INDEPENDENT CONSUMER AND COMPETITION COMMISSION

ISSUES PAPER

SEPARATION OF PNG PORTS CORPORATION’S REGULATED AND UNREGULATED BUSINESSES

30 October 2013
FOREWORD

The Independent Consumer and Competition Commission (“Commission” or “ICCC”) is a statutory body established under the provisions of the Independent Consumer and Competition Commission Act 2002 (“the ICCC Act”). The Commission’s mandate under the ICCC Act is to promote fair trading, regulate prices of certain goods and services, protect consumers’ interests and undertake other related functions. Pursuant to its mandate, the Commission is responsible for the regulation of PNG Ports Corporation’s essential port services.

The Commission has three Commissioners:

- Dr Billy Manoka, PhD - Commissioner & CEO
- Mr David Dawson, Associate Commissioner (Non-Resident)
- Dr Eric Omuru, PhD - Associate Commissioner (Resident)

Together, these three commissioners form the ICCC, in which decisions are made in respect to its functions under the ICCC Act and the PRA.

The Commission regulates PNG Ports Corporation Ltd in accordance with the section 32 of the ICCC Act. In 2009, the Commission undertook its first review into the price setting arrangement of PNG Ports Corporation to determine whether there was a need to continue to regulate prices of essential port services and if so, the appropriate form of regulation to apply for these port services. At the conclusion of the review, a Final Report and the PNG Ports Regulatory Contract (Regulatory Contract) were released for the regulatory period 2010-2014.

PNG Ports has a regulated business and an unregulated business component. The regulated business, pursuant to the Regulatory Contract, consists of the provision of PNGPCL essential port services. Essential Ports Services includes berthage, berth reservation and wharfage services.

Over the course of this regulatory period 2010-2014, the Commission has noted the potential need for a more effective separation of PNGPCL’s regulated and unregulated businesses, pursuant to Clause 7 of the Regulatory Contract. Therefore, the ICCC is conducting this study to examine various issues that may warrant such a separation.

As part of the ICCC’s statutory obligations, this Issues Paper is being released to stakeholders and the public for comments and submissions. The timetable for this review process is as follows:

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<td>Release of Issues Paper</td>
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<td><strong>Release of Draft Report &amp; Draft Determination</strong></td>
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Those intending to make submissions should be aware that the Commission publishes all submissions made to its inquiries, unless there is a specific claim for information to be treated as confidential and the Commission agrees with the claim in accordance with Section 131 of the ICCC Act. Submissions are usually published at the Commission’s website and are available for public viewing.

Submissions to this Issues Paper should be received by the Commission no later than **November 29, 2013** and be directed to the following address:
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Commissioner & Chief Executive Officer
Independent Consumer and Competition Commission
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For further information about making a submission or to obtain a copy of the Issues Paper, please contact Mr Jack Timi, Executive Manager Regulated Industries on telephone number 325 2144 or via email on jtimi@iccc.gov.pg or jtimi02@gmail.com. Copies of the Issues Paper can also be downloaded from the ICCC Website - www.iccc.gov.pg.

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1. INTRODUCTION

PNG Ports Corporation ("PNG Ports" or "PNGPCL") is a State-owned provider of essential port services with a network of 16 declared ports in Papua New Guinea. The Commission regulates PNG Ports pursuant to Section 32 of ICC Act. The current PNG Ports Regulatory Contract ("Contract") was established in 2009 after a review of the PNG Harbours Regulatory Contract and the port industry was conducted by the Commission. Only certain services, defined as ‘essential port services’ are regulated, while other services are not regulated.

The Regulatory Contract between the Commission and PNG Ports outlines the rules and requirements regarding the supply of essential port services, including such key features as its pricing, capital expenditure and minimum service standards.

1.1 Background

The original regulatory framework for PNGPCL was established in 2002, pursuant to Section 32 of the ICC Act, under a regulatory contract issued by the then Minister for Treasury which governs the provision of certain services ("regulated services"). In addition to the provision of essential port services, PNG Ports provides services that are not regulated under the Contract and also performs a regulatory role within the industry, in accordance with the Harbours Act (Chapter 240) ("Harbours Act"), its delegated powers from the Department of Transport ("DoT") and the National Maritime Safety Authority ("NMSA"). These services include storage, pilotage, licensing of towage services stevedoring operators and harbour safety.

Over the past 4 years, PNG Ports has evolved considerably as a port business and port landlord as a result of significant growth in the demand for port services within Lae and Port Moresby Ports. This was primarily driven by the construction phase of the PNG LNG Project and its associated multiplier effects on the PNG economy in general.

As a result of the growth in the demand for port services and the physical constraints on port infrastructure expansion, PNG Ports in 2012 acquired mobile harbour cranes ("MHCs") and rubber tyred gantries ("RTGs") for the ports of Lae and Port Moresby through funding assistance from the Government. The MHCs and RTGs were acquired to improve port productivity and yard utilisation at these two ports.

These developments raise issues regarding their potential impact on the market and competition for the provision of unregulated services.

1.2 Legal Requirements

Pursuant to Section 25A of the Harbours Act, the supply of essential port services is declared to be a regulated industry for the purpose of the ICC Act.

The operation of the essential port services for which a licence is required is defined under Section 25B (2) of the Harbours Act as:

a) Providing port facilities for loading and unloading vessels at a declared port; or
b) Providing berths and berth reservation services for vessels at a declared port.

PNG Ports is licensed under the Harbours Act to provide port facilities for loading and unloading vessels at declared ports and to provide berths and berth reservation services for vessels at declared ports.

In accordance with Section 25A of the Harbours Act and Section 32 of the ICC Act, the Minister for Treasury matters in 2002 declared PNG Harbours Ltd, now PNG Ports to be a regulated entity and essential port services to be regulated services.

