31 May 2023

2023-24 Tariff Compliance Statement

General Statement

Port of Melbourne

Port of Melbourne acknowledges Bunurong, Wadawurrung, and Wurundjeri Peoples of the Kulin Nation as the Traditional Custodians of the land and waters on which our business operates.

We recognise and value their unique cultural heritage, customs, spiritual beliefs and relationship with the land. We pay our respects to their Elders past, present and emerging, and to all Aboriginal and Torres Strait Islander peoples across the communities in which we work.

We acknowledge that we work on the unceded land of Aboriginal and Torres Strait Islander peoples. We recognise the past wrongdoings and injustices against Aboriginal and Torres Strait Islanders and the ongoing inequalities that continue today.

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CEO Foreword

As Australia's largest container and general cargo port, the Port of Melbourne plays an integral role in the lives of our community and the economy of south-eastern Australia. To meet our obligation to act in the long-term interest of Victorians, we have undertaken rigorous engagement to inform our Tariff Compliance Statement (TCS) submission to the Essential Services Commission.

We have heard from Port Users, including international and domestic shipping lines, stevedores and transport providers, cargo owners and freight forwarders and engaged in line with our Pricing order Engagement Protocol, published in late October 2022.

The TCS submission covers our next regulatory period, which is the period of time over which we forecast our costs and prices for Prescribed Services. Although we have done this annually since 2016, following engagement and with consideration of our stakeholders' views, we have decided to adopt a five-year regulatory period, commencing 1 July 2023 and ending on 30 June 2028.

This longer regulatory period will promote stability and predictability of Prescribed Service Tariffs for Port Users. Although our regulatory period will be longer, we will continue to engage with our stakeholders and community on the short and long-term projects undertaken at the port.

We are committed to meeting the obligations of our regulatory framework, our Stakeholder Engagement Framework, progressing our sustainability program and collaborating to deliver projects as part of our 2050 Port Development Strategy.

We look forward to working together.

Saul Cannon

Chief Executive Officer

Port of Melbourne

Abbreviations and acronyms

Term	Description
AASB	Australian Accounting Standards Board
ABBM	Accrual Building Block Methodology
AER	Australian Energy Regulator
AMS	Asset Management System
ARR	Aggregate Revenue Requirement
AtoNs	Aids to Navigation
BST	Base-Step-Trend
CAGR	Compound Annual Growth Rate
CAPM	Capital Asset Pricing Model
CBA	Cost-Benefit Analysis
CGS	Commonwealth Government Securities
CPI	Consumer Price Index
DAE	Deloitte Access Economics
DDM	Dividend Discount Model
DOA	Delegations of Authority
EBITDA	Earnings before interest, taxes, depreciation and amortisation
ECI	Early Contractor Involvement
ELT	Executive Leadership Team
EPCG	Enterprise Project Control Group
EPMF	Enterprise Project Management Framework
ERA	Economic Regulation Authority Western Australia
ESC	Essential Services Commission
FTSE	Financial Times Stock Exchange
HER	Historical excess returns
HV	High Voltage
ICRC	Independent Competition and Regulatory Commission
ICT	International Container Terminal

Term	Description
IMS	Integrated Management System
IPART	Independent Pricing and Regulatory Tribunal of New South Wales
IRC	Investment Review Committee
ISO	International Organization for Standardization
KPI	Key Performance Indicator
MCA	Multi-Criteria Analysis
MDP	Maintenance Dredging Program
MNR	Minimum Necessary Requirements
MRP	Market Risk Premium
NPV	Net present value
NZCC	New Zealand Commerce Commission
OH&S	Occupational Health and Safety
P&CM	Procurement and Contract Management
PCD	Port Concession Deed
PCEP	Port Capacity Enhancement Program
PCG	Project Control Group
PCP	Port Capacity Project
PDIP	Port Development Implementation Plan
PDS	2050 Port Development Strategy
PLT	Port Lease Transaction
PMA	Port Management Act 1995
POEP	Pricing Order Engagement Protocol
PoM	Port of Melbourne
PRTA	Port Rail Transformation Agreement
PRTP	Port Rail Transformation Program
QCA	Queensland Competition Authority
QS	Quantity Surveyors
RAB	Regulatory Asset Base
RBA	Reserve Bank of Australia

Term	Description
RTS	Reference Tariff Schedule
SAMP	Strategic Asset Management Plan
SDW	Swanson Dock West
SL-CAPM	Sharpe-Lintner Capital Asset Pricing Model
SoRA	Statement of Regulatory Approach
SRM	Stakeholder Relationship Management
TAL	Tariffs Adjustment Limit
TCS	Tariff Compliance Statement
TEU	Twenty-foot equivalent unit
VPMF	Voluntary Performance Modelling Framework
WACC	Weighted Average Cost of Capital
WATI	Weighted Average Tariff Increase
WDE	Webb Dock East
WDN	Webb Dock North

Executive Summary

Our 2023-24 Tariff Compliance Statement

This document forms part of our annual Tariff Compliance Statement (TCS) to the Essential Services Commission (ESC). It demonstrates how our tariffs for Prescribed Services for the next regulatory period comply with the Pricing Order.

The next regulatory period runs from 1 July 2023 until 30 June 2028, and so the content of this TCS relates to that period.

Prescribed Services include the provision of channels, berths, short-term storage and access to wharves, roads and rail.[1] Leasing of space and facilities on Port land is classified as a non-Prescribed Service and is not covered by this TCS.[2]

Stakeholder engagement is a priority for Port of Melbourne

We value the relationships and interactions with stakeholders that inform our business strategy, daily operations and regulatory obligations. The current regulatory period (2022-23) saw a number of key developments in our engagement practices that will deliver near term objectives and position us for continual improvement.

This included clarifying and confirming our commitments through the Pricing Order Engagement Protocol (POEP) and Stakeholder Engagement Framework, implementation of a new annual Stakeholder Perceptions Survey which facilitates a better understanding of our stakeholders, and developing an engagement culture and capacity within our organisation.

A number of project engagements also provided an opportunity for us to embed practices, develop a broader understanding of stakeholder perspectives and refine our approach to engagement.

Together, these activities have informed the 2023 Industry Engagement program. This program provided further insight into how we can best respond to our stakeholder needs. The feedback we received has influenced the decisions we have made in this TCS and is being incorporated into our future work and engagement plans. In addition, insights gained from the 2023 Industry Engagement program will be used to inform continued internal implementation and operationalisation of our Stakeholder Engagement Framework.

There was substantially greater participation in the 2023 Industry Engagement compared to 2022:

- 15 in-depth interviews to co-design the engagement compared to 12 in 2022;
- 65 people attended our in-person and online briefing sessions compared to 51 in 2022;
- 14 stakeholders requested one-on-one meetings, compared to nine in 2022; and
- 41 submissions via our Feedback Form compared to eight in 2022.

Encouragingly, 29 out of 30 respondents agreed with the statement "Port of Melbourne's engagement with my organisation is continuously improving."[3]

[1]

[2]

[3] While we received 41 submissions, not all submissions responded to each question in the Feedback Form – e.g. we received 30 responses to the question "PoM's engagement with my organisation is continuously improving"

We are adopting a five-year regulatory period to promote stability and certainty

The regulatory period is the period of time over which the Pricing Principles and Cost Allocation Principles in the Pricing Order apply. It is the period of time over which we forecast our costs and prices for Prescribed Services.

The ESC has previously outlined its view that a longer regulatory period, such as a five-year period, would be in the best interests of Port Users and Victorian consumers compared to a one-year period.

We have been engaging with stakeholders on the length of the regulatory period for some time. In previous years we heard from stakeholders that we should consider principles of stability, transparency and consistency when choosing the length of regulatory period. We have also heard from Port Users that they would like greater certainty and more advanced notice about price changes.

Building on this feedback, for our 2023 Industry Engagement we designed an approach with our stakeholders that sought to maximise participation in our decision on regulatory period length. We presented our proposal to adopt a five-year regulatory period, outlining our views that a five-year regulatory period would:

- Provide more certainty and stability for prices and service delivery; and
- Improve cost recovery and provide stronger incentives for us to make efficient investments in the long-term interests of Victorian consumers.

The findings of our engagement process were that stakeholders had maximum opportunity to participate, and that nobody was against the move to a longer regulatory period. A number of stakeholders identified benefits of a longer regulatory period in their feedback to us, such as:

- Prices would be fair and reasonable;
- Increased pricing stability and certainty; and
- It would support planning and promote investment.

After having regard to the feedback from our stakeholders, for the next five years, PoM has decided to adopt a five-year regulatory period, commencing 1 July 2023 and ending on 30 June 2028.

We are investing to maintain service levels and preparing to ensure we can meet Victoria's trade needs

PoM's net prescribed capex forecast for the 2023-24 to 2027-28 Regulatory Period is $705.7m. Average total capital expenditure is $141.1m per annum, compared to the historical average of around $90.4m per annum (including the $207.4m forecast to be spent in 2022-23).

Our capital expenditure forecast has been developed in line with the following principles to ensure we deliver services to Port Users at least cost and meet our regulatory obligations:

- Prudency and efficiency – projects need a well-defined driver and demonstrated approach for achieving least cost in procurement and delivery;
- Deliverability – the forecast as a whole should be consistent with our proven ability to deliver a certain
- level of capex; and
- Appropriate allocation of risk – there should be appropriate sharing of risks of forecasting error between PoM and Port Users, and we need to demonstrate that cost recovery from Port Users is reasonable.

The key drivers of our forecast are:

- Maintaining services in accordance with our obligations under the Port Concession Deed, including:
- Swanson Dock West remediation, which requires major remediation to ensure that we maintain the service levels required by Port Users. We engaged extensively on the project such that the delivery

approach reflects the concerns and preferences of impacted stakeholders, and will continue to work with our Port Users to reduce and mitigate impacts on port operations during the project works; and

- Our ongoing program of periodic dredging. We are planning to undertake dredging less frequently and more efficiently, to ensure we deliver the required level of service at least cost and with the least amount of disruption.
- Preparing for the next phase of investment in container capacity and closing out existing growth programs:
  - The Port Capacity Enhancement Program (PCEP) has the core objective of expanding capacity and enhancing facilities at the Port to meet Victoria's growing trade needs. Expenditure included in the TCS forecast includes only the scope of works required for the planning and design activities necessary to make a decision concerning the timing for progressing to construction. Stakeholder engagement is a key focus for this phase of the program and is ongoing. We recognise that engaging stakeholders in our planning process for PCEP leads to informed decision-making that balances the needs and interests of relevant parties; and
  - The Port Rail Transformation Project (PRTP) and Webb Dock East Berth 4/5 Extension project will be completed in the first year of the regulatory period and will provide enhanced rail services and support us in meeting our obligations to accommodate changing vessel size.

We are taking a risk-based approach to our investment program and taking on project risks on behalf of Port Users

With respect to managing uncertainty for the capital projects forecast, we are taking a risk-based approach to forecasting and bearing a material level of forecasting and delivery risk, such that Port Users are not asked to bear the full cost should the project scope or timing change. This has been achieved via:

- Including only a portion of the total expected capex in the forecast. For example:
  - for the Port Capacity Enhancement Program (PCEP) we have included early design and planning costs in our forecast, but no construction costs[4];
  - while we anticipate undertaking major rehabilitations at Yarraville 6 and Appleton Dock, we have included only minor renewals expenditure in our forecast. To the extent that we do incur costs above our forecast we will bear the upfront costs before including only prudent and efficient expenditure in our regulatory asset base;
- Optimising contingency allowances where we consider it appropriate for PoM to bear the costs of uncertainty on behalf of Port Users. In total, we have excluded $45.6m of project allowances and contingencies from our forecast; and
- Smoothing the profile of major project expenditure to ensure deliverability.

Our view is that these approaches have the effect of providing significant benefits to Port Users from the adoption of a five-year regulatory period, because there will be strong incentives on PoM to deliver outcomes via capital projects at the lowest efficient cost.

The level of our prices will not increase in real terms over the regulatory period

Our Prescribed Services Tariffs for the regulatory period from 2023-24 to 2027-28 are subject to the Tariffs Adjustment Limit (TAL), which requires that our Weighted Average Tariff Increase (WATI) be no more than the annual change in the Consumer Price Index (CPI).

[4] If actual PCEP expenditure exceeds our forecast we may seek to make an ex-post revision to our cost base, but only in the event that our expenditure over the next five years exceeds our forecast by more than $100m

Our 2023-24 tariffs are set out in the accompanying Reference Tariff Schedule (RTS) and are effective from 1 July 2023. For 2023-24:

- All tariffs will increase by 7.0 per cent, being the annual change in CPI to March 2023;
- All tariffs have been adjusted by the same percentage adjustment (consistent with clause 3.2.1 of the Pricing Order); and
- There are no new or discontinued tariffs.

For each year of the five-year regulatory period, the WATI will be set at the TAL (the annual change in CPI to March for the preceding financial year). That is, our price path for the five-year regulatory period is CPI – 0% for each year.

Unless PoM submits, and the ESC approves, a tariff rebalancing application during this period, all tariffs will increase at CPI for each of the five years of the regulatory period.[5]

Table E1 WATI and TAL, 2023-24 to 2027-28

	2023-24	2024-25	2025-26	2026-27	2027-28
Weighted Average Tariff Increase	7.02%	CPI – 0%	CPI – 0%	CPI – 0%	CPI – 0%
Tariff Adjustment Limit	7.02%	CPI (March 2023 to March 2024)	CPI (March 2024 to March 2025)	CPI (March 2025 to March 2026)	CPI (March 2026 to March 2027)

We have complied with the terms of the Undertaking and addressed compliance issues raised by the ESC in its Inquiry and Interim Commentary

On 20 May 2022, the Victorian Government accepted an Undertaking prepared by PoM in response to the findings of non-compliance in the ESC's inquiry into PoM's compliance with the Pricing Order for the five-year period from 1 July 2016 to 30 June 2021. The Undertaking was accepted by the ESC Minister as appropriate to adequately address PoM's non-compliance, and is legally binding until 30 June 2027. The Undertaking:

- Commits to the approaches that will be applied by PoM to calculate the Weighted Average Cost of Capital (WACC), which addresses the ESC's findings on return on capital and ARR; and
- Outlines PoM's commitment to develop and publish a Pricing Order Engagement Protocol which will, among other internal process initiatives, improve PoM's engagement practices under the Pricing Order.

In line with the undertaking, we delivered on our commitment to develop and publish a Pricing Order Engagement Protocol (POEP)[6], and in March 2023, we went further by launching our Stakeholder Engagement Framework publicly for the first time.[7]

Our approach to estimating the WACC complies with the Undertaking, and we have also addressed the preliminary views of the ESC on WACC as outlined in its Interim Commentary by adopting a country filter for the selection of comparators to estimate beta for the 2023-24 to 2027-28 regulatory period.

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[5] Under a rebalancing application, the weighted average annual change in tariffs will still be capped at CPI, however some tariffs could change by more or less than others.

[6] The POEP and a summary of feedback from our 2022 Industry Consultation Program and how it has informed the draft POEP, is available on our website here.

[7] PoM, Stakeholder Engagement Framework, 2023. Available on our website here.

We have also addressed comments made by the ESC in both its Inquiry and Interim Commentary regarding our operating expenditure forecasts, by:

- Adopting the Base-Step-Trend (BST) as the basis of the opex forecast for the five-year regulatory period;
- Using 2019-20 operating expenditure as the base year for the forecast; and
- For the purposes of establishing an efficiency assumption for the next regulatory period, we have used net efficiency as the driver of trend operating expenditure.

Our operating cost forecast for the next regulatory period contains explicit and ambitious efficiency targets. We have committed to achieving:

- A general productivity growth rate of 3.0% p.a.; and
- An average net efficiency rate of -0.3% p.a. (i.e., no real growth in opex from 2022-23 through 2027-28 including step changes).[8]

[8] We have set our internal opex targets based on total controllable opex rather than prescribed opex. This approach is considered to provide a more meaningful target on the basis that a significant portion of opex is shared between prescribed and non-prescribed services and allocated based on share of revenue, which is largely outside of PoM's control.

1 About this TCS

1.1 Purpose

PoM is required to submit an annual TCS to the ESC by no later than 31 May each year[9] that demonstrates how its tariffs for Prescribed Services for the upcoming financial year comply with the Pricing Order. Prescribed Services include the provision of channels, berths, short-term storage and access to wharves, roads and rail. The leasing of space and facilities on Port land are classified as non-Prescribed Services. These non-Prescribed Services are not subject to the Pricing Order with our associated charges based on commercial agreements. Non-Prescribed Services are not covered by this TCS.[10]

Clause 7.1.2 of the Pricing Order provides that the TCS must:

- Set out our tariffs for the forthcoming financial year;
- Detail the basis of any adjustments to tariffs (i.e., re-balancing), including any new or discontinued tariffs, including the cost building blocks that have been applied and the basis on which the rate of return has been estimated;
- Provide information on contracts with Port Users;
- Describe how we have consulted with, and had regard to feedback from, Port Users;
- Explain how our tariffs for the forthcoming year comply with the Pricing Order, including the Pricing Principles and Cost Allocation Principles;
- Contain any further supporting information determined by the ESC, in accordance with clause 9 of the Pricing Order; and
- Comply with the information requirements in clause 8 of the Pricing Order.

Appendix S is a compliance checklist that cross-references where in this TCS the requirements of clause 7 have been addressed.

1.2 Structure

This document is structured as follows:

- Chapter 2 explains the regulatory context to this TCS;
- Chapter 3 summarises our stakeholder engagement and how we have had regard to comments from Port Users and stakeholders;
- Chapter 4 explains why we have adopted a longer regulatory period and how we will manage implementation issues and the allocation of risks;
- Chapter 5 sets out our approach to forecasting prudent and efficient capital expenditure;
- Chapter 6 sets out our approach to forecasting prudent and efficient operating expenditure;
- Chapter 7 describes how we have allocated costs to prescribed and non-prescribed services;
- Chapter 8 provides a summary of our demand forecast for the next regulatory period;
- Chapter 9 sets out the rate of return on capital;
- Chapter 10 demonstrates the calculation of the Aggregate Revenue Requirement and compares this to Prescribed Services revenue;

[9] Under clause 7.1.1(a) of the Pricing Order

[10] The ESC undertakes periodic reviews of our rental agreements with Port tenants in accordance with section 53 of the *Port Management Act (Victoria) 1995*.

- Chapter 11 describes how our Prescribed Services tariffs for the regulatory period comply with the Pricing Order; and
- Chapter 12 describes our alternative depreciation methodology and provides updated indicative projections of impacts on Port Users.

Key supporting information is included in the Appendices:

- Appendix A — Reference Tariff Schedule
- Appendix B — Regulatory Model
- Appendix C — Regulatory Model User Guide
- [redacted]
- Appendix E — Insync - Industry Engagement Summary
- Appendix F — 2023 Industry Engagement Information Pack
- Appendix G — Incenta - Transitioning to a multi-year regulatory period
- Appendix H — Swanson Dock West Remediation Project – Stakeholder Engagement Report
- [redacted]
- Appendix M — DAE - Trade Forecasts Summary Report
- Appendix N — GHD - Port of Melbourne Fleet Forecasts – Channels
- Appendix O — HoustonKemp – Estimation of the weighted average cost of capital and forecast inflation
- Appendix P — HoustonKemp – 2022-23 WACC for the Port of Melbourne with and without country filter
- [redacted]
- Appendix R — TCS Governance
- Appendix S — Compliance with the Pricing Order
- [redacted]

[redacted]

1.3 Financial information and use of terminology

This document contains the following financial information:

- 2016-17 to 2021-22 – actual values;
- 2022-23 – estimated values — values for the financial year in progress (i.e. the 'current regulatory period') have been updated to reflect the most recent estimates available. These estimates generally reflect nine months of actual data and three months of forecast data; and
- 2023-24 to 2027-28 – forecast values for the five-year regulatory period (i.e. the 'next regulatory period').

All financial information provided in this TCS is denominated in nominal dollars (referred to as "current price terms" in clause 8.1.1 of the Pricing Order), unless otherwise stated. The numbers in the tables may not sum due to rounding. All clause references are to the Pricing Order, unless otherwise stated. Capitalised terms that are not otherwise defined have the meaning given in the Pricing Order.

In this document:

- 'Prescribed Services revenue (subject to the TAL)' means revenue from Prescribed Services in our Reference Tariff Schedule (RTS). It does not include revenue associated with contracts for Prescribed Services; and
- 'ARR' means the Aggregate Revenue Requirement calculated using the ABBM. The initial 2016 capital base included the assets associated with legacy contracts for Prescribed Services that were in place at the time of Port Lease Transaction (PLT). The ARR is therefore inclusive of revenue associated with these legacy contracts.

We have added Prescribed Services revenue associated with the legacy contracts to "Prescribed Services revenue (subject to the TAL)" for the purposes of comparing it with the ARR. We have agreed to this treatment of legacy contracts with the ESC.

We have also agreed with the ESC that the costs and revenues of all new Prescribed Services contracts entered into after the PLT should be excluded from the WATI calculation and all comparisons of revenue streams, albeit that we are fully disclosing the revenue earned under these Prescribed Services contracts in Appendix Q.

We are only submitting data for the regulatory period from 2023-24 to 2027-28. Future calculations beyond 2027-28, and any modelling input assumptions (e.g. CPI in future years), are included for illustrative purposes only.

2 Regulatory context

2.1 Our regulatory framework and investment obligations

PoM's regulatory framework and investment obligations are primarily contained in:

- The stewardship and development obligations in the Port Lease; and
- The regulatory and pricing controls in the Pricing Order.

A brief summary of our stewardship obligations under the Port Lease and regulatory controls under the Pricing Order is provided below.

2.1.1 Stewardship obligations

PoM's stewardship obligations under the Port Lease require PoM to:

- Manage, operate and maintain the Port in accordance with Good Operating Practice;[11]
- Ensure the Port is capable of providing access to shipping, including being able to reasonably accommodate changing vessel sizes;[12]
- Develop the Port land and infrastructure to:
  - Cater for actual and reasonably anticipated growth;
  - Provide quality and efficiency standards expected of a major port; and
  - Maintain the Port's leading position among major Australian ports in terms of its quality, efficiency and effectiveness.[13]

2.1.2 Pricing Order

The Pricing Order is a regulatory instrument issued by the Governor in Council under section 49A of the Port Management Act 1995 (PMA) to regulate the setting of tariffs for Prescribed Services.[14]

The Pricing Order came into effect on 1 July 2016 and regulates the setting of tariffs for Prescribed Services, which relate to the provision of services by investing in wharves, berths and channels for shipping. The Pricing Order was amended in May 2020 to adjust prices and deem prudent certain expenditure in relation to the Port Rail Transformation Agreement (PRTA).

The Pricing Order defines a 'Pricing Order transition period' which runs until 2032, or latest 2037.[15] During the Pricing Order transition period a price smoothing mechanism limits the tariffs to the lesser of two binding constraints:

- The Tariffs Adjustment Limit (TAL), which limits weighted annual tariff increases to inflation (CPI);[16] or
- To recover no more than PoM's prudent and efficient costs, determined by application of an accrual building block methodology.[17]

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[11] Where 'Good Operating Practice' means: adherence to a standard of practice which includes the exercise of that degree of skill, diligence, due care, prudence and foresight which would reasonably be expected of a reasonably experienced, competent, prudent and qualified operator of the Port; and provision of appropriate services and facilities for the ease of access to, expeditious and safe movement in and efficient use of the concession area and port infrastructure by vessels, vehicles and other users of the Port.

[12]

[13]

[14] The Port Management Act, Pricing Order and May 2020 amendment to the Pricing Order are available on our website here [Regulatory Quick Links | Port of Melbourne]

[15] Pricing Order clause 3.4

[16] Pricing Order clause 3.1

[17] Pricing Order clause 2.1.1

The Pricing Order also requires that any operating and capital costs we incur and recover from Port Users through prices are prudent and efficient.[18]

2.2 ESC Pricing Order compliance inquiry

On 28 January 2022, the ESC published its final report on its first inquiry into PoM's compliance with the Pricing Order for the five-year period from 1 July 2016 to 30 June 2021 (the review period).[19]

The key findings of the ESC were as follows:

- The ESC made a finding of significant and sustained non-compliance in relation to the rate of return (and therefore aggregate revenue requirement), and with respect to consultation with Port Users;
- The ESC found sustained non-compliance in relation to PoM's operating expenditure forecasts, cost allocation, tariffs, and the content of Tariff Compliance Statements; and
- The ESC found PoM was compliant in relation to its capital expenditure, depreciation (including the deferral of depreciation) and demand forecasting.

There were no price impacts on Port Users during the review period as a result of the findings of non-compliance.

2.3 PoM's response to the inquiry

The Victorian Government has accepted an Undertaking prepared by PoM in response to the ESC Inquiry. The Undertaking and associated response outlines actions PoM will take to remedy the non-compliance identified by the ESC and our commitment to ensure compliance going forward.

The Undertaking has been accepted by the ESC Minister as appropriate to adequately address PoM's non-compliance. The Undertaking is legally binding until 30 June 2027, in line with the ESC's next review. PoM considers that the Undertaking will provide the appropriate degree of certainty to PoM and to Port Users for the next five years until the ESC completes its next review of PoM's compliance with the Pricing Order.

The Undertaking responds to matters on which the ESC found significant and sustained non-compliance by PoM. The Undertaking:

- Commits to the approaches that will be applied by PoM to calculate the Weighted Average Cost of Capital (WACC), which addresses the ESC's findings on return on capital and ARR. Chapter 9 describes how we have estimated the WACC for this regulatory period in a manner consistent with the commitments in the Undertaking; and
- Outlines PoM's commitment to develop and publish a Pricing Order Engagement Protocol which will, among other internal process initiatives, improve PoM's engagement practices under the Pricing Order. Chapter 3 details the process we undertook to develop a Pricing Order Engagement Protocol and documents a number of other initiatives undertaken during 2022-23 to improve our approach to engaging with our stakeholders.

Our 2022-23 TCS detailed a number of additional measures that respond to matters that were raised by the ESC which were considered sustained but not significant. Chapters 5 and 6 of this TCS include updates on our actions to address ESC findings and recommendations on capital expenditure and operating expenditure, respectively.

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[18] Pricing Order clause 4.1.1 and 4.2.1
[19] The ESC's final report is available on its website: [Inquiry into Port of Melbourne compliance with the pricing order 2021 | Essential Services Commission]

The Undertaking and a summary of other measures taken by PoM to respond to the ESC's findings can be found in the Public Summary of the PoM Response to the ESC Review Findings, available on the PoM website.

2.4 ESC's Interim Commentary on the 2022-23 TCS

On 20 December 2022, the ESC released its Interim Commentary which set out its preliminary views on PoM's Pricing Order compliance in setting tariffs for 2022-23. The ESC's preliminary views were that:

- Our WACC generally reflected well accepted approaches;[20]
- Our stakeholder engagement processes were effective;[21]
- The measures we had taken to strengthen our capital planning processes appear appropriate for our proposed capital works;[22] and
- Our approach to the recovery of deferred depreciation was reasonable.[23]

The ESC did, however, note that we should:

- Use 2019-20 as the base year for future operating expenditure forecasts (rather than the most recent year of actuals) and consider net efficiency as the driver of trend operating expenditure;[24]
- Reconsider our decision to not apply a country filter to estimate the beta in our WACC;[25] and
- Continue to engage on our deferred depreciation approach.[26]

Chapters 6 and 9 describe how we have addressed the ESC's comments regarding forecasting operating expenditure and estimation of the WACC, respectively. Chapter 12 describes the additional engagement we have undertaken regarding our deferred depreciation approach and provides updated indicative projections of tariff impacts to ensure Port Users are informed.

The ESC also commented on the one-year regulatory period we adopted in 2022-23, expressing the view that a longer regulatory period would provide greater certainty for Port Users.[27] Chapter 4 describes how we have adopted a longer regulatory period of five years beginning in 2023-24.

[20] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 9
[21] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 23
[22] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 17
[23] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 21 8)
[24] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 16
[25] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. vi
[26] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. 21
[27] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p. viii

3 Stakeholder engagement

3.1 Overview

This Chapter of the TCS sets out:

- Regulatory context for stakeholder engagement;
- A summary of our work in continuing our stakeholder engagement uplift;
- An overview of our major engagement activity over the past year, and how we have complied with the Pricing Order and guidance from the ESC in its Statement of Regulatory Approach (SoRA):
  - 2023 Industry Engagement;
  - Swanson Dock West Rehabilitation;
  - Port Capacity Enhancement Program (PCEP); and
  - Ongoing commercial and industry information.

3.2 Regulatory context

3.2.1 Pricing Order requirements

The Pricing Order sets out the following requirements for stakeholder engagement:

> *7.1.2(d) The Tariff Compliance Statement must… set out the process by which the Port Licence Holder has effectively consulted and had regard to the comments provided by Port Users.*

The Pricing Order defines a 'Port User' as a 'person who requests or receives Prescribed Services', which include the provision of channels, berths, short-term storage and access to wharves, roads and rail.[28]

The ESC considers that Port Users may include international and domestic shipping lines carrying cargo to and from Melbourne through Port Phillip Bay, stevedores that access and use wharf infrastructure to handle cargo for shipping lines and transport providers, cargo owners and freight forwarders.[29]

Notwithstanding this definition and the specific obligations concerning Port Users, our stakeholder engagement, where appropriate, extends to other stakeholders that may not be captured under this definition.

3.2.2 Progress against Undertaking and Interim Commentary

In its inquiry into PoM's compliance with the Pricing Order for the period from 1 July 2016 to 30 June 2021 (published 28 January 2022), the ESC made a finding of significant and sustained non-compliance in relation to clause 7.1.2(d). The ESC's view was that PoM had not demonstrated it effectively consulted or had adequate regard to Port Users' comments in our 2020-21 and 2021-22 TCS.[30]

In our 2022-23 TCS we identified that we addressed the ESC's findings on engagement via:

- An enforceable Undertaking that addresses the ESC's findings of significant and sustained non-compliance. In relation to stakeholder consultation, the Undertaking outlined PoM's commitment to develop and publish a Pricing Order Engagement Protocol (POEP) in the subsequent months which would, amongst other general internal process initiatives, improve PoM's engagement practices under the Pricing Order[31] (the POEP has since been published, as explained below); and

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[28] Prescribed Services are defined in Section 49(1)(c) of the Port Management Act 1995 (Vic)
[29] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.8
[30] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.112
[31] The Undertaking is available on our website: Regulatory Process | Port of Melbourne

- Further refinement of our annual engagement on the TCS under the 2022 Industry Consultation program, including extending the timeframe for engagement, preparing a detailed Consultation Paper and undertaking a post-engagement review.

On 27 October 2022, PoM published the Pricing Order Engagement Protocol (POEP) following public engagement on the draft through September 2022.

On 20 December 2022, the ESC released its Interim Commentary on PoM's 2022-23 TCS. The ESC's Interim Commentary recognised the progress made by PoM in addressing compliance issues raised in the Inquiry, including in relation to engagement:[32]

> *We are encouraged by the Port's approach to continually improve its engagement processes. A post engagement review report of the virtual March 2022 forum and meetings was undertaken by the Port's consultants. The findings and learnings from the review appear to be incorporated into the Port's engagement practices.*
>
> *Overall, our preliminary view is that it appears that the Port has undertaken engagement with port users and other stakeholders that is consistent with generally accepted practices and approaches for effective consultation. The Port also appears to have had regard to port users' comments, which have informed its decisions.*

3.3 Continuing our stakeholder engagement uplift

3.3.1 Overview

We are committed to stakeholder engagement that is inclusive, timely, genuine and transparent. The current regulatory period (2022-23) saw a number of key developments in our engagement processes that will deliver near term objectives and position us for continual improvement.

These activities included clarifying and confirming our commitments through the POEP and Stakeholder Engagement Framework, better understanding stakeholders through a new annual Stakeholder Perceptions Survey, and developing the engagement culture and capacity within our organisation.

A number of project engagements also provided an opportunity for us to embed practices, develop a broader understanding of stakeholder perspectives and refine our approach to engagement.

Our engagement leading up to the 2023-24 TCS included:

- 2023 Industry Engagement to address specific issues for decisions to be made for the 2023-24 TCS and beyond;
- Stakeholder and Community Perceptions Research by SEC Newgate; [33]
- Engagement on the scope of and adoption of our POEP;[34]
- Engagement on major projects and their service outcomes, to inform delivery of projects under the PDS; and
- Our regular program of commercial and industry information exchange.

Activities during the current regulatory period are outlined below in Figure 3-1.

