulation should be appropriate to the level of market power. The limitations and costs of highly intrusive forms of regulatory intervention in price-setting, such as the 'building blocks' are becoming increasingly apparent, and to employ such an approach in the South Australian port sector would be counter-productive. There are many parallels between the market situation of Finders Ports and that of the major airports. If price regulation of the port sector in South Australia is to continue, the price monitoring regulatory model recently implemented for major airports may provide a useful and appropriate model.

Flinders Ports' conclusions and views are summarised in Section 7.

[3] Open letter from the Independent Industry Regulator dated 29 August 2002

2. SERVICE DEFINITION ISSUES

2.1 The "Essential Infrastructure Facilities" concept

The concept of the 'essential infrastructure facility' has been central to the development of access regimes in Australia. The currency of the term dates back to the origins of National Competition Policy. The Hilmer Committee noted that the provisions in Part IV of the TPA, which regulates anti-competitive behaviour, would be inadequate to deal with access to essential infrastructure. Consequently, it proposed the introduction of a national access regime to address the denial of access by vertically integrated service providers (Hilmer Committee 1993).

In 1994, COAG agreed to the recommendations of the Hilmer Committee Report and established a regime for third party access to services provided by means of significant infrastructure facilities based on the Hilmer Committee's recommendations as well as detailing further provisos regarding safety issues.

The National Access Arrangements are contained in two main documents:

1. Clause 6 of the Competition Principles Agreement (CPA), which requires the Commonwealth to establish a national access regime, explains when that regime will apply, and details the principles with which an effective State or Territory access regime must comply.
2. Part IIIA of the *Trade Practices Act 1974* (TPA), which discharges the Commonwealth's obligation under Clause 6. The national access regime is therefore commonly referred to as the Part IIIA regime

Section 6.3 of the Competition Policy Agreement defines the conditions under which infrastructure services are eligible for declaration under Part IIIA. Services provided by means of a particular infrastructure facility are eligible for declaration if:

- it would be economically unfeasible to duplicate the facility;
- access to the service is necessary in order to permit effective competition in a downstream or upstream market; and
- the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist".

2.2 The National Access Regime and Price Regulation

Price regulation under national or state legislation is not necessarily restricted to essential infrastructure facilities. For example, price movements for towage operations in some ports are regulated (albeit by a rather light-handed means) under the Prices Surveillance Act. Nevertheless, although it may not always clear or precise, there is a connection between the scope of price control in port regulation and the essential infrastructure facility concept.

It is reasonable to expect that control of essential infrastructure facilities would form the basis of any market power that might be enjoyed by an infrastructure enterprise such as a port. At the same time, it is the existence of market power that provides the justification for the imposition of price regulation. There is therefore a linkage between the essential infrastructure facility concept and need for price regulation via the concept of market power.

This view is reinforced by the fact that where price controls are imposed in the port sector, control of essential infrastructure facilities has customarily been cited as the primary justification. The Victorian *Port Services Act 1995* and *Grain Handling and Storage Act 1995* both link the concept of 'prescribed services', which are subject to price regulation, to the concept of essential infrastructure facilities. In its final report on the regulation of port services in Victoria, for instance, the Office of the Regulator-General remarked of the original pricing orders that they

cover only 'infrastructure services' - the provision of channels, berths and short-term storage. Rates for towage, pilotage, and connection of water and electricity are not covered by the Orders, and the Office has not until now regulated prices for these services under its general powers(ORG, 1999).

Subsequent to the review, the Office (and later the Essential Service Commission, Victoria) has continued to apply price regulation only to services provided by what it considers to be essential infrastructure facilities. The recommendations of the Essential Services Commission on whether to continue price regulation of grain handling facilities in Victorian ports also drew heavily on the concept of essential infrastructure facility in forming its opinion on whether continued price regulation was justified. (ESC, 2002).

The linkage between 'essential infrastructure facilities' and the coverage of price regulation therefore appears to be fairly well established in regulation of the Victorian port sector. Given the requirement of the ESCOSA act that ESCOSA have regard to the consistency of regulation in South Australia with practice in other jurisdictions, it seems appropriate to consider whether it would be useful to also link the coverage of price regulation in South Australia to the 'essential infrastructure facilities' concept.

2.3 Application to SA Ports

The notion of an Essential Maritime Service in South Australia seems to owe a great deal to the concept of an essential infrastructure facility. As ESCOSA points out in its discussion paper, Section 4 of the MSA Act defines an Essential Maritime Service as a Maritime Service consisting of:

a) providing or allowing for access of vessels to a proclaimed port; or

b) providing port facilities for loading or unloading vessels at a proclaimed port; or

c) providing berths for vessels at a proclaimed port.

The first and third of these groupings appear to relate directly to services provided by means of facilities that have, in Victoria, been judged to be 'essential infrastructure facilities'. In the case of the first grouping, the corresponding infrastructure facilities are the shipping channels and associated navigation aids; in the case of the third, the corresponding infrastructure facilities are obviously the berths and wharf structures. The correspondence in the case of the second grouping is less immediately obvious, since at first sight it would appear include stevedoring plant and equipment. However, again as the Discussion Paper points out, stevedoring equipment is expressly excluded by the definitions of the MSA Act. When this exclusion is taken into account, it appears that the provision relates to services provided by means of:

- The provision of wharves and loading areas; and

- The provision of certain fixed loading infrastructure - most notably bulk grain terminals.

Both of these types of facilities have been judged to be 'essential infrastructure facilities' in Victoria.

These observations lead us to the view that price regulation should only apply to essential infrastructure facilities:

1. That it would be uneconomic to duplicate
2. Where access is necessary to permit effective competition in a downstream or upstream market
3. Where market power exists

In the subsequent sections, we discuss the application of this three part test to the specific issues that are raised in the Discussion Paper.

2.4 Mooring

Prices for mooring services are regulated at present, in that they form a part of the Harbour Services Charge. The provision of mooring services would not meet the test proposed in Section 2.3 above.

Although access to the port is required in order to provide mooring services, control of port facilities is not. In this respect, mooring is essentially the same as stevedoring, which is expressly excluded from the scope of price regulation. In some ports, the service is provided by the port organization: in others, by independent contractors; in others, different parties provide mooring services at different locations. With low capital requirements, it is inherently contestable. We believe that the operational efficiencies that can be gained by integrating mooring operations with other activities allow us to deliver these services more economically than a stand-alone service provider could do. However, we see no reason why this proposition should not be subject to testing in the market place.

It might be argued that Flinders Ports could inhibit fair competition in mooring, either through cross-subsidising or through restricting access to the port to alternative service providers. The first of these possibilities is inherently unlikely. While there is an incentive to continue to provide these services if we can provide them profitably at market rates, there is no incentive to cross-subsidise them. In any case it is not particularly useful applying a pricing cap to a service that is alleged to be too low.