As a result of those ministerial declarations, the Commission regulates the provision by PNG Ports of essential port services including the tariffs and service standards within PNG through the PNG Ports
Regulatory Contract ("Contract"), This Contract is binding on PNGPCL and the Commission pursuant to the provisions of the Harbours Act and the ICCC Act.

The Regulatory Contract defines essential port services as:

- Berth Reservation Services,
- Berthing Services and
- Wharfage Services.

A Declared Port refers to a port declared under Section 2 of the Harbours Act.

2. PORT INDUSTRY AND PNG PORTS CORPORATION

2.1 PNG Ports Corporation Ltd

PNGPCL is a State-owned provider of essential port services within 16 declared ports in PNG. In addition to these essential port services, it also provides: stevedoring access and issues licences provides cargo storage and pilotage services; and performs other harbour management functions through delegation from DoT and/or NMSA.

According to its website, PNGPCL is a State Owned Entity ("SOE") whose ownership is vested in trust with the Independent Public Business Corporation ("IPBC") on behalf of the Government of PNG. It is one of the oldest state owned entities in Papua New Guinea. It is the sole authority over all declared ports in the country and manages 16 declared ports.

These ports are Lae, Port Moresby, Kimbe, Madang, Aitape, Rabaul, Kavieng, Oro Bay, Kieta, Buka, Vanimo, Samarai, Lorengau, Wewak, Daru and Aitape.

Traditionally the core business of PNGPCL was to act as a landlord at the port and provide berthing, pilotage and wharfage services for shipping companies and storage for container and general cargo transiting through its ports. These ports handle in excess of over 5.8 million tonnes of cargo annually.

PNGPCL is vested under the Harbours Act and with a delegated authority by DoT and/or NMSA to provide harbour management and maritime compliance regulation at all land/water interfaces (wharves and jetties) at declared and non-declared ports and harbours throughout the country.

PNGCL’s essential port services are regulated by ICCC under a regulatory contract that is currently in force until the end of 2014. The Contract specifies a price path and service standards for all essential port services (i.e. Berthage, Berth Reservation and Wharfage) as defined in the Contract.

In its remodernisation [sic] effort the company has begun investing in terminal infrastructure, facilities and people and has undertaken a customer care approach to establish relationships and work closely with customers and business partners and key stakeholders to attempt to provide quality services.

2.1.1 PNG Harbour Management Services

PNG Ports’ harbour regulatory and compliance functions are currently managed by PNG Harbours Management Services, which is a Division of PNGPCL.

Also according to the PNG Ports Website, PNG Ports established the PNG Harbours Management Services ("PNGHMS") in its organisational structure to be responsible for the regulatory functions including compliance issues. The new division is also responsible for harbour management and the regulatory pilotage functions following a delegation of the pilotage authority and functions from NMSA to PNGPCL. That

1 This information is taken from PNGPCL’s website - www.pngports.com.pg.
delegation has since been revoked, following investigation by the Commission of the refusal by PNGPCL to licence pilots working for competing pilotage service providers seeking to enter the market. This matter is discussed in more detail further in this paper.

Furthermore, PNGPCL is empowered by the Harbours Act of PNG to control and regulate activities within the declared ports as stipulated under section 15H and 15K of the Harbours Act. The powers and functions of PNGPCL under these sections are:

- To control and regulate all waters and the use of all waters within a declared port
- To act as a pilotage authority for the purposes of Part VIII of the Merchant Shipping Act (Chapter 242) where appointed as such under that Act
- To erect and place in position buoys, markers, beacons and leads, and other things, that are necessary or desirable to facilitate navigation in or into a declared port
- To dredge and maintain channels and berthing places
- To build retaining walls for the purpose of reclaiming, and to claim and obtain title to land that is the bed of the declared port
- To do all such other acts as will facilitate the use of the declared port by shipping
- To control the use of foreshores in a declared port, subject to any right of occupation or tenancy granted under a law
- To require a person to remove or destroy or to be caused to be removed or destroyed, any object or thing that in its opinion is an obstruction, hindrance or danger to navigation in, or to the use of a declared port by any vessel.

PNG Ports also outlined on its website that PNGHMS is formulating policies, procedures and guidelines to properly control all activities in the declared ports and harbours, consistent with the above functions and the Port (Management and Safety) Regulation 2010.

3. COMPETITION ISSUES ARISING FROM PNGPCL’S PROVISION OF REGULATED AND NON-REGULATED SERVICES

A starting point for examination of the issues relating to the provision of regulated and unregulated services by PNGPCL is the scope and nature of the regulated services.

‘Essential Port Services’ are defined in sub-clause 1.1 of the Contract as:

‘Berth Reservation Services’; ‘Berthing Services’; and ‘Wharfage services’.

In this paper, they are also referred to as ‘regulated services’.

‘Contestable Services’ are defined in sub-clause 1.1 as meaning:

’a service other than an Essential Port Service that is provided using or that is otherwise related to Essential Port Services and includes stevedoring, pilotage and storage services.’

In this paper, the services defined in the Contract as ‘contestable services’ are also referred to as ‘unregulated services’.

Stevedoring and handling services are provided by licensed stevedores which are private sector players in the industry. Most stevedores are partly owned by the shipping lines and landowner groups. PNGPCL is not a direct player; however, it provides port infrastructure for the stevedores to effectively perform their services. Apart from the services above, PNGPCL also issues license to stevedores entering the stevedoring industry or seeking to continuing operations on expiry of their licences.
In its Report PNG Ports Corporation - Mid-term Review of Competition - Final Report and Findings: 29th August 2012 ("Competition Review"), the Commission explored the possibility that pilotage services and storage services be regulated under the Contract. The Commission has, however, now formed the view that the provisions of the ICCC Act read together with relevant provisions of the Harbours Act do not allow additional services to be included in an existing regulatory contract by reason of the definition of Essential Port Services in the latter, which has been imported into the Contract by virtue of the provisions of the ICCC Act.

