Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23

20 December 2022

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Essential Services Commission 2022, Interim commentary – Port of Melbourne Tariff Compliance Statement 2022–23: 20 December

Contents

Summary

On 31 May 2022, the Port of Melbourne Operations Pty Ltd (the Port) submitted its 2022–23 tariff compliance statement to us, available on our website.[1]

In setting its prices for prescribed services[2], the Port is required to comply with requirements in the pricing order[3] – a regulatory instrument made by the Governor in Council under section 49A of the Port Management Act 1995 (Vic).

It also requires the Port to submit annual tariff compliance statements to us. These must, among other things, explain how the prescribed service tariffs[4] the Port proposes to charge for prescribed services in the forthcoming financial year comply with the pricing order.

This is the second tariff compliance statement the Port has submitted to us since our first five-yearly inquiry into the Port's compliance with the pricing order during the review period 1 July 2016 to 30 June 2021.[5]

Our role

We are responsible for assessing and reporting on the Port's compliance with the pricing order. We must, at five-yearly intervals, conduct an inquiry and report to the minister responsible for administering the Essential Services Commission Act 2001 (Vic):

- whether the Port has complied with the pricing order during the relevant five-year review period
- if any non-compliance was, in our view, 'significant and sustained'.[6]

Our first review, covering the period 2016–21, found 'significant and sustained' non-compliance with the pricing order in a number of respects. The Port gave the Assistant Treasurer an

[1] 'Port of Melbourne compliance with pricing regulations', Essential Services Commission, accessed 28 October 2022, www.esc.vic.gov.au/transport/port-melbourne/port-melbourne-compliance-pricing-regulations.

[2] Port Management Act 1995, s.49(1)(c). This sets out what 'prescribed services' comprise.

[3] *Victorian Government Gazette*, No S 201, Friday 24 June 2016, as amended by V*ictorian Government Gazette*, No S 247, Wednesday 20 May 2020.

[4] Pricing Order, clause 14. This defines 'prescribed service tariffs' as meaning the prices charged for the provision of, or in connection with, prescribed services.

[5] 'Port of Melbourne compliance with pricing regulations', Essential Services Commission, accessed 28 October 2022, www.esc.vic.gov.au/transport/port-melbourne/port-melbourne-compliance-pricing-regulations/inquiry-port-melbourne-compliance-pricing-order-2021.

[6] Port Management Act 1995, s.49I(1).

undertaking in relation to our adverse compliance report. This undertaking was accepted by the Assistant Treasurer and commenced on 20 May 2022.[7] [8]

The purpose of an undertaking given under the Port Management Act is to address the Port's non-compliance with the pricing order. We do not have a role in enforcing the undertaking. The relevant minister (the Assistant Treasurer) may apply to the Supreme Court for orders where a breach of the undertaking is alleged to have occurred. [9]

Following the inquiry, the Port entered into a voluntary undertaking with the ESC Minister (the Assistant Treasurer) to address these findings. The voluntary undertaking has effect from 20 May 2022 until 30 June 2027.

We have prepared this interim commentary on the Port's 2022–23 tariff compliance statement in anticipation of our next five-yearly compliance inquiry, in 2026. It sets out our preliminary views on the Port's pricing order compliance in setting its tariffs for 2022–23.

This will be the second year of the review period (2021–26) for our next five-yearly pricing order compliance inquiry. Our interim commentaries are intended to inform the Port's current and future work, to ensure compliance with the pricing order during this review period.

Why we are providing this commentary

While the pricing order requires the Port to submit an annual tariff compliance statement, we are not required to publish an interim commentary each year in response to the Port's tariff compliance statement. However, publishing feedback on the Port's annual tariff compliance statements promotes transparency and predictability in our approach to our next five-yearly pricing order compliance inquiry.

This gives the Port and other stakeholders advance notice of issues or topics that may be the subject of detailed examination in our five-yearly inquiries.

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[7] Under section 49M(1) of the PMA, the ESC Minister may accept a written undertaking given by a provider of prescribed services who is the subject of an adverse compliance report in relation to the provider's non-compliance with a Pricing Order if the ESC Minister is satisfied that:

a) the terms of the undertaking offered by the provider are appropriate to adequately address the provider's non-compliance with a Pricing Order; and

b) the provider is reasonably likely to comply with the terms of the undertaking.

[8] The undertaking can be found in the Public Summary of the Port's response to the ESC Review Findings - https://www.portofmelbourne.com/regulatory-information/regulatory-process/. It sets out how the Port should approach the estimation of its weighted average cost of capital and sets out that the Port must develop an engagement protocol to outline the Port's approach to consulting on regulatory matters under the pricing order.

[9] Port Management Act 1995 (Vic), s 49N(2).

Our interim commentaries are not informed by stakeholder submissions, including from the Port. They are preliminary views only, which will be further developed, and may change, as we receive further information during the review period.

