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Economic Regulation of Harbour Towage and Related Services

Supplementary Submission to Productivity Commission

1. Role of Port Authorities

Adsteam are highly critical of Port Authorities “self appointed role as entities responsible for ensuring operational efficiency of towage, the passing on of efficiency gains to towage users and protection from fear of towage service providers abusing their natural monopoly power”.

It is clear that there is a lack of understanding of the role of the Port Authority. Port Authorities are established by State legislation and their prime function is to facilitate trade and also to implement regulations covering safety, environmental and maritime matters generally.

The Port Authority has a responsibility to, and works on behalf of, the whole port community to ensure that safety regulations are complied with, that the port generally operates efficiently and reliably, and that trade is facilitated as far as possible. Port Authorities have assumed a role as strategic managers covering all these activities. If there were not an overall coordinator it is possible that commercial pressure could lead to a situation where some groups were disadvantaged relative to others. Further, there may be short cuts in terms of safety and meeting environmental standards, the port may not operate as efficiently as it should, and there could well be a lack of a long-term strategic focus on what is needed for the ongoing development of the port for the benefit of shipping, service providers and the wider community.

There is a need to recognise that the economic impact of a port goes far beyond the needs of one service provider and that decisions in relation to port activity have an effect on the direct and broader regional communities.

2. Exclusive Licences

We note that Adsteam challenges the benefits of exclusive contracts - “benefits are limited to the issuing port ...” which “craves greater control over other port service providers”.

There are no grounds for such an extreme statement which comes from one party with a vested interest in maintaining a natural monopoly in as many ports as possible. It should be noted that shipping companies and shippers alike see benefits from exclusive licences.

Furthermore, the benefits from exclusive licences have been proved in recent years where tenders have been arranged for the provision of towage services.

In all cases, prices for towage fell after a tender.

In the case of Fremantle, it is reported that prices offered under exclusive licensing arrangements were significantly lower than prices offered under a non-exclusive licence. Adsteam were willing participants in both tender options in Fremantle and their prices were competitive with other tenderers.

One conclusion arising from these tenders is that towage prices in those ports may have been too high. Furthermore, one must question whether a competitive tender process in the declared ports would have led either to price reductions or at least limited the increases applied by Adsteam

Exclusive contracts provide an opportunity for a new supplier to enter a market in the confidence that the considerable sunk costs invested can be recovered over a reasonable period linked to capital cost recovery. A further benefit is that exclusive licences stop an incumbent in a port from unfairly competing where there is a new entrant along the lines set out in section 3 “Barriers to Entry”..

Our concept of exclusive contracts is that they will be:

- For a fixed term, near the end of which the process could be repeated depending on market circumstances, stakeholder advice etc.
- Transparent in that the tender document will set out all service levels, KPI's etc required following consultations with stakeholders; (we recognise that service delivery is just as important as price.)
- Capable of providing an opportunity of bringing forward new technology, innovations and other improvements to the provision of towage services and include some flexibility in the licence terms to facilitate this.

Many of the comments not supporting exclusive contracts either totally or by degree are based on academic assumptions alone and demonstrate a lack of practical understanding of the current towage market in Australia. Whilst these arguments may be sound intellectually, they do not take account of the

practical effects of the towage market structure and service providers' market behaviour and attitudes toward the provision of that service. Furthermore, these academic arguments do not take into consideration the market power that one incumbent operator can maintain by remaining in a port when there is a new entrant (refer to section 3, "Barriers to Entry").

A number of specific issues have been raised in submissions and at the hearings in relation to the negative effects of exclusive licences which we believe should be specifically addressed. These include:

- **Ports have a conflict of interest in issuing towage licences**

It is argued that ports have an incentive to drive prices of service providers down to below efficient levels and to levels that do not necessarily recover sunk costs. This is based on the argument that issuing a licence to a new operator may not allow the (previous) incumbent to fully recover his sunk investments from improvements in towage services in previous years which now become benefits to the new operator who has not made the appropriate investment. Furthermore, it has been stated that issuing licences may deny the introduction of innovation.

The desire to go to tender may reflect issues other than price such as those relating to the incumbent's market behaviour, service levels etc. It is relevant here to note that Adsteam's and Howard Smith's successful moves to reduce manning on some tugs from four to three people led to statements by Adsteam that towage prices would be reduced in relation to the particular vessels. This has not occurred.

