OFFICIAL

ESSENTIAL SERVICES COMMISSION

Interim commentary – Port of Melbourne Tariff Compliance Statement 2023–24

20 December 2023

Acknowledgement

We acknowledge the Traditional Owners of the lands and waterways on which we work and live.

We acknowledge all Aboriginal and Torres Strait Islander communities, and pay our respects to Elders past and present.

As the First Peoples of this land, belonging to the world's oldest living cultures, we recognise and value their knowledge, and ongoing role in shaping and enriching the story of Victoria.

An appropriate citation for this paper is:

Essential Services Commission 2023, Interim commentary – Port of Melbourne Tariff Compliance Statement 2023–24: 20 December

Contents

Summary

On 31 May 2023, the Port of Melbourne Operations Pty Ltd (referred to as the Port) lodged its statement regarding the prices it will charge for specific services in 2023–24. The Port has determined these prices by reference to a five-year regulatory period, being 2023–28. You can find this statement on our website.

The Port is required to follow certain rules, called the pricing order, when setting prices for these services.[1] The pricing order is made by the Governor in Council under the Port Management Act 1995 (Vic).[2]

The Port must give us an annual statement about its prices, explaining how they comply with the pricing order and other requirements.[3] This is the third time the Port has given us such a statement since our 2021 five-yearly inquiry (compliance inquiry) into the Port's compliance with the pricing order.

Our role

We are tasked with evaluating and reporting on the Port's compliance with the pricing order. Every five years, we conduct an assessment and submit a report to the minister responsible for overseeing the Essential Services Commission Act 2001 (Vic). This report includes our findings on whether the Port has followed the pricing order during the relevant five-year review period and whether we consider any deviations to be 'significant and sustained'.[4]

In anticipation of our next compliance inquiry, scheduled for 2026, we have prepared this interim commentary on the Port's 2023–24 tariff compliance statement. It includes our initial observations regarding the Port's adherence to the pricing order in respect of the tariffs to apply during 2023–24 which, as noted above, the Port has determined by reference to a regulatory period spanning five years from 1 July 2023 to 30 June 2028.

[1] The Pricing Order was made on 21 June 2016 (Victoria, *Victoria Government Gazette*, No. S 201, 24 June 2016) and amended on 19 May 2020 (Victoria, *Victoria Government Gazette,* No. S 247, 20 May 2020).

[2] s 49A.

[3] Pricing Order, clause 7.1.1.

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

This marks the third year within the review period from 2021 to 2026 for the next five year compliance inquiry. Our interim commentaries are designed to provide the Port with our preliminary views on the Port's compliance with the pricing order throughout the five year review periods.

Why we are providing this commentary

While the pricing order requires the Port to submit an annual tariff compliance statement, there is no legal requirement for the commission to release an annual interim commentary in response.

Nevertheless, making our preliminary evaluations of the Port's annual tariff compliance statements publicly available enhances transparency and predictability in our approach for the subsequent comprehensive five-yearly pricing order compliance inquiry.

This practice offers the Port and other interested parties an early insight into potential areas or topics that are likely to receive closer examination during our five-yearly inquiries. As an example, we sought the Port's feedback on our consultant's CEPA 2023 review of the Port's beta and gearing estimates.[5] We have had regard to the Port's feedback in this interim commentary, which CEPA incorporated into their report.[6]

Our interim commentaries are preliminary views only, which will be further developed and may change as we receive further information during the review period. This commentary does not restrict the range of issues that we may address in future commentaries or in our comprehensive five-yearly inquiries. Additionally, we released an updated version of our regulatory approach statement, version 3.0, on 20 December 2022. This statement furnishes guidance to the Port on how it may demonstrate compliance with the pricing order, including the information it provides in its tariff compliance statements.

Our high-level assessment of the Port's 2023–24 tariff compliance statement

Overall, we consider that the Port's 2023-24 tariff compliance statement is an improvement from the last two years. We consider that the Port has addressed a number of the issues we raised in our previous commentaries and appeared to improve its stakeholder engagement, and processes to estimate its demand, operating expenditure and capital expenditure forecasts.

---

[5] CEPA, *Port of Melbourne – Review of Gearing and Beta,* 21 November 2023.

[6] We did not agree with all of the Port's feedback on CEPA's draft report. How the Port's feedback has been addressed is outlined in the final CEPA report.

The Port has also adopted a five-year regulatory period, which we support as we consider it better serves the long term interests of port users compared to a one year regulatory period. We discuss our views on this in more detail in our commentary. We also stated in our 2021 compliance inquiry that in transitioning to a longer period, we expect the Port to adopt processes to ensure efficiency and robustness of forecasts. We also suggested the Port consider how the risks of any forecasting errors would be allocated between itself and the port users and consider how to manage the uncertainty of major unforeseen events that may affect its annual revenue requirement.[7]

The Port has proposed three end of regulatory period adjustment mechanisms that would feed into the calculation of its aggregate revenue requirement in the following regulatory period. Our preliminary view is that these adjustment mechanisms are not currently provided for in the framework established by the pricing order.

In the 2023–24 tariff compliance statement the Port has adopted a gearing estimate of 10 per cent. Our preliminary view is that we do not consider that the Port has provided sufficient justification to alter its benchmark gearing estimate from the levels adopted in previous regulatory periods of between 20–30 per cent to 10 per cent in the 2023–24 tariff compliance statement.

Length of regulatory period

The Port has the flexibility to adopt regulatory periods of varying lengths throughout the port lease agreement.[8] The Port has adopted a five-year regulatory period spanning 2023–24 to 2027–28. We consider a regulatory period longer than one year 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.

We consider that the building blocks methodology outlined in the pricing order is forward looking. Specifically, it requires the Port to estimate prudent and efficient expenditure and demand forecasts over the length of regulatory period. Each five-year compliance inquiry then compares the Port's previous five-year actual expenditure with its forecasts and assesses if it reflects prudent and efficient forecasts. Hence, regulatory periods greater than one year have the capacity to more fully draw out the incentive properties of the ex-ante building blocks framework as it places greater incentives on the Port to outperform its expenditure and demand forecasts.

---

[7] Essential Services Commission, *Inquiry into the Port of Melbourne Compliance with the pricing order,* 31 December 2021, p 35.

[8] Clause 13.1.1 of the pricing order.

Uncertainty mechanisms and application of the trailing average cost of debt approach

The Port has also outlined in its 2023–24 tariff compliance statement mechanisms that it says it will apply to make adjustments to components of its building blocks – return on capital, operating expenditure, return of capital and inflation adjustment – on an ex-post basis to recalculate its aggregate revenue requirement for the 2023–28 period. These mechanisms apply to specified material or unforeseen events, for example a change in tax policy, as well as to provide for a 'true-up' for the cost of debt arising from the application of the trailing average cost of debt approach.

The commission understands that the Port proposes that amounts arising from the restatement of the aggregate revenue requirement for the 2023–28 period would be carried over into a future regulatory period or periods.

It is not uncommon in economic regulatory frameworks that use a building block methodology to provide for uncertain and unforeseen event mechanisms, as well as mechanisms to provide for updates to the return on debt during a regulatory control period arising from the application of the trailing average approach to the cost of debt. We consider such provisions may play an important role in making regulatory periods that span multiple years sustainable as these mechanisms allow for material unexpected changes to be passed through to customers as well as giving effect to efficient debt management approaches.