Therefore, this commentary does not limit the scope of issues we may consider in future commentaries or our five-yearly inquiries.

We have also published a revised statement of regulatory approach V3.0. This statement provides guidance to the Port on how it may demonstrate compliance with the pricing order, including through information provided in its tariff compliance statements.

Our high-level assessment of the Port's 2022–23 tariff compliance statement

This is our first interim commentary since our inaugural five-yearly inquiry into the Port's compliance with the pricing order over the review period from 2016 to 2021. It focuses on the Port's approach to:

- estimating its weighted average cost of capital
- forecasting expenditure
- depreciation methodology post tariffs adjustment limit
- stakeholder engagement.

Weighted average cost of capital

The Port estimated a weighted average cost of capital of 8.99 per cent for the 2022–23 regulatory period. This is 76 basis points higher than its 2021–22 weighted average cost of capital estimate of 8.23 per cent.[10]

Our preliminary view is that the Port's approach to calculating its weighted average cost of capital appears to generally reflect our views in our 2016–21 compliance inquiry on well accepted approaches.

However, unlike previous tariff compliance statements, the Port does not use country filters in its 2022-23 tariff compliance statement to estimate its beta. We note that the Port cites one decision of the Supreme Court of Western Australia, concerning the price to be paid by Qantas to Perth Airport for aeronautical services to support its decision to not use country filters. The commission's preliminary view is that it is not persuaded that the Port can rely on that decision as to the

[10] The major driver of the increase in the weighted average cost of capital is an increase in the risk free rate from 1.70 per cent in 2021–22 to 2.56 per cent in 2022–23, that reflects market conditions

application of country filters as encompassing a well accepted approach in the terms of the pricing order. We consider that the use of country filters would have reduced the Port's weighted average cost of capital from 8.99 per cent to 8.82 per cent.

The Port should re-consider the use of country filters to estimate its beta, which we noted in our 2016–21 inquiry as a well-accepted approach. The use of country filters will help ensure the comparator set of countries to estimate benchmark systematic risk (beta) reflect similar risks to Australia.

Expenditure

We have not undertaken an in-depth review of the measures the Port has commenced or completed to improve the prudency and efficiency of capital expenditure for more complex capital works. However, our preliminary view is that the measures outlined in its 2022–23 tariff compliance statement appear to reflect capital planning processes appropriate for its proposed capital works.

The Port also sets out its approach to establishing a base-step trend, including a productivity factor, to estimate operating efficiencies.[11] We recommended a base-step approach to establishing benchmark operating expenditure in our 2016–21 compliance inquiry. It is an approach used by other regulated entities to estimate efficient operating expenditure forecasts. The Port's approach includes:

- setting a productivity growth target of 0.5 per cent for prescribed services operating expenditures
- an initial assessment between operating expenditures and key cost drivers (demand and capital growth)
- comparing the base-step trend to a bottom-up forecast to inform the efficiency of the forecast.

Our preliminary view is that the Port's approach to establishing a benchmark step-change in operating expenditure would not lend itself to estimating prudent and efficient forecasts. This is because the Port's proposed approach does not use actual prudent and efficient operating expenditure to build forecast expenses. Actual prudent and efficient expenditure is established once we complete our five yearly inquiry.

The Port proposes to use actual expenditure each year that has not yet been reviewed by us. Hence, forecasting expenses off a base expenditure level that has not yet been established as prudent and efficient may not lead to prudent and efficient forecasts.

[11] The base-step trend approach is outlined in detail in the Expenditure section of this commentary.

We consider that the Port should use 2019–20 as its base year for future tariff compliance statements because it was the last year of actual expenditure we undertook a prudency and efficiency review.[12] The next five-yearly review will reset the prudent and efficient base year.

In this interim commentary we identify specific areas for the Port to address in this regard in future tariff compliance statements to ensure its approach to estimating operating forecasts reflect prudent and efficient processes.

Depreciation

The Port has proposed an alternative depreciation methodology once the tariffs adjustment limit ends in 2037 with the aim of minimising price volatility over the life of the lease.

The Port proposed to apply a tilted annuity approach to estimating depreciation at the end of the tariffs adjustment limit period. While a straight-line approach depreciates at a constant rate each year, a tilted annuity approach changes the time profile in which the Port would collect depreciation, increasing depreciation gradually over time at a pre-set ‘tilt’ rate (three per cent in the current model).

Our preliminary view is that this new approach reflects a methodology that may address future price volatility. The Port has not settled on all the detail of its proposed methodology for us to make a view on the approach.[13]

We are encouraged that the Port sought stakeholder views and has incorporated those views by developing an objective for the future recovery of depreciation. That is, to not only reduce but minimise price volatility throughout the remainder of the Port lease. The Port should continue to engage on this issue and review how it will periodically update the tilt rate, respond to changing forecasts and ensure the approach continues to achieve the Port’s stated objective of minimising price volatility.

