

Port of Melbourne



Market Rent Inquiry 2020 Interim Report

Port of Melbourne Submission

April 2020

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1. Introduction

The Port of Melbourne (PoM) is pleased to present this submission to the Essential Services Commission (ESC) in response to the Interim Report on its Market Rent Inquiry – the Inquiry.

The Inquiry arises from the *Port Management Act 1995* (PMA), which requires the ESC to undertake a market rent inquiry, specifically to (section 53(1)):

- (a) conduct and complete an inquiry into the following matters-
 - (i) whether a port lessee or the port of Melbourne operator has power in the relevant market that it may exercise in relation to the process for the setting or reviewing of rents or associated payments (however described) payable by a tenant under an applicable lease;
 - (ii) whether a port lessee or the port of Melbourne operator has exercised that power in a way that has the effect of causing material detriment to the long term interests of Victorian consumers (a misuse of market power);

The section goes on to say:

- (b) if and only if the Commission finds that there has been a misuse of market power, make recommendations to the ESC Minister about whether provision of access to port of Melbourne land by means of an applicable lease should be subject to economic regulation, and, if so, the form of the economic regulation.

In undertaking its role under the PMA, the ESC is required to take into account the objectives set out in section 48, which include (as relevant to the Inquiry):

- (d) to facilitate and promote competition-
 - (i) between ports; and
 - (ii) between shippers; and
 - (iii) between other persons conducting other commercial activities in ports;

The ESC released a Scope and Process Paper in September 2019¹ setting out its proposed approach to considering the matters related to the Inquiry as set out in the PMA. In addition, it issued two notices in accordance with section 37 and Part 5 of the *Essential Services Commission Act 2001* (the ESC Act) seeking information on tenant leases for port land, and the terms of the Port Concession Deed. An Interim Report was released in March 2020² setting out its conclusions on the power of PoM in the setting or reviewing of rents payable by a tenant.

This submission is provided to the ESC in response to its Interim Report.

PoM reiterates its support for the Inquiry, as a critically important part of the process for ensuring that the rents payable by tenants at the port are fair and reasonable and so represent market-based prices.

¹ Essential Services Commission, (2019), *Port of Melbourne – Market Rent Inquiry 2020*, Scope and process Paper, 26 September, Melbourne.

² Essential Services Commission (2020), *Port of Melbourne – Market Rent Inquiry 2020*, Interim Report, 20 March, Melbourne.



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When combined with the obligations of the Port Concession Deed, and the market rent clauses within our leases, there are comprehensive protections against the potential for a misuse of market power by PoM. It follows that PoM believes that the current regulatory framework and requirements on PoM achieve the competitive objectives of the framework.

Further, PoM considers that its processes for setting and reviewing market rents (and associated payments), and the outcomes of those processes, clearly demonstrate that there has not been a misuse of market power.

In this submission we provide further information to support the ESC's Inquiry, while also addressing the matters raised in the Interim Report. It is structured as follows:

- section 2 provides an overview of the PoM leasing function, including summarising the principal land uses within the port precinct. This information is relevant when considering the opportunity for PoM to exercise power in setting land rental rates;
- section 3 sets out the principles that are relevant when considering power in land rent setting, and the constraints on the misuse of market power within the current regulatory arrangements for rent setting and review; and
- section 4 responds to several matters raised by stakeholders and highlighted within the ESC's Interim Report.
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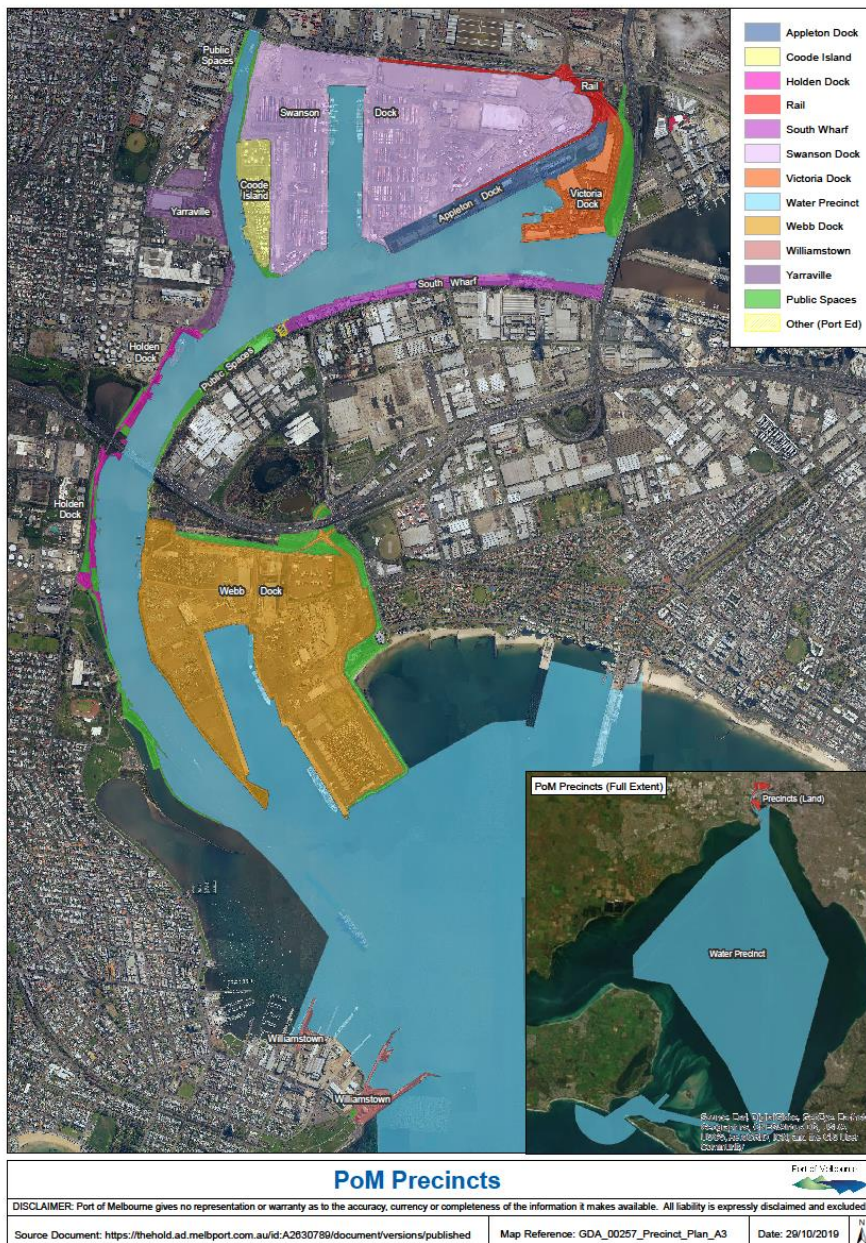
2. Overview of the PoM leasing function