The second is a matter for access regulation not price regulation. In any event, it is in Flinders Ports' broader interests to ensure that the total costs of using Flinders Ports ports is kept as low as possible. There has so far been one approach from a customer wishing to establish its own mooring service, and Flinders Ports expressed its willingness to work with the customer to facilitate this. (In the event, the customer decided, for internal commercial reasons, not to proceed with the initiative).

The key point is that price regulation is inappropriate for any potentially competitive service like mooring.

2.5 Storage

At present, storage is not formally subject to price regulation, although it is subject to regulation under the access provisions of the Act.

It is our view that storage in general should not be covered by either price or access regulation. Storage areas, whether covered or uncovered, would not meet the 'essential infrastructure facilities' criterion, since they are both in principle and in practice readily duplicated. Port customers have a choice as to whether to store their goods within the port or at a location outside the port boundaries, and many in practice elect to take the latter course. Storage is therefore both highly competitive and highly contestable, and the appropriate course in general is to depend on the market to set appropriate prices.

Under the Victorian *Port Services Act 1995*, while the provision of storage in general is not a 'prescribed' (i.e. regulated) service, 'the provision of short term storage and or cargo marshalling facilities in connection with the berthing of vessels at adjacent berths buoys or dolphins' is subject to price and access regulation. This distinction is a useful one, and consistent with the test that we propose in Section 2.3. The 'marshalling' services can only be economically and effectively provided in the immediate vicinity of the berth, and require access to what could arguably be defined as 'essential infrastructure facilities'. To exclude them from price regulation if price regulation continues to apply to the provision of the berth would be to invite strategic pricing and gaming: it would invite the port operator to substitute a new unregulated 'marshalling' change for the regulated Cargo Services Charge. This would clearly be inappropriate.

We therefore regard it as important than any future regulated framework distinguish clearly between two activities: port storage and what, for want of a better term, we will refer to as 'marshalling'.

- 'Marshalling' should defined as the storage of cargoes on or immediately adjacent to the wharf for the minimum period required necessary to ensure the efficiency of the ship loading or discharge operation. This should be regarded as an integral part of the service of 'providing port facilities for the unloading and loading of vessels'; be covered by whatever regulatory regime is in force for that service; and included in a single price for that service. This is keeping with general practice in port pricing internationally.

- Port storage should be defined as the occupation of either covered or uncovered site within the port for any purpose other than marshalling. Port storage should be subject to neither price nor access regulation.

2.6 Pricing Structure and Services

2.6.1 The Coverage of Current Charges

In its Discussion Paper, ESCOSA comments that

There is a general understanding of what services these charges cover, but not an explicit list of services. As an example, the South Australian Government still uses the three charge categories for Indentured ports (not subject to ESCOSA regulation).

ESCOSA articulates this 'general understanding' as follows:

Charge	*Service Provided*
Navigation Services Charge	Navigational aids, channels, harbour control
Cargo Services Charge	Wharves, cargo loading/unloading areas
Harbour Services and Mooring Charge	Berths, mooring structures, fenders, mooring and provisioning connections

Flinders Ports did not establish the current charging structure. The First Pricing Determination essentially preserved the pricing practices of the South Australian Ports Corporation: it did not match individual charges against specific costs in any structured way. Our understanding of what the regulated charges are intended to cover comes primarily for the Information Memorandum that was issued prior to the sale. This document expresses the purpose of the regulated charges as follows.

Charge	Explanation / Description
Cargo Services Charge	Is levied on Ports Corp customers to recover the costs of providing basic port facilities, including jetties and wharves.
Harbour Service Charge	Charge to vessels and is to recover the costs of servicing vessels in ports and berths.
Navigation Service Charge	Charge to recover the costs of providing navigational aids and channels to commercial shipping.
Pilotage Charge	Charge to vessels and is to recover the costs of providing various services by pilots.

In general, it seems reasonable to conclude that the charges are collectively intended to cover the costs of the providing, maintained and operating the basic infrastructure facilities of the port. There therefore appears to be, at an aggregate level, a rather good correspondence between the three regulated charges and the services provided by means of facilities that could reasonably be regarded as an 'essential infrastructure facility'

The Harbour Services Charge (HSC) is however a partial exception to this. This charge comprises two separate components:

- a fixed component and
- a variable component, charged on the basis of the size of the vessel and the length of time for which it occupies the berth.

The variable component resembles the berth hire charge in use in a number of other Australian ports, and could reasonably be considered an element of the system for recovering the costs of providing basic infrastructure services. The fixed component, on the other hand, would be an appropriate charge to reflect the costs of providing the mooring and unmooring services, and related minor services such as connection of electricity and water supplies.

The Navigation Services Charge, the Cargo Services Charge, and the variable component of the Harbour Services Charge collectively comprise the suite of charges used in Flinders Ports' ports to recover the costs of providing basic infrastructure services. As in most ports, the precise form of each of these elements, and the weighting given to each of them within the total basket, is a compromise hammered out over the years between the port and its user community, taking into account a wide range of factors, one – but only one – of which is the cost of providing services. Others include:

- Perceptions of ability of different users to pay – which may be thought of as a rough and intuitive approximation to Ramsey pricing
- Acceptability to the trading community, usually facilitated by reasonable consistency with national and international practice in the port sector and
- Historical and political factors specific to the South Australian scene.

The current structure has a number of desirable attributes:

- It includes a charge for port access that is scaled according to the size, and therefore in an approximate way to the earning capacity, of the vessel (the Navigation Services Charge), and which can be readily adapted when necessary to encourage vessels to make marginal viable calls in Flinders Ports' ports
- It includes a charge that can differentiate between cargoes according to their ability to contribute to fixed and common costs, and is readily adapted to provide volume discounts to encourage trade (the Cargo Service Charge)
- It includes a charge that provides a price incentive for the efficient utilisation of berths (the Harbour Services Charge)
- It is generally well accepted by the user community.

Traditional port charging practices are generally complex. Most port operators obtain their revenue from a variety of sources. Some of these are specific charges for identifiable services offered, such as mooring charges or pilotage. Others, which generally comprise a far greater share of port revenue, are generally regarded as charges for the provision and maintenance of infrastructure. The balance between these charges, the form of the charge, and even the terminology used, vary greatly from port to port (ESCAP, 1990). The relationship between specific costs and charges is often also relatively ill-defined. In its report on the Regulation of Port Prices in Victoria, the Office of the Regulator-General noted that:

The current structures result from the interaction of historical accident, government policy and regulatory inhibition to change. There are substantial differences between the pricing structures of the regulated ports, but no persuasive reason why they should be different to that extent. (ORG, 1999)

There are a range of strongly held views on the appropriate structure of port tariffs. Some commentators have advocated exclusive reliance on time-based ship charges for port services, in order to encourage efficient berth utilisation. Others have advocated relying solely on leases and area rentals, on the basis that this gives a stevedore or cargo handler the incentive to maximise throughput. Others favour cargo-based charges, which have the advantage of predictability for both the buyer and seller of port services. Reflecting on this debate, the Office of the Regulator-General concluded:

On balance, the Office is of the view that, while some charges may be more efficient than others in specific circumstances, it is not possible or valid to claim that as a general rule one form of charge is superior to another. Moreover, given the complex of other costs, factors and incentives impacting on importers, exporters and port service providers, the effect that the structure of port charges will to have on economic efficiency is not likely to be large. (ORG, 1999).