Engagement

The 2022–23 tariff compliance statement outlines:

- the Port’s engagement program with port users and other stakeholders over 2021–22
- what it heard from its stakeholders

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[12] Although we found in our 2016-21 inquiry that the Port’s operating expenditure was not prudent and efficient. We noted that the amount of non-compliance was insignificant and that the Port was still in a transition phase of its operations. Hence, we consider it appropriate to use 2019-20 as the base-year.

[13] For example, the Port notes that the ‘tilt’ rate it would apply should be linked to demand forecasts once the tariffs adjustment limit period ends and that it is too early to accurately estimate demand forecasts post tariffs adjustment limit. This means it is too early to estimate the ‘tilt’ rate required to ensure price stability post tariffs adjustment limit.

- how the Port has had regard to feedback and submissions when setting its prescribed service tariffs for 2022–23.

Our preliminary view is that the processes the Port has undertaken appear to be effective in ensuring stakeholders are able to effectively collaborate. This is a key component of effective consultation on important issues and to inform outcomes.[14]

Length of regulatory period

We are not required to assess the length of the regulatory period under the pricing order.

However, while we acknowledge the Port's reasoning for adopting a one-year regulatory period outlined in the 2022–23 tariff compliance statement, we remain of the view that a longer regulatory period promotes a stable rate of return estimate and an aggregate revenue requirement based on long-term demand and expenditure forecasts. This, coupled with deeper insight into the Port's forward capital planning would create greater certainty for port users and support their own long-term investment decisions compared to rolling one-year regulatory periods.[15] We provide guidance on the length of regulatory period in our updated statement of regulatory approach v3.0.

[14] Clause 7.1.2(d) of the pricing order requires the Port to demonstrate that it has undertaken effective consultation and had regard to the comments provided by port users in coming to its decision about prescribed service tariffs (in this case for 2022–23).

[15] During the first five years of the lease, the Port was in the process of finalising its long-term strategies and performance standards which created uncertainties around future investment. In our 2021 compliance inquiry report, we encouraged the Port to consider a longer term such as a five-year period.

Weighted average cost of capital

We consider that the Port's approach to estimating the weighted average cost of capital more closely reflects well accepted approaches

The Port estimated a weighted average cost of capital of 8.99 per cent for the 2022–23 regulatory period, which is 76 basis points higher than its 2021–22 weighted average cost of capital estimate of 8.23 per cent.

The major driver of the increase in the weighted average cost of capital is an increase in the risk free rate from 1.70 per cent in 2021–22 to 2.56 per cent in 2022–23, which reflects market conditions.

A minor driver of the increase are changes in the Port's approach to estimating weighted average cost of capital parameters, which generally reflects our views on well accepted approaches. Table 1.1 summarises the weighted average cost of capital parameters estimated by the Port over the last three years.

1.1 The Ports weighted average cost of capital parameters over the period 2020-23

Parameter	2020–21	2021–22	2022–23
Risk free rate	0.90%	1.70%	2.57%
Market risk premium	7.57%	6.54%	6.63%
Equity beta	1.00	1.00	0.90
Gearing	30%	30%	20%
Gamma	0.33	0.50	0.50
Cost of equity (pre-tax nominal)	10.60%	8.24%	8.54%
Cost of debt (pre-tax nominal)	5.04%	4.90%	4.78%
WACC (pre-tax nominal)	8.93%	8.23%	8.99%

Source: 2022–23 Tariff Compliance Statement, Appendix I- HoustonKemp Estimation of the WACC for Port of Melbourne.

We reviewed the Port's approach to estimating its weighted average cost of capital and consider its approach more closely reflects well accepted approaches. The Port's approach is summarised in the Table 1.2.

1.2 The Port's approach to estimating its 2022–23 WACC

WACC parameter	The Port's approach
Return on debt	The Port continues to use a BBB credit rating, 10-year term of debt, trailing average debt management strategy and 0.1 per cent debt raising cost to calculate its return on debt. We found these approaches were well accepted in our 2016–21 inquiry.
Return on equity	The Port is using SL-CAPM with no weight given to the Black CAPM or Fama French Model to calculate its return on equity. We found the SL-CAPM approach was well accepted in our 2016–21 inquiry.
Risk free rate	The Port continues using a 20-day average of the 10-year Commonwealth Government Securities yields to estimate the risk free rate. We found this approach was well accepted in our 2016–21 inquiry.
Market Risk Premium	The Port changed its approach to estimating the market risk premium and now applies a zero weight to the Wright method. Our 2016–21 inquiry found that the Wright method was not a well accepted approach. Consequently, to estimate the market risk premium, the Port now allocates 85 per cent weight to the historical excess returns approach, and 15 per cent to the dividend discount model. We note that the Port has not completely excluded the use of the Wright method in its calculation of the market risk premium - it is only applying zero weight to the result from that method in the calculation of the 2022–23 premium. In doing so, we understand the Port to be explicitly leaving open the possibility that it could place some weight on the Wright method in future tariff compliance statements and include the Wright method in the estimation of future premiums. The Port utilises the median dividend discount model estimate from across regulators instead of the mean, the latter was considered not to be a well accepted approach in our 2016–21 inquiry. The Port agrees with our view that the median is preferable to the mean because of its robustness to extreme observations.