All of the above is relevant because in the case of services which are contestable, the entity with control over the waterfront land, the aquatory and adjoining precincts, enjoys market power in terms of allowing access. Such market power can be translated into its anti-competitive exercise, where the landlord itself competes or could compete with access seekers in the provision of services such as pilotage, stevedoring and storage.

Anti-competitive activity can take many forms including pricing strategies devised to reduce competition. It is in that context that this paper has been prepared - to explore the necessity or desirability of preventing such anticompetitive practices which may damage competition or prevent it from emerging where it can otherwise do so viably.

3.1 The Relevant Provision of the Regulatory Contract

This review is conducted under the provision of paragraph 7.1 (a) of the Regulatory Contract, executed under the ICCC Act, which 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. \(^2\)

Over the course of this regulatory period 2010-2014, the Commission has considered the potential need for an effective separation of PNGPCL, pursuant to Clause 7 of the Regulatory Contract and has informed PNGPCL of its intention to enter into a consideration of the exercise of its powers under that clause (copy of letter attached as Annexure A).

3.2 The potential for competition in various contestable services

By definition, ‘contestable services’ offer scope for entry by new competitors, if not already the subject of competition. The Contract explicitly mentions storage, stevedoring and pilotage services as examples of ‘contestable services’.

3.2.1 Storage Services

Storage services within port boundaries have been described by PNGPCL in its submission on the Competition Review as “In-port storage services for in-transit cargo”. In the Competition Review, it was concluded, for reasons outlined therein, that, in effect, it was not possible to regulate such storage services under the contract but that “……further inquiries were to be conducted before a decision is made on declaration.”

3.2.2 Marine Pilotage

In the case of marine pilotage, the facts are well documented in the Competition Review. Despite the service being classified as ‘contestable’, measures were put in place by NMSA and PNGPCL that had the effect of preventing competition and consequently, competition did not eventuate during the currency of such measures.
3.2.3 New Services

Since the execution of the contract, other services have been introduced by PNG Ports e.g. services supplied through the use of rubber-tyred gantries ("RTGs") and mobile harbour cranes ("MHCs"), which, in the Commission’s view, fall within the definition of Contestable Services.

Services provided by rubber tyred gantries are not regulated under the contract and information was sought, in the Commission’s draft report on the Competition Review, on the terms and conditions of provision of services utilising them, as follows:

“The contractual nature of services to be provided by straddle carriers (known in PNG as ‘rubber tyred gantries’) i.e.

a. whether to be
   (i) hired out to stevedores under an equipment hire agreement;
   (ii) made available under a service-provision agreement to stevedores inclusive of labour;
   (iii) used by PNGPCL as a supplier of relocation services for containers between the unloading point on the wharf and the storage area of the port of RTGs directly to ship-operators or stevedores;

b. The charging regime if settled;
c. The date of deployment if commenced or such proposed date;
d. The cost of acquisition and whether funded by budget subvention, own financial resources.

PNG PCL did not respond to those questions in the context of the Competition Review, but responded to the Issues Paper for the Stevedoring and Handling Services Pricing Arrangement that the MHCs and RTGs will only assist to improve productivity of stevedoring, handling and storage services. In order to use the equipment, PNGPCL needs to provide intensive training to the users of the equipment in order to improve productivity. As indicated in its submission “While acting as the equipment training expert, and in currently providing these training services at no cost to facilitate the use of the equipment, PNG Ports does not intend to enter into the Stevedoring Market as a stevedore.”

3.2.4 Out of port storage services

It is understood that PNGPCL is planning to provide storage facilities outside the port precincts in Port Moresby, at the ‘Rainbow’ development in the City of Port Moresby. This brings it into direct competition with such facilities operated by private sector participants.

Role of regulation and current framework

Under the current regulatory framework, only services defined in the Contract as essential port services can be regulated. Regulation is intended to achieve an outcome, which, in so far as possible, imitates workable or effective competition. In respect of unregulated services, however, if appropriate safeguards are put in place, competition is possible and should be encouraged.

The objective of this paper is to examine whether some form of separation of PNGPCL’s regulated and unregulated businesses is necessary or desirable to promote competition in unregulated services to prevent

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3 Submission to ICCC’s Stevedoring and Handling Services pricing Review Issues Paper, 22nd May 2013, Response 12
anti-competitive conduct and which of the available forms of separation are best suited to do so in an effective way.

PNGPCL currently uses a revenue allocation approach to allocate the revenues and costs pertaining to its regulated business and the unregulated business. Various issues arise in relation to such an approach, including appropriateness of the methodology of allocation of costs, assets, and revenues. All of the above affect competition in unregulated services as potential entrants cannot be certain about the likely pricing and strategic response by PNGPCL to new entrants. Unless the assets, costs and revenues of the regulated and unregulated businesses are properly and transparently attributed, the ability to detect anti-competitive pricing behaviour is limited.

2.3 Regulatory framework and information deficiencies

As outlined above, it is the view of the Commission that the legislative and regulatory framework does not permit any services, other than those defined as essential port services to be regulated under the contract. It is therefore appropriate to consider whether, and if so how, to ensure that competition is not constrained by the market power of PNGPCL in the form of access to port precincts or by way of economic or pricing strategies.

The current framework of information provision on regulated and unregulated services is considered by the Commission to be inadequate to yield sufficiently transparent and useful information on the allocation of assets, costs and revenues of the regulated and unregulated businesses of PNGPCL to enable potential competitors to make decisions on entry. While actual or potential competitors in other markets are not privy to incumbents’ costs, they can estimate them from prevailing market conditions and generally available information, although not with mathematical exactitude. In the case of PNGPCL, it is well known that a substantial proportion of its assets have been ‘gifted’ to it by the State and their allocation between regulated and unregulated services is opaque. While the regulatory framework uses a revenue allocation model (discussed in greater detail below), that is not a robust approach and may allow room for pricing approaches which do not reflect fully distributed costs.