There have been many attempts to make radical changes to the structure of port tariffs. A few of these have succeeded: most have failed because of the inability to convince users as a group that the benefits of change outweigh the costs. The marginal costs of port use, and often even the average long run incremental cost of handling a specific customer's cargo, are low. Changes in pricing structure often do nothing more in practice than change the balance of the burden of meeting the common costs of port facility provision. The economic benefits that flow from such a change are dubious and long-term, but the commercial inconvenience and costs immediate and certain.

2.6.2 Implications

The existing pricing structures are not perfect. The distinction between the costs that should be covered by the Cargo Services Charge and the Harbour Services and Mooring Charge is unclear. The structure of the Navigation Service Charge, which is applied on a Statewide basis and covers calls at ports with different owners, is no longer appropriate. These issues will need to be addressed in greater detail if ESCOSA determines that the continuation of price regulation is desirable.

But our experience suggests that these issues are generally of relatively minor importance to most of our customers. What interest them is, firstly, the total costs of moving their cargo through our ports; and secondly ways of structuring our commercial relationship so that there is some sharing of the risks and rewards associated with fluctuations in cargo volumes. This is consistent with experience in New Zealand, where ports have been (partially) privatised for some years, and also operate in a competitive environment. The practice in most New Zealand ports is to negotiate an all-in price to cover the full range of services provided by the port: separate elements of that package, such as channel services, are not separately priced.

In our view, the best approach to resolving any anomalies in pricing coverage and structure is a gradualist one, involving consensual change based on bilateral negotiations between Flinders Ports and customers within a flexible time frame. This will require a degree of flexibility and commercial sensitivity that would be hard to achieve within the context of mandated regulatory prices.

3. MARKET ANALYSIS

3.1 Defining the Market

Defining the market within which Flinders Ports operates is a more complex task that it may at first appear.

The following definition, taken from a Trade Practices Tribunal judgement over 20 years ago (ATPR, 1976), is quoted in the review of port pricing by Victorian Office of the Regulator General, and appears equally appropriate here:

We take the concept of a market to be basically a simple idea. A market is the area of close competition between firms or putting it a little differently, the field of rivalry between them. Within the bounds of a market there is substitution — substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive . (ORG, 1999)

Even if the immediate users of port services have little opportunity to use an alternative port, the ultimate field of potential substitution may be very broad. Maritime economists, led by Professor Richard Goss of UWIST, have developed a hierarchy of levels of competition in the port sector which includes what he refers to as global competition. While it is true that Australian grain must pass through Australian ports, Iranian and Egyptian importers are not constrained to source their wheat or barley in Australia, and can and do respond to poor port performance or high port charges by changing their source of supply to Argentina, Canada or Europe. Looked at from this perspective, an Australian port may effectively be in competition with another port in East Asia or South America.

The situation in the container trades is different, but the end result is similar. Almost all major container services now operate on a fixed day weekly schedule. This implies that the total round trip for each individual vessel must be completed within a strictly defined time period: for instance, in a trade operated by five vessels, each one must complete its journey within a 35 day rotation period. The number of ports at which the ship can call within that period is strictly limited. A call at Adelaide implies a decision not to call at (say) Tacoma in the USA or Port Klang in Malaysia. The liner shipping operator will chose to call at the port which maximises its net return, and the charges that it faces in each port is clearly a part of this calculation.

Price changes by Flinders Ports can therefore result in the substitution, sometimes in the long run but often – especially in the case of container shipping – within a very short time frame, of a call at a port very remote from South Australia for a call at a Flinders Ports port. In this very real sense the market in which Flinders Ports competes is genuinely global.

There is of course a very special sense in which Flinders Ports competes in the market for port services in South Eastern Australia. Many of the cargoes that flow through Flinders Ports' ports, must, if they are to move at all, be shipped through one of the ports in the Newcastle to Thevenard range. There are opportunities for substitution within this range that do not exist at a global level.

The market for Flinders Ports services can therefore be conceptualised as a market within a market. The inner market consists of the market for port services in South Eastern Australia (in the case of containers extending West to Fremantle). With this range there are opportunities for simple switching of cargoes from one port to another. The outer market is a global one: within this market, substitution is a somewhat more complex and indirect process, but remains a powerful constraint on what prices Flinders Ports can charge for its services.

3.2 Structure

Competition is best understood as a process that takes place over a substantial period rather than a state or condition that exists at a particular point in time. But there are a number of structural factors that tend to be associated with the intensity of competition, and therefore the ability of an industry to exercise effective market power. One way of organizing information about the structure of industry is the five powers model, originally developed by Professor Michael Porter of Harvard University. This model is particularly useful because it recognises that market power is a consequence of the complex but systematic interplay of a number of structural elements:

The intensity of competition in an industry is neither a matter of coincidence nor bad luck. Rather, competition in an industry is rooted in its underlying structure and goes well beyond the behaviour of current competitors…….The five competitive forces — entry, threat of substitution, bargaining power of buyers, bargaining power of suppliers, and rivalry amongst current competitors — reflect the fact that competition in an industry goes well beyond the established players. Customers, suppliers, substitutes and potential entrants are all "competitors" to firms in the industry and may be more or less prominent depending on the particular circumstances. (Porter, 1980).

3.2.1 Forms of competitive pressure

The influence of existing competitors

Where there are a large number of existing service providers, unless there are legislative or regulatory strictures enforcing uniform behaviour, competition will normally be intense. However, the opposite is not necessarily true: the fact that only a few firms are currently operating in an industry does not necessarily imply that competition between them is any less fierce. It is likely that competition amongst few competitors will be more intense if:

- The major competitors are similarly sized, so that there is no clear natural market leader;
- The major competitors have different backgrounds and structures: in this case they are less likely to share common cost structures and assumptions, and more likely to respond differently to changes in the market
- Competitors have substantial sums invested in fixed assets which cannot be transferred to other uses.
- Demand is variable and unpredictable, since this will make it harder to arrive at tacit 'live and let live' agreements on market share.

Because of the different mix of trades that move through different ports, it is difficult to make appropriate scale comparisons between Australian ports. However, Sydney and Melbourne now handle almost identical shares of Australia's container market, and each is committed to striving for the position of Australia's premier port. This is particularly important for Flinders Ports because part of Melbourne's strategy for securing this title is an aggressive drive to win South Australian cargoes.(This was evident in the case of the North Asian Service which ceased to call Adelaide in 1999. The consortium (ANSCON) commenced handling all Adelaide cargo through Melbourne as a result of an offer made to them from the Melbourne Port Corporation (MPC) which effectively enabled the shipping service to drop a port (Adelaide) and hence a vessel from its service at a cost saving of $USD5.0M.)