Gamma	The Port is employing the utilisation approach to estimating gamma based on an equity ownership methodology and has not used either the market valuation or finance practitioner approaches. Our 2016–21 inquiry considered the market valuation and finance practitioner approaches were not well accepted approaches to estimating a weighted average cost of capital for a regulated business.
Equity Beta (systematic risk)	The Port's estimate of the equity beta has been reduced from 1 to 0.9, mainly due to change in gearing from 0.3 to 0.2. Our preliminary views on the Port's estimated equity beta is outlined in our discussion below on the Port no longer using a country filter.
Gearing	The Port has calculated benchmark gearing using the net debt of preferred comparators. Our preliminary view on the Port's approach to estimating its benchmark gearing level is outlined below in our discussion on the Port no longer using a country filter.
Credit rating	The Port continues to use a BBB rating which is consistent with our views of a well accepted approach in our 2016–21 inquiry.
Asset beta	The Port's estimate of asset beta remains unchanged at 0.7.
Selection of comparators	The Port has identified a preferred sample of comparators (24 firms) and alternative list (30 firms) to derive the benchmark asset beta and gearing. The preferred sample contains firms that own and operate container port and channel infrastructure, and whose revenues are primarily derived from container port operations. The alternative sample includes firms whose revenues could be derived from activities unrelated to container port operations. The Port has used the alternative list of comparators as a cross-check. The Port does not use country filters in its 2022-23 tariff compliance statement to estimate its beta. Our preliminary view is that the Port's WACC of 8.99 per cent is higher than if the Port used country filters to establish comparator firms. We consider the well accepted approach is to apply country filters, consistent with our views in our 2016–21 inquiry and discussed below.

The Port no longer uses a country filter to identify comparators

Unlike previous tariff compliance statements, the Port did not apply a country filter when identifying comparator firms, which means their preferred comparator sample includes firms from developing countries and China.

We consider these countries do not have similar economic, political, and social conditions to Australia.[16] In our 2016–21 inquiry, we found that even though there was no unified framework for country selection among Australian regulators, limits were applied to ensure the sample of comparator countries represent those with similar risks to that faced in Australia. Hence, we concluded that the practice of filtering the sample for Financial Times Stock Exchange Developed and Advanced Emerging countries was well accepted.

In support of its decision to exclude country filters, the Port referred to the decision of the Supreme Court of Western Australia in connection with Perth airport, where it accepted a comparator sample with no country filter.[17] To the extent the Port relies upon this decision as representing a well accepted approach, the Commission notes that it is one decision of the Supreme Court of Western Australia concerning the price to be paid by Qantas to Perth Airport for aeronautical services, access to which is not the subject of a traditional regulatory regime.[18] Although there may be some similarities in the Court's determination of that claim with revenue and pricing regulatory regimes, for example, the use of a building block model, the Commission's preliminary view is that it is not persuaded that the Port can rely on that decision as to the application of country filters as encompassing a well accepted approach in the terms of the pricing order. It also appears from the decision that the application of the country filter in that case resulted in a very small sample of comparators and its application may have been inappropriate for that reason.[19]

The Port has undertaken a sensitivity analysis to assess the impact of applying country filters on its systematic risk (beta estimate). The result is presented in Table 1.3. The Port's analysis indicates that excluding Chinese firms does not materially change the asset beta. We note that excluding Chinese firms can lower the benchmark gearing from 0.20 to 0.16. This will result in its equity beta

[16] CEPA, Port of Melbourne five-year review – WACC, December 2021, p.48.

[17] The court's decision removes six illiquid and delisted airports from the NZCC's sample, as well as omitting one additional company that is not an appropriate comparator. See: *Perth Airport Pty Ltd v Qantas Airways Ltd [No 3]* [2022] WASC 51 [265]-[267].

[18] Perth Airport's cause of action was a "quantum meruit" claim, being for reasonable renumeration for the aeronautical services it provided to Qantas.

[19] See [236]. The application of the country filter resulted in six comparators: Sydney Airport; Auckland Airport (New Zealand); Vienna Airport (Austria); Aeroports de Paris (France); Fraport (Germany); and Zurich Airport (Switzerland).

decreasing from 0.90 to 0.85. The overall impact of excluding Chinese firms is a reduction in WACC from 8.99 per cent to 8.92 per cent.

We undertook further analysis on the Port's approach and estimated that if the Port removes developing countries as comparators, equity beta decreases to 0.80 and gearing changes to 10 per cent. This results in the WACC reducing to 8.82 per cent (compared to its estimated 8.99 per cent).

