



Statement of Regulatory Approach – version 4.0

Port of Melbourne Pricing Order

8 May 2024



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Revisions to this Statement

Version number	Date	Amendment
1.0	December 2017	Inaugural version
2.0	28 April 2020	<ul style="list-style-type: none"> • Amendments to interpretation of ‘well-accepted’ approaches to determining the cost of capital. • Amendment to annual reviews significance to five-yearly inquiry. • Section 2.1.2 altered to clarify annual reviews • Updated section 4.3.2 guidance on well accepted approaches • Inclusion of Appendix A on cross checks • inserted Appendix B on engagement
3.0	December 2022	<ul style="list-style-type: none"> • Introduction amended to further explain the commission’s function of monitoring the Port’s compliance with the pricing order • Section 2.1.2 amended to clarify our role in publishing interim commentary on the Port’s tariff compliance statements • Section 2.2.1 updated to include our key findings from 2021 inaugural inquiry • Specified the precise timeframe of our inquiry period • Introduced Port’s Undertaking and its relationship with pricing order • Inclusion of our consultation process with Port • Section 2.2.2 updated to provide definition of significant non-compliance • Updated section 2.3.2 to include requirement to address prudency and efficiency of capex and inclusion of our expectations for the Port to thoroughly test the project and the application with port’s users and relevant stakeholders. • Modified section 3.3.2 to provide guiding principles on customer consultation and note the Port’s application of the IAP2 Quality Assurance Standard Also mentioned the engagement findings of our 2021 review • Inclusion of fit for purpose vs best practice principles in section 3.4 • Section 4.1.2 amended to include guidance on roll forward of asset base vs forecast • Section 4.2.2 modified to provide further guidance on capital expenditure • Defined our views in regards to “well accepted approaches” in section 4.3.2 and provided implementation methodologies.

		<ul style="list-style-type: none"> • Updated depreciation pricing order requirement in section 4.4 • Section 4.5.2 updated to provide guidance on the forms of evidence and tools for showing compliance with pricing order. Included key principles in reviewing the baseline controllable operating expenditure • Section 4.7 amended to include guiding principles for determining the length of the Regulatory period and our views on re-opener provision
4.0	May 2024	<ul style="list-style-type: none"> • Section 4.7 amended to include further guiding principles for determining the length of regulatory period and our views on the pricing order on re-opener provisions and adjustment mechanisms.

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1. Introduction

In 2016, the Victorian Parliament passed legislation enabling the port of Melbourne's commercial operations to be leased to a private operator for 50 years. The authorised private operator, the Port of Melbourne Operations Pty Ltd (as trustee for the Port of Melbourne Unit Trust) (the Port) commenced operations on 1 November 2016.

A number of services provided by the Port are 'prescribed services' in the *Port Management Act 1995*. These include the provision of:¹

- channels for use by shipping in port of Melbourne waters
- berths, buoys, or dolphins in connection with the berthing of vessels in the port of Melbourne
- short-term storage or cargo marshalling facilities in the port of Melbourne
- access to, or allowing the use of, places or infrastructure (including wharves, slipways, gangways, roads and rail infrastructure) on port of Melbourne land
- any other service that is prescribed by Port Management Act regulations.²

In setting prices for the provision of prescribed services, the Port must comply with requirements in the pricing order. The pricing order is a regulatory instrument made by the Governor in Council under section 49A of the Port Management Act.³

We are responsible for ensuring the Port complies with various pricing order obligations when it sets and levies prices. Our compliance function is set out in Part 3 of the Port Management Act.⁴

Our main compliance function is to conduct an inquiry every five years on:

- the Port's compliance with the pricing order during a review period in setting or levying its prices for prescribed services
- whether any non-compliance was 'significant and sustained'.⁵

¹ Port Management Act 1995, s. 49(1)(c).

² Port Management Act 1995, s. 98. No regulations have yet been made to specify any additional prescribed services for purposes of section 49(c)(v) of the Port Management Act 1995.

³ The Pricing Order was designed and developed by the Victorian Department of Treasury and Finance.

⁴ Port Management Act 1995, Part 3, Division 2A.

⁵ Port Management Act 1995, s 49(1).

We also investigate complaints from prescribed service users about Port non-compliance with the pricing order. We must inform the complainant of the outcomes of our investigation.⁶ We may refer complaints and report non-compliance to the ESC Minister (the Assistant Treasurer).⁷

Our other compliance functions include:

- receiving and deciding tariff rebalancing applications
- receiving tariff compliance statements
- making determinations about what constitutes ‘sufficient supporting information’ for purposes of tariff rebalancing applications and tariff compliance statements.

We must perform these compliance functions in line with the objectives of both:

- section 8 of the *Essential Services Commission Act 2001*
- section 48 of the *Port Management Act*.⁸

Where there is conflict between these objectives, we must act to best achieve the objectives specified in the *Port Management Act*.⁹

Our objective is to promote the long term interests of Victorian consumers.¹⁰ In seeking to achieve this, we must consider the price, quality and reliability of prescribed services.¹¹ We must also consider other matters where relevant, including:

- efficiency in the industry and the incentives for long term investment
- degree of scope for competition, including countervailing market power and information asymmetries
- consistency in regulation between states and on a national basis.¹²

The objectives set out in section 48 of the *Port Management Act* are to:¹³

- promote efficient use of, and investment in, the provision of prescribed services for the long-term interests of users and Victorian consumers.

⁶ *Port Management Act 1995*, s 49Q(5).

⁷ *Port Management Act 1995*, s 49Q(6).

⁸ *Port Management Act 1995*, s 48A.

⁹ *Port Management Act 1995*, s 48A read with *Essential Services Commission Act 2001*, s 5(2).

¹⁰ *Essential Services Commission Act 2001*, s 8(1).

¹¹ *Essential Services Commission Act 2001*, s 8(2).

¹² *Essential Services Commission Act 2001*, s 8A(1).

¹³ *Port Management Act 1995*, s48(1)(a) to (e).

- protect the interests of users of prescribed services by ensuring that prescribed prices are fair and reasonable whilst having regard to the level of competition in, and efficiency of, the regulated industry.
- allow a provider of prescribed services a reasonable opportunity to recover the efficient costs of providing prescribed services, including a return commensurate with the risks involved.
- facilitate and promote competition between ports, and between shippers and between other persons conducting commercial activities in ports.
- eliminate resource allocation distortions by prohibiting a State sponsored port operator from providing a relevant service at a price lower than the competitively neutral price for that service.

Sections 11 and 13 of the Essential Services Commission Act respectively enable us to:

- do all things necessary or convenient to be done in performing our functions so as to enable us to achieve the objectives¹⁴ under the regulatory regime.¹⁵
- publish statements and guidelines relating to performing our functions and exercising our powers.

These latter two legislative provisions enable us to:

- communicate with the Port, port users¹⁶ and other relevant stakeholders on matters relevant for our pricing order compliance functions
- publish statements and guidelines relevant for this to facilitate transparency and predictability in our approach to undertaking our functions.

Our first five-yearly review found ‘significant and sustained’ non-compliance with the pricing order between 2016 to 2021 in relation to a number of matters.¹⁷ The Port gave the Assistant Treasurer

¹⁴ These objectives are set out in section 48 of the Port Management Act (Vic) 1995, and section 8 of the Essential Services Commission Act 2001 (Vic). We provide a summary of the relevant legislative framework in; Essential Services Commission 2017, *Overview of the Port of Melbourne and Essential Services Commission’s Regulatory Roles*, March.

¹⁵ Throughout this guidance, ‘regulatory regime’ refers to the Port Management Act 1995 (Vic) and Essential Services Commission Act 2001 (Vic).

¹⁶ Pricing order, clause 14, see definition of ‘port user’.