The Commission notes that asset allocation methodologies are not specified in the regulatory contract and the approach of revenue-based allocation has not been consistently applied by PNG Ports:

- Where assets are used jointly or in common in the provision of Essential Port Services and Contestable Services - the allocation of assets to those two categories of businesses has been based on an ‘implied’ regulatory asset base, which itself does not necessarily represent a proper economic basis for the allocation of assets; and

- There are inconsistencies in the approach adopted by PNGPCL’s consultants to the allocation of asset values at the commencement of the contract period, based on the ‘implied’ methodology, and that used for assets unconditionally contracted within the contract period. This issue came to light during the Commission’s review of PNGPCL’s capital expenditure progress report and its subsequent submission of proposed tariffs for 2013.

There is, therefore, considerable difficulty in properly identifying the assets and assessing the values of assets used in the provision of essential port services, which are the regulated services and, consequently, the values of those assets properly attributable to the provision of Contestable Services, either individually, or collectively.
4. PROMOTING COMPETITION IN CONTESTABLE SERVICES

Subject to consideration of the necessity or desirability of the introduction of some form of separation of PNGPCL’s regulated and unregulated businesses, the question which follows is which form of separation is appropriate to most effectively promote competition in contestable services.

4.1 Forms of business separation

There are three main forms of business separation that have been used in regulatory jurisdictions, where vertically integrated firms or conglomerates have substantial power in a market through control over facilities which its competitors in related markets need to access in order to compete in those markets which are nominally competitive.

The simplest and most elementary form is accounting separation. This involves separation of the assets, liabilities, costs and revenues of the businesses within its financial accounts. The degree of granularity of the accounts would depend on the nature of the businesses and the potential ‘economic harm’ to be addressed. For example, a vertically integrated firm with market power in a key element that it also supplies to its downstream competitors, would merit separation between its ‘upstream’ arm and its ‘downstream’ arms. However, that may not be enough, as the downstream activities may be numerous and potentially involve cross subsidies between some of the downstream activities themselves, or ‘bundling’ of services or products to harm competition. In the latter situation, further separation of accounts as between downstream products may be necessary.

A refinement of accounting separation is current cost accounting separation which takes account of current values of assets and liabilities to reflect changing values of money; technological obsolescence or innovation; and changing demand patterns which reduce or increase the market value of assets. This approach addresses the issue of long-lived assets the value of which may be understated due to historic cost accounting systems. On the other hand, obsolete assets that may be on the books under an historical cost accounting system would not be included under a current cost accounting system or appropriately reduced in value to reflect their current economic utility. Current cost accounting allows the economic value of assets to be taken into consideration and permits prices that reflect such values. This is particularly relevant to ‘legacy’ assets such as pipes, ducts and network infrastructure in telecommunications and similar network industries.

The next gradation of separation is functional separation. Under this approach, the activities in which the firm has substantial market power and are regulated are separated from competitive activities in respect of their management and operational arrangements. Where cross subsidies between competitive activities are considered to be a risk, further functional separation as between the competitive activities may also be necessary. So-called ‘Chinese Walls’ may be necessary or desirable in the separation to prevent confidential information from the regulated services area flowing into the unregulated services area which may give the firm a competitive advantage in one or more of the markets for unregulated services.

Finally, organisational separation or structural separation involves complete separation of activities in which the firm has substantial market power from competitive activities in an organisational sense, by creating new legal entities for each group of activities from the original entity. Such an approach involves separating the two businesses in a corporate sense, as distinct legal entities, with their own boards, separate assets, accounts and staff.
4.2 Consideration of issues relevant to the forms of separation

In considering the form of separation, subject to a decision on the need for any form of separation, the Commission needs to take account of circumstances relevant to the issues affecting such an assessment including:

- Information symmetry or asymmetry between the regulated entity, the regulator and parties who interact with the regulated entity;
- The approach of the regulated entity to regulation as evidenced by past conduct;
- The likely future approach to regulation by the regulated entity;
- The degree of confidence the regulator can have in achieving a high level of compliance by the regulated entity with less intrusive forms of separation of regulated and unregulated businesses;
- The degree of confidence that competitors and the public can have in the regulator achieving a high level of compliance by the regulated entity with less intrusive forms of separation of regulated and unregulated businesses;
- The public interest in securing a high level of compliance with requirements for separation of regulated and unregulated businesses; and
- Whether the separation needs to go beyond the separation of regulated and unregulated businesses to encompass adequate separation of the various components of unregulated businesses to prevent leverage from those contestable businesses which give PNGPCL some market advantage to those in which it has a lesser degree of market advantage.

To properly address the above issues, it is appropriate to examine each of the contestable services currently provided and explore possible future areas of competition between PNGPCL and other competitors.

4.3 Examining forms of separation necessary or desirable in the context of specific contestable services

This section of the paper discusses the nature, competitive features, obstacles to competition and PNGPCL’s strategic approach to the relevant markets which form the basis of consideration of possible separation of its regulated and unregulated businesses.

4.3.1 Storage services

In its Competition Review Report, in respect of storage services, the Commission made the following observation:

“PNGPCL currently allows for five free storage days before storage charges are applied to consignees. Transhipment cargo is allowed 10 free storage days in the port of transhipment. … The purpose of the charge is to discourage customers from using the port area to store their cargoes (both containerized and non-containerized) for longer periods than absolutely necessary.”

“PNG Ports has also suggested in the past that it is not in the business of providing storage services and that the limited storage space at its facility in Port Moresby is only for the facilitation of customs and quarantine services.”

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4 PNG Ports Corporation Ltd - Mid-Term Review of Competition – Final Report & Findings, page 57

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Section 6.5 of the Competition Review Report provides a further discussion on the issue of storage services as follows:

“The Commission has been informed on a confidential basis that it could take up to 4 days to obtain a gate pass from PNGPCL. PNGPCL stated that no statistics are kept on the time or dates applications are received for gate passes and the actual dates when they are issued. In these circumstances, it is incumbent upon PNGPCL to provide evidence that no, or insignificant, delays on its part are responsible for cargo being required to be stored on its premises. PNG Ports in this instance may have a perverse incentive to delay the timely issuance of gate passes because it profits from storage charges.