This section sets out the current land uses at the port, and describes the lease agreements, processes for, and governance of, lease rental reviews. This provides the factual context for the ESC’s Inquiry.

Current land uses at the port

The port precinct has a total land area of approximately 505 hectares and accommodates a variety of land uses, around 330 ha of this area is lettable (non-lettable areas might include, for example, roads, rail, services, public spaces etc.). There are 121 leases or licences within the precinct. Figure 1 provides a map of the main precincts and land uses within each precinct.

Figure 1: Map of the main precincts at the Port of Melbourne, 2020





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Swanson/Victoria/Appleton Dock precinct

This precinct is the largest at the port and comprises over 153 hectares, which represents approximately 46 per cent of the lettable port area. It accommodates a variety of land uses, and a number of berthing related uses.

The main leases within the precinct are:

- Swanson Dock which consists of two international container terminals (Swanson Dock East and Swanson Dock West), which are leased to existing stevedores, Patrick Stevedores (Patrick) and DP World Melbourne (DPW);
- Appleton Dock consists of five berths (B to F) comprising four general cargo berths (B to E) and one common user berth (F). Major tenants include Australian Amalgamated Terminals (AAT) and Melbourne Terminal Operations (MTO);
- Victoria Dock comprises a single berth used for break bulk, dry bulk (grains) and a rail siding, which is leased to Qube Logistics; and
- Intermodal and warehousing facilities operated by ACFS, Qube and Patrick.

Webb Dock precinct

The Webb Dock precinct is the second largest at the port, comprising of 138 hectares (42 per cent of total PoM land area) and includes an international container terminal, automotive terminal, motor vehicle pre-delivery and inspection operations and most of the Bass Strait trades. The main leases in this area are:

- one international container terminal leased to Victoria International Container Terminal Ltd at Webb Dock East;
- Bass Strait trade terminals operated by Toll and SeaRoad;
- MIRRAT for the international roll on / roll off automotive terminal; and
- Vehicle inspection facilities operated by Prixcar Services and Autocare Services.

South Wharf precinct

This precinct has a number of uses including bulk cement imports, general cargo, tug boat mooring and dry bulk. It occupies a land area of around 17 hectares (around 5 per cent of the total port area).

Coode Island precinct

The Coode Island precinct is the port's primary Bulk Liquid precinct for Hazardous Bulk Liquid operations. It includes liquid bulk berthing and storage facilities, occupies a total area of around 18 hectares (around 5 per cent of total port area).

Tenants use No. 1 Maribyrnong berth for bulk liquid imports.

Yarraville precinct and Holden Dock

The Yarraville precinct and Holden Dock houses a variety of land uses ranging from sugar, various food logistics and warehousing facilities. It occupies around 7 hectares, which represents around 2 per cent of the lettable area at the port. Holden Dock is used for petroleum imports.



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Williamstown (Gellibrand Pier) precinct

This precinct accommodates the Mobil Refining bulk liquid importation and storage facilities. It comprises an area of around 3 hectares, which represents around 1 per cent of the lettable area at the port.

Summary of current lease agreements

In summary, there are currently 121 lease and licence agreements in place across the port. 26 leases have been put in place following the commencement of our lease of the port of Melbourne, and so have an updated market rent review clause. All previous leases also contain a market rent review clause of a form similar to the current templated precedent clause.

The current template market rent review clause requires that a market review be undertaken no earlier than three months before a Market Review Date, as specified in the lease. If a lease is of more than eight years' duration, the Rent Review occurs on each 5th anniversary of the date of commencement of the lease.

This clause is adjusted based on agreement between PoM and a prospective tenant, based on the specific needs of a tenant. All leases, including the specific formulation of the market rent review clauses, have been provided to the ESC for this Inquiry.

Table 1 provides a summary of the area of land, by principal land use across the entire port precinct.