¹⁷ ‘Port of Melbourne compliance with pricing regulations’, Essential Services Commission, www.esc.vic.gov.au/transport/port-melbourne/port-melbourne-compliance-pricing-regulations/inquiry-port-melbourne-compliance-pricing-order-2021

an undertaking in relation to our adverse compliance report. This undertaking was accepted by the Assistant Treasurer and commenced on 20 May 2022.^{18 19}

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 (currently the Assistant Treasurer) may apply to the Supreme Court for orders where a breach of the undertaking is alleged to have occurred.²⁰

1.1. Purpose and structure of this Statement of Regulatory Approach

This statement of regulatory approach:

- sets out our compliance roles
- 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 guidance in this statement has been informed by:

- our 2016–2021 five-yearly review of the Port's compliance with the pricing order, which was completed in December 2021
- findings from a complaints investigation we concluded in mid-2022
- our 2023 interim commentary
- consultation with the Port.

We consulted directly with the Port on our proposed amendments to the Statement of Regulatory Approach v3.0. We have had regard to the Port's comments in this Statement of Regulatory Approach v4.0. We may make updates to this statement of regulatory approach over time. This will allow our approach to remain relevant to new information and key issues as they arise. We will consult with the Port and stakeholders, if appropriate, where any amendment to this statement of regulatory approach is contemplated.

¹⁸ 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.

¹⁹ 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.

²⁰ Port Management Act 1995 (Vic), s 49N(2).

The statement is structured as follows:

- Chapter 2 sets out our roles in administering the pricing order, which include:
 - our role relating to annual tariff compliance statements
 - our approval of tariff rebalancing applications
 - our five-yearly inquiry for the Port's compliance with the pricing order
 - determining the form and content of supporting information.
- Chapter 3 sets out our guidance on process requirements in the pricing order, including the development and provision of an annual tariff compliance statement
- Chapter 4 sets out our guidance on the pricing order requirements for the accrual building block methodology.

2. Our roles in administering the Pricing Order

We have four key roles relating to the pricing order:

- receiving the Port's annual tariff compliance statement
- undertaking five-yearly inquiries of the Port's compliance with the Pricing Order
- approving tariff rebalancing applications which may be submitted by the Port
- determining the form and content of supporting information to be provided by the Port.

2.1. Receiving tariff compliance statements

2.1.1. Pricing Order requirements

The Port must provide us with a tariff compliance statement by 31 May each year,²¹ describing how its prescribed service tariffs for the coming financial year comply with the pricing order. These statements will be a key input for our formal five-yearly inquiries (with the second inquiry commencing in 2026).

Clause 7.1.2 of the pricing order lists what the Port's tariff compliance statement must contain to demonstrate compliance with the pricing order. The Port's tariff compliance statement must also include any sufficient supporting information that we may determine under clause 9 of the pricing order.

2.1.2. Guidance on the tariff compliance statement

Each year (other than the year in which we undertake the formal five-yearly inquiry) we may conduct an interim or preliminary assessment of the Port's tariff compliance statement.

In conducting our assessment, we may request further information in the form of written information requests to the Port to clarify its tariff compliance statement. The assessment is interim or preliminary in the sense that it does not comprise part of our formal five-yearly inquiry. However, the work undertaken is likely to inform the formal five-yearly inquiry.

Publishing interim commentary on the Port's tariff compliance statements

Although the Port must submit an annual tariff compliance statement in accordance with the pricing order, we are not required to publish an interim commentary in response to the port's annual tariff compliance statement. Conducting and publishing an interim or preliminary evaluation on the Port's tariff compliance statement between the formal five-yearly commentary is not mandated by or

²¹ Pricing Order 2016, clause 7.1.1.

under the Port Management Act. However, we publish feedback on the Port's annual tariff compliance statements to promote transparency and predictability in our approach to our next five-yearly pricing order compliance inquiry.

This will help the Port and stakeholders to be aware of what are likely to be the key issues or concerns in advance of our formal inquiries. It gives the Port an opportunity to take account of the issues we raise in its next tariff compliance statement.

The interim commentary should not be regarded as an assessment of the Port's compliance with the pricing order, nor will it provide findings on whether any non-compliance was 'significant or sustained'.

The scope and extent of our commentary will be informed by the quality of information provided by the Port and the materiality of issues arising from our interim assessments of compliance.

2.2. Conducting formal five-yearly inquiries

2.2.1. Legislative requirements

Every five years, we must conduct and complete an inquiry and report to the ESC Minister on:²²

- whether the Port has complied with the Pricing Order during the five-year period
- if there was non-compliance with the Pricing Order, whether that non-compliance was, in our view, non-compliant in a 'significant and sustained manner'.

We must complete our formal inquiry not later than six months after the end of a five-year review period.

In the sections below, we outline the legislative process for our formal inquiries and what will happen if we find the Port has not complied in a significant and sustained manner.

The process for five-yearly inquiries is outlined in legislation

Five-yearly inquiries must be conducted in accordance with Part 5 of the Essential Services Commission Act (except for sections 40 and 46²³).²⁴ We must conduct at least one public hearing during our inquiry. We may also consult with any person that we consider appropriate, hold public seminars and workshops, and establish working groups and task forces.

²² Port Management Act 1995, s. 49I(1).

²³ Section 40 of the Essential Services Commission Act states that after consultation with the Minister, we may conduct an inquiry if we consider an inquiry is necessary or desirable for the purpose of carrying out our functions. Section 46 of the Essential Services Commission Act enables us to prepare a 'special report' if, in the course of an inquiry, there is another matter we consider we should report to the Minister on.

²⁴ Port Management Act 1995, s. 49I(2).

In conducting our five-yearly inquiries, the Port Management Act states we may take into account findings we have made in previous inquiries and the nature and details of any instance of non-compliance with the pricing order reported in those inquiries.²⁵ This does not limit us from taking account of any other matters we consider relevant to our inquiries.

Under section 49J of the Port Management Act, we must provide a draft inquiry report to the Port. The Port will be given an opportunity to make a written submission on the draft report prior to us preparing a final report on the inquiry.

Our final report on the inquiry must include our findings as to whether there has been non-compliance with the pricing order and whether that non-compliance is in a significant and sustained manner.²⁶ We must also include our reasons for those findings.

Summary of our key findings

We undertook the first inquiry in 2021 on the Port's compliance with the pricing order over the period 2016–2021 and provided the report to the ESC Minister (Assistant Treasurer) in December 2021. The report was made publicly available on 28 January 2022.

We reviewed the Port's aggregate revenue requirement, tariffs, capital and operating expenditure, demand forecasts, return of capital, return on capital and stakeholder consultation.

Significant and sustained non-compliance

- weighted average cost of capital did not reflect a benchmark efficient entity with a similar degree of risk as the Port.
- revenue requirement was overstated by around \$300 million and \$650 million.²⁷
- consultation was not effective nor had adequate regard to port users' comments.

Sustained non-compliance

- approach to forecasting its operating expenses was not consistent with that of a prudent or efficient service provider.
- tariffs, cost allocation and content of its tariff compliance statements were not compliant with the requirements of the Pricing Order.

²⁵ Port Management Act 1995, s. 49I(3).

²⁶ Port Management Act 1995, s. 49I(4).

²⁷ The range of the overstated revenue requirement is calculated by applying the range of the values of WACC we found to be well accepted in our compliance inquiry.

Our findings were based on our review of the tariff compliance statements and supporting information the Port provided to us over the 2016-2021 period.²⁸ We used our legislative powers to obtain relevant information to assist our review. We obtained information from the Port via a section 56 compulsory information notice.²⁹

We also considered the Port's written submission to our draft inquiry report and its accompanying consultants' reports. In reaching our findings, we sought advice from our external consultants on the Port's expenditure forecasts, pricing and costing, depreciation, and demand forecasts. The Port was provided with an opportunity to review our consultants' reports and provide its response to our draft inquiry report in November 2021.

We expect that we will use our information gathering powers to obtain documents and information to inform future five-year inquiries.

Establishing the inquiry period

The inquiry period is the five years beginning on the day after the previous inquiry period concludes and ending five years after that date. Therefore, the second inquiry will cover the period 1 July 2021 to 30 June 2026.³⁰

We will aim to publish the result of our inquiry by no later than 31 December 2026.