After taking into consideration the above the Commission concluded that:

“PNGPCL’s storage charges have increased substantially. On the other hand, PNGPCL rightly claims that charges are necessary to dissuade unnecessary storage being availed of and appropriate pricing signals are essential to create the incentive to reduce dwell times for cargo in ports and to the extent the strategy prevents unnecessary storage that is justifiable. PNGPCL, however, is regulated by a revenue cap, linked to service charges for defined regulatory services. The Contract does not cover storage services. Hence, the prices for storage services cannot be regulated under the Contract.”

Given that PNGPCL is not regulated by the current regulatory contract in the conduct of its storage services business, the Commission must give further consideration to the competition issues associated with the provision of storage services, in particular the opportunity for new entrants to compete in the provision of these services.

In most markets, where prices increase appreciably, or revenue grows substantially, that constitutes an incentive for entry by potential competitors. There should be no reason why that is not occurring in the port storage markets in PNG. Should new entrants decide to enter the storage market for in-transit cargo by providing facilities for such storage, PNGPCL could retaliate by reducing prices. The question whether such pricing is predatory in terms of section 58 of the ICCC Act depends on the respective costs of provision of such services. Section 58 (2) of the ICCC Act provides as follows:

“A person that has a substantial degree of power in a market shall not take advantage of that power for the purpose of –

(a) Restricting the entry of a person into that or any other market; or
(b) Preventing or deterring a person from engaging in competitive conduct in that or any other market; or
(c) Eliminating a person from that or any other market.”

Issues that arise in relation to existing and new entrants include the value of land, which is the key asset required for the provision of storage services and is a legacy asset inherited by PNGPCL, on which no return is required to be gained. Hence, PNGPCL has a substantial capability to retaliate by reducing prices which do not have to recover the return on the market value of the land. The ability of the Commission to prove such pricing constitutes a breach of section 58 is limited by the scope for demonstrating ‘below cost’ pricing in the context of the ‘free’ legacy land assets inherited by PNGPCL.

At current levels of charges for storage, new entrants may have the incentive to enter but would not know the extent to which potential retaliatory action by PNGPCL in reducing prices would make their business case unsustainable. In such circumstances, entry is likely to be inhibited. While there are some players in the storage market, as pointed out in the Competition Review Report, they are not directly competitive with PNGPCL.

The key point is that, with appropriate regulatory changes to Customs and NAQIA requirements, it would be possible for private parties to compete directly with PNGPCL in the future, in respect of both international

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5 ibid
and coastal cargoes. The Commission’s regulatory role is to ensure that the opportunity for anti-competitive pricing or other conduct which takes advantage of market power does not inhibit competition.

### 4.3.2 Possible leverage into other services

Conceivably, PNGPCL can achieve scale and scope economies in the provision of downstream services in conjunction with its port management function arising from its control over port precincts. This raises issues of a ‘level playing field’ in the issue of gate passes and control over access to the port precincts. Submissions to the Competition Review suggested significant delays in the issue of gate passes, as outlined above.

Perfectly legitimate business strategies for PNGPCL could include extension into land transport services, which would constitute contestable services under the contract. Users may well be inhibited from using transport providers other than PNGPCL for fear of being discriminated against in the issue of gate passes for their cargo if they do use transport service providers other than PNGPCL. Conceivably, such extension could include other competitive services such as fumigation, container cleaning, container provision, stevedoring etc.

If PNGPCL is deliberately engaging in delay in issue of gate passes, or increasing storage charges to levels well above cost, that would constitute profit maximisation in the context where prospective entrants who would otherwise have an incentive to enter that market, could be inhibited from entry due to information asymmetry relating to the costs of provision of such services by PNGPCL, particularly arising from the lack of necessity to secure a market rate of return on land, for reasons discussed earlier in this paper. A consequence is that due to the opacity of costs, PNGPCL has the ability to reduce prices, in retaliation to imminent or actual entry, potentially well below the market costs of provision, a possibility that potential entrants would take into account in their decision to enter, in consideration of their potential inability to respond without incurring significant losses under such pricing strategies by PNGPCL.

The relevance of the above issue is whether there is sufficient oversight to reduce the potential for anti-competitive strategic approaches from the current arrangements or whether any form of separation such as accounting separation, or functional separation, or structural separation is necessary.

In light of the above possibilities, prudence suggests a robust form of separation of regulated and unregulated businesses to reduce the potential for anti-competitive strategic approaches.

<table>
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<tr>
<th>Submissions are invited on whether</th>
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<td>• users experience unnecessary delays in the issue of gate passes by PNGPCL and whether the lack of adequate space and physical facilities for fumigation/washing of containers has been resolved;</td>
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<tr>
<td>• the experience of users gives them confidence that PNGPCL can be relied upon to adhere to less intrusive forms of separation such as accounting separation or functional separation, rather than structural separation.</td>
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**Marine pilotage**

With regards to competition in the area of Marine pilotage, the Commission in its Competition Review Report, said:⁶

“The National Maritime Safety Authority (NMSA) is the mandated “Pilotage Authority” under the Merchant Shipping Act (MS Act), empowered to declare areas that are to require marine pilots and to licence such pilots. ... NMSA previously delegated PNGPCL to be the Pilotage authority at the following declared ports in Papua New Guinea.

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“The instrument of delegation by NMSA is understood to have purported to have delegated the power of licensing pilotage providers. If so, that delegation appears to have been ultra vires and the exercise of the purported delegated powers by PNGPCL, unauthorised and beyond power.

Subsequent to the Commission’s initial examination of the delegation of the NMSA delegation of the licencing,

- NMSA revoked PNG Ports’ pilotage authority delegation. The revocation was published in the National Gazette on 08th March 2012 (Gazette No. 92).