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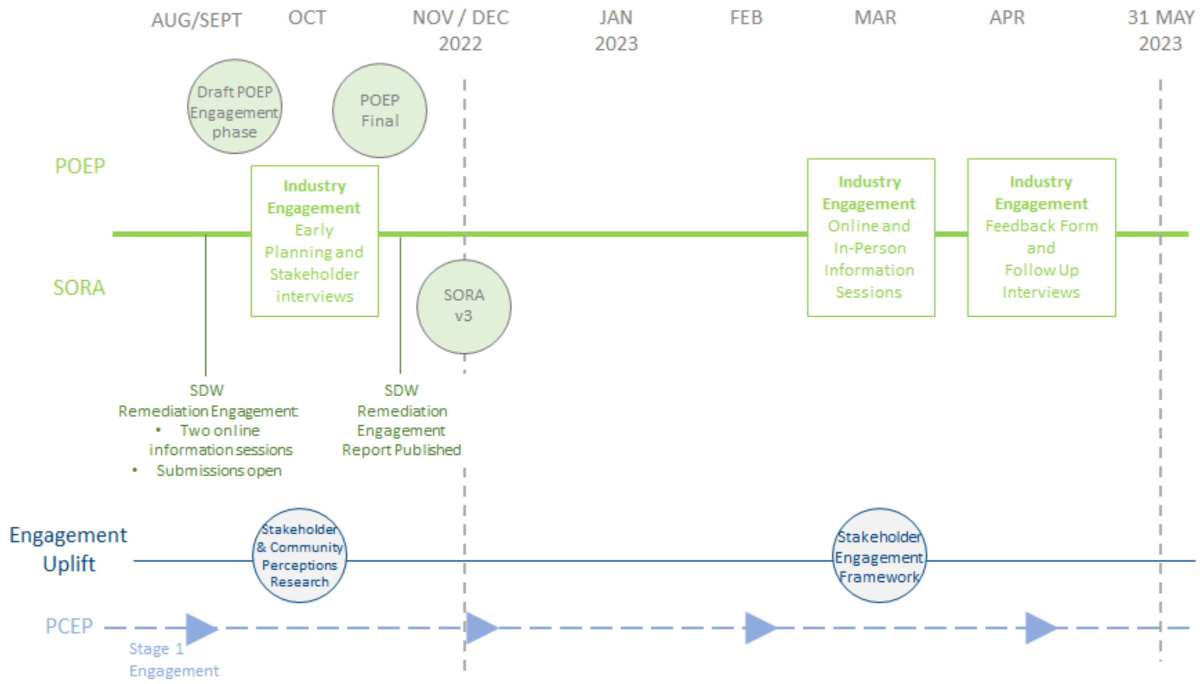
[32] ESC, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23, 20 December 2022, p.22

[33]

[34] A summary of the 2022 Industry Engagement input into POEP can be found here: https://www.portofmelbourne.com/wp-content/uploads/Stakeholder-Feedback-Report-as-input-to-draft-POEP.pdf

Figure 3-1 Key engagement activities during the 2022-23 regulatory period



3.3.2 Development of our Pricing Order Engagement Protocol (POEP)

The POEP, as required under PoM's Undertaking, was developed through engagement with stakeholders. The POEP:

- Provides clarity on our approach to consulting Port Users on matters under the Pricing Order. In particular, it sets out a five-step process with key issues to be considered at each stage of the process; and
- Articulates our consultation commitments and the process by which PoM incorporates Port User feedback into our decision making.

Stakeholders provided feedback during the 2022 Industry Engagement as to how they would like to be engaged on port development,[35] and a draft POEP was released for comment in September 2022. Following consideration of feedback and advice to stakeholders as to how PoM had regard to that feedback, the POEP was published on 27 October 2022.

The POEP is intended to be refreshed as required to reflect feedback received through consultation, research, the changing dynamics of stakeholders and projects, emerging trends, and important innovations in engagement practice.

Table 3-1 Summary of feedback on the draft POEP and how we responded

What we heard	How we responded
Consultation Commitment PoM should publish a statement outlining its approach to consultation and commit that consultation will meet this standard moving forward.	We published the protocol that outlines PoM's approach to consulting on regulatory matters. PoM's commitment to the POEP and its application is outlined in Section 1 of the POEP.

[35] See PoM, 2022-23 TCS – General Statement, May 2022, available on our website here; and PoM, 2022-23 TCS – Appendix G: Summary of consideration of stakeholder comments, May 2022 , available on the ESC website here

What we heard	How we responded
Consultation Standards PoM should identify a recognised consultation standard or framework that it will adhere to.	We have a commitment to apply the IAP2 (International Organisation for Public Participation) Quality Assurance Standard when consulting with Port Users on material matters and in formal consultation programs where it is not inconsistent with the requirements of the regulatory framework.
Consultation Audience PoM should identify who it will consult and at what stage.	Given the broad nature of the POEP it is difficult to identify specific Port Users at specific stages of consultation. Rather, the POEP recognises the need to identify Port Users and their particular consultation needs in general and to consider the level of interest of different Port Users as part of the approach to consultation planning.
Consultation Timeframes A reasonable timeframe is required for consultation and for stakeholders to consider and respond to supporting information.	On material matters and in formal consultation programs, we will provide a reasonable time period for engagement. For most matters this is expected to be: ▪ 2 weeks' notice prior to commencement of consultation with the notice to be provided in a form appropriate to reaching Port Users, and ▪ 4 weeks for a formal consultation period.
Confidential Information PoM should explain how it will use confidential information to inform its decision making.	*Section 6* of the POEP explains how PoM will treat commercially sensitive information.
Port User Feedback Greater transparency on how feedback is used by PoM to inform decision making including providing some level of visibility to stakeholders about how feedback was adopted or disregarded	The POEP recognises the need to allow appropriate consultation when proposals are still in the formative stage and explains the mechanisms through which Port Users can provide feedback. The POEP also outlines the mechanisms for us to communicate how feedback has been used to inform our decision making.
Consultation Materials An agreed level of minimum supporting information which will be provided to support consultation.	The POEP covers our approach to consulting on regulatory matters under the Pricing Order and therefore needs to be broad in nature. However, the need to ensure that consultation materials provide appropriate information to enable Port Users to make meaningful contributions has been captured under *Section 5 Our Regulatory Consultation Process* ('Implement consultation' step).
Consultation planning Where topics are substantial they may warrant separate and more detailed analysis in a standalone consultation process.	Section 5 *Our Regulatory Consultation Process* addresses this point of feedback by identifying the key matters for us to consider including, for example, the process of and approach to consultation and ensuring the consultation materials and form of consultation are appropriate to the matter on which we seek to engage.

3.3.3 Stakeholder and Community Perceptions Research 2022

We commissioned research on stakeholder and community perceptions in 2022 from SEC Newgate.[36] The first of its type undertaken by PoM.

Research findings were shared with stakeholders, and showed that while PoM has a positive reputation overall, there were some clear priorities for further improving our engagement:

- Consistent and clear engagement processes for, and information about, future plans;
- More effort to understand stakeholder needs and establish appropriate engagement with them;
- Appropriate resourcing for, and whole of business commitment to, stakeholder engagement; and
- More timely and consistent follow-up, including closing the loop on how feedback has been considered.

The research also highlighted a shared focus on sustainability, including participants' desire to collaborate for broader supply chain resilience. This feedback informed development of our Stakeholder Engagement Framework and the 2023 Industry Engagement Program, and we will test the progress in the 2023 Stakeholder Perception Survey.

3.3.4 Public release of our Stakeholder Engagement Framework

In March 2023, we publicly launched our Stakeholder Engagement Framework (the Framework).[37] This incorporated the feedback we received through various project engagements, as well as the Stakeholder Perception Survey and past TCS engagements.

The Framework brings together our principles, our approach, and what our engagement looks like at an overall corporate level. It is a public document on our website and was promoted during our 2022-23 Industry Engagement, as well as through our social media channels.

We will be seeking feedback on the Framework in our 2023 Stakeholder Perception Survey, with findings expected in August.

3.3.5 We are developing a culture of engagement

PoM's strong focus is on developing and resourcing a culture of engagement to cement and activate our Stakeholder Engagement Framework. We are investing in internal capacity, including:

- Formal IAP2 training for all executives, senior managers and to be rolled out across the organisation;
- A dedicated stakeholder relations team and representation on the Executive Leadership Team;
- New Stakeholder Relationship Management (SRM) technology platform;
- New stakeholder engagement policies, templates and internal processes; and
- Alignment of stakeholder engagement with our Enterprise Management Framework.

We are delivering a cultural and organisational program to embed engagement practice across our business. The objective of the three-phase program is to ensure changes to stakeholder engagement practices and systems are adopted, used and sustained by PoM staff through cultural and behavioural change. The main activities within each of the three phases include the following:

- Phase One – change health check, stakeholder analysis, and change planning;
- Phase Two – training preparation and delivery, communications and engagement, and tracking and monitor readiness; and
- Phase Three – sustainment planning, transfer of ownership, change performance review.

36

37 PoM, Stakeholder Engagement Framework, 2023. Available on our website here.

3.4 2023 Industry Engagement

PoM's 2023 Industry Engagement Program reflects PoM's Stakeholder Engagement Framework and POEP, delivering an inclusive, genuine, timely and transparent engagement process. It incorporated lessons learnt from previous engagements, including how stakeholders wished to be engaged, the matters they were interested in and the form of information they received. It included clear identification and planning stages, provided different and tailored options for engagement and informed final decisions for implementation in the 2023-24 TCS and beyond.

The Pricing Order[38] and the ESC's Statement of Regulatory Approach (SoRA)[39] require us to set out the process to effectively consult Port Users. Specifically, the SoRA states that the ESC expects our TCS to provide:

- Details of our consultation process with Port Users;
- Issues raised and feedback provided by Port Users; and
- How we have taken into account the views of Port Users when making decisions.

Our 2023 Industry Engagement addressed these requirements as described in detail in the materials listed below in Table 3-2, all of which form part of this TCS.[40]

In section 3.4.3 below we also provide a reconciliation to the principles for assessing compliance with the Pricing Order as contained in the SoRA.[41]

There was substantially greater participation in the 2023 Industry Engagement compared to 2022:

- 15 in-depth interviews to co-design the engagement compared to 12 in 2022;
- 65 people attended our in-person and online briefing sessions compared to 51 in 2022;
- 14 stakeholders requested one-on-one meetings, compared to nine in 2022; and
- 41 submissions via our Feedback Form compared to eight in 2022.

Encouragingly, 29 out of 30 respondents agreed with the statement "PoM's engagement with my organisation is continuously improving."[42]

Table 3-2 2023 Industry Engagement materials

Materials	Content and purpose
2023 Industry Engagement Information Pack	The form and content of the Information Pack was directly influenced by engagement with key stakeholders in late 2022. It provides in-depth information to accompany industry presentations, and sets out: ▪ The purpose of engagement; ▪ Detailed information about the topics of engagement so that stakeholders were informed about the potential implications of the issues at play and could provide feedback to influence the positions that we adopt; – A description of the engagement process, and how we would use feedback received to inform our decision-making; – Our commitment to the level of participation according to the IAP2 Spectrum of Public Participation;

[38] Pricing Order, Clause 7.1.2(d)
[39] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3
[40]
[41] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3.2
[42] While we received 41 submissions, not all submissions responded to each aspect of the Feedback Form – e.g. we received 30 responses to the question "PoM's engagement with my organisation is continuously improving"

Materials	Content and purpose
	– Timelines for engagement activities; ▪ Descriptions of the questions that would be included in the Feedback Form that followed the industry presentations; and ▪ Links to various supporting information for each topic, including an independent report from Incenta Economic Consulting to provide further detail on the topic of the regulatory period length.[43]
Port of Melbourne Industry Engagement Summary Report, May 2023 (prepared by Insync Consulting)	The Engagement Summary Report sets out the findings of the 2023 Industry Engagement. It is designed to meet the requirements of the Pricing Order and POEP by: ▪ Encompassing the key steps in the consultation process as set out in Section 5 of the POEP; and ▪ Addressing each of the consultation-related questions in the ESC's SoRA. The Engagement Summary Report includes: ▪ A detailed description of the engagement approach and how it was influenced by engagement with stakeholders; ▪ A detailed summary of the engagement findings, including for each topic: – The information provided; – The questions asked; and – The responses from Port Users and other stakeholders.

3.4.1 Details of our consultation process

The purpose of the 2023 Industry Engagement was to afford Port Users and other stakeholders an opportunity to be informed about, and influence, matters that impact the services that we offer to Port Users and the prices charged for those services.[44]

Our 2023 Industry Engagement Program was complemented by tailored engagements on major projects and other topics as outlined in Sections 3.5 to 3.7, below.

The table below sets out the details of our engagement process.

Table 3-3 2023 Industry Engagement process

Activity	Timing	Approach and outcomes
Round 1 of engagement program		
Early engagement to inform the 2023 Industry Engagement	October 2022 to January 2023	Targeted engagement to co-design the approach, topics and questions for 2023 Industry Engagement. All stakeholders were given an equal opportunity to take part.[45] Fifteen in-depth interviews were held with stakeholders and Port Users from across the supply chain (including industry bodies, stevedores, shipping lines, bulk trade tenants, freight forwarders, unions and rail operators). The early engagement complied with the commitments and processes as outlined in the POEP.[46]

[43] PoM, 2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023
[44] PoM, 2023-24 TCS – Appendix F – Insync, Industry Engagement Information Pack, March 2023, p.4
[45] Port Users and stakeholders from more than 300 organisations were given the chance to be interviewed in this early engagement. Eight Port Users with high levels of knowledge and sophistication were targeted with phones calls to specifically encourage participation. Other stakeholders who accepted the invitation to participate received a follow up phone call from the third-party researcher.
[46]

Activity	Timing	Approach and outcomes
		The majority of the Feedback Form questions arose from stakeholder suggestions in this early engagement, demonstrating that the Port has been "willing to be flexible in its plan"[47], and PoM has continued to test proposals and feedback with Port Users on an ongoing basis, as the engagement progressed.
Round 2 of engagement program		
Launch 2023 Industry Engagement period	14 February 2023	Launched the 2023 Industry Engagement program on PoM's website and via social media. Invites were sent to stakeholders via direct email to attend an in-person or online briefing session.
Briefing sessions	1 March 2023 to 2 March 2023	Held an in-person briefing session with 24 stakeholders on 1 March 2023. Held an online briefing session with 41 stakeholders on 2 March 2023. Recording of the online session and presentation materials were uploaded to the website following the sessions. Provided access for all participants to ask questions of our CEO and leadership team.
Information Pack	3 March 2023	Published an Information Pack to commence the formal consultation period. The level of detail included within the information pack was in direct response to the feedback we heard on the level of information required for stakeholders to effectively participate in engagement.
Feedback Form and interviews	6 March 2023 to 3 April 2023	Invitations to complete the Feedback Form were sent to the 65 stakeholders who had attended the briefing sessions (and multiple contacts persons within those organisations), as well as over 600 other stakeholders on the contact list who had not attended a briefing session. Stakeholders were offered the opportunity to respond to the Feedback Form via a one-on-one interview with the third-party consultant (Insync) if they preferred. Forty-one responses were received from 38 different organisations (including one stakeholder who responded via a one-on-one interview with Insync).
Follow up meetings with the PoM team	4 April 2023 to 28 April 2023	Fourteen stakeholders requested a follow up meeting with PoM in a confidential setting. We offered follow-up meetings to all stakeholders that indicated that they would like to have them, and ultimately held meetings with eight. Some stakeholders indicated that they were satisfied with the engagement process and information already provided, some sought to defer the follow-up meeting to a later time, and two stakeholders did not respond to our requests.

3.4.2 Issues raised, feedback provided and decision-making

We engaged and received feedback on seven topics. Six of them are summarised here, with the length of the Regulatory Period dealt with separately in Chapter 4 due to its length and complexity.

[47] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3.2

This section provides a summary of the issues raised and feedback provided, collected through a combination of completed Feedback Forms and direct engagement. A full description of the findings (what we heard) can be found in the 2023 Industry Engagement Stakeholder Engagement Report at Attachment E to this TCS. The following focuses on how PoM has had regard to the views of stakeholders when making decisions.

During the engagement process, it was made clear to stakeholders that PoM would be making a decision on the length of the regulatory period for this 2023-24 TCS submission.

Most of the other topics are not linked to specific decisions to be made for this TCS, but rather form part of an ongoing engagement process to enable the participation of Port Users and other stakeholders in how we deliver on our obligations under the Port Lease, Port Concession Deed and Pricing Order.

The topics discussed in this Section include:

- Our role;
- Looking ahead;
- Tariffs;
- Rail;
- Sustainability; and
- Engagement.

Table 3-4 2023 Industry Engagement – what we heard and how we have had regard to stakeholder feedback

Topic and what we heard	How PoM has had regard to the views of stakeholders
Our role Our stakeholders all agreed that they have a sufficient understanding of our role. Two organisations requested more information: ▪ An industry body asked for further detail on the contents and interpretation of the Port Lease and Port Concession Deed and suggested that PoM publish information about its engagement with the Melbourne Port Lessor. ▪ A logistics services provider noted that it is not clear whether PoM can influence land-side levies. Information on the charges that we levy was provided on page 20 of the Information Pack.	Where stakeholders requested further information on our role, we held follow-up meetings to discuss and provide further detail. We have also extended the information included in this TCS as follows: ▪ Regarding the contents and interpretation of the Port Lease and Port Concession Deed (PCD), PoM has obligations to the Victorian Government to keep the terms of the Port Lease and PCD confidential and not to disclose them without consent. For that reason, we are unable to provide a copy of, or further extracts from, the PCD, except as already set out on our website (which has been approved by the Victorian Government). A detailed description of our role is set out in Chapter 2 of this TCS. ▪ We provided information about our tariffs and how they fit into the supply chain in the Information Pack, and have included further detailed information in Chapter 10 of this TCS. For the avoidance of doubt, PoM is not able to influence charges levied by other participants in the supply chain. This information will also be included in future corporate communications and industry engagement materials where appropriate.
Looking ahead We sought to understand our stakeholders better, by asking about the megatrends that could influence what they need from PoM. A wide range of economic, environmental, digital/cyber and industry trends (and needs) were reported, including in particular: ▪ ESG opportunities;	We contacted all stakeholders that asked for an opportunity to share their views on megatrends with PoM in a confidential setting and held meetings with a number of them to discuss their views (several stakeholders indicated that they would prefer to defer the meetings until a later date or decided not to take up the offer). The feedback received is critical for PoM in how we manage the port today and plan for the future. Having had regard to the feedback provided, we have identified the following priority areas of work:

Topic and what we heard	How PoM has had regard to the views of stakeholders
▪ Rail improvements; ▪ More flexible and transparent tariffs; ▪ Regular assessments of port capacity; and ▪ Stakeholder engagement.	▪ ESG opportunities, rail improvements and more flexible and transparent tariffs – we are integrating this feedback into our future plans in these areas, as discussed in the following sections; ▪ Regular assessments of port capacity – we are continuing to adapt the PCEP engagement process to accommodate the needs of our stakeholders, as discussed in Section 3.6 below; and ▪ Stakeholder engagement – see Section 3.3 above for discussion of our continued stakeholder engagement uplift. In particular, the TCS feedback has informed the development of 2023 Stakeholder Perception Survey.
Tariffs On the subject of tariffs, the majority of respondent stakeholders advised that our Information Pack was effective in providing sufficient information to allow them to participate in the decision. However, four stakeholders asked for more information, mostly to better understand the process and methodology for tariff recovery after 2037, including how the tariffs will be calculated and the forecast price impacts. Three stakeholders provided suggestions for tariff reforms for PoM to consider, including: ▪ a request for infrastructure to help shipping lines meet their emissions reductions targets; ▪ tariff reform to encourage the use of rail to reduce emissions; and ▪ suggested changes to the way levies are calculated on vessel size.	We contacted all stakeholders that asked for follow-up meetings on the topic of tariffs and held meetings with those that wished to progress (one stakeholder indicated they were satisfied with the information provided and one did not respond). We provided further information directly to those stakeholders that wanted more information on the methodology for tariff recovery after 2037. Noting that it is a highly technical topic, we also offered individual briefings specifically on this issue to those stakeholders who wanted more information. In addition, Chapter 11 of this TCS provides a summary of the approach and updates to the indicative price forecasts based on the latest available data. Having regard to the feedback provided by our stakeholders, we recognise that there is some (though not necessarily widespread) appetite for tariff reform. Based on this feedback, we intend to come back to stakeholders to seek their input on a longer-term tariff strategy later in 2023-24. The timing and approach to this engagement will need to be flexible, to accommodate and work around other ongoing engagement programs, such as PCEP.

Topic and what we heard	How PoM has had regard to the views of stakeholders
Rail Although most of our stakeholders indicated they now have sufficient information on the topic of rail, two wanted more information, and one did not think PoM understood their needs. A further suggestion on rail tariffs was made to the effect that rail should be paid for by exporters rather than importers.	We held follow-up meetings with the stakeholders that sought a further opportunity to discuss their views. The feedback received has influenced our approach to the development of new rail operating procedures within the port in the short term. PoM is now consulting with the rail industry users of the port (rolling stock operators and terminal operators) on potential changes to rail operating procedures within the port, as a result of new rail infrastructure currently being delivered within the port. For longer term rail infrastructure planning, we advised participants that PoM's strategic plan for rail, 'Our Plan for Rail', was to be reviewed and a new version published by 2025, also noting that the review of this strategic document will incorporate detailed stakeholder engagement. In addition, we have taken on board the information made available with regard to import volumes moving through PoM direct to Adelaide via rail for our land-bridge / mode shift strategy. In particular, the feedback provided by our stakeholders has revealed that there is a potential opportunity to support more importers on certain routes that may benefit from shorter shipping transit times through Melbourne and then on to rail, along with the Adelaide export market. Given the feedback we received on rail tariffs, we will include this in our further work on potential future tariff reforms.
Sustainability Sustainability is of great interest to many of our respondent stakeholders, two-thirds of whom already have specific targets in this area: ▪ Almost half of the responses we received to our Feedback Form expressed a desire to collaborate with us on sustainability initiatives, on matters as diverse as energy efficiency, decarbonisation research and modern slavery risks in shipping; and ▪ We also sought, and received, suggestions from our stakeholders about where we could look for best practice examples of sustainability.	We held a number of follow-up meetings with stakeholders concerning sustainability, and provided stakeholders with additional information, including, in particular, our recently released Sustainability Report. Our Sustainability Strategy is aligned to the United Nations Sustainability Development Goals most relevant to PoM and our stakeholders, and is supported by objectives, three-year targets and key performance indicators. A key focus for PoM in delivering the strategy is to embed sustainability into all aspects of our business, including infrastructure operations and maintenance, and port development planning and delivery. We report our sustainability progress annually in our Sustainability Report.[48] Feedback from industry engagement will influence PoM's sustainability planning and has helped identify common goals that stakeholders want to collaborate on, or hear more about. Many topics of conversation related to opportunities for PoM to facilitate sustainability action across the wider port precinct, as part of planning and infrastructure activities that would support stakeholders to meet their own sustainability objectives. Opportunities for decarbonisation, biodiversity and land use, supply chain, human rights and emerging technology were identified. PoM will aim to incorporate these opportunities into its infrastructure planning, future commercial contracts and ongoing communications. PoM will look for opportunities to continue discussions via the best stakeholder-specific channels to address each issue of interest. This may include sustainability as an agenda item in existing engagement activities, or new options and platforms for engagement being considered such as a port user sustainability forum.

[48] Our sustainability report is available on our website here [Sustainability - Port of Melbourne]

<table>
<tr><th>Topic and what we heard</th><th>How PoM has had regard to the views of stakeholders</th></tr>
<tr><td></td><td>PoM also committed to stakeholders that some of the initiatives in progress or in early stages of investigation, that could only be informally discussed in the feedback sessions, would be shared publicly in more detail in the next Sustainability Report. For example, based on interest from stakeholders PoM will provide more detail on the progress of PoM's decarbonisation plans for itself and the wider port precinct.

Given the level of interest, sustainability will also be a key focus for the 2023 Stakeholder Perception Survey.</td></tr>
<tr><td>Engagement
With respect to stakeholder feedback on the level of information provided:
One stakeholder noted there was minimal information regarding PCEP.
One stakeholder said some topics lacked sufficient detail.
In terms of how we engage:
In reference to the IAP2 spectrum, our stakeholders tended to want more participation than they feel they are being given (although this balance has shifted since the 2022-23 TCS).
More than half of respondents now think we are consistent and coordinated in our engagement with their organisation. However, one third of stakeholders responding that our performance is "mixed" and ten percent think we are not more stakeholder-centric than previously.
With regard to engagement topics, stakeholders were most interested in engaging on decarbonisation, rail, tariffs, port capacity, rent reviews for leases of Port land, and supply chain discussions.

Although 28 stakeholders responded that they had been given sufficient time to contemplate and respond to our requests for engagement in the past 12 months, two disagreed.

Respondents suggested we could improve by providing more opportunities for two-way feedback, communication and information about PoM's key commercial responsibilities, coordinated planning around Webb Dock, and having a dedicated person to</td><td>Five stakeholders requested follow-up meetings on engagement and three meetings were ultimately held with stakeholders that wished to progress. We have followed up with all stakeholders that requested a further discussion with PoM on any of the topics raised, and also provided a range of additional information.

With respect to the areas where stakeholders desired more information:
We recognise that the 2023 Industry Engagement materials did not include information on PCEP. Given that PCEP has a separate (and concurrent) engagement stream, this decision was made deliberately. We also note that in our early engagement process, PCEP was not raised as a topic that stakeholders wanted us to include in the 2023 Industry Engagement; and
The engagement materials provided in the 2023 Industry Engagement sought to maintain a balance of providing sufficient detail to allow stakeholders to participate from an informed position, but also make the materials accessible to facilitate as many stakeholders participating as possible. The Information Pack was 68 pages long, and to address the requirements of stakeholders wishing for further detail on specific topics, we provided links in each section to where further information could be found.
In the future, we will seek to address the above issues by achieving higher levels of participation in the early engagement process to make sure that the information needs of stakeholders are met.

In terms of how we engage:
We recognise that stakeholders desire a greater level of participation, and while each initiative's level of engagement will be assessed on a case-by-case basis, we will be guided by our Framework to ensure broad consistency in our approach, and clearly articulate this. There will be instances where we will not be able to engage at a 'Collaborate' or 'Empower' level of the IAP2 Spectrum of Public Participation, for example, due to commercial imperatives that preclude such transparency at certain stages of project planning.
We are pleased to note that the efforts we are putting into our stakeholder engagement uplift are reflected with most stakeholders considering that we are consistent and coordinated. However, we also recognise that some consider our performance was 'mixed' or did not notice improvement. Our focus on building our stakeholder engagement team and processes will respond to this feedback.</td></tr>
</table>

Topic and what we heard	How PoM has had regard to the views of stakeholders
handle sustainability projects and initiatives. Just one out of 30 respondents disagreed with the statement "PoM's engagement with my organisation is continuously improving."	We note the topics of interest to our stakeholders and will ensure our future engagement activities deliver on what our stakeholders are interested in (as per our efforts in this engagement). We will continue to have a strong focus on the timeliness of, and timeframes for, our engagement in future. This is also the subject of specific provisions of the POEP. Feedback on how we communicate (more opportunities for two-way feedback, communication and information about PoM's key commercial responsibilities) has been noted and will be incorporated by the relevant teams within PoM.

3.4.3 Alignment to the SoRA principles for assessing compliance

The principles in this section are drawn from the SoRA, which indicates the guiding principles the ESC will use to assess our compliance with the consultation requirements of the Pricing Order.[49]

The Engagement Summary Report prepared by Insync demonstrates that we have also satisfied the requirements of our POEP.[50]

Table 3-5 Alignment of 2023 Industry Engagement to the SoRA

SoRA compliance principle	2023 Industry Engagement
Start engagement early in its planning of projects, programs, and other initiatives. The engagement should be ongoing, to keep testing proposals with port users and stakeholders.	Following a process to identify and reach out to stakeholders for the engagement[51], fifteen in-depth conversations with stakeholders began in late 2022. These occurred well before the agenda or any of the questions to be used in the 2023 Industry Engagement had been decided. Since then, the engagement was ongoing, via in-person and online briefing sessions, a 68-page Information Pack, a 35 question Feedback Form, and a series of one-on-one follow up meetings to share confidential information, ask further questions, and explore opportunities for future collaboration. With respect to the engagement on the length of the regulatory period, our engagement on this topic goes back some years: ▪ In 2021, we received feedback stating that we should consider principles of stability, transparency and consistency in choosing the length the regulatory period. ▪ In 2022, following the ESC's inquiry, we noted our intention to transition to a longer regulatory period from 1 July 2023 and consulted stakeholders on: ▪ their preferences for PoM's regulatory period length and the timing of the transition; and how they would like to be consulted on implementation issues. Submissions indicated a preference for the regulatory period to support prudency and efficiency of investment, and interest in being informed going forward. This informed our decision making, guided our engagement approach and helped stakeholder mapping. Based on the feedback from Port Users and the ESC, in our 2022-23 TCS (released 31 May 2022), we committed to transitioning to a longer regulatory period from 1 July 2023.

[49] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3.2

[50]

[51]

SoRA compliance principle	2023 Industry Engagement
Ensure engagement process prioritises matters that have a significant impact on the Port's services and prices.	The Industry Engagement which preceded this TCS afforded stakeholders the chance to effectively co-design the agenda, a process that led to the inclusion of topics such as Rail and Sustainability. We had a heavy focus on the length of the regulatory period, as we identified this as one of the key decisions for the 2023-24 TCS. Our engagement materials outlined why the length of the regulatory period is important. Specifically, we noted that it has an impact on Port Users because of its implications for: ▪ Prices – it can affect price stability, certainty, and even price levels. Longer regulatory periods provide greater price stability and certainty; and ▪ Costs and investment – it can affect incentives for cost reduction and incentives for efficient investment. Longer regulatory periods create stronger incentives for efficiency, and these efficiency gains ultimately pass through to customers through lower costs and/or better services. More generally, we have undertaken (and continue to undertake) extensive engagements on our major projects, being the SDW Remediation Project, and PCEP, which we know from previous years' engagement to be matters that are of greatest interest to, and will have the greatest impact on, Port Users and other stakeholders.
Demonstrate that the engagement is genuine and clearly communicate the level of influence stakeholders will have on the decision.	The Information Pack was clear in explaining the level of influence being offered ('Consult' under the IAP2 Spectrum of Public Participation). It included the associated "promise", which was to "…keep you informed, listen to and acknowledge your concerns and aspirations, and provide feedback on how your input influences our decisions." Two out of 30 respondents disagreed with the statement in our Feedback Form "PoM's engagement with my organisation is Genuine". This compares favourably with 22 who agreed, with the remaining six neither agreeing nor disagreeing. Our stakeholder engagement uplift, POEP and approach taken in the 2023 Industry Engagement collectively demonstrate that our efforts are genuine: ▪ Greater stakeholder participation in agenda setting; ▪ More individuals and more organisations invited to participate; ▪ More of our leaders and SMEs took part in the process; ▪ Multiple channels were provided for stakeholders to give feedback; ▪ Measures taken to increase inclusiveness, particularly targeting stakeholders who were new to the industry or less informed about the regulatory context, by including basic background information in the Information Pack, alongside a comprehensive set of links to other relevant documents; and ▪ Opportunities for one-on-one follow-up meetings and direct contact with us were provided.
Tailor the form of engagement to suit the content on which it is seeking to engage, and to the circumstances facing port users and stakeholders.	The engagement approach was also informed by our earlier stakeholder research project, which revealed a preference among our stakeholders for personal engagement and direct dialogue, as well as a more tailored approach. The fifteen early engagement interviews iteratively developed and tested ideas on the format of the 2023 Industry Engagement as well as the substance. The first in-depth conversations asked, "how would you like to get information and give your feedback?" Feedback from these conversations led to a draft process design. In later interviews, this draft design was described to stakeholders for feedback and further refinement. Noting the existing low-knowledge base and lack of time faced by smaller stakeholders, Round 2 engagement was designed with these insights in mind. As a result, questions in the Feedback Form were made optional, so that time-poor stakeholders could participate to the extent they wanted to, and enabled targeted participation. Navigation between the Information Pack and the Feedback Form

SoRA compliance principle	2023 Industry Engagement
	was made easy, so that stakeholders did not have to digest the entire 68 pages to participate meaningfully. A further concern expressed by some stakeholders in the early engagement interviews was around sharing commercially sensitive information. In response, we included a check box in each section of the Feedback Form where respondents could request a follow-up interview to discuss rather than record such information.
Provide participants in its engagement process with appropriate information, given the purpose, form and the content of the engagement.	We created a more comprehensive Information Pack to maximise participation. Questions were added to the Feedback Form to confirm that respondents felt appropriately informed, such as "I have a sufficient understanding of PoM's role based on the information provided about its contractual, legislative and regulatory obligations." On this question, all of the respondents agreed with this statement. On the other hand, two stakeholders disagreed with the statement "I have a sufficient understanding of how rail at PoM is funded", and PoM has followed up with both organisations to address information gaps. Finally, we asked, "Was the information provided as part of this Industry Engagement of value to you?" 87% of respondents agreed. Stakeholders who found the information useful wrote that it was clear, concise, provided sufficient detail on each topic, provided an overview of future plans, and indicated that PoM wants to engage and listen to its stakeholders. The strong positive response is clear demonstration of our increasingly stakeholder-centric culture.
Demonstrate how stakeholder feedback has influenced its decisions, including communicating to participants how their input influenced the decision.	This TCS sets out how stakeholder feedback has influenced our decisions and how we will continue to work with stakeholders to support their participation in our decisions. Chapter 4 of this report outlines in detail how the input from stakeholders influenced our decision on the length of the regulatory period.

3.5 Swanson Dock West Rehabilitation

Swanson Dock West (SDW) is a critical International Container Terminal (ICT) comprising of a 944m wharf with three container-handling berths, which were constructed in several stages between the 1960s and 1980s.

The existing SDW wharf is of varying ages and forms of construction. Sections of the wharf are close to or beyond the typical design life of 30 years (standard design life utilised at the time) and as a result, major remediation and asset intervention is required.

SDW International Container Terminal currently has a three-berth operation. Our three-stage program has been developed to enable it to maintain a two-berth operation for the duration of the works. Commencing from Berth 1, the project will focus on completing works moving progressively toward Berth 3. The timeframes and staging for Berths 2 and 3 are still pending further project development and approval.

The SDW Remediation project was consulted on and included in our Port Development Strategy (PDS) and PDS Delivery Program. In the lead up to this 2022-23 TCS we continued to engage on the options assessment, scope, timing, and works delivery aspects of this project. Details of previous engagement on SDW Remediation are set out in our 2022-23 TCS. [52]

[52] See PoM, 2022-23 TCS – General Statement, May 2022, available on our website here; and PoM, 2022-23 TCS – Appendix G: Summary of consideration of stakeholder comments, May 2022, available on the ESC website here

Our engagement on the SDW Remediation over the past year is described in detail in the key materials listed below in Table 3-6, all of which are available on our website, and form part of this TCS.[53] A brief summary of the content of these materials is set out in the table below and the following sections. These documents, together with this section of the TCS, cover the compliance demonstration requirements identified by the ESC in the SoRA including:

- Details of our consultation process with Port Users;
- Issues raised and feedback provided by Port Users; and
- How we have taken Port Users views into account, when making decisions.