Our final report is reviewable

If our final compliance inquiry report finds that the Port has been non-compliant with the pricing order in a significant and sustained manner, the Port may apply to the Victorian Civil and Administrative Tribunal (VCAT) for a review of that decision.³¹

The only grounds for review are that the decision was not made in accordance with the law, or is unreasonable having regard to all the relevant circumstances.³² VCAT may affirm our decision, vary our decision, or set aside our decision and remit it to us for amendment.³³ Our final compliance report may also be taken on judicial review to the Victorian Supreme Court.

²⁸ Port Management Act 1995, s56.

²⁹ Compulsory information requests issued via section 56 of the Port Management Act 1995 (Vic).

³⁰ As we state in our guidance on the roll forward (section 4.1.2), our role during a compliance inquiry will be to assess only the capital expenditure that is included in tariff compliance statements and the roll forward model that falls within the compliance inquiry review period. As a general proposition, the consequence of this is that forecast capital expenditure included in the roll forward model provided by the Port to the commission and published by 31 May for the financial year that commences one day after the inquiry period ends, will not be subject to commission scrutiny during the inquiry.

³¹ Essential Services Commission Act 2001, s 55(1)(d).

³² Essential Services Commission Act 2001, s 55(2)(d).

³³ Essential Services Commission Act 2001, s 56(e).

If we make an adverse compliance finding the Minister may take further steps

If the ESC Minister, having had regard to our adverse compliance report,³⁴ considers that the Port has not complied with the pricing order in a significant and sustained manner, they may issue the Port with a 'show cause notice'.³⁵ The ESC Minister's show cause notice must set out the nature and details of the non-compliance, specify any actions the Port may take to remedy the non-compliance and invite the Port to make written submissions as to why the ESC Minister should not make a re-regulation recommendation to the Governor in Council.³⁶

After giving a show cause notice, the ESC Minister must decide whether to make a re-regulation recommendation. Before making a decision, the ESC Minister must consult with the Ports Minister and have regard to a range of matters (including the Port's response to the show cause notice).³⁷

The ESC Minister may also accept a written undertaking from the Port if they are satisfied that the terms of the undertaking are appropriate to address the non-compliance and that the Port is reasonably likely to comply with the undertaking.³⁸

In May 2022, the Assistant Treasurer accepted an undertaking from the Port regarding its approach to calculating and implementing its cost of capital and approach to stakeholder engagement.³⁹ This was in response to our 2016–2021 inquiry, which found the Port was non-compliant with the pricing order in these areas in a significant and sustained manner.⁴⁰

2.2.2. Guidance on conducting the five-yearly inquiry

We will consider information from several sources during our inquiries

We will use the Port's annual tariff compliance statements as our main source of information for the inquiries, as well as other supporting information the Port has provided during these processes.

We may also consider:

³⁴ An adverse compliance report is a final five-yearly inquiry report in which we have found that the port has not complied with the Pricing Order in a significant and sustained manner.

³⁵ Port Management Act 1995, s. 49K(1).

³⁶ Port Management Act 1995, s. 49K(2).

³⁷ Port Management Act 1995, s. 49L(3).

³⁸ Port Management Act 1995, s. 49M.

³⁹ Undertaking to the Essential Services Commission Minister - [PoM-Public-Summary-Response-to-ESC-5-Year-Review-20-May-22.pdf \(portofmelbourne.com\)](#)

⁴⁰ As part of this undertaking, the Port has drafted an Engagement Protocol which aims to address the matters we raised in our five-yearly inquiry with respect to effectively consulting with Port Users. On 27 October 2022, the Engagement Protocol was finalised and is available on Port's website - [Final Engagement Protocol](#).

- any public statements we have made in relation to the Port (such as our interim commentary on the tariff compliance statements)
- any complaints received under s.49Q of the Port Management Act
- any submissions received to processes we undertake during the five-year review period
- information received during the formal inquiry process (such as written submissions, the results of public hearings and workshops) and any findings made in relation to that information
- any other information we consider relevant to our inquiry – for example, nature of any previous non-compliances and the Port’s actions to rectify any previous non-compliances).

Assessing ‘significant and sustained’ non-compliance

We will assess whether there is non-compliance with the Pricing Order in a ‘significant and sustained manner’ having regard to the purpose of the Port Management Act (Vic) and objectives of Part 3 of this Act. In some cases, the nature of non-compliance may not be clearly foreseeable. As such, the information in this section should act as a broad guide to our approach. We will maintain our discretion to assess any non-compliance as we become aware of it after considering any relevant facts and circumstances.

In our 2016–2021 inquiry, we considered the cumulative nature of the Port’s non-compliance was significant and sustained and defined non-compliance as significant and sustained on the following basis:

- significant, because it does not meet the objectives of the *Port Management Act* (Vic)
- sustained, because the impact on these objectives is not fleeting or transitory.⁴¹

In our view, significant non-compliance with the pricing order is non-compliance that has an impact that is important or of consequence (i.e. is not insignificant, immaterial, minor or unlikely) when considered in the context of the objectives of Part 3 of the Port Management Act.

In considering whether any non-compliance is significant and sustained, the following matters may be of relevance:

- the materiality of the harm to port users or consumers as a consequence of any non-compliance
- whether the non-compliance has the potential to undermine stakeholder confidence in the integrity of the regulatory framework
- whether the Port has established and adhered to effective processes to support compliance and to monitor and review remediation of identified non-compliance

⁴¹ Essential Services Commission 2021, Inquiry into the Port of Melbourne compliance with the pricing order: Final report, 31 December, p.iii.

- the adequacy and timeliness of the Port's responses to any potential non-compliance issues that we have identified or raised
- whether harm to port users or Victorian consumers is ongoing or whether the harm can be reversed (at all or retrospectively)⁴²
- the future effects of the non-compliance, not just past impacts
- whether it may, or will, affect future prescribed service tariffs.

All of the above matters were assessed as part of the inaugural 2016–2021 five-year inquiry.

2.3. Assessing rebalancing applications

2.3.1. Pricing Order requirements

The pricing order requires the Port to vary its tariffs by the same percentage adjustment each financial year, unless we accept a rebalancing application.⁴³ If we accept the application, the Port may alter its tariffs by differing percentage amounts within the tariffs adjustment limit. This requirement remains in place for the initial 16 to 21 years of the regime, while the tariffs adjustment limit applies.⁴⁴

The Port must submit any rebalancing application prior to 1 January for tariffs to apply in the upcoming financial year.⁴⁵ The application may propose that:

- certain prescribed service tariffs be revised by different percentage adjustments
- a new prescribed service tariff be introduced
- an existing prescribed service tariff be discontinued.⁴⁶

Prior to making a rebalancing application, the Port must consult its port users about the proposal and provide them with a reasonable opportunity to express their views.⁴⁷

⁴² For example, the Port may set future tariffs lower to specifically offset additional revenue it gained through previously non-compliant tariffs. This may reverse the impact on the Port's revenue. However, the action may not equally reverse the harm to port users and Victorian consumers previously affected by non-compliant tariffs, as future port users and consumers may be different to previous port users and consumers.

⁴³ Pricing Order 2016, clause 3.2.1.

⁴⁴ Pricing Order 2016, clause 3.3.

⁴⁵ Pricing Order 2016, clause 3.2.4.

⁴⁶ Pricing Order 2016, clause 3.2.4.

⁴⁷ Pricing Order 2016, clause 3.2.5.