- NMSA informed the Commission on 15 June 2012 that the relevant requirements and standards had been approved by the NMSA Board during its meeting on 12 June 2012 and persons intending to carry out marine pilotage services could apply directly to NMSA, and if they satisfied the relevant the requirements, a licence would be issued.

In summary, the Commission found that while effective monopoly existed in the market for pilotage services with PNGPCL as the monopoly supplier the service of marine pilotage cannot be covered within the current regulatory framework for supervision of prices and service standards because of the definition of essential port services in the relevant legislation and, consequently, in the Contract.

The substantial increases in pilotage charges by PNGPCL a few years ago could well have provided economic incentives for entry. In view of the above developments the Commission considers that there is potential for competition in the provision of marine pilotage services and that entry should not be frustrated by strategic pricing initiatives by PNGPCL.

The Commission is concerned that under the current arrangement there is no effective oversight to ensure that PNGPCL does not use its monopoly in the provision essential port services to facilitate its effective monopoly in pilotage services via anti-competitive conduct.

A further matter is PNGPCL’s representation on the board of NMSA. Ordinarily, such a presence should not create competition problems, if governance issues in NMSA meet high standards. However as this may not be the case, the Commission is concerned that PNGPCL’s representation may have, and may continue to facilitate anti-competitive outcomes in areas where both bodies co-operate, such as in the area of marine pilotage.

In light of the clear need for effective oversight to ensure PNGPCL does not engage in anti-competitive conduct in order to protect its effective monopoly in the provision of marine pilotage services, the question arises as to the necessity or desirability of, and the form of, separation that is appropriate in the circumstances to deal with this particular commercial activity.

The key issue is whether PNGPCL can be relied upon or has the capacity to adhere strictly to regulatory requirements relating to accounting separation or functional separation or whether only structural separation will ensure competition ‘on the merits’ in contestable services. Allied to that issue is a related issue, whether IPBC, as shareholder, has any incentive to encourage competition in contestable services in PNGPCL or legislative mandate to do so.

The discussion above, in relation to storage services and marine pilotage has been provided as a basis for assessment of the above issues.
Submissions are invited on the likelihood that PNGPCL 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.

4.4 The Rubber Tyred Granties and Mobile Harbour Cranes
4.4.1 Status of Rubber Tyred Ganties and Mobile Harbour Cranes

The Rubber Tyred Ganties and Mobile Harbour Cranes were introduced by PNG PCL as both have the potential to significantly improve the productivity of the cargo loading/unloading/handling and storage functions within the two main ports. According to the PNG Ports submission to the Stevedoring and Handling Services Issues Paper, “The MHCs are included in the total regulatory asset base through the approved capital expenditure program.”

The structure of the incentives is subject to negotiation with stevedoring companies. Given the size and configuration of vessels, combining the use of the MHCs and RTGs with existing stevedoring equipment such as forklifts and trailers may provide the most efficient loading/unloading, handling and storage outcomes.

Furthermore, PNG Ports has recognised the need to price the use of the equipment by stevedores, but also recognises the strong need to provide incentives to stevedores in order to improve productivity at the two busiest ports. PNG Ports noted that the initial negotiations with the stevedores were unsuccessful. As such, PNG Ports proposes to recover its cost through the introduction of new tariffs for the use of the equipment to be off-set through tariff reduction on other services. Such tariff changes require the approval of the Commission.

The Commission notes that both the RTG’s and MHC’s were funded by the tax payers of PNG via budget appropriations. As such, if the cost of this equipment were to also be recovered from customers of PNG ports via tariffs PNG Ports would effective be recovering twice the equipment cost.

4.4.2 Operations of the RTGs and MHCs

In regards to the operations of the MHCs and RTGs, PNG Ports formulated the Terminal Management Agreements (TMAs), to seek introduce equipment or stevedores to use. The equipment will be managed through introduction of different tariff arrangements and rebalancing of existing tariffs under the weighted average revenue cap currently in place under the annual approval process administered by ICCC. These new tariffs shall only be applicable in Lae and Port Moresby.

The RTGs were intended to stack containers but were not mechanically operational in Port Moresby since February 2013 and the RTGs requires maintenance due to the condition of the equipment.

Most shipping lines used the vessel cranes in Port Moresby and Lae ports. In this case, the MHCs and RTGs are, or will be, operated by the PNG Ports and stevedoring companies through fully trained stevedore personnel. The training will be conducted by PNG Ports at no cost to facilitate the use of the equipment. In-depth training, service/R&M Contracts and a Terminal Management System would have to be in place before possible lease of the equipment to stevedores.

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8 Steamships Shipping JV Stevedoring Response to ICCC Stevedoring & Handling Services Pricing Review Issues Paper, Response 26 and 27
9 Ibid
4.5 **Information provision and contractual obligations**

A key component of accounting separation and functional separation is the accuracy of information provided and the reliance the regulator can reasonably place on the entity in terms of the veracity of its systems, whether accounting, or organisational, to achieve the requisite standard of separation of business activities.

Both accounting and functional separation require a high standard of probity, if the regulator is not put in the position of having to undertake extensive and onerous responsibilities to ‘police’ the system by ongoing scrutiny, audit and enforcement activity, all of which are time-consuming and expensive.

The Commission’s Competition Review Report recounts, at some length, the following sequence of events:

- PNGPCL’s failure to file its tariff increase proposal in 2011 by the date stipulated in the Contract, the Commission’s entitlement to decline approval of the proposed tariffs, which would have prevented PNGPCL from imposing any charges at all for regulated services, quite apart from imposing new proposed charges;

- The Commission’s proposal to PNGPCL to agree to amend the Contract to allow a partial review of the Contract in respect of:
  1. Review of the existing pricing structure to enhance efficiency of stevedoring;
  2. Review cost allocation methodology;
  3. Review operating expenditure to enhance efficiency;
  4. Revisit and review the definitions of regulated and non-regulated services; and
  5. Commence work in relation to the mid-term capital expenditure review before the scheduled date;\(^{10}\)

- PNGPCL’s oral and written agreement to such a review; and

- PNGPCL’s subsequent purported withdrawal of such agreement.