Table 1: Principal land uses at the Port of Melbourne, 2020

Land use	Area (ha)	Percentage of total	Number of leases
Container terminal	130.3	37.9%	5
Automotive and RO/RO terminal	35.9	10.5%	3
Pre-delivery and inspection services	16.2	4.7%	2
Dry bulk	9.5	2.8%	7
Liquid bulk	12.7	3.7%	6
General cargo	8.3	2.4%	1
Bass Strait Trade	31.4	9.1%	3
Warehousing, storage and transport	67.3	19.6%	17
Services	9.4	2.7%	8

Note: Excludes licences, and a range of land use and lease types (e.g. pipelines and utilities) and hence area covered is less than 100% of port land



Process of market rent review

The obligation on PoM to undertake a market rent review is a critically important requirement to ensure that any power that PoM may possess is constrained. In this section we set out the process that is used for undertaking a market rent review.

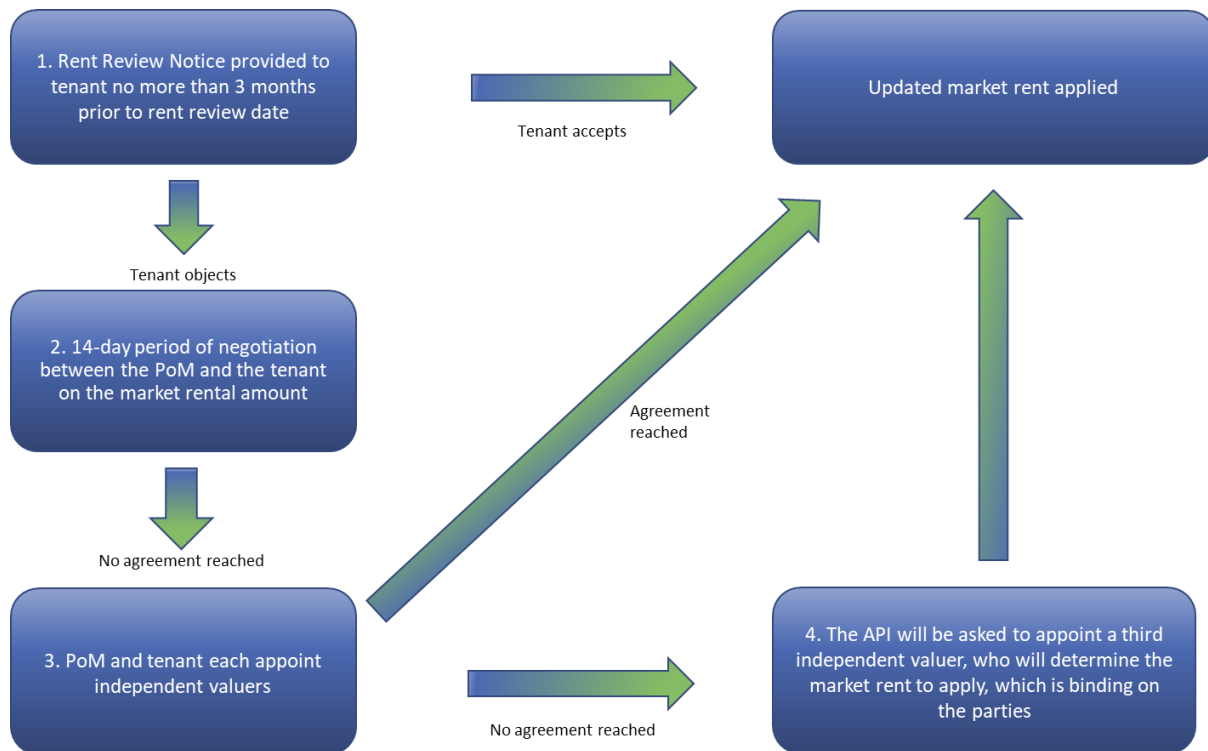
The typical process for undertaking a market rent review is as follows:

1. PoM will give the tenant a written notice (a Rent Review Notice) specifying its assessment of the current market rent no earlier than 3 months before a market review date. The assessment is typically based on the advice of property valuers engaged by PoM.
2. The tenant may object to the Rent Review Notice within one month, which triggers a 14-day period of negotiation between PoM and the tenant on the market rental amount.
3. If there is no agreement within the 14-day period, both PoM and the tenant must each appoint a valuer to prepare reports on the market rent. The two valuers independently prepare a market rental appraisal report, setting out the reasons and evidence for their assessment.
4. PoM and tenant may then use their respective reports (which are not shared) to continue negotiations to determine the market rent.
5. If there remains no agreement, then the Australian Property Institute President will be asked to appoint a third independent valuer, who will determine the market rent to apply, which will be binding on the parties.

In making an independent valuation, the third valuer must determine the reasonable market rent, having regard to factors such as the location and condition of the premises, permitted use, term of the lease, and rents on comparable land.

Figure 1 provides a diagrammatical representation of the process for market rent review.

Figure 1: Process for market rent review



What is clear from the market rent review process, is that:

- PoM does not unilaterally determine the rental amount. Rather, it is ultimately determined as the reasonable market rent, either by an independent valuer or the parties agreeing in advance as to what is a reasonable market rent knowing that an independent valuer can be used to determine the market rent; and
- there is ample opportunity for a tenant to engage with PoM and, if necessary, appoint independent valuers to facilitate agreement on the reasonable market rent.

It is important to acknowledge that proceeding to rental determination by an independent valuer selected by the API is considered by PoM to be a fair and reasonable process when agreement cannot otherwise be reached. It provides a helpful backstop to ensure that negotiations on the rental price are not dominated by any one party. Typically, PoM and tenants will seek to exhaust all negotiation options before choosing to proceed to a rental determination.

Finally, it is important to acknowledge that the tenants at the port are themselves sophisticated commercial entities that have the resources to review and negotiate in good faith with PoM.