The last three of these conditions are applicable to the port sector. The diversity of physical conditions that exist in individual ports is sufficient in itself to ensure that there are significant differences in cost structure. Port assets are almost entirely fixed infrastructure that is of little value in alternative uses. Seasonal fluctuations in particular trades – especially but not exclusively the grain trade – and the ability of shipping services – especially in the container trades – to rapidly adjust service patterns ensure that demand for port services is in a permanent state of flux.

The influence of potential entrants

In recent years, increasing recognition has been paid to the impact of new entry in ensuring that incumbent firms do not charge excessive prices. The rise of contestability theory has shown that the threat of entry in 'contestable' markets can ensure that prices are maintained at an appropriate level even if there are few firms – or even one just one firm – actively engaged in providing services.

In general, the easier it is for firms to enter and exit an industry, the more effective the threat of new competition will be in curbing the market power of existing firms. Factors likely to limit the scope for new firms to enter the industry include:

- legal and regulatory barriers to firms entering: for example, exclusive provision of pilotage services
- structural barriers to entry, such as economies of scale or indivisibilities in the provision of channels; and
- strategic barriers to entry, such as special knowledge or expertise.

The principal structural barrier to entry in the port sector arises from the nature of shipping channel provision. It is rarely likely to be economically viable to develop more than one channel to a particular port site, and even less likely that a proposal to do so would be able to secure the requisite environmental approvals.

Competition in channel services within an individual port is therefore implausible. But the development of wholly new ports, including approach channels, is possible; and the development by competing interests of new facilities within existing ports probable. The investments required to develop such facilities are substantial, and the inability to recover these investments if the enterprise is unsuccessful, may deter some potential entrants. The ports industry therefore does not meet the textbook definition of a perfectly contestable industry. But as developments such as the MPT grain terminal in Melbourne have amply demonstrated, there are investors prepared to develop new facilities to compete with established service providers, even when excess capacity already exists in the system. Specific proposals have been publicly canvassed for new grain terminals at several sites in South Australia. The Australian Wheat Board (AWB) and ABB have and continue to heavily promote the concept of building a deepwater grain berth at either Port Stanvac (South of Adelaide) or at Myponie Point on the Yorke Peninsula (with, it is understood, AWB commissioning a feasibility study for this latter option). In addition Ausbulk have recently announced that they are in the process of completing a feasibility study into upgrading its Port of Ardrossan on the Yorke Peninsula to handle grain. The consequences of such entry for an established operator such as Flinders Ports, most of whose costs are fixed and whose assets have little value in alternative uses, are severe. The threat of entry therefore acts as a powerful disciplining force.

The influence of substitutes

The availability of substitutes may provide an important source of competitive pressure on a service provider. In the aftermath of the oil crises of the 1970's, for example, the substitution of alternative energy sources was an important element in undermining the OPEC cartel.

As discussed in Section 3.1, there is a very real sense in which Flinders Ports competes in a global market place. For competition at the global level to be effective, it has historically been necessary for a final customer to be willing to change its supplier and disturb what may be longstanding commercial relationships. However, globalisation and prevalence of trans-national corporations have given renewed impetus to the optimisation of worldwide logistics costs, and have opened up new opportunities for international substitution within the framework of established commercial relationship.

Other opportunities for substitution that exist in the case of Flinders Ports' customers:

- The use of alternative Australian sources of supply, shipped through other ports
- The substitution of sales into domestic markets for export sales
- The use of inland transport, and particularly rail, instead of shipping for certain coastal/international cargo movements.

The influence of buyers

Our customers are rarely private individuals. In general, we deal with business clients, often with companies that are very much larger than our own. In the container trade, for example, we negotiate with global shipping companies such as P&O Nedlloyd (the third largest container shipping company in the world, with an annual revenue of nearly US$4 billion) and Mediterranean Shipping Company (the second largest container shipping company in the world). Our customer base is also fairly concentrated, and the loss of an individual customer can have a significant impact on our bottom line. The grain trade, for instance, which is controlled in large part by AWB Ltd and ABB Ltd, accounts for around 30% of our total throughput.

In many cases, these companies have access to detailed information and analyses of the transport options that are available to them: information that we do not possess. The major container lines call at all of Flinders Ports' main competitors, and know precisely what it costs them to do so. They also know precisely how much they have to lose by ceasing to call in Adelaide: Flinders Ports does not.

Like the container shipping operators, the grain marketers are in possession of detailed information on both inland logistics costs and costs of using other ports. They have sophisticated tools for analyzing the impact on these costs and the implications for total costs of moving cargo through Portland or Melbourne rather than South Australian ports. They also know the total cost implications of developing new exports facilities.

This places them in a very strong position when it comes to price negotiation. The importance of information in determining market power has been increasingly recognized in recent years, and in the case of Flinders Ports the advantage is almost always with the customer.

The influence of suppliers

The influence of suppliers is the other major force that Porter includes in his analysis of industry competition. In our view, this is less relevant to the analysis of industry structure for regulatory purposes than it is for assessing corporate strategy, and we will not dwell on it here.

3.2.2 Competitive pressures in Flinders Ports markets

Competition for customers and cargoes

Each of the trades served by Flinders Ports is subject to competition from one of other of these sources, either in the short or the long term. Table 1 below presents a cross-section of the major commodities currently moving through Flinders Ports facilities, and the nature of the principal (not necessarily the only) competitive threat to which each is exposed.

Further details on the competitive threat facing a number of these commodities is given in the confidential case studies that accompany this submission.

Market Segment	Principal Sources of Competitive Pressure
Containerised Cargoes	Landbridging, mainly through Melbourne but also through Fremantle. Over 50,000 TEU (i.e. nearly one-third of total South Australian trade) currently moves by this route. Liner shipping operators changing their port rotations.
Motor Vehicles	Landbridging through Melbourne. Several important components of this trade, including exports to New Zealand, are particularly vulnerable to this threat.
Grain	New entry and upgrading of existing facilities in other ports, probably by grain interests. Ausbulk is currently undertaking a feasibility study into the upgrading of Ardrossan. AWB/ABB have promoted the development of a new deepwater port at either Port Stanvac or Myponie point.