In that report, the Commission said:

> "Without the agreement, the Commission could easily have withheld its price determination indefinitely, thereby putting at risk the entire regulated business components of PNGPCL’s revenue. As a responsible regulatory authority, however, the Commission put forward a proposal in the national interest and, without coercion; PNGPCL accepted it, thus constituting a binding contract under common law, to amend the regulatory contract."

The above summary is intended to assist interested parties to form a view on the degree of reliance the regulator is able to place on PNGPCL in relation to the substance, as opposed to the form, of less intrusive forms of separation of business activities, namely, accounting or functional separation, rather than the more severe form, namely, structural separation.\(^{11}\)

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\(^{10}\) Ibid

\(^{11}\) Ibid
PNGPCL already has a form of management separation arrangements in place within its business. According to PNGPCL, PNGHMS was established by PNGPCL to manage its regulatory functions including certain compliance issues. It is also responsible for harbour management and has previously been responsible for regulatory pilotage licensing.

5. IMPLEMENTING SEPARATION OF THE REGULATED AND UNREGULATED BUSINESSES OF PNG PORTS CORPORATION

PNGPCL has a form of management separation arrangements in place within its business. According to PNGPCL, PNGHMS was established by PNGPCL to manage its regulatory functions including certain compliance issues. It is also responsible for harbour management and has previously been responsible for regulatory pilotage licensing.

5.1 Separation Approach

5.1.1 What kind of Ring-fencing is necessary?

As outlined above, there are three main types of ring-fencing approach that can be used to separate regulated and unregulated businesses:

- Accounting separation;
- Functional separation; and
- Structural separation.

5.1.1A Accounting Separation

A very basic form of accounting separation is currently used to separate the revenues and costs associated with the regulated and unregulated business. This ring fencing approach is currently based on the ratio of revenue generated from the regulated business and unregulated business, with a very limited amount of information on regulated and unregulated business required to be submitted annually. The present system is considered by the Commission to be inadequate to provide sufficient information for regulatory purposes.

The Commission needs to consider, therefore, whether an improved form of accounting separation or functional separation approach is adequate or whether structural separation should be implemented. Under this sort of ring-fencing arrangement, the actual costs of delivering essential port services are not clearly disclosed due to the asset allocation methodology used in the Contract. The method used is the apportionment of assets based on revenues attributable to regulated and unregulated services. Such an approach is not sufficiently robust because the appropriate sharing of costs of enabling infrastructure to deliver the various regulated and contestable services under generally accepted accounting approaches is not likely to be directly proportional to revenues earned by the relevant businesses.

Furthermore, the Commission questions whether the granularity of the accounting arrangements under the Contract permit the level of transparency required to properly attribute costs and revenues to the categories of businesses.

Given PNGPCL’s position in the industry, controlling ‘essential facilities’ which competitors need to access, this accounting approach to asset allocation potentially acts as a barrier to entry for potential entrants to the contestable markets because it creates a situation where the actual costs associated with delivering unregulated services is not known to potential entrants into the market and they are unsure about the extent of PNGPCL’s ability to retaliate by price cutting. This situation is quite different to that which would prevail if the unregulated businesses were operated as standalone entities, where normal commercial costs could be estimated by competitors, based upon their own experience or information applying to their own businesses.

There is also the issue of ‘legacy assets’ with which PNGPCL was endowed and the accounting treatment to be accorded them. The implied principle is that the State bequeathed those assets with the objective of reducing the costs of provision of essential port services so that users could benefit from lower charges and that the lower costs of delivering essential port services would enhance economic growth.

As those assets, particularly land, form part of the assets used to provide contestable services, the question arises as to what value should be attributed to it for each of the contestable services which uses that asset.
Too low a figure pre-empts competition but reduces charges for users. Too high a figure raises charges for services which are intended to be contestable, in theory creating competitive entry incentives, but in practice, as exemplified by storage services, considerable barriers to entry prevail. Because of such asset allocation, the return on unregulated businesses may appear relatively high. In the current situation, arguably, high revenue from unregulated services leads to a higher allocation of assets to that category of business, while, the discontinuities in competition prevent entry. On the other hand, it may well be that a much lower proportion of assets are properly attributable to the unregulated businesses, if a more robust analysis of ‘actual use’ of assets is undertaken.

The issue of asset allocation methodology assumed significance in the mid-term capex review wherein:

- Assets at commencement of contract were allocated on ‘implied’ methodology of ratio of regulated/unregulated revenue; but PNG Ports adviser chose to allocate ‘in-contract’ capex on what is suggested was a “case-by-case” whereby all major projects were allocated solely to the regulated business. The Commission notes this is inconsistent with PNG ports pricing model and its ring-fencing reporting.

- There was a lack of prudence and efficiency test in investment.

In 2012, the Commission undertook a review of the PNG Ports capital expenditure (capex) program, pursuant to clause 4.1 of the Regulatory Contract, and noted the following approach taken by PNG Ports to identify the cumulative capital investments since 1 January 2010.

The actual cumulative expenditure was a critical factor used to determine whether the regulated entity had met its capital investment requirements set by the Commission in 2009 during the regulatory reset of the PNG Harbours Regulatory Contract and the price path. According to PNG Ports’ capital expenditure progress report of 2012, the actual cumulative expenditure was taken from the following sources:

| Work In Progress (WIP) Reports | Monthly and annual reports which record progress of expenditure on large infrastructure projects. Non-regulated capital expenditure and gifted assets was deducted from these three sources of capex data. |
| Fixed asset register (FAR) or account asset book report | Summary of existing assets that are not reflected in the WIP such as IT expenditure, motor vehicles and plants and equipment acquired in single lump-sum payments. Non-regulated capex was deducted based on % of regulated to non-regulated revenue. |
| Unconditionally Contracted Capex | Contracts entered into in the period 1 January 2010 to 30 June 2012. Deduct amounts already spent (WIP) and identify remaining Contract balance. |

**Cumulative Capex in WIP**
In regard to the capex recorded in the WIP, PNGPCL and its consultants excluded unregulated capex and gifted assets from the reported actual cumulative expenditure (1 January 2010 to 30 June 2012).