Considerations relevant to an independent valuer in determining reasonable market rent

The market rent review is critically important for ensuring that rental rates do not reflect any market power that PoM may possess.

Typically, an independent valuer will assess the market rent of land with reference to the observed rental rates for land that is most directly comparable to the land subject to the rental review. This is most likely to be land that has the same use as the land subject to rental review, with similar terms and conditions, modified for any value attributes that distinguishes the land from the comparator.



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In undertaking a market rent review, the valuer considers first the requirements set out in the lease (and set out above), and then considers a hierarchy of evidence. The Australian Property Institute *Technical Information Paper – Assessing Rent and Rent Determinations* sets out the evidence to be used in assessing market rent:³

In assessing market rent the Member should consider the most appropriate evidence in the market place. The circumstances where the lease was entered into are also relevant. There is a hierarchy to weight that is placed on evidence. That priority is:

1. New lease to a new tenant;
2. Where Current Market Rent is agreed between the lessor and lessee at a mid-term review or exercise of option specifically, where the rent is to be the Market Rent and, if not agreed, can be set by determination;
3. Where Current Market Rent is set by determination at a mid-term review or exercise of option. In this case the evidence used by the determining Valuer may have more relevance; and
4. New lease to a sitting tenant on expiry of an existing lease where the tenant has no right of continuing tenure. In this circumstance consideration must be given as to whether a premium rent was agreed rather than lose the goodwill and benefit of an existing fit out.

...

Evidence is not limited to actual rental agreements. For instance, micro economic factors in a particular location may be a significant consideration. Further, changes in micro economic factors taking into account temporal aspects should also be considered when applying the evidence.

It follows that there is a well-established set of factors that independent valuers apply to determining reasonable market rents both at the port and in any other leasing context.

The ESC has been provided with confidential examples of independent market rent valuations, which provide insights into the specific factors that valuers have taken into account in determining market rents at the port. Broadly, this includes evidence from port land based on competitive tendering processes for similar land uses, as well as rental rates in adjacent or similar land for similar uses, with appropriate adjustments.

Seeking expressions of interest for unused land

The port currently has approximately 5 hectares of vacant land, compared to a total lettable land area of around 330 hectares (i.e., around 1 per cent of lettable land is currently vacant). Vacant land is actively marketed, reflecting PoM's commercial interest to maximise rental revenue from its land, and also contribute to trade volumes flowing through the port, for which it earns revenue from the associated services (i.e., wharfage etc.).

To this end, in May 2018 PoM undertook a global marketing campaign to attract tenants to the port precinct to utilise the land that was vacant at that time – Figure 2. There were eight vacant parcels of land representing 17.7 hectares, of different sizes and potential permitted uses. Working with property advisors, PoM sought expressions of interest for prospective tenants of the vacant land, with the campaign concluding in December 2019. These efforts resulted in:

- the long term lease of 2.4 hectares at South Wharf, including hardstand and wharf access;
- short term licence of 7.4 hectares currently under negotiation at Coode Road of hardstand and an existing warehouse facility; and

³ AVTIP10 – *Assessing Rent and Rent Determinations*, pp 13-14.



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- three new short term licences of 2.8 hectares for existing office, warehouse, and hardstand sites at South Wharf.

The campaign resulted in the letting of over 70 per cent of the land that was vacant at that time.

Currently, there are approximately 5 hectares of available vacant land, with around 10 hectares of land currently occupied under short term licences.

Figure 2: Australian Financial Review advert to support the expression of interest campaign for vacant land

FOR LEASE
EIGHT PROPERTIES WITHIN THE PORT OF MELBOURNE
 VIC, Port of Melbourne

SECURE YOUR OPERATIONAL FUTURE

- + Australia's largest container Port
- + Unparalleled proximity to international container terminals
- + Lease existing buildings, hardstand/yard areas or purpose build a facility
- + Land areas from 5,802sqm² - 68,653sqm²
- + Building areas from 4,406sqm² - 17,404sqm²
- + Various lease terms up to 48 years
- + Multiple sites with various features that include wharves, site access from land/water and proximity to port rail
- + Immediate proximity to West Gate Fwy, CityLink, Monash Fwy, Western Ring Rd, Future West Gate Tunnel and Dynon Rail Terminal

FOR LEASE VIA INTERNATIONAL EOI CLOSING THURSDAY 15TH NOVEMBER 2018 AT 3.00PM AEST

GUY NASELLI +01 413 750 744
JAKE GEORGE +01 421 221 019

TOM HAYES +01 413 997 703
DEAN HUNT +01 418 543 301

CBRE

PoM has recently agreed to a vacant land strategy to proactively source tenants for the remaining unused vacant land, following from the 2018-19 campaign. This involves a number of approaches including:

- EOI campaigns for specific sites;
- leveraging PoM's existing network to identify tenant opportunities;
- identifying potential for shorter term licences or leases to attract tenants (rather than longer term leases); and
- engaging with existing tenancies on potential expansion needs.

The relatively low levels of unused and vacant land at the port reflects the efforts that have been given towards minimising the extent of vacant land at the precinct. This is consistent with commercial drivers for the port.

Internal governance arrangements for establishing new leases and setting and reviewing rents

The ESC has asked for information related to the internal governance arrangements at the port for establishing new leases, and the setting and reviewing of rents.