In its application, the Port must utilise a reasonable estimate of the upcoming March consumer price index for the purposes of calculating the tariffs adjustment limit.⁴⁸

After receiving a rebalancing application, we must notify the Port of our intention to accept or reject the application before 1 March.⁴⁹ If we have not notified our interim decision by that date, we are deemed to have given interim acceptance to the application.⁵⁰ In the event that we make an interim decision to reject the application, the Port may submit an amended rebalancing application within 30 days.⁵¹

Our interim acceptance or rejection of a rebalancing application will be based on criteria outlined in the pricing order. Specifically, clause 3.2.10 of the pricing order states that we must grant interim acceptance if we are satisfied the Port's proposed tariffs comply with the following clauses of the pricing order:

- clause 2 (general pricing principles)
- clause 3.1.1 (the tariffs adjustment limit)
- clause 4 (the aggregate revenue requirement as determined through the use of an accrual building block methodology)
- clause 5 (cost allocation principles).

Within seven days of the Australian Bureau of Statistics' release of the March quarter consumer price index, the Port is required to update and submit its final rebalancing application with the actual consumer price index.⁵² We must notify the Port of our final acceptance or rejection of their application within seven days of receiving the final rebalancing application.⁵³ If we do not notify the Port of our decision, we are deemed to have accepted the application.⁵⁴

2.3.2. Guidance on reviewing rebalancing applications

When deciding whether to accept or reject a rebalancing application, we must assess whether the Port's application complies with the relevant pricing order provisions. Due to the fixed timelines

⁴⁸ Pricing Order 2016, clause 3.2.6.

⁴⁹ Pricing Order 2016, clause 3.2.8. This date may be extended at our discretion where we have not received sufficient supporting information from the port in accordance with a determination made under clause 9 of the Pricing Order. The extension can span any period starting on the day we request further information and ending on the day the port complies. Source: Pricing Order 2016, clause 3.2.9.

⁵⁰ Pricing Order 2016, clause 3.2.8.

⁵¹ Pricing Order 2016, clause 3.2.13.

⁵² Pricing Order 2016, clause 3.2.15.

⁵³ Pricing Order 2016, clause 3.2.18. As with the interim decision, we may extend this timeframe if we have not received sufficient supporting information from the port in accordance with a determination made under clause 9 of the Pricing Order 2016 (clause 3.2.19).

⁵⁴ Pricing Order 2016, clause 3.2.18.

Our roles in administering the Pricing Order

outlined above, we consider it should be clear to the Port prior to applying, the information we expect in order to assess a rebalancing application. We would expect the Port to provide:

- information sufficient to demonstrate compliance with clause 2 (general pricing principles), clause 3.1.1 (tariffs adjustment limit), clause 4 (cost base for setting prescribed services tariffs) and clause 5 (cost allocation principles) of the Pricing Order
- a comprehensive overview of its consultation process with port users about its rebalancing proposals including port users' views regarding the proposals.

Compliance with clauses 2, 3.1.1, 4 and 5 means that we are required to consider the prudence and efficiency of capital expenditure (existing and proposed new expenditure) that underpin the prescribed service tariffs that are subject of the application. That is, the proposed tariffs must be based on efficient costs.⁵⁵

We may issue a determination, detailing the form and content of sufficient supporting information required to be submitted as part of the rebalancing application.⁵⁶

If we consider that the tariff balancing application does not contain sufficient supporting information to enable us to verify the proposed prescribed services tariffs to comply with one or more of clauses 2, 3.1.1, 4 and 5, we may not be able to properly assess the application, and there may be a threshold question as to whether any such application has been properly made and whether the commission is not required to make an interim decision.⁵⁷

We consider that the Port should canvass with port users at least the following matters in relation to the tariffs subject of the application in order to provide those users with a reasonable opportunity to express their views to the Port on the application:⁵⁸

- how the proposed tariff(s) meet the pricing order provisions
- scope and characteristics of the project underpinning the tariff (if applicable)
- demand forecasts (if applicable)
- impact on depreciation, including any deferral into future periods.
- number and variety of port users affected

⁵⁵ We will assess the prudence and efficiency of the Port's capital whenever a tariff rebalancing application comprises proposals that has implications for the Port's capital base, either generally or specifically for any prescribed service tariffs that are affected by a tariff rebalancing application.

⁵⁶ Pricing Order 2016, clause 9.

⁵⁷ Clause 3.2.7 states that the rebalancing application must contain sufficient supporting information to enable the commission to verify that the proposed prescribed services tariffs comply with clauses 2, 3.1.1, 4 and 5. Clause 3.2.8 provides that subject to compliance with clause 3.2.7, the Commission must notify the Port of either its interim acceptance of the Rebalancing Application or intention to reject the Rebalancing Application.

⁵⁸ Pricing Order 2016, clause 3.2.5.

- impact of the tariff both in immediate term and likely trend over longer term on port users

Port to consult port users on proposals to rebalance tariffs

The Port's decision to rebalance tariffs will directly impact port users. We consider that port users should be engaged on the substance of those decisions and be able to understand how these will affect them over time. As a guide, we consider the Port should consult its port users as outlined in section 'Customer consultation requirements' and well in advance of submitting an application to us. To promote appropriate engagement between the Port and port users, we expect the Port to provide evidence of its consultation with port users as part of any rebalancing application.

We expect the Port to consult port users on how it plans to rebalance prescribed service tariffs over the short and medium term. We expect the Port to provide port users with information on how the structure of prescribed service tariffs will change and how this would be compliant with pricing order requirements, including:

- how the Port has estimated its stand alone and avoidable costs and how this complies with the upper and lower bound pricing rules in clause 2.1.1(b)
- if different tariffs are charged to different port users for the same or similar services, how these would comply with the objectives of the regime and the relevant clauses of the Pricing Order, as per clause 2.1.2
- how the Port has had regard to the efficient costs caused by port users, transaction costs and the extent to which port users will be able to respond to price signals, as per clause 2.1.3.

Clause 3.2.5 of pricing order requires the Port to consult with port users on its rebalancing application proposals and to provide them with a reasonable opportunity to express their views. A failure to comply with this clause may be relevant to whether the Port has provided sufficient supporting information, and whether the commission is able to satisfy itself that the proposed prescribed service tariffs comply with clauses 2, 3.1.1, 4 and 5 of the pricing order.

We will publish our final rebalancing application decision on our website

We are required to write to the Port after completing a review and inform them of our final decision in relation to their rebalancing application. If we reject the Port's rebalancing application, we must provide our reasons for this decision.⁵⁹ We consider it is in the interest of port users to have access to the reasoning of these decisions and we intend to publish any final rebalancing application decision on our website.

⁵⁹ Pricing Order 2016, clauses 3.2.18 and 3.2.20.

2.4. Determining the form and content of supporting information

2.4.1. Pricing Order requirements

Under clause 9.1.1 of the Pricing Order, we may issue a determination of what constitutes sufficient supporting information for us to:

- be satisfied that the Port's tariff compliance statement has complied with the Pricing Order⁶⁰
- assess a rebalancing application and verify whether those tariffs comply with other clauses in the Pricing Order⁶¹
- assess an application for the cessation of clause 3, which includes the tariffs adjustment limit and price rebalancing provisions⁶².

The Pricing Order requires the Port to provide any information we specify in a 'sufficient supporting information' determination.

2.4.2. Guidance on form and content of supporting information

The Pricing Order places a range of obligations on the Port to provide us with information. In this statement we indicate our expectations about information provision on particular matters.

We will consider exercising our legislative power to specify the form and content of sufficient supporting information if it aids the demonstration of compliance or helps target our assessment of compliance.⁶³ There is no statutory time limit by which information determinations must be issued. The timing of this will depend on our experience in the early years of the regime as we assess and potentially identify gaps in the Port's information provision.

⁶⁰ Pricing Order 2016, clause 7.1.2 (f).

⁶¹ Pricing Order 2016, clause 3.2.7, which further refers to clauses 2, 3.1.1, 4 and 5.

⁶² Pricing Order 2016, clause 3.3.2.

⁶³ As noted earlier in the Statement, we used our legislative powers to issue section 56 Notices to seek information from the Port during our 2021 inquiry.