In the sections below we also provide a reconciliation to the principles for assessing compliance in the SoRA. [54]

Table 3-6 SDW Remediation project engagement materials

Materials	Content and purpose
Project Factsheet – Swanson Dock West Remediation Project, August 2022	Provides project background, scope of works and key issues to ensure stakeholders were adequately informed.
2022 Industry Presentation – Swanson Dock West Remediation	Engagement materials setting out: ▪ Purpose of engagement; ▪ Background to the project, including need for the investment, scope, options analysis and recommended option (including costs and pricing implications of alternative options), proposed cost recovery arrangements; ▪ Questions to guide feedback; and ▪ Next steps including how PoM would use feedback received.
Swanson Dock West Remediation Project – Stakeholder Engagement Report, November 2022 (prepared by RPS Group)	This report provides the outcomes of direct stakeholder engagement undertaken by Port of Melbourne to support the Swanson Dock West Remediation Project. It includes the following key elements: ▪ Who PoM invited to engage and who participated in the activities; ▪ How PoM engaged, including an overview of the engagement stages and the methods of engagement used; ▪ What PoM heard – a review of the feedback received from stakeholders; and ▪ Next steps for PoM to consider in the development and delivery of future stakeholder engagement activities.

3.5.1 Details of our consultation process

Following engagement at the Identification and Development Stages, PoM sought to meaningfully engage with Port Users and key stakeholders to provide insights about the project and seek feedback on potential impacts during remediation works. This feedback would be used by PoM to make decisions about project timing and staging.

Given the industry-focused nature of the SDW remediation works, PoM determined that two online information sessions were the best way to reach other stakeholders and community about the project. Sessions were promoted via various channels including digital advertising, social media and media release, directing interested parties to a project web page and PDF fact sheet.

[53] PoM, 2023-24 TCS – Appendix H - RPS, Swanson Dock West Remediation Project – Stakeholder Engagement Report
[54] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3.2

Consulting firm RPS Group was engaged to deliver the engagement program, including independent facilitation of information sessions held on 16 August 2022 and 18 August 2022. An additional four-week feedback submission period was promoted to ensure stakeholders had an appropriate timeframe to comment on the project. The Stakeholder Engagement Report was published on the PoM website in November 2022.

A detailed description of the engagement process is set out in the Stakeholder Engagement Report, which was made available on our website. [55]

3.5.2 Issues raised, feedback provided and decision-making

The key issues raised by stakeholders were around potential impacts from project works to shipping operations for Swanson Dock West.

Overall, the proposed scope, timeline, and cost recovery methodology of the SDW Remediation Project was well received by Port Tenants, Port Users, key stakeholders, and the broader community, with no opposition to the project or scheduling.

Stakeholders indicated a preference for ongoing updates on the progress of the SDW Remediation Project through industry briefings, meetings, and emails.

In the Stakeholder Engagement Report, RPS noted that[56]:

> *These concerns are already very well understood by the project team, who have been liaising closely with the two International Container Terminal operators at Swanson Dock and Ports Victoria.*
>
> *PoM has indicated that these concerns have been responded to, and there will be further coordination and ongoing management with all impacted stakeholders, to reduce and mitigate impacts on port operations during the project works.*

The Stakeholder Engagement Report provides a detailed summary of all stakeholder questions and comments, and the PoM response.[57]

3.5.3 Alignment to the SoRA principles for assessing compliance

The table below provides a summary of the alignment of the SDW Remediation project engagement to the ESC's principles for assessing compliance as outlined in the SoRA.[58]

Table 3-7 Alignment of SDW Remediation engagement to the SoRA

SoRA compliance principle	Swanson Dock West Remediation engagement
Start engagement early in its planning of projects, programs, and other initiatives. The engagement should be ongoing, to keep testing proposals with port users and stakeholders.	The SDW wharf remediation project was consulted on and included in our Port Development Strategy (PDS) and PDS Delivery Program. In the lead up to this 2022-23 TCS we continued to engage on the options assessment, scope, timing, and works delivery aspects of this project. Following engagement at the Development and the Planning Stages, PoM sought to meaningfully engage with Port Users and key stakeholders to provide insights about the project and seek feedback on potential impacts during remediation works to inform its decisions about staging and timing.

[55] The engagement report and further information is available on the PoM website: Current projects - Port of Melbourne
[56] PoM, 2023-24 TCS – Appendix H - RPS, Swanson Dock West Remediation Project – Stakeholder Engagement Report, November 2022 p.7, available on the PoM website: Current projects - Port of Melbourne
[57] The engagement report and further information is available on the PoM website: Current projects - Port of Melbourne
[58] ESC, Statement of Regulatory Approach v3.0, December 2022, section 3.3.2

SoRA compliance principle	Swanson Dock West Remediation engagement
Ensure engagement process prioritises matters that have a significant impact on the Port's services and prices.	PoM sought feedback on potential project impacts on port services during remediation works. Engagement materials provided detailed information on service outcomes, cost and pricing impacts of alternative options for delivery.
Demonstrate that the engagement is genuine and clearly communicates the level of influence stakeholders will have on the decision.	The purpose of the engagement, including project negotiables and non-negotiables were clearly explained to stakeholders during the online information sessions. The engagement materials specified that PoM is required to remediate SDW to comply with its obligations under the Port Lease and Port Concession Deed, and we were seeking feedback on the impacts on Port Users of alternative timing and staging options to assist us in making a decision on the approach to delivery.
Tailor the form of engagement to suit the content on which it is seeking to engage, and to the circumstances facing port users and stakeholders.	Given the industry-focused nature of the SDW remediation works, PoM determined that online information sessions were the best way to reach other stakeholders about the project.
Provide participants in its engagement process with appropriate information, given the purpose, form and the content of the engagement.	A draft stakeholder presentation and project fact sheet were made available on PoM's website before the information sessions. With 96 attendees across the two sessions, the engagement campaign was successful in supporting participation via the provision of appropriate information.
Demonstrate how stakeholder feedback has influenced its decisions, including communicating to participants how their input influenced the decision.	The primary concerns raised were around potential impacts from project works to shipping operations for Swanson Dock. These concerns were already very well understood by the project team, who will continue to liaise closely with the two International Container Terminal operators at Swanson Dock and Ports Victoria for the duration of the project. PoM's responses to questions and comments from stakeholders were documented in the Stakeholder Engagement Report, which was sent to participants and published on the PoM website in November 2022.[59]

3.6 Port Capacity Enhancement Program

As part of PoM's stewardship obligations, we are required to ensure that port capacity can meet the future demands of Victoria's growing economy. We are engaging with stakeholders about the next stage of that port capacity, called the Port Capacity Enhancement Program (PCEP).

PCEP was outlined in PoM's 2050 Port Development Strategy (PDS) and involves developing a Webb Dock North (WDN) container terminal and securing the long-term future for the Tasmanian trades.

Once delivered, the PCEP will ensure the Port continues to play a significant role in driving forward the Victorian economy.

Stakeholder engagement is a key focus for this current stage of the program and is ongoing. This engagement program has been informed by previous engagements (such as 2022 PDS) and POEP. We

[59] The Stakeholder Engagement Report is available on the PoM website: [Current projects - Port of Melbourne]

recognise that engaging stakeholders in our planning process for PCEP leads to informed decision-making that balances the needs and interests of relevant parties.

In Stage 1 of the engagement program, PoM has sought feedback on three key drivers of capacity, contained in three expert technical reports:

- Port Capacity;
- Trade Demand; and
- Ship Fleet Forecast.[60]

The approach to engagement includes feedback received during the process, with changes to both the timing and approach, to increase opportunities for stakeholder participation. In addition to public forums and seeking written feedback, PoM also held a number of workshops with the incumbent International Container Terminal Operators to allow them to provide direct, detailed feedback on port capacity work. To this extent, the Stage 1 engagement has been extended from the originally planned three-month engagement to over nine months and (at the time of preparation of the 2023-24 TCS) remains open.

In February 2023, the expert technical reports were updated following initial feedback[61] and detailed responses provided to all parties who made submissions as to how their feedback had been considered.

Feedback on those updated reports remains open, with expected further engagement on most recent trade forecasts to be undertaken in June/July 2023.

At the conclusion of Stage 1 engagement on technical reports, a stakeholder engagement report will be made available on the PoM website. This engagement report will outline feedback received and how this feedback has been considered in finalising the technical reports.

When finalised, the three reports will be used to inform the Cost Benefit Analysis (CBA) which will be the subject of future engagement activities.

Stage 2 of the stakeholder engagement process will focus on the CBA, prior to creating a preliminary business case. The timelines for Stage 2 will be communicated once the engagement for Stage 1 is complete and PoM has had the opportunity to review and be informed by the feedback and engagement "lessons learned" during Stage 1.

3.7 Ongoing commercial and industry information exchange

In addition to the engagement activities discussed above, we undertake a range of engagement activities as part of the ongoing commercial and industry information exchange required for good operating practice.

In the 12-month lead-up to the 2023-24 TCS these activities have included:

- **Industry Updates** – electronic newsletters which provide information about PDS projects, supply chain issues and broader port information, including key PoM contact details for stakeholders to raise any feedback or follow-up questions. [62] Industry Updates were distributed in April and June 2022, and April 2023.
- **Monthly Trade Reports**, which provide information on container terminal productivity (port-wide), container trade, non-containerised trade, and top commodities.[63]

[60] The updated technical reports are available on the PoM website: Port Capacity Enhancement Program - Port of Melbourne
[61] The updated technical reports are available on the PoM website: Port Capacity Enhancement Program - Port of Melbourne
[62] Industry Update newsletters are available on the PoM website: Port News | Port of Melbourne
[63] Monthly Trade Reports are available on the PoM website Under the PCD, PoM is obliged to publish quarterly trade reports, but : Monthly trade reports - Port of Melbourne

- PoM provides data to the Department of Transport and Planning on the load-discharge ratio for inclusion in the **Voluntary Performance Modelling Framework (VPMF)** quarterly dashboard. The load-discharge ratio is the ratio of total exports to total imports (full and empty), which shows whether trade is generating or removing surplus empty containers at the port.[64]
- **Regional relationship managers** in the Riverina and Tasmania, who work with Port Users (in particular, exporters) to solicit feedback, keep them abreast of issues at the port, and help address supply chain issues.
- **Port of Melbourne Industry Evening** – this event held in July 2022 provided an opportunity for stakeholders to meet with PoM and network across industry outside our regular formal engagement programs.
- **Wider industry engagement,** in November 2022 we collaborated with Committee for Melbourne and Melbourne Chamber of Commerce to co-create briefing sessions and boat tours, to engage the broader business community.

[64] The VPMF dashboards are available on the Department of Transport website: [Voluntary Performance Monitoring Framework | Department of Transport and Planning (dtp.vic.gov.au)]

4 Extending the regulatory period

4.1 Overview

The regulatory period is the period of time over which the Pricing Principles and Cost Allocation Principles in the Pricing Order apply. It is the period of time over which we forecast our costs and prices for Prescribed Services.

Prices are set for the regulatory period based on forecasts of the efficient costs (i.e. the 'Aggregate Revenue Requirement', or ARR), and then shortly before the end of the regulatory period, prices are re-set again for the next regulatory period based on new forecasts of the ARR and demand.[65]

For the next five years, PoM has decided to adopt a five-year regulatory period, commencing 1 July 2023 and ending on 30 June 2028.

This Chapter of the TCS sets out:

- Regulatory context, including:
  - Our obligations with respect to the regulatory period;
  - Feedback and guidance from the ESC with respect to the choice of regulatory period length;
- The basis for adopting a longer regulatory period;
- Engagement;
- Implementation issues; and
- Allocation of risk, including the risk management mechanisms we have adopted.

4.2 Regulatory context

4.2.1 Pricing Order obligations

Under the Pricing Order, PoM is required to determine the length of the regulatory period. The Pricing Order also confirms that PoM may adopt regulatory periods of different lengths over the term of the Port Lease.[66]

4.2.2 ESC Pricing Order compliance inquiry and Interim Commentary

In the final report of its five-year Inquiry into compliance with the Pricing Order, the ESC encouraged PoM to consider adopting a longer regulatory period, as it would promote stability and predictability of prescribed service tariffs for Port Users within the applicable tariff limit.[67]

The ESC also considered a longer regulatory period, such as a five-year period would be in the best interest of Port Users and Victorian consumers compared to a one-year period.[68]

Following the ESC's Inquiry, in our 2022-23 TCS we chose to adopt a one-year regulatory period for 2022-23. We considered that this approach was appropriate because:

- There was insufficient time between the finalisation of the ESC's inquiry (released 28 January 2022) and the due date for the TCS submission (31 May 2022) to both address the ESC's findings and consult on and implement a longer regulatory period; and

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[65] Prices are set for the regulatory period in real terms, which means that they are still updated annually for changes in inflation.
[66] Pricing Order, Clause 13
[67] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.34
[68] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.35

- Adopting a longer regulatory period would require longer lead times for consultation, which would have overlapped with the ESC's inquiry if we were to adopt a longer regulatory period from 2022-23.[69]

On 20 December 2022, the ESC released its Interim Commentary on Port of Melbourne's (PoM) 2022-23 Tariff Compliance Statement (TCS). In the Interim Commentary, the ESC acknowledged PoM's reasoning for adopting a one-year period for the 2022-23 TCS, but reiterated its view that a longer regulatory period would be in the interests of port users.[70]

4.2.3 Guidance in the SoRA

The ESC provides further guidance on the length of the regulatory period and matters of Pricing Order interpretation in its updated SoRA.

In the SoRA, the ESC reiterates previous commentary where it has promoted the adoption of a regulatory period of longer than one-year, and notes the conventional practice of a five-year regulatory period[71]:

> *… We consider that a longer than one-year regulatory period promotes a stable rate of return estimate and an aggregate revenue requirement based on long-term demand and expenditure forecasts.[117] This, coupled with greater insight into the Port's forward capital planning, would create greater certainty for port users and support their long-term investment decisions compared to rolling one-year regulatory periods.*
>
> *[Footnote 117: The conventional practice in other large infrastructure asset regulatory regimes is to adopt five-year regulatory periods]*

The ESC expects PoM to outline the factors influencing its choice of regulatory period, including:

- How the chosen regulatory period length will achieve the objectives of the regime;
- The comparative benefits of longer versus shorter regulatory periods, including:
  - ensuring certainty for Port Users and stakeholders about the outcomes to be delivered and prices to be charged;
  - providing sufficient time for PoM to focus on service delivery and achieving the port user outcomes it has set for the period;
  - demonstrating efficient compliance with the in-period TCSs and effective engagement with the stakeholders; and
  - avoiding unwarranted continuation of any non-compliance that the ESC identifies during a compliance review;
- Confidence that forecasts are efficient and robust, and how forecasting risks are allocated between PoM and Port Users; and
- Port Users' views on the proposed length of the regulatory period and how the feedback has been taken into account.

4.3 Basis for adopting a longer regulatory period

4.3.1 Background on the regulatory period

The regulatory period is the period of time over which the Pricing Principles and Cost Allocation Principles in the Pricing Order apply. It is the period of time over which we forecast our costs and prices.

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69 See PoM, 2022-23 TCS – General Statement, May 2022, available on our website here
70 ESC, *Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23*, 20 December 2022, p.viii
71 ESC, Statement of Regulatory Approach v3.0, 20 December 2022, p.38

Prices are set for the regulatory period based on forecasts of the efficient costs (i.e. the 'Aggregate Revenue Requirement', or ARR), and then shortly before the end of the regulatory period, prices are re-set again for the next regulatory period based on new forecasts of the ARR and demand.

This periodic fixing and re-setting of prices has a number of roles in the regulatory framework:

- It defines the period over which we are required to develop and publish forecasts of the cost of capital (WACC), expenditure, demand and prices;
- It provides incentives for us to minimise costs and creates a mechanism through which cost reductions are passed through to customers:
  - The fixing of prices gives us an incentive to achieve efficiencies. All else equal, if we out-perform the forecasts that were the basis of the prices, we retain the difference (likewise, if we under-perform against forecasts, we incur additional costs); and
  - The re-setting of prices passes benefits through to customers. Over a regulatory period, if we deliver the same services at a lower cost, when prices are re-set they are based on those lower costs, resulting in lower prices.

4.3.2 Our reasons for proposing a five-year regulatory period

In its SoRA, the ESC sets out a range of factors that it expects us to consider in deciding on the length of the regulatory period, including (in summary):

- How our proposed regulatory period achieves the objectives of the regulatory regime (as set out in section 48 of the Port Management Act); and
- Various factors concerning the pros and cons of a longer versus shorter regulatory period.[72]

Our consideration of these factors is set out in detail in the Information Pack we provided to stakeholders in our 2023 Industry Consultation, which forms part of this TCS submission.[73] In the table below, we provide a brief summary of our key reasons for adopting a five-year regulatory period, which include:

- Prices – stability and certainty;
- Efficiency – incentives to minimise costs;
- Cost recovery – efficient investment and fair and reasonable prices; and
- Allocation of risk – how increased forecasting risks are to be managed.

Table 4-1 Summary of reasons for adopting a five-year regulatory period

Reasons	Impact of a five-year regulatory period
Prices – stability and certainty	A five-year regulatory period would provide greater certainty to Port Users about outcomes to be delivered and prices to be charged, as they are fixed for the duration of the period. It will also provide greater stability on cost inputs to the revenue requirement. One of the key inputs affecting price is the WACC, which accounts for the vast majority of the Aggregate Revenue Requirement (ARR). Currently we re-estimate the WACC on an annual basis, which can result in large movements in the ARR from matters outside of our control (in particular, interest rates, which are a key input into the cost of equity component of the WACC). A five-year regulatory period would fix the cost of equity component of the WACC and so increase stability and certainty of the key building block that affects prices. Although we would update the cost of debt on an annual basis (as per conventional practice), given this is calculated using a ten-year trailing average, it is reasonably stable.

[72] ESC, Statement of Regulatory Approach v3.0, 20 December 2022, p.39
[73] PoM, 2023-24 TCS – Appendix F –Insync, 2023 Industry Engagement Information Pack, March 2023

Reasons	Impact of a five-year regulatory period
Efficiency – incentives to minimise costs	Prices are set at the start of each regulatory period based on forecasts of the building block inputs and demand. This has the effect of rewarding PoM for reducing costs below forecast, since efficiency gains are retained during the regulatory period before prices are re-set. It also delivers benefits for Port Users and Victorian consumers, because any efficiency improvements we make will be used to re-set forecasts in subsequent regulatory periods, driving down costs and prices. Longer regulatory periods provide stronger incentives for efficiency, but also generate greater risks of windfall gains or losses if forecasts are wrong. Incenta has noted that a five-year period appears to appropriately balance these two factors, and the prevalence of five-year regulatory periods in regulated infrastructure supports this position.[74]
Cost recovery – efficient investment and fair and reasonable prices	Longer regulatory periods increase risks to cost recovery because there is more scope for actual costs and actual demand to deviate from forecast. As noted on the previous slide, this is a key property of regulatory regimes designed to incentivise efficiency, and also forms part of our regime. However, while the TAL is in place, longer regulatory periods will also enhance our ability to recover our efficient costs in two ways: ▪ Firstly, by reducing the likelihood that the TAL will not bind – a longer regulatory period would increase our ability to smooth prices (see section 0, below), which reduces the likelihood of the TAL not binding (which would create significant under-recovery of costs during the TAL period and reduce incentives for efficient investment); and ▪ Secondly, by reducing under-recovery of costs across a regulatory period – as set out below, the ARR will be smoothed over the regulatory period and reduce the extent to which (notional) negative depreciation outcomes occur (which would be set to zero), reducing under-recovery of efficient costs. We consider that recovery of efficient costs is consistent with the objectives of the regulatory regime and will promote efficient investments in infrastructure and lower supply chain costs.
Allocation of risk and dealing with uncertainty	As set out in this TCS, we have implemented a range of measures to ensure that our forecasts are robust (see Chapter 5 capex, Chapter 6 opex and Chapter 8 trade). However, it is inevitable that actual outcomes will deviate from forecasts. Our treatment of these forecasting risks is intended to provide an efficient allocation of risk and also contribute to the establishment of efficient incentives: ▪ Demand forecasting risk – Under the price cap form of price control imposed by the TAL, the risks of demand forecasting errors are borne by us on behalf of Port Users. ▪ Opex forecasting risk – Our approach to fixing deferred depreciation at the commencement of the regulatory period means that PoM bears the risk of forecasting errors in opex. We have proposed an uncertainty mechanism to adjust future costs and prices should pre-defined, exogenous events result in material deviations from forecasts (see section 4.6, below) ▪ Capex forecasting risk – We have adopted a risk-based approach to capex forecasting to ensure that Port Users are not asked to bear the full cost should the project scope or timing change (section 5.6.3). Our view is that these approaches have the effect of providing significant benefits to Port Users from the adoption of a five-year regulatory period, because there will be a strong incentive for us to deliver the service outcomes from capital projects at the lowest efficient cost.

[74] 2023-24 TCS – Appendix G – Incenta Transitioning to a multi-year regulatory period, February 2023

4.4 Engagement

4.4.1 What we heard in past engagement on the regulatory period

PoM has been engaging with stakeholders on the length of the regulatory period for some time.

We asked for stakeholders' views on the regulatory period in 2021 and 2022. A summary of this engagement is included in our Tariff Compliance General Statements from those years (2021-22 and 2022-23, respectively), which are available on our website.[75]

In 2021, we engaged widely with Port Users and other stakeholders about the principles we should take into account in choosing the length of regulatory period. We received feedback stating that we should consider principles of stability, transparency and consistency.

In 2022, we engaged with stakeholders on their preferences for PoM's regulatory period length and the timing of the transition, including how they would like to be consulted on implementation issues. Port Users expressed a desire to remain informed on the topic, and no stakeholders opposed any move to a longer regulatory period. Therefore, in the 2022-23 TCS, we committed to transitioning to a longer regulatory period from 1 July 2023.

4.4.2 2023 Industry Engagement on the regulatory period

In the 2023 Industry Engagement we undertook an extensive engagement process to seek Port Users' views on our proposed length of regulatory period and our reasoning for choosing that length of regulatory period. It was informed by, and consistent with, our POEP.

Details of our consultation process

The process for our 2023 Industry engagement is set out in detail in Chapter 3 of this TCS, and in the accompanying Stakeholder Engagement Report from Insync.[76]

In summary, with regard to engagement on the regulatory period:

- We identified stakeholders with an interest in the regulatory period based on previous engagements, and also sought to engage Port Users (as defined under our regulatory framework) more broadly;
- We undertook early engagement with stakeholders via a series of in-depth interviews to shape the engagement content and approach, including asking stakeholders about the information they required to participate in the decision on regulatory period length;
- Based on the feedback we received, we prepared a detailed Information Pack which provided information about the topic and the purpose of engagement, being to seek feedback on our proposal to move to a five-year period and reasoning behind the proposal;[77]
- We also provided stakeholders with a supporting technical report prepared by Incenta Economic Consulting, which provided additional content on the reasons to extend the regulatory period and key implementation decisions, for those stakeholders who wished to engage at this level of detail; and
- We sought feedback via a Feedback Form, which asked stakeholders whether they had sufficient information and whether they thought PoM's proposed five-year regulatory period will achieve the objectives of the regulatory regime.

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[75] See Regulatory Quick Links | Port of Melbourne

[76] PoM, 2023-24 TCS – Appendix E – Insync, Port of Melbourne – Industry Engagement Summary Report, May 2023

[77] PoM, 2023-24 TCS – Appendix F – Insync, 2023 Industry Engagement Information Pack, March 2023

Issues raised, feedback provided and decision-making

A description prepared by our engagement consultants, Insync, of the engagement approach and findings with respect to the length of the regulatory period from the 2023 Industry Engagement is provided in Appendix E to this TCS.

In summary, Insync found that PoM went to considerable effort to make the Consultation clear, accessible, and inclusive.

The findings were that stakeholders had maximum opportunity to participate, and that nobody was against the move to a longer regulatory period:

- None of the respondents indicated that a lack of information had prevented them from participating in the discussion about length of regulatory period; and
- Although there were varying degrees of support expressed by stakeholders concerning whether a five-year regulatory period would meet the objectives of the regulatory regime, no stakeholders disagreed.

We contacted all five stakeholders that asked for follow-up meetings on the topic of the regulatory period and held meetings with those that wished to progress (one stakeholder indicated they were satisfied with the information provided and one did not respond).

The table below summarises the questions and comments from stakeholders concerning the length of the regulatory period and how PoM has responded, which included both individual meetings and discussions with those stakeholders that sought them, and information that was directly provided (including to those stakeholders who chose not to participate in follow-up meetings).

In summary, given that no stakeholders raised objections to PoM's proposal to adopt a five-year regulatory period, and many provided explicit support, we have decided to adopt a five-year regulatory period commencing 1 July 2023.

Table 4-2 Stakeholder feedback and PoM's response and consideration

Feedback Form questions	Stakeholder feedback	PoM's response and consideration in decision-making
Please share your views, if any, on whether PoM's proposed five-year regulatory period will achieve the objectives of the regulatory regime	A shipping line sought clarification of how price adjustments will work during the period and raised concerns that: ▪ the methodology could lead to price hikes much higher than CPI, catching shipping lines off guard; and ▪ there could be inflated costs for the regulatory period.	We directly provided additional, clarifying information to the stakeholder concerning how the price path would be set under a multi-year regulatory period – further information is also provided in Chapter 10 of this TCS. We would also like to clarify that adopting a multi-year regulatory period will not lead to price hikes of greater than CPI (and should lower costs over the long-term) or inflated costs for the regulatory period (since prices will remain capped by the Tariffs Adjustment limit (CPI)). Chapter 12 of this TCS provides an indicative, long-term view of pricing. We will continue to update stakeholders on indicative long-term pricing outcomes to ensure that they are not caught off-guard by any future price changes.
	A number of stakeholders identified benefits of a longer regulatory period, such as: ▪ Prices would be fair and reasonable;	We recognise the benefits of longer regulatory periods and have sought to deliver them in this TCS. We will continue to engage with Port Users and other stakeholders on the regulatory period

Feedback Form questions	Stakeholder feedback	PoM's response and consideration in decision-making
	▪ Increased pricing stability and certainty; and ▪ Support planning and promote investment. Some stakeholders suggested that a period longer than five years would be preferrable.	length prior to the commencement of each new regulatory period, to determine whether five years remains appropriate or an alternative would better to meet the objectives of the regulatory framework.
	A stevedore noted that it is not entirely clear how the setting of capex, costs, volume forecasts would be made and requested greater visibility on the impact of the change in the regulatory period.	PoM provided additional, written information directly to the stakeholder clarifying how we prepare forecasts of expenditure and trade and held a follow-up meeting to provide an opportunity for further discussion. Further detail on how we have developed our forecasts of expenditure and trade is in Chapter 5 capex, Chapter 6 opex and Chapter 8 trade of this TCS.
	A shipping line raised concerns about the fairness of investment and cost recovery, which they perceived to largely favour the container industry.	We recognise the concerns raised by the shipping line and note that there might be opportunities to improve the efficiency and fairness of tariffs and cost recovery with reference to the investment in different services and cargo types. We will ensure that this issue is given appropriate consideration in future engagement on tariff structures, which we intend to progress in 2023-24 (subject to our broader engagement schedule).
Please share your views, if any, on PoM's explanation of the comparative benefits of a longer regulatory period	A number of stakeholders noted that the explanation provided by PoM was clear and that a longer regulatory period would provide benefits for planning and investment. While recognising long-term benefits, a retailer made a general comment around the contribution of the costs of logistics services (from PoM and others) to inflationary pressure.	PoM notes the recognition of the benefits of a longer regulatory period, and also the concerns that some stakeholders have around supply chain costs. As set out above and in the engagement materials, our view is that a longer regulatory period facilitates lower supply chain costs by improving incentives for efficiency. We will continue to engage with Port Users and other stakeholders about their concerns with regard to pricing. Chapter 12 of this TCS provides an indicative, long-term view of pricing.
	A stevedore queried whether there would still be TCS submissions annually, and how they would differ between the current annual TCS and under a five-year regulatory regime.	PoM provided additional, written information directly to the stakeholder clarifying the commentary on the treatment of uncertain capital projects and held a follow-up meeting to provide an opportunity for further discussion.
Please provide any other views you have on PoM's proposed five-year regulatory period not already covered in the questions above	A stevedore queried the meaning of the content on page 40 of the Information Pack (which describes "How the risks of the Port making forecast errors (for example, overestimating demand forecasts) are allocated between PoM and Port Users."	PoM provided additional, written information directly to the stakeholder clarifying the commentary on the treatment of uncertain capital projects and held a follow-up meeting to provide an opportunity for further discussion. Further detail on our approach to the treatment of uncertain capital projects is

Feedback Form questions	Stakeholder feedback	PoM's response and consideration in decision-making
		provided in this section and in section 5.6 (Appropriate allocation of risk) of this TCS.

4.5 Implementation issues

Implementing a multi-year regulatory period requires consideration of the approach to the following issues:

- Calculating the Aggregate Revenue Requirement (ARR) and prices;
- Forecasting inflation;
- Treatment of the WACC over a multi-year regulatory period;
- Fixing deferred depreciation and rolling forward the RAB; and
- Dealing with uncertainty.[78]

4.5.1 Calculating the ARR and prices

The regulatory period is the period over which to apply the Pricing Principles in the Pricing Order, which require the use of an accrual building block methodology to establish an ARR for the regulatory period.

We engaged Incenta Economic Consulting (Incenta) to advise on implementation issues in transitioning to a regulatory period.[79] Incenta's report was also made available to Port Users and other stakeholders in our 2023 Industry Engagement.

Incenta outlines the standard approach in infrastructure regulation to setting a multi-year price path in its report as follows.

Table 4-3 Approach to implementing a multi-year regulatory period

Approach to implementing a multi-year regulatory period
First, establish an Aggregate Revenue Requirement for the regulatory period, following the requirements of the Pricing Order. This will involve making forecasts of, amongst other things, operating expenditure, capital expenditure, the WACC and inflation. **Secondly**, forecast demand over the regulatory period. **Thirdly**, determine a price path that is expected to generate a revenue stream (given the forecast of demand) over the regulatory period that is equal to the Aggregate Revenue Requirement. ▪ Price controls are typically such that the price path is smoothed over the regulatory period (i.e. rather than following the annual components of the Aggregate Revenue Requirement) and to provide inflation protection. ▪ This would imply setting a price control under which prices follow actual inflation, (i.e. CPI - X%). **Fourthly**, at the end of the regulatory period, prices are reviewed, following the same process. The important features of this process are that: ▪ The RAB from the start of the last regulatory period is updated to include actual capital expenditure and indexation based upon actual inflation; and ▪ The new forecasts of expenditure and demand take account of the actual performance over the previous regulatory period.

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79 PoM, 2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023

Table 4-3 above outlines how prices are smoothed over the regulatory period. We will also smooth the ARR over the regulatory period, to ensure that under-recovery of efficient costs due to the Tariffs Adjustment Limit (TAL) is minimised. Specifically:

- The ARR will be smoothed over the regulatory period to generate a depreciation allowance for the regulatory period that is either positive in every year, or negative in every year (in which case, depreciation would be set to zero, as per clause 4.4.3 of the Pricing Order); and
- Any unrecoverable depreciation will be deferred and recovered in a subsequent regulatory period.

Incenta notes that this approach has the advantages of:

- Simplicity and consistency with the price smoothing approach outlined above;
- Generating a depreciation allowance for a regulatory period that is either positive in every year, or negative in every year (in which case, depreciation would be set to zero, as per clause 4.4.3), and thereby avoiding the possibility of a positive depreciation allowance to be generated in some years and a negative depreciation allowance in others, and so minimise the extent PoM would not be afforded a reasonable opportunity to recover efficient costs.[80]

Incenta considers that an alternative approach of setting the depreciation allowance for each year equal to the capital that is able to be recovered given the revenue and building block costs in that year would be inferior. The reason is that tying the depreciation allowances for each year to the recovered capital for the relevant year increases the potential that a mix of positive and negative depreciation allowance may be calculated for the regulatory period (i.e. rather than depreciation being either positive or negative in all years). This outcome will increase the extent to which efficient costs are unable to be recovered and so create a disincentive to undertake efficient investment (or inefficiently defer investment), which would be inconsistent with the objective of the regime to promote efficient investment.[81]

We consider that this smoothing is consistent with guidance provided by the ESC around the importance of price certainty and stability[82], and preferences expressed by customers for PoM to smooth prices in the 2022 Industry Consultation around future prices and depreciation recovery.

4.5.2 Forecasting inflation

Transitioning to a longer regulatory period requires PoM to include a forecast of inflation and a number of related cost indices as inputs to the calculation of forecast revenue, the aggregate revenue requirement and the capital base for the next regulatory period.

We engaged HoustonKemp to provide independent expert advice on the approach to forecasting inflation over a multi-year regulatory period.[83]

HoustonKemp noted that regulatory precedent supports using RBA forecasts for forecasting inflation, with six Australian regulators and the NZCC adopt some variation of this approach, which pairs short-term central bank inflation forecasts with a longer-term forecast equal to the midpoint of central bank inflation targets and then takes the geometric average of these forecasts (i.e. the RBA glide path approach).[84]

In addition to the smoothing of the ARR discussed above, we note that adopting the geometric mean of the RBA glide path approach to forecasting inflation for RAB indexation and the indexation allowance in the

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[80] PoM,2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023, p.26
[81] PoM,2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023, p.31
[82] See for example, ESC, Statement of Regulatory Approach v3.0, 20 December 2022, p.38
[83] PoM,2023-24 TCS – Appendix O – HoustonKemp, Estimation of the weighted average cost of capital and forecast inflation for the Port of Melbourne, May 2023
[84] PoM,2023-24 TCS – Appendix O – HoustonKemp, Estimation of the weighted average cost of capital and forecast inflation for the Port of Melbourne, May 2023, p.57

ARR would itself have the effect of materially smoothing the ARR over the duration of a five-year regulatory period.

