



28 February 2020

Price Monitoring and Regulation Division – Transport
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Via email: transport@esc.vic.gov.au

Re: Draft Statement of Regulatory Approach Version 2.0

Thank you for the opportunity to make a submission on the Essential Services Commission (ESC) staff's redraft of the Statement of Regulatory Approach (SRA), provided to the Port of Melbourne (PoM) for comment on 7 February 2020 for comment.

We note that the changes in the draft SRA do not reflect the commission's final views, as the commission has yet to review or approve the changes. Should the commission make further substantive amendments, PoM would appreciate the opportunity to comment on these changes before the update to the SRA is finalised.

The substantive changes proposed by ESC staff to the Pricing Order relate to the requirement that PoM must use "one or a combination of well accepted approaches" to derive a weighted average cost of capital.¹ The proposed amendments are mainly to the following sections of chapter 4.3.2 of the SRA:

- Guidance on well accepted approaches
- Guidance on our approach.

'Guidance on well accepted approaches'

The changes proposed by ESC staff would replace the entire section on 'Guidance for well accepted approaches' in the current SRA.

The current SRA contains the following wording:²

To comply with the requirement to use 'well accepted approaches' to estimate the cost of equity and cost of debt, we consider that:

- the approach or combination of approaches must be well accepted for the purpose of setting an allowed return for use within an accrual building block methodology
- a view on the meaning of 'well accepted' that would be consistent with the regulatory regime would be approaches that are accepted by those entities that normally determine the inputs to an accrual building block methodology – that is, economic regulators [footnote: Or review bodies that have the

¹ Pricing Order, clause 4.3.1

² ESC, *Statement of Regulatory Approach – version 1.0*, December 2017, p.20

task of overseeing the decisions of economic regulators, such as the Australian Competition Tribunal].

We further consider that:

- the greatest weight should be placed on an approach or combination of approaches that best achieve the requirements of the pricing order and the objectives in the regulatory regime. In this regard, we consider that it would be consistent with the regulatory regime if the port were to adopt approaches used by economic regulators, namely to determine an aggregate revenue requirement through an accrual building block methodology
- if the port uses more than one approach when determining the rate of return, all of those approaches used must be well accepted
- 'approaches' implies a method or a series of steps used in the estimation process
- at a minimum, at least one economic regulator should be using (or should have recently used) an approach for it to be considered 'well accepted'. We will consider each approach on a case-by-case basis, based on evidence available, whether it ought to be considered well accepted for the purposes of assessing compliance against the requirements of the pricing order.

The draft SRA replaces the above with the following:³

We consider that the requirement to use "one or a combination of well accepted approaches" is likely to be satisfied where that approach is, or approaches are, broadly or generally recognised as being used, or appropriate for use, to estimate a return on capital in the context of an economic regulatory regime which has objects such as efficiency and principles such as that a regulated service provider should be provided with a return commensurate with a benchmark efficient entity providing services with a similar degree of risk.

In looking at whether an approach is generally recognised as being used, or appropriate for use, in the terms set out above, the views and practices of practitioners in the area of economic regulation may be informative. This would include the views of regulators and other professionals engaged in the practice of economic regulation in regimes similar to that applying to the port. These other professionals might include academics, economists and finance practitioners.

We also understand that the amended SRA would replace the *Feedback on consultation and other matters: Statement of regulatory approach version 1.0* paper that accompanies the current SRA. This change in guidance material implies that a number of positions previously held by the ESC no longer apply. This includes, for example, guidance relating to the interpretation of well accepted approaches set out in section 5.6.1 of that paper, such as:

- That the meaning of the term 'well accepted' relates to approaches that are accepted by economic regulators (or review bodies such as the Australian Competition Tribunal)⁴
- 'Well accepted approaches' means those approaches that are commonly used in Australian regulatory practice⁵
- The way in which PoM combines approaches to determine the cost of capital must also be well accepted by economic regulators.⁶

PoM commentary on the proposed revisions to 'Guidance on well accepted approaches'

We consider that the proposed revisions make a number of positive changes from the current SRA, such as:

- Broadening the interpretation of well accepted to not be limited to acceptance by economic regulators. That is, recognising that the views and practices of both regulators (local and overseas) and persons other than regulators may be relevant.
- No longer specifying that the combination of approaches must be a well accepted combination. Given the number of approaches that are used to estimate returns on capital and nuances of application within those approaches (and corresponding lack of unanimity), such a requirement would have likely resulted in PoM needing to adopt the exact same approach as another person in

³ ESC Staff, *Draft Statement of Regulatory Approach – version 2.0*, February 2020, p.23

⁴ ESC, *Feedback on consultation and other matters: Statement of regulatory approach version 1.0*, December 2017, pp.39-40

⁵ ESC, *Feedback on consultation and other matters: Statement of regulatory approach version 1.0*, December 2017, p.36

⁶ ESC, *Feedback on consultation and other matters: Statement of regulatory approach version 1.0*, December 2017, p.40

order to pass the test for well accepted. We do not consider this is consistent with the requirements of the Pricing Order.