However, our preliminary view is that the pricing order does not permit the Port to recalculate or restate the aggregate revenue requirement at the end of a regulatory period to adjust for differences between forecast and actual expenditure and for the effects of that recalculation to be carried forward into a future regulatory period or periods. For the similar reasons, it is not clear that the pricing order permits between regulatory period 'true-ups' to give effect to the trailing average cost of debt approach. Our initial views on the Port's proposed adjustment mechanisms are outlined immediately below and in further detail later in this interim commentary.[9]

The Port's proposed uncertain capital expenditure project (Port Capacity Enhancement Program) mechanism may not be permitted under the pricing order

The Port proposed an uncertain capital expenditure project Port Capacity Enhancement Program mechanism to be applied only if actual capital expenditure incurred for the Port Capacity Enhancement Program exceeds the five-year forecast in the 2023–24 tariff compliance statement by more than $100m (nominal).

[9] See further detail provided in the section titled *Length of regulatory period and adjustment mechanisms*.

Our preliminary view is that prescribed service tariffs are set to allow the Port reasonably to recoup efficient costs as determined by the application of the accrual building block methodology outlined in clause 4 of the pricing order. Each of those building blocks is calculated on an ex-ante basis prior to the commencement of a regulatory period and combine to determine the aggregate revenue requirement.

We consider that the roll forward of the capital base from one regulatory period to the subsequent regulatory period does not provide a “backdoor” mechanism to permit ex-post adjustments to the building blocks used to calculate the aggregate revenue requirement in the prior regulatory period for the purposes of then calculating the aggregate revenue requirement for the subsequent regulatory period.

The allowance for the return of capital is the capital that was returned in the previous regulatory period by the depreciation methodology adopted pursuant to clause 4.4 of the pricing order. In the present case the Port has not applied the straight-line depreciation methodology because doing so would hinder the recovery of the return of capital in the relevant financial years. Rather, the Port calculates the amount of depreciation using the straight-line methodology, recovering the amount of depreciation that can be recovered in the relevant financial year considering the tariffs adjustment limit (being the return of capital included in the aggregate revenue requirement) and then defers the remainder of the depreciation amount for future recovery by adding it to the capital base.

The commission’s preliminary view is that the concept of an “alternative depreciation methodology” does not extend to using the deferred depreciation amount as an adjustable value or balancing item that permits the Port to recover amounts assessed to be prudent and efficient on an ex-post basis and to carry that amount forward into a future regulatory period or periods.

For the above reasons, our preliminary view is that the Port’s proposed uncertain capital expenditure project Port Capacity Enhancement Program mechanism is not permitted under the pricing order.

The Port’s exogenous cost pass-through mechanism may not be permitted under the pricing order

The Port proposed an exogenous cost pass-through mechanism to be applied only if a change in regulations, an insurance event or a tax change event caused actual operating expenditure to differ from forecast operating expenditure by an amount equal to more than 1 per cent of the aggregate revenue requirement (excluding deferred depreciation) in the relevant year.

For the reasons outlined above, our preliminary view is that the pricing order does not permit the Port to apply its proposed exogenous cost pass-through mechanism. The building block outlined in the pricing order permits “an allowance to recover [the Port’s] forecast operating expenses”. That is, it is not an allowance to recover some part of the difference between forecast and actual operating expenses in one regulatory period in a future regulatory period or periods, even where those expenses are prudent and efficient.

The Port’s proposed cost of debt adjustment mechanism may not be permitted under the pricing order

The Port has proposed an annual re-calculation of its cost of debt to give effect to the trailing average cost of debt approach, but to be implemented by way of a true up at the end of the regulatory period. For similar reasons noted above, the commission’s preliminary view is that the pricing order does not contain a mechanism to carryover from one regulatory period to the next amounts arising from purported adjustments to building blocks that were used to calculate the aggregate revenue requirement in the previous regulatory period.

Our preliminary view is that an annual adjustment during a regulatory period for the cost of debt based on the trailing average approach may be permitted under the pricing order—that is, within or “intra” regulatory period adjustments. The annual adjustment would result in a recalculation or adjustment to the building blocks that had been (notionally) calculated at the commencement of the regulatory period by reference to methodology clearly stated at the commencement of the regulatory period capable of operating automatically. In this way, the annual cost of debt adjustment could be viewed as still adhering with the requirement in clause 2.1.1(a) of the pricing order insofar as prescribed service tariffs would continue to be determined by application of the accrual building block methodology in clause 4. The only distinction lies in the aggregate revenue requirement, which is initially calculated using notional cost of debt amounts at the commencement of the regulatory period but subject to change in accordance with the approach adopted by the Port.

If the Port considers that the adoption of regulatory periods longer than one year require a mechanism or mechanisms to deal with uncertain events, our view is that it is up to the Port to make the case, including the circumstances that would trigger a reopening or variation to the period, to Government.

Information requirements in future annual tariff compliance statements

As noted in our statement of regulatory approach v3.0, when considering the Port’s reasons for its choice of regulatory period, we will pay particular attention to the interaction between the length of regulatory period and the expected accuracy and reliability of forecasts.[10] To this end, and to undertake our five-yearly compliance review, the information provided to us should be consistent with pricing order requirements. Not to do so is to risk a finding of non-compliance during the s 49I inquiries.

In order for us to undertake our five-yearly review on compliance, we would also require the Port to provide us by 1 June 2026 an updated model that reflects actual expenditures and revenues to at least 31 December 2025. This is so we can compare those with the forecasts in the models provided in the tariff compliance statements to the commission over 2021 to 2026.[11] The commission will likely have difficulties with any presentation of forecasts that incorporate the operation of the Port's proposed mechanisms and, to the extent that the Port seeks to rely on those mechanisms, we would expect the Port make clear where it has done so and what the forecasts would be in the event the Port had not applied them.

Weighted average cost of capital

The rate of return on capital is an input into the accrual building block methodology and accounts for a significant proportion of the Port's aggregate revenue requirement and prescribed services tariffs.

The Port estimated a weighted average cost of capital of 9.34 per cent for the 2023–28 regulatory period, which is 35 basis points higher than its 2022–23 weighted average cost of capital estimate of 8.99 per cent. A key driver of the increase in the weighted average cost of capital is an increase in the risk-free rate from 2.57 per cent in 2022–23 to 3.45 per cent in 2023–24, which reflects market conditions. Our preliminary view is that the Port should have considered applying more than five comparators to estimate its equity and gearing, and hence its weighted average cost of capital, which, in particular would have delivered a more intuitive and consistent debt to equity ratio.

[10] Essential Services Commission, *Statement of Regulatory Approach,* version 3, 20 December 2022, p40.

[11] If the Port has actuals up to a later date, for example 31 March 2026, it should update the model to reflect these actuals.

Gearing

The Port applied a country filter when identifying comparator firms to calculate gearing and beta. The Port applied the same comparator set when estimating its benchmark gearing and beta.[12] Its revised equity beta declined from 0.89 to 0.78 while its asset beta remained relatively unchanged.

The Port's calculation of benchmark gearing resulted in a 50 per cent reduction in the gearing ratio from 20 per cent in 2022–23 to an aggregate of 10 per cent in 2023–24, while applying the country filter.

While it is well accepted to adjust gearing to reflect the average gearing of the comparator sample, we consider it is also well accepted to give consideration to whether there is sufficient evidence that the gearing of a benchmark efficient port has changed, or whether changes in gearing estimates year on year primarily reflects short-term adjustments in gearing across the comparator sample. In previous regulatory periods (and tariff compliance statements) the Port has adopted a gearing of 30 per cent (2017–18; 2018–19; 2019–20; 2020–21; 2021–22) and then 20 per cent (2022–23).

