PNG PORTS CORPORATION LIMITED

RESPONSE TO ICCC ISSUES PAPER – SEPARATION OF PNG PORTS CORPORATION’S REGULATED AND UNREGULATED BUSINESSES

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1.0 Executive summary

1.1 Background and regulatory framework

PNG Ports Corporation Limited (PNG Ports) is pleased to present to the Independent Consumer and Competition Commission (ICCC) its written submission to the Issues Paper on Separation of PNG Ports’ Regulated and Unregulated Businesses.

The Regulatory Contract is not prescriptive about the principles that must be considered by the ICCC in determining whether it is necessary or desirable for PNG Ports to separate its Essential Port Services business from a regulated business(es) that it operates. However, PNG Ports believes that such a substantial decision which could result in significant costs to PNG Ports and customers needs to be undertaken within a rigorous framework. In particular, it is incumbent on the ICCC to ensure that in undertaking this review it is acting in a manner that is consistent with its objectives under the ICCC Act.

PNG Ports considers that the ICCC’s issues paper falls short of:

- Clearly articulating any concerns about the current state of competition in the market for contestable services
- Identifying the benefits that the ICCC expects to achieve via intervening in the industry
- Recognising the costs of alternative approaches to intervention under consideration, and most critically, whether the benefits of intervention will outweigh the costs.

These issues should form a fundamental part of the review, as they go to the heart of the achievement of the objectives of the ICCC.

1.1 Objective of the Issues Paper – the case for intervention

The Issues Paper seeks submissions on the necessity or desirability of less or more intrusive forms of separation than currently exist in the Regulatory Contract to achieve transparency in the costs of provision of:

- In-port storage services for in-transit cargo;
- Pilotage services;
- Charges for the use of rubber-tyred gantries (RTGS) and mobile harbour cranes (MHCs);
- Stevedoring services or services allied to them, such as terminal management services;
- Other new contestable services; and
- The type of approach for doing so – accounting, functional or structural separation.

Requirement for and approach to separation

Whether any form of separation is required, and the appropriate approach to separation, need to be considered in the context of the objectives of pursuing separation. PNG Ports is of the view that the
ICCC has not adequately demonstrated the benefits of heavy-handed regulatory intervention in relation to storage, pilotage, MHCs and RTGS, or other, unspecified “new contestable services”.

In particular, the majority of the ICCC’s concerns are based on speculation about:

- Potential price responses that PNG Ports may take to the entry of competitors, in particular, by reducing prices below costs – despite the fact that this has not occurred, even with substantial market entry in the storage sector
- Possible entry by PNG Ports into related markets such as downstream transport services – again, despite the fact that this has not occurred, and PNG Ports having no intention of operating as a road transport provider.

PNG Ports recognises that as an entity that provides both regulated and unregulated services, appropriate cost allocation approaches are required to ensure that there are no cross subsidies between the provision of regulated and unregulated services.

PNG Ports has submitted several ring fencing reports pursuant to schedule 6 of the Regulatory Contract, none of which have been commented on by the ICCC, and nor has the ICCC suggested alternative methods of allocating costs attributable to the regulated and unregulated businesses.

**Functional separation and structural separation**

The discussions of functional separation and structural separation in the ICCC’s Issues Paper are based entirely on conjecture. The ICCC identifies a number of concerns that functional and structural separation are designed to address, but does not provide any evidence or analysis of the extent to which these issues may be risks in the present circumstances.

Overall, it is PNG Ports’ strongly held view that a rigorous cost-benefit assessment of the different types of separation needs to be undertaken by the ICCC, with continual reference to the objectives of the ICCC as set out in the ICCC Act. The costs of the more intrusive option of structural separation are indisputable, and would include:

- Significant once-off transition costs in terms of establishing an additional entity (or multiple entities)
- Ongoing head office costs associated with separate staff, operational support systems and IT and accounting systems
- Separate governance structures with separate boards and executive
- Duplication of administrative costs around the regulatory framework.

On the other hand, the benefits of more intrusive regulation to separate PNG Ports’ businesses are far less certain. The issues raised by the ICCC in relation to potential price responses by PNG Ports to new entry and entry by PNG ports into related markets (or “new contestable services”) are not supported by evidence and are purely hypothetical in nature. At no stage in its Issues Paper does the ICCC provide an assessment of the potential benefits of the options under consideration with respect to the price, quality or reliability of Essential Port Services.
1.2 Summary and conclusions

PNG Ports is one of the leading State Owned Entities with respect to the rigour and integrity of its internal and is proud of the improvements made to its data and accounting systems in recent years. The 2011 Audit Report was a ‘Qualified Opinion’ after years of consecutive disclaimed opinions. The 2012 accounts are expected to be signed off shortly with 2013 audits to immediately commence at the start of 2014. PNG Ports has also undertaken a comprehensive reconciliation and update of the company’s fixed asset register, which now meets international accounting standards.

PNG Ports welcomes the opportunity to discuss ways to improve its cost approach to cost allocation, and would be pleased to work with the ICCC to establish a cost allocation policy or guideline that would alleviate the ICCC’s concerns about transparency around the allocation of costs.

The ICCC’s key objectives under the ICCC Act include promoting economic efficiency and protecting the long-term interests of consumers with respect to price, quality and reliability of goods and services. PNG Ports believes it would be inconsistent with these objectives for the ICCC to fail to test the effectiveness of an accounting separation option prior to embarking on the extreme (and costly) path of functional or structural separation. Strengthening and clarifying cost allocation requirements should be explored as a first step.

It should also be noted that introducing a new approach to cost allocation for some services while others remain regulated under the Regulatory Contract would be likely to distort incentives for investment in regulated and contestable markets, and runs counter to the objectives of the ICCC.
2.0 Introduction and background

2.1 Overview of regulatory framework and discussion of the ICCC’s approach

The ICCC’s review of the separation of PNG Ports’ regulated and unregulated businesses is being conducted under the provision of paragraph 7.1(a) of the Regulatory Contract. In particular, the ICCC has noted that the current review is being undertaken to explore the necessity or desirability of preventing anti-competitive practices which may damage competition or prevent it from emerging where it can otherwise do so viably.