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We have a documented process that outlines the Board’s responsibilities and delegations for management, a precedent lease that is approved by the Board, and a Principal Terms Sheet (PTS), which provides the basis for negotiating and clearly setting out the principal commercial terms for leasing agreements. PoM also maintains appropriate records of approvals and interactions with the Board.

This information, documentation around PoM’s internal process flows, and examples of the end-to-end processes for market rent reviews and establishing new leases has been provided to the ESC in our response to the section 37 notice. We would be happy to respond to any further queries that the ESC has about PoM’s internal governance arrangements.



3. Considering power in land rent setting and associated constraints

The ESC's Market Rent Inquiry raises several important questions about the scope for PoM to exercise power to set land rents that exceed what would be expected to arise from a competitive market, thereby creating the potential to cause a material detriment to consumers in Victoria.

In this section, we provide our views on the key matters that are relevant to the ESC's Inquiry. Specifically, we:

- set out the economic principles that are relevant for setting market-based land rents;
- describe the availability of substitutes, and the scope for competitive constraint of land rents; and
- describe the circumstances when a material detriment might arise, and how these circumstances are constrained by the regulatory arrangements currently in place.

Economic principles for land rent setting

The economic principles for land rent setting are well established. The starting point is that land lease rental rates are derived through mutual negotiation between the supplier of land (in this case PoM), and the tenant or prospective tenant (the lessee). There are a number of factors that influence the willingness for a landlord and tenant to agree to a particular rental amount.

From PoM's perspective, the acceptable rental rate will reflect the opportunity cost of the land having regard to the net impact of:

- the value of land consistent with comparable permitted uses;
- plus any additional incremental value to prospective tenants having regard to logistical and operational benefits of being located at the port and at the highest and best use such as:
 - direct access to deep water enabling high value and high productivity cargo exchanges
 - integrations between various complementary operations at the port that reduce the last mile costs;
 - but reduced to the extent that there are constraints in relation to competition from international export markets, other ports and off port substitutes and from countervailing powers of tenants;
- less the additional costs that are associated with providing the land for that use (e.g., the cost of land improvements or services provided to make the land useable).

In considering the land use and rental rate, PoM will also consider other non-rental factors such as supply chain benefits, precinct planning, competition and access.

From the tenant's perspective, the rental rate that they will be willing to accept reflects:

- the rental rate for alternative land sites not located on port land, where this allows the tenant to continue to operate in its related market;
- the additional revenue that can be expected to be earned from use of the land in the related markets that the tenancy allows access to (e.g., the stevedoring market), which will depend on factors relevant to that related market;
- less the additional ongoing non-land costs that the tenant will incur in providing the relevant service.



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In short, the willingness to pay of the tenant will be defined by the net benefit that it is expecting to receive from the use of the land.

Importantly, the reasonable market rental rate will lie between these two boundaries. In summary it will reflect the unique attributes of the land in question, with reference to the economic value that can be derived from those attributes. As the location of the land moves away from the unique revenue generating attributes of the use of the land, then the value will be lower in line with the associated reduction in ability for the land to generate economic profits (i.e., revenue in excess of all other costs excluding the land rental).

It is through negotiation between the parties, taking into consideration the above principles, that an appropriate rental rate will be achieved.

It follows that higher rental rates may result if a tenant is able to pass through the costs associated with a land rental without materially affecting market share of the tenant in the related market (which would have the effect of increasing the expected revenue). Lower rental rates may result if there are limited alternative uses for the land or there are more important strategic considerations in the allocation of use of the land.

Therefore, the issues relevant to the assessment of market power include:

- availability of substitutes for the land by the tenant; and
- extent of competitive constraint in the market in which the tenant operates, which limits the scope for pass through of rental rate rises.

We assess these issues below.

Competitive constraints on land rents

There are two principal competitive constraints on land rents, namely:

- the availability of substitutes to port land; and
- competitive constraint in a tenant's market.

We discuss each of these constraints in turn below.

Availability of substitutes to port land

As we set out in section 2, the principal land uses at the port include:

- stevedoring services, which include for:
 - international container cargo;
 - motor vehicle cargo;
 - Bass Strait trade terminals;
 - dry bulk cargo;
 - liquid bulk cargo;
 - general cargo;
- warehousing, storage and transport (including pre-delivery and inspection services); and
- other services including electricity, etc.



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Of these land uses, there is viable non-port land for all uses apart from stevedoring services (which require access to wharves to enable the delivery of the services), and some intermodal services.

Importantly, for the other services there are likely to be cost advantages for being located adjacent to wharves, due to the time or cost efficiencies associated with being proximate to cargo traversing the port site. Consistent with the economic principles for land rent setting, these efficiencies affect the willingness of a tenant to pay for port land as compared to using a non-port substitute. However, higher market rents of port land where there are alternative substitutes do not represent evidence of market power.

Regardless, non-port land rents provide an effective constraint for port land used for these services because:

- a port tenant will be willing to pay up to the point where being located on port land justifies a higher land rent to a non-port land substitute; and
- if PoM sought to raise rents above this level, the tenant would relocate to non-port land and so PoM would lose the rental income associated with the lease of the land. This would not be in the commercial interest of PoM.

It follows that for a high proportion of land uses where there are non-port land alternatives for tenants, there is an effective market constraint on rental rates.

Scope for competitive constraint arising in a tenant's market

While for many land uses within the port there is likely to be a non-port land alternative, there remain some land uses that require adjacency to the wharves for the provision of services. This relates principally to the various stevedoring services provided at the port.