The assessment of the gearing, or capital structure, in the weighted average cost of capital requires an assessment of an optimal (or benchmark) long-term target capital structure. The commission would expect that such a material change in the benchmark gearing used by the Port would be supported by evidence directed at why the benchmark long-term target capital structure adopted by the Port for five to six years had shifted from 20–30 per cent, to just 10 per cent. The commission's view is that it is not sufficient to simply derive gearing as a mathematical output of the asset beta comparator set—particularly where that gives rise to a result that is not intuitive or consistent with previously adopted values. Rather, what is required is a broader assessment of the long-term capital structure of the benchmark efficient entity.

Therefore, our preliminary view is that we do not consider the Port has set out sufficient evidence for it to adopt a benchmark gearing to 10 per cent. The Port in its next tariff compliance statement could provide further reasoning for its proposed benchmark gearing level.

Expenditure

Expenditure forecasts are a component of the building blocks methodology to establishing the aggregate revenue requirement over the regulatory period. The Port is required to forecast prudent and efficient operating and capital expenditure under the pricing order.

[12] Our Statement of Regulatory Approach v3.0 does not outline that the Port use the same comparator set to estimate both beta and gearing.

Operating expenditure

The Port has outlined its approach to forecasting operating expenditure in its 2023–24 tariff compliance statement including the adoption of a base-step-trend approach and a longer regulatory period. Our 2021 five-yearly compliance inquiry recommended the Port adopt a base-step-trend approach to forecast operating expenditure. The Port's 2023–24 tariff compliance statement has addressed issues we raised in our 2022–23 interim commentary. Our preliminary view is that the Port has improved its approach to estimating operating expenses by adopting 2019–20 as the base year and applying a net efficiency factor (adjusted for growth) instead of a gross efficiency factor.[13] The Port has also introduced additional governance processes when developing its operating expenditure forecasts.

Capital expenditure

The Port's capital expenditure forecast for the five-year regulatory period from 2023–28 averages around $140.8 million per year. As a result, the average annual capital expenditure over the second inquiry period from 2022–26 is significantly higher at $152.5 million per year compared to the average over the first five years of the port lease amounting to $66.8 million per year.[14]

In addition, it also advised that it will apply its proposed uncertain capital project mechanism to recalculate the forecast aggregate revenue requirement and amend its forecast deferred depreciation at the beginning of the following regulatory period.

We generally support uncertain capital expenditure projects, in terms of timing or amount (or both), to not be reflected in forecasts until there is greater certainty around the timing or amount (or both) of expenditure. This is so customers do not wear the costs associated with forecast capital expenditure that is not incurred during the regulatory period when, and to the extent, it was forecast at the commencement of the period.[15]

As noted earlier, our preliminary view is that the pricing order does not allow using the deferred depreciation amount as an adjustable value or balancing item that permits the Port to recover

---

[13] At our five-yearly compliance reviews, an independent consultant will review the Port's base-year to assess if it reflects prudent and efficient expenses.

[14] We identified an inconsistency between the total capital expenditure forecast in the tariff compliance statements' General Statement and the regulatory model. The Port confirmed the figure in the General Statement was incorrectly stated.

[15] We note that the tariffs adjustment limit places a cap on prices, hence in the Port's case if the capital expenditure spend was included in the forecast, it would earn a return on and return of capital, where the majority of the depreciation would be deferred and reflected in future prices.

amounts assessed to be prudent and efficient on an ex-post basis and to carry those forward into future regulatory periods.

Stakeholder engagement

The purpose of customer engagement is for the Port to understand the priorities of customers, including the products and services its customers expect. This is to enable it to deliver outcomes that matter most to customers, as efficiently as possible. In assessing the Port's engagement, we reviewed its 2023–24 tariff compliance statement and additional documents we requested directly from the Port.

The Port's 2023–24 tariff compliance statement outlines its engagement program with port users and other stakeholders over 2022–23, what it heard from its stakeholders and how the Port has had regard to feedback and submissions.

Our preliminary view is that the Port appears to have effective engagement processes and has considered port users' and stakeholders' comments in coming to its decisions. We continue to be encouraged by the Port's continuous improvement in its engagement.

Length of regulatory period and adjustment mechanisms

The Port has adopted a five-year regulatory period

The Port has the flexibility to adopt regulatory periods of varying lengths throughout the port lease agreement.[16] The 'regulatory period' is the timeframe during which the Port is required to apply the pricing principles and cost allocation principles.[17]

In its 2023–24 tariff compliance statement, the Port has chosen a five-year regulatory period, from 2023–24 to 2027–28. This overlaps with the period of the next compliance review, which covers 2021 to 2026.

As set out in our previous interim commentaries, we consider a regulatory period longer than one year 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.

The Port has also outlined in its 2023–24 tariff compliance statement, mechanisms to adjust elements of its building blocks – return on capital, operating expenditure, return of capital and inflation adjustment – to recalculate its forecast aggregate revenue requirement for the 2023–28 period for material or unforeseen events, for example a change in tax policy.

It is common to provide for adjustment mechanisms for unexpected and unforeseen events, or uncertain capital projects in regulatory instruments. We consider such provisions play an important role in making regulatory periods that are longer than one year sustainable as these mechanisms allow for material unexpected changes to be passed through to customers.

However, the commission's preliminary view is that the pricing order does not cater for such adjustment mechanisms.

[16] Clause 13.1.1 of the pricing order

[17] The pricing principles are defined as the principles and requirements outlined in clauses 2, 2.3.1, and 4, while the meaning of Cost Allocation Principles is provided in clause 5.2.1.

Our preliminary view is that Port's proposed adjustment mechanisms are not permitted under the pricing order

In its 2023–24 tariff compliance statement and Memo to the commission dated 10 October 2023, the Port outlined the information it proposes to provide in its annual tariff compliance statements, when it will update its forecasts to reflect actual information and uncertainty mechanisms for adjustments to forecasts under its five-year regulatory period, 2023–24 to 2027–28.[18]

The Port's 2023–24 tariff compliance statement described three uncertainty mechanisms that the Port will apply from the first year of the five-year regulatory period, as outlined in Table 1.1.

The 2023–24 tariff compliance statement provides that any adjustment to deferred depreciation as a result of the mechanisms described in Table 1.1, would be performed at the same time as the "true-up" for the cost of debt and given effect by restating the aggregate revenue requirement for the difference between actual expenditure incurred during the regulatory period and forecast expenditure.[19]

Our preliminary view is that the pricing order does not provide an avenue for the restatement or recalculation of any of the building blocks applied over a regulatory period for the purposes of adjusting for differences between actual expenditure incurred during a regulatory period and forecast expenditure, and for the effects of that restatement or recalculation to be carried forward into a future regulatory period or periods. For similar reasons, it is not clear that the pricing order permits between regulatory period "true-ups" to give effect to the trailing average cost of debt approach.

We note that the Port's advisors Incenta Economic Consulting stated that a decision would need to be made about whether the pricing order permits adjustments to the aggregate revenue requirement so as to cater for the types of uncertainty measures that might be applicable to the Port, at least in the context of within regulatory period adjustments.[20]

Our preliminary view is that the mechanisms contemplated by the Port are not provided for under the current pricing order and that there is that there is greater scope under the pricing order for within regulatory period adjustments to cater for the trailing average cost of debt approach,

---

[18] Port of Melbourne, *Approach within-period Tariff Compliance Statements,* 10 October 2023.

[19] Port of Melbourne, *2023–24 Tariff Compliance Statement, 31 May 2023,* p 49.