Our preliminary view is that the difference in WACC from 8.99 per cent (not using the country filter) to 8.82 per cent (using a country filter for Financial Times Stock Exchange Developed and Advanced Emerging countries) appears to be material.

Our view in the 2016–21 inquiry was that the practice of filtering the country sample for Financial Times Stock Exchange Developed and Advanced Emerging countries is considered well accepted. The Port should consider using the Financial Times Stock Exchange Developed and Advanced Emerging country filter in future estimates of its WACC.

1.3 Variation to equity beta in response to change of selection of comparators

Parameter	Port final estimate	Removing developing country risk	Removing Chinese risk
Assets beta point estimate	0.72	0.72	0.72
Gearing	0.20	0.10	0.16
Equity beta[20]	0.90	0.80	0.85

Source: 2022–23 TCS, Appendix I- HoustonKemp Estimation of the WACC for PoM,

The Port's weighted average cost of capital is relatively high compared to other regulated businesses.

We have reviewed recent regulatory decisions, which indicate that the weighted average cost of capital applied by the Port is relatively high compared to recent Australian regulatory determinations – Table 1.4.

[20] Equity beta is calculated internally based on the information provided by the Port in its Tariff Compliance Statement, Appendix I, p 27.

1.4 Comparison of Port's weighted average cost of capital parameters for selected regulated businesses

Companies	WACC	Source
Port of Melbourne	**8.99%**	**2022–23 Tariff Compliance Statement**
Queensland Rail	6.87%	2020 undertaking
Aurizon UT5	6.30%	Annual Report 30/06/2021
Dalrymple (DBCT)	7.03%	2015 DAU
PTA	4.41%	ERA WA 2021
Arc Infrastructure (Brookfield)	6.93%	ERA WA 2021
Pilbara Rail	9.50%	ERA WA 2021
ARTC HVAU	7.91%	HVAU 2020 Compliance assessment submission

Sources: QCA - Queensland Competition Authority; ERA - Economic Regulation Authority Western Australia; ACCC - Australian Competition and Consumer Commission; and PoM - Port of Melbourne

Expenditure

More can be done to improve the efficiency of operating expenditure forecasts

Operating expenditure

Our 2016–21 compliance inquiry found that the Port's approach to forecasting operating expenditure did not demonstrate prudent and efficient forecasts. We found that the Port's forecasting methodology was not sufficiently sound or robust. We considered that its methodology did not ensure expenditure forecasts were arrived at on a reasonable basis and represented the best forecasts possible.

In its 2022–23 tariff compliance statement, the Port outlined that it has implemented changes to improve the accuracy of forecasts including the adoption of independent external forecasts of wage and construction cost increases. In addition, the Port stated that it will commence benchmarking labour costs.

The Port also set out its approach to establishing a base-step trend, including a productivity factor, to estimating forecast operating expenditure. A base-step approach to establishing benchmark operating expenditure was recommended in our 2016-21 compliance inquiry and is an approach used by other regulated entities. The Port's approach includes:

- setting a productivity growth target of 0.5 per cent for prescribed services operating expenditure
- an initial assessment between operating expenditure and key cost drivers (demand and capital growth), and
- comparing the base step trend to a bottom-up forecast to inform the efficiency of the forecast.

The 2022–23 tariff compliance statement also notes that in the future, further work will be undertaken to build an understanding between operating expenditure and growth (demand), and its impact on the base-step trend calculation. We have the following observations on the Port's approach as outlined in its 2022–23 tariff compliance statement.

Base year

The base year is the starting year for calculating the trend growth in operating expenses and should be the final year of prudent and efficient actual operating expenditure. The Port's tariff compliance statement sets out that it will use the last year of actuals as the base year.

We consider that using the final year of actuals without first establishing if actual expenses are prudent and efficient will not support verifying prudent and efficient operating expenditure forecasts. We reviewed the Port's expenditure in our 2016–21 compliance inquiry and found that although the actual expenditures over the review period 2016–21 were not prudent and efficient, the adjustments to operating expenditure to reflect prudent and efficient levels would have been minor.

We consider that the Port should use 2019–20 as its base year for future tariff compliance statements because it was the last year of actual expenditure where we undertook a prudency and efficiency review. The next five-yearly review will reset the prudent and efficient base year.

Growth rate

The growth rate of the drivers of operating expenditure, that is those factors that are demand driven, was calculated by the Port using container growth forecasts and the growth in its regulatory asset base, then weighting the growth rates with 2020–21 actual operating expenditure costs to establish a weighted average growth rate. As noted above, this principle does not lend itself to establishing prudent and efficient operating forecasts because it used 2020–21 actual costs, which were not verified by us as prudent and efficient. We consider that the Port should use the 2019-20 actual costs to forecast operating expenditure.