- No longer specifying that an approach should be used by at least one economic regulator to be considered well accepted. In conjunction with the additional words in the draft SRA “or appropriate for use”, PoM considers that this change correctly recognise the discretion afforded to both regulators and persons other than regulators to choose from one of a number of well accepted approaches.

However, we have some concerns that there are aspects of the proposed revisions to the SRA that are too narrow. This specifically relates to the use of the terms “In the context of an economic regulatory regime” and “engaged in the practice of economic regulation”. These terms could be read as excluding acceptance by persons other than economic regulators, and/or excluding acceptance of approaches to estimate returns on capital outside of economic regulatory applications.

PoM recognises that the context in which the approach is accepted is relevant, and that contexts analogous to that of the benchmark efficient entity are likely to be the most relevant. However, we also note that the purpose of economic regulatory regimes is to act as a surrogate for, or to mimic, the outcomes of a workably competitive market. As such, we consider that the Pricing Order permits PoM to use one or a combination of approaches that are well accepted by practitioners who derive or determine a weighted average cost of capital in either:

- a competitive market, or
- a context that is a surrogate for the rewards and disciplines normally provided by a competitive market (i.e. a regulatory regime).

Given the objective of those engaged in the practice of economic regulation is to mimic the outcomes of competitive markets, well accepted approaches in competitive markets often form a basis for, or are referenced by, approaches adopted in regulatory regimes. For example, regulators may look at academic work attempting to explain movements in competitive markets, or rely on surveys of practitioners operating in competitive markets. Therefore, PoM considers that the Pricing Order allows some weight to be placed on evidence of use by persons (other than regulators) who are engaged in deriving a rate of return on capital as a practical matter, for entities in competitive markets, such as finance practitioners in the capital markets.

PoM commentary on the proposed revisions to ‘Guidance on our approach’

The draft SRA makes a number of changes to the ‘three step process’ set out by the commission to assess compliance with the Pricing Order in relation to the return on capital.

Consistent with our submission on the Statement of Regulatory Approach version 1.0, we are uncertain as to the how the high-level cross-checks of the overall return on capital will be performed. The examples of high-level cross-checks set out in the ESC’s *Feedback on consultation and other matters: Statement of regulatory approach version 1.0 paper* are relatively broad and undefined. The cross-checks that would appear to relate to the overall return on capital are:

- “other regulatory decisions for similar entities”; or
- “examination of whether the return on capital estimate (and individual parameter estimates) used by the port fall within reasonable confidence bands or plausible ranges.”⁷

However, it is not clear if there are appropriate benchmarks for the commission to draw on to inform these cross-checks or analysis, in particular as it would relate to the overall return on capital.⁸ Further, we note that a ‘top down’ or high-level assessment of the overall return on capital does not appear to be a well accepted approach to deriving a weighted average cost of capital. It is therefore not clear how the commission (or PoM) would apply such cross-checks to inform itself about compliance with the Pricing Order.

⁷ ESC, *Feedback on consultation and other matters: Statement of regulatory approach version 1.0*, December 2017, pp.46-47

⁸ Given the lack of publicly listed benchmark entities, directly comparable regulatory regimes (given most other regimes are deterministic) or similar regulated entities (no other ports in Australia are subject to a similar regime to the Pricing Order).

Subject to further guidance from the commission on the approach to undertaking these cross-checks, we consider a bottom-up approach to determining the weighted average cost of capital is likely to be the only robust, replicable and transparent method to demonstrate compliance with the Pricing Order.

Contact

If you have any questions about this submission, please do not hesitate to contact Michael Black, Head of Regulation, on 0438394274.

A handwritten signature in black ink, appearing to read 'D Mutzelburg', with a stylized flourish at the end.

Darryl Mutzelburg
Chief Financial Officer