We agree with HoustonKemp advice is that the approach of using the RBA glide path approach (with a geometric mean) is reasonable and consistent with regulatory precedent, and have therefore adopted this approach for forecasting inflation (for indexation of the RAB and tariffs) for the next regulatory period.

Since the Pricing Order specifies the use March-March inflation figures for pricing, we take the midpoint of the RBA's December and June forecasts to represent a figure for March of the relevant year.[85] We consider that this is approach has the benefits of simplicity and transparency.

4.5.3 Treatment of the WACC over a multi-year regulatory period

We also engaged HoustonKemp to provide advice on treatment of the WACC under a multi-year regulatory period as part of their independent expert advice on estimation of the WACC. [86]

- A multi-year regulatory period effectively results in PoM reallocating some of its rate of return on capital risks away from port users and onto itself. In particular, adopting a longer regulatory period while maintaining PoM's current trailing average return on debt approach means that PoM will generate stable return on equity over the regulatory period but risks fixing the return on equity at a level that may not reflect the prevailing return on equity over subsequent years; and
- Most regulators update the benchmark trailing average return on debt annually or include a true-up in the next regulatory period, but adopt fixed estimates of all other parameters at the beginning of each regulatory period (or when finalising a rate of return instrument).

Based on HoustonKemp's advice, we propose to update the trailing average cost of debt annually during the regulatory period. This adjustment would likely not impact prices, but could result in a change to the deferred depreciation balance (by altering the ARR). While we would perform the calculations annually, the actual update to deferred depreciation would be performed at the end of the regulatory period (rather than annually). Given that prices will be set by the TAL, whether the update is performed within the regulatory period or at the end has no impact in terms of prices. Therefore, we propose to perform the adjustment at the end of the regulatory period so that all upward and downward movements could be consolidated in a single adjustment.

4.5.4 Fixing deferred depreciation and rolling forward the RAB

As described in Table 4-3 above, implementing a multi-year regulatory period involves making forecasts of, amongst other things, operating expenditure, capital expenditure, the WACC and inflation. This has the effect of rewarding PoM for reducing costs below forecast, since efficiency gains are retained during the regulatory period before prices are re-set.

Forecasts of expenditure and demand will not be revisited during the regulatory period (for the purpose of establishing the ARR and prices). This means that the deferred depreciation balance will be 'locked in' at the commencement of the regulatory period, and not revisited until the end of the regulatory period for:

- Annual updates to the cost of debt component of the WACC, as described above; and
- Pre-defined events that have a material impact on expenditure, as described below.

As noted by Incenta, this approach will produce the same incentive properties for efficiency improvements as under a standard regulatory regime without a TAL.[87]

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[85] Further details of our inflation forecasting methodology are available in a supporting memo.
[86] PoM,2023-24 TCS – Appendix O – HoustonKemp, Estimation of the weighted average cost of capital and forecast inflation for the Port of Melbourne, p.57
[87] PoM,2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023, pp.1-2

However, we will provide annual updates concerning performance against the ARR inputs as follows:

- As part of the annual TCS submission, we will provide updates on how we are performing against the outcomes and forecasts established for the regulatory period. This would include comparisons of how actual expenditure and demand are tracking against forecast, with a focus on major projects and the related service outcomes for port users; and
- We may also comment on any material changes in actual demand from forecast.

At the end of the regulatory period, the RAB will be updated using actual inflation, actual capex and actual depreciation. As noted by Incenta, using actual depreciation to update the RAB (as opposed to forecast depreciation) provides a slightly higher incentive for capital cost reduction; however, both choices are widely applied and feasible.[88]

4.6 Allocation of risk

In making a choice on the regulatory period, the ESC has stated that PoM should consider how to deal with the uncertainty of major unforeseen events that may affect the ARR.[89] In its updated SoRA, the ESC also commented on the issue of mechanisms to deal with uncertainty (such as re-opening mechanisms) as follows:

> *Under the tariffs adjustment limit, we consider that the deferment of depreciation allows the Port to manage any readjustments of prices to reflect efficient costs the same way as reopening provisions allow. Hence, we do not necessarily foresee a need for explicit reopening provisions during the tariffs adjustment limit period.* [90]

In our view, this mechanism, by operating in the same way as a re-opening mechanism, would promote the objectives of the regulatory regime by reducing the likelihood that PoM would be subject to material windfall gains or losses where:

- A forecast major capital investment proceeds or does not proceed, or is delayed or required to be brought forward; or
- An exogenously driven event (outside of PoM's control) results in a material change in its operating costs.

As noted by Incenta, provided that the threshold for accessing this mechanism is clear, and set at an appropriately high level, there should be no adverse effect in the form of reducing PoM's incentive to promote the utilisation of the port. On the contrary, Incenta's view is that the incentive properties of the regime would be enhanced by this mechanism.[91]

Table 4-4 below outlines the uncertainty mechanisms that we will apply in implementing a multi-year regulatory period.

Table 4-4 Uncertainty mechanisms for the 2023-24 to 2027-28 regulatory period

Mechanism	Principles and description
Uncertain capex project (PCEP) mechanism	This mechanism would only apply where there is a material change in capex under the Port Capacity Enhancement Program (PCEP). For the 2023-24 TCS, forecast capex includes only planning and design costs that will be incurred regardless of future evolution of the scope and timing of the project.

[88] PoM,2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023, p.14
[89] ESC, Statement of Regulatory Approach v3.0, 20 December 2022, pp.38-39
[90] See for example, ESC, Statement of Regulatory Approach v3.0, 20 December 2022, p.40
[91] PoM, 2023-24 TCS – Appendix G – Incenta, Transitioning to a multi-year regulatory period, February 2023, p.14

Mechanism	Principles and description
	An ex-post adjustment to deferred depreciation would be considered by PoM only if actual capex incurred for PCEP exceeded forecast by more than $100m.
Exogenous cost pass-through mechanism	This mechanism would only apply where there is a material change in opex related to a change in regulations, insurance event, or tax change event. An ex-post adjustment to deferred depreciation will be considered by PoM where an exogenously driven event of the following kind occurs: ▪ A change in regulations (such as under the Port Management Act, Pricing Order, or other regulations); government obligations or service obligations (such as the Port Lease or Port Concession Deed); ▪ An insurance event, where actual insurance costs are higher (or lower) than provided for in the opex forecast; ▪ A tax change event, where a change in taxes not already covered by the ARR results in a change in the costs of providing prescribed services. An ex-post adjustment to deferred depreciation would be considered by PoM only if actual opex incurred differed from forecast by more than 1% of the ARR in the relevant year. The mechanism would by symmetrical, such that material decreases in costs related to the above issues would also require consideration of an adjustment.

We have had regard to the following matters in determining the thresholds for the uncertainty mechanisms:

- For the uncertain project mechanism – the materiality threshold of $100m has been determined having regard to regulatory precedent where contingent projects generally have a pre-defined trigger event, rather than a specific materiality threshold (this is the case in both the ESC's water industry determinations and the National Electricity Rules), balanced with the intent to provide certainty to stakeholders around when the mechanism would be considered, and the likely amount of capex under PCEP;
- For the exogenous cost mechanism – the materiality threshold of 1% of annual ARR has been determined having regard to regulatory precedent in the National Electricity Rules, where insurance events are defined as being for events that have an impact of greater than 1% of maximum allowed revenue in a regulatory year.[92]

Any adjustment to deferred depreciation for the above reasons would be performed at the same time as the 'true-up' for the cost of debt described above. This would be enacted by restating the ARR for the difference between actual expenditure incurred during the regulatory period and forecast expenditure, with all else remaining equal.

[92] National Electricity Rules, chapter 10 (definition of 'insurance event')

5 Capital expenditure

5.1 Overview

This Chapter of the TCS sets out:

- Regulatory context, including:
  - Our obligations with respect to capital expenditure (capex)
  - A summary of our actions in response to feedback from the ESC
- Our approach to capital planning and delivery;
- Actual capex outcomes;
- Major projects; and
- Forecast capex for the next Regulatory Period.

5.2 Regulatory context

5.2.1 Pricing Order requirements

Clause 4.2.1(c) of the Pricing Order provides that PoM is entitled to recover a return on:

> *…efficient capital expenditure when incurred, or to be incurred during that Financial Year, by the Port Licence Holder, acting prudently, in the provision of the Prescribed Services ….*

Clause 8.2 of the Pricing Order provides in respect of forecasts:

> *8.2.1 Information in the nature of an estimate or forecast must be supported by a statement of the basis of the forecast or estimate.*
>
> *8.2.2 A forecast or estimate:*
>
> *(a) must be arrived at on a reasonable basis; and*
>
> *(b) must represent the best forecast or estimate possible in the circumstances.*

Under clauses 4.2.4 and 4.2.5 of the Pricing Order the requirement that capital expenditure be both prudent and efficient does not apply to the Port Rail Transformation Project (PRTP), the Port Capacity Project (PCP) or any other project necessary to comply with a term of the Port Lease. These projects are deemed to be prudent, but must still be demonstrated to be efficient.

5.2.2 Stewardship obligations

PoM's stewardship obligations under the Port Lease require PoM to:

- Manage, operate and maintain the Port in accordance with Good Operating Practice[93];
- Ensure the Port is capable of providing access to shipping, including being able to reasonably accommodate changing vessel sizes;[94]
- Develop the Port land and infrastructure to:
  - Cater for actual and reasonably anticipated growth;

[93] Where 'Good Operating Practice' means: adherence to a standard of practice which includes the exercise of that degree of skill, diligence, due care, prudence and foresight which would reasonably be expected of a reasonably experienced, competent, prudent and qualified operator of the Port; and provision of appropriate services and facilities for the ease of access to, expeditious and safe movement in and efficient use of the concession area and port infrastructure by vessels, vehicles and other users of the Port

[94] Port Lease, clause 8.2 and 8.4

- Provide quality and efficiency standards expected of a major port; and
- Maintain the Port's leading position among major Australian ports in terms of its quality, efficiency and effectiveness.[95]

The Port Concession Deed imposes specific obligations that relate to matters such as channel depths, maintenance and repair of assets, and also the remaining asset life for each Asset Class. These obligations are focused on ensuring that existing levels of service are maintained. These obligations are prescriptive, and include technical parameters for matters such as channel depths, asset lives and Port Load Charts.[96]

5.2.3 ESC Pricing Order compliance inquiry and Interim Commentary

In its inquiry into PoM's compliance with the Pricing Order (published 28 January 2022), the ESC found PoM's approach to capital expenditure, forecasting, planning and management over the 2016-2021 period to be compliant with the Pricing Order.[97]

However, the ESC considered PoM's existing assurance process may not be adequate for the next review period given potentially more complex and larger capital spends. The ESC indicated that it expects PoM to demonstrate the following for the next review period:[98]

- Sufficiently detailed business cases;
- Appropriate management of risk between PoM and Port Users through its cost estimation and procurement process; and
- Capital projects meet the needs of Port Users and also Victorian consumers.

Our 2022-23 TCS (published 31 May 2022) set out the actions we had undertaken, and planned to undertake, in response to the ESC's inquiry (including issues raised and recommendations from the ESC's expenditure consultants, FTI Consulting).[99] In addition to these improvements, the 2022-23 TCS also contained increased documentation for compliance demonstration.

On 20 December 2022, the ESC released its Interim Commentary on PoM's 2022-23 TCS. With respect to capital expenditure, the ESC noted its preliminary view that the measures undertaken by PoM to improve the prudency and efficiency of capital expenditure for more complex capital works appear to reflect capital planning processes appropriate for PoM's proposed capital works.[100]

Table 5-1below provides an update on the actions we have taken to continue to improve our capex forecasting and governance, with further details provided in this chapter and supporting documentation.

Table 5-1 Update on our actions to address ESC findings and recommendations on capex

Issue	Actions identified in the 2022-23 TCS	Update on progress
Adequacy of information	The 2022-23 TCS included additional detail on capital projects, including engagement activities and service outcomes from projects.	Further increases in the level of detail on major capital projects, including: ▪ A clear statement of outcomes for Port Users for each major project; ▪ A summary of the project, where the project is in the Enterprise Project Management Framework (EPMF) project lifecycle, and the total expenditure required over the regulatory period; and

[95] Port Lease, clause 26
[96] The Port Load Charts are available on PoM's website, here Use of Port Facilities | Port of Melbourne
[97] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.96
[98] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.96
[99] PoM, 2022-23 Tariff Compliance Statement – General Statement, 31 May 2022, pp.32-35
[100] ESC, *Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23*, 20 December 2022, pp.16-17

Issue	Actions identified in the 2022-23 TCS	Update on progress
		▪ A register of supporting documents.[101]
Detailed business cases	Actions in response will be delivered via the current review of the EPMF, due for completion by December 2022. Relevant activities include: ▪ Refining and clarifying the Stage Gate Process (including contingencies at each stage); ▪ Business case documentation will be reviewed to be standardised for major and minor projects. The FY23 budget includes funding for a targeted roll-out of Better Business Cases training; and ▪ The capital reporting process is to be reviewed to identify opportunities for improvement including efficient reporting for financial management and project management and dashboard capability.	The EPMF was updated in December 2022, and again in March 2023, to include:[102] ▪ A revised Stage Gate process;[103] ▪ Requirements for stakeholder engagement requirement throughout the EPMF Project Phases, referencing the Pricing Order Engagement Protocol (POEP); ▪ Additional contingency management guidelines and a Project Risk Assessment Tool.[104] Project Management Templates were updated in late 2022 to ensure standardisation of business case documentation for preliminary and investment business cases.[105] Training to improve business case quality has included: ▪ Prince2 training was delivered in March/April 2023 to key project managers and team members, including business case development; ▪ Board reporting training which outlines the critical information for decision making on business cases has been rolled out and is also now delivered to all new starters; ▪ An annual awareness program has been implemented for PoM senior leadership. In FY22, this included an information sharing session on project governance.[106] As part of the capex end-to-end reporting process review, we are currently exploring systemising monthly capex reporting and the Stage Gate process into our financial reporting system (TechOne).[107]
Contingencies	Actions already complete and in implementation: ▪ Independent Quantity Surveyors are engaged for independent advice on cost estimates early in the project lifecycle; ▪ For complex projects, Early Contractor Involvement (ECI) procurement methods are sometimes utilised to reduce uncertainty / contingency;	As noted above, the EPMF was updated in March 2023 to include additional contingency management guidelines and a Project Risk Assessment Tool.[108] This guideline operates along-side the practice of developing contingencies as part of the cost estimation process using Quantity Surveyors (QS), where risk factors are considered as part of the cost build up.

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Issue	Actions identified in the 2022-23 TCS	Update on progress
	▪ Exclusions, risks and contingencies are now quantified where possible in consultation with suppliers and Independent Quantity Surveyors; and ▪ Post project reviews will include consideration of the extent of use of contingencies. Further guidance on contingencies drawing on the above will be developed by end 2022.	Lessons from past projects have been integrated into the capital planning process via: ▪ Project Closure Report[109] and Post Implementation Reviews[110] are part of the EPMF process. This includes consideration of the extent to which contingencies have been used to inform future projects and is part of PoM's continuous improvement; ▪ The capex forecast for the next 5 years is based on QS incorporating appropriate risks contingencies based on learnings from past projects.
Pipeline view of projects	▪ The PDS Delivery Program outlines the timing and sequencing of projects over the next 15 years. PoM sought feedback from stakeholders on the PDS Delivery Program during the 2022 Industry Consultation and will implement suggested changes in the next update. ▪ The capital reporting process is to be reviewed to identify opportunities for improvement including efficient reporting for financial management and project management & dashboard capability, to be complete by end FY23.	The adoption of a five-year regulatory period for this TCS provides a more focussed five-year capex view, demonstrates a longer-term planning focus and identification of required works; and assists in project delivery by engaging the market earlier and allowing contractors to plan for projects.[111] As noted above, we are currently exploring systemising monthly capex reporting and the Stage Gate process into our financial reporting system (TechOne).
Second capex categorisation	▪ The capital reporting process is to be reviewed to identify opportunities for improvement including efficient reporting for financial management and project management & dashboard capability, with a target date for completion of end FY23. ▪ We have reviewed the possibility of adding a second capex categorisation, but having found that it is not clear that there would be any benefits to PoM or Port Users we have not implemented this change.	As noted above, we are currently exploring systemising monthly capex reporting and the Stage Gate process into our financial reporting system (TechOne). We are also in the process of scoping and procuring a new Project Management System for capex reporting.
Review ECI process	▪ In late 2021, PoM commissioned an internal audit to assess the processes and controls in place to support the execution of the ECI approach.[112] The internal audit reported a 'satisfactory' rating, and provided (minor) recommendations, which	We have continued to progress the agreed actions from the ECI audit, including: ▪ Guidance was added to the EPMF on procurement strategy and planning, including a requirement for procurement strategy to be considered on a project specific basis taking into account

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111 Planned timing and approximate value ranges for projects would provide sufficient information for contractors while maintaining some commercial tension.

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Issue	Actions identified in the 2022-23 TCS	Update on progress
	management has adopted for implementation by June 2022. A performance framework will be developed as a component of the EPMF to manage, measure, and demonstrate performance against overall project outcomes/critical success factors, with a target completion date of December 2022.	complexity, risks and feedback from the construction market.[113] This formalises the approach to determining use of ECI as one of the methods to account for risk on larger projects. ▪ A draft Contractor Performance KPI framework (incorporating ECI KPIs) has been developed[114] and will be trialled for new projects.
Review approach to establishing procurement and contracting strategy	Actions already complete and in implementation: ▪ Depending on project requirements, Independent Procurement experts are engaged to facilitate the identification of an appropriate procurement delivery approach which considers amongst other factors prudency and efficiency; ▪ The process also captures data inputs from suppliers and vendors through market engagement; and ▪ Any recommended options are not final until assumptions are validated and if assumptions materially change then recommended options are reviewed prior to making a final decision.	As noted above, the EPMF has been updated to include guidance on procurement strategy and planning.[115] Any procurement strategy is considered on a project basis considering complexity, risks and feedback from the construction market. If a Multi-Criteria Analysis (MCA) is undertaken criteria is developed based on the above. Depending on project complexity this could be independently facilitated. In addition, the new Contingency Management Guidelines in the EPMF provide tools and a template guiding the selection of procurement strategy based on project risks.[116]
Extend terms of reference for governance committees	▪ As part of the annual review of the EPMF, the Terms of Reference for governance committees are being reviewed and updated to ensure standardisation and alignment. This review will be completed in June 2022.	Terms of Reference for the Investment Review Committee (IRC) has been reviewed and updated and explicitly refer to the EPMF.[117] Enterprise Portfolio Control Group (EPCG) Terms of Reference were updated to add responsibilities to review and update the EPMF to reflect learnings to ensure it remains fit for purpose and incorporates the approval of project governance related policies and processes.[118]

5.3 Approach to capital planning and delivery

PoM's capex planning framework comprises a number of components that enable it to be confident that it is making soundly based, prudent and efficient investment decisions that will deliver outcomes that support the long-term interests of Port Users and Victorian consumers.

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The planning processes to deliver on PoM's obligations necessarily need to span long-time horizons. PoM employs fit for purpose engagement with stakeholders as well as internal governance processes consistent with each of these planning, scoping and works delivery horizons.

As recommended by the ESC in its final report, PoM has reviewed and improved its capex governance framework and project management systems to form a more robust process suited to larger and more complex projects that have been introduced into the program, such as PCEP.

5.3.1 Asset Management Systems

5.3.1.1 The Compass – PoM's Integrated Management System

The Port Concession Deed (PCD) contains specific obligations that require PoM to prepare a Port Development Implementation Plan (PDIP) and maintain accreditation to ISO 55001-Asset Management. This certification was achieved on 11 April 2019, subsequent audits of compliance have been successfully passed, and renewal of certification occurred on 25 July 2022.[119] The annual surveillance audit finished on 25 April 2023. The next recertification audit is due April 2025.

PoM seeks to achieve broader and sustainable business efficiencies through the Compass, an internal Integrated Management System (IMS), that encompasses quality, safety, environmental, and asset management systems. The Compass is designed to meet the requirements of three further ISO standards in addition to ISO 55001. These are ISO-9001:2015 – Quality Management Systems, ISO 14001:2015 – Environmental Management and ISO 45001:2018 – Occupational Health and Safety.

The intent of the Compass is to ensure PoM:

- Identifies and systematically meets customer, stakeholder and interested party needs, expectations, and compliance requirements;
- Operates in a manner that minimises potential harm to staff, sub-contractors, the community, and the environment;
- Manages its assets as a prudent port operator in accordance with compliance obligations and strategic objectives, considering stakeholder requirements and expectations; and
- Continuously improves performance in the above areas.

PoM maintains a range of policies and process flows to support its integrated management framework. Collectively they provide a framework to enable PoM to meet its responsibilities and goals.

5.3.1.2 PoM's Asset Management System

PoM's Asset Management System and supporting documents were reviewed by the ESC's consultant as part of the ESC's Inquiry into PoM's compliance with the Pricing Order. The review concluded that:[120]

> *these documents … are considered to represent a comprehensive and detailed Asset Management System. It is understood that considerable investment has been made over recent years. The system represents best practice, and many aspects (for example, wharves, dredging) are highly advanced and tailored to the Port of Melbourne's specific assets.*

All phases of investment planning and delivery are supported by PoM's asset management system.

As noted above, under the PCD PoM is required to achieve certification of its asset management system to ISO 55001:2014 - Asset Management by 2021, which has been met.

The certification process has involved the development of a Strategic Asset Management Plan (SAMP), which provides a framework to define asset management objectives in line with current organisational

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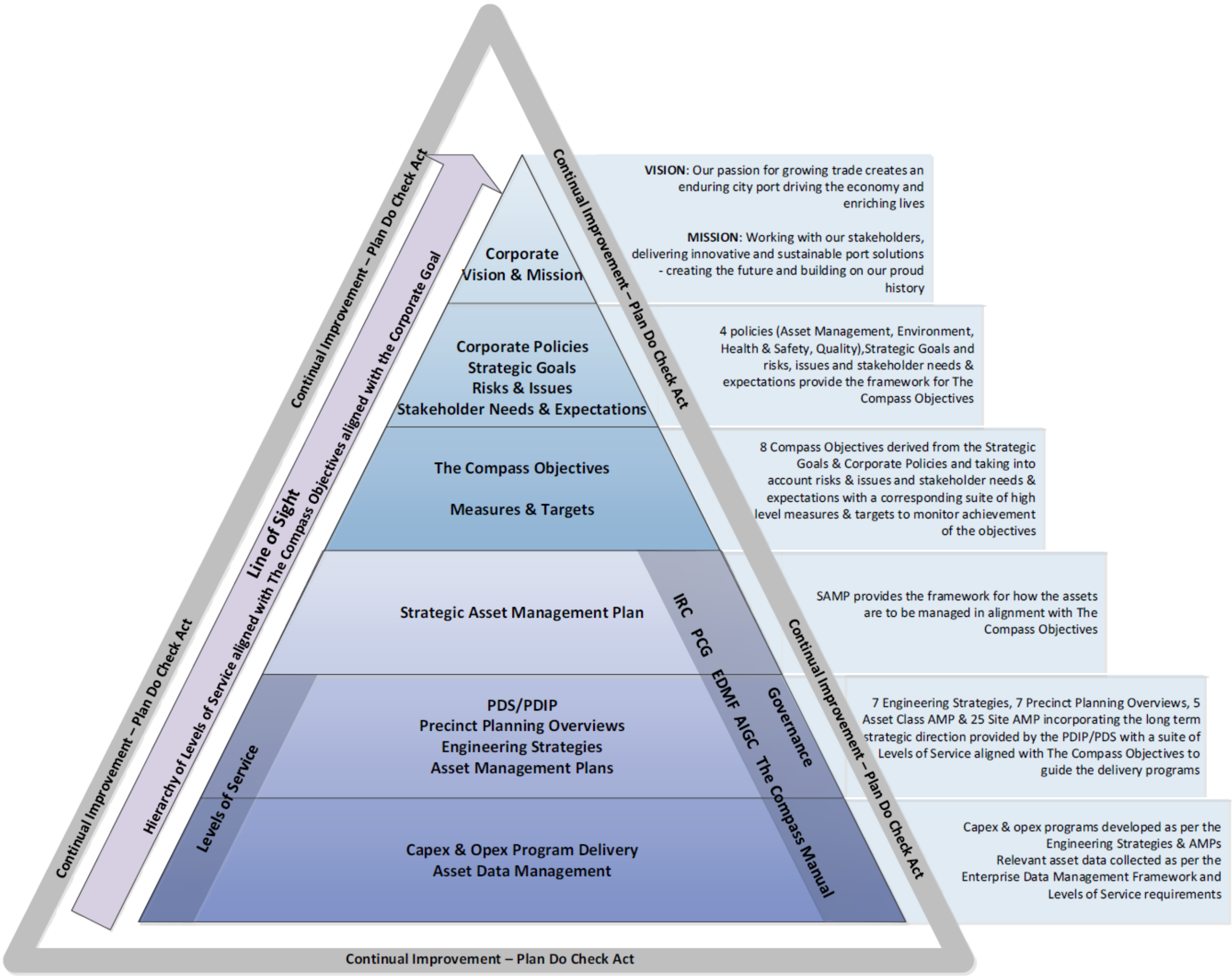
goals and aligns these with operational processes. Long-term asset management strategies and individual asset management plans align with the SAMP and overall Asset Management System (AMS).

Figure 5-1 below is a summary diagram of the AMS and its core components.[121]

Figure 5-1 Asset Management System Map



5.3.2 Medium to long-term planning

Key long term Asset Management Strategies include the PDS, the PDIP and the PDS Delivery Program. These documents provide a long-term view on investment required to meet regulatory obligations including the growth of the port.

- The 2050 PDS[122] is PoM's publicly available 30-year roadmap for the growth and development of the Port (through to 2050). The PDS outlines our development objectives and details key projects that are forecast to be required by 2035 and 2050 to meet demand and support ongoing efficiency and productivity improvements. The PDS was developed consistent with the requirements of the Ministerial Guidelines[123] and in consultation with industry, key stakeholders and the community, with 190 stakeholders participating in the development of the 2050 PDS. The PDS was finalised in 2020.

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122 The latest PDS is available on our website, [2050 Port Development Strategy | Port of Melbourne]

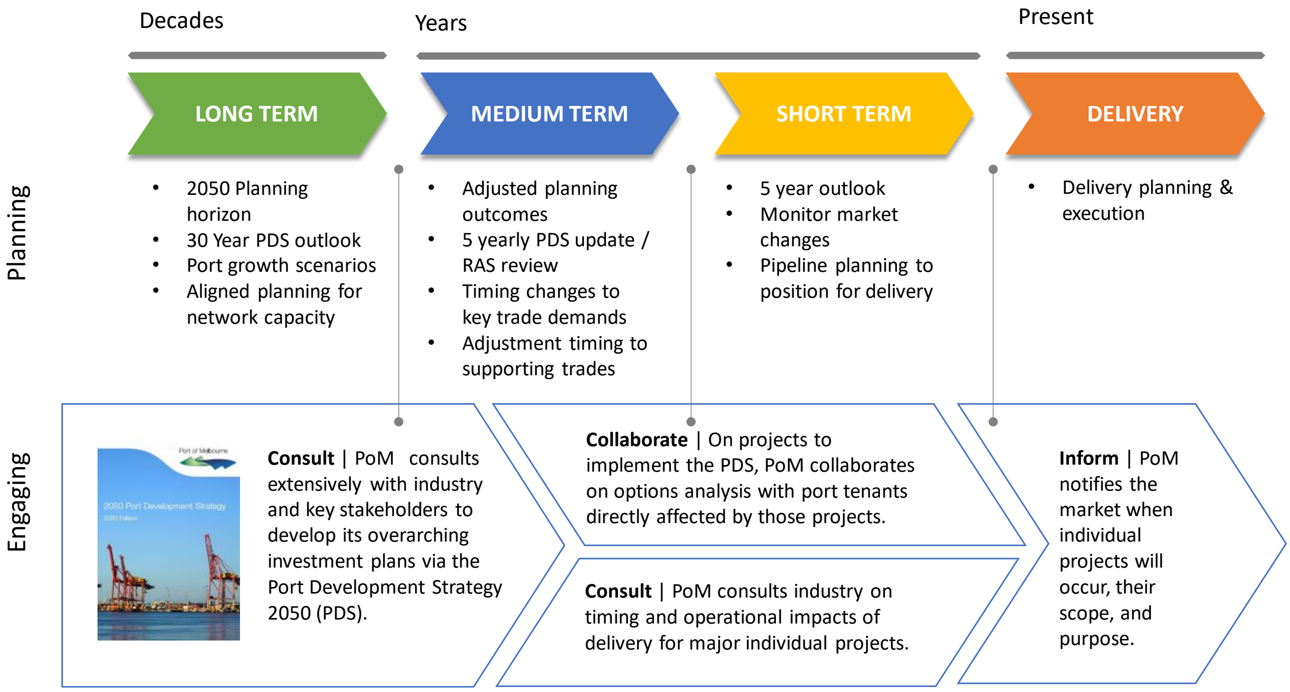
123 The Ministerial Guidelines are available on the Department of Transport and Planning website, [Port development strategies | Department of Transport and Planning]

Subsequently, the PDS will be updated and provided to the Victorian Government (at least) every five years.

- In addition to the PDS, PoM must prepare, maintain and update a Port Development Implementation Plan (PDIP) for the port precinct and the port. The PDIP includes a more detailed 15-year view of planned development activities within the Port to support port capacity and growth in trade demand. PoM submitted its first PDIP to the Victorian Government on 31 October 2017 and subsequently updated the PDIP in 2020 alongside the PDS. The PDIP is not a public document and is intended to only be used by PoM and the Victorian Government.
- The PDS Delivery Program[124] is a public version of the PDIP focused on providing Port Users and other stakeholders with information about the scope and timing of projects identified in the PDS over a fifteen-year period. The PDS Delivery Program reflects PoM's detailed internal planning to ensure that the port is developed in a logically sequenced manner and to meet obligations to develop the port. As with the PDS, the PDS Delivery Program is available on PoM's website. The timing and scope of projects, particularly those that are yet to commence, is regularly reviewed to reflect stakeholder input, updated asset condition reports, market needs and procurement considerations.

Figure 5-2 below illustrates the planning and engagement horizons and associated activities.

Figure 5-2 Planning horizons and stakeholder engagement



5.3.3 Enterprise Project Management Framework

5.3.3.1 Overview

The Enterprise Project Management Framework (EPMF) is our framework to ensure the successful delivery and effective management of capital projects.[125] The purpose of the EPMF is to:

- promote the effective governance of programmes and projects in a consistent, transparent and robust way, by providing guidance to assist project managers to:

[124] The latest PDS Delivery Program is available on our website 2050 PDS Delivery Program
[125]

– plan, govern, control and report on all projects supported by an appropriate level of governance;
– establish an approved project baseline (business case and/or project plan) before progressing to project delivery; and
– apply an appropriately scaled project governance methodology.
– provide fit for purpose guidance, templates and techniques.

The EPMF provides guidance to all employees to promote effective governance, transparency and consistency in approach across projects. However, as all projects are unique, each one is considered on an individual basis using the EPMF as a guide rather than an instruction manual.

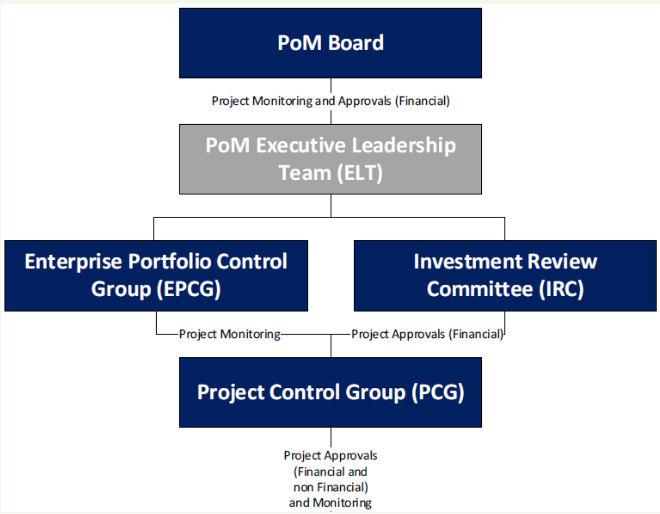
The EPMF also provides guidance and reference material on the:

- Minimum Necessary Requirements (MNR);
- Stage Gate Approval Process;
- Risk Management Methodology;
- Cost Methodology; and
- Procurement Planning and Methodology.

Following the ESC's five-year Inquiry, the EPMF has been reviewed and updated to strengthen PoM's capital planning and governance processes.

Table 5-2 provides a summary of the content of the EPMF and identifies key updates.