Efficiency benchmark

The Port's 2022–23 tariff compliance statement says that it is still in the process of achieving steady state operations. We consider that seven years after its establishment in 2016, the Port would have completed its 'steady state' phase. Also, for the purposes of establishing an efficiency assumption, the Port should consider net efficiency as the driver of trend operating expenditure. That is, the efficiency factor after removing the increase in operating expenditure due to the growth rate. Otherwise, the gross efficiency factor may not represent true efficiencies.

Overall, we consider the Port is progressing towards improving its forecast operating expenditures however, it should address the areas we have identified above in future tariff compliance statements.

Capital expenditure

Our 2016–21 compliance inquiry found that the Port's governance process and approach to establishing its capital expenditure forecasts over 2016 to 2021 led to prudent and efficient forecasts.

We also noted that the Port was primarily focused on maintenance and renewals rather than projects that cater more for anticipated growth at the port. We found that the Port's assurance processes at the time may not be adequate for more complex capital planning and suggested that the Port in future tariff compliance statements demonstrate:

- sufficiently detailed business cases
- appropriate management of risk between the Port and port users through its cost estimation and procurement processes
- its projects meet the needs of port users and also Victorian consumers.

In its 2022–23 tariff compliance statement, we note that the Port has commenced:

- strengthening its business case processes
- developing internal guidelines for setting contingencies
- looking at the costs and benefit of a pipeline view of projects.[21]

Other measures completed by the Port to improve the prudency and efficiency of its capital expenditure forecasting are:

- a review of the early contractor involvement process
- establishing its procurement and contracting strategy
- aligning the internal governance committees to the project management framework.

We have not undertaken an in-depth review of the measures the Port has put in place or completed to improve the prudency and efficiency of capital expenditure for more complex capital works. However, our preliminary view is that the measures appear to reflect capital planning processes appropriate for its proposed capital works.

[21] A pipeline view of projects provides for a streamlined approach to managing current projects to assist in re-prioritising and managing projects efficiently.

Depreciation

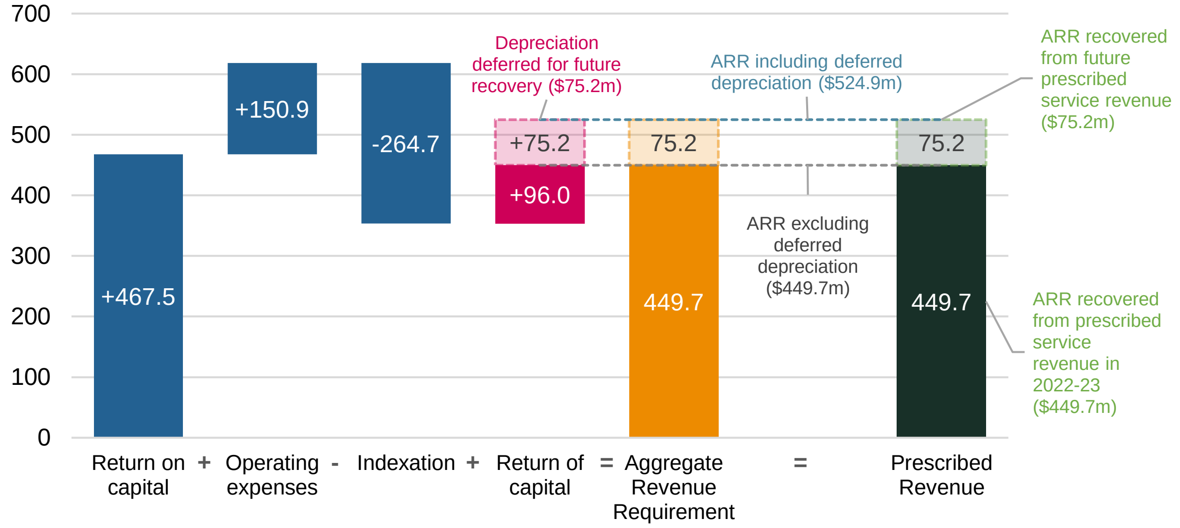
The Port has outlined a depreciation methodology that it will apply once the tariffs adjustment limit period ends in 2037

The Port will recover $96 million of depreciation in 2022–23

Similar to previous years, the regulatory model calculates straight-line depreciation which is partially or fully deferred if the estimated aggregate revenue requirement exceeds the revenue that the Port can raise under the tariffs adjustment limit. The deferred depreciation is recorded as a separate asset that is amortised over the life of the lease and treated like other assets in the regulatory model.

For 2022–23, higher than expected inflation means that the return of capital (depreciation) component will be above zero for the first time since the beginning of the lease in 2016. The Port expects that there will be $449.7 million in prescribed revenue and that the return on capital, operating expenses, and indexation will collectively account for $353.7 million. This means that the Port can recover $96 million of depreciation as return of capital, while the remaining $75.2 million of depreciation will be deferred and recovered in a future period (as shown in Figure 1.5).