7.1(a) of the Regulatory Contract provides as follows:

"If the Regulator considers it necessary or desirable to do so in order to promote competition in a market for Contestable Services, it may serve a notice on PNG Ports specifying steps PNG Ports must take in order to separate its Essential Port Services business from a Contestable Services business or businesses operated by PNG Ports or Relevant Interest Holder in PNG Ports. PNG Ports must comply with any such notice within 20 Business Days of service of the notice or within such longer period as the Regulator may allow."

7.1(d) states that:

"Without limiting what may be required by the Regulator under paragraph 7.1(a) the Regulator may require:

(i) that PNG Ports not provide Contestable Services (although a Relevant Interest Holder in PNG Ports or a Subsidiary of PNG Ports would be free to do so);
(ii) require that any contract, arrangement or understanding between PNG Ports and a Relevant Interest Holder in PNG Ports or a Subsidiary of PNG Ports providing Contestable Services in relation to the provision of Essential Port Services by PNG Ports to the shareholder of PNG Ports not be entered into unless first approved by the Regulator; and/or
(iii) that confidential information provided by a user of Essential Port Services to PNG Ports not be provided to employees, contractors or advisers of PNG Ports or a Relevant Interest Holder in PNG Ports or a Subsidiary of PNG Ports involved in the provision of Contestable Services."

The Regulatory Contract is not prescriptive about the principles that must be considered by the ICCC in determining whether it is necessary or desirable for PNG Ports to separate its Essential Port Services business from a regulated business(es) that it operates, including the type of separation to be undertaken.

PNG Ports believes that such a substantial regulatory decision which could result in significant costs to PNG Ports and ultimately the people of PNG needs to be undertaken within a rigorous cost-benefit
framework. In particular, it is incumbent on the ICCC to ensure that in undertaking this review it is acting in a manner that is consistent with its objectives under the ICCC Act.

The primary objectives of the ICCC under the ICCC Act are:

a) to enhance the welfare of the people of Papua New Guinea through the promotion of competition, fair trading and the protection of consumers’ interests; and

b) to promote economic efficiency in industry structure, investment and conduct; and

c) to protect the long term interests of the people of Papua New Guinea with regard to the price, quality and reliability of significant goods and services.

Having regard to these objectives, PNG Ports is of the view that the ICCC is obliged to undertake an assessment of the costs and benefits of the proposed separation against these objectives in conducting its review.

PNG Ports considers that the ICCC’s issues paper falls short of:

- Clearly articulating any concerns about the current state of competition in the market for contestable services
- Identifying the benefits that the ICCC expects to achieve via intervening in the industry
- Recognising the costs of alternative approaches to intervention under consideration, and most critically, whether the benefits of intervention will outweigh the costs.

These issues should form a fundamental part of the review, as they go to the heart of the achievement of the objectives of the ICCC.

In particular, PNG Ports notes that the ICCC has not addressed the issue of the additional costs that functional or structural separation would impose on the industry. In the absence of this assessment, PNG Ports is concerned that the additional cost of regulating the non-regulated services could outweigh any perceived advantage to the consumer and to the functioning of the market.

Notwithstanding the above concerns about the deficiencies in the approach taken by the ICCC to the current review, PNG Ports is committed to working with the ICCC to address any legitimate concerns about the competitiveness of the market for port infrastructure services. PNG Ports welcomes the opportunity to improve on its ongoing work in ensuring that the approach to allocating costs between the regulated and contestable services meets the requirements of the regulatory framework and best practice.

2.2 Information provision and contractual obligations

In its Issues Paper, the ICCC makes a number of insinuations with the implication that the ICCC is unable to rely on PNG Ports ‘in terms of the veracity of its systems, whether accounting, or organisational, to achieve the requisite standard of separation of business activities’.

Specifically, the ICCC recounts a sequence of events involving:
• A late submission of a tariff increase proposal by PNG Ports in 2011, which the ICCC interpreted as entitling it to preventing PNG Ports from imposing any charges for regulated services
• A proposal by the ICCC to undertake a partial review of the Regulatory Contract in respect of a number of issues
• PNG Ports’ refusal to submit to the ICCC’s proposed review.

PNG Ports takes great exception to the insinuations of the ICCC that this sequence of events suggests that PNG Ports cannot be relied upon to implement and maintain robust accounting and organisational systems to manage the separation of business activities.

PNG Ports acknowledges that its 2011 tariff submission was seven (7) days late. However, it is critical to clarify that ICCC is **not** empowered to withhold approval of PNG Ports’ regulated prices in the event of a late tariff approval submission. This is an incontrovertible fact. Furthermore, the ICCC’s attempt to coerce PNG Ports into a review of the Regulatory Contract under the threat of withholding price approvals was also contrary to the regulatory and legislative framework.

The ICCC’s threats and attempts to deny PNG Ports its rights under the Regulatory Contract and abandon due process raise grave concerns about the integrity of the ICCC and its ability to uphold the principles of the regulatory framework. Nevertheless, PNG Ports is committed to complying with its obligations under the regulatory framework and willing to work with the ICCC to address issues around cost allocation and information, so long as it remains within the regulatory framework.

As set out in section 7.0, below, PNG Ports has consistently discharged its obligations under the Regulatory Contract concerning the submission of Schedule 6 Ring-fencing reports, all of which have been accepted by the ICCC. The ICCC has not provided any guidance on its preferred approach to cost allocation. Should the ICCC be willing to engage with PNG Ports on cost allocation issues, PNG Ports would welcome the opportunity to work with the ICCC to address any legitimate concerns it may have.
3.0 Market for storage services

3.1 Issues raised by the ICCC

The following provides a summary of the issues raised by the ICCC in relation to the provision of storage services:

- The ICCC has previously concluded that it was not possible to regulate storage services under the current Regulatory Contract, and that further inquiries would be conducted on declaration.
- The ICCC re-iterates issues raised in its Mid Term Review of Competition around storage, including:
  - That PNG Ports may have an incentive to delay the issuance of gate passes because it profits from storage charges.
  - PNG Ports is right in its assertion that storage charges are necessary to create an incentive to reduce cargo dwell times.
- While there are some players in the storage market, they do not directly compete with PNG Ports.
- The ICCC notes that should new entrants decide to enter the market for ‘in-transit cargo’ by providing storage services PNG Ports could retaliate by reducing prices.
- With respect to ‘out of port’ storage services, the ICCC states that PNG Ports’ plans to provide storage facilities at the Rainbow development in Port Moresby brings it into direct competition with facilities operated by private sector participants.
- PNG Ports does not have to recover the return on the market value of the land, as this is a legacy asset inherited by PNG Ports, and therefore has substantial capability to retaliate to new entry by reducing prices.