3. Guidance on process requirements in the Pricing Order

The Pricing Order imposes a range of obligations on the Port to follow certain processes. In this chapter, we discuss some key regulatory process requirements in the Pricing Order and provide guidance on these processes.⁶⁴ These include:

- calculating weighted average tariff increases
- treatment of contract revenue
- consultation and customer engagement
- forecasting and information provision.

In Chapter 4, we separately provide guidance on demonstrating compliance with the accrual building block methodology and related provisions of the Pricing Order, including cost allocation and the regulatory period.

3.1. Calculating the weighted average tariff increase

3.1.1. Pricing Order requirements

The Port is required to set its tariffs for prescribed services in line with the tariffs adjustment limit, which is a requirement that weighted average tariff changes do not exceed the percentage change in the annual consumer price index.⁶⁵ The Port must calculate the percentage weighted average tariff increase to demonstrate that its weighted average tariff increase for prescribed services does not exceed the tariffs adjustment limit.⁶⁶

The Pricing Order defines weighted average tariff increase as:⁶⁷

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

⁶⁴ This is a non-exhaustive list and reflects our experience with the Port's tariff compliance statements to date.

⁶⁵ Pricing Order 2016, clause 3.1.1.

⁶⁶ Pricing Order 2016, clause 3.1.1.

⁶⁷ Pricing Order 2016, clause 14.

weighted average rate of increase on this basis, an alternative estimate of revenue for the purpose of calculating weightings on a basis determined by the commission.

The tariffs adjustment limit requirement will continue to apply for price adjustments made during the initial period of the lease, which is up to the end of the twentieth year from when the Pricing Order commenced (expiring on 30 June 2037). The Port may apply to the commission after 30 June 2032 (at the end of the fifteenth year after the Pricing Order commencement date) to seek an earlier cessation of the tariffs adjustment limit.⁶⁸

3.1.2. Guidance on compliance with tariff increase requirements

In showing compliance with the tariffs adjustment limit, the Port should provide models showing its calculation of the weighted tariff increase in a format where all formulas are visible and data sources identified.

If there is no audited data available for the most recent financial year to calculate the expected weighted average rate of increase, the Port should use audited revenues from the most recent year for which audited data is available for the purpose of calculating weightings. For the purpose of presenting the weighted average tariff increase, we suggest the Port round all tariffs to four decimal places.

Where a tariff rebalancing application seeks to introduce a new prescribed service tariff and we have approved the application, there will not be any audited historical data for the new tariff for the purposes of calculating the weighted average tariff increase for the next financial year. In this instance, we would expect the Port to:

- identify the previous prescribed service tariff that customers have been moved from
- identify a reasonable estimate of demand associated with the new prescribed service tariff based on the number of existing customers it has moved on to the new tariff
- justify the reasonableness of the demand forecast used to derive the revenue used in the weighted average tariff increase calculation and identify how this meets the Pricing Order and the objectives of the regulatory regime.

⁶⁸ Pricing Order 2016, clause 3.3.5.

3.2. Assessing contract revenues

3.2.1. Pricing Order requirements

Prescribed services may be provided under the standard terms and conditions in the Port's reference tariff schedule or negotiated under contract. Clause 6.2 of the Pricing Order sets out the conditions under which the Port may enter into contracts to provide prescribed services on terms that differ from those in the Port's reference tariff schedule.

The Port may enter into a contract with port users to provide prescribed services on terms and conditions that differ from those in the reference tariff schedule if, amongst other things:⁶⁹

- it has offered to provide prescribed services in accordance with its reference tariff schedule⁷⁰
- the prices in the contract provide the Port with a reasonable opportunity to recover the efficient cost of providing prescribed services⁷¹
- the prices in the contract for prescribed services are no lower than their avoidable cost and no higher than their standalone cost⁷²
- the prices in the contract comply with the export pricing decision.⁷³

In addition to these requirements, the Pricing Order provides that revenue from prescribed services provided under contract must be included in the port licence holder's calculation of its aggregate revenue requirement.⁷⁴

3.2.2. Guidance on contract revenue

For the purpose of showing compliance with the tariffs adjustment limit, we expect contract revenue should be excluded from the weighted average tariff increase calculation. Any revenue generated from prescribed services under contract must be included in the Port's calculation of its aggregate revenue requirement.⁷⁵

To demonstrate compliance with clause 6.2, we expect the tariff compliance statement to show:

- how the Port offered to provide port users prescribed services in accordance with the Port's reference tariff schedule as a first option before negotiating contracts

⁶⁹ Pricing Order 2016, clause 6.2.1(a).

⁷⁰ Pricing Order 2016, clause 6.2.1(c).

⁷¹ Pricing Order 2016, clause 6.2.1(d).

⁷² Pricing Order 2016, clause 6.2.1(d).

⁷³ Pricing Order 2016, clause 6.2.1(d).

⁷⁴ Pricing Order 2016, clause 6.2.2(b).

⁷⁵ Pricing Order 2016, clause 6.2.2(b).

- how the contracted terms and conditions outlined in the contract comply with the prescribed service tariff pricing principles as required in clause 2 of the Pricing Order
- how the Port has accounted for contract revenue.⁷⁶

3.3. Customer consultation requirements

3.3.1. Pricing Order requirement

A key requirement for the Port in preparing its tariff compliance statement is to set out the process it undertook to effectively consult port users and that it has had regard to their comments.⁷⁷

3.3.2. Guidance on customer consultation

The onus is on the Port to demonstrate that it has consulted effectively with port users and had regard to the comments provided by port users. We consider that for effective consultation to take place, the Port should provide sufficient information and reasons for proposals to ensure party/ies consulted are adequately informed and able to make intelligent and useful submissions and responses to Port's proposals.

We will assess the Port's consultation process in relation to their tariff compliance statement and inquire into whether in fact that consultation represents effective consultation and whether the Port has had regard to the comments provided by port users. The Port needs to demonstrate that it made a genuine effort in consulting with port users and the stakeholders. The Port should show how it has conscientiously taken into account port users' responses, and how the final decision was made taking the responses into genuine consideration. This entails being willing to be flexible in its plan as the consultations progresses.

To demonstrate compliance with the Pricing Order we expect the Port's tariff compliance statement to provide:

- details of its consultation process with port users
- issues raised and feedback provided by port users
- how the Port has taken into account the views of port users when making decisions.

We note that the Port has undertaken in its Pricing Order Engagement Protocol,⁷⁸ to apply the International Association for Public Participation 2 (IAP2) Quality Assurance Standards in its

⁷⁶ Pricing Order 2016, clause 6.2.2(b).

⁷⁷ Pricing Order 2016, clause 7.1.2(d).

⁷⁸ Developed consistent with the voluntary undertaking given by the Port under section 49M of the Port Management Act 1995, and accepted by the Assistant Treasurer on 20 May 2022, to address the commission's findings in its 2016–2021 inquiry of non-compliance by the port of pricing order requirements for consultation with port users in preparing certain tariff compliance statements.

approach to port user consultation where it is not inconsistent with the requirements of the regulatory framework. These provide a set of standards the International Association for Public Participation consider can be used to measure any engagement process against what the Association considers are best practice principles for effective community engagement.

We support application of the IAP2 Quality Assurance Standard, which adopts the IAP2 Core Values as the principles upon which to define quality throughout the process of community and stakeholder engagement.⁷⁹ These define high level and internationally accepted expectations and aspirations for effective public consultation processes. We consider the Port should have regard to this when developing and implementing its consultation processes.

In our 2016–2021 inquiry review, we found that the Port had not demonstrated effective consultation nor shown that it had regard to port users’ comments in its 2020–21 tariff compliance statements. This non-compliance was found to be significant and in a sustained manner. We consider “had regard to” means that the Port must demonstrate the product of consultation must be conscientiously taken into account when the ultimate decision is taken.