[20] Incenta Economic Consulting, *Transitioning to a multi-year regulatory period - Port of Melbourne,* February 2023, pp 14–15.

however that is not the mechanism proposed by the Port. Our views on each of the Port's proposed mechanisms is discussed further below.

1.1 Port of Melbourne proposed uncertainty mechanisms

Mechanism	Trigger	Port's proposed approach
Uncertain capital expenditure project (Port Capacity Enhancement Program (PCEP)) mechanism	To be applied only if actual capital expenditure incurred for the (PCEP) exceeds the five-year forecast in the 2023–24 tariff compliance statement by more than $100m (nominal).	Each within-period tariff compliance statement will report cumulative actual PCEP capital expenditure incurred to-date during the regulatory period, relative to the forecast presented in the 2023–24 tariff compliance statement and to the mechanism threshold.
Exogenous cost pass-through mechanism	To be applied only if a change in regulations, an insurance event or a tax change event caused actual operating expenditure to differ from forecast operating expenditure by an amount equal to more than 1 per cent of the aggregate revenue requirement (excluding deferred depreciation) in the relevant year.	Each within-period tariff compliance statement will report any significant events resulting in a major deviation of actual operating expenditure from forecast operating expenditure and whether any event crosses the 1 per cent aggregate revenue requirement threshold.
Cost of debt update	Annual re-calculation, with a true up at the end of the regulatory period.	Each within-period tariff compliance statement will include an updated calculation of the trailing average cost of debt for the forthcoming financial year. For the avoidance of doubt, the Port will not recalculate the weighted average cost of capital for within-period tariff compliance statements.

We do not consider the Port's proposed uncertain capital expenditure project (PCEP) mechanism is permitted under the pricing order

Pursuant to the pricing order, prescribed service tariffs are to be set so as to allow the Port *a reasonable opportunity* to recoup efficient costs as determined by the application of the accrual building block methodology as set out in clause 4 of the pricing order. Each of those building blocks is calculated on an ex-ante basis prior to the commencement of a regulatory period, and combine together to determine the aggregate revenue requirement. In accordance with the framework established by the pricing order, the commission does not approve, on an ex-ante basis, any of these building blocks or the revenue requirement, unlike for instance the determinations the Australian Energy Regulator (AER) makes on revenue proposals submitted by electricity distribution and transmission networks under the national electricity rules.[21]

We consider that the roll forward of the capital base from one regulatory period to the subsequent regulatory period does not provide a "backdoor" mechanism to permit ex-post adjustments to the building blocks used to calculate the aggregate revenue requirement in the prior regulatory period for the purposes of then calculating the aggregate revenue requirement for the subsequent regulatory period. The methodology to be applied when rolling forward the capital base is set out in clause 4.2.1 of the pricing order. It provides that the capital base must be defined at any particular time on a roll forward basis by:

1. taking the value at the commencement of any financial year;
2. adding an indexation allowance for that financial year in accordance with clause 4.6.1(a);
3. adding efficient capital expenditure when incurred, or to be incurred during that financial year, by the Port, acting prudently, in the provision of the prescribed services; and
4. deducting an allowance for the return of capital.

The allowance for the return of capital is the capital that was returned in the previous regulatory period by the depreciation methodology adopted pursuant to clause 4.4 of the pricing order. In the present case the Port has not applied the straight-line depreciation methodology because doing so would hinder the recovery of the return of capital return of capital in the relevant financial years. Rather, the Port calculates the amount of depreciation using the straight-line methodology,

---

[21] Instead, the commission assesses if the forecast building blocks set at the beginning of the regulatory period are deemed prudent and efficient when it undertakes its compliance inquiry per s.49I of the Port Management Act. This is carried out by looking back in time at the forecasts during the review period (which encompasses the regulatory period/s), and concluding whether there was compliance or non-compliance with pricing order clauses. And if there was non-compliance with the pricing order, whether that non-compliance was, in the commission's view, non-compliance in a significant and sustained manner. See Port Management Act 1995, cl 49I(1)(a) and (b).

recovering the amount of depreciation that can be recovered in the relevant financial year considering the tariffs adjustment limit (being the return of capital included in the aggregate revenue requirement) and then defers the remainder of the depreciation amount for future recovery by adding it to the capital base.

The commission's preliminary view is that the concept of a "alternative depreciation methodology" does not extend to using the deferred depreciation amount as an adjustable value or balancing item that permits the Port to recover amounts assessed to be prudent and efficient on an ex-post basis and to carry that amount forward into a future regulatory period or periods.

For example, if the Port's actual expenditure was materially different to its forecast expenditure, the Port would not be permitted under the pricing order to recalculate the forecast aggregate revenue requirement and amend its forecast deferred depreciation at the beginning of the following regulatory period based on its actual expenditure.[22]

For the above reasons, our preliminary view is that the Port's proposed uncertain capital expenditure project (Port Capacity Enhancement Project) mechanism is not permitted under the pricing order.

Our preliminary view is that the Port's proposed exogenous cost pass-through mechanism is not permitted under the pricing order

For the same reasons as those outlined above with respect to the proposed capital expenditure mechanism, our preliminary view is that we do not consider that the pricing order permits the Port's proposed exogenous cost pass-through mechanism. The building block outlined in the pricing order for operating expenditure permits "an allowance to recover [the Port's] forecast operating expenses". That is, it is not an allowance to recover actual operating expenses in a future regulatory period or periods, even where those expenses are considered to be prudent and efficient.[23]

---

[22] The pricing order identifies the building blocks that are to be used to determine the aggregate revenue requirement—being forecast amounts that do not look back to any differences between forecast and actual amounts in past regulatory periods and to adjust or "true up" for those differences. In our view, this is also consistent with the definition of "accrual building block methodology" in s 49S of the Port Management Act 1995.

[23] We will update our statement of regulatory approach v3.0 to clarify our statement on pp 39 that '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'. For the avoidance of doubt, this was in relation to capital expenditure and the provision in the pricing order for actual capital expenditure to roll into the capital base at the commencement of a regulatory period as providing a mechanism for recovery of efficient costs that were not forecast at the commencement of a regulatory period.

Our preliminary view is that within regulatory periods adjustments to give effect to the trailing average cost of debt may be allowed under the pricing order

The Port transitioned to a trailing average approach to calculate its benchmark efficient cost of debt in 2017-18. The trailing average approach calculates the cost of debt for a benchmark efficient entity as a moving weighted average of the benchmark cost of debt for different periods. In its 2023-24 tariff compliance statement, the Port's trailing average cost of debt at 4.68 per cent comprises of:[24]

- 2017-18 prevailing cost of debt (50 per cent weight): 5.35 per cent
- 2018-19 prevailing cost of debt (10 per cent weight): 4.48 per cent
- 2019-20 prevailing cost of debt (10 per cent weight): 4.11 per cent
- 2020-21 prevailing cost of debt (10 per cent weight): 3.32 per cent
- 2021-22 prevailing cost of debt (10 per cent weight): 3.02 per cent
- 2022-23 prevailing cost of debt (10 per cent weight): 5.08 per cent

In each subsequent year, 10 per cent of the return on debt estimate is refreshed with the prevailing estimate for the given year.