Furthermore, work on simulation activity carried out by Adsteam not only benefits the port and shipping lines but has very material benefits to Adsteam as well in the more efficient deployment of their tugs. It is a cost that may not necessarily be borne by one party alone, and in some circumstances could be shared.

We consider that port authorities are competent to be able to design and administer tender documents and procedures to take into account technological developments over the life of the contract and changes in market requirements such as the effects of larger sized vessels. This can be achieved by providing flexibility in the tender documents which would flow through to licence performance as well as an operational review process so that actual or potential changes in circumstances can be discussed between the licence holder, towage contractor and industry representatives. If there are changes in circumstances that imply a higher cost of service provision, then methods as to how to meet this cost during the life of the licence can be discussed, for example the licence could be written with an option for additional years so that higher costs can be amortised over a longer period etc.

In most circumstances innovation does not come overnight and there is a time lag before it can be effectively introduced. This would be reflected in licence arrangements. We disagree that there would be greater incentives for innovation under open entry which were reported to be continuous in nature.

In this regard it is interesting to note that in the absence of any discussion with users or the port authority, and after a cancelled tender for towage services, Adsteam introduced a larger sized tug into Mackay in response to the likelihood that larger vessels would be using the port and therefore a larger tug capacity would be required. There was an indication that towage charges would need to increase by over 50% to cover this increased capacity. Such unilateral decisions, most likely designed to protect their market position in the likelihood of a future tender for towage services by Mackay, would not necessarily occur under an exclusive licence as such a development would be required to be discussed.

An example of conflict of interest given by Adsteam was the potential for a port authority to enter the towage business themselves and become a competitor to an incumbent or adopt unfair practices in any licensing procedure.

As ports are owned by State Governments and as port stakeholders would be well aware of any potential entry into towage by a particular port authority, undoubtedly there would be some form of independent assessment authority to review the full licensing process if a particular port authority wished to become an entrant to the market. In fact, in the licensing processes in Bunbury and Fremantle, the State Government provided probity controls over the process even though there was no intention by the port authority to enter the market themselves.

- **Criticism over the ability of ports to adequately design licences, the cost of the licensing process and the enforcement of such licences**

We do not see any issues concerning the ability of port authorities to design licences. AAPMA provides a mechanism for discussions on such matters and individual ports could speak to each other on a one-on-one basis, if they needed advice.

We would contend that the costs of administering a licence are legitimate costs that should be born by the port authority as part of its overall business – it is part of their trade facilitation function and would normally be built into costs as part of normal budgetary processes. Such costs are small when spread over the total port authority business.

If the end result to the users of the towage service is demonstrably better than previously in terms of cost and service delivery, then they are in a stronger position to enhance their trading operations.

As far as enforcement is concerned, it must be born in mind that anyone who wins the right to provide a towage service would probably do so on the basis that they would want to be in the port for the longer term and also to be in a position to expand into other ports when there is an opportunity to do so. It is therefore unlikely that a new licensed operator would not perform the terms of the licence, except in exceptional circumstances, in which case there should be recourse in the licence for discussions to work out the best means of addressing the particular circumstance.

It was argued by Adsteam that under open entry, such enforcement is performed by competition rather than by the regulator. We do not agree that this would be the case given the barriers to entry in place.

- **Difficulties in setting up procedures for exclusive licences**

These concerns appear to be related to collusion. Whilst we acknowledge that collusion could take place in towage licensing it must be noted that potentially this would apply equally in any other industry in Australia in which tenders for the supply of goods or services are undertaken. There are remedies under the Trade Practices Act which can address any evidence of collusion. We do not agree that service provision in ports should be treated any differently to other industries.

- **Price reductions from exclusive licences may not indicate inefficiency or excess costs but may reflect quality differentials. Such outcomes may not lower the total price of the bundle of services that users purchase and may not benefit users but would, instead, lower efficiency in the long term**

The content of the exclusive licence tender document would include input from shipping companies and users as to the level of service required as well as input from the port on types of tugs, their capacity etc., which would be determined, in turn, with input from pilots and marine safety authorities. This would constitute the bundle of services and service qualities that would be required and a tenderer would then respond to this with his price and how he would meet conditions of service. An incumbent would also tender to the same terms and conditions so that there would be a level playing field in terms of efficiency and costs which would meet the needs of all parties concerned over the life of the licence.