Table 5-2 Summary of the contents of the EPMF and updates following the five-year inquiry

EPMF content	Description
Ch3 – The Compass & Related Documentation	Overview of where the EPMF fits into the Compass system, key governance committees and their interrelationships. Guidance and links on key PoM policies and frameworks that must be applied throughout the project lifecycle, including: ▪ Delegations of Authority (DOA); ▪ Enterprise Risk Management; ▪ Procurement & Contract Management (P&CM); ▪ Occupational Health and Safety (OH&S); and ▪ Pricing Order Engagement Protocol (POEP), updated in late 2022.
Ch5 – Project Governance Structure	Overview of the overarching governance structure consisting of two discrete committees – Investment Review Committee (IRC) and Enterprise Portfolio Control Group (EPCG) which are executive level committees 

EPMF content	Description
	As noted in Table 5-1 above, as per the recommendations made by the ESC's consultant, the Terms of Reference for governance committees have been amended to fully align with the updated EPMF and approval gate process. Updated versions of the Terms of Reference for the IRC,[126] EPCG,[127] and PCG[128] have been provided to ESC.
Ch6 – Project Approval	Role of the Investment Review Committee (IRC). The IRC is an Executive Committee that reviews, evaluates, approves and/or endorses (where relevant for PoM Board approval) all capex projects and certain opex projects across all PoM divisions. Once projects are approved, the monitoring and control of projects is governed through the EPCG and PCGs, respectively.
Project Control	Role of the Enterprise Portfolio Control Group (EPCG) and Project Control Group (PCG). The EPCG is an executive committee that monitors project execution and ensures overall alignment of the project portfolio with corporate strategy, business plan and Compass objectives. PCGs are formed for individual high risk and/or high complexity projects and/or large value projects at the discretion of the ELT, to support risk management and delivery of project outcomes. The PCG is also responsible for ensuring appropriate management of project components outlined in the project management plan, and specifically, change request approvals. The PCG is chaired by the ELT member (typically the project sponsor) and consists of key senior management representing the key stakeholder groups that will assist with or be impacted by the project.
Ch8 Reporting Requirements	The EPCG uses two main sources for project reporting which are: ▪ Capex Dashboard Report (Capital Projects) – overall health of the portfolio across all projects within the PoM; and ▪ Corporate projects – overall status update on key corporate initiatives that may be non-capital in nature.
Ch9 Project Lifecycle and Approval Gate Process	The Project Lifecycle at the PoM is defined by four phases undertaken to deliver the required outcomes. These phases are Identification, Planning, Delivery and Close Out with the lifecycle explained further throughout the document. The Project Lifecycle is supported by a six-stage gate approval process (Figure 4) with a purpose of providing a staged approach to expenditure approval with specific controls and considerations at each approval stage. The approval gate process is a guideline only and depending on project specifics, from time to time projects may not go through each stage gate for approval of expenditure and progress. In response to the findings of the ESC Inquiry, the project lifecycle and approval gate process has been updated to create a more robust project management framework and to provide a higher level of control throughout the project lifecycle: ▪ Two additional stage gates to align with the updated six investment stages; ▪ Splitting the Deliver project phase into two separate investment stages, Pre-Delivery/Procurement and Delivery. The additional approval gate was introduced in the event of funding variations due to significant variance from the baseline established in the Planning phase. These variances may be a result of tender outcomes and scope changes that can have a significant impact on a project. The additional approval stage will provide greater control over the procurement phase to ensure cost effective outcomes are delivered;

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EPMF content	Description
	▪ Project Closure Reports and Project Implementation Reviews are now a requirement of the final Close phase to ensure that completed projects are ready to be to handed over to operations and that any important lessons learnt are captured for future projects; and ▪ Updated business case templates and guidelines are aligned to the first three approval gates and are required by the IRC before granting approval.
Appendix A – PoM Project Lifecycle Roadmap	The roadmap depicts the key stages to consider as the project progresses through PoM's project lifecycle.
Attachment 1 – Minimum Necessary Requirements	Minimum Necessary Requirements (MNR) for each stage of the project lifecycle. Developed to assist Project Managers to ensure they prepare and actively maintain the necessary documents and artefacts to support consistent project management practices. Identifies which documents are required as mandatory or by exception and at what stages they need to be created and/or updated. Provides links to all project management templates required for each stage.
Attachment 2 – Stage gate approval process	Updated in December 2022 to align with the revised Stage Gate Approval process described in Chapter 9 (see above). Summary of the purpose and requirements for each stage gate (gates 1 to 6). Provides detailed guidance material on the purpose and key steps in each phase in the project lifecycle: ▪ Identify – formally initiate a project with the intent to define the problem, scope, justification, deliverables, potential solutions, timescales, governance structure and risks; ▪ Planning – further define the scope of the project and further explore potential options to provide a recommended option for delivery; ▪ Deliver – project deliverables are physically built in accordance with the approved project scope and detailed designs; and ▪ Close out – wind up project and review.
Attachment 3 – Risk Management Methodology	Updated in December 2022 to align with the updated EPMF (see above). Provides links to our Risk Management Policy (Enterprise Risk Management Framework). Risk management will typically be the domain of the PCG and/or EPCG. Risks that are Extreme or High are escalated via the PCG and/or EPCG to ensure risks are appropriately managed.
Attachment 4 – Cost methodology	Updated in December 2022 to align with the updated EPMF and revised stage gate approval process (see above): ▪ Identify (Gate 1) – aim to achieve 50-70% cost accuracy, typically via the use of an independent Quantity Surveyor; ▪ Planning – Concept (Gate 2) – aim to achieve 50-30% cost accuracy, reflect a more specific scope with detailed data; and ▪ Planning – Development (Gate 3) – aim to achieve 30-20% (pre-tender) or 20-10% (post-tender) cost accuracy, based on detailed design.
Attachment 5 – Procurement planning and methodology	Guidance on the three key delivery models that the PoM utilises – Construct Only, Design & Construct (D&C); and Early Contractor Involvement (ECI). Following the five-year Inquiry, PoM commissioned an internal audit to assess the processes and controls in place to support the execution of the ECI approach. The internal audit reported a 'satisfactory' rating, and provided (minor) recommendations. We have continued to progress the agreed actions from the ECI audit as follows: ▪ Guidance was added to the EPMF on procurement strategy and planning, including a requirement for procurement strategy to be considered on a project

EPMF content	Description
	specific basis taking into account complexity, risks and feedback from the construction market.[129] This formalises the approach to determining the use of ECI as one of the methods to account for risk on larger projects. ▪ Implemented guidance to engage an independent QS to appropriately assess and assign risk via the Contingency Management Guidelines (Attachment 6 of the EPMF). ▪ Margin & Overhead tendered and locked in for the duration of the project from commencement of ECI phase; ▪ ECI rates are competitively tendered and locked in for duration of ECI phase; ▪ Trade costs are competitively tendered to sub-contracting market where three quotes per trade works package are required for PoM's assessment and approval; and ▪ Preliminaries - developed through ECI phase. Separate from the EPMF, a draft Contractor Performance KPI framework (incorporating ECI KPIs) has been developed and will be trialled for new projects.[130]
Attachment 6 – Contingency Management Guidelines	Updated in March 2023 to provide guidance on how to develop and use contingency when establishing project budgets and managing contingency throughout the project lifecycle. Definitions of cost components for budget development: ▪ Budget cost estimate: an estimate of the direct and indirect costs of a project (usually with the assistance of a QS). ▪ Contingency: an additional sum based on the risk profile of the project to account for “known unknowns” and possibly minor “unknown unknowns”. Guidelines on contingency determination at each approval stage. A questionnaire has been developed to qualitatively determine the level of contingency required in a given project. This questionnaire has 12 criteria, and their questions are specifically tailored for port related projects (Appendix A of Attachment 6).

5.3.4 Capitalisation framework

PoM capitalises costs in accordance with its Capitalisation of Costs Framework. The framework is reviewed no later than every two years subject to any event which, in the opinion of Management, necessitates an earlier review. This framework was most recently updated in July 2022.[131]

It sets out the basis by which PoM capitalises its costs in accordance with the relevant accounting standards including AASB16 Property, Plant & Equipment, AASB 138 Intangible Assets, AASB 123 Borrowing Costs and AASB13 Fair Value Measurement. It is maintained by PoM’s Financial Controller.

PoM’s capitalisation framework, and compliance with the framework, was reviewed as part of PoM’s internal audit process in 2022 by Deloitte Touche Tohmatsu, and was assessed as ‘effective’ (the highest level). The auditor’s conclusion noted that our testing over capitalised costs and assets validated the strength of the processes and controls, with all costs tested being capital in nature with appropriate review and approval.[132]

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Capitalised cost balances are also subject to PoM's annual external audit process (currently undertaken by KPMG) which provides the Board with independent assurance that the capitalisation process being followed is consistent and compliant with accounting standards and practices.

A copy of PoM's capitalisation framework has been provided to the ESC.[133]

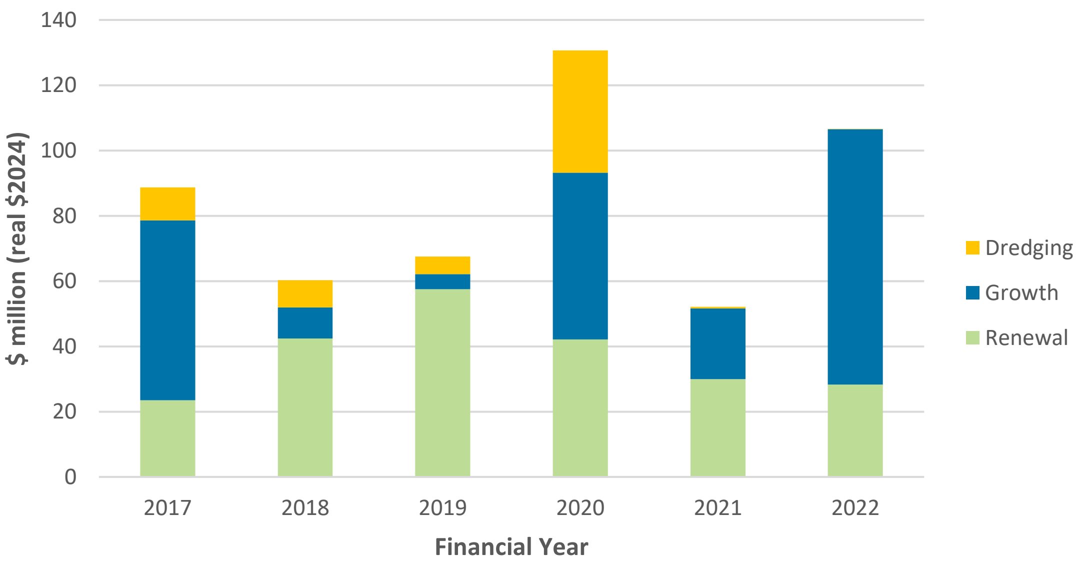
5.4 Actual capex outcomes

5.4.1 Historic capital expenditure

Figure 5-3 provides a summary of actual capex by driver since the commencement of the Port Lease. Expenditure has varied from a low of $45.9m in 2020-21 to $112.5m in 2019-20 ($real $2024).[134] Drivers of the capital program have included:

- Completion of the Port Capacity Project in 2016-17;
- Dredging in 2019-20, with a portion of the program brought forward to take advantage of the availability of the large dredge Magnor to achieve cost reductions;
- Commencement of the PRTP in 2019-20, which began ramping up in 2021-22;
- Rehabilitation of Swanson Dock East in 2019-20 and Swanson Dock West in 2021-22; and
- Commencement of the WDE Berth 4 & 5 Extension in 2020-21 and mobilisation in 2021-22.

Figure 5-3 Prescribed capex by driver, 2016-17 to 2021-22, $m (real $2024)



5.4.2 Actual expenditure in 2021-22

Actual gross prescribed capex in 2021-22 was $94.8m, $91.2m below the original forecast in the 2021-22 TCS of [redacted]

Table 5-3 Comparison of 2021-22 forecast and actual capex, ($m, nominal)

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134 All capex figures in this section are expressed in gross prescribed terms (i.e. before capital contributions and asset disposals are removed and inclusive of capitalised costs) unless otherwise stated.

	2021-22(F)	2021-22(A)	Difference (%)	Difference ($m)
Gross Prescribed Capex	186.0	94.8	(49%)	(91.2)

Note: Capex is expressed in gross prescribed terms (i.e. before capital contributions and asset disposals are removed).

Unprecedented supply chain issues as a result of the COVID-19 pandemic were the key driver in underspend against forecast. In addition, there was some reallocation of timing of the dredging program to reduce overall project costs. The shortfall in expenditure is largely due to delays and restructuring of four projects:

- PRTP expenditure was [redacted] below forecast, primarily attributable to:
  - Delayed acceptance from stakeholders of the signalling design and ongoing supply chain constraints that affect the timely availability of materials (such as storm water pits, electrical substations and High Voltage (HV) cabling) with suppliers struggling to meet scheduled delivery dates;
  - Severe direct impacts to site operations occurred due to construction staff and subcontractors contracting COVID-19 and/or being required to isolate;
  - Delays in the procurement of HV equipment and associated power cabling due to industry demand, with lead times up to 20 weeks from typical industry average of 10-12 weeks. This is consequently impacting the completion of the Intermodal Way (PPV Road), which is dependent on existing HV power assets being relocated to enable the construction of the Intermodal Way assets being installed; and
- WDE Berth 4 & 5 Extension was [redacted] below forecast. COVID-19 shutdowns in China caused disruption to supply chains, resulting in major delays in the delivery of piles. Piles were delivered in July 2022 rather than the scheduled delivery date of June 2022. Chinese ports were shut down from 30 March 2022 for a period of 4 weeks, with cascading effects through the supply chain.
- Swanson Dock West remediation was [redacted] below forecast, due primarily to:
  - DP World Australia's request to explore additional staging options, which led to a revised stakeholder engagement approach to allow stakeholder participation on staging alternatives. This saw a deferral of commencement of works from the originally forecast of late 2021-22 to early 2023;
  - Severe direct impacts to site operations occurred due to construction staff and subcontractors contracting COVID-19 and/or being required to isolate; and
  - Similarly to WDE, major delays due to COVID-19 saw piles delivered in July 2022 rather than the scheduled June 2022.
- Maintenance Dredging Program was [redacted] below forecast. The 2021-22 MDP was deferred to 2023-24, to align with availability of a large backhoe dredge in Australian waters, which reduces both unit rates and mobilisation costs.

5.4.3 Estimated expenditure in 2022-23

The 2022-23 financial year is not yet complete, however the current estimate is that capex will be approximately $218.7m compared to the original forecast of $192.8m.

This estimate is based on actual capex (before cost allocation) data up until 31 March 2023 (total spend before cost allocation of $142.8m), and a re-forecast of expenditure for the last three months of the year as at 31 March 2023.

Table 5-4 Comparison of 2022-23 forecast and estimated capex, ($m, nominal)

	2022-23(F)	2022-23(E)	Difference (%)	Difference ($m)
Capex	192.8	218.7	13%	25.9

Note: Capex is expressed in gross prescribed terms (i.e. before capital contributions and asset disposals are removed).

PoM expects to marginally exceed the original capex forecast for 2022-23, primarily due to bringing forward the (previously deferred) dredging program to commence in late May 2023 and run for a duration of approximately five weeks. This adds [redacted] forecast above the original 2022-23 budget.[135]

PoM notes that the ramp up in expenditure in 2022-23 reflects concurrent delivery of three major projects (SDW Remediation, PRTP, and WDE Berth 4/5 Extension) in conjunction with a large dredging program.

As shown in the following sections, this level of expenditure is anticipated to remain for the next two years, before either:

- Falling away, with the completion of the major growth projects (PRTP and WDE) such that ongoing expenditure is mainly taken up by the SDW Remediation; or
- Increasing towards the back end of the regulatory period, if foreshadowed growth projects (in particular, PCEP) progress within the regulatory period.

We consider that recent delivery of capex supports the deliverability of the capex program for the next regulatory period.

5.5 Major projects and programs

Table 5-5 below provides a summary of the major projects and programs for the next regulatory period. These 9 projects and programs amount to $517.3m (real $2024) in capex over the regulatory period, and account for approximately 77% of the total prescribed capex program (before accounting for capitalised costs and capital contributions). The table also identifies the capex classification (renewal, growth, or dredging) and project phase within the EPMF (Identification, Planning, Delivery, Close).

Table 5-5 Major projects and service outcomes for the next regulatory period

Project/Program (EPMF stage)	Scope and service outcome	Timing of completion	2024-28 cost ($m, real $2024)
SDW Remediation Renewal (Gate 4 – Delivery)	Wharf remediation, retaining walls remediation and bollard upgrades. This project ensures that current customers are able to continue using the SDW wharf consistent with the tenancy agreements in place. The proposed works have been scoped to ensure that the Port can continue to provide reliable access to shipping including accommodating vessels of the size and type required by customers, and to provide future infrastructure opportunities to cater for expected customer growth, to maintain the quality, effectiveness and efficiency of services provided to customers, and specifically to improve the operational efficiency and long-term commercial sustainability of the Swanson Dock terminals.	2027-28	[redacted]

[135] Before allocation of capitalised costs.

Project/Program (EPMF stage)	Scope and service outcome	Timing of completion	2024-28 cost ($m, real $2024)
PRTP Growth (Gate 4 – Delivery)	Acquisition of existing rail assets and rail terminal land within the Port, construction of the Swanson Dock East Rail Terminal, and improvements to rail and road access infrastructure. The improved rail infrastructure within the Swanson, Appleton and Victoria Dock Precincts aims to support lower cost rail services into the Port as well as providing additional network wide capacity for servicing regional/interstate trains and metro trains. The PRTP will therefore improve efficiency in the current and future use of, and future development and improvements to, rail throughout the Port.	2023-24	[redacted]
Webb Dock East 4&5 Berth Extension Growth (Gate 4 – Delivery)	Demolition of the knuckle, extraction and replacement of timber piles with steel, construction of new wharf and hardstand, and dredging of the berth pocket. The project will restore the operational capacity of WDE, and allow it to accommodate two large vessels simultaneously, providing competition in the stevedoring market and the ability to service an increasing number of larger vessels deployed in the Australian market.	2023-24	[redacted]
South Wharf Berth 28-29 Rehabilitation Renewal (Gate 2 – Planning)	Various rehabilitation works including slab replacement, beam replacement, concrete repair, replace/rehabilitate bollards and fenders, and repair/replace sheet pile walls. The rehabilitation of the site will allow customers to continue to utilise the berths and enable larger vessels to once again be serviced there, consistent with the original design expectations.	2027-28	[redacted]
Stony Creek Pipe Bridge Replacement Renewal (Gate 2 – Planning)	Construction of a new bridge with pedestrian access, and piling with the existing structure footprint. The current bridge and pipeline alignment will be retained. The project will ensure that the pipeline operators can continue to operate, inspect, and maintain the product pipelines in accordance with current arrangements. PoM has committed to funding the construction of a basic level structure in accordance with the PCD, with pipeline operators responsible for all costs associated with the removal/re-establishment of their pipelines and any additional costs incurred from changes to the design they request to achieve higher levels of service.	2025-26	[redacted]
PCEP Growth (Gate 1 – Identification)	Expenditure included in the TCS forecast includes only the scope of works required for the planning and design activities necessary to achieve the investment decision point, that is, the Investment Business Case. Following the Investment Business Case, a decision will be made concerning the timing for progressing to construction. The program's core objective is to expand capacity and enhance facilities at the Port to meet Victoria's growing trade needs. The expenditure included in this TCS will enable the preparation of an Investment Business Case to support a decision on progressing to construction in 2024-25.	2024-25 (Investment Business Case)	[redacted]

Project/Program (EPMF stage)	Scope and service outcome	Timing of completion	2024-28 cost ($m, real $2024)
Maintenance Dredging Program (MDP) Dredging (Gate 3 – Planning)	An ongoing program of works involving periodic dredging campaigns to maintain the channel depths. The dredging program will ensure that customers are able to continue to safely navigate the Port by maintaining the required declared depths outlined in the PCD.	Ongoing	[redacted]
Beacon pile replacement program Renewal (Gate 2 – Planning)	A program for the replacement and repair of Aids to Navigation (AtoNs) which provide navigational assistance to vessel traffic while in Port waters. This project enables PoM to deliver safe, responsible, and reliable port facilities and ensures that customers can continue to safely navigate Port waters.	2027-28	[redacted]
Roads CAPEX program Renewal (Gate 3 – Planning)	Targeted intervention is required to remediate or reconstruct the pavement sections identified as having high levels of failure. Certain sections will require full-depth stabilisation and some sections will require reconstruction of kerbs and potentially even drainage. A rolling, ongoing and annual Roads Capex Program will provide flexibility in the programming of road remediation and reconstruction works. This will allow for the continued access to the Port and places of infrastructure as heavy vehicles continue to grow in volume and potentially in axle loads over time.	Ongoing	[redacted]

Source: 2023-24 TCS – Appendix I – Major Projects
Note: Capex is expressed in gross prescribed terms (i.e. before capital contributions and asset disposals are removed) and before allocation of capitalised costs.

5.6 Forecast capex for the next Regulatory Period

5.6.1 Key principles and approach

The key principles for developing the capex forecast were as follows:

- Prudency and efficiency – projects need a well-defined driver and demonstrated approach to achieving least cost in procurement and delivery. Demonstrated alignment with key capex systems and processes (such as the Enterprise Project Management Framework (EPMF)) is a key component of this;
- Deliverability – the forecast as a whole should be consistent with PoM’s proven ability to deliver a certain level of capex; and
- Allocation of risk – there should be appropriate sharing of risks of forecasts being wrong between PoM and our customers. PoM needs to demonstrate that the costs we are imposing on customers for projects are reasonable. Consideration of the EPMF stage gate process is an important component of this decision.

Following development of the draft forecast over the course of late 2022 and early 2023, a series of specially convened workshops with the Investment Review Committee (IRC) were convened to challenge and refine the forecast.

We have undertaken significant engagement programs in relation to two of our major projects (PCEP and SDW Remediation) during the current regulatory period, which are summarised in Chapter 3. The PCEP engagement program is ongoing.

5.6.2 Key drivers

Much of PoM's capex is for renewals and reflects contractual, compliance and regulatory obligations. Our renewals expenditure is driven by our obligations under the PCD to:

- Maintain and repair assets in good repair, in good working order and condition and fit for purpose; and
- Maintain minimum remaining service lives for each class of port asset.

The PCD also establishes strict requirements concerning dredging.

The remainder of the capex program is on the following growth projects:

- The PRTP and WDE Berth 4/5 Extension, which have previously been assessed by the ESC and are due for completion within the first year of the regulatory period; and
- PCEP, for which we have only included capex required to take the project to the Investment Business Case (Delivery stage under the EPMF), noting that there is the potential for material additional expenditure on this project should a decision be made to proceed to construction within the regulatory period.

5.6.3 Appropriate allocation of risk

With respect to managing uncertainty for the capital projects forecast, we are taking a risk-based approach to forecasting and bearing a material level of forecasting and delivery risk, such that Port Users are not asked to bear the full cost should the project scope or timing change. This has been achieved via:

- Including only a portion of the total expected capex in the forecast. For example:
  - for PCEP we have only included design and planning costs out to 2024-25 (the forecast timing of when the project would arrive at Gate 3 under the EPMF), but no construction costs;
  - while we anticipate a need to undertake material renewal expenditure at Yarraville 6 and Appleton Dock during the next five years, the final scope and timing of these works are uncertain (including the potential for direct contributions from Port Users for bespoke service solutions). While our indicative estimates suggest the combined expenditure for these two projects could exceed [redacted], we have only included minor renewals capex for these assets in our TCS forecast. Actual prudent and efficient capex (that are not subject to direct contributions from Port Users) will be rolled into the asset base at the beginning of the subsequent regulatory period, however PoM will bear the financing costs of capex undertaken during the coming regulatory period;
- Optimising contingency allowances where we consider it appropriate for PoM to bear the costs of uncertainty on behalf of Port Users. In total, we have excluded [redacted] of project allowances and contingencies from our forecast; and
- Smoothing the profile of major project expenditure to ensure deliverability. Specifically, we have shifted [redacted] of the forecast for SDW Remediation from 2023-24 to 2024-25. The effect of this has been to reduce 2023-24 capex forecast and bring it in line with our current estimate for 2022-23, which we consider is consistent with demonstrating that the forecast is prudent, efficient and deliverable.

Our view is that these approaches have the effect of providing significant benefits to Port Users from the adoption of a five-year regulatory period, because there will be strong incentives on PoM to deliver outcomes via capital projects at the lowest efficient cost.

5.6.4 Independently validated cost estimates

Cost estimates in our TCS are independently developed and/or validated by external experts:

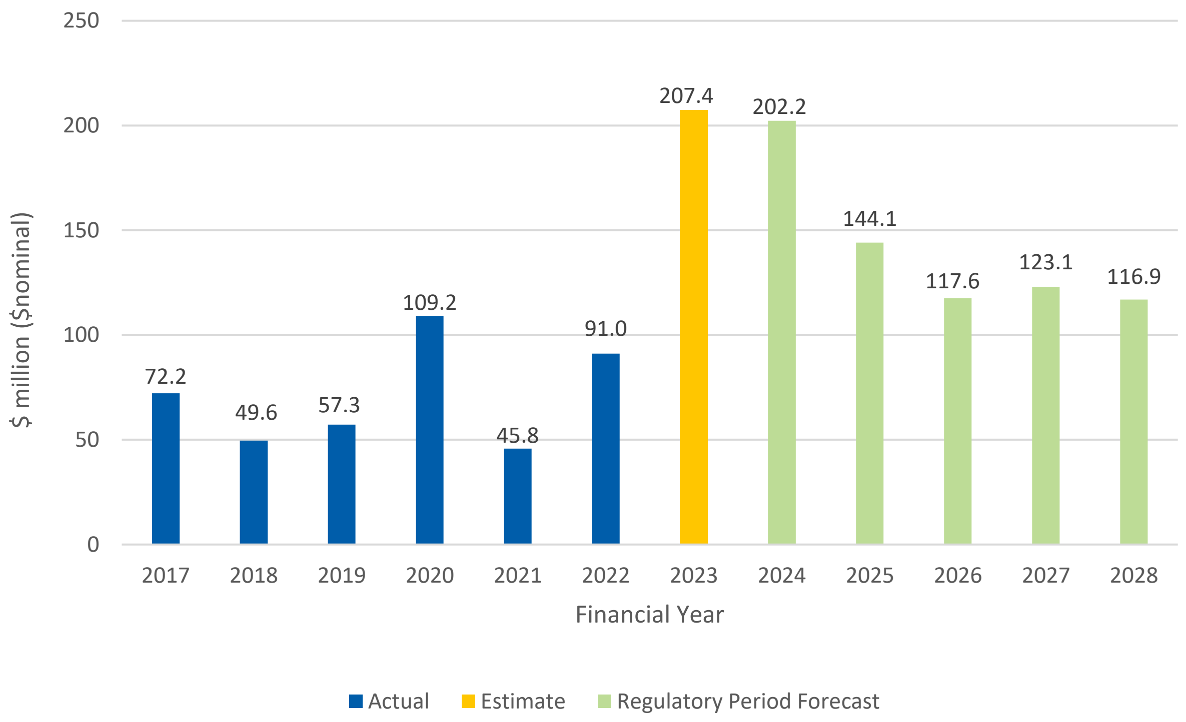
- Depending on project needs, Independent Quantity Surveyors are engaged for advice on cost estimates early in the project lifecycle and these estimates are continuously updated by the QS as the project matures through the project lifecycle;
- Engagement of independent expert advisors on Quality Assurance, which supports improvement in all areas (e.g. utilising Swanson Dock East remediation learnings on productivity rates and improved engineering processes); and
- We have engaged an Independent Quantity Surveyor to provide benchmark unit rates across various asset types to inform budget forecasting for minor remediation works less than $10 million.

5.6.5 Prescribed capex forecast for the next regulatory period

PoM's net prescribed capex forecast for the 2024-28 Regulatory Period is $705.7m. Average total capital expenditure is $141.1m per annum, compared to the historical average of around $90.4m per annum (including the $207.4m forecast to be spent in 2022-23).

While this is a step up from historical capex, progress to-date against the 2022-23 budget provides a clear indication of PoM's ability to deliver on a capital program of this size.

Figure 5-4 2024-2028 forecast net prescribed capex $m ($nominal)



Note: Capex is expressed in net prescribed terms (i.e. after capital contributions and asset disposals are removed).

6 Operating expenditure

6.1 Overview

This Chapter of the TCS sets out:

- Regulatory context, including:
  - Our obligations with respect to opex
  - A summary of our actions in response to feedback from the ESC
- Actual opex outcomes and variations from forecast expenditure;
- Our opex forecasting governance processes;
- Forecast opex for the next Regulatory Period; and
- A revised forecast for the 2022-23 Regulatory period.

6.2 Regulatory context

6.2.1 Pricing Order requirements

The Pricing Order sets out the following requirements for operating expenditure:

> *4.1.1 For the purposes of determining its Aggregate Revenue Requirement, the Port Licence Holder must apply an accrual building block methodology over the Regulatory Period comprising: …*
>
> *c) an allowance to recover its forecast operating expenses, commensurate with that which would be required by a prudent service provider acting efficiently …*
>
> *8.2.1 Information in the nature of an estimate or forecast must be supported by a statement of the basis of the forecast or estimate.*
>
> *8.2.2 A forecast or estimate:*
>
> *a) must be arrived at on a reasonable basis; and*
>
> *b) must represent the best forecast or estimate possible in the circumstances.*

6.2.2 ESC Pricing Order compliance inquiry and Interim Commentary

In its inquiry into PoM's compliance with the Pricing Order, the key findings of the ESC in relation to operating expenditure were as follows:

- PoM did not comply with 4.1.1(c) because it had not demonstrated that its approach to establishing total opex for the review period was prudent and efficient;[136]
- The opex forecasts for 2019-20 and 2020-21 did not comply with clause 8.2.2(a) and (b);[137]
- PoM's non-compliance was sustained because its approach to forecasting and governance processes remained consistent over the review period;[138] and
- The non-compliance was not significant because PoM's forecasts did not have a material impact on Port Users over the review period.[139]

[136] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.83
[137] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.90
[138] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.83
[139] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.83

Our 2022-23 TCS (published 31 May 2022) set out the actions we carried out, and planned to undertake, in response to the ESC's inquiry (including issues raised and recommendations from the ESC's expenditure consultants, FTI Consulting).[140] In addition to these improvements, the 2022-23 TCS also contained increased documentation for compliance demonstration.

On 20 December 2022, the ESC released its Interim Commentary on PoM's 2022-23 TCS. With respect to operating expenditure, the ESC noted that:

- PoM was progressing towards improving its forecasting of operating expenditure and reiterated its recommendation that PoM adopt a Base-Step-Trend forecasting approach;
- However, the ESC considered that PoM should use 2019-20 as its base year for the forecast, rather than the last year of actual operating expenditure as proposed in the 2022-23 TCS; and
- For the purposes of establishing an efficiency assumption, the Port should consider net efficiency (the efficiency factor after removing the increase in operating expenditure due to the growth rate) versus gross efficiency as the driver of trend operating expenditure.[141]

Table 6-1 below provides an update on the actions we have taken to continue to improve our operating expenditure forecasts, with further details provided in this chapter and supporting documentation.

Table 6-1 Update on our actions to address ESC findings and recommendations on opex

Issue	Actions identified in the 2022-23 TCS	Update on progress
Adequacy of information	The 2022-23 TCS included additional detail on opex, including engagement activities and service outcomes from projects.	Further detail is provided on forecast opex, including: ▪ Background, justification and estimates for each of the step changes included in PoM's controllable opex forecast[142]; ▪ Supporting consultant report providing independent expert advice on application of the Base-Step-Trend approach[143]; and ▪ A register of supporting documents.[144]
Review of forecast versus actual costs	We have reviewed opex forecasting accuracy for the previous review period and implemented changes to improve accuracy going forward, which include the adoption of independent, external forecasts of wage and construction cost increases.	A further review of forecast accuracy against actual outcomes has been undertaken, and contributed to the improvements outlined below and throughout this chapter. Analysis of historical outcomes reveals: ▪ Significant cost reductions post-privatisation, such that 2019-20 is one of the lowest years of opex in recent history; ▪ Increases in actual opex from 2019-20 to 2022-23/2023-24 reflect rebuilding the business to meet the demands of the regulated operating environment. The key drivers of these cost changes are set out in further detail in this section of the TCS and in the supporting report from Deloitte Access Economics (DAE) (Appendix K).

[140] PoM, *2022-23 Tariff Compliance Statement – General Statement*, 31 May 2022, pp.54-56
[141] ESC, *Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23*, 20 December 2022, pp.15-16
[142]
[143]
[144]

Issue	Actions identified in the 2022-23 TCS	Update on progress
Efficiency targets and forecasting process – Base-Step-Trend	A first cut of Base-Step-Trend approach has been developed, including: - A productivity growth target of 0.5% for Prescribed Services opex; and - An initial assessment of the relationship between opex and key cost drivers (demand and capital growth). The Base-Step-Trend was then compared to the bottom-up forecast to inform efficiency of the forecast. Following submission of the 2022-23 TCS we will undertake further work to build on our understanding of the relationship between opex and growth to inform the 2023-24 TCS.	The concerns raised by the ESC in its Interim Commentary have been addressed: - The Base-Step-Trend (BST) has been adopted as the basis of the opex forecast for this TCS and the five-year regulatory period; - 2019-20 has been adopted as the base year for the forecast; and - For the purposes of establishing an efficiency assumption for the next regulatory period, PoM has used net efficiency as the driver of trend operating expenditure. PoM has put in place ambitious opex targets for the next regulatory period[145]: - A general productivity growth rate of 3.0% p.a.; and - An average net efficiency rate of -0.3% p.a. (i.e. no real growth in opex from 2022-23 through 2027-28 including step changes). This results in an average net efficiency rate (exclusive of step changes) of 0.8% p.a. from 2019-20 to 2027-28 (the equivalent figure after step changes is 2.9% p.a.). The implementation of the Base-Step-Trend approach has been informed by independent expert advice from DAE. [146] To address compliance issues raised by the ESC in relation to operating expenditure for the 2022-23 TCS, PoM has investigated re-stating the opex forecast from the 2022-23 TCS using the BST approach with a base year of 2019-20. As set out in this chapter, the revised forecast would be higher than the original forecast, so we have retained the original forecast.
Forecasting process – bottom-up forecasts	The bottom-up forecast approach has been enhanced via: - Adoption of a growth-adjusted CPI cap on cost increases for total opex; - Additional guidance material provided to teams preparing the forecasts, including an expectation to identify efficiency savings; and	PoM has continued to develop forecast opex using a bottom-up approach, as a requirement for annual budgeting purposes. The bottom-up forecast process has been conducted in conjunction with the development of the BST forecast, to ensure accuracy and consistency. Updates to the process for this year included: - Longer lead times to develop key aspects of the forecast at the Divisional and Responsibility Centre level; - A formal Opex Challenge Workshop; and

[145] PoM has set its internal opex targets based on total controllable opex rather than prescribed opex (results are shown in both total and prescribed opex). This approach is considered to provide a more meaningful target on the basis that a significant portion of opex is shared between prescribed and non-prescribed services, and allocated based on share of revenue, which is largely outside of PoM's control.