Our 2021 compliance inquiry considered the trailing average approach to estimating the cost of debt is well accepted as it better aligns the actual cost of debt for an efficient business to the regulated benchmark. We also consider that it reduces price volatility through annual updates to the rate of return.[25]

We consider an annual adjustment during a regulatory period for the cost of debt based on the trailing average approach is likely to be permitted under the pricing order.[26] The annual adjustment would result in a recalculation or adjustment to the building blocks that had been (notionally) calculated at the commencement of the regulatory period. The annual cost of debt adjustment would remain consistent with the pricing principle in clause 2.1.1(a) insofar as prescribed service tariffs would continue to be determined by application of the accrual building block methodology in

---

[24] Houston Kemp, *Estimation of the weighted average cost of capital for the Port of Melbourne,* 11 May 2022, p 20.

[25] Essential Services Commission, *Inquiry into the Port of Melbourne compliance with the pricing order*, Final report, 31 December 2021, p 74.

[26] Whether an annual adjustment during a regulatory period for the cost of debt based on the trailing average approach is permitted by the pricing order can only ultimately be determined by a court. To the extent the Port wishes to make such within period adjustments and seeks certainty as to its ability to do so, the Port may consider approaching the Government for an amendment to the pricing order to put that issue beyond doubt.

clause 4. The only distinction lies in the aggregate revenue requirement, which is initially calculated using notional cost of debt amounts at the commencement of the regulatory period but subject to change in accordance with the approach adopted by the Port.

However, what the Port has in fact proposed is a "true up" for the cost of debt which is applied in the following regulatory period for annual differences in the cost of debt from the previous period. There is no obvious mechanism in the pricing order which permits adjustments resulting from the application of the trailing average cost of debt in a previous regulatory period to be carried over into a subsequent regulatory period or periods.

We consider that the pricing order would require amendment to permit the adjustment mechanisms proposed by the Port

If the Port considers it requires a mechanism or mechanisms to deal with uncertain events that may occur over a regulatory period, our view is that it is up to the Port to make the case, including the circumstances that would trigger a reopening or within period variation, to Government.

Our preliminary view on the proposed adjustment mechanisms does not affect the roll-forward of the asset base to reflect actual capital expenditure

The pricing order is clear in its terms as to the method to be applied for the roll-forward of the capital base from one regulatory period to the next. It provides for actual prudent and efficient capital expenditure incurred the previous regulatory period to be rolled into the capital base for the purpose of determining the aggregate revenue requirement in the subsequent regulatory period.

We consider that the addition of actual capital expenditure incurred in a regulatory period to the capital base does not adjust for the difference between forecast and actual capital expenditure during a regulatory period, for example, by way of adding an allowance for the return on capital expenditure, which was not forecast.

Rather, it simply rolls in actual capital expenditure from the previous regulatory period, and a return on that expenditure is then provided for in the building blocks from the commencement of the subsequent regulatory period. This is applied standard regulatory practice in water, network gas and the electricity sectors.

In summary, our preliminary view is that the pricing order clearly sets out how the aggregate revenue requirement forecast is to be calculated. It does not seem to allow for adjustments to the building blocks that define the aggregate revenue requirement as proposed by the Port in its 2023–24 tariff compliance statement and outlined in Table 1.1.

Information requirements in future annual tariff compliance statements

As noted in our statement of regulatory approach v3.0, when considering the Port's reasons for its choice of regulatory period, we will pay particular attention to the interaction between the length of regulatory period and the expected accuracy and reliability of forecasts.[27] To this end, and to undertake our five-yearly compliance review, the information we would require from the Port is outlined in Table 1.2 and set out in the pricing order.

Table 1.2 also outlines the Port's proposed level of information it intends to provide the commission in each annual tariff compliance statement. We expect that the information the Port provides the commission (and by extension port users who rely on that information for the tariffs they are charged) in its annual tariff compliance statement is consistent with pricing order requirements. Not to do so is to risk a finding of non-compliance during the s 49I inquiries. In order for us to undertake our five-yearly review on compliance, we would also require the Port to provide us with an updated model by 1 June 2026 reflecting actual expenditures and revenues to at least 31 December 2025. This is so we can compare those with the forecasts in the models provided in the tariff compliance statements to the commission over 2021 to 2026.[28] The commission will likely have difficulties with any presentation of forecasts that incorporate the operation of the Port's proposed mechanisms and, to the extent that the Port seeks to rely on those mechanisms, we would expect the Port make clear where it has done so and what the forecasts would be in the event the Port had not applied them.

[27] Essential Services Commission, *Statement of Regulatory Approach,* version 3, 20 December 2022, p 40.

[28] If the Port has actuals up to a later date, for example 31 March 2026, it should update the model to reflect these actuals.

1.2 Information requirements for annual tariff compliance statements

Clause	The tariff compliance statement (TCS) must:	Port's proposed approach
7.1.2(a)	…set out the Prescribed Service Tariffs for the forthcoming Financial Year (where clause 7.1.1(a) applies) or for the remainder of the Financial Year (where clauses 7.1.1(b) applies)	Within-period TCS submissions will set out tariffs for the forthcoming financial year.
7.1.2(b)	…provide information detailing the basis by which adjustments to, or introduction of new, Prescribed Service Tariffs have been made, including the cost building blocks that have been applied and the basis on which the rate of return has been determined	The basis for annual adjustments during a regulatory period is set out in the first (2023–24) TCS of the Regulatory Period. The 2023–24 TCS sets out that tariffs will increase at CPI for each year of the Regulatory Period and the basis for this adjustment, including the cost building blocks that have been applied and the basis on which the rate of return has been determined. Within-period TCS submissions will demonstrate that all tariffs have been adjusted in accordance with the basis set out in the first year's TCS (i.e. they will demonstrate that tariffs have been increased at CPI for the forthcoming financial year). Within-period TCS submissions will not restate the cost building blocks or the basis on which the rate of return has been determined, but will provide a reference to the relevant chapters of the first year's TCS where this information is contained.
7.1.2(c)	…provide information on all contracts with Port Users of the kind described in clause 6.2.1 and the basis on which they comply with clause 6.2.1	Within-period TCS will include information on any new contracts for Prescribed Services with Port Users and how they comply with the Pricing Order (i.e. information provided in Table 1 of Appendix Q to the 2023–24 TCS for new contracts).
7.1.2(d)	…set out the process by which the Port Licence Holder has effectively consulted and had regard to the comments provided by Port Users	Within-period TCS will include information on effective consultation processes and how during the past financial year PoM has had regard to Port User comments on matters relating to the provision of Prescribed Services. For the avoidance of doubt, consultation on the TCS and inputs to the TCS is likely to be limited given the Aggregate Revenue Requirement (and underlying forecasts) has been set for the Regulatory Period.

Clause	The tariff compliance statement (TCS) must:	Port's proposed approach
		Within-period TCSs would provide Port Users with updates on progress against the major projects and service outcomes identified in the 2023–24 TCS.
7.1.2(e)	…explain how the Prescribed Service Tariffs comply with this Order, including the Pricing Principles and Cost Allocation Principles	As per the definitions under clause 4 of the Pricing Order: • Pricing Principles means the principles and requirements contained in clauses 2, 2.3.1 and 4; and • Cost Allocation Principles has the meaning set out in clause 5.2.1 Compliance with Pricing Principles and Cost Allocation Principles is set out in the first TCS of the regulatory period. Given that prices are set for the Regulatory Period, there is no need to revisit these principles for within-period TCS submissions, rather, PoM will provide a reference to the first TCS of the regulatory period. In the absence of a rebalancing, the Tariffs Adjustment Limit is the only other relevant Pricing Order requirement for Prescribed Service Tariffs. Within-period TCSs will demonstrate that the Weighted Average Tariff Increase for the forthcoming financial year does not exceed the Tariffs Adjustment Limit.
7.1.2(f)	…contain any other sufficient supporting information determined by the Commission under clause 9	Within-period TCS submissions would include supporting information as required under any future information determination.
7.1.2(g)	Comply with the requirements in clause 8, which requires that TCSs must: • specify the terms in which any financial information is denominated (clause 8.1);	Within-period TCS submissions will continue to specify whether any financial information is denominated in constant or current price terms. Given that the Aggregate Revenue Requirement (and underlying forecasts) has been set for the regulatory period, within-period TCSs will not include new forecasts of revenue or expenditure. Therefore, other than by referencing the forecasts or estimates in the first TCS of the regulatory period, PoM does not anticipate that within-period TCS submissions will include forecasts or estimates, or inferred or derivative information.