**Cumulative Capex in FAR**
In regard to the FAR, the actual cumulative expenditure was derived by PNGPCL and its consultants on the basis of the portion of regulated revenue earned by the essential port services business. PNG Ports used the portion of regulated revenue earned in the regulatory years 2010, 2011 and 2012 (to 30 June) to allocate the regulated capital investments recorded in the FAR.
Cumulative Capex from Unconditionally Contracted Capex

However the Commission was concerned with methodology used by PNGPCL and its consultants in allocating the regulated capex from the following projects, which were classified as unconditionally contracted:

- POM Ports Remodelling Projects;
- POM main wharf Pavement Repairs;
- Lae/POM Master Plan; and
- Lae Port remodelling Projects.

It appeared to be inconsistent with PNGPCL’s previous approach to identifying regulated capex used in the FAR. Furthermore there was no allowance for such an approach under the Regulatory Contract.

The Commission would expect that the same methodology used in separating regulated capex from the total capex in the FAR should have been applied in this instance as the Commission considered that the above projects were related to the whole business and not just the essential port services business.

This experience calls into question the ability of the current accounting approach to effectively ring-fence PNGPCL’s costs and revenue and suggests there is a need to more effectively separate the essential port services business from the unregulated businesses of PNGPCL.

As mentioned above, asset allocation principles are set out in the regulatory contract, including for, but not limited to, the reasons that assets are used jointly or in common in the provision of Essential Port Services and Contestable Services. The allocation of assets to those two categories of businesses has, for a period of time, been based on an ‘implied’ regulatory asset base, which itself does not necessarily represent the true economic allocation of assets.

In addition, as outlined above, there have been inconsistencies in the approach adopted by PNGPCL and its consultants, to the allocation of asset values at the commencement of the contract period, based on the ‘implied’ methodology, to that used for assets unconditionally contracted within the contract period, which emerged during the Commission’s review of PNGPCL’s capital expenditure progress report and its subsequent submission of proposed tariffs for 2013.

### 5.1.1B Functional separation

Functional separation involves, in effect, the creation of so-called ‘Chinese walls’ within the organisation to separate the relevant businesses. Such separation is intended to eliminate the flow of sensitive, competitive information between the staff and decision-makers of the relevant businesses to prevent the use of competitive information in the regulated businesses by the decision-makers in the unregulated businesses.

The strategies commonly alleged by complainants who are usually downstream competitors of vertically integrated monopoly providers of essential facilities to be adopted by them include the following:

- Transmission of customer information between the two businesses such that the competitor’s business strategies as evidenced by its requests for access to essential facilities are shared between the two arms of the vertically integrated monopoly to allow strategic responses in the unregulated business arm, to frustrate the competitor's initiatives in the competitive markets;
- Delay or poor provision of regulated services to competitors, vis-à-vis own competitive arm;
- Access pricing at high levels to competitors of the downstream business, while supplying such services on an ‘integrated’ basis at effectively lower costs to its own downstream arm;
- ‘Regulatory gaming’ to postpone observance of legal obligations until compelled by Court action or a credible threat thereof;
- Discriminatory pricing among competitors to facilitate tacit collusion.

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

5.1.1C Structural separation

Under this approach, a complete separation of businesses is required. The relevant clause in the Contract clearly envisages this approach by suggesting that the relevant activities could be carried out by related companies.

Directors’ duties require them to act in the interests of the company as a primary objective, rather than in the interests of the parent, subsidiary or related company.

A more robust asset allocation methodology will be required and separation will be permanent, for the foreseeable future.

There will be less opportunity to ‘fudge’ the accounts with the objective of ‘gaming’ the regulator and gaining an unjustified advantage over competitors.

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 PNGPCL 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.

5.2 Time frames for possible separation approaches

Each of the various forms of separation requires an appropriate time frame for implementation. While the Contract specifies 20 days for separation, the Commission does not consider that sufficient to implement any of the forms of separation.

Clearly there is a gradation of complexity in the various forms of separation and the steps required to implement them.

On the one hand, too short a period for implementation would not allow the process to be implemented appropriately; on the other, too long a period delays the benefit of the initiative.
Submissions are invited on the appropriate time frames for implementing
(a) accounting separation;
(b) functional separation; and
(c) structural separation

Taking into account the steps required to implement each form of separation
Ref: 2000-10.2
2nd April 2013

Mr Stanley Alphonse
Chief Executive Officer
PNG Ports Corporation Limited
PO Box 671
PORT MORESBY
National Capital District

Dear Mr Alphonse

Regulatory Contract Sub-clause 7.1

The Commission intends to enter upon a consideration of whether it is necessary or desirable, in order to promote competition in a market or markets for Contestable Services, for the Commission to require separation of Ports’ Essential Port Services business from one or more Contestable Services businesses.

The Commission invites Ports to participate in this inquiry by providing information and comment relevant to the issue of whether any such requirement would be necessary or desirable in order to promote competition in any market or markets for Contestable Services. In the first instance, the Commission requests that Ports provides any information and comments which it wishes the Commission to consider within 21 days of the date of this letter.

The Commission also invites Ports to address the issue of whether, if such a requirement or requirements were to be made, the form in which a notice or notices under clause 7.1(a), in light of clause 7.1(d), might take.

Yours sincerely

Billy Manoka (PhD)
Commissioner/CEO

"Friend to Businesses, Friend to Consumers"