[146]

Issue	Actions identified in the 2022-23 TCS	Update on progress
	▪ Forecasts have been challenged by senior management, shareholders and the Board.	▪ Early engagement with the Board to refine the forecast before seeking approval.
Benchmarking and labour costs	Actions to review and benchmark labour costs, including: ▪ Development of a five-year workforce plan; ▪ Benchmarking labour force against another capital city port; ▪ Benchmarking remuneration for executive and key roles; and ▪ A proposal to share port data for workforce benchmarking.	In mid-2022, PoM initiated a benchmarking exercise with 11 Australian port organisations. The benchmarking work was undertaken by independent experts DAE and involved survey design, data collection and reporting.[147] All data were treated confidentially, such that participating ports (including PoM) are not able to access data from other ports. Participating ports each received a version of the benchmarking report specific to their business. The results of this benchmarking report contributed to DAE's advice on the implementation of the Base-Step-Trend.

6.3 Actual operating expenditure outcomes and forecast accuracy

Table 6-2 sets out the difference between forecast and actual opex over the last two annual regulatory periods.

Table 6-2 Forecast less actual controllable prescribed opex, $m ($nominal)

Opex category	2021-22			2022-23		
	Forecast	Actual	Difference	Forecast	Updated Forecast	Difference
PRTA Costs	NA	4.4	NA	4.5	4.9	0.4
Insurance, Rates & Taxes	2.2	2.0	-0.3	2.6	2.6	0.0
Land Tax	0.0	0.0	0.0	0.0	0.0	0.0
Labour Costs	16.3	13.8	-2.4	15.8	12.1	-3.7
Repairs & Maintenance	4.2	3.9	-0.3	3.9	4.9	1.0
Construction	0.0	0.0	0.0	0.0	0.0	0.0
Professional Services	6.3	5.0	-1.3	7.2	5.9	-1.3
Security	1.8	1.7	-0.2	1.9	1.8	0.0
Utilities, Admin, Rental & IT	7.7	4.0	-3.7	4.9	4.5	-0.5
Non-Recurring	1.0	4.9	4.0	2.3	1.6	-0.8
Total	**39.5**	**39.6**	**0.2**	**43.0**	**38.2**	**-4.8**
Total forecast error (%)			**0.5%**			**-12.6%**

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We make the following observations on the level of forecast error in the last two years:

- In 2021-22, with a significant level of unanticipated non-recurring costs, PoM adopted a strategy of stringent cost control across the business to offset this cost increase. Higher than forecast non-recurring costs were offset by lower than forecast labour costs and professional services costs;
- Differences in the Insurance, Rates & Taxes and Utilities, Admin, Rental & IT categories in 2021-22 primarily reflect the fact that PRTA costs were included within these categories in the 2021-22 forecast but are now separated out into a separate category because these costs are considered noncontrollable; and
- Forecast error in 2022-23 is based on the latest available estimate for 2022-23 opex. It shows a significant increase in forecast error, with PoM delivering a much lower actual opex outcome than forecast. This has been primarily the result of a tight labour market resulting in both vacancies and difficulties in filling new roles (a number of roles targeted for 2022-23 have shifted into 2023-24). We are also forecasting a much lower level of labour costs going forward, based on the ambitious efficiency target and initiatives outlined in the following sections.

We recognise the need to take action to continuously strengthen our approach to forecasting and improve forecast accuracy. These actions are outlined in the following sections.

6.4 Opex forecasting governance processes

The ESC's compliance review for the 2016-2021 period criticised PoM's internal governance processes for developing operating expenditure forecasts, noting[148]:

> *As a result of our assessment for the review period, we consider the Port does not have sound or robust forecasting methodologies and governance processes, it has not adequately accounted for ongoing productivity improvements.*

This TCS builds on the opex forecasting enhancements outlined in our 2022-23 TCS, and includes a range of improvements to our forecasting methodologies and governance processes and accounts for ongoing productivity improvements.

6.4.1 Improved governance for forecasting

The governance process for developing the opex forecast included:

- Independent expert advice on efficiency of the base year and the trend rate (encompassing economies of scale, productivity, and input cost indices);
- Introduction of an 'Opex Challenge Workshop' (see Table 6-3, below);
- Presentation of Draft Forecasts to the Board in April for feedback and refinement;
- Presentation of Final forecasts for approval to the Board in May.[149]

Table 6-3 Opex Challenge Workshop

Opex Challenge Workshop
The opex challenge workshops were a key component of the governance process for developing the opex forecast for the next regulatory period. A first draft forecast was developed via: ▪ initial workshops with divisional teams and Responsibility Centre owners to determine baseline expenditure and identify key cost drivers in each Responsibility Centre (Sept-Oct 2022);

[148] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.90
[149]

Opex Challenge Workshop

- further, meetings with divisional teams and Responsibility Centre owners to review trends in actual historical expenditure and identify any step changes (Jan-Mar 2023).

Outcomes from the workshops and meetings were combined with a draft trend growth rate developed by independent experts DAE to prepare a draft forecast.

The Opex Challenge Workshop (Mar 2023) provided a formal opportunity for the Executive to challenge the base year adjustments and step changes to be included in the 2023-24 TCS opex forecast.

As a result of this exercise, [redacted] in forecast opex was removed from the forecast across the regulatory period (in net terms).

This forecast was further refined with input from the CFO and CEO, before draft forecasts were presented to the Board in April and final forecasts in May. Following presentation of draft forecasts to the Board in April, additional refinements were made resulting in further reductions in the forecast, including the adoption of a 3.0% general productivity growth rate during the next regulatory period in order to target no real cost growth in the controllable opex forecast.

From the first to final workshop, the total controllable opex forecast for the next regulatory period was reduced by [redacted] via the above process.

6.4.2 Initiatives to deliver ongoing efficiency improvements

We have adopted a productivity growth rate of 3% p.a. for the next regulatory period. After accounting for output growth and growth in input prices (which is based on independent forecasts of wage price inflation), the average net efficiency rate for the next regulatory period (inclusive of step changes) is -0.3%. This means PoM is committing to delivering no real growth in total controllable opex over the next regulatory period even after accounting for step changes.

We have also implemented enhanced governance processes to deliver opex outcomes that meet or exceed the net efficiency rate, comprising the following:

- Business Efficiency Strategy – a new corporate priority focus area, with an Operational KPI which requires the development of a Board approved Business Efficiency Strategy to improve our operating practices and enable our people to work more efficiently and effectively (e.g. through improved business systems implemented by the IT division);
- A quarterly Divisional Cost Efficiency Review, where divisional heads meet with the CEO, CFO and Head of People and Culture, to review performance against the budget and efficiency targets, identify cost pressures and opportunities for cost efficiency;
- To manage and reduce labour costs, a commitment to seek to reallocate internal resources to deliver strategic projects in preference to hiring to minimise headcount growth and drive down operating costs (e.g. seeking internal resources to contribute to PCEP);
- To manage and reduce insurance costs (the largest controllable cost item outside labour), we will
  - Work with our brokers to identify and implement initiatives to reduce premiums;
  - Engage with the Victorian Government to ensure the approach to meeting our insurance obligations is consistent with principles of prudency and efficiency and the long-term interests of Port Users and Victorian consumers; and
- Annual budget processes and staff incentives are tied to performance against budget outcomes (e.g. EBITDA).

6.5 Forecast opex for the next regulatory period

6.5.1 Forecasting methodology

The key change to our forecasting methodology has been the adoption of the Base-Step-Trend (BST) approach to forecasting opex, as recommended by the ESC.[150]

The BST forecasting methodology we have adopted aligns with the approach used by the ESC in the water sector, and by regulators in other jurisdictions and industries, and involves:

- Establishing an efficient and prudent level of costs in a 'Base year'. This is typically actual costs in the most recent regulatory year, adjusted for any one-off factors that are unlikely to occur going forward;
- Determining an annual 'Trend' which usually reflects a combination of the change in opex due to changes in demand, plus an efficiency factor which reflects overall improvements in productivity; and
- Identifying any one-off and material upward or downward 'Steps' in opex. These steps can include changes in regulatory requirements, but also any other significant impacts on costs. Each of these 'steps' needs to be clearly identified and justified.

To assist us in implementing the BST approach, we engaged independent experts, DAE, to:

- Review operating expenditure in order to establish a prudent and efficient base, including via benchmarking;
- Analyse and quantify the relationship between opex and growth; and
- Advise on an appropriate range for a net efficiency rate.[151]

We have prepared our BST forecast, including the efficiency target and step changes, using the totality of our controllable opex (prescribed and shared opex), as opposed to only prescribed opex. We consider that this approach is consistent with adopting a sound forecasting methodology and establishing targets for productivity and monitoring outcomes, primarily because:

- A material portion of our controllable opex is shared, so this approach aligns to how budgets are tracked and set by management, and reviewed by the Executive and Board; and
- The prescribed component of shared opex is affected by changes in trade volumes, which means there could be movements in prescribed opex that are unrelated to efficiency (but rather driven by trade volatility).

The BST forecast thus defined is then converted to a prescribed opex forecast in accordance with the cost allocation Pricing Principles in the Pricing Order, using our Regulatory Cost Allocation Guideline.[152]

6.5.2 Establishing a prudent and efficient base year

To address the ESC's Interim Commentary, 2019-20 has been adopted as the base year for the BST forecast.

As noted by the ESC's expenditure consultants, FTI Consulting, in the five-year Inquiry, PoM was still in a process of achieving 'steady state' operations over the first five years of the Port Lease.[153]

[150] In the 2022-23 TCS, the BST approach was used as a cross-check for the bottom-up forecast, with the bottom-up forecast used for pricing purposes.

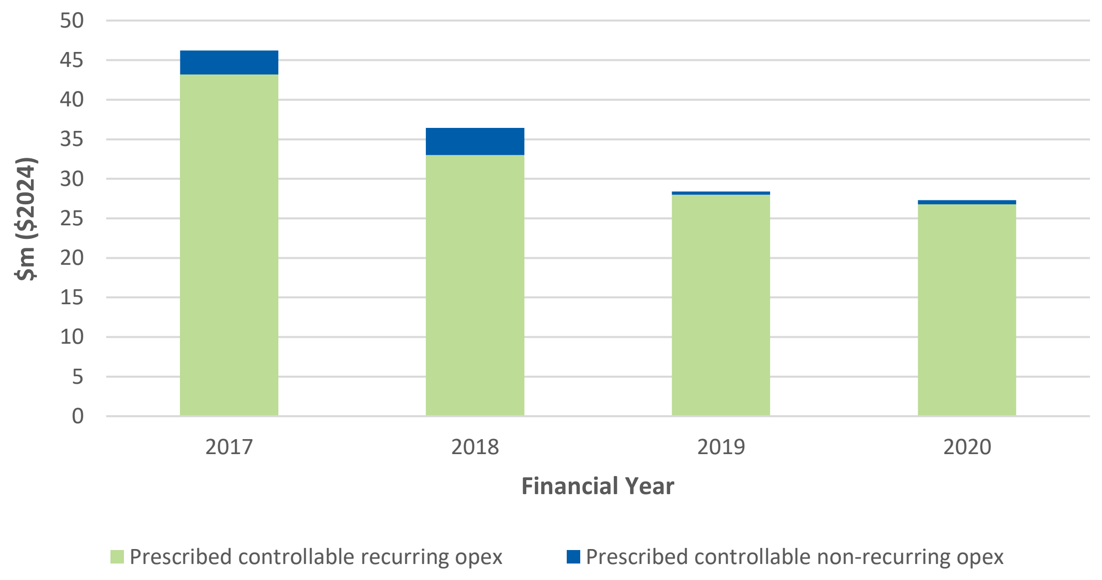
[151]

[152]

[153]

Following the Port Lease, PoM engaged in a significant cost cutting exercise. Prescribed controllable opex in 2019-20 was 38% lower in real terms than in 2016-17 (excluding non-recurring costs) and is the lowest year for prescribed controllable opex in recent history (Figure 6-1).

Figure 6-1 Total prescribed controllable opex post privatisation, $m real ($2024)



In accordance with the guidance set out by the ESC in its SoRA, in establishing the base year we have removed non-controllable costs[154] and made adjustments to ensure that base year 2019-20 operating expenditure reflects the nature of PoM's operations as they existed at that time. Broader changes resulting from PoM's move to a 'steady state' of operations (and due to significant post-base year events, including changes in regulation) are categorised as 'step changes' and discussed in the following sections.

The adjustments made are as follows.

- Upwards adjustments to labour incentive payments and maintenance contractor costs to reflect normal levels; and
- Downwards adjustments to remove one-off costs associated with regulatory compliance, developing the Port Development Strategy, severance payments, and engagement and sustainability costs.

These adjustments have been reviewed and assessed as prudent and efficient by independent experts, DAE.[155] The net impact of these changes is an increase in total controllable opex in the base year of [redacted] ($ nominal).

[redacted]

[redacted]

- [redacted]

154

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156

- [redacted]

[redacted]

6.5.3 Trend rate and ongoing productivity improvements

As noted above, to address the ESC's Interim Commentary, for the purposes of establishing an efficiency assumption for the next regulatory period, PoM has used net efficiency as the driver of trend operating expenditure, where net efficiency is the trend growth in opex after accounting for output growth and changes in input prices.

Consistent with the guidance in the ESC's SoRA and in the Interim Commentary, our approach includes:

- Explicit recognition of economies of scale from higher trade volume growth, based on independent forecasts of trade volume growth. DAE also undertook a rigorous assessment of the relationship between PoM's opex and output;
- Realistic expectations for labour cost forecasts, using an independent forecast of the Wage Price Index and changes in superannuation guarantee payments[158]; and
- A general productivity factor to account for ongoing productivity improvements (0.5% p.a.), based on productivity assessments undertaken by DAE. PoM has adopted a higher productivity growth factor (3.0% p.a.) for the next regulatory period than that recommended by DAE to target an average net efficiency rate of 0% p.a. over the next regulatory period for total controllable opex. The average net efficiency rate from 2019-20 to 2027-28 is 0.8% before step changes are included and 2.9% after.

The composition of the trend rate is summarised in Table 6-4, below.

Table 6-4 Net efficiency rate

Trend component	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Output growth	14.5%	-1.6%	-2.5%	3.4%	4.7%	4.3%	4.2%	3.6%
General productivity growth	0.5%	0.5%	0.5%	**3.0%**	**3.0%**	**3.0%**	**3.0%**	**3.0%**
Economies of scale adjustment	3.0%	-0.3%	-0.5%	0.7%	1.0%	0.9%	0.9%	0.8%
Real wages growth factor	0.1%	0.1%	-1.1%	-1.3%	-0.1%	0.1%	0.1%	0.3%
Superannuation cost growth	0.0%	0.2%	0.2%	0.2%	0.2%	0.2%	0.0%	0.0%
Net efficiency rate (real)	**11.1%**	**-1.4%**	**-3.4%**	**-1.5%**	**0.8%**	**0.7%**	**0.4%**	**0.2%**

Note: real wages growth factor and super cost growth are weighted by the proportion of opex that is labour

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158 An annual 0.5% increase in the superannuation guarantee levy is legislated for five years commencing 1 July 2021.

6.5.4 Identifying and explaining step changes in opex

We have identified step changes in costs above the base year, from 2019-20 to the end of the regulatory period in 2027-28 of $69.6m in total (real $2024), $45.3m of which relates to increases over 2019-20 opex in the next regulatory period (2023-24 to 2027-28).

The overall increase in total controllable opex is almost entirely attributable to changes that have occurred in the period from 2019-20 to 2022-23 (and recur thereafter), in the process of transitioning to steady state[159] operations following the cost cutting that occurred post-privatisation. By 2027-28, we forecast total controllable opex to be $0.9m lower than currently forecast for 2022-23 in real terms ($2024).

The increase in total controllable opex over 2019-20 is driven by investments to re-shape the internal capabilities of the business towards the new operating environment, in areas including the following (all figures in real $2024):

- Enhanced legal capability, periodic Pricing Order submissions and Port Strategy obligations ([redacted] from 2019-20 to 2027-28). This includes investment in legal and regulatory functions to meet increased legal and regulatory workload; periodic costs associated with Pricing Order submissions; and the costs associated with meeting our obligations in relation to preparing port strategies such as the PDS;
- Establishment of a separate Corporate Relations division to drive a major uplift in engagement to meet stakeholder expectations and regulatory obligations ([redacted]);
- Establishment of a sustainability team and strategy, consistent with Good Environmental Practice and stakeholder expectations ([redacted]);
- Investments in cybersecurity and cloud computing, including requirements to address our obligations under the *Security of Critical Infrastructure Act 2018*, which emerged in 2022 ([redacted]);
- Increases in insurance premiums, which more than doubled from 2019-20 to 2022-23 ([redacted]). As one of our largest single cost items, we note there are significant risks to the forecast for the next regulatory period, and we have commenced working towards efficiency measures to mitigate future increases;
- Increased asset planning costs to meet PCD requirements, including the need to maintain ISO55000 certification, address legacy issues identified in the Asset Management Review, demolish legacy assets in a poor state of repair, and improve rail maintenance services ([redacted]); and
- Other non-recurring costs related to legal and tax responsibilities that occurred in the three years from 2020-21 to 2022-23 ([redacted]).

Further details on step changes and cost drivers are set out in Appendix L – Operating cost step changes, which provides a detailed breakdown of costs and bases for the forecast costs.

6.5.5 Cost increases to be absorbed by the business

In addition to the step changes outlined above, we have identified a number of likely (and known) cost increases where we are committed to absorbing increased costs and bearing the risk of potential increases above the forecast on behalf of Port Users. These include:

- Cost increases from the recent change in payroll tax. On 23 May 2023 the Victorian Government announced an increase in payroll tax of 0.5% for businesses with payroll costs of over $10m p.a. from 1 July 2023 to 30 June 2033.[160] We have estimated that this is likely to lead to an increase of approximately [redacted] per annum in our total controllable operating costs. Given the timing of the change we have not included it as a step change in our forecast. We note that this event is consistent with a 'tax change event' under our mechanisms to manage uncertainty (see section 4.6), however upon

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160 State Government of Victoria, Victorian Budget 2023/24 – Budget Paper No. 3, May 2023, p.6

current forecasts it is unlikely to meet the threshold of 1% of ARR for an ex-post adjustment to be applied. We will revisit the actual costs incurred due to this change towards the end of the regulatory period to determine whether a change in deferred depreciation is warranted;

- Cost increases associated with the increased capital program. Cost increases identified include land planning costs, noise management, and general operating costs associated with major project delivery. In some cases these costs will be capital in nature. Where costs are operating in nature, we have taken a view to absorb these costs increases under the Business Efficiency Strategy, including by reallocating internal resources towards strategic project delivery; and
- Future increases in insurance costs. PoM's insurance premiums doubled from 2019-20 to 2022-23, and are budgeted to further increase in 2023-24. PoM is not aware of any dynamics in the insurance market that suggest that the growth rate in insurance premiums will slow over the next regulatory period. While the cost of insurance is highly likely to increase further over the next regulatory period, it has not been possible to develop a reliable estimate. Therefore, on this occasion, PoM will not include a step change and will absorb the risk on behalf of Port Users.[161]

We have outlined a number of initiatives to deliver ongoing efficiency improvements to manage these risks on behalf of Port Users (see section 6.4).

6.5.6 Total controllable opex

Table 6-5 below shows the calculation of total controllable opex following the BST process outlined above, and also total prescribed controllable opex, which excludes non-prescribed costs.

Table 6-5 Opex forecast for the next regulatory period ($m, $2024)

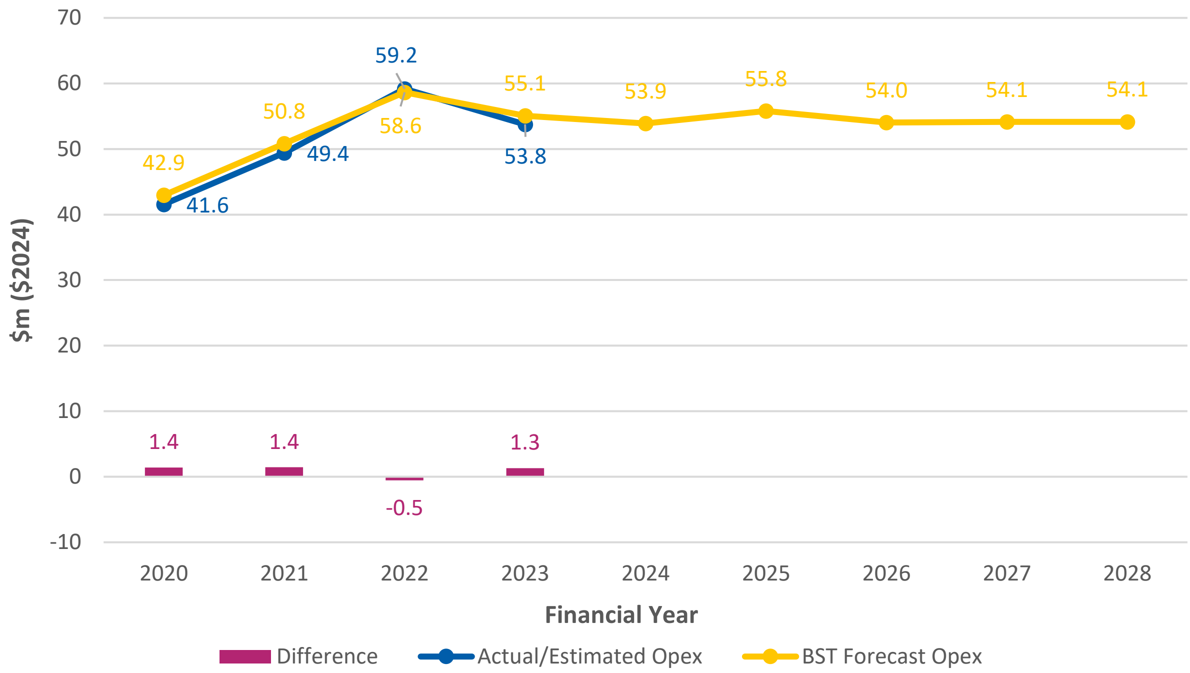
					Five-year regulatory period				
Forecast	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Base year opex	41.6	41.6	41.6	41.6	41.6	41.6	41.6	41.6	41.6
Adjustments	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Trend		4.8	4.1	2.5	1.8	2.2	2.5	2.7	2.8
Step changes		3.1	11.6	9.6	9.1	10.7	8.6	8.5	8.4
Total controllable opex	**42.9**	**50.8**	**58.6**	**55.1**	**53.9**	**55.8**	**54.0**	**54.1**	**54.1**
Total prescribed controllable opex									
Actual/estimated	**27.3**	**33.7**	**39.7**	**35.7**					
BST Forecast					**37.5**	**39.5**	**38.4**	**38.6**	**38.8**

Note: Total controllable opex is converted to prescribed controllable opex in accordance with the cost allocation approach described in chapter 7. In 2019-20, an unusually low share of total revenue came from prescribed services. As some costs are allocated based on the prescribed revenue share, prescribed controllable opex grows at a faster rate than total controllable opex.

As shown in Figure 6-2, the total controllable opex determined through the BST process closely follows actual historical opex since the base year (and the current estimate for 2022-23).

[161] Given the significant risks to this forecast, PoM has proposed an adjustment mechanism to apply in the event of a change in insurance costs that exceeds 1% of annual Aggregate Revenue Requirement.

Figure 6-2 BST total controllable opex forecast – comparison to actuals, $m real ($2024)



6.5.7 Non-controllable opex

Non-controllable opex for the next regulatory period includes:

- The Port Licence Fee, which escalates at Melbourne CPI;
- Cost Contribution Amount, which, from 2023-24 is calculated as 20% of channel fee revenue; and
- PRTA costs, which grow at contracted rental rates.

These non-controllable costs are all prescribed in nature. Forecasts of these costs are based on our forecasts of CPI and channel fee revenue.

Table 6-6 Non-controllable opex forecast for the next regulatory period (real $2024)

					Five-year regulatory period				
Forecast	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Port Licence Fee	100.3	99.7	99.8	97.2	96.7	98.3	98.7	98.9	99.1
Cost Contribution Amount	18.4	18.0	18.5	18.6	15.8	16.2	16.5	16.9	17.3
PRTA Costs	0.4	4.9	4.9	5.2	5.2	5.2	5.2	5.3	5.3
Total non-controllable opex	**119.1**	**122.6**	**123.2**	**121.0**	**117.7**	**119.6**	**120.5**	**121.0**	**121.7**

6.6 Revision to 2022-23 forecast

The adoption of the BST approach with a base year of 2019-20 for the opex forecast for the next regulatory period gives rise to an inconsistency with the 2022-23 regulatory period, where:

- The forecast itself was based on a bottom-up assessment of opex requirements; and
- We applied a BST forecast as a cross-check for the bottom-up forecast, using the more recent year of actual expenditure (2021-22) as the base year.

To address this inconsistency and respond to the ESC's Interim Commentary, we have recalculated the BST for the 2022-23 Regulatory period using a forecast trend growth rate for 2022-23 calculated using variables available at the time that the 2022-23 TCS was prepared. The step changes adopted in this re-forecast are the same as those outlined above. Though these are not truly 'forecast' step changes, it would be very difficult to recreate forecasts for step changes that occurred in the past. Non-recurring costs forecast in the 2022-23 Regulatory Period for 2022-23 were somewhat higher than those now estimated so this is likely a conservative approach (i.e. step changes would likely be somewhat higher if forecasts were re-created).

As shown in Table 6-7, below, the impact of revising the 2022-23 TCS Opex Forecast would be to increase total forecast controllable opex for 2022-23 by $0.4m.

Given that revising the forecast would increase the ARR (and therefore increase the RAB and future prices, though immaterially so), we have decided to leave the 2022-23 TCS opex forecast unrevised.

Table 6-7 Updated opex forecast for the 2022-23 regulatory period, total controllable opex ($m nominal)

Source	Variable	2020-21	2021-22	2022-23
Revised 2022-23 TCS forecast	Output growth (import containers)	14.5%	-0.2%	2.9%
	Net trend growth rate (nominal)	13.6%	0.8%	6.0%
	Total opex ($m nominal)	44.7	52.6	53.8
Original 2022-23 TCS forecast	Total opex ($m nominal)	NA	NA	53.4
Difference	**Total opex ($m nominal)**	**NA**	**NA**	**+0.4**

7 Cost allocation

7.1 Regulatory context

The Pricing Order sets out the following requirements for cost allocation:

> *5.1.1 The objective of the Cost Allocation Principles is to provide a transparent and consistent methodology for allocating and monitoring costs for the purpose of setting Prescribed Service Tariffs.*
>
> *5.2.1 Costs of the Port Licence Holder must be allocated between Prescribed Services and all other services provided by the Port Licence Holder in a manner consistent with the following cost allocation principles:*
>
> *a) costs that are directly attributable to the provision of the Prescribed Service must be attributed to that Prescribed Service; and*
> *b) costs that are not directly attributable to the provision of the Prescribed Service but which are incurred in the course of providing both one or more Prescribed Services and other services must be allocated to the Prescribed Service on the basis of its share of total revenue from all services provided by the Port Licence Holder*

7.2 Our approach to cost allocation

Our approach and process for applying the cost allocation principles in the Pricing Order is detailed in our Regulatory Cost Allocation Guideline.[162]

In essence:

- Costs specified in the Pricing Order as directly attributable to prescribed services are allocated accordingly (clause 4.5.1, clause 2.1.6).
- Other operating costs are attributed to Prescribed Services, non-prescribed services or both (referred to as 'shared' costs) on a causal basis by Responsibility Centre.
- Other capital costs are attributed to Prescribed Services, non-prescribed services or both on a causal basis by capital activity.
- Where costs are identified as directly attributable to one or more Prescribed Services, they are assigned to a relevant Prescribed Services bucket and then allocated out to the prescribed services within that bucket based on the revenue shares of those individual Prescribed Services.
- Where shared costs are identified, these are allocated to Prescribed Services and non-prescribed services based on the share of PoM's relevant revenues (using revenue from the relevant year).

The allocation of capital costs is undertaken on a case-by-case basis, at the establishment of the capital project and reviewed at project completion.

Under the base-step-trend approach outlined in section 6.5, controllable opex is forecast on a 'top down' rather than 'bottom up' basis. For the purposes of cost allocation, base year costs are assumed to grow at the same trend rate across all categories. This means the proportion of trended base year costs allocated to prescribed services is the same as in the base year (after accounting for base year adjustments). Base year adjustments and step changes in opex are attributed to Prescribed Services, non-prescribed services or both on a causal basis by Responsibility Centre.

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[162])

The Regulatory Cost Allocation Guideline is subject to review once every two years, or earlier if circumstances require (for example, changes to the Pricing Order or ESC guidance).

7.3 Cost allocations for this regulatory period

7.3.1 Capital expenditure

Table 7-1 provides a breakdown of the cost allocation of forecast capital expenditure for each year of the five-year regulatory period. Of the $733.1m in total forecast capex across the regulatory period, $703.9m is prescribed capex (after accounting for capital contributions and asset disposals).

Table 7-1 Cost allocation of forecast capital expenditure by year, $m (nominal)

Forecast Capex	2023-24	2024-25	2025-26	2026-27	2027-28
Total Forecast Capex	**206.2**	**147.8**	**125.5**	**128.9**	**124.5**
Dedicated Prescribed Capex	199.7	142.7	120.2	122.2	116.5
Dedicated Non-Prescribed Capex	2.8	2.6	3.2	5.5	7.4
Shared Capex	3.7	2.5	2.2	1.3	0.6
Prescribed share of total revenue	67.9%	69.0%	70.2%	70.4%	70.8%
Gross Forecast Prescribed Capex *= Dedicated Prescribed Capex + (Shared Capex × Prescribed share of total revenue)*	**202.2**	**144.5**	**121.7**	**123.1**	**116.9**
less Forecast Capital Contributions	0.0	0.3	4.2	0.0	0.0
less Forecast Asset Disposals	0.0	0.0	0.0	0.0	0.0
Net Forecast Prescribed Capex	**202.2**	**144.1**	**117.6**	**123.1**	**116.9**

7.3.2 Operating expenditure

Table 7-2 provides a breakdown of the cost allocation of forecast operating expenditure for each year of the five-year regulatory period. Of the $933.1m in total forecast opex (controllable and non-controllable) across the regulatory period, $848.6m is prescribed opex.

Table 7-2 Cost allocation of forecast operating expenditure by year, $m (nominal)

Forecast Opex	2023-24	2024-25	2025-26	2026-27	2027-28
Controllable Opex	53.9	58.1	58.0	59.7	61.2
Non-Controllable Opex	117.7	124.4	129.2	133.5	137.5
Total Forecast Opex	**171.6**	**182.5**	**187.2**	**193.2**	**198.7**
Dedicated Prescribed Opex	128.0	136.0	139.8	144.7	149.0
Dedicated Non-Prescribed Opex	3.5	3.7	3.8	3.9	4.0
Shared Opex	40.1	42.8	43.6	44.5	45.7
Prescribed share of total forecast revenue	67.9%	69.0%	70.2%	70.4%	70.8%
Forecast Prescribed Opex *= Dedicated Prescribed Opex + (Shared Opex × Prescribed share of total revenue)*	**155.2**	**165.6**	**170.4**	**176.1**	**181.3**

8 Trade volumes

8.1 Regulatory context

8.1.1 Pricing Order requirements

The Pricing Order sets out the following requirements for forecasts:

> *8.2.1 Information in the nature of an estimate or forecast must be supported by a statement of the basis of the forecast or estimate.*
>
> *8.2.2 A forecast or estimate:*
>
> *(a) must be arrived at on a reasonable basis; and*
>
> *(b) must represent the best forecast or estimate possible in the circumstances.*
>
> *8.3.1 Information on the nature of an extrapolation of inference must be supported by the primary information on which the extrapolation or inference is based.*

8.1.2 ESC Pricing Order compliance inquiry and Interim Commentary

In its inquiry into PoM's compliance with the Pricing Order (published 28 January 2022), the ESC found that PoM's demand forecasts complied with requirements of clauses 8.2 and 8.3.[163] The ESC considered that PoM's long-term modelling was reasonable and consistent with industry practice, based on reasonable assumptions and that the underlying data was clear.[164] However, the ESC noted some concerns with aspects of PoM's short-term modelling. In particular, the ESC noted that the validity of the relationship between trade with demand drivers had not been supported by econometric analysis and that failure to use parameters derived from correctly specified econometric models may result in poor forecasts.[165]

In our 2022-23 TCS, we addressed the ESC's comments with a number of updates to the demand forecasting approach (correcting for minor errors in calculations) and compliance demonstration materials (by incorporating econometric analysis).[166]

The ESC did not make any further comments regarding demand forecasting in its December 2022 Interim Commentary on our 2022-23 TCS.

8.2 Actual trade volumes in 2021-22

Actual trade volume for import containers in 2021-22 was reflective of forecasted levels (Table 8-1). Actual trade volumes in motor vehicles, dry bulk, breakbulk and empty containers exceeded expectations while export containers and channel volumes were below anticipated levels. Variances between actual and forecast trade volumes are partially explained by the following events in 2021-22:

- Export containers levels were negatively impacted by Chinese trade bans on Australian timber exports. All things being equal, the volume of empty containers is inversely related to the level of export containers, resulting in higher than anticipated levels;
- Motor vehicle volumes were higher than forecast as a result of strong local demand despite COVID-19 related supply side shortages;

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[163] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.104
[164] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.104
[165] ESC*, Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.107
[166] PoM, 2022-23 Tariff Compliance Statement – General Statement, 31 May 2022, Chapter 7

- Channel volumes were lower than expected due to fewer larger container vessel arrivals than scheduled due to global disruptions; and
- Breakbulk trade volumes were positively impacted by higher than anticipated iron, steel, metal imports and exports.