Clause	The tariff compliance statement (TCS) must:	Port’s proposed approach
	• provide supporting statements for forecasts and estimates (clause 8.2); and • and provide primary information forming the basis for inferred or derivative information (clause 8.3).	

Source: Port of Melbourne Memo dated 10 October 2023

Weighted average cost of capital

The Port should consider increasing the number of comparators while also applying a country filter to estimate its benchmark beta and gearing

The Port estimated a weighted average cost of capital of 9.34 per cent for the 2023–28 regulatory period, which is 35 basis points higher than its 2022–23 estimate of 8.99 per cent.

A key driver of the increase in the weighted average cost of capital is an increase in the risk-free rate from 2.57 per cent in 2022–23 to 3.45 per cent in 2023–24, which reflects market conditions.

Table 1.3 summarises the weighted average cost of capital parameters estimated by the Port over the last four years.

1.3 The Port's weighted average cost of capital parameters since 2020

Parameter	2020–21	2021–22	2022–23	2023–24
Risk free rate	0.90%	1.70%	2.57%	3.45%
Market risk premium	7.57%	6.54%	6.63%	6.31%
Equity beta	1.00	1.00	0.90	0.78
Gearing	30%	30%	20%	10%
Gamma	0.33	0.50	0.50	0.50
Cost of equity (pre-tax nominal)	10.60%	8.24%	8.54%	8.36%
Cost of debt (pre-tax nominal)	5.04%	4.90%	4.78%	4.88%
WACC (pre-tax nominal)	8.93%	8.23%	8.99%	9.34%

Source: 2023–24 Tariff Compliance Statement, Appendix O – Houston Kemp Estimation of the Weighted Average Cost of Capital and Forecast Inflation;

* -- Applies to the 5 year regulatory period between 2023–24 to 2027-28

We reviewed the Port's approach to estimating its weighted average cost of capital and consider its approach more closely reflects well accepted approaches than previous approaches it has adopted. The Port's approach is summarised in the Table 1.4.

1.4 The Port's approach to estimating its weighted average cost of capital for the period 2023 to 2028

WACC parameter	The Port's approach
Return on debt	To calculate its 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. 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 continues to apply zero weight to the Wright method and continues to allocate 85 per cent weight to the historical excess returns (HER) approach, and 15 per cent to the dividend discount model (DDM). Our 2016–21 inquiry found that the Wright method was not a well accepted approach. We note that in estimating historical excess returns the Port now only gives weight to the Brailsford, Handley and Maheswaran dataset (previously a 50-50 weighting was split with the NERA dataset). Methodological changes were also made to the estimation of the dividend discount model. Long-run growth estimations were reduced from 4.6 per cent to 3.74 per cent and the AER's two-stage DDM was removed.
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	The Port's estimate of the equity beta has reduced from 0.9 to 0.78. The Port estimated beta with: • an OLS regression • across 5- and 10-year estimation periods • using weekly and 4-weekly return specifications • applying the local market index and • applying the Brealey-Meyers deleveraging formula. We consider the Port's approach and its use of a country filter is well accepted.
Gearing	The Port estimated its gearing to be equal to the average gearing of the beta comparator sample, using the book value of net debt. Our preliminary view is that 10 per cent gearing for a benchmark efficient firm appears low. We consider it would also be well accepted to use a different comparator sample to estimate gearing and to only adjust the benchmark gearing used if there is sufficient evidence to indicate a change in the gearing of a benchmark efficient port. We discuss this further below.
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	In developing its set of comparator firms, the Port appears to have: • used comparators from relevant sectors • used international comparators • applied market capitalisation and liquidity filters • manually removed companies they considered were not relevant. The Port applied a country filter, market capitalisation and liquidity limits to its selection of the comparator sample. The Port used only five comparators to estimate both its gearing and beta. We consider that the Port's sample of five firms is limited, and that up to 10 comparators were available to have been selected for estimation purposes. Our discussion is set out below.

The Port applied a country filter when identifying comparator firms to calculate gearing and beta. Its revised equity beta declined from 0.89 to 0.78 while its asset beta remained relatively unchanged.

The Port has stated it prefers to exclude country filters on the premise that it would lead to a larger sample and in its view, more likely to generate stable estimates of 'true' parameters.[29] Our preliminary view, consistent with our 2022 interim commentary, is that excluding country filters is not well accepted as there is little or no regulatory precedents for such an approach.[30] However, consistent with regulatory precedents, the Port could reconsider how it uses market capitalisation or liquidity filters to increase its selection of comparators, even while applying a country filter.

While it is well accepted to adjust gearing to reflect the average gearing of the comparator sample, we consider it is also well accepted to give consideration to whether there is sufficient evidence that the gearing of a benchmark efficient port has changed, or whether changes in gearing estimates year on year primarily reflects short-term adjustments in gearing across the comparator sample. In previous regulatory periods (and tariff compliance statements) the Port has adopted a gearing of 30 per cent (2017–18; 2018–19; 2019–20; 2020–21; 2021–22) and then 20 per cent (2022–23).

The assessment of the gearing, or capital structure, in the weighted average cost of capital requires an assessment of an optimal (or benchmark) long-term target capital structure. The commission would expect that such a material change in the benchmark gearing would be supported by evidence directed at why the benchmark long-term target capital structure adopted by the Port for the last five to six years had shifted from 20–30 per cent, to just 10 per cent. The commission's view is that it is not sufficient to simply derive gearing as a mathematical output of the asset beta comparator set—particularly where that gives rise to a result that is not intuitive or consistent with previously adopted values. Rather, what is required is a broader assessment of the long-term capital structure of the benchmark efficient entity.

Our consultant CEPA has re-estimated the Port's beta and gearing estimate using a well accepted approach.[31] Table 1.5 illustrates the range of beta and gearing parameters based on this recalculation.

---

[29] Port of Melbourne, *2023–24 Tariff Compliance Statement, 31 May 2023*, p. 90.

[30] As noted earlier, the Port has recalculated its 2022-23 beta estimate using a country filter to reflect our views in our 2022 interim commentary that it is a well accepted approach.

[31] CEPA, *Port of Melbourne – Review of Gearing and Beta,* 21 Nov 2023. This report can be found on our website.

1.5 Recalculation of beta and gearing parameter ranges

Parameter	Port's proposal	Re-estimated range - Low	Re-estimated range - High
Gearing	10%	18%	19%
Asset beta	0.70	0.59	0.75
Equity beta	0.78	0.72	0.93

Source: CEPA, *Port of Melbourne – Review of gearing and beta,* 21 November 2023, p 15

Our preliminary view is that we do not consider the Port has set out sufficient reasoning to support its proposed benchmark gearing of 10 per cent in its 2023–24 tariff compliance statement. The Port in its next tariff compliance statement could provide further reasoning for its proposed benchmark gearing level.