Market Segment	Principal Sources of Competitive Pressure
Petroleum	Road/pipeline deliveries from Port Stanvac refinery. Historically, SA market has been served by a internal supply from Mobil's Port Stanvac refinery and imports from inter-State. The balance between these two components is under constant threat.
Gypsum	Substitution of alternative source of supply. Gypsum is a very low value commodity and available from a wide range of sources, both within Australia and overseas.
Salt	As for gypsum.
Cement & Cement Clinker	Closure of ABC plant in Adelaide and substitution of imports from inter-State and overseas for local production
Fertiliser	Importation by road or rail from inter-State: notably Geelong. Pivot has major storage facilities in Geelong and Incitec is in the process of building facilities at the same location. The Victorian Government is developing a standard gauge siding that will serve these two plants.
Lead and Zinc	Landbridging through Melbourne. The shipping service that carries this trade has recently increased the size of the vessels that is used, and the traditional port of shipment of Port Pirie can not handle these larger vessels. Total costs of shipping through Melbourne are now very competitive with the total costs of shipping through, Adelaide, the most appropriate of Flinders Ports ports.

TABLE 1: SOURCE OF PRINCIPAL COMPETITIVE THREAT: MAJOR COMMODITIES

Competition for specific services

Competition in the port sector also occurs at a second level: the competition to provide additional value-added services, such as purpose-built storage facilities, to port customers. The desire to enhance the range of services that it provides to a customer acts as an important deterrent to the use of any market power that a port organization may possess with respect to basic infrastructure services.

3.3 Conduct and performance

Statements of intent and structural analysis of the markets in which Flinders Ports operates are important, but ultimately both are relevant to the question of future price regulation only in so far as they determine conduct and performance in the market place. For the argument advanced in the previous section to be credible, it is important to demonstrate that we actually behave in a way which is consistent with this.

Flinders Ports has chosen for reasons of competition and customer orientation to defer implementation of CPI increases available to us under the FPD. We also offer a wide range of structured pricing arrangements to individual customers, and there are virtually no major trade movements with the exception of grain (which is dealt with separately under the FPD to hold down pricing levels) that is not benefiting from some such arrangements. These arrangements have been put in as a competitive response to customer requirements and are the norm for any industry. However, pricing is not the only aspect by which we respond to our customers and the competitive pressures on them. Non pricing measures include a range of options, including:

- The development of new in-port storage facilities
- Berth deepening to accommodate deeper vessels
- A focus on improved cargo handling performance
- Investing in providing improved access and security arrangements for customers cargo

Not all of our competitive initiatives are structured to retain existing trade. We actively seek to identify opportunities for new trades that could be shipped through Flinders Ports ports, and have provided various price and non-price incentives to encourage this trade to pass through SA ports rather than inter-State.

Case study material outlining both price and non-price measures that we have taken in order to retain trades or to encourage increases in the volume shipped is provided (Appendix 1) as a confidential attachment to this Submission.

4. REGULATORY OBJECTIVES AND FLINDERS PORTS COMMERCIAL INTERESTS

4.1 The importance of the long term

Simplistic textbook models of monopoly behaviour are premised on a diametrical opposition of the interests of suppliers and customers. In these models, which usually focus only on a single period, the interests of suppliers are in maximising net revenue; the interests of customers are in minimising prices. Within the framework of such models, wherever a degree of market power exists, it is likely that the supplier will restrict output and charge excessive prices.

The reality is that, behaviour in one time period has consequences for outcomes in subsequent periods. Flinders Ports has a high capital investment and as a result has a long term focus. Flinders Ports judgement is that our shareholders interests will be best served by taking the long-term view, and this is reflected in our operating principles. This focus on the long-term acts to align the interests of suppliers and customers (and hence with the objectives of regulation) in ways that are not adequately reflected in single-period models, and greatly reduces the need for price regulation.

4.2 Flinders Ports Operating Principles

Flinders Ports is committed to conducting a viable port business in South Australia in the long term. We recognize that both we and our customers operate in an increasingly competitive environment. In our view, this implies that our best strategy for building our business is to ensure that those who use our services gain a competitive advantage from doing so.

This focus on the long-term is reflected in that way that we articulate our business goals. Our 2002-2007 Business Plan articulates our Business Purpose and General Objectives.

The Business Purpose is:

"To provide port related services and infrastructure to satisfy the needs of the market and to achieve or exceed shareholders' ongoing financial expectations.

This statement reflects Flinders Ports' consciousness of the causal link between meeting the needs of our customers and fulfilling the expectations of shareholders.

The long-term focus that is implicit in the Business Purpose is made more explicit in our General Objectives, which include 'to develop strong long term relationships with customers by being customer focused, responsive and reliable at every level of the organisation' and to 'operate the business with a view to optimising long term income and capital growth with security'.

These statements of principle have been formally accepted and ratified by the Board, and provide active guidance to the management on how to conduct the business of the company.

We have not adopted these principles through altruism. There are based on commercial judgements about what is in the long-term interests of our shareholders. In part, we are responding to the market pressures outlined in the previous section. But there are other reasons.

In its review of the regulation of airport price regulation, the Productivity Commission cites the UK Civil Aviation Authority's comment that:

the airport itself has incentives to set aeronautical prices to reflect demand complementarities. Where complementarities are important the airport will have strong incentives to set low aeronautical charges in any case (particularly if they are able to price differentiate effectively). Therefore any potential loss of economic efficiency is likely to be substantially reduced, and needs to be set against the presumption that scope of economic regulation should not be unnecessarily wide unless the efficiency arguments in favour are compelling.(Productivity Commission, 2001).

That is, the desire of the airport owner to sell additional services to passengers using the airport acts as a significant brake on the incentive to charge high prices for core infrastructure services. Similar considerations apply in the case of Flinders Ports.

Flinders Ports can grow its business in two (potentially complementary) ways. We can increase the volume of our trade, selling more of the basic infrastructure services we provide; and we can increase the range and value of services that we sell to each of our customers. Both of these are very important to us. But there are limits to the rate of growth at which we can achieve from the first of these two avenues. It is constrained at best to the natural growth of our hinterland markets, plus any additional trade that we can win from other ports. Even if prices and performance are extremely competitive, the potential growth from these sources are modest. On the other hand, there is a great deal of potential for providing value-added logistics services to our clients, particularly through the provision of specialised storage and distribution facilities. But Flinders Ports' ability to persuade existing or new clients to use Flinders Ports' to provide these services, which they currently purchase from other providers or perform in-house, will rest in large part on the quality of the relationship that is established with them in providing basic infrastructure services. As a result, in order to achieve its business objectives Flinders Ports needs to behave in ways that are likely to further the objectives of the ESCOSA Act.

4.3 The Objectives of the ESC Act

In its discussion paper, ESCOSA has drawn attention to its primary objective that is defined in the ESCOSA Act as 'the protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services'.(ESCOSA, 20002). The priorities and perspective embedded in this objective are, in our view, centrally important in assessing whether or not the continuation of price regulation is desirable.