While there was variance within specific trade categories in the 2021-22 forecasts, in aggregate there is a relatively low discrepancy between actual and forecast Prescribed Services revenue. PoM's actual Prescribed Services revenue in 2021-22 was $407.8m, which was $2.6m (0.6 per cent) lower than the forecast of $410.4m.

Table 8-1 Comparison of 2021-22 forecast and actual trade volumes

Trades	Units (Million)	2021-22 (F)	2021-22 (A)	Difference (A-F)	Difference (%)
Containers – import	TEU	1.38	1.40	0.0	1.3%
Containers – export		0.81	0.72	-0.1	-12.4%
Containers – empty		0.66	0.75	0.1	12.2%
Containers – Bass Strait		0.25	0.25	0.0	0.7%
Dry bulk	Revenue tonnes	4.38	5.11	0.7	14.2%
Liquid bulk		5.34	5.48	0.1	2.5%
Motor vehicles		6.21	7.86	1.6	21.0%
Breakbulk		3.47	4.24	0.8	18.3%
Channel — Melbourne	Gross tonnes	119.74	109.52	-10.2	-9.3%
Channel — Shared		132.09	124.77	-7.3	-5.9%

Notes:1. 'Containers - Bass Strait' excludes empty containers, which are not subject to a tariff. 2. 'Breakbulk' includes Wheeled Unitised cargos.

8.3 Forecast trade volumes in the next regulatory period

We engaged Deloitte Access Economics (DAE) to forecast wharfage volumes and GHD to forecast channel volumes for the five-year regulatory period. Volumes for minor items such as hire fees are forecast internally with reference to historical trends and market intelligence.

A summary of DAE's forecasting approach is provided in Appendix M.[167] We consider that the DAE forecast has been prepared on a reasonable basis and represents the best forecast possible in the circumstances. In particular, we note that DAE has carried out econometric analysis to produce robust statistical models for forecasting trade activity.

A summary of GHD's forecasting approach for channel volumes is provided in Appendix N.[168] We consider that the GHD forecast is in compliance with the Pricing Order in that the methodology and assumptions used are reasonable and consistent with standard industry practice.

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Table 8-2 Overview of DAE forecasting approach

Overview of DAE forecasting approach
Deloitte Access Economics took a data driven, bottom-up approach to developing robust forecasts for 18 trade categories defined by PoM. An overview of Deloitte Access Economics' approach is provided below. 1. Thorough examination of the detailed trade data provided by PoM, which was then mapped to trade categories using advanced software capable of handling large data sets. 2. Bottom-up statistical analysis of trade patterns over time was conducted, with a focus on the most detailed commodity classifications. 3. Commodities were grouped into sensible bundles based on similarities in characteristics and mutual relationships with macroeconomic factors. Caution was taken to ensure that the inclusion of the specific commodity did not materially dilute the statistical pattern of the bundle. 4. Commodities with significant volume shares and unique trends were isolated. 5. Econometric analysis was carried out to produce robust statistical models capable of forecasting trade activity over the short to medium term, with a revision of previous steps as necessary. 6. Key findings from relevant literature informed the approach, including guidance on forecasting empty container volumes outlined by the Bureau of Infrastructure, Transport and Regional Economics; and previous trade forecasts, informed by stakeholder consultation, produced by Deloitte Access Economics for Freight Victoria (2023). 7. Trade forecasts were produced using forecasts for relevant explanatory macroeconomic variables sourced from Deloitte Access Economics Quarterly Business Outlook, December Quarter 2023.

Source: 2023-24 TCS – Appendix M – DAE Trade Forecasts PoM Summary Report, May 2023, p.12

DAE forecasts container trade to grow at 3.2% on average (Compound Annual Growth Rate (CAGR)) over the next regulatory period[169]:

- Containerised imports are forecast to grow at CAGR of 4.0%, driven by demand for high volume commodity groups including building materials, manufacturing products and plastics, and goods associated with capital investment and industrial production;
- More modest growth is expected for exports, with a CAGR of 1.4%, driven by demand for agricultural commodities, and household, intermediate and capital goods due to economic growth in our major export markets;
- Non-containerised trade volume forecasts for 2023-24 until 2027-28 are driven by various factors:
  - Strong post COVID-19 growth in motor vehicle imports is expected to wane in 2024-25 as supply chains return to normal and the backlog of orders is filled. Motor vehicle import volumes are forecast to return to a long run growth trajectory by 2027-28, while export volumes will continue to decline;
  - Break bulk is expected to remain relatively constant, reflective of historical trends; and
  - Liquid bulk trade volumes are anticipated to decline, primarily driven by a loss of market share to the Port of Geelong and the Geelong refinery following the closure of the Altona refinery. This is partially offset by elevated levels of petroleum imports to due to the loss of production at the Altona refinery.

Forecast trade volumes for 2022-23 until 2027-28 for major tariff categories are provided below (Table 8-3).

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Table 8-3 Forecast trade volumes for 2022-23 until 2027-28

Trades	Units (Million)	2022-23 (E)	2023-24 (F)	2024-25 (F)	2025-26 (F)	2026-27 (F)	2027-28 (F)
Containers – import	TEU	1.36	1.41	1.48	1.54	1.60	1.66
Containers – export		0.72	0.73	0.74	0.75	0.76	0.78
Containers – empty		0.77	0.78	0.82	0.86	0.90	0.94
Containers – Bass Strait		0.25	0.25	0.26	0.26	0.26	0.26
Dry bulk	Revenue tonnes	4.76	4.67	4.75	4.83	4.92	4.99
Liquid bulk		5.65	5.56	5.77	5.96	6.04	6.11
Motor vehicles		8.74	8.10	7.65	7.26	7.16	7.17
Breakbulk		4.72	4.71	4.70	4.77	4.88	5.00
Channel — Melbourne	Gross tonnes	114.71	118.77	120.16	120.83	123.06	125.69
Channel — Shared		141.80	148.16	155.35	161.97	164.32	167.06

Notes: 1. 'Containers - Bass Strait' excludes empty containers, which are not subject to a tariff. 2. 'Breakbulk' includes Wheeled Unitised cargos. 3. Estimated volumes for 2022-23 are based on partial year actuals and partial year forecasts.

9 Rate of return on capital

9.1 Overview

The rate of return on capital (referred to as the weighted average cost of capital, or WACC) aims to compensate debt and equity holders for the opportunity cost of either lending or investing their funds in PoM.

This Chapter of the TCS sets out:

- Regulatory context;
- Our WACC estimate for the next regulatory period; and
- Our re-statement of the 2022-23 WACC.

9.2 Regulatory context

9.2.1 Pricing Order requirements

The Pricing Order sets out the following requirements for the return on capital allowance:

> *4.1.1 For the purposes of determining its Aggregate Revenue Requirement, the Port Licence Holder must apply an accrual building block methodology over the Regulatory Period comprising:*
>
> > *a) an allowance to recover a return on its capital base, commensurate with that which would be required by a benchmark efficient entity providing services with a similar degree of risk as that which applies to the Port Licence Holder in respect of the provision of the Prescribed Services …*
>
> *…*
>
> *4.3.1 Subject to clause 4.3.2, in determining a rate of return on capital for the purposes of clause 4.1.1(a) the Port Licence Holder must use one or a combination of well accepted approaches that distinguish the cost of equity and debt, and so derive a weighted average cost of capital.*
>
> *4.3.2 The rate of return to be calculated for the purpose of clause 4.1.1(a) must be determined on a pre tax, nominal basis.*

9.2.2 ESC Pricing Order compliance inquiry and Interim Commentary

In its inquiry into PoM's compliance with the Pricing Order (published 28 January 2022), the ESC made a finding of significant and sustained non-compliance in relation to PoM's compliance with the Pricing Order requirements for the return on capital over the review period. The ESC's view was that:

- PoM's return on capital during the review period did not reflect that of a benchmark efficient entity with a similar degree of risk;[170] and
- PoM's approach to setting the rate of return over the review period was not compliant with the Pricing Order because its methodology and implementation of key drivers of the rate of return were not 'well accepted'.[171]

[170] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report*, 31 December 2021, p.28
[171] ESC, *Inquiry into the Port of Melbourne compliance with the Pricing Order: Final Report,* 31 December 2021, p.54

In our 2022-23 TCS, we addressed the ESC's inquiry findings on compliance via:

- An enforceable Undertaking that addresses the ESC's findings of significant and sustained non-compliance. In relation to WACC, the Undertaking commits to the approaches that will be applied by PoM to calculate the WACC.[172] The ESC Minister confirmed that he was satisfied that the terms of the Undertaking are appropriate to adequately address PoM's non-compliance; and
- Engagement of an independent expert, HoustonKemp, to estimate the WACC in accordance with the Pricing Order and in a manner consistent with the commitments in the Undertaking.

On 20 December 2022, the ESC released its Interim Commentary on PoM's 2022-23 TCS. In its Interim Commentary, the ESC considered that PoM's approach to estimating the weighted average cost of capital more closely reflects well accepted approaches.

However, the ESC also set out its preliminary views that, with regard to PoM's approach in its 2022-23 TCS not to apply a country filter when identifying comparator firms:

- PoM cannot rely on the decision of the Supreme Court of Western Australia concerning the price to be paid by Qantas to Perth Airport for aeronautical services as to the application of country filters when identifying comparator firms (for the purpose of estimating the asset beta and gearing used in the WACC) as a well-accepted approach[173]; and
- Applying a country filter would have no impact on the asset beta (0.72), but would reduce the benchmark gearing level from 20% to 10% (resulting in an overall reduction in the WACC of 17 basis points, from 8.99% to 8.82%). The ESC's view was that this is material.[174]

9.3 Rate of return estimate for the next regulatory period

9.3.1 We sought independent expert advice for the 2023-24 to 2027-28 WACC

For the WACC estimate for the next regulatory period, we obtained independent expert advice from HoustonKemp. Under the terms of this engagement, HoustonKemp was required to be objective, professional and to form an independent view on the estimate of the WACC.

HoustonKemp considered the ESC's view that filtering the comparator sample for Financial Times Stock Exchange (FTSE) developed and advanced emerging countries is well accepted, and the ESC's view that PoM should consider using these filters in its subsequent WACC estimates.

In summary, HoustonKemp's views are that[175]:

- The issue of whether a country filter should be applied involves a trade-off between bias and variance. This trade off arises because the 'true' asset beta and gearing of the benchmark efficient firm are unobserved and must be estimated, commonly through taking some average of the parameters calculated from a sample of comparator firms;
- There are several drawbacks to introducing a country filter, namely that it results in a small comparator sample that:
  - Generates more volatile estimates across regulatory periods since fluctuations in the estimates for individual companies will be less likely to offset one another overall; and
  - Increases the influence of outlier firms on the final parameter estimate;

[172] The Undertaking is available on our website: Regulatory Process | Port of Melbourne
[173] PoM's approach to estimating beta did not apply a country filter when identifying comparator firms, on the basis that the Supreme Court of Western Australia had rejected the use of a country filter when identifying comparator firms for estimating beta for Perth Airport (Perth Airport Pty Ltd v Qantas Airways Ltd (No 3) [2022] WASC 51.
[174] ESC, *Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23*, 20 December 2022, pp.12-13
[175]

- An important consideration for assessing this trade-off is whether the industry exhibits systematic risks that are uniform or diverse. When evaluating the trade-offs between using a smaller sample with comparators that are more similar to the benchmark efficient port against a larger sample with comparators that are less similar to the benchmark efficient port, HoustonKemp considered that the diversity of characteristics across different ports results in varied systematic risks, such that the trade-offs favour the latter approach;
- It is unclear that including comparator firms operating in developing countries necessarily introduces bias to the parameter estimates, since sovereign risks may be captured in market returns such that estimated betas are unaffected by these risks. Thus, HoustonKemp considered that identifying a comparator sample without a country filter is a well-accepted approach in the context of a firm such as PoM, which operates in an industry with diverse systematic risks; and
- Nevertheless, there is some regulatory precedent that supports adopting a small sample for diverse industries such as rail and toll roads.

Having regard to the above and regulatory precedent, HoustonKemp concluded that the alternative approaches of applying and not applying a country filter when identifying comparator firms are both well accepted. Therefore, while HoustonKemp's preference is to not apply a country filter (primarily due to the diversity of systematic risks across ports and consequently the benefits of expanding the sample of comparators, and noting the Western Australian Supreme Court's precedent), they consider that it is open to PoM to adopt the asset beta and gearing derived using the alternative approach.[176]

Following from the above, HoustonKemp provided two benchmark pre-tax nominal WACC estimates as at 31 March 2023 using methods that it considers well-accepted:

- 9.49%, using HoustonKemp's preferred broad comparator sample (of 21 firms) that does not apply a country filter. This estimate is 50 basis points (bp) higher than the 8.99% preferred estimate from PoM's 2022-23 TCS, which is primarily caused by the 88 bp increase in the risk-free rate; and
- 9.34% using an alternative narrow comparator sample (of five firms) that omits firms with a country of risk outside the FTSE Developed and Advanced emerging countries. This estimate is 35 bp higher than the 8.99 per cent preferred estimate from PoM's 2022-23 TCS.

PoM disagrees with the ESC's approach (which is at odds with *Perth Airport v Qantas*) and is concerned that a country filter will generate volatile estimates; however, for the forthcoming regulatory period we have decided to adopt the WACC estimate provided by HoustonKemp that does apply a country filter. For the avoidance of doubt, PoM considers that not applying a country filter is a well accepted approach, and it reserves its position to take such an approach in future regulatory periods.

9.3.2 WACC estimate for the next regulatory period

Table 9-1 below sets out HoustonKemp's estimates of the individual WACC parameters for the next Regulatory Period and reconciles them to the Undertaking.

As noted above, we have decided to adopt the WACC estimate with the country filter applied of 9.34% (pre-tax nominal) for the next regulatory period.

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Table 9-1 WACC estimate for the 2023-24 to 2027-28 regulatory period

Parameter	2022-23 TCS	2024-28 Regulatory period (no country filter)	2024-28 Regulatory period (country filter applied)	Reconciliation to Undertaking
Return on debt	4.78%	4.88%	4.88%	No change in approach, HoustonKemp continues the use of the trailing average cost of debt (beginning in 2017-18), which reflects: ▪ BBB credit rating; ▪ 10-year term of debt; and ▪ 10 basis points debt raising costs. These parameters are consistent with clauses 19, 24, and 27 of the Undertaking.
Return on equity	8.54%	9.05%	8.36%	HoustonKemp continues the use of the Sharpe-Lintner Capital Asset Pricing Model (SL-CAPM), and does not use the Black CAPM or Fama-French Model. Consistent with clause 18 of the Undertaking.
Risk free rate	2.57%	3.45%	3.45%	No change in approach, HoustonKemp continues the use of the 20-day average of the 10-year Commonwealth Government Securities (CGS) yield. However, it is noted that as of 31 March 2023, the RBA has discontinued publishing the Government bond yield data (statistical table F16) used for estimating the 10-year risk-free rate. HoustonKemp has identified an alternative source in the RBA's statistical table F2, which contains a 10-year Government bond yield series from the RBA's own interpolation approach, which would mean that HoustonKemp cannot apply the interpolation method from the Undertaking to this data. Consistent with clause 20 of the Undertaking with the alteration that the interpolation of the data series is performed by the RBA rather than HoustonKemp.
Market Risk Premium (MRP)	6.63%	6.31%	6.31%	HoustonKemp's approach entails the following minor updates: ▪ Retained 85% weight to the estimate from historical excess returns (HER), but now gives weight only to the Brailsford, Handley, and Maheswaran (BHM) data set, and no weight to the NERA datasets (previously 50:50), plus minor computational changes to match the AER's approach; and ▪ Retained 15% weight to forward-looking returns (Dividend Discount Models, or DDMs). Maintains the use of IPART's 'current' MRP estimate and Dividend Discount Model (DDM) estimates from AER, ERA and QCA. Retain AER's preferred three-stage DDM but removed AER's two stage DDM; reduced long-run growth assumption from 4.6 per cent to 3.74 per cent in AER's DDM; made computational changes to methodology used to adjust stock returns for franking credits in order to be consistent with AER's Ibbotson HER spreadsheet. HoustonKemp does not use the Wright approach. Consistent with clause 21 of the Undertaking.
Equity beta	0.90	0.89	0.78	No change in approach, where: ▪ (equity beta) = (asset beta) / (1 – gearing)

Parameter	2022-23 TCS	2024-28 Regulatory period (no country filter)	2024-28 Regulatory period (country filter applied)	Reconciliation to Undertaking
Asset beta	0.72	0.71	0.70	No change, other than to prepare two estimates – one with and one without a country filter. HoustonKemp's construction of the comparator set entails: ▪ Identifying a preferred sample of comparator firms that own and operate container port and channel infrastructure, and whose revenues are primarily derived from container port operations; ▪ Applying filters for market capitalisation ($100m) and liquidity (based on bid-ask spread >1% or >20 days of no trading); and ▪ Preparing one comparator set by applying a country filter, and another by not applying a country filter. The estimate is the average of: ▪ the weekly and four-weekly asset beta estimates, where each estimate is itself the average of betas derived for each day of the week/four weeks; and ▪ the five-year and ten-year asset beta estimates. Both estimates are consistent with clause 24, 25 and 26 of the Undertaking.
Gearing	20%	20%	10%	No change. HoustonKemp calculates the benchmark gearing as the average of five-year and ten-year gearings of its preferred comparator sample (based on net debt) with a preference for maintaining a stable gearing estimate from previous determinations. Consistent with clause 23 of the Undertaking.
Tax rate	30%	30%	30%	No change. HoustonKemp adopts a corporate income tax rate of 30 per cent, consistent with Australian legislation.
Gamma	0.50	0.50	0.50	No change, based on the utilisation approach, where: ▪ (gamma) = (utilisation rate 0.625 x distribution rate 0.8) Consistent with clause 22 of the Undertaking.
Pre-tax nominal WACC	**8.99%**	**9.49%**	**9.34%**	Consistent with clause 17 of the Undertaking.

9.3.3 Annual updates to the cost of debt

We also sought advice from HoustonKemp on the approach to implementing the WACC over a multi-year regulatory period. HoustonKemp has advised that in the event PoM adopts a longer regulatory period, HoustonKemp considers it well-accepted for PoM to update the cost of debt estimate annually. HoustonKemp notes that the AER, ERA, ICRC, IPART and QCA all update their cost of debt estimates annually.[177]

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Based on the advice from HoustonKemp, we confirm that for the next regulatory period we will:

- Update our estimate of the cost of debt estimates annually and apply a true-up in the next regulatory period for annual differences in the cost of debt from the previous period; and
- Continue using the current averaging period, i.e., 20 trading days to 31 March of each year, consistent with clause 27(b)(iii) of the Undertaking.

9.4 Re-statement of the 2022-23 WACC

Having regard to the ESC's preliminary views in relation to the WACC estimate for the 2022-23 TCS, and the approach we have adopted for the 2023-24 TCS, we have decided to re-state the WACC for the 2022-23 regulatory year by applying a country filter to the selection of comparators for the estimation of beta.

Notwithstanding our view that not applying a country filter is a well accepted approach we consider that re-stating the 2022-23 WACC in this manner has the benefits of mitigating any customer impacts from the difference in views between PoM and the ESC in WACC estimation at this time.

We engaged HoustonKemp to re-estimate the WACC for 2022-23 by applying a country filter.[178] As shown in Table 9-2, below, applying a country filter reduces the WACC from 8.99% to 8.81% (pre-tax nominal), due to the reduction in gearing from 20% to 10%.

Table 9-2 WACC estimate for the 2022-23 regulatory year with and without a country filter

Parameter	2022-23 TCS (no country filter)	2022-23 WACC (country filter applied)
Return on debt	4.78%	4.78%
Return on equity	8.54%	7.87%
Risk free rate	2.57%	2.57%
Market Risk Premium (MRP)	6.63%	6.63%
Equity beta	0.90	0.80
Asset beta	0.72	0.72
Gearing	20%	10%
Tax rate	30%	30%
Gamma	0.50	0.50
Pre-tax nominal WACC	**8.99%**	**8.81%**

We note that HoustonKemp's WACC estimate is 1 bp lower than that estimated by the ESC in its Interim Commentary. Whilst we do not have access to the ESC's calculations, HoustonKemp notes that it is likely due to the ESC applying the country filter on the country of listing, rather than the country of risk.

The implication of re-estimating the WACC for 2022-23 is to change the ARR for 2022-23, which also changes recoverable depreciation and the RAB. As set out in section 10.3, this leads to a $9.4m reduction in the closing balance of the RAB for 2022-23.

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10 Aggregate Revenue Requirement

10.1 Overview and regulatory context

This Chapter of the TCS sets out:

- The calculation of the Aggregate Revenue Requirement (ARR) using the Accrual Building Block Model (ABBM) for the next regulatory period (2023-24 to 2027-28);
- Prescribed Services revenue (subject to the TAL) plus revenue from legacy contracts; and
- A comparison of the ARR with smoothed Prescribed Services revenue forecast over the regulatory period.

10.1.1 Pricing Order requirements

The Pricing Order sets out the following requirements for the determination of the ARR:

> *4.1.1 For the purposes of determining its Aggregate Revenue Requirement, the Port Licence Holder must apply an accrual building block methodology over the Regulatory Period comprising:*
>
> *a) an allowance to recover a return on its capital base, commensurate with that which would be required by a benchmark efficient entity providing services with a similar degree of risk as that which applies to the Port Licence Holder in respect of the provision of the Prescribed Services (see clauses 4.2 and 4.3);*
> *b) an allowance to recover the return of its capital base (see clause 4.4); and*
> *c) an allowance to recover its forecast operating expenses, commensurate with that which would be required by a prudent service provider acting efficiently (see clause 4.5); less*
> *d) an indexation allowance (see clause 4.6).*

10.2 Aggregate Revenue Requirement

PoM's ARR for the five-year regulatory period from 2023-24 to 2027-28 totals $2,623.0m in nominal terms ($2,004.2m in discounted 2022-23 terms).

We have calculated the ARR for this regulatory period using the ABBM in accordance with clause 4 of the Pricing Order, as set out in the Regulatory Model at Appendix B and User Guide at Appendix C. In accordance with clause 2.2.1 of the Pricing Order, we have used the same ABBM and parameters for both Dedicated and Shared Channels.

Table 10-1 sets out the ABBM inputs.

Table 10-1 Total ARR, 2023-24 to 2027-28 $m (nominal)

	$m (nominal)					$m (nominal)	$m (NPV, 2022-23)
	2023-24	2024-25	2025-26	2026-27	2027-28	Five Year Total	Five Year Total
Return on capital	512.1	546.9	578.9	611.1	644.3	2,893.2	2,208.4
Return of capital	14.0	15.2	16.5	17.8	19.3	82.8	62.9
Forecast operating expenses (opex)	155.2	165.6	170.4	176.1	181.3	848.6	650.1
Indexation allowance	-212.7	-227.1	-240.4	-253.8	-267.6	-1,201.6	-917.2
ARR	**468.6**	**500.5**	**525.3**	**551.1**	**577.4**	**2,623.0**	**2,004.2**

10.3 Recovery of depreciation and roll-forward of the capital base

In accordance with clause 4.4.2(a) we have adopted an alternative depreciation methodology because the return of capital derived using the straight-line depreciation methodology cannot be fully recovered over the regulatory period from Prescribed Services revenue subject to the TAL. Under our alternative methodology, the amount of straight-line depreciation that cannot be recovered from Prescribed Services revenue in a given regulatory year is deferred for recovery in future years. Chapter 12 provides further detail on our alternative depreciation methodology.

Over the five-year regulatory period, using our alternative depreciation methodology, we are forecasting:

- Recovery of $82.8m of depreciation; and
- Deferral of $1,002.5m of depreciation (Table 10-2).

PoM is forecasting to recover some depreciation across the regulatory period, primarily due to the impact of high inflation (forecast to average 3.9% across the regulatory period). A high CPI drives up the Prescribed Services revenue that PoM may recover under the TAL via larger tariff increases and drives down the ARR via a larger indexation allowance.

Table 10-2 details forecast depreciation across the regulatory period as well as revised figures for 2021-22 and 2022-23.

Table 10-2 Depreciation accrued, recovered and deferred in each Financial Year, $m (nominal)

	2021-22 (A)	2022-23 (E)	2023-24 (F)	2024-25 (F)	2025-26 (F)	2026-27 (F)	2027-28 (F)	Regulatory Period Total[1]
Straight-Line Depreciation from existing and new assets in the Financial Year	152.2	167.8	183.9	199.0	215.7	233.4	253.3	**1,085.3**
Depreciation recovered in the Financial Year (i.e. the return of capital included in the ARR)	0.0	102.0	14.0	15.2	16.5	17.8	19.3	**82.8**
Depreciation from Financial Year deferred for future recovery	152.2	65.9	169.9	183.9	199.2	215.6	234.0	**1,002.5**

Notes: 1. Regulatory Period total includes figures from 2023-24 to 2027-28 only.

10.3.1 Capital base roll forward

For the commencement of the five-year regulatory period, we have rolled forward the value of the capital base in accordance with clause 4.2.1 of the Pricing Order by:

- Adding indexation in accordance with clauses 4.2.1(b) and 4.6.1(a) of the Pricing Order. Clause 4.6.1(a) provides that the opening capital base must be indexed by the percentage change in CPI for the relevant financial year;
- Adding prudent and efficient net Capex in accordance with clauses 4.2.1(c) and 4.6.1(b) of the Pricing Order. Clause 4.6.1(b) provides that Capex is indexed by half a year's inflation (i.e., half of the percentage change in CPI) for the relevant financial year. This assumes Capex is incurred halfway through a financial year, and is net of any capital contributions or proceeds from disposing assets; and
- Deducting depreciation (i.e., the return of capital allowance). As described above, under PoM's alternative depreciation methodology, straight-line depreciation that cannot be recovered from Prescribed Services revenue in 2022-23 is deferred for recovery in future years.

At the end of the regulatory period, the capital base will be updated using actual inflation, actual capex and actual depreciation.

Table 10-3 sets out our forecast closing capital base values at 30 June for each regulatory year from 2021-22 (the most recent year in which actuals are available) to 2027-28. We forecast a closing capital base at 30 June 2028 of $7,206.5m.

This capital base includes the costs of contracts for Prescribed Services that were in place at the time of the commencement of the Pricing Order. It does not include the costs of any new contracts that were entered into after the Pricing Order commenced. The Regulatory Model at [Appendix B] provides further details on the capital base roll forward.

Table 10-3 Capital Base roll-forward, $ million (nominal)

	2021-22 (A)	2022-23 (E)	2023-24 (F)	2024-25 (F)	2025-26 (F)	2026-27 (F)	2027-28 (F)
Opening Capital Base (1 July)	4,871.9	5,017.7	5,383.7	5,784.6	6,140.7	6,482.2	6,841.3
Plus Indexation Allowance	54.8	260.6	212.7	227.1	240.4	253.8	267.6
Plus Efficient Capex	91.0	207.4	202.2	144.1	117.6	123.1	116.9
Less Return of Capital	0.0	102.0	14.0	15.2	16.5	17.8	19.3
Closing Capital Base (30 June)	**5,017.7**	**5,383.7**	**5,784.6**	**6,140.7**	**6,482.2**	**6,841.3**	**7,206.5**

The actual closing capital balance for 2021-22 of $5,017.7m is $95.5m lower than the estimated closing capital base submitted in our 2022-23 TCS. This adjustment is due to the inclusion of actual values for 2021-22 capex, which were $95.0 million[179] lower than estimated (Table 10-4).

The estimated closing balance for 2022-23 of $5,383.7m is $75.9m lower than forecast in our 2022-23 TCS. This is due to three factors:

- An actual opening capital base $95.5m lower than estimated (as described above);
- Estimated capex $29.6m higher than forecast; and
- A downwards revision to the 2022-23 WACC (as discussed in section 9.4) which translates to a $9.4m reduction in the closing balance.

Due to the operation of the TAL, the downwards revision of the 2022-23 WACC does not require a revision to the tariffs charged to Port Users in 2022-23.

Table 10-4 Revisions to Closing Capital Base (30 June), difference between 2022-23 and 2023-24 TCS, $m (nominal)

	2021-22 (A/E)	2022-23 (E/F)
2023-24 TCS	5,017.7 (A)	5,383.7 (E)
2022-23 TCS (revised WACC)	5,113.2 (E)	5,450.3 (F)
2022-23 TCS (original WACC)	5,113.2 (E)	5,459.6 (F)
Change (relative to 2022-23 TCS with original WACC)	**-95.5**	**-75.9**

10.4 Prescribed services revenue (subject to the TAL)

The TAL is defined in clause 14 of the Pricing Order as "…the percentage change in CPI between the March quarter immediately preceding the relevant Financial Year and the March quarter in the Financial Year two years preceding the relevant Financial Year".

[179] The remaining difference of $0.5m is due to a reduction in the indexation allowance which flows from the lower capex figure.

The 2023-24 TAL is based on the percentage change between the 2022 March quarter and 2023 March quarter CPI (All Groups Index Number, weighted average of eight capital cities published by the Australian Bureau of Statistics) and is 7.0 per cent.

The TAL for the remaining years of the regulatory period (2024-25 to 2027-28) has not yet been determined as it must be based on actual CPI data. TALs for each of these years will be published in successive annual Tariff Compliance Statements over the course of the next regulatory period.

The 2023-24 Prescribed Services revenue (subject to the TAL) is derived by:

- Applying the TAL of 7.0 per cent to the tariffs set out in our 2022-23 Reference Tariff Schedule; and
- Multiplying these tariffs by the 2023-24 forecast trade volumes prepared by DAE, GHD and PoM (discussed in Chapter 8).

The WATI is the weighted average rate of change in all tariffs. As agreed with the ESC, the calculation of the WATI excludes revenue from contracts with Port Users for Prescribed Services.

The WATI for 2023-24 was calculated using weightings based on 2021-22 audited revenue[180] (described in section 11.2). The 2023-24 WATI is 7.0 per cent.

We have added Prescribed Services revenue associated with the legacy contracts to 'Prescribed Services revenue (subject to the TAL)' for the purposes of comparing it with the ARR. We have agreed to this treatment of legacy contracts with the ESC.

For the avoidance of doubt, our total Prescribed Services revenue comprises:

- Prescribed Services Tariff revenue (subject to the TAL); and
- Revenue from both legacy and new contracts for Prescribed Services.[181]

10.4.1 Comparison of ARR and Prescribed Services revenue

Table 10-5 sets out our ARR and Prescribed Services revenue (subject to the TAL) plus revenue from legacy contracts for the five-year regulatory period expressed in net present value terms. As described in Chapter 5, the ARR has been smoothed across the regulatory period to generate a depreciation allowance that is positive in every year and afford PoM a reasonable opportunity to recover efficient costs, with prices set to generate a revenue stream (given the forecast of demand) over the regulatory period that is equal to the ARR in NPV terms, with unrecovered depreciation deferred for recovery in subsequent regulatory periods.

Over this regulatory period, after deferring the amount of straight-line deprecation that cannot be recovered, we forecast that PoM's Prescribed Services revenue plus revenue from legacy contracts will be equal to the ARR (in net present value terms). In other words, after deferring depreciation, we forecast no unrecoverable ARR during this regulatory period.

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181 Contract revenue is confidential and is separately reported to the ESC.

Table 10-5 Comparison of ARR and smoothed Prescribed Services revenue (subject to the TAL), $m

	Regulatory Period Total (2022-23, NPV terms)
Return on capital	2,208.4
Return of capital	62.9
Operating expenses (opex)	650.1
Indexation allowance	-917.2
ARR (excl. deferred depreciation)	**2,004.2**
Smoothed Prescribed Services revenue	**2,004.2**
Unrecoverable ARR	**0.0**

Note 1 We have adopted an alternative approach to straight-line depreciation on the basis that the return of capital derived using a straight-line depreciation methodology is not capable of being recovered in the applicable Financial Year (clause 4.4.2 of the Pricing Order).

11 Tariffs

11.1 Tariffs across the regulatory period

Our forecast of smoothed Prescribed Services revenue (subject to the TAL) plus revenue from legacy contracts is equal to the ARR (calculated under the ABBM) in net present value terms after deferral of depreciation. Our Prescribed Services Tariffs for the regulatory period from 2023-24 to 2027-28 are therefore subject to the TAL.

For 2023-24, we also confirm that:

- The WATI (excluding tariffs for full outbound container wharfage services) for Prescribed Services is 7.0 per cent;
- All tariffs will increase by the TAL of 7.0 per cent, being the annual change in CPI to March 2023;
- All tariffs have been adjusted by the same percentage adjustment consistent with clause 3.2.1 of the Pricing Order; and
- There are no new or discontinued tariffs.

Our 2023-24 tariffs are set out in the Reference Tariff Schedule (RTS) provided at Appendix A and are effective from 1 July 2023.

For each year from 2024-25 to 2027-28, the weighted average tariff increase (WATI) will be set at the TAL (the annual change in CPI to March for the preceding financial year) (Table 11-1). Unless PoM submits, and the ESC approves, a tariff rebalancing application during this period, all tariffs will increase at CPI for each of the five years of the regulatory period.[182]

Our price path for the next regulatory period is CPI – 0% for each year.

Table 11-1 WATI and TAL, 2023-24 to 2027-28

	2023-24	2024-25	2025-26	2026-27	2027-28
Weighted Average Tariff Increase	7.02%	CPI – 0%	CPI – 0%	CPI – 0%	CPI – 0%
Tariff Adjustment Limit	7.02%	CPI (March 2023 to March 2024)	CPI (March 2024 to March 2025)	CPI (March 2025 to March 2026)	CPI (March 2026 to March 2027)

11.2 Compliance with the Weighted Average Tariff Increase

Under clause 3.1.1 of the Pricing Order, PoM must ensure that the Weighted Average Tariff Increase (WATI) implied by prescribed service tariffs does not exceed the tariff adjustment limit (the percentage change in CPI over the preceding year). The WATI is defined under clause 14 of the Pricing Order as follows:

Weighted Average Tariff Increase means, in respect of a Financial Year, the expected weighted average rate of increase in the Prescribed Service Tariffs using weightings based on historical revenues derived from the Prescribed Service Tariffs in the most recent Financial Year for which audited data are available or, if there is no historic audited data upon which to calculate the expected weighted average rate of increase on

[182] Under a rebalancing application, the weighted average annual change in tariffs will still be capped at CPI, however some tariffs could change by more or less than others.

this basis, an alternative estimate of revenue for the purpose of calculating weightings on a basis determined by the Commission.