In light of this, we will be guided by the following principles in assessing Port’s compliance with the consultation requirements of the pricing order.⁸⁰ The Port:

- should start engagement early in its planning of projects, programs, and other initiatives. The engagement should be ongoing, to keep testing proposals with port users and stakeholders.
- should ensure engagement process prioritise matters that have a significant impact on the Port’s services and prices.
- should demonstrate that the engagement is genuine and clearly communicate the level of influence stakeholders will have on the decision
- should tailor the form of engagement to suit the content on which it is seeking to engage, and to the circumstances facing port users and stakeholders.
- should provide participants in its engagement process with appropriate information, given the purpose, form and the content of the engagement.

⁷⁹ We support the Port adopting the IAPs Quality Assurance Standards, to the extent they are consistent with the regulatory framework, for its approach to consultation. We consider that adopting and applying these Standards should go a long way to facilitating and supporting the Port in meeting its pricing order consultation obligations. We however note that whether the Port has met its pricing order obligations in any particular circumstance, is a legal question that will be reviewed on a case-by-case basis.

⁸⁰ We note that the Port has submitted the Final Pricing Order Engagement Protocol to the Assistant Treasurer on 27 October 2022 as per the provisions of the Undertaking. It also includes the Port’s commitment to apply the IAP2 Quality Assurance Standard for Community and Stakeholder Engagement.

- should demonstrate how stakeholder feedback has influenced its decisions, including communicating to participants how their input influenced the decision.

3.4. Forecasts and information provision

3.4.1. Pricing Order requirements

The pricing order requires that information in the nature of an estimate or forecast must be supported by a statement of the basis of the forecast or estimate.⁸¹ A forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.⁸² It also requires that information in the nature of an extrapolation or inference must be supported by the primary information on which the extrapolation or inference is based.⁸³

3.4.2. Guidance on forecasts

The pricing order requires the Port to determine its aggregate revenue requirement through the application of the building block methodology. The building block methodology requires the use of forecasts and estimates on items including expenditure data, demand projections and forward looking assumptions regarding the consumer price index.

In assessing compliance, we will focus on whether the Port's forecasts or estimates are transparent, replicable, and are able to be traced back to primary information.

The Port should explain its forecast methodology, assumptions underlying the methodology, why the assumptions are reasonable, and the data underlying the forecasts. We encourage the Port to provide attestations verifying that its submitted information is fit for purpose or best fit.⁸⁴

If forecasts are based on consultants' reports, these reports should be provided to us with any confidential information clearly identified. We expect the models and data underlying consultants' forecasts to be provided.

⁸¹ Pricing Order 2016, clause 8.2.1.

⁸² Pricing Order 2016, clause 8.2.2.

⁸³ Pricing Order 2016, clause 8.3.1.

⁸⁴ We found in our 2022 complaints investigation that the Port's forecasts of average ship sizes calling at the port were simplistic. However, we considered that adopting more complex forecasting methods would not have changed the outcome of the decision, and therefore concluded that the Port's assumptions were reasonable and represent the best estimate possible in the circumstance for the purposes of compliance with clause 8.2 of the Pricing Order.

4. Guidance on compliance with the accrual building block methodology

This chapter provides guidance on key requirements in the pricing order for applying the accrual building block methodology and how the Port should demonstrate compliance. We also discuss how we expect to assess the Port's compliance with these requirements.

4.1. Capital base roll forward

4.1.1. Capital base roll forward Pricing Order requirements

The Port must calculate the value of the capital base on a 'roll forward basis' as specified in clause 4.2.1 of the pricing order. Specifically, the Port is required to define its capital base at any particular time by:

- taking the starting value of the capital base at the beginning of a financial year⁸⁵
- adjusting the capital base for the effect of inflation⁸⁶
- adding efficient capital expenditure that has been, or will be, prudently incurred during that financial year:
 - efficient capital expenditure is assumed to be incurred halfway through the financial year and adjusted for inflation⁸⁷
 - capital expenditure on the Port Capacity Project⁸⁸ may be added if it is efficient⁸⁹
 - public sector capital contributions must not be included in the capital base⁹⁰
- deducting depreciation expenses.⁹¹

⁸⁵ Pricing Order 2016, clause 4.2.1(a).

⁸⁶ This is calculated as the percentage change, or forecast percentage change, in the consumer price index for that financial year multiplied by the value of the capital base at the beginning of that year. Pricing Order 2016, clauses 4.2.1(b) and 4.6.1(a).

⁸⁷ This is done by multiplying new capex by half the percentage change in the consumer price index for that financial year. Pricing Order 2016, clause 4.2.1(c).

⁸⁸ The Port Capacity Project significantly expands the capacity of the Port's container and automotive terminals. It includes a reconfiguration and redevelopment of Webb Dock East to include a new third international container handling facility (now operated by the Victorian International Container Terminal) and a new automotive terminal.

⁸⁹ Pricing Order 2016, clauses 4.2.3 to 4.2.5.

⁹⁰ Pricing Order 2016, clause 4.2.6.

⁹¹ Pricing Order 2016, clause 4.2.1(d).

4.1.2. Guidance on the roll forward

The roll forward refers to an equation used to calculate the value of the Port's capital base over time. In a building block model, the value of the capital base is a key input into determining the aggregate revenue requirement. The depreciation and return on capital building blocks are both calculated using the value of the capital base.

The Port should submit its roll forward model as part of its tariff compliance statement. The model should be unlocked and include all formulas underlying the roll forward calculations. Calculations should be in a format where all formulas are visible and data sources identified.

We may review inputs underlying the calculations. For example, capital expenditure should reflect the prudent and efficient capital costs of the Port, and depreciation should only recover the capital base costs once over the Port lease term.

Our role during a compliance inquiry will be to assess only the capital expenditure that is included in tariff compliance statements and the roll forward model that falls within the compliance inquiry review period. As a general proposition, the consequence of this is that forecast capital expenditure included in the roll forward model provided by the Port to the commission and published by 31 May for the financial year that commences one day after the inquiry period ends, will not be subject to commission scrutiny during the inquiry.

This means the tariff compliance statement published by the Port on or by 31 May 2026 for tariffs in the reference tariff schedule to apply in financial year 2026-27 will not form part of the investigation for the inquiry period 1 July 2021 to 30 June 2026. Instead, that data and information for 2026-27 will typically only form part of the subsequent inquiry period.

Guidance on adjusting for disposals and contributions

We expect the Port to account for asset disposals and contributions in its capital base roll forward.

For all years where actual data is available, we expect the Port will record actual disposals and contributions for each asset class defined in the Port's roll forward model. If the value of contributions and disposals is zero, the roll forward model should confirm this. For years where actual data is not available, we expect the Port to provide forecasts or estimates.

Where deductions for disposals are made, we expect the Port to use a consistent approach to valuing those assets.⁹²

⁹² Two approaches to valuing asset disposals are commonly used. A regulatory value approach would remove the regulatory value of the asset from the capital base, while a disposals value approach would remove the market value (sale price) of the asset.

Guidance on the use of actual or forecast depreciation

The Port may use actual or forecast depreciation to roll forward its capital base.

However, we expect the Port to nominate at the beginning of a regulatory period whether it has used forecast or actual depreciation when calculating its roll forward capital base for the next regulatory period. It must continue to apply that depreciation method for the duration of the regulatory period and when subsequently performing the roll forward for that period.

4.2. Capital expenditure

4.2.1. Capital expenditure Pricing Order requirements

The Pricing Order requires that actual or forecast capital expenditure that is added to the capital base be efficient and reflects prudent actions.⁹³

Clause 4.2.1 of the Pricing Order serves the objectives of the Port Management Act and the Essential Services Commission Act by ensuring that prescribed service prices are fair and reasonable and promote the long term interests of Victorian consumers.

4.2.2. Guidance on capital expenditure

We consider prudent and efficient capital expenditure to have the following characteristics:

- is based on robust asset planning, management and governance practices
- is based on sound forecasting methodologies including, where relevant, market tested cost inputs and reliable escalation indexes
- contingency allowances that are transparent and have considered actual outcomes from recent capital works
- contractual agreements with service providers have been designed to manage project delivery risks.