For these services, the competitive constraint results from the market in which a tenant is operating, and the extent to which competition in that market can affect whether a tenant is able to pass on the rent costs to consumers within the market. Also relevant to this consideration is the extent to which rents form a material component of the cost base, and whether or not tenants are able to absorb changes in costs (much like other components of the cost base that might change from time to time).

The constraint arises from a tenant or its customers being a price taker in the market in which it operates. In these circumstances, increases in rent above a reasonable market rate may not be able to be passed on to the tenant's customers, and may affect the tenant's ability to compete in the provision of services in that market. This would not be in the commercial interests of PoM and so becomes an effective constraint on rent increases above a reasonable market rate.

For stevedoring services, it is therefore appropriate to consider the markets in which each service is operating to determine the extent of competition for stevedoring services.

In PoM's opinion, there is likely to be a competitive constraint on land rents from facilities at Geelong, Hastings and Portland as well as the competing Bass Strait trade operated by TT Line operated from facilities in Melbourne not owned and leased by the Port of Melbourne (recently announced to move to Port of Geelong in 2022) for:

- dry bulk cargo (principally grain handling);



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- liquid bulk cargo;
- Bass Strait trades; and
- break bulk cargo.

These other ports already have facilities that compete for market share in the above commodities.

While for some of these cargoes there are significant investments in facilities to facilitate the trade (e.g., grain silos), given exported goods compete on international markets and there are medium term viable competitive alternatives, there is an effective competitive constraint on land rents.

For international containers and motor vehicle cargo, we note that there are not proximate port facilities competing in these markets, however, there are nevertheless material constraints in these markets.

In relation to international container cargo, the introduction of a third stevedore has created significant competitive tension in this market. This is evidenced by the fact that in only a few years of operation, VICT has captured significant market share.

Although all of Victorian motor vehicle imports currently come through the Port of Melbourne, this trade could relocate to Geelong or Hastings if rental costs increased. For example, we note that all motor vehicle imports in NSW currently come through Port Kembla after being dislocated from Port Botany – demonstrating that locational shifts of this nature are clearly feasible.

Further, the combination of long-term leases, market testing of rental rates, countervailing powers of large tenants and access to independent valuation effectively constrains PoM from raising rents above reasonable market levels. This is evidenced by the fact that rental rates paid by tenants involved in international container and motor vehicle stevedoring are not materially more than rates paid by tenants subject to substitutes and competitive constraints, despite the significantly higher utility resulting from these operations.

Market rent reviews within long-term leases provide an effective constraint on market power

As described earlier, tenants have a right to seek independent determination of market rents. The independent valuer needs to take into consideration, when determining the reasonable market rent, factors consistent with best practices of market rent valuation as set out by guidelines produced by the Australian Property Institute.

This section describes the role of the PCD in providing an effective constraint on market power for leases entered into after 2016. We also describe the constraint arising from the long-term lease agreements with a market rental review clause for leases entered into prior to 2016.

We explain these constraints in greater detail below.

Role of the Port Concession Deed as an effective constraint on market power

PoM acknowledges the concern expressed by the ESC and tenants that the PCD requirements have been confidential..



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However, PoM can confirm that market rent reviews are included in all new leases that have been negotiated and agreed since 2016, as per the documentation provide to the ESC under the section 37 notice.

Relevantly, these obligations apply to all leases at the port that have been entered into since 2016 and so provide additional protections for tenants, in addition to the land substitution and competitive constraints affecting market power of PoM for many land uses at the port.

Prior to 2016, port rental leases had market rental review clauses that provided an effective constraint on market power

For leases entered into prior to 2016, there was also a market rent review clause, which was of a substantially similar form to that operating in current lease agreements. These clauses also provided the option for access to independent determination of market rents, where the port and tenant could not otherwise negotiate an effective rent.

While there are some minor differences between the clauses included in older leases (i.e., prior to 2016), the effect of these clauses is analogous to the newer leases. Specifically:

- for longer leases, there is a market rent review undertaken periodically over the term of the lease, informed by information provided by independent valuers; and
- in determining the market rent, the valuer is obliged to take into account the land's use and relevant market benchmarks.

The ESC has been provided with confidential examples of the relevant market rent review clauses from a number of pre-2016 lease agreements.

Importantly, in practice PoM adopts the same process and approach for post-2016 leases and pre-2016 leases. These practices ensure that the rents paid for land at the port reflect reasonable market levels.

A material detriment can only occur if land rents exceed the negotiation range bounded by willingness to pay by the tenant and willingness to accept by PoM

The ESC's Interim Report indicates that it is currently considering whether a material detriment has occurred from the setting of rents by PoM.

PoM believes that there has not been any material detriment arising from the setting of rents. This is principally because a material detriment could only arise if the rental level is above that which reflects the reasonable market rent. As explained earlier, the protections that exist against this outcome include the following:

- through access to binding independent determination, rental levels cannot exceed the reasonable market rent level, as would be determined by an independent valuer taking into consideration factors such as the location and condition of the premises, permitted use, term of the lease, and rents on comparable land; and
- additional commercial rental constraints resulting from:
 - the availability of non-port land substitutes for many port land uses; and
 - constraints within the competitive markets that port tenants operate within.



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The ESC highlights that if rents were set above the reasonable market rent level then this would potentially affect the ability for tenants to compete within the market that they are operating in, which would be inconsistent with competitive market outcomes.

The ESC also identifies two other circumstances it believes to be a material detriment, namely:

- if PoM prevents prospective tenants from accessing port land; or
- if PoM undertakes an activity that affects the costs of a tenant's operations.