- **Effect of volume rebates**

We accept that volume rebates reflect economies of scale and accept that this is a fairly normal part of commercial business operations. However, we contend that such rebates can be used as a significant barrier to entry as was demonstrated in the Fremantle tender where some shipping lines were not in favour of a new towage provider even if the costs of the towage service were lower than the existing costs, as this would have affected the level of rebate they received from Adsteam on a national basis.

Whilst these rebates only apply to a number of larger shipping companies we consider that they could be a sufficient barrier to entry of a new operator in any **single** port unless the new operator were able to meet the value of the rebate to a particular line or lines on a national basis. This may be difficult to achieve for a new entrant initially in view of the high sunk costs of entry and the need to develop business – and only if a new entrant decided to commence operations in several ports, particularly the container ports, over a short period of time.

It must be recognised that port authorities have a responsibility to ensure that benefits for any decisions taken in relation to licence conditions can be achieved by as many stakeholders as possible.

3. Barriers to Entry

We maintain that the level of contestability of this towage market is low and that sustainable long-term entry by a towage provider into a single port is difficult in Australia, not only because of the economies of scale and the sunk costs that are involved in entry, but also because of the national market coverage by a dominant supplier which can utilise:

- Transfer pricing/costing in relation to the charges set in the port when there is a threat of, or actual, competition;
- Relocation of existing tugs to support different cost bases (but which can also create over-capacity because they may not be the most suitable tug in terms of capacity and cost available and therefore establish an unnecessary higher cost basis);
- Long term towage contracts with shipping lines both on a national basis and in one port;
- Reliance on the effect of national rebates for large users which may decrease and even negate the value of price reductions in a single port offered by an alternative supplier;
- Generally aggressive (or even potentially anti-competitive) market behaviour;

and use these mechanisms to drive out a competitor over time either by purchasing the business outright or simply causing him to cease operations because he is unable to make a profit.

In fact, the situation in Australia is such that each of these practices is known to potential entrants so that entry is considerably less attractive in the absence of licence arrangements.

We contend that individual ports in Australia are too small in terms of vessel movements to sustainably allow a second operator. This situation is likely to continue be made more difficult through further technological developments on vessels which will result in fewer tugs required per vessel, balanced of course, by natural growth in trade.

Even in Newcastle where the new entrant was able to control a proportion of the vessel towage business to provide at least a base for entry and was able, over time, to increase its market share through service delivery etc, it was found that the market was too small to maintain two operators. The result was that Adsteam purchased the BHP towage business and became the sole supplier again. One of the reasons for the failure of one of the two operators was that the number of tugs in the port was too high. The operators could not agree to share tugs which led to both having the minimum of tugs required to carry out all towage operations. Whilst in a competitive situation this may be the expected response, it does increase the costs of operation in the port and thus competition may not yield the best price and service quality.

AAPMA does not accept that the towage market is highly contestable as we note that the towage market has consolidated over the last ten years or so by acquisition of competitors, predominantly by Adsteam, to a far greater extent than there have been new entrants.

If it is argued that the towage market is contestable and that the towage service provider is pricing efficiently because of the threat of new entrants, one must question why there have been significant reductions in towage charges when towage has been put out to tender on both an exclusive and non-exclusive basis.

4. Towage Costs as a Proportion of Overall Transport Costs

Adsteam argue that towage is a small element in the overall cost of transporting goods.

We believe that this is not the issue.

The real issue is that a provider with a natural monopoly appears to want to maintain a market position where there is no effective impediment to the adoption of monopoly pricing with or without a level of service specifically required by users. They use the argument that the price (cost) is only small in terms of the contribution to the overall cost of transporting goods in order to effectively sanction their monopoly position.

The argument mounted by Adsteam generally refers to containers and pays little attention to bulk and breakbulk shipments, where Australian exporters are often in the position of being “price takers” and thus unable to influence

the selling price of their product. In this situation, where much bulk trade is sold on an FOB basis, the exporter is unable to influence the freight rate which is agreed by the buyer, and any increase in costs can reduce the exporters' competitive position, especially when the export is a low value product.