The clear focus in the legislation is on long-term rather than short-term outcomes. As we discussed in section 4.2 above, Flinders Ports business goals are also driven primarily by long-term considerations. A focus on the long-term tends to align our internal business goals with the objectives of the ECOSA Act. In the very short term, there is an apparent divergence of interest between consumer (and hence regulator) and producer: consumers would generally benefit from lower prices, while we would benefit from higher prices. However, in the longer term, the customers' interest in lower prices is moderated by their interest in maintaining service quality and ensuring reliable supply, both of which are also explicitly incorporated in the ESCOSA Act objective. Similarly, our interest in higher prices is moderated by our need to ensure the ongoing viability of our customers, to avoid loss of market share and to develop value-added business. As a result, incentives and interests that may appear, considered solely in a short term context, to be diametrically opposed are, in the long term, largely complementary.

The long term focus also emphasises the importance of giving considerable weight to the implications of price regulation for the dynamics of the industry – for innovation, for investment and for the encouragement of new entry – rather than focusing exclusively on the relationship between prices and current and projected costs. It argues for a degree of flexibility and responsiveness to emergent circumstances and opportunities that is difficult to accommodate in even the best designed and most skilfully managed system of regulated prices.

4.4 Implications

The reason we have dwelt at some length on the consonance of our business objectives with those of the ESCOSA Act is that we believe that this bears directly on the issue of the need for price regulation. They reflect our understanding of what we need to do in order to build a successful long-term port business. Our view is that the real risk of abuse of market power is small. The essential reason for this is a commercial one: while we acknowledge that as is the case in almost all markets, it might be possible to achieve some short term revenue gains by imposing unjustifiable price increases, in the long run this would be counter-productive. It would harm our customers' ability to compete in the markets they serve; provide them with the incentive to seek and to develop alternative sources of supply for port services; and deter them from purchasing value-added services from Flinders Ports. All of these developments would undermine Flinders Ports' long-term business interests.

Our contention is that, in acting in accordance with our business principles and within the constraints imposed by the market, we will behave in a way that will further the objectives set out in Essential Services Commission Act and lead to appropriate pricing outcomes.

5. COSTS OF CONTINUED PRICE REGULATION

5.1 The need for balance costs with benefits

In practice, neither unregulated markets nor regulatory systems are likely to deliver perfect economic outcomes. The decision on whether to continue with price regulation ultimately requires a judgment to be made on whether the costs and risks associated with any likely market failure exceed the costs and risks associated with regulation.

5.2 Costs of Regulation

In its Review of the National Access Regime, the Productivity Commission identified five main costs of regulation:

- administrative costs for government and compliance costs for business;
- constraints on the scope for infrastructure providers to deliver and price their services efficiently;
- reduced incentives to invest in infrastructure facilities;
- inefficient investment in related markets; and
- wasteful strategic behaviour by both service providers and access seekers. (Productivity Commission, 2001).

Other commentators have pointed out the importance of price signals in promoting dynamic efficiency, and in particular in encouraging new entry into markets.

All of these are, in differing degrees, relevant to the question of the continuation of price regulation in the South Australian Ports Sector.

5.2.1 Administrative and compliance costs

Compliance costs fall on regulated firms and comprise the paperwork burden to establish mechanisms for ensuring that prices conform to regulatory limits, undertake monitoring and reporting, and prepare for periodic reviews. The scale of these costs will obviously depend on the form of price regulation that is used. Under the relatively simple and predictable arrangements that were established by the First Pricing Determination compliance costs have been comparatively modest. Even so, they are far from trivial: we estimate that the total cost of our full participation in the current review is likely to exceed $80,000.

Other parties preparing and delivering submissions may also incur substantial costs. Additionally, government may incur significant costs in administering price regulation, through the costs of staffing, advertising and enforcement to conduct reviews and monitor/enforce compliance.

It seems reasonable to assume that the deadweight loss due to these costs is likely to be proportionally higher when the scale of the regulated industry is comparatively small. Some elements of the costs of compliance and administration vary little with the scale of the enterprise being regulated. Parry, in a submission to the Productivity Commission review, noted that

the access arrangement for Great Southern Energy's Wagga Wagga gas distribution network — servicing some 14 000 customers — involved the same procedures and efforts as the access arrangement for AGLGN's New South Wales distribution network servicing some 70 000 customers. (Parry, 2000).

Insofar as this is the case, the size of the business being regulated bears on the likelihood that the costs of regulation will exceed the benefits. Compared to most other regulated industries, revenue from the provision of regulated port services is very small – Flinders Ports forecasted total revenue from regulated services in 2003 is a little over $35 million.

5.2.2 Constraints on the delivery and pricing of services

The Productivity Commission has noted that:

Were access regulation to be purely a mechanism to appropriate any super profits or so-called 'monopoly rent' (see section 4.3), leaving untouched the provider's freedom to tailor access prices and conditions to market requirements, it might have few detrimental effects on operating or pricing efficiency.

However, developing mechanisms that target only genuine rents has proved to be very difficult. Indeed…..even identifying what part, if any, of a provider's profits is a true rent, can be highly problematic.

As a result, regulation of access prices and conditions — whether explicit or through a negotiate-arbitrate process — will almost always have some adverse impacts on pricing and operating efficiency. (Productivity Commission, 2000)

One form that such adverse impacts may take is the reluctance of the service provider to lower prices lest it not be able to again increase prices at a later point in time. This is an issue of immediate concern to Flinders Ports. As discussed in Section 3.3, we have taken a commercial decision to defer the implementation of the CPI price rise permitted by the First Pricing Determination. However, in considering this decision, we were seriously concerned that, in a regulated environment, this decision could affect the pricing basis from which future price movements were calculated: if not during the duration of the First Pricing Determination, then under whatever regime succeeded it. This concern was a powerful argument against taking the action that we did: fortunately, it did not prove an overwhelming one. But it is quite possible that in future conditions, if immediate market pressures are somewhat less intense, it would be sufficient to dissuade us from repeating this action.

Another form that such impacts take is a reduced ability to introduce more flexible pricing packages to meet the needs of specific customers. The cost structure of our business makes pricing at marginal cost infeasible. Many of our costs are fixed or common, and in order to obtain an acceptable return on our investment it is necessary that most of our prices will be set at levels in excess of marginal costs. We are attempting to deal with this by putting in place arrangements that offer incentives for individual customers to increase their volumes: that is, moving to a pricing structure that sets the price for the marginal unit of cargo closer to the marginal cost of catering for the cargo. This will be in the interests of both customers and ourselves – and of economic efficiency. But as we introduce these pricing arrangements we need to ensure that the average price is maintained at a level that allows us to maintain and enhance the services provided. Our ability to do this is constrained when some prices are subject to regulatory control.

5.2.3 Investment

While most regulatory regimes, including the regime in South Australia, make some provision for the recognition of new investment in pricing determinations, price regulation inevitably adds to the risks associated with the investment decision. If regulation increases the risk faced by the regulated enterprise and reduces its confidence or ability to undertake new investment then the range of services offered by the regulated firm will not expand as quickly as they otherwise would. Firms in related industries may then have to look to less preferred/efficient ways of moving their goods which will involve additional costs for them.