In PoM's opinion, there are no circumstances where it would prevent a prospective tenant from accessing port land. It is in the commercial interest of PoM to lease land at the highest market value. Given that tenants are required to be port-related, this will also likely maximise trade coming to the port. The current vacant land at the port represents around 1 per cent of total lettable land and reflects a market outcome whereby there is limited demand for the vacant port land given its potential uses.

Finally, PoM contends that it does not engage in any activity that would impact the costs of a tenant's operations, unrelated to its decisions about land rent. Access to land, and other land attributes which are the basis of land rentals are agreed and maintained over the term of the lease.

Summary

In summary, PoM believes that the ESC's interim report incorrectly concludes:

... that the Port of Melbourne has power in setting and reviewing rents and that there is currently limited countervailing market, contractual or legislative power available to tenants to constrain this power.

Rather, PoM believes that there are constraints on its scope to exercise market power for those leases where:

- there are direct substitutes for some port land uses outside of the port area;
- for land uses involving stevedoring services for dry bulk, liquid bulk, Bass Strait trades and break bulk due to competitive market constraints arising in the tenant's market; and
- large tenants involved in international container and motor vehicle stevedoring have strong countervailing powers.

Regardless of this conclusion, tenants have access to independent valuers to determine the Reasonable Market Rent, if required. Whilst there are some minor differences between the clauses included in older leases (i.e., prior to 2016), the effect of these clauses is analogous to the PCD. This clearly constrains market rents from being set at a level that could result in a material detriment.

For a market detriment to arise, rents would need to be set above the Reasonable Market Rent level. PoM considers that the market, procedural and regulatory constraints are a highly effective protection against rents reaching a level where a market detriment can be considered to have arisen.



4. Addressing matters raised in the Interim Report

This section addresses several matters that have been raised by the ESC in its Interim Report for the Inquiry.

Concerns expressed by tenants on rent levels

The ESC highlights in its Interim Report that some tenants indicated that rent levels were too high when compared to rental rates observed for adjacent non-port land.

As highlighted in this submission, the current market rent review processes mean that PoM is unable to set rental rates that are in excess of market rates. The way by which this is achieved is through access to independent valuation of reasonable market rents, which consider the hierarchy of information that is used for determining market land rents in any context, including for port land.

PoM notes that for some tenancies, rental levels within the port precinct may be higher than land near to, but outside of the port. However, circumstances where tenants on port land face higher rental rates than for adjacent non-port land for similar land uses, is entirely consistent with reasonable market rents. Such a circumstance would reflect the higher value attributes associated with the proximity of land sites within the port area, which can create efficiencies for those businesses.

Of course, if PoM set rental rates higher than those observed for similar non-port land absent the higher value attributes on port land, then it risks the tenant departing at the end of the lease, which would not be in the commercial interests of PoM.

For these reasons, observations of rental rates being lower outside of the port is not sufficient evidence, in and of itself, of rental rates in excess of market outcomes.

Withholding of land supply

The ESC indicates in its Interim Report that PoM can reduce the effective supply of land by not making vacant land available to the market, and that this strategy has the potential to increase aggregate rates for other land within the port precinct.⁴

PoM rejects the contention that a strategy of withholding vacant land from the market would be profitable. As noted in the previous section of this submission, there is no opportunity for PoM to raise rental rates amongst current tenants above market levels, given the constraints on the exercise of market power in the setting of rental rates such as:

- opportunities for some tenants to substitute for non-port land to conduct their business;
- competition in related markets; and
- restrictions arising from the PCD market rent review obligations.

Irrespective of these constraints, there is clear evidence that PoM regularly seeks expressions of interest for vacant land. Currently around 1 per cent of lettable land at the port is vacant. As outlined earlier, PoM has a vacant land strategy, which seeks to identify and target prospective tenants for its available vacant land.

⁴ Essential Services Commission (2020), *Port of Melbourne – Market Rent Inquiry 2020*, Interim Report, 20 March, Melbourne, p 18.



Control of negotiation timelines

As highlighted earlier in this submission, PoM has a clear process for undertaking market rent reviews and lease negotiations. For a market rent review, this process is commenced no earlier than three months prior to the market review date, to provide sufficient time for parties to reach agreement taking into account all of the surrounding circumstances and the potential need to undertake independent valuations to inform the negotiations.

The three-month period is appropriate to ensure that the rate negotiated, agreed or determined is as close as possible to a market rate, at the market rent review date. It allows time for the negotiation to take place and the clause prescribes a timeline to ensure an efficient process is followed.

That said, in some circumstances negotiations on the market rent review may commence earlier, should a tenant request more than three months of time for particular commercial purposes such as for a lease expiry and extension involving market rent agreements. This is the only circumstance where a market rent review would commence prior to the 3-month requirement set out in the precedent lease. Commencing a rent review prior to 3 months before the market review date is not PoM's preferred approach.

Approach to outgoings including management fees

The ESC indicates that several stakeholders raised concerns about PoM including management fees as an outgoing expense associated with a lease.⁵

It is important to recognise that a typical commercial lease charges for outgoings at a rate that reflects the underlying costs of services provided to the tenant, and the costs incurred in the administration of the lease. These outgoings can include:

- land taxes;
- utilities or other services provided to the tenant;
- insurance costs; and
- management fees.

The scope to charge for management fees as part of outgoing charges has been a part of the lease arrangements entered into by PoM with tenants for some time. Historically, PoM has not sought to recover these management fees through outgoings, but as the costs of administration of leases has risen and PoM has faced other cost pressures, PoM has decided to commence seeking to recover management fees as an outgoing expense.