Furthermore, many FOB bulk shipments are "spot" chartered or not subject to long term freight contracts and so the shipping company is unlikely to take an active interest in towage charges to the extent that it would seek to influence them in one or more ports which they visit irregularly. In this regard, it should be noted that Adsteam also run an active ships agency business in many ports in Australia which can be used to influence the direction of towage service provider.

5. Price Monitoring

We support some cost effective form of price monitoring of towage prices in all ports where there is no exclusive license or other acceptable form of market testing or monitoring acceptable to towage users. In this regard, we see exclusive licences as one option in terms of an overall regulatory or monitoring process. Other options could include agreed rates of return. However, any form of regulation must acknowledge the need for and the encouragement of innovation and efficiency gains in towage service delivery such as adoption of technological developments, labour arrangements, etc.

Monitoring must be wholly transparent by both users and the regulatory authority. Criteria capable of implementation must be in place to enable a monitoring process to be undertaken by the regulatory authority with appropriate input by towage users that is consistent in its application, is cost effective to the service provider and towage users, and has an enforceable outcome.

If implemented, such regulation should be reviewed in, say, three to five years time.

If the process of prices declaration were to continue then it is essential for a far wider range of ports to be declared rather than only "container" ports for the reasons set out in other sections of this submission. Furthermore any monitoring must also include a wider range of ports.

6. Countervailing Power

We have doubts over the potential for countervailing power in ports with a small number of users. In such ports there is often a dominant user or users of towage services and their requirements are often quite specific and may be at variance with the service levels and requirements of the other users. There may also be different perspectives on market condition, duration of arrangements, need for price and stability, etc. In such situations it may be difficult to reach agreement on a common approach. We note that Shipping Australia share this view and also do not consider that it would be effective in container ports.

7. Salvage

We do not accept Adsteam's contention that "exclusive towage licences, because of their port specific focus, pose a serious threat to the ongoing viability of Australia's existing national salvage and coastal protection capability."

Salvage is a most important issue for an island nation like Australia. The enormous coastline that needs to be protected poses a number of very significant problems in relation to salvage and also emergency response. Ports are highly responsive to wider economic and community needs and it is most unlikely that any port would specifically exclude salvage and emergency response requirements from any towage licensing arrangements as this is an essential part of meeting the needs of our stakeholders.

There are a number of potential (and actual) salvage vessels/providers in Australia with maritime salvage expertise other than Adsteam and, in view of the high rewards from successful salvage, competition can be intense and response immediate.

The issue with salvage capabilities is that invariably a salvage capable tug will also be used as a harbour tug and thus part of the towage capability that the towage operator undertakes to provide under any licensing arrangements – or in the absence of a licence.

The absence from a port of a harbour tug undertaking salvage operations, which earn a substantial profit for the salvage contractor, can leave the port in a position where there is a lack of towage capacity to meet their normal ongoing requirements. This, in turn, can affect the ability of the port to meet its users' needs especially in periods of adverse weather, or with movements of larger capacity vessels, etc. This situation can be exacerbated where one or more harbour tugs are used as relief tugs at other ports.

Furthermore, there is the issue of whether one particular port where the salvage tug is stationed should, in effect, meet the cost of this vessel alone, particularly when that vessel is used for salvage operations in a wider area, possibly covering areas closer to other ports. This results in the home-port users of the salvage vessel bearing additional costs for this service which gives singular benefits to the salvage/towage operator.

There is also a distinction to be made between emergency response and salvage operations. In most cases, emergency response can be handled by harbour tugs which may only need to be away from the port for a short period whilst they make fast the stricken vessel.

We have concerns over situations in which a harbour tug is retained for a salvage operation and thus away from its home port for a lengthy period, eg., towage of a salvage vessel to a repair port in Asia. Whilst licences could stipulate conditions for time away for salvage, emergency response work and

the associated towage cover required, we are concerned that a harbour towage operator with salvage capacity could decide to run the risk of non-performance of their licence in order to profit from the high rewards that can come from successful salvage.

We support the Productivity Commission's suggestion that the issue of salvage availability, and how it should be paid for, should be the subject of another separate enquiry in view of its enormous importance to Australia.