Whenever prescriptive price regulation is imposed, there is therefore some chance that future investment will be discouraged. The recent Russell review of port reform in Victoria, where a CPI-X regime was applied during the initial stages of the port reform process, commented on the decline in strategic investment, and attributed this as least in part to price controls.[4]

The cost control mechanisms introduced at the time had merit in the short term. However, the strict price controls imposed contributed to a position that limited the capital available…(Russell, 2001)

While this comment was particularly related to public investment in the Port of Melbourne, the review also noted a concomitant *"lack of certainty of ongoing major investment by private operators."*

The Victorian Essential Services Commission has recently remarked on the importance of the impact of direct price regulation on the incentive to invest in port grain handling terminals:

In this context, and an environment of considerable industry restructuring more generally, there is a risk that continuation of direct price regulation disadvantage further investment in the Portland terminal and have an inappropriate impact on the decision as to whether to continue to operate the terminal.

More generally in an environment of considerable industry restructuring, requiring significant investment in new facilities to achieve the greater logistical efficiencies that will be crucial to the competitive position of grain handlers, there is a significant risk that continuation of an inappropriate level of regulation could distort investment incentives, leading to an economically less efficient outcome in terms of the mix and locations of grain handling capacity installed at Victorian ports. (ESC, 2002)

Flinders Ports also operates in a rapidly changing commercial environment in which substantial and irreversible investment decisions will need to be made in order to maintain our competitiveness. In assessing the business case for future investment, prudent management requires that we take into account all commercial risks, including the risk that differences of view between ourselves and ESCOSA on the level of efficient investment or on appropriate rates of return. This could in some instances lead to delayed investment, or under-investment.

The costs to the community as a whole of setting prices too low, and as a consequence discouraging investment, may well outweigh costs of setting the price too high. Charges in port services that are higher than they should be do not necessarily lead to significant loss of economic welfare. There are two main reasons for this:

[4] The Next Wave of Port Reform in Victoria – an Independent Report to the Minister for Ports, November 2001 (The Russell Report)

- where customers have realistic alternatives available to them, an attempt to charge prices that are too high will be self-correcting: the loss or the threat of the loss of business will force a reconsideration of pricing policy

- where customers have no realistic alternative, charges for port infrastructure services will often comprise only a small part of the total landed cost of the product. In this case, prices that are too high may not impact significantly on the quantity of cargo exported or imported. If this is so, the excess charge results only in a transfer payment from the customer to the supplier of port services. While this is clearly undesirable from an equity point of view, there is little or no economic loss involved.

Prices that are too high will lead to significant loss of economic well-being only is so far as they impact on that (very important) subset of cargoes which has no realistic alternative but is sold on such thin margins that even a very small increase in overall costs will result in significant reductions in volume. The failure to undertake necessary investment, on the other hand, will always result in a loss of economic welfare.

Considerations such as these have led the Victorian Essential Services Commission to conclude that:

The costs of failing to invest in essential infrastructure may well be larger than the costs of monopoly pricing of the services it provides. (ESC, 2002).

A similar view is expressed by the Network Economics Consulting Group in its submission to the Productivity Commission Enquiry:

There are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives are maintained for efficient investment and for continued productivity increases. The dynamic and productive efficiency costs associated with distorted investment incentives and with slower growth in productivity are almost always likely to outweigh any allocative efficiency losses associated with above-cost pricing. (NECG, 2000)

While the Commission rejects the notion that there is simply choice to be made between allocative efficiency and the benefits of encouraging dynamic efficiency, it concludes that the economic loss that flows from prices that are too high is likely to be smaller than the loss that flows from prices that are two low:

Nonetheless, the Commission accepts that there is a potential asymmetry in effects:

- *Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.*

- *On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be forgone, again with flow-on effects for investment in related markets.*

In the Commission's view, the latter is likely to be a worse outcome. Accordingly, it concurs with the argument that access regulators should be circumspect in their attempts to remove monopoly rents perceived to attach to successful infrastructure projects. (Productivity Commission, 2000)

The issue of the impact of price regulation on incentives to invest is clearly germane to the current discussion: the ESC Act provides that ESCOSA must, inter alia,

… facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment…

Flinders Ports' commitment to the long term sustainability of its business provides the incentive for prudent strategic investment aligned with its customers' long term interests. It is our view – a view that appears to be shared by the majority of commentators – that there is a significant risk that price regulation could reduce this incentive. Reliance on negotiated pricing options is likely to be more conducive to the long term growth of the port as a business, and to the economic development of South Australia.

5.2.4 Distortions and Distractions

Price regulation can also lead to the adoption of pricing structures and behaviour that are driven by a perceived need to position an enterprise with respect to the regulatory framework rather than by commercial considerations and customer needs. It can introduce incentives for the regulated firm to:

- transfer costs and introduce cross-subsidies between the regulated and unregulated parts of its business
- change the timing of efficiency improvements around regulatory reset periods so as not to disadvantage itself in the next regulatory period

More subtlety but perhaps ultimately just as importantly, meeting regulatory requirements can distract management attention from the ultimate common purpose of both service provider and regulator – the provision of excellent service at an affordable price. This objective must compete for scarce management attention with the objectives maximizing the scope for commercial decision-making within the regulatory framework, and strategising to secure favourable changes to that framework.

This factor was explicitly by the Office of the Regulator General in 1999 review of Port Price Regulation:

The Office acknowledges that there is a real risk under any regulatory regime that management attention will be diverted to meeting the requirements of the regulator at the expense of the requirements of the business. It is therefore important to manage the regulatory framework in a way that minimises this risk. (ORG, 1999)

5.2.5 Dynamic Efficiency – Price Signals and Entry

The Hilmer Committee recognised that fostering dynamic efficiency (and hence the long term interests of consumers) has important implications for access pricing:

Decisions in this area [access pricing] also need to take account of the impact of prices on the incentives to produce and maintain facilities and the important signalling effect of higher returns in encouraging technical innovation. (Hilmer, 1994, p 253).

Rising prices provide signals not only for technical innovation but also for new entry into a market. Naturally, Flinders Ports is not anxious to encourage the entry of new competitors into the markets that we serve, and we would hope that by operating efficiently, pricing reasonably and being responsive to customer needs we will provide few profit opportunities for potential entrants. But we recognise the important role that prices pay in ensuring that, if we fail to deliver, some other party will have an incentive to offer an attractive alternative to our customers.

We note also that the ESCOSA Act requires ESCOSA to have regard to the need to 'facilitate entry into relevant markets'. The Discussion Paper specifically canvasses the possibility that price regulation could stifle competition, and comments that 'the main message from this objective [promotion of competitive markets] for this review, is to avoid "over regulation", which stifles competitive markets'.

We would strongly support the contention that permitting prices to move in line with market conditions is more likely to do this than the application of price regulation.