Importantly, the recovery of these expenses falls within the usual commercial constraints on prices, and so cannot in and of themselves represent a material detriment, particularly given they are determined based on a nominal percentage of rent ranging from 1% to 2.5%. This is significantly below the costs incurred by PoM in managing its land property portfolio, which are estimated at around 5% of rent.

As part of future negotiations, PoM will continue to seek to recover these costs as part of its lease arrangements.

⁵ Essential Services Commission (2020), *Port of Melbourne – Market Rent Inquiry 2020*, Interim Report, 20 March, Melbourne, p 23.



Use of term sheets and negotiation approach

Some stakeholders raised concerns about PoM's use of term sheets as part of the negotiation approach for commercial leases.

Term sheets are more widely known as Heads of Agreement and are always used throughout Australia to agree the key terms of a commercial lease prior to negotiation of the detailed terms and conditions. The role of the Principal Terms Sheet is for the commercial parameters of the lease to be agreed between the parties, before costly legal negotiations are undertaken on the specific terms of the lease.

The signing of a Principal Terms Sheet signals a commitment by both parties to negotiate the terms of the lease, consistent with the commercial parameters set out in the Heads of Agreement. While the signing of a Principal Terms Sheet is an indication of intent, it does not prevent a prospective tenant from choosing to not sign the legal agreement, at a future time.

In addition, the Principal Terms Sheet is non-binding, and expressly provides that it is subject to board approval from both parties.

It follows that PoM's use of term sheets is consistent with common practices used by commercial landlords throughout Australia.

PoM has a commercial interest in ensuring that its land is leased at the highest market rental value, given the specific characteristics of the land and its potential current and alternative uses. We engage in ethical negotiation practices and provide our tenants with the opportunity to seek independent legal advice on the specific terms and conditions of the lease.

There are numerous examples of modifications that have been made to our standard terms and conditions of the lease, as evidenced to the ESC in the confidential lease agreements provided to the ESC in response to its information requests.

Applicability of the *Retail Leases Act 2003* and use of ratchet clauses

The ESC in its Interim Report notes that the *Retail Leases Act* is unlikely to apply to most leases within the port precinct. This reflects the purpose of the *Retail Leases Act*, which is principally to provide protections to small tenants leasing retail premises from landlords. The Act explicitly does not apply to larger retail premises where the occupancy cost exceeds \$1 million per annum, or for tenants that are listed companies, amongst other exclusions.

While the use of ratchet clauses is rendered void by the *Retail Leases Act*,⁶ this does not mean that ratchet clauses more generally should not be applied to commercial leases.

Ratchet clauses on rental adjustments are a common tool used for long-term leases at ports in Australia to manage market rent adjustment risks between a tenant and the landlord. They need to be considered in conjunction with the starting rent level. These clauses, in combination with periodic market rent reviews, ensure that rents are adjusted in line with market drivers over time, thereby avoiding a potentially large step up in market rent at a periodic review.

⁶ Section 35(3), *Retail Leases Act 2003*.



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In addition, ratchet clauses also act to mitigate the risks inherent to landlords in locking in long-term leases, which prevent the landlord from using competitive processes to market test rental rates. In this way, they act to manage the interests of both the tenant seeking a long-term lease and the landlord who might otherwise prefer to seek competitive testing of market rents, over a parcel of land.

In addition, by avoiding large step ups in rental amounts, ratchet clauses facilitate competition between similar land users within a port. By smoothing market rent increases over time, it avoids competitive impacts that might otherwise arise from out-of-sync market rent reviews.

Ultimately, ratchet clauses ensure that rent rises keep pace with increases in market value, avoid price shocks at rent reviews, and facilitate the maintenance of parity between similar port land uses.

Finally, PoM is aware that ratchet clauses are used in other sectors where tenants prefer longer term leases, which prevents competitive testing of land rents (e.g., leases for service station land). It follows that such clauses are commonly used in commercial (non-retail) leases.

Importantly, when negotiating lease terms, PoM is open to considering shorter term leases with options to renew (at the tenant's absolute discretion) as an alternative mechanism for managing rental changes as market value changes over time. These mechanisms allow a tenant to opt out of the lease at the option date for any reason including if the lease clauses result in rentals that are in excess of market rates at the time. Accordingly, a tenant could seek to renegotiate rents at this time at the risk to the landlord of the tenant exiting the lease. For example, PoM recently entered into a 10-year lease with an option for a further 10 years for the sites occupied by a tenant. This provides the tenant with an opportunity to manage its market risks, while also providing for an opportunity to re-evaluate the rental value at the time of exercising the lease renewal option.

Requirements of the Port Concession Deed provide an effective constraint thereby limiting the benefits of additional regulatory methods

PoM believes that there has been no material detriment arising given the constraints on market power and the processes adopted by PoM, and so the current obligations imposed on PoM through the PCD provides sufficient regulatory constraint to address any concerns that the ESC may have.

This reflects PoM's opinion that:

- the costs and risks of a more intrusive regulatory arrangement are not likely to be commensurate with the likelihood or extent of harm that might be avoided; and
- the parties involved in negotiating lease terms and conditions are themselves sophisticated purchasers that have the capability to negotiate effectively within the current arrangements. This is most likely to result in appropriate determinations of market rents, consistent with the intent underpinning the PCD requirements.

PoM would welcome the opportunity to discuss with the ESC its preliminary conclusions on material detriment prior to the finalisation of its report to the Minister, at the conclusion of its Inquiry.