Expenditure

Operating expenditure

Our 2021 five-yearly inquiry (compliance inquiry) into the Port's compliance with the pricing order found the Port's approach to forecasting operating expenditure did not demonstrate prudent and efficient forecasts. The forecasting methodology was also not sufficiently sound or robust.

The compliance inquiry recommended the Port adopt a base-step-trend approach to forecast operating expenditure.[32] The Port's 2023–24 tariff compliance statement has addressed issues we raised in our 2022–23 interim commentary. Our preliminary view is that the Port has improved its approach to estimating operating expenses by adopting 2019–20 as the base year and applying a net efficiency factor (adjusted for growth) instead of a gross efficiency factor. The Port has also introduced additional governance processes when developing its operating expenditure forecasts.

Forecasting operating expenditure over the next five years

The Port's total prescribed controllable operating expenditure forecast for 2023–24, the first year of the new regulatory period, is 37 per cent higher than the base year (2019–20). The Port has proposed $45.3m in step changes over the next regulatory period, which are costs in addition to the base year to account for expected expenditure. Table 1.7 sets out controllable operating expenditure as well as the calculation of the base-step-trend approach to forecasting over the next five years.

[32] The Port's 2022–23 tariff compliance statement set out how it would adopt this approach. The approach included a productivity growth target of 0.5 per cent, an initial assessment of the links between operating expenditure and cost drivers as well as comparing the results of its existing forecast approach with the proposed base-step-trend approach. In our 2022–23 interim commentary we made some recommendations to improve this approach.

1.6 Controllable operating expenditure 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	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 operating expenditure									
	42.9	50.8	58.6	55.1	53.9	55.8	54.0	54.1	54.1
Total prescribed controllable operating expenditure									
Actual	27.3	33.7	39.7	35.7					
Base StepTrend forecast					37.5	39.5	38.4	38.6	38.8

Source: Port of Melbourne 2023, *2023–24 Tariff Compliance Statement: General Statement*, Melbourne.

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

The step changes are the main driver for the increase in prescribed controllable operating expenditure. The Port explains the step changes are driven by establishing or increasing internal capabilities of the business including legal, sustainability, engagement, and asset management. The Port is also forecasting step increases in insurance, tax and costs associated with improved cybersecurity.

Base year is 2019–20

The Port has adopted the actual controllable operating expenditure incurred in 2019–20 as the base year. We consider using 2019–20 as the base year will better support sound forecasts. This is in contrast to more recent years' actual expenditure that has not been subjected by us to a prudency and efficiency review.[33] The Port has established a recurring level of controllable expenditure by adjusting the expenditure incurred in 2019–20, removing non-controllable and one-off costs and adding normally occurring costs.[34]

Growth rate

In the 2022–23 tariff compliance statement, the Port used a weighted average approach to determine a growth rate that would be applied to the drivers of operating expenditure. This was calculated by using the growth rate of forecast container volumes and the growth of its regulatory asset base, weighted by 2020–21 operating expenditure.

In the 2023–24 tariff compliance statement, the Port shifted from a weighted average growth factor to a single measure of growth (number of inward containers), which then informs the net efficiency factor (discussed below). The Port also provided analysis of the link between growth and the level of operating expenditure and found there is not a clear or strong link between the movement of these two factors.

Using a simpler approach in determining the rate of growth is reasonable. We would anticipate the Port undertaking ongoing analysis to determine drivers of specific cost categories to enable it to identify further efficiencies and realise economies of scale.

Net efficiency factor

The Port adopted a net efficiency factor opposed to a gross factor it intended to use as stated in its 2022–23 tariff compliance statement.[35] In the 2023–24 tariff compliance statement the Port reviewed its expected growth, productivity and real price changes. It proposed an annual average net efficiency rate over the next regulatory period (2023–28) of 0.12 per cent.

In our 2022–23 interim commentary we considered a net efficiency factor would better represent true efficiencies when adjusted for expected growth. While we consider this approach is an improvement, it is expected that the Port will continue to look for ways to support targeted

---

[33] Expenditure incurred in 2019–20 underwent a prudency and efficiency assessment as part of the 2016–21 compliance inquiry.

[34] The Port is subject to prescribed operating expenditure that is non-controllable in nature. This expenditure includes the Port Licence Fee, Port Rail Transformation Agreement costs and Cost Contribution Amounts. The amounts forecast to be incurred over the next five years uses forecast inflation, contract rental rates and channel fee revenue.

[35] A net efficiency factor is calculated by taking the growth rate mentioned above, less a general productivity factor and less economies of scale, adding real wage growth and superannuation cost growth. In the 2022–23 tariff compliance statement the Port proposed a 0.5 per cent gross efficiency factor.

efficiency improvements, as could be expected in a workably competitive industry, and for which customers would benefit through service-price improvements.

Step changes

In addition to the expenditure incurred in the base year (2019–20) the Port proposed $45.3m real costs (step changes) over the next regulatory period (2023–28). The proposed step changes are the main contributor to the forecast increase in prescribed controllable operating expenditure, as outlined in Table 1.7.

Step changes account for expected and forecast increases in cost such as legal services and tax responsibilities, new corporate relations division, sustainability team, cybersecurity, insurance premiums, rail management, asset repairs and maintenance, and asset planning costs.[36] [37]

We will undertake a detailed independent review of the prudency and efficiency of the Port's approach to forecasting controllable operating expenditure during the 2026 five-year compliance inquiry, including the basis for the proposed step changes.

The more material step changes are increases to insurance premiums, cybersecurity risk, planned engagement, sustainability responsibilities and asset planning costs. The Port's sustainability responsibilities are noted to be a recent issue raised by their stakeholders; we will continue to monitor the Port's engagement on this topic and will form a prudency and efficiency view in the next compliance inquiry.

Capital expenditure

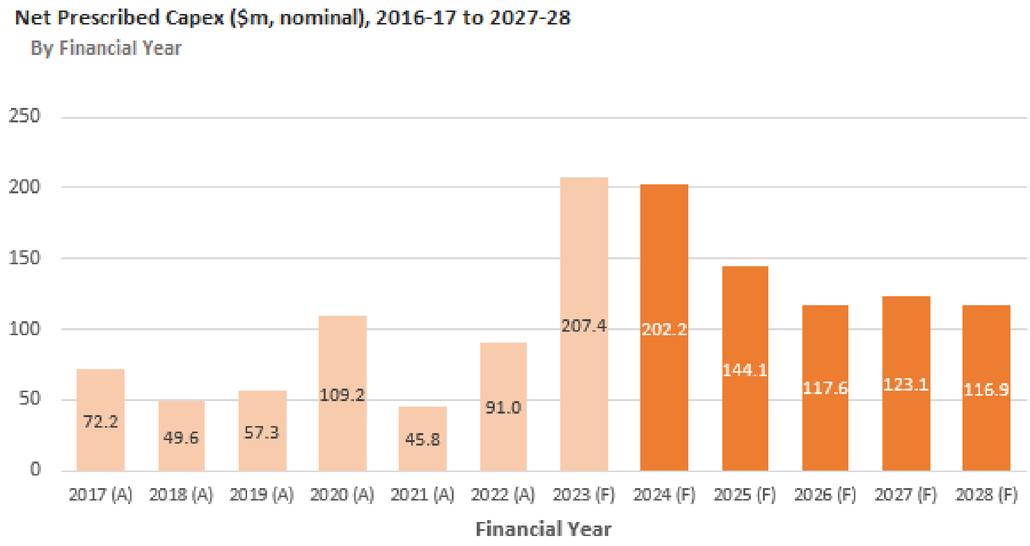
The Port's capital expenditure forecast for the five-year regulatory period from 2023–2028 averages around $140.8 million per year. As a result, the average annual capital expenditure over the second inquiry period from 2022–26 is significantly higher at $152.5 million per year compared

[36] The background, justification, and basis of the cost estimate for each step change is set out in 2023–24 Tariff Compliance Statement: Appendix L Operating cost step changes.