We expect the Port's tariff compliance statements will provide supporting information demonstrating how capital expenditure is prudent and efficient. Demonstrating compliance may include, among other things:

- providing evidence of the prudence of investment governance and asset management processes
- explaining how the Port's procurement and project delivery processes are consistent with efficient cost outcomes, including any inbuilt incentive arrangements

⁹³ Pricing Order 2016, clause 4.2.1(c).

- for actual capital expenditure, explaining how and why the actual expenditure has differed from the forecasts provided in any previous tariff compliance statement
- submitting its capitalisation policy
- providing trend or productivity assessments
- benchmarking, activity-based costing and unit rate analysis
- providing independent forecasts of demand and input price escalation.

Where capital expenditure is relatively low, or stable, simplified analysis such as trend analysis by capital expenditure category, combined with an overview of asset management governance procedures, may suffice.

However, where expenditure is considered material or lumpy, more detailed review may be required, which could include review of large capital works and forecasting methodologies used in preparation of capital forecasts. We would expect the Port to demonstrate:

- sufficiently detailed business cases
- appropriate management of risk between the Port and port users through its cost estimation and procurement processes.
- risks of project delays and cost overruns are managed through contractual agreements with service providers
- its project/s meets the objectives of s48 of the Port Management Act
- forecast capital expenditure for renewals incorporates expectations for a reasonable rate of improvement in cost efficiency

Where capital projects are not fully scoped, costed or internally approved (via an approved business case, for example) at the time of preparing the tariff compliance statement, the Port should explain how it ensured port users are not asked to bear the full cost should the project scope or timing change. For example, this may include optimising contingency allowances.

Interactions between service quality and capital expenditure

To demonstrate the prudence of capital expenditure, we expect the Port to provide the service performance outcomes its forecast and actual expenditures are intended to deliver. The Port should work with port users to identify and create metrics for the service performance outcomes they value most.

Once these outcomes and metrics have been established, we expect the Port to include in its tariff compliance statements:

- the forecast service performance outcomes the Port intends to deliver
- the actual service performance outcomes delivered over the prior period.

4.3. Return on capital

4.3.1. Return on capital Pricing Order requirements

The Port's aggregate revenue requirement must include an allowance to recover a return on its capital base that is:

commensurate with that which would be required by a benchmark efficient entity providing services with a similar degree of risk as that which applies to the Port Licence Holder in respect of the provision of the Prescribed Services.⁹⁴

In determining the return on capital building block, the Port must use:

one or a combination of well accepted approaches that distinguish the cost of equity and debt, and so derive a weighted average cost of capital.⁹⁵

The Pricing Order specifies that the return on capital be determined on a pre-tax, nominal basis.⁹⁶

4.3.2. Guidance on return on capital

Guidance on well accepted approaches

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. A 'well accepted approach' is one that is widely accepted as appropriate for use when determining the weighted average cost of capital for a firm for the purposes of calculating a revenue requirement.⁹⁷ There are various elements and parameters that make up the rate of return—measured by the weighted average cost of capital—and we outline later in this section what we considered was a 'well accepted' approach to estimating and implementing these parameters when we undertook our 2016–2021 inquiry.

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

⁹⁴ Pricing Order 2016, clause 4.1.1(a).

⁹⁵ Pricing Order 2016, clause 4.3.1.

⁹⁶ Pricing Order 2016, clause 4.3.2.

⁹⁷ Essential Services Commission 2021, Inquiry into the Port of Melbourne compliance with the pricing order: final report, 31 December, p.37.

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.

Guidance on returns commensurate with those required by a benchmark efficient entity

To demonstrate that its returns are commensurate with those that would be required by a benchmark efficient entity, we expect the Port to show that:

- the return on capital it has determined reflects the risk characteristics of a benchmark efficient entity providing the prescribed services. This would entail, amongst other things, demonstrating that any comparator firms used by the Port to estimate the return on capital are sufficiently comparable to the benchmark efficient entity and, where differences exist, these differences have been accounted for and explained appropriately when determining the return on capital.
- the Port has used appropriate techniques and methods to estimate the return on capital.

Guidance on relevant risk characteristics

We consider that the relevant risk characteristics of the services provided by the Port, for the purpose of identifying comparators to estimate the return on capital that would be required by a benchmark efficient entity, include that the prescribed services:

- relate primarily to the provision of wharfage and channel access services
- are provided by a port that predominantly derives revenue from services to container cargo, with a smaller share of bulk and non-bulk cargo
- are provided by a port in Australia
- are unlikely to face significant competition in the short to medium term.

The benchmark efficient entity need not be defined as being either a regulated or unregulated entity. Rather, the appropriate benchmark is an entity that is 'efficient'. This efficiency should be that expected in a workably competitive market.

Guidance on selection of comparators

We note that no firms in Australia supply services having all of these characteristics. As a result, we recognise that the Port may need to use comparator firms that supply services which do not have all of these characteristics. We would expect any comparators used to estimate weighted average cost of capital parameters would have risk characteristics as close as possible as those faced by the Port. We would expect the Port to provide reasoning for its use of comparators and how their risk characteristics have been interpreted and adjusted to calculate its statistical estimates of equity beta (and gearing).

Guidance on estimation techniques

We will assess whether the Port has used appropriate techniques and methods to estimate the return on capital. Therefore, we would expect the Port to:

- justify the techniques and models it has used to estimate the return on capital, including that the techniques and models used do not produce biased estimates of the return on capital
- demonstrate that it has accounted for estimation uncertainty appropriately (for example, by where appropriate, presenting ranges for individual weighted average cost of capital parameters and the overall return on capital, and justifying the reasonableness of any point estimates chosen from within such ranges)
- justify the reasonableness of the overall return on capital used to calculate the aggregate revenue requirement
- explain any changes in approach the Port has adopted over time.

Guidance on our approach

We intend to apply a three-step process to assess whether the Port has complied with the requirements of the pricing order and the objectives of the regulatory regime:

We will assess whether the approach or approaches used by the Port to determine the allowed rate of return are 'well accepted'. We refer to this as the 'well accepted test'. In order to apply this test, we will consider the approach or combination of approaches used by the Port in light of the considerations set out above under 'guidance on well accepted approaches' and our findings from our 2016–2021 inquiry.

If the Port has used an approach or approaches that are well accepted and appears to have used appropriate inputs in applying the approach or approaches, it is likely that the Port will have passed the well accepted test, and the Port may be compliant with the requirements of the Pricing Order.

If the Port has not used an approach or approaches that are well accepted, then the Port will not be compliant with that particular requirement of the Pricing Order.

If the Port has passed the well accepted test, then we would assess whether the return on capital outcomes determined by the Port, when calculating the aggregate revenue requirement, are commensurate with the return required by a benchmark efficient entity with a similar degree of risk as that which applies to the Port in respect of providing prescribed services. We refer to this as the '*benchmark efficient entity test*'. We would apply this test using two steps.

We would undertake high-level cross-checks to assess if the overall return on capital used by the Port is likely to be commensurate with the returns that would be required by a benchmark efficient entity. Examples of the types of the high-level cross-checks that we may use are set out in Appendix A. If these cross-checks indicate that the return on capital used by the Port is

commensurate with the returns that would be required by a benchmark efficient entity, then the Port is likely to be considered compliant.

If the cross-checks suggest that the return on capital used by the Port is not commensurate with the returns that would be required by a benchmark efficient entity, then we would likely go on to identify specific areas of potential concern—for example, individual parameter estimates that may have been over-estimated or under-estimated, or the way in which estimates have been combined to determine the overall rate of return—for further investigation.

We will also assess whether the Port's approach is consistent with the pricing order and the objectives of the regulatory regime. If we identify specific areas of concern with the Port's estimate of the return on capital, we may do further, focused analysis in those specific areas to assess in further detail if the Port's return on capital complies with the requirements of the pricing order.⁹⁸

Well accepted approaches to estimating the rate of return in our 2016–2021 inquiry report⁹⁹

The below are our views of 'well accepted' approaches to estimating and implementing the Port's rate of return when we undertook our review of the Port's compliance with the pricing order over the period 2016–2021. We consider that if the Port applies these approaches, it will be compliant with our views of 'well-accepted' approaches.