3.2 PNG Ports’ response

Definition of the market and overview of PNG Ports’ pricing strategy

The ICCC’s approach to assessing the level of competition for storage services fails to adequately define the market in question. The definition of market is critical to the assessment of competition under the ICCC Act.

The storage services offered by PNG Ports, which comprise both open and undercover storage, are intended for transit purposes only. That is, while PNG Ports provides short-term storage for containers en route to and from the port, this service is not intended to be utilised for the long-term storage of cargo. Once the free period for in-transit storage has expired, cargo owners have effectively opted for a long-term storage solution, for which there are a multitude of private sector providers.

PNG Ports provides a number of free days of storage for containerised and bulk cargo, after which it applies an escalating scale of rates with increases applied as the duration of storage increases.
PNG Ports generally allows five free consecutive days of storage for international and coastal cargo, either from the date of discharge of the vessel (for inbound cargo) or the date of shipment (for outbound cargo). The following general conditions apply to storage services provided by PNG Ports:

- Export cargo will receive 5 free days storage in the Port prior to declared ship estimated time of arrival (ETA);
- Import cargo will receive 5 free days storage in the Port from ship departure day;
- Transhipment cargo will receive 10 free days in the Port of Transhipment; and
- There is no long term storage available for empty international containers at the ports of Port Moresby, Lae and Kimbe. Containers left in these ports past the allowed 5 free days discharge or back-loading will attract a penalty fee.

In its 2010 Final Report on the review of the PNG Harbours Regulatory Contract, the ICCC stated that PNG Ports’ storage tariffs were below the level that would otherwise be set in the open market. Following the release of the ICCC’s 2010 report, PNG Ports made a number of changes to its approach to charging for storage to drive efficiency in the use of storage facilities, improve revenue outcomes and align with international best practice. These changes have been effective in clearing empty containers from the wharf, reducing dwell times and therefore improving port efficiency. As recognised by the ICCC, ultimately, the structure of storage tariffs is underpinned by the limited storage capacity at Port Moresby and Lae and the imperative to drive greater efficiency.

PNG Ports strongly encourages port users to remove their cargo from the port within the free storage period, incurring no charges and improving port efficiency.

Only when port users fail to remove their cargo from the port precinct within the free storage period do storage charges commence – it is at this point that the in-transit (free) storage services provided by PNG Ports convert to a charging regime, which is designed to discourage cargo owners from contributing to port congestion.

**Competition from private operators**

Once the free in-transit storage period has expired, PNG Ports contends that this cargo has effectively entered the broader market for storage services, for which there are a number of alternative suppliers.

Private providers of storage services play a critical role in the overall market for storage services. Private operators may provide storage services in a number of ways:

- By establishing bonded yards outside the port precinct – these yards enable cargo to be removed from the port immediately, without the need for customs clearance, addressing potential delays in customs clearances. PNG Ports has no control over the efficiency of the customs clearance process, which is reliant on the actions of Customers agents and shippers/consignees (or their agents). Customs has advised that the process for establishing a bonded facility is not onerous.
By establishing their own long-term storage facilities outside the port precinct – this is the appropriate approach to long-term storage of cargo, rather than leaving cargo on the wharf. A number of importers and exporters have significant storage yards, which provide the capacity to minimise the need for dwell time at the wharf.

A number of alternative storage providers now operate at both Port Moresby and Lae, offering bonded storage facilities that can be utilised by customers prior to receiving Customs clearance, thereby providing a similar service to that provided by PNG Ports.

The below table sets out the available information on storage providers at Port Moresby and Lae. While these companies do not provide in-transit storage, this is irrelevant, as this service is provided by PNG Ports free of charge. It is only when cargo owners exceed the free storage period that PNG Ports imposes storage charges, in which case providers of bonded storage facilities provide a similar, substitutable service.

**TABLE 1: ALTERNATIVE STORAGE PROVIDERS, PORT MORESBY AND LAE**

<table>
<thead>
<tr>
<th>Port locality</th>
<th>Bonded storage facility operators</th>
<th>Other storage facility operators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Port Moresby</td>
<td>• Motukea</td>
<td>• GFS</td>
</tr>
<tr>
<td></td>
<td>• East West Transport</td>
<td>• SP Brewery</td>
</tr>
<tr>
<td></td>
<td>• Express Freight Management</td>
<td></td>
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<tr>
<td></td>
<td>• Hi-Lift</td>
<td></td>
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<tr>
<td></td>
<td>• World Link Logistics</td>
<td></td>
</tr>
<tr>
<td>Lae</td>
<td>• Express Freight Management</td>
<td>• Trukai</td>
</tr>
<tr>
<td></td>
<td>• Consort</td>
<td>• Goodman Fielder</td>
</tr>
<tr>
<td></td>
<td>• Riback</td>
<td>• Mainland Holdings</td>
</tr>
<tr>
<td></td>
<td>• Agility</td>
<td>• Seeto kui</td>
</tr>
<tr>
<td></td>
<td>• Boroko Motors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Ela Motors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• PNG Motors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Coca Cola- (Application under consideration)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Transwonderland Trucking</td>
<td></td>
</tr>
</tbody>
</table>

The existence of these other storage operators demonstrate that private operators have not been precluded from entering the storage market due to either barriers to entry or a perception of being priced out of the market by PNG Ports.

**Incentives for PNG Ports to retaliate by reducing prices**

PNG Ports notes that alternative storage providers (for which price data is available) are charging similar rates to PNG Ports for the long-term use of storage facilities. In Lae, Consort offers a storage service for containers costing between PGK58 and PGK79 per day for up to 30 days. By way of comparison, in 2012, PNG Ports charged PGK55.51/day per container for Days 6 and 7 (i.e. the first two days after the five-day free storage period), increasing to PGK76.46 for Days 8-14 and PGK97.41 for Day 15 onwards.
Previous analysis undertaken by PNG Ports has also shown that its charges are comparable to those offered in other jurisdictions, with storage fees for twenty foot containers at the Port of Singapore for example starting at around PGK 98 per day (after the free period has expired).¹

This demonstrates that:

- PNG Ports is not charging significantly higher tariffs than alternative storage providers, as would be the case if it were exercising market power
- PNG Ports has not retaliated to Consort’s entry into the market by reducing its prices to a below cost level, as suggested by the ICCC as a possible reaction to market entry.