1.5 Aggregate revenue requirement (ARR) and prescribed service revenue in 2022–23, $ millions



Source: Port of Melbourne 2022-23 financial model

The Port is proposing to use a tilted annuity approach to depreciation to minimise price volatility once the tariffs adjustment limit ends

The Port will be able to recover the return of capital component in full when the tariffs adjustment limit period ends in 2037. Their regulatory model shows that the amount of deferred depreciation will have accumulated to $4,032 million in 2037.

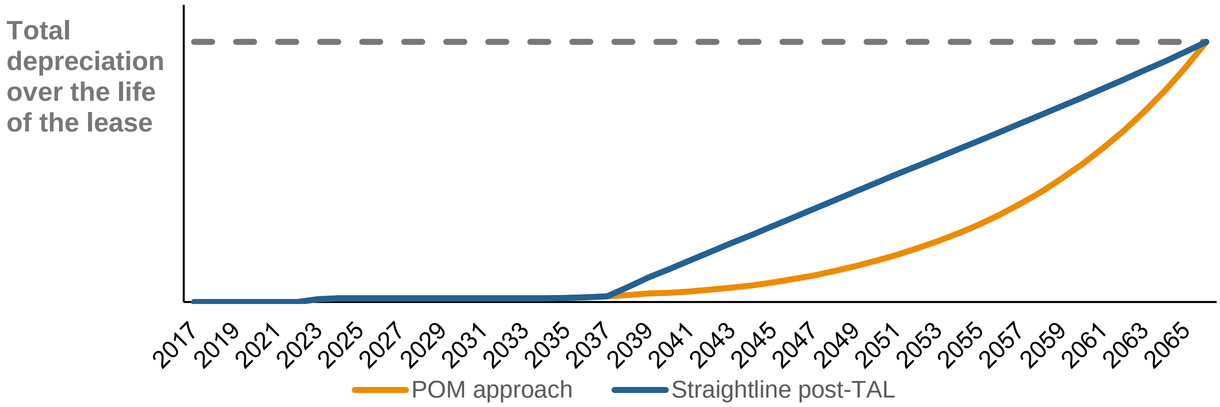
We noted in our compliance review that the immediate recovery of the accumulated depreciation from 2037 would result in large price increases or price shocks for future port users. The stakeholder submissions provided as part of the Port's 2022–23 tariff compliance statement suggest that stakeholders are concerned with how prices will be affected by the future recovery of deferred depreciation.

The Port has proposed an alternative depreciation methodology once the tariffs adjustment limit ends with the aim of minimising price volatility over life of the lease. While a straight-line approach depreciates at a constant rate each year, a tilted annuity approach changes the time profile in which the Port would collect depreciation, increasing depreciation gradually over time at a pre-set 'tilt' rate (three per cent in the current model). The Port argues that a tilted annuity approach can help reduce price volatility by:

- reducing the risk of price shocks by gradually increasing the recovery of depreciation over time
- aligning the recovery of the full capital component (return on and return of capital) with the growth in demand
- enabling periodic updates to the tilt rate in response to changes in trade flows, capital expenditure, demand, or other economic conditions.

While a tilted annuity approach could reduce price volatility by gradually increasing the recovery of depreciation over time, it will lead to higher prices in nominal terms by the end of the lease. However, in net present value terms, the total amount paid by Port users will be the same as for a straight line methodology. Figure 1.6 illustrates the difference between straight-line and tilted annuity in net present value terms.

1.6 Cumulative depreciation comparison of approaches



Source: Port of Melbourne 2022-23 financial model

We consider that the Port is starting to address future 'price shocks' but are unclear how the tilted annuity approach will work in practise

We have examined the regulatory model and can confirm that the Port has implemented the alternative approach to depreciation outlined in its submission. The model includes checks to demonstrate that assets are depreciated over an appropriate period and that depreciation is collected only once, as required by section 4.4.1 of the pricing order.

For the 2022–23 year, and until 2037 when the tariffs adjustment limit period ends, the Port is continuing to defer depreciation.[22]

In our 2016–21 compliance inquiry, and in previous commentaries, we encouraged the Port to consider how it would recover the deferred depreciation once the tariffs adjustment limit period ends. We considered that the accumulation of deferred depreciation would have a significant impact on port users and raised concerns with the Port's lack of stakeholder engagement on this issue.

The 2022–23 tariff compliance statement indicates that the Port has begun to engage with port users on the recovery of deferred depreciation. The Port shared resources with stakeholders on the regulatory framework and sought views on proposed depreciation approaches, revenue and tariff forecasts, and sensitivity analysis.

[22] Our 2016–21 compliance inquiry found that this was compliant with the pricing order. Section 4.4.2(a) of the pricing order allows the Port to use an alternative depreciation methodology (in this case, deferring some or all of depreciation for recovery in a future period) when depreciation cannot be recovered due to the operation of the TAL.