If new information or material emerges before our next five-yearly review and our views of well accepted approaches change based on that new information or material, we will use our preliminary or interim commentaries to outline our views prior to the next five-yearly review. We will consult with the Port and revise our statement of regulatory approach v3.0 to reflect any new views of well-accepted approaches. Changes in regulatory practice tend to evolve over the course of several years as they are proposed, consulted upon, tested and ultimately adopted or not by practitioners in the area of economic regulation. As such, we do not anticipate that any changes in view as to what is well-accepted will occur quickly. As a consequence of the building block methodology the Port is required to apply pursuant to clause 4.1 of the Pricing Order, any new views of well-accepted approaches reflected in a

⁹⁸ For examples of detailed analysis which we may undertake, see: Feedback on consultation and other matters: Statement of regulatory approach version 1.0.

⁹⁹ Recommendations from our 2021 compliance inquiry were included in the 2022 undertaking the Port agreed to with the Assistant Treasurer.

revised statement of regulatory approach will be relevant to the Port's weighted average cost of capital from the beginning of a new regulatory period.¹⁰⁰

Implementation methodologies

The Sharpe-Lintner capital asset pricing model represented a 'well accepted approach' to estimating a rate of return. Giving weight to the Fama-French or Black CAPM estimation models for calculating WACC was not considered a 'well accepted approach' in economic regulation.¹⁰¹

Risk free rate

The risk free rate is the return that investors can receive in a riskless asset. It is an input into the Sharpe-Lintner capital asset pricing model used to estimate the cost of equity and the cost of debt.

The use of a 10-year Commonwealth Government bond and an averaging period between 20 and 60 days as a proxy for the risk free rate was a 'well accepted approach'. Implementing the averaging period close to the commencement of the regulatory period satisfied the 'well accepted' criterion.¹⁰²

Market Risk Premium

The Market risk premium (the premium) is the minimum return above the risk free rate that an equity investor would require in order to invest capital in a diversified portfolio of assets in the economy.

It is estimated with reference to total market returns. Approaches to derive the premium include Historic Excess Returns, the Wright method and Dividend Discount Models. The premium should also be estimated in a manner consistent with the approach to estimating gamma.

¹⁰⁰ For example, the Port may apply the well accepted approaches set out in the statement of regulatory approach V3.0 to estimate its weighted average cost of capital for a fixed five year regulatory period. If during this regulatory period our view of well-accepted changes and our statement is updated to reflect our changed views (after consulting with the Port), we will apply our revised view to the Port's weighted average cost of capital from the beginning of a new regulatory period when assessing compliance with the pricing order. This recognises that during a regulatory period, the Port is required to apply a building block methodology over that regulatory period which necessarily involves the adoption of a return on capital approach that is fixed for that regulatory period (although with the potential ability for the value of individual parameters to vary according to a stated methodology during that period). The Port will have the opportunity to consider and update its estimation of the weighted average cost of capital to reflect any changed view of well accepted approaches to apply to the building block methodology at the commencement of any new regulatory period.

¹⁰¹ Essential Services Commission 2021, Inquiry into the Port of Melbourne compliance with the pricing order: final report, 31 December, p. 47.

¹⁰² Essential Services Commission 2021, Inquiry into the Port of Melbourne compliance with the pricing order: final report, 31 December, p. 50.

We considered the Wright approach is not 'well accepted', based on recent regulatory experience in Australia.

Most regulatory precedent places greatest emphasis on the Historic Excess Return method, which we considered did not satisfy the 'well accepted approach' test. Implementation of this method depends on the data sources and averaging (time) periods adopted.

There are numerous ways to estimate the output of a Dividend Discount Model, including considering other regulators' estimates of this parameter. To avoid extreme or outlier values having a large impact on the output of this model, we considered that using the median, instead of the mean, of other regulators' estimates was a 'well accepted' approach to deriving a Dividend Discount Model estimate.

Beta

The beta measures systematic risk, or the degree to which an entity's returns are correlated with returns of the market as a whole. It is an input into the Sharpe-Lintner capital asset pricing model.

Determining a sample size of comparator firms is an important element of estimating beta for the benchmark efficient entity. The Port should give consideration to comparator firms that operate within the container ports sector and where practicable ports that operate within Australia.

Use of the FTSE Developed and Advanced emerging countries filter to obtain comparator container firms that operate in international markets was considered a 'well accepted' approach.

We considered that market capitalisation filters and specific industry sector filters can form part of the approach to arrive at a best estimate of beta. These filters should be applied consistently across the regulatory period, that is not varied from one year to the next where the Port chooses a regulatory period that exceeds one year.

The use of weekly data was considered a 'well accepted' approach to estimate beta.

Use of the Brealy-Myers formula for converting the equity beta of comparator firms into asset betas is considered a 'well accepted' approach.

Gearing

The level of gearing—or debt—should be estimated by using observed gearing of an appropriate comparator sample to determine benchmark gearing. This was considered a 'well accepted' approach.

Gamma

Gamma measures the value of imputation credits to equity investors to enable shareholders to offset tax liabilities. A utilisation approach using the equity ownership model to calculate gamma is considered a 'well accepted approach'. Other approaches, such as market valuation estimates and the zero-gamma approach were not considered well accepted approaches.

Given dividend imputation is almost unique to Australia, a 'well accepted' approach would involve assessing Australian regulators' approaches to estimating gamma.

Cost of Debt

The cost of debt is the sum of the risk-free-rate, debt risk premium and debt raising costs. The adoption of a corporate bond with a BBB credit rating with a 10-year term to maturity is considered a 'well accepted approach' to establishing the debt risk premium.

The use of a trailing average approach (with a transition period from the 'on the day' approach) for the averaging period was considered a 'well accepted approach' to establishing the cost of debt.

4.4. Depreciation (return of capital)

4.4.1. Depreciation Pricing Order requirements

The accrual building block methodology provides for a depreciation allowance (this is also called return of capital).

Clause 4.4 defines the default approach for depreciation as straight-line depreciation. The asset lives used to determine straight-line depreciation are either the reasonable economic lives of the assets¹⁰³ or the remaining term of the Port lease, whichever is shorter.¹⁰⁴

Clause 4.4.2 allows the Port to use different depreciation methods if either:

- the tariffs adjustment limit¹⁰⁵ prevents the Port from being able to recover the full amount of straight-line depreciation for that financial year (clause 4.4.2(a)), or
- a depreciation method, other than straight-line depreciation, would reduce the expected variance in prescribed service tariffs until the end of the Port lease (clause 4.4.2(b)).

¹⁰³ The 'reasonable economic life' of assets is not defined in the Pricing Order. The common regulatory meaning of economic lives is the expected period of time during which an asset will be used to provide regulated services. The economic life of an asset could be shorter than its actual physical life.

¹⁰⁴ Pricing Order 2016, clause 4.4.1.

¹⁰⁵ For up to the first 21 years of the port lease, the port must not increase its tariffs for prescribed services by more than the change in the consumer price index for the previous year.

In addition to this, the amount by which an asset is depreciated over its life must not exceed the value of the asset¹⁰⁶ and negative depreciation is also not permitted.¹⁰⁷ Our decision on depreciation in our 2016-2021 compliance inquiry considered that the pricing order does not rule out the amount of depreciation being zero.¹⁰⁸

4.4.2. Guidance on return of capital

How we assess depreciation will depend on the depreciation approach used by the Port. If the Port uses straight-line depreciation, our assessment will focus mainly on checking that the Port has correctly calculated its depreciation costs. However, if the Port uses a different method, we will also check how the Port proposes to allocate its depreciation costs over time. In particular we will check to see if a proposed depreciation approach reduces tariff variation compared to straight line depreciation and allows recovery of the capital base costs only once.

Guidance on straight-line depreciation requirements

If the Port