Indeed, PNG Ports recognises the efficiency benefits of new entry into the market. The provision of storage services by alternative providers allows PNG Ports to focus on providing Essential Port Services which is its primary focus. Contrary to the assertions of the ICC, the actions of PNG Ports encourage private operators to enter the market for storage services. This can be seen both in the charging regime implemented for cargo which has exceeded the free storage period, and also the Board of PNG Ports’ recent resolution to sell its inland storage yard in Lae through a public tender process — these actions promote, rather than constrain competition.

To reduce the prices it charges for storage to the extent that market entry was inhibited would run counter to the objectives of PNG Ports in implementing the charging regime in the first place, and is inconsistent with the actions of PNG Ports in actively supporting new entry. The ICCC’s argument that PNG Ports might reduce its storage prices to below cost to retaliate against imminent or actual entry is purely hypothetical, and is not supported by any evidence — all available evidence directly contradicts the ICCC’s hypothesis.

Furthermore, the ICCC’s assertion that the establishment of the Rainbow development in Port Moresby represents entry into the market for out of port storage services is incorrect. There are no storage facilities proposed for this site. The Rainbow development is an institutional residential development for employees of PNG Ports on land that is classified as residential which would be illegal to develop a container storage yard.

**Issues concerning the promotion of competition and efficiency**

The ICCC also notes that PNG Ports does not have to recover the return on the value of the land, as this is a legacy asset inherited by PNG Ports, and therefore has substantial capability to retaliate to new entry by reducing prices. The ICCC contends that this is likely to inhibit new entry, and while there are some players in the storage market, they are not directly competitive with PNG Ports.

PNG Ports disagrees with this assertion. The ICCC re-valued PNG Ports’ assets for the purpose of establishing the asset base used in the current regulatory contract. The ICCC achieved this by taking the Property, Plant and Equipment amount from PNG Ports’ balance sheet (PGK 285m), which includes the value of land.²

Where these assets are deployed in the provision of Essential Port Services, PNG Ports is incentivised to achieve the benchmark regulated rate of return. To the extent that these assets are deployed in the

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² Both the 2009 and 2010 financial accounts include this information and are available on PNG Ports’ website.
provision of contestable services, Government policy on SOEs requires PNG Ports to be at least as profitable as comparable private sector businesses. Therefore, it is incumbent on PNG Ports to set prices for contestable services in a manner that are consistent with achieving a commercial rate of return that would be required by a private operator. As an equity holder in PNG Ports, the Government of PNG requires PNG Ports to return a dividend commensurate with equity held in the business by the Government – this equity includes the value of land held by PNG Ports, which is clearly reflected in its publicly available financial accounts.

PNG Ports considers that its approach to pricing for long-term storage of cargo (that is, after the free period for in-transit storage has expired) has resulted in significant efficiency gains across the supply chain. There are a number of private operators who provide long-term storage solutions for cargo, both under bonded and non-bonded facilities. As discussed above, the evidence clearly shows that PNG Ports has not responded to market entry in storage services through retaliatory pricing.

We are strongly of the view that the stringent forms of separation the ICCC is considering far exceed any requirement to respond to potential competition issues. If the ICCC considers that it is necessary or desirable to implement reforms to the market for long-term storage services to promote competition, it is incumbent on the ICCC to demonstrate that any reforms to pricing or the structure of the industry would result in a net benefit to consumers, and would be consistent with the objectives of the ICCC as set out in the ICCC Act.

To the extent that the ICCC has any residual concerns about the allocation of costs between PNG Ports’ storage services and its Essential Port Services, PNG Ports would welcome the opportunity to work with the ICCC to establish a suitable cost allocation guideline.

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3 Clause 9, PNG Community Service Obligation Policy for State Owned Enterprises
4.0 Possible leverage into other services

4.1 Issues raised by the ICCC

The following provides a summary of issues raised by the ICCC in relation to ‘other services’ in its Issues Paper:

- ‘Perfectly legitimate business strategies for PNG Ports could include extension into land transport services...Users may well be inhibited from using transport providers other than PNG Ports for fear of being discriminated against in the issue of gate passes for their cargo if they do use transport service providers other than PNG Ports’
- This same argument could include other competitive services such as fumigation, container cleaning, container provision, stevedoring etc.
- The ICCC again raises the allegation that PNG Ports is deliberately engaging in the delay of gate passes
- Asserts that a robust form of separation is therefore required.

4.2 PNG Ports’ response

The issues raised by the ICCC are totally unsubstantiated and based on hypothetical scenarios which bear no relevance to PNG Ports’ actual operations. If PNG Ports did actually one day enter the land transport market, it would not object to the ICCC considering the potential impacts on competition in the market. However, PNG Ports has not entered the land transport market and has no intention of doing so. This is also the case for the long list of other services that the ICCC is suggesting PNG Ports might begin to compete in: fumigation, container cleaning, container provision, stevedoring etc.

With respect to stevedoring in particular, PNG Ports refers the ICCC to its May 2013 submission to the ICCC’s Stevedoring and Handling Pricing Review Issues Paper where PNCPCL provided a detailed submission explaining that PNG Ports is not licenced to and does not provide stevedoring services.

Gate passes

In order to transport cargo from the port, consignees/agents require a gate pass. Gate passes are provided to consignees/agents upon presentation of documentation verifying ownership of the cargo and that the cargo has been cleared by Customs for release. If the cargo has been cleared by Customs and a release authority provided, the consignee’s documents are satisfactory, and all necessary in-port charges such as stevedoring and handling, wharfage, quarantine (where applicable) etc. are paid, PNG Ports can confirm there would be no delays in gate pass issuance.