Consistent with the approach described in the 2022-23 TCS[183], we have derived the WATI for 2023-24:

- Using revenue weights at an individual tariff level directly derived from audited revenue figures at a tariff category level; and
- Based on unrounded tariffs calculated by applying the annual percentage change in CPI to the previous year's unrounded tariffs as presented in the Regulatory Model [Appendix B].

11.3 Compliance with efficient cost bounds

Clause 2.1.1 of the Pricing Order requires that revenue for each Prescribed Service Bundle should be on, or between, the upper bound (clause 2.1.1(b)(i)), which represents the standalone cost of providing each Prescribed Service Bundle, and the lower bound (clause 2.1.1(b)(ii)), which represents the avoidable cost of not providing the Prescribed Service Bundle. This is commonly known as the "efficient pricing band" to represent the range of possible tariff revenue that could be considered economically efficient for a given service bundle. If revenue from a service bundle were below the avoidable cost this could imply that users of this bundle were inefficiently subsidised by other Port Users. If revenue from a service bundle were above the standalone cost, this could imply that Port Users would be incentivised to inefficiently self-provide these services, despite PoM's cost of provision being lower.

PoM's Regulatory Model [Appendix B] demonstrates our compliance with clause 2.1.1(b) of the Pricing Order by:

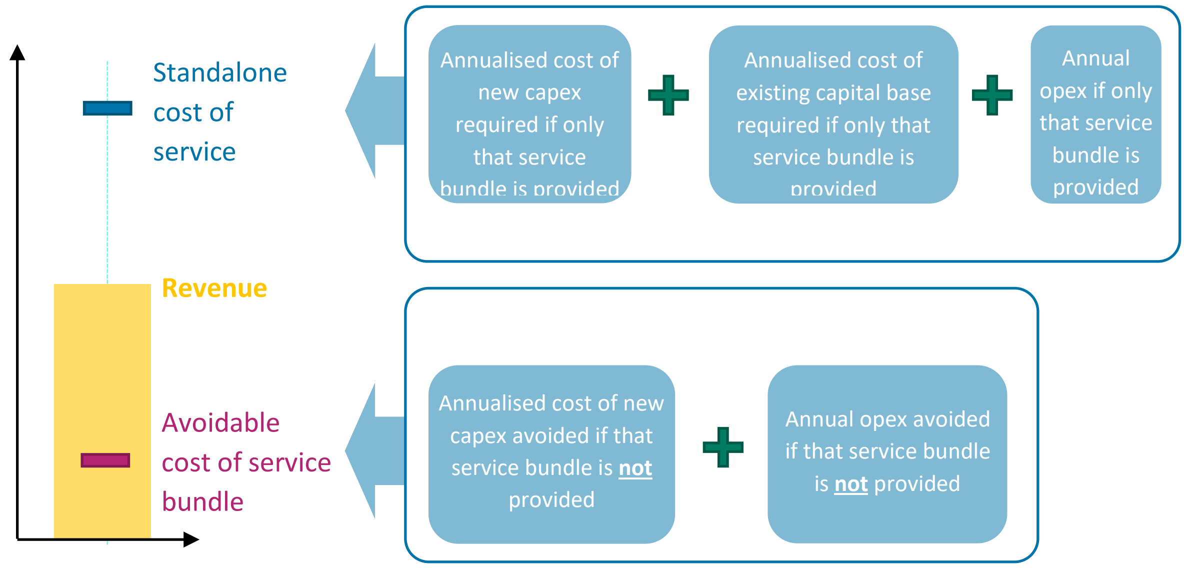
- Estimating the indicative standalone and avoidable costs of supplying each Prescribed Services Bundle, based on the most recent available data; and
- Demonstrating that forecast revenue for each Prescribed Services Bundle falls within those efficient pricing bounds in accordance with the Pricing Principles in the Pricing Order.

Figure 11-1 shows the conceptual approach that is used to calculate the efficient cost bounds in the model. The blue bar represents the revenue from a given Prescribed Services Bundle, while the two orange circles represent the standalone and avoidable costs for that bundle. The two boxes to the right illustrate which components are used to calculate the upper efficient cost bound (the standalone cost) and lower efficient cost bound (the avoidable cost).

For the five-year regulatory period, annualised standalone costs and avoidable costs illustrated below are summed up across the five years and compared to the sum of smoothed revenue on a net present value basis.

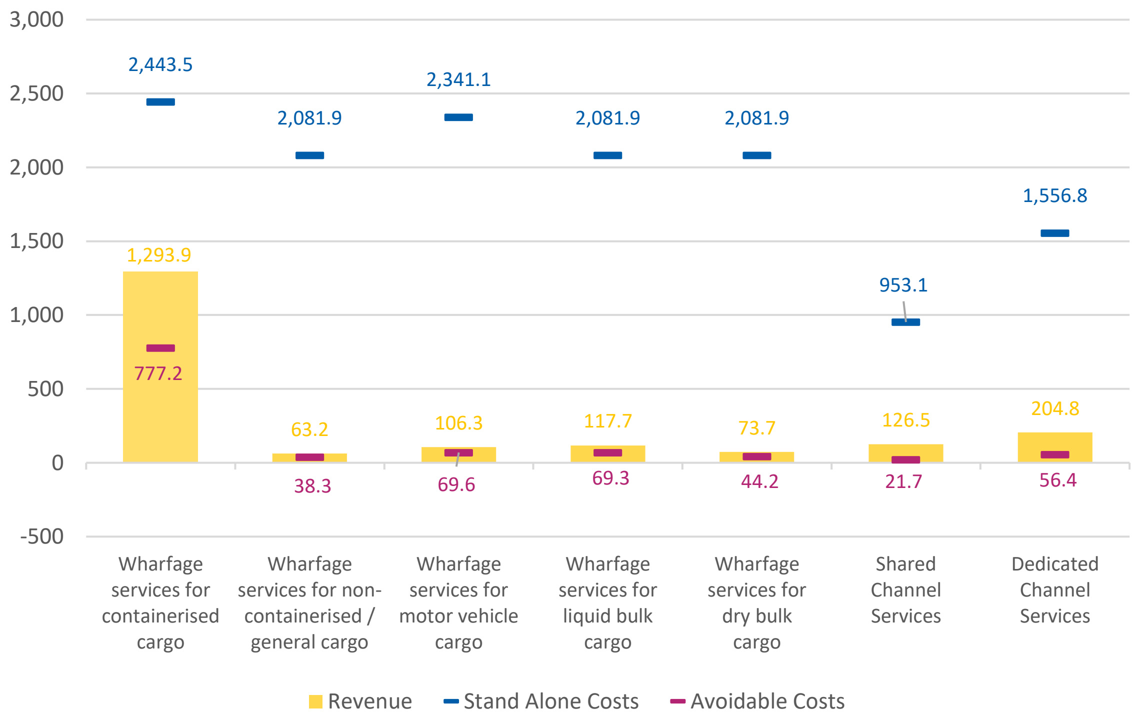
[183] PoM, 2022-23 TCS General Statement, pp. 86-87

Figure 11-1 Illustrative representation of the efficient cost bounds



For the five-year regulatory period, the revenue from each prescribed service bundle is forecast to fall within the relevant efficient cost bounds (Figure 11-2).

Figure 11-2 Efficient cost bounds and revenue by prescribed service bundle, 2023-24 to 2027-28 ($m 2022-23, NPV terms)



12 Depreciation deferral and recovery

12.1 Background

During the 'Pricing Order transition period' — which runs from the commencement of the Pricing Order in 2016 until 2032 at the earliest, or 2037 at the latest — the costs that PoM may recover through tariff revenue from Prescribed Services are constrained by the Tariffs Adjustment Limit (TAL). Over the first seven years of the Port Lease, the operation of the TAL has meant that PoM's tariff revenue from Prescribed Services has fallen well short of the efficient costs incurred to provide those services.[184] We expect these revenue shortfalls to persist for much of the remainder of the TAL period.

The Pricing Order partly addresses the potential for revenue shortfalls during the Pricing Order transition period (i.e. the TAL period) via a mechanism to change the timing of the recovery of depreciation costs. Under clause 4.4.2(a) of the Pricing Order, the operation of the TAL means that if straight-line depreciation costs cannot be recovered in any year, PoM may use an 'alternative depreciation methodology' to change the profile of the recovery of depreciation costs.[185]

Over the five-year regulatory period from 2023-24 to 2027-28, we expect to partially recover depreciation costs, with unrecoverable depreciation costs deferred in accordance with clause 4.4.2(a) (see also, section 10.3). By deferring depreciation recovery, some of the revenue shortfall PoM incurs can be recovered through future tariffs.

For the remainder of the TAL period, we expect that most new depreciation will continue to be deferred, and that there will be a substantial deferred depreciation balance to be recovered through tariffs after the end of the TAL period. By the end of the TAL period in 2037, our current projections suggest that PoM's deferred depreciation balance could be in the order of $6 billion and constitute just under half of PoM's total capital base at that time (Figure 12-1).[186]

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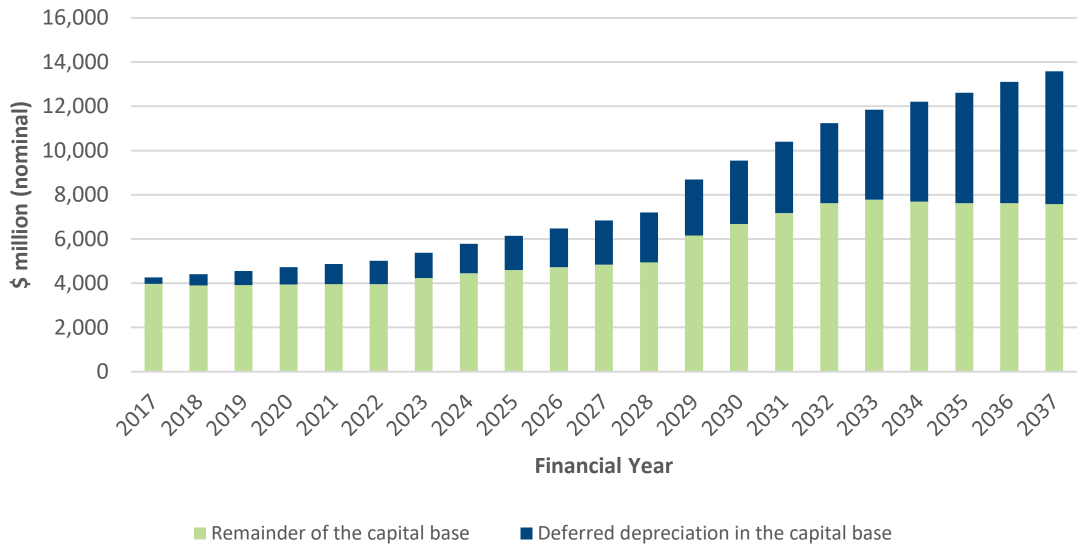
[184] Under clause 2.1.1(a) of the Pricing Order, the efficient costs of providing Prescribed Services are determined by the application of an accrual building block methodology, which is described in clause 4 (Aggregate Revenue Requirement)

[185] Pricing Order clause 4.4.2

[186] Under clause 4.2.1 of the Pricing Order, there are two key drivers of growth in the capital base: prudent and efficient capital expenditure, and indexation (inflation). In addition to PoM's investment gateway processes for developing and executing capital expenditure plans, actual capital expenditure is subject to periodic, ex-post review by the ESC to ensure that PoM's capital base complies with the Pricing Order, particularly in relation to additions of prudent and efficient capital expenditure. Hence while these projections are based on our current expectations of expenditure requirements over the course of the Port Lease, they are high-level and indicative only, and not reflective of any commitments to invest or investment decisions to be made in the future.

Figure 12-1: Indicative projection of PoM's capital base to the end of the TAL period



The timing and approach of PoM's recovery of deferred depreciation in the post TAL period will therefore significantly impact the tariff profile after the TAL comes to an end. As required under the Pricing Order, once the transition period ends, PoM can only adopt an alternative methodology to straight-line depreciation if it is "reasonably likely to reduce the variance in the expected annual percentage changes in the level of Prescribed Services Tariffs through to the end of the Port Lease" (relative to the straight-line approach).[187]

12.2 Our approach

Informed by feedback from stakeholders, our approach to the recovery of depreciation prioritises minimising price volatility.

At a high level, PoM's depreciation methodology is as follows:

- For regulatory periods during the TAL period, we apply straight-line depreciation with an unrecovered depreciation account, with uncharged depreciation recorded as a separate asset with a life equal to the remaining lease term; and
- After the TAL period ends, a tilted annuity depreciation method will be applied with the tilt factor chosen at the time to minimise the variance in the expected annual percentage change in weighted average tariff increases until the end of the Port Lease.

This approach was informed by the views of stakeholders and independent advice from Incenta Economic Consulting (Incenta). Incenta advised PoM on alternative deprecation methodologies that were compliant with the Pricing Order in the lead up to the 2021-22 TCS. Incenta's report was submitted to the ESC as part of our 2021-22 TCS and is publicly available on the ESC's website.[188]

A brief explainer on the tilted annuity approach is provided below, and a more detailed explanation of the methodology is available in the 2022-23 TCS.[189]

An explanation and justification for PoM's approach during and after the TAL period is provided below.

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[187] Pricing Order clause 4.4.2(b)
[188] See Port of Melbourne compliance with pricing regulations | Essential Services Commission
[189] PoM, 2022-23 TCS General Statement, pp. 94-97

Box 12-1 What is tilted annuity depreciation?

The tilted annuity method calculates the depreciation of an asset over its useful life such that the 'total capital charge' (the sum of the return on, and return of, capital) grows at a selected 'tilt rate'. By contrast, under the straight-line method, an asset is depreciated by an equal amount each year over its useful life.

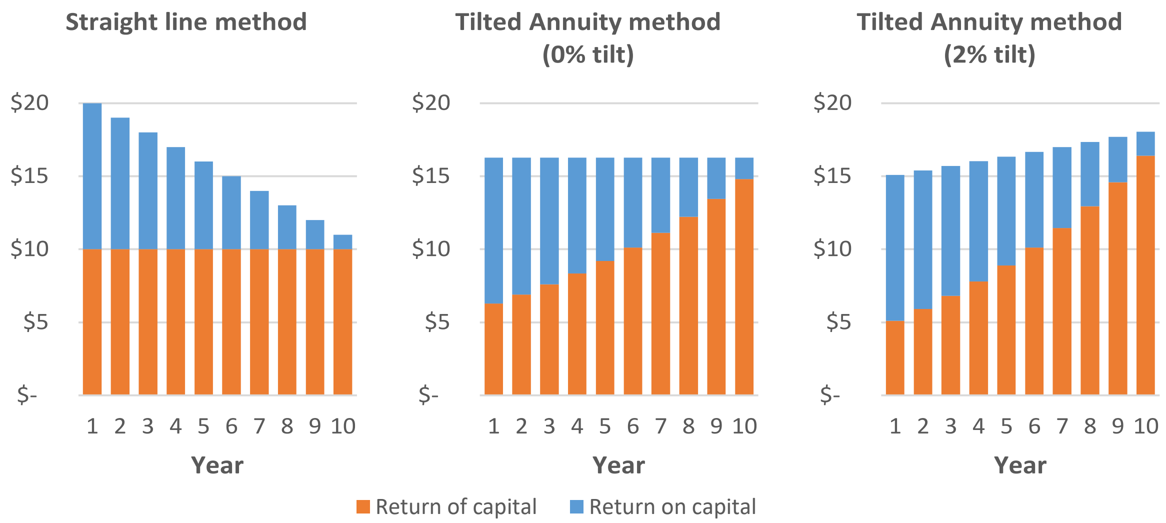
For example, consider an asset of $100 with a useful life of 10 years, with a 10% rate of return on capital.

Under the straight-line method, the return of capital is the same in each year. The total capital charge decreases over time as the capital base is quickly depreciated and the return on capital declines.

Under the tilted annuity method with a 0% tilt rate, the return of capital is set so that the total capital charge is constant over the life of the asset. As the return of capital increases over time, the return on capital decreases. This is analogous to a typical 'principal plus interest' loan repayment where the total repayment (the 'total capital charge') is constant over time, because the principal component (the 'return of capital') of the repayment increases while the interest component (the 'return on capital') declines.

Under the tilted annuity method with a 2% tilt rate, depreciation is set such that the total capital charge increases at 2% each year. Compared to the 0% tilt rate, the return of capital is smaller in early years and the return on capital larger, but the return of capital grows more quickly resulting in a growing total capital charge.

In each case, the net present value of the depreciated capital is the same (i.e. the same amount of capital is recovered and the total payments are equal in NPV terms), but the profile of recovery is different.



12.3 Stakeholder engagement

We are committed to ensuring that Port Users remain well informed about the potential impact of the recovery of deferred depreciation on future tariffs.

As part of our 2023 Industry Engagement we presented updated indicative tariff projections for the post TAL period[190] and asked stakeholders if they needed any further information about the recovery of depreciation and tariffs after 2037. Out of 37 respondents, four requested further information about the process and methodology for tariff recovery after 2037, including how the tariffs will be calculated and the forecast price impacts. As described in Chapter 3, we provided further information directly to these stakeholders and offered individual briefings specifically on this issue, and we addressed the issues that were raised.

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To further ensure that stakeholders can stay well informed, the section below presents updated indicative projections. This is in keeping with our commitment to present updated projections at the commencement of each regulatory period.

12.4 Projections

This section presents indicative projections of our depreciation recovery and future tariffs impacts under our adopted approach.

Calculating these impacts requires projecting a number of uncertain variables to the end of the Port Lease period (2066). Among the many uncertain variables are inflation, the cost of capital (and interest rates), capital and operating expenditure, and trade volumes. In order that the illustration of potential future impacts of alternative depreciation recovery profiles is as meaningful as possible, we have sought to adopt realistic assumptions that we consider reflect a feasible future state. However, given the number of variables involved and long time horizons, there are a myriad of possible future outcomes, and these projections represent just one of many possible future states.

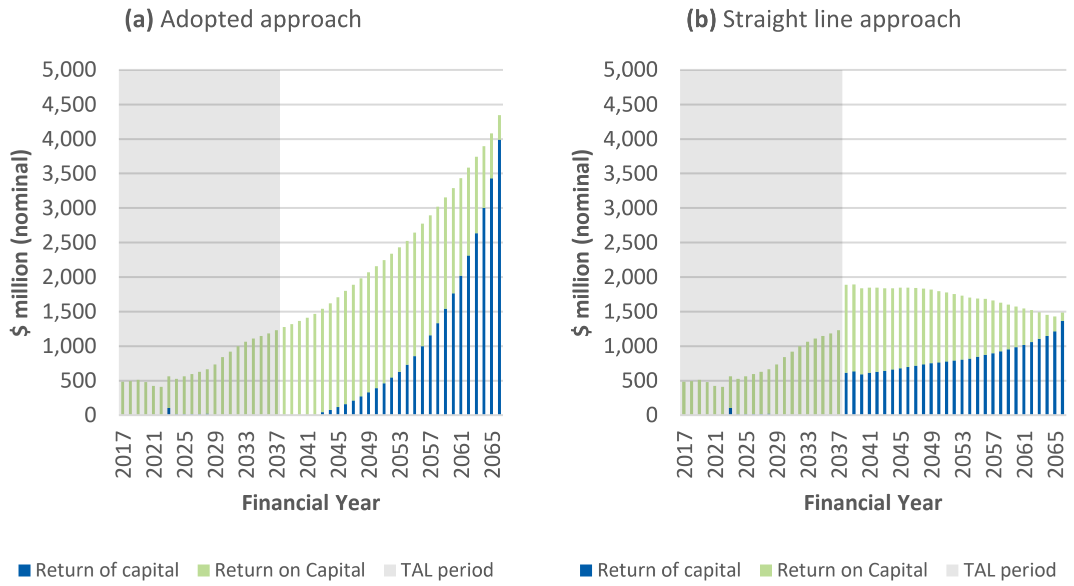
These projections are likely to change significantly from one regulatory period to the next, should be considered illustrative only, and should not be relied upon for any other purpose.

12.4.1 Projected depreciation recovery

Figure 12-2 provides an indicative projection of PoM's annual capital charge (the sum of the return on capital and return of capital) under the adopted approach to depreciation recovery **(a)**, and an alternative approach where depreciation is recovered via the straight-line method in the post TAL period **(b)**:

- Based on current projections, only a small amount of PoM's capital base will be recoverable via tariffs during the TAL period. Unusually high inflation allows for the partial recovery of PoM's straight-line depreciation between 2022-23 and 2027-28. However, assuming inflation returns to a level more consistent with the RBA's target range in coming years, recovery of straight-line depreciation during the TAL period is not projected to continue beyond 2027-28;
- Adopting a tilted annuity approach to the return of capital in the post TAL period **(a)** enables PoM to reduce the total capital charge component of the revenue requirement in the years immediately after the expiry of the TAL. By contrast, if PoM chose to continue to recover depreciation via a straight-line approach in the post TAL period **(b)**, the capital charge would increase sharply in 2038, and then gradually decline until the end of the Port Lease; and
- While the adopted approach results in a total cumulative capital charge which is larger in nominal terms, it is the same under either methodology when expressed in net present value (NPV) terms. This means that PoM's choice of depreciation methodology does not impact the total amount paid by Port Users (in aggregate, NPV terms), only the timing and profile of cost recovery.

Figure 12-2 PoM's projected capital charge under the adopted approach and straight-line approach

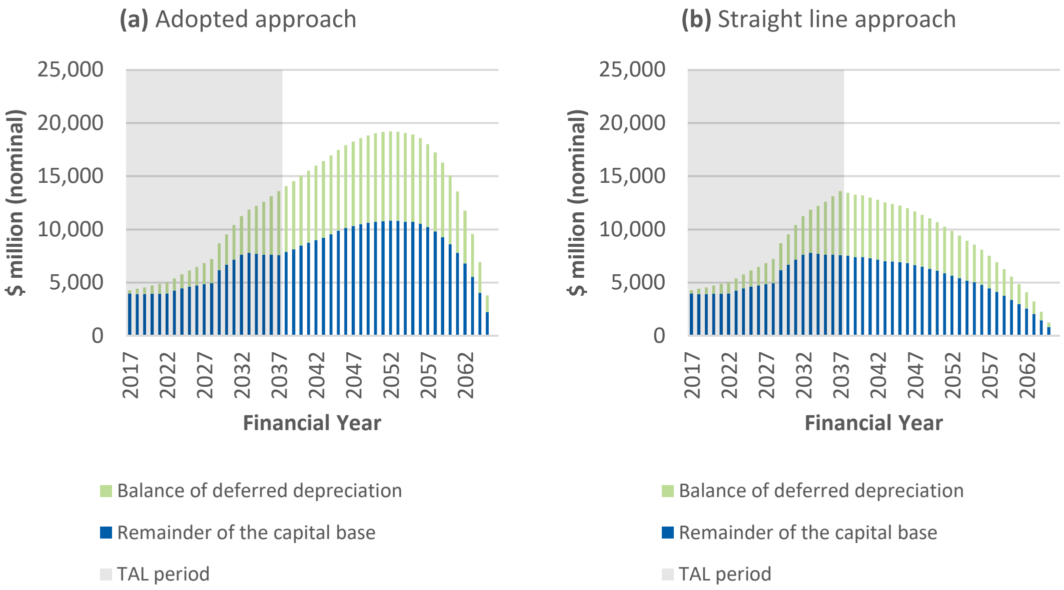


Note: Due to the operation of the TAL, the return on capital during the TAL period that is shown in this figure may not be fully recovered through tariffs.

Figure 12-3 provides an indicative projection of PoM's closing capital base under the adopted approach to depreciation recovery **(a)**, and an alternative approach where depreciation is recovered via the straight-line method in the post TAL period **(b)**:

- On current projections, PoM's capital base is projected to be around $13 billion in nominal terms at the conclusion of the TAL period (assumed to be 2037), with the deferred depreciation balance constituting just under half of this total;
- Under the adopted approach **(a)**, we project PoM's capital base will continue to grow in nominal terms until around 2050 as capital additions and indexation outpace the return of capital. After about 2050, the capital base declines as the return of capital increases;
- By contrast, if PoM chose to continue to recover depreciation via a straight-line approach in the post TAL period **(b)**, we project that PoM's capital base would peak in 2037 at the conclusion of the TAL period, and decline across the remainder of the Port Lease.

Figure 12-3 PoM's projected closing capital base under the adopted approach and straight-line approach



12.4.2 Potential tariff impacts

Figure 12-4 provides an indicative projection of future tariffs under the adopted approach and an alternative approach where depreciation is recovered via the straight-line method in the post TAL period. As shown in the figure:

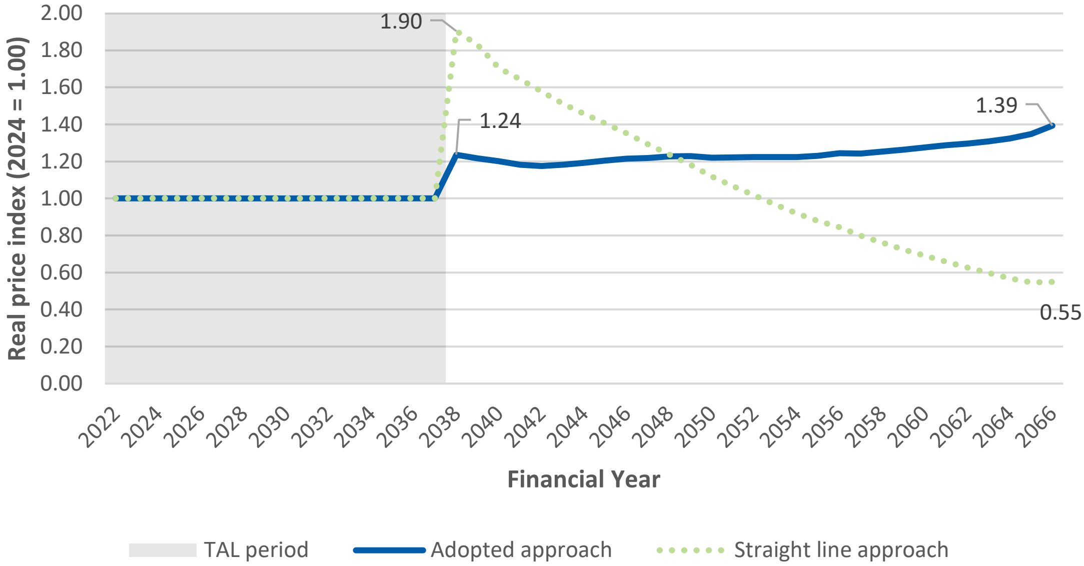
- Tariffs are projected to remain constant in real terms (i.e. increase at the rate of inflation) for the remainder of the TAL period;
- Under the adopted approach, tariffs are projected to increase by 24% in inflation-adjusted terms at the end of the TAL period (2038) and increase by 39% in inflation-adjusted terms by 2066; and
- By contrast, if a straight-line approach were applied in the post TAL period, tariffs would increase sharply post TAL (by 90% in inflation-adjusted terms), before steadily declining over the post TAL period.

Deferring depreciation recovery to later in the Port Lease provides tariff control because costs can be spread across higher trade volumes, reducing the price impact on customers.

The adopted approach results in a flatter tariff profile because the growth in the 'tilt rate' (which determines the rate of growth in the sum of the return on capital and the return of capital) can be set to broadly match the growth in demand. The effect of the adopted approach is to significantly reduce the step change in the revenue requirement at the end of the TAL period as the growth in the revenue requirement under the adopted approach is set to minimise the variance in annual percentage tariff changes over the post TAL period.

As described in section 12.2, the Pricing Order requires that an alternative depreciation methodology is reasonably likely to reduce the variance in expected annual percentage changes in tariffs through to the end of the Port Lease (relative to the 'default' approach of straight-line depreciation). As the tariff profiles in Figure 12-4 demonstrate, the adopted approach clearly meets this requirement.

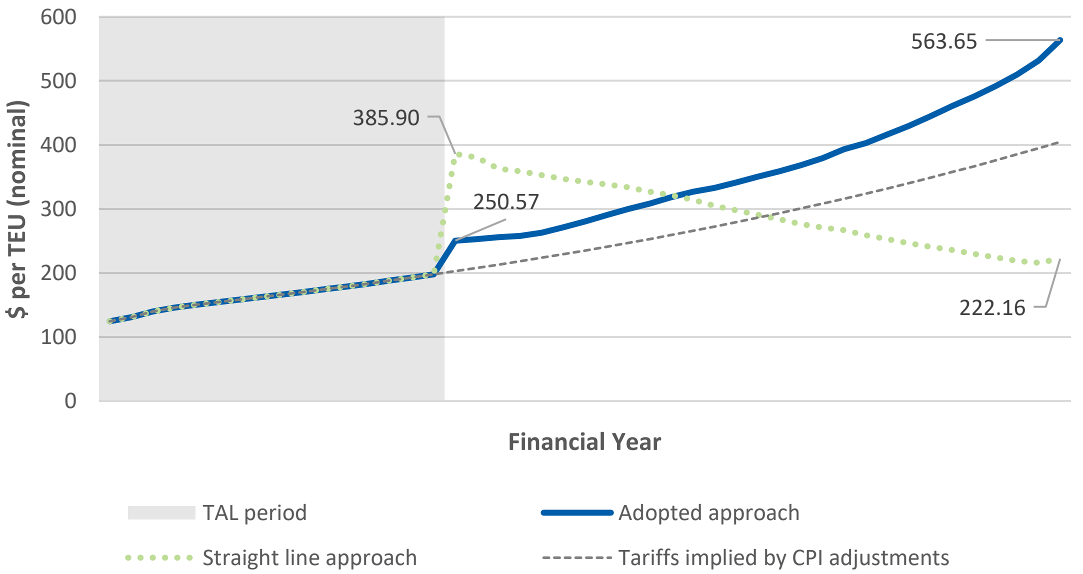
Figure 12-4 Projected real tariff index under the adopted approach and straight-line approach



To illustrate the impact on actual tariffs, Figure 12-5 provides an indicative projection of the containerised (full inward) wharfage fee under the adopted approach and the straight-line approach, expressed in nominal terms (i.e. not adjusted for inflation). This projection assumes all tariffs are increased at the same rate from 2023-24 onwards:

- Under the adopted approach, the fee increases by $53 (27 per cent, including inflation) in 2038, and rises fairly steadily during the post TAL period at a rate slightly above inflation;
- Under the straight-line approach, the fee increases by $188 (95 per cent, including inflation) in 2038 at the conclusion of the TAL period, before steadily declining over the post TAL period; and
- While the adopted approach is projected to result in a significantly higher fee by the conclusion of the Port Lease, the total amount of prescribed revenue recovered across all tariffs over the Port Lease is the same under either approach in net present value terms.

Figure 12-5 Projected containerised (full inward) wharfage fees under the adopted approach and straight-line approach (excl. GST)

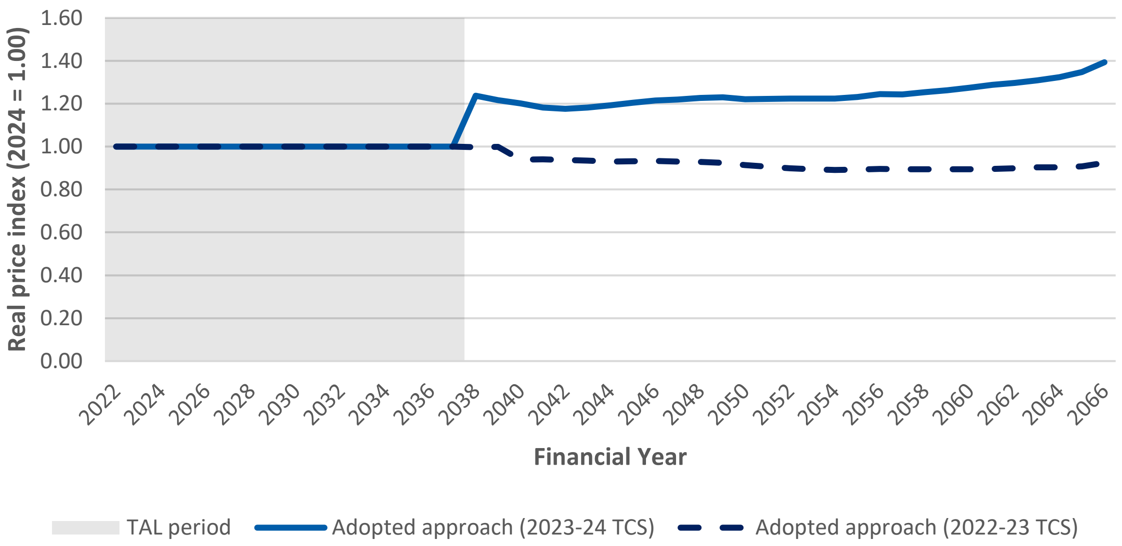


We note that these projections are significantly higher than those provided in the 2022-23 TCS (Figure 12-6).[191] The main reasons for the increase are:

- An increase in the capex expected to be required to complete major projects set out in the 2050 Port Development Strategy;
- A decrease in the projected growth of trade volumes to the end of the Port Lease[192]; and
- An increase in the projected WACC, due to increases in the risk-free rate.

The change in projected tariff increase over the Port Lease from last year to this year emphasises that these projections are highly sensitive to changes in underlying variables. We will continue to update these projections with the latest expenditure and trade forecasts so stakeholders can stay informed of potential future impacts.

Figure 12-6 Projected real tariff index under the adopted approach, 2023-24 TCS vs 2022-23 TCS



[191] PoM, 2022-23 TCS General Statement, pp. 99-101

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For more information

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