5.2.6 The Operation of Regulatory Systems

Several commentators have suggested that, once a regulatory system is introduced – even a very well-designed and appropriate system – there are inherent pressures that will bias the system in favour of decisions that lead to excessive conservatism. Speaking generally of trade practices regulation, Briggs and Scheelings conclude that:

the good intentions of those who draft such reforms may well be undone by those entrusted to enforce the trade practices legislation. This is not meant to be a simple-minded criticism of bureaucrats or regulators. Rather, it refers to an inherent administrative bias, independent of the intentions of administrators, in favour of over-regulation, when the dictates of dynamic efficiency require, if anything, a winding back of top-down regulation (Briggs and Scheelings, 2000).

Essentially, the reason for this conclusion is that, when the regulator makes a decision to allow the market to determine the outcome (that is, not to impose a regulatory solution), if that decision is a bad one the consequences are often immediate, directly traceable to a decision and highly visible. On the other hand, if the regulator decides to impose a regulated outcome, if that decision is a bad one the consequences tend to be deferred, only indirectly traceable to a decision and obscured by the operation of a range of intervening factors.

If a regulator permits a practice (say, a merger) and prices rise, then such a detrimental effect is immediately observable and the regulator's error of judgement available for all to see. If, on the other hand, a banned practice would have been of lasting benefit to the community, this would not be observable, for the error takes the form of an opportunity forgone. The regulator's error of judgement in this case is invisible. (Briggs and Scheelings, 2000).

In the technical argument of this debate, the two different type of possible mistake are referred to as Type I and Type II errors. Type I errors occur when the best solution is to impose regulation, but the regulator does not do so. Type II errors occur when the best solution is **not** to impose regulation, but the regulator decides to do so.

In the view of Briggs and Scheelings errors of excessive conservatism (Type II errors) will be not only more probable but also more costly than errors arising from a too liberal approach to regulation (Type I errors): 'from the standpoint of dynamic efficiency, Type II errors are probably more costly than Type I errors' and therefore 'regulators should make more Type II errors than they do'.

5.3 The magnitude of the risk

Risk assessment generally involves a judgement of the consequences of possible failure as well as the probability of failure.

The South Australian ports are very important to the smooth function of the South Australian economy, and suspension or interruption of port services would be immensely costly. Excessive prices for port services would also clearly have a detrimental effect on the South Australian economy, but the magnitude of this effect would be very much lower.

Even if no price regulation is in place, the regulatory framework in South Australia provides the opportunity for an aggrieved customer to take action under the access provisions of the MSA Act. With this safeguard in place, it is implausible that massive increases in port charges could take place without a recourse to the mechanism, and a consequent regulatory response. Any price rise that would escape regulatory scrutiny must therefore be of a scale that could conceivably be introduced without massive customer disquiet. If as an example, we assume that a 20% increase in price could be achieved without massive customer response, the maximum revenue effect would be 20% of our current income, or about $7 million dollars per year. It is difficult to conceive that this would have a major effect on the overall wellbeing of the South Australian community, even if this resulted is a direct transfer of wealth out of the State. But in practice the effect would be much smaller than this: customers would respond in various ways to minimize the impact of the price increases on their businesses. The net result would be a significantly lower total impact on economic well-being - perhaps half of this value.

Such a loss would clearly be highly undesirable. But the scale of the impact is orders of magnitude lower than that which would result from significant market failure in most other regulated infrastructure industries – and, for the reasons argued in Section 4, it is also highly unlikely to materialise.

5.4 Summary

One need not agree entirely with the line of argument advanced by Briggs and Sheelings to accept it as a useful caution. It is important that ESCOSA, in arriving at a decision on whether to continue to regulate prices for prescribed services, take into account not only the risks that might arise if price regulation is discontinued, but also the cost and risks that arise from the continuation of price regulation. In making this assessment, it is especially important to ensure that sufficient weight is given to the impact of ESCOSA's decision on the dynamics of the industry, particularly with respect to investment behaviour and the function of prices in providing signals for innovation and new entry. This focus is, we believe, entirely consistent with the clear focus of the ESCOSA Act on long term outcomes. It is also consistent with ESCOSA's general regulatory strategy of ensuring 'balance in the regulatory bargain'. (ESCOSA, 2002).

6. IF PRICE REGULATION IS TO CONTINUE?

We understand that the purpose of the current phase of the review is to arrive at a decision on whether price regulation should continue, not to determine the appropriate form of any future price regulation. Moreover, for the reasons discussed in earlier sections of this submission, we believe that the continuation of price regulation is neither necessary nor desirable. It is therefore not appropriate at this time to discuss in detail the various options available for price regulation.

Nevertheless, it would seem appropriate to indicate in very broad terms the style of price regulation that would, if price regulation is to continue, be most likely to lead to the achievement of the objectives of the ESCOSA Act. The most important features of any future price regulation would in our view be that it should:

- Maximise the scope for commercial negotiation
- Ensure incentives to invest and grow the business are protected
- Have simplicity and predictability in application

It is important that the intensity of regulatory oversight be proportional to the risk and consequences of any potential abuse of market power. We have argued in this submission that, in the case of Flinders Ports, these are both low. Under these circumstances, it would be difficult to justify the application of the application of the 'building blocks' style of regulation that is commonly applied in, for instance, the energy sector. The link between the degree of competitive pressure and the style of price regulation was explicitly made by the Office of the Regulator General in Victoria (ORG) in its 1999 Review:

The Office has also taken the view that the form and intensity of regulatory supervision should reflect the extent of the market power against which it is intended to provide protection. It therefore proposes to adopt different approaches to the regulation of MPC and VCA compared to the regional ports on the basis of the substantial differences in the extent of their market power. (ORG, 1999)

The recent modifications to the regulatory regime adopted for the major Australian airports was specifically designed to address a situation the extent of market power was assessed to be modest and the risk of discouraging investment in long-lived assets high . The industry and the competitive context in which that regime has been applied is similar in many respects to that in which Flinders Ports operates. In our view, if price regulation is to be continued, the new regime for the regulation of airport prices may provide an appropriate regulatory model.

7. SUMMARY AND CONCLUSIONS

Flinders Ports does not believe that future price regulation is necessary because:

- The behaviour that Flinders Ports must adopt to meet its own business objectives will in general lead to the achievement of regulatory objectives
- Our business is subject to a variety of competitive threats, and our pricing practices demonstrate that market pressure provides an effective discipline on our pricing behaviour
- Our customer base is concentrated and our customers are other businesses – often large and sophisticated ones – who typically possess better information on transport alternatives available to them than we do, and as a result can exercise substantial countervailing power

However, if price regulation is to continue, then it is important that:

- it is confined to services that are provided by means of essential infrastructure facilities
- it disrupts as little as possible the normal commercial relationships between Flinders Ports and its customers
- it does not interfere with Flinders Ports' incentive to grow the business and to invest
- it provides some scope for addressing current anomalies in price structures.

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