The below figure demonstrates the process consignees or their agents must follow when transporting imported cargo from PNG Ports’ storage facilities:
FIGURE 1: GATE PASS ISSUANCE PROCESS FOR IMPORTED CARGO

Free storage period

Five days
- Consignee/agent arrives at port
- Obtain Delivery Order
- Obtain Customs Clearance
- Obtain NAQIA Clearance
- Obtain Import Delivery Docket
- Pre-book
  - Present documentation at Admin office for processing
  - Proceed to Storage Clerk for document verification
  - Fail to pre-book

Charges required*

No charges required

Three days
- Proceed to Admin office to collect invoice
- Proceed to Finance office to pay invoice
- Obtain gate pass
- Authentication of cargo documents
- Collect cargo and proceed to gate
- Gate pass verification
- Remove cargo from port

Responsibility
- Consignee/agent
- Customs
- NAQIA
- Stevedores
- PNG Ports
- Consignee/agent

**Charges will only be required if gate pass is not obtained within five days of cargo arriving at port.

***If the cargo incurs storage charge, a pro-forma invoice is issued. An additional 3 free days is given for consignee to settle the invoice.
The above figure shows that so long as consignees have their documentation in order, the process they are required to follow from port arrival to gate pass collection involves a small number of steps. Even in the case when a consignee has not pre-booked, obtaining a gate pass simply requires presentation of the necessary documents for processing and approval and collection, as well as payment of an invoice in cases where the free storage period has expired.

Accordingly, PNG Ports’ role in the gate pass process is restricted to the confirmation of documentation and clearance processes, including citing evidence of Customs and NAQIA Clearance Documents, as well as Delivery Orders (processed by Shipping Agents) and the Import Delivery Docket (processed by Stevedores).

The ICCC has suggested that it could take up to four days to obtain a gate pass from PNG Ports. No evidence has been provided by the ICCC to support this allegation. Further, the ICCC does not appear to have examined the processes and various parties involved in the process of having goods cleared for removal from ports. Delays are not necessarily the result of PNG Ports failing to provide a gate pass in a timely fashion, but could be due to delays in the processing and clearance of the cargo through the port which relies on a number of parties, including:

- Transport companies/freight forwards
- Consignees/agents
- Customs
- NAQIA
- Stevedores.

Finally, PNG Ports notes that once a gate pass has been provided, customers are allowed three additional free days of storage providing sufficient time to arrange for the removal of their cargo – meaning customers have a total of eight days in which to clear cargo from the wharf in which they will incur no storage charges.
5.0 Market for pilotage services

5.1 Issues raised by the ICCC

The following provides a summary of issues raised by the ICCC in relation to pilotage in its Issues Paper:

- Measures were put in place by National Maritime Safety Authority (NMSA) and PNG Ports that had the effect of preventing competition
- In August 2012, the ICCC noted in its Final Report to the Midterm competition review that it had been informed by the NMSA that persons intending to carry out marine pilotage services could apply directly to the NMSA. However, the ICCC also noted that no pilots had been licenced under these new arrangements that were not employed by PNG Ports and consequently, found that pilotage is a monopoly service that should be subject to price regulation.
- PNG Ports is a monopoly provider of pilotage services, however the current regulatory contract prevents its prices from being regulated
- PNG Ports has a representative on the NMSA board, which may facilitate anti-competitive outcomes due to concerns regarding NMSA’s governance standards.

5.2 PNG Ports’ response

Licencing arrangements

PNG Ports requests clarification and/or evidence from the ICCC to substantiate the following claims made by the ICCC:

- That ‘under the current arrangement there is no effective oversight to ensure that PNG Ports does not use its monopoly in the provision of essential port services to facilitate its effective monopoly in pilotage services via anti-competitive conduct.’
- That PNG Ports has put in place measures that had the effect of preventing competition.

Under a delegation from NMSA, PNG Ports has for many years been obliged to manage the licensing of pilots. On March 2012, the NMSA revoked this delegation upon instructions by ICCC, and resumed the function of licensing pilots. From this point forward, persons wishing to provide pilotage services have been required to apply directly to the NMSA, not PNG Ports, to obtain a licence.

If the ICCC is concerned about the current licencing arrangements, PNG Ports contends that the ICCC:

- Should allow sufficient time for these licencing arrangements to be tested and their effectiveness evaluated
- Consult with the NMSA to ensure the facts of the matter are fully understood, prior to undertaking costly additional regulation
PNG Ports accepts that there was a dispute with an alternative pilotage provider, Niugini Pilots, in regards to its operations at Kimbe. PNG Ports has, however, put in place measures to ensure licensed pilots employed by other organisations are able to pilot vessels into its wharfs, and can confirm that these measures have been effective. The presence of Niugini Pilots also signals that competitive forces are at play in the market for pilotage services.

As the new licensing arrangements continue to mature, PNG Ports expects to see increased non-PNG Ports pilots entering the market, and would be pleased to work with the NMSA to assist in capacity building at the NMSA.

**PNG Ports’ representation on NMSA Board**

Section 7(1)(h) of the National Maritime Safety Authority Act 2003 requires that the NMSA Board include one person appointed by the Papua New Guinea Harbours Ltd, the predecessor organisation to PNG Ports. Accordingly, PNG Ports submits that its membership on the board is a legislative requirement, put in place to ensure appropriately qualified persons are able to contribute to key decisions affecting the organisation and the industry.

Further to this point, the membership of the Board is well represented by different stakeholders including a representative from Ship Owners Association – a peak shipping industry body which is currently occupied by a representative from Steamships Shipping – as well as a representative from the PNG Chamber of Commerce and Industry. PNG Ports therefore questions the ICCC’s concerns regarding the NMSA Board’s governance standards and requests that the ICCC provide evidence supporting its concerns.

Regardless, to alleviate the ICCC's concerns on this matter PNG Ports would be happy to commit to a formal conflict of interest policy relating to its participation on the NMSA Board. This would involve some simple rules about not being present when matters relating to pilotage licensing are being considered and not voting on matters relating to pilotage licencing. PNG Ports considers that this is a proportionate response to the alleged problem in comparison to increased regulation.
6.0 Rubber Tyred Gantries and Mobile Harbour Cranes

6.1 Issues raised by the ICCC

The following provides a summary of issues raised by the ICCC in relation to RTGs and MHCs in its Issues Paper:

- In the ICCC’s view, the RTGs and MHCs constitute contestable services
- The RTGs and MHCs have the potential to significantly improve the productivity of the cargo loading/unloading/handling and storage functions within the two main ports
- Tariff changes to recover the costs of the equipment will require the approval of the ICCC
- The ICCC also notes that “both the RTG’s and MHCs were funded by the taxpayers of PNG via budget appropriations” and as such if these costs are also recovered from customers PNG Ports will recover twice the equipment cost.

6.2 PNG Ports’ response

PNG Ports understands that the ICCC has legitimate interest in how the equipment will be used and what the charging arrangements will be, and is keen to take this opportunity to provide transparency in regard to the proposed arrangements.