[37] Treasurer of the State of Victoria 2023, *Victorian Budget 2023/24: Doing What Matters Service Delivery Budget Paper No. 3*, State Government of Victoria, Melbourne, May 2023. In the 2023–24 tariff compliance statement the Port explained the recent increase in payroll tax is consistent with a 'tax change event' that may trigger a cost pass-through mechanism. It also outlined that restating the aggregate revenue requirement may be needed if actual expenditure differed from the forecast amount by more than one per cent of aggregate revenue requirement in that year. The Port has explained it will revisit the actual costs incurred towards the end of the regulatory period to determine if the uncertainty mechanism is necessary. Our views on the Port's proposed uncertainty mechanism are outlined earlier in our 2023 interim commentary.

to the average over the first five years of the port lease amounting to $66.8 million per year.[38] Figure 1.8 outlines the Port’s forecast and actual capital expenditure spend over the last 10 years.

1.7 The Port’s forecast and actual capital expenditure spend over the last 10 years



Source: Port of Melbourne, 2023 Tariff Compliance Statement, 31 May 2023 and financial model

The Port’s transition towards larger capital spends involving more complex capital planning occurred in 2022–23 with an actual capital expenditure estimate of $214.0 million against a $207.9 million forecast.

The enhanced capital program for the next five-year period is predominantly driven by renewals expenditure followed by three growth projects; namely, the Port Capacity Enhancement Project, the Port Rail Transformation Project and the Webb Dock East 4&5 Berth Extension.

Our 2022–23 interim commentary noted that the Port’s approach to establishing capital expenditure forecasts at the time may need to be reviewed to ensure the prudency and efficiency of more complex and significant future spends are adequately justified. We observe the Port in response has detailed improvements to its capital planning, project management and governance practices.

---

[38] We identified an inconsistency between the total capital expenditure forecast in the tariff compliance statements’ General Statement and the regulatory model. The Port confirmed the figure in the General Statement was incorrectly stated.

In addition, it also advised that it will apply its proposed uncertain capital project mechanism (outlined in Table 1.1) to recalculate the forecast aggregate revenue requirement and amend its forecast deferred depreciation at the beginning of the following regulatory period.

We generally support uncertain capital expenditure projects, in terms of timing and / or amount, to not be reflected in forecasts until there is greater certainty around the timing and / or amount of expenditure. This is so customers do not wear the costs associated with forecast capital expenditure that is not in fact incurred during the regulatory period.[39]

As noted earlier in our commentary, our preliminary view is that the pricing order does not allow using the deferred depreciation amount as an adjustable value or balancing item that permits the Port to recover amounts assessed to be prudent and efficient on an ex-post basis and to carry those forward into future regulatory periods.

[39] We note that the tariffs adjustment limit places a cap on prices, hence in the Port's case if the capital expenditure spend was included in the forecast, it would earn a return on and return of capital, where the majority of the depreciation would be deferred and reflected in future prices.

Stakeholder engagement

The Port appears to have continued to engage stakeholders effectively

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 – version 3.0 also provides guidance. In commenting on the Port's compliance, we are guided by the following principles. The Port should:

- start engagement early in its planning of initiatives and undertake ongoing engagement
- ensure the engagement process prioritises matters with a significant impact on services and prices
- demonstrate genuine engagement and clearly communicate the level of stakeholder influence
- tailor the form of engagement to suit the engagement content and the circumstances
- provide participants in its engagement process with appropriate information
- demonstrate and communicate how stakeholder feedback has influenced its decisions.

The Port's engagement program:

- took place between October 2022 and April 2023
- included a series of engagement methods including surveys, interviews, targeted one on one meetings and online and in person forums
- considered findings from its first annual stakeholders' perceptions survey to shape its engagement program
- included participants representing direct and indirect port users including shipping lines and its peak body, cargo owners, shippers, stevedores and residents and businesses from the four local government areas surrounding the Port
- covered matters such as the length of regulatory period, tariffs, rail, sustainability and engagement.[40]

[40] The Port's overarching sustainability goal is to work with its stakeholders to build a sustainable port for the benefit of the Victorian economy and liveability of Melbourne. This goal is underpinned by three key objectives: lead the decarbonisation of the port's supply chain, minimise the port's impact on its land, air and waters, and build strong stakeholder and community relationships to protect its social license. 'Sustainability at Port of Melbourne', Port of Melbourne, accessed 29 August 2023, https://www.portofmelbourne.com/community-education/sustainability-at-port-of-melbourne/. Port of Melbourne, 2023 Industry Engagement Information Pack, March 2023, p. 52.

Our preliminary views

Our preliminary view is that the Port's engagement processes for the 2023-24 tariff compliance statement continue to improve and build on the learnings from its 2022-23 tariff compliance engagement processes. We note an increase in participation from users and stakeholders and the welcomed provision of additional information on the port's projects and the different methods used to support stakeholders' feedback. Its open approach to explore matters that are a priority for its port users seems to demonstrate genuine engagement.

Transition to a five-year regulatory period and other matters

The Port stated it had engaged on the transition to a 5-year regulatory period in 2021 and 2022 and initially proposed moving to a longer regulatory period in its 2023-24 tariff compliance statement.

The Port appears to justify the reasons behinds its transition proposal in the Port's industry engagement information pack. The engagement approach for this matter appears to demonstrate early and ongoing engagement as well as the use of appropriate information for the purpose.

The Port undertook early engagement activities to find out the topics that mattered to port users and stakeholders. The Port also undertook a perception survey to better understand its reputation and performance and identify areas of opportunity. The findings of these activities uncovered stakeholder current interests including engagement and sustainability. There areas were further explored in its 2023 industry engagement.

The Port communicated to stakeholders that they would have a 'consult' level of influence in its engagement information pack. Engagement materials design and delivery were tailored to stakeholder preferences. The Port's industry engagement summary report seems to demonstrate the Port made a considerable effort to continue improving its engagement practices. In the Port's survey, 87 per cent of respondents agreed the information provided as part of the engagement was of value to them and most respondents agreed that the Port's engagement with their organisation is genuine.[41]

The Port's summary of considerations of stakeholder comments identifies its considerations of the matters raised in the 41 submissions received by the Port via its survey.

[41] Port of Melbourne, 2023-24 Tariff Compliance Statement: General Statement, 31 May 2023, pp 31 and 32.

Most respondents considered that they had been given sufficient time to contemplate and respond to engagement requests and that the Port's engagement is continuously improving. Other respondents noted areas for future improvement in the Port's engagement approach.

The Port's major projects with a growth driver have standalone engagement programs, including the Port Rail Transformation Project, Webb Dock East 4 & 5 Berth Extension and the Port Capacity Enhancement Program (PCEP). The Port's PCEP stage 1 engagement – extended from three months to over nine months in response to stakeholder feedback – has included public forums, seeking written feedback and workshops with terminal operators.

The Port had a dedicated engagement program on its deferred depreciation approach to inform port users of indicative projections, which was a recommendation noted in our 2023 interim commentary.

Our preliminary view is that the Port appears to have effective engagement processes and considered port users' and stakeholders' comments in coming to its decisions. We continue to be encouraged by the Port's continuous improvement in its engagement.