The Port also appears to have incorporated stakeholder views in the development of its depreciation approach, identifying that stakeholders have a preference for minimising price volatility. On this basis, the Port put forward the tilted annuity approach with the goal of minimising price volatility over the life of the lease.

Section 4.4.2(b) of the pricing order allows for an alternative approach to depreciation if the alternative approach is reasonably likely to reduce price volatility over the life of the lease, which ends in 2066. Given the long timeframe involved, it is difficult to determine whether the application of a tilted annuity approach will result in less price volatility over the life of the lease. For example, the appropriate level of tilt required to ensure smooth prices is influenced by demand growth. It is difficult to accurately forecast demand for port services from 2037 and beyond.

However, our preliminary view is that the Port's approach is reasonable. The 2022–23 tariff compliance statement illustrates that, hypothetically, a three per cent tilt rate leads to more stable price outcomes than a straight-line approach based on the current assumptions in its pricing model. It also includes sensitivity testing that shows a tilted annuity approach displays less price volatility than a straight-line approach over a range of different assumptions.

Most importantly, we are encouraged that the Port sought stakeholder views and has incorporated those by developing an objective for the future recovery of depreciation. That is, to not only reduce but also minimise price volatility throughout the remainder of the lease.

We consider that the Port should continue to engage on this issue and reflect on how the Port will periodically update the tilt rate, respond to changing forecasts and ensure the approach continues to achieve the Port's stated objective of minimising price volatility.

Stakeholder engagement

The Port has set out the process by which it has effectively consulted and had regard to port users

The 2022–23 tariff compliance statement outlines:

- the Port's engagement program with port users and other stakeholders over 2021–22
- what it heard from its stakeholders
- how the Port has had regard to feedback and submissions.

In our 2016–21 compliance inquiry, we found the Port non-compliant with the pricing order on effective consultation with port users. We found the Port had not demonstrated it effectively consulted or had adequate regard to port users' comments in its 2020–21 and 2021–22 tariff compliance statements.[23]

The requirement on the Port regarding stakeholder engagement is set out in section 7.1.2(d) of the pricing order. Our statement of regulatory approach V2.0 also provides guidance. In commenting on the Port's compliance, we are guided by these four questions:[24]

1. Has the Port's form of engagement been tailored to suit the topic on which it seeks to engage?
2. Has the Port provided port users with appropriate information outlining the purpose, form and the content of the engagement?
3. Has the Port provided port users with a reasonable opportunity to participate?
4. Does the Port's engagement program give priority to matters that could have a significant impact on port users?

The Port's engagement program:

- took place between October 2021 and May 2022
- included a series of engagement methods including a dedicated online consultation website, targeted one on one meetings and online forums

[23] Essential Services Commission, *Inquiry into the Port of Melbourne compliance with the pricing order*, December 2021, p.5.

We note that the Port has drafted an Engagement Protocol as part of its Undertaking with the Assistant Treasurer, which aims to address the matters we raised in our five-yearly inquiry on their engagement. We are also aware that the Port is increasing the awareness and understanding of effective consultation within the company.

[24] Essential Services Commission, *Statement of Regulatory Approach – version 2.0*, April 2020, p.15.

- involved a two-stage approach where stage one informed the key issues to be covered by the second stage
- included participants representing direct and indirect port users including shipping lines and its peak body, cargo owners, shippers, stevedores, and government
- covered matters such as services, service standards, market changes, tariff structures, and investment priorities that affect the Port's decision making and its project delivery for 2022–23.

Our preliminary views

We consider that the Port has undertaken a clear set of engagement processes and our preliminary view is that these processes are effective in collaborating with stakeholders on key issues.

We consider a collaborative approach lends itself to effective engagement. It provides port users with the opportunity to increase their impact on the Port's decision making - such as port development, which is an area of significant impact on port users.

In doing so, the Port aimed to understand:

- the matters to be given priority when engaging on port development
- the level of detail and information its stakeholders expect to see in order to make informed decisions.

The Port's summary of considerations of stakeholder comments identifies the eight submissions received by the Port and the Port's considerations of the matters raised in the submissions. Several submissions contain positive feedback on the structure of the consultation program as well as on the quality of information presented. Other submissions note the expectations for the Port's current and future engagement processes:

- ANL Container Line, Victorian International Container Terminal and the International Forwarders & Customs Brokers Association of Australia indicated the Port's consultation program provided multiple opportunities for participation and noted the detailed level of information provided on the Port's development strategy.
- Patrick Stevedores noted there would be merit in the Port publishing a public statement to understand the Port's approach for future engagement including timeframes, participants and the use of feedback and confidential information provided to the Port.
- DP World indicated that for important projects a dedicated consultation process should be run. Maritime Union of Australia would be interested in seeing more detail on Port capacity, vessel fleet and container forecasts and outcomes.

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.