Investing in productivity

In the first instance, it is useful to provide some contextual information for PNG Ports’ investment in RTGs and MHCs. As explained in PNG Ports’ submission to the ICCC’s Stevedoring and Handling Issues Paper, PNG Ports exercises a delegated power to licence stevedores within declared ports within PNG. PNG Ports is not licensed and does not provide Stevedoring Services.

While PNG Ports leaves the loading/unloading and handling of cargo to experienced stevedores, PNG Ports is strongly committed to improving the efficient operation of declared ports (an objective which coincides with one of the key objectives of the ICCC Act).

Until now, port operations in PNG have been distinguished by the use of on-ship loading and unloading equipment (ship’s gear), with the stevedores providing access to forklifts, trailers and tractors to move containers around the port designated area. This has been the situation for more than 30 years. PNG has not had the heavy lifting and container cargo handling facilities common in overseas major ports. The investment in MHCs and RTGs is a significant innovation and step change in ports operations in PNG and is intended to significantly improve the productivity of the cargo loading/unloading, cargo handling and storage within these ports.

It is estimated that the cranes have already reduced the stevedores’ operational cost by millions of kina.
PNG Ports – SEPARATION OF PNG PORTS CORPORATION’S REGULATED AND UNREGULATED BUSINESSES

Treatment of services as regulated or contestable

PNG Ports notes the ICCC’s view that the RTGs and MHCs fall within the definition of contestable services.

As noted by the ICCC, PNG Ports has proposed to treat the MHCs as regulated, by rolling the value of these assets (less any amount that was funded by the Government of PNG) into the regulated asset base and recover the costs over time through regulated charges (wharfage services, berthing services and berth reservations). The reason for this is as follows:

- The MHCs effectively replace the on-board cranes previously required to load and unload cargo at Port Moresby and Lae ports
- By doing so, the MHCs allow for a significant modernisation and improvement in the number and capacity of vessels servicing PNG’s two main ports (as vessels with on-board cranes are seldom produced, and the presence of the cranes reduces the carrying capacity of the vessels)
- PNG Ports views this investment as being targeted towards the overall efficiency of the ports, with the ultimate aim of supporting economic growth by facilitating increased throughput
- As such, PNG Ports has proposed to treat the investment in the same way as it would a berth extension or wharf upgrade – by rolling it into the regulated asset base and recovering the efficient costs (less the gifted amount) over time.

The operation of RTGs, on the other hand, is more explicitly associated with improving stevedoring efficiency and storage services. Accordingly, PNG Ports considers that the classification of RTGs as unregulated is appropriate, and intends to design an appropriate charging structure to reflect the costs of the assets (again, less any component of the costs that were gifted by the Government of PNG).

Notwithstanding the above, PNG Ports would welcome any further views from the ICCC on the appropriate treatment of these assets. In any case, PNG Ports is committed to recovering only the efficient costs of the infrastructure from customers, less the amount that was gifted by the Government of PNG (as set out below).

Cost allocation and regulatory accounting approach

The ICCC’s assertion that both the RTGs and MHCs were funded by the taxpayers of PNG via budget appropriations is not correct.

Only a portion of each asset was gifted by the PNG Government, with the remaining amount component funded by PNG Ports. The following table summarises the total cost, gifted amount, and amount to be recovered through charges for the RTGs and MHCs.
In the interest of transparency, PNG Ports would also like to reiterate that Government funding in the form of gifted contributions totalling around PGK 15 million has been received for the Alotau Wharf rehabilitation project which was recently commissioned for a total cost of K43.4 million.

It is PNG Ports’ policy to treat these contributions as gifted (noting that generally only a partial contribution towards the total costs is received), and exclude them from the regulatory asset base thereby not leading to any increases in prices for customers. The gifted amounts of assets were explicitly identified in PNG Ports Capital Expenditure Progress Report, and any other additional gifted amounts will be similarly and transparently treated in PNG Ports’ submission to the upcoming review of the Regulatory Contract.

Proposed access arrangements for MHCs and RTGs

The ICCC has previously raised concerns in relation to competitive outcomes in the stevedoring market with certain stevedores gaining market power by being granted monopoly rights to the MHC and RTG facilities.

PNG Ports’ submission to the ICCC’s Stevedoring Issues Paper provides detailed commentary on the Expression of Interest undertaken for proposed Access Arrangements for each of its declared ports and Terminal Management Contracts for codifying key performance indicators for stevedores. In the interest of brevity we will not repeat all of this discussion here. It is worth noting here however, that the ICCC interestingly chose not to intervene when certain stevedores demonstrated recently against attempts by PNG Ports to explore the possibility of introducing competition via the Expression of Interest process.

PNG Ports’ submission to the ICCC’s Issues Paper on Stevedoring and Handling Services set out the following key points:

- The need for any particular stevedore to undertake significant investment in infrastructure up-front has been reduced by PNG Ports undertaking this investment at the primary ports
- All competing stevedores and any new entrants will be allowed to access this infrastructure once their teams are fully trained in its safe operation, thus reducing the barrier to entry caused by significant start-up costs.

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4 22 May 2013
PNG Ports is disappointed that its initial process to publish an Expression of Interest for stevedores in declared ports was not initially successful. However, we believe that the approach was transparent and public and was intended to be uniform in all respects for any stevedoring company (existing and new) which seek access to a particular port, including the maximum price(s) that is contracted for each access seeker. The intention is to design and implement access arrangements in a way which enhances competition by limiting barriers to entry, improving transparency for all stakeholders and making the access seeker responsible for its relative service performance.

PNG Ports invites the ICCC to provide its views on what additional actions, if any, should be taken to ensure appropriate access arrangements are in place. PNG Ports considers that public scrutiny of any proposed actions is integral to the success of this process.
7.0 Implementing separation of the regulated and unregulated businesses of PNG Ports Corporation

7.1 Issues raised by the ICCC

In its Issues Paper, the ICCC notes that PNG Ports already has separate management for the discharge of regulatory and compliance functions.

The Issues Paper seeks submissions on the necessity or desirability of less or more intrusive forms of separation than currently exist in the Regulatory Contract to achieve transparency in the costs of provision of:

- In-port storage services for in-transit cargo so as to limit the ability of PNG Ports to reduce prices as a retaliatory measure in case of substantial new entry into the market for “in-port storage for in-transit cargo” or for services competitive with such services;
- Pilotage services;
- Charges for the use of rubber-tyred gantries (RTGS) and mobile harbour cranes (MHCs);
- Potentially stevedoring services or services allied to them, such as terminal management services;
- Other new contestable services; and
- The type of approach for doing so – whether accounting, functional or structural separation is the most appropriate.

7.2 PNG Ports’ response

Objectives and requirements for separation

Firstly, whether any form of separation is required, and the appropriate approach to separation needs to be considered in the context of the objectives of pursuing separation. As noted in the previous sections, PNG Ports is of the view that the ICCC has not adequately demonstrated any evidence of the benefits of, or need for, heavy-handed regulatory intervention in relation to storage, pilotage, MHCs and RTGs, and other, unspecified “new contestable services”.

In particular, the majority of the ICCC’s concerns are based on speculation about:

- Potential price responses that PNG Ports may take to the entry of competitors, in particular, by reducing prices below costs – despite the fact that this has not occurred, even with substantial market entry in the storage sector
- Possible entry by PNG Ports into related markets such as downstream transport services – again, despite the fact that this has not occurred, and PNG Ports has no intention of operating as a road transport provider.
However, PNG Ports does recognise that as an entity that provides both regulated and unregulated services, appropriate cost allocation approaches are required to ensure that there are no cross subsidies between the provision of regulated and unregulated services.

It is in this context that we have considered the ICCC’s assessment of alternative forms of ring-fencing.

**Accounting separation**

The ICCC describes the current approach to separating revenues and costs between regulated and unregulated businesses as accounting separation, with costs allocated on the basis of revenue. The ICCC has described this approach as inadequate, on the basis on the ICCC’s view that:

- The current framework of information provision on regulated and unregulated services is considered by the ICCC to be inadequate to yield sufficiently transparent and useful information on the allocation of assets, costs and revenues of the regulated and unregulated businesses to enable potential competitors to make decisions on entry

- The approach of revenue-based allocation has not consistently been applied by PNG Ports:
  - For the allocation of assets at the commencement of the contract period, where assets are used jointly or in common the allocation of assets has been based on an ‘implied’ regulatory basis (i.e. using revenue as allocation driver), which itself does not necessarily represent a proper economic basis for the allocation of assets
  - For the purpose of the mid-term capex review, assets unconditionally contracted within the contract period were allocated on a case-by-case basis whereby all major projects were allocated to the regulated business.

PNG Ports offers the following response to the ICCC’s concerns:

- Since the commencement of the current regulatory period, PNG Ports has submitted annual Schedule 6 ring-fencing reports to the ICCC, with explicit allocation of costs between regulated and unregulated business segments

- At no stage up until now has the ICCC provided any commentary to PNG Ports on the suitability or otherwise of the information provided in the Schedule 6 ring-fencing reports provided. In fact, the ICCC has accepted all reports presented by PNG Ports to-date

- Nor has the ICCC provided any guidance to PNG Ports on its preferred methodology of ring-fencing apart from the reporting framework set out in Schedule 6 of the Regulatory Contract

- We also note that the Regulatory Contract does not provide any guidance on the approach to allocating costs between regulated and unregulated business segments

With respect to the ICCC’s perceived ‘inconsistencies’, we offer the following response:
Firstly, the ICCC’s assertion that all major projects drawn from unconditionally contracted capital expenditure were allocated to regulated services is factually incorrect. As was verified by Deloitte Access Economics, the following unconditionally contracted expenditure items were excluded from the mid-term capital expenditure report on the basis that they relate to the provision of unregulated services:

- Port Moresby RTG Civil Works (POM 419) – PGK 8,821,720
- Lae RTG Civil Works (LAE 422) – AUD 288,000
- Lae Pavement Repairs (LAE 283) – PGK 13,443,696.

Secondly, it is entirely consistent with good regulatory practice for cost allocation policies to apply different methods or drivers to different groups of costs depending on the nature of the costs. In fact, the allocation of major projects on a case-by-case basis is consistent with best practice cost allocation principles because it allocates costs directly wherever possible.

Finally, the use of revenue as a cost allocator, while simple, is not necessarily a poor economic approach to allocating indirect costs. Indirect costs need to be allocated in some way, with methods ranging from more accurate (e.g. time sheeting) to more basic (e.g. a simple pro-rata allocation driver). There are pros and cons for using different methods, including simplicity, cost of information collection and accuracy. In some cases, the benefits of greater accuracy might not outweigh the costs of implementing a more sophisticated approach, for example where the simple and more sophisticated approaches provide results that are not significantly different.

PNG Ports is proud of the continual improvement in its data and accounting systems in recent years, which has enabled it to apply increasingly accurate approaches to allocating costs between its regulated and unregulated business.

With its Annual Financial Statements up to 2011 already signed off by the Auditor-General with a ‘Qualified Opinion’ for the first time in many years, and the 2012 accounts soon to follow, PNG Ports is one of the leading State Owned Entities with respect to the rigour and integrity of its internal accounting systems, and disputes the suggestion by the ICCC that it cannot be relied upon to implement an accounting separation approach.

Notwithstanding the above, PNG Ports welcomes the opportunity to discuss ways to improve its cost approach to cost allocation, and would welcome the opportunity to work with the ICCC to establish a cost allocation policy or guideline that would alleviate the ICCC’s concerns about cost transparency.

**Functional separation and structural separation**

The discussions of functional separation and structural separation in the ICCC’s Issues Paper are based entirely on conjecture. The ICCC identifies a number of concerns that functional and structural separation are designed to address, but does not provide any evidence or analysis of the extent to which these issues may be risks in the present circumstances.
As noted in section 5.0 above, PNG Ports has acknowledged the access issues raised by Niugini Pilots and put in place policies to ensure that any appropriately licensed pilots must be allowed equal access to PNG Ports’ wharves to address this issue.

Overall, it is PNG Ports’ strongly held view that a rigorous cost-benefit assessment of the different types of separation needs to be undertaken by the ICCC, with continual reference to the objectives of the ICCC as set out in the ICCC Act.

PNG Ports believes that a rigorous cost-benefit study will show that going down the path of functional or structural separation would add significant costs to the ports industry, costs that are ultimately paid for by customers. The costs of the more intrusive option of structural separation are indisputable, and would include:

- Significant once-off transition costs in terms of establishing an additional entity (or multiple entities)
- Ongoing head office costs associated with separate staff, operational support systems and IT and accounting systems
- Separate governance structures with separate boards and executive
- Duplication of administrative costs around the regulatory framework.

On the other hand, the benefits of more intrusive regulation to separate PNG Ports’ businesses are far less certain. The issues raised by the ICCC are not supported by evidence and are hypothetical in nature, and at no stage in its Issues Paper does the ICCC provide an assessment of the potential benefits of the options under consideration with respect to the price, quality or reliability of essential services.

Having due regard to the ICCC’s key objectives under the ICCC Act, which include promoting economic efficiency and benefits to consumers, PNG Ports believes it would be inconsistent with these objectives for the ICCC to fail to test the effectiveness of an accounting separation option prior to embarking on the extreme path of functional or structural separation. Strengthening and clarifying cost allocation requirements should be explored as a first step.

### 7.3 Time frames for possible separation approaches

The ICCC is seeking submissions on the appropriate time frames for implementing:

- Accounting separation
- Functional separation; and
- Structural separation.
PNG Ports’ response is as follows:

- Accounting separation: at least six months would be required to establish a cost allocation guideline and to implement the change
- Functional separation: at least twelve months would be required to establish functional separation including Chinese walls, accounting guidelines and employment of additional resources
- Structural separation: reflecting the high cost and complexity involved with this approach, including establishing separate boards and management structures, new buildings and IT systems, PNG Ports estimates that at least two years would be required to implement.

In estimating these timeframes PNG Ports notes that the ICCC has a recent history of missing deadlines for regulatory decisions by a significant margin – for example, with the latest decision on PNG Power Ltd.’s Regulatory Contract being finalised more than one year after the due date. Significant delays have also occurred in the finalisation of MVIL’s Regulatory Contract.

In light of this, the capacity of the ICCC to administer such a substantial change to the ports industry is questionable, with a significant risk that the ICCC will be unable to discharge its duties in a reasonable timeframe, resulting in significant costs to both the ICCC and PNG Ports, which are ultimately passed through to customers in the form of higher prices. We also note that the ICCC has explicitly provided for other regulated entities, including MVIL and PNG Power, to pay the costs of the ICCC’s reviews and consultants engaged by the ICCC without giving any opportunity to MVIL and PNG Power to agree to the consultancy Terms of Reference or the independence of the consultant engaged. Given this ‘open cheque book’, PNG Ports is deeply concerned about the prospects of the ICCC spending significant amounts of time and money pursuing reforms with ill-defined benefits that will drive up the costs paid by Papua New Guineans for essential services, contrary to the objectives set out in the ICCC Act.
Appendix 1 - Response to specific questions raised by the ICCC

The main body of our report sets out our views on what PNG Ports believes are the key issues raised by the ICCC. For each direct question raised by the ICCC in its Issues Paper, this Appendix aims to directly address the question by referencing the relevant section of the report.

7.1 Issues Paper Chapter 3 Competition issues arising from PNG Ports’ provision of regulated and non-regulated services

Issue 1: Submissions are invited on whether the potential for competition in contestable services suggests that it is necessary or desirable to introduce or enhance safeguards against anti-competitive conduct by PNG Ports to limit competition.

Issue 2: Submissions are invited on the question of whether a more effective, transparent and sustainable system of separation of the regulated and unregulated businesses of PNG Ports is necessary or desirable to promote competition in existing contestable services or new contestable services that may emerge.

PNG Ports response: Please refer to Sections 3.0 to 6.0 regarding Issue 1, and to the Introduction and Section 8 regarding Issue 2.

7.2 Issues Paper Chapter 4 Promoting competition in contestable services

Storage services

Submissions are invited on whether:
- Users experience unnecessary delays in the issue of gate passes by PNG Ports and whether the lack of adequate space and physical facilities for fumigation/washing of containers has been resolved;
- The experience of users gives them confidence that PNG Ports can be relied upon to adhere to less intrusive forms of separation such as accounting separation or functional separation, rather than structural separation.

PNG Ports response: Please refer to section 4.0 and section 7.0 for a response to this question.

Marine pilotage

Submissions are invited on the likelihood that PNG Ports will adhere to generally accepted standards of accounting separation or functional separation to ensure that scrutiny of its pricing strategies will be facilitated to an adequate extent to detect any predatory practices to damage competition or prevent entry.

Alternatively, views on the necessity or desirability of structural separation are sought, to ensure competition on the merits in contestable services.

PNG Ports response: Please refer to section 5.0 and section 7.0 for a response to both parts of this section.

Information provision and contractual obligations

In light of the above material, interested parties are invited to make submissions on whether PNG Ports can be relied upon to:
- Provide complete and accurate accounting information under an accounting separation model; and
- Implement organisational systems with safeguards to ensure no confidential information is passed formally or informally between business areas under a function separation framework.
PNG Ports response: Please refer to section 2.2 and section 7.0 for a response to this question.

### 7.3 Issues Paper Chapter 5

#### Approach to separation

In view of the above, submitters are invited to comment on the likelihood that PNG Ports will strictly observe functional separation obligations.

PNG Ports response: Please refer to section 7.0 for a response to this question.

Submissions are invited on the necessity or desirability of less or more intrusive forms of separation than currently exist in the Regulatory Contract to achieve transparency in the costs of provision of:

- in-port storage services for in-transit cargo so as to limit the ability of PNG Ports to reduce prices as a retaliatory measure in case of substantial new entry into the market for “in-port storage for in-transit cargo” or for services competitive with such services;
- pilotage services:
  - charges for the use of rubber-tyred gantries (RTGSs and mobile harbour cranes (MHCs);
- potentially stevedoring services or services allied to them, such as terminal management services;
- other new contestable services; and
- the type of approach for doing so – whether accounting, functional or structural separation is the most appropriate.

PNG Ports response: Please refer to section 7.0 for a general response to this question, with issues specific to each services set out in the following sections:

- Storage – section 3.0
- Pilotage – section 5.0
- RTGs and MHCs – 6.0
- Other ‘new contestable services’ – section 4.0.

#### Time frames for possible separation approaches

Submissions are invited on the appropriate time frames for implementing:

- accounting separation
- functional separation; and
- structural separation.

Taking into account the steps required to implement each form of separation.

PNG Ports response: Please refer to section 7.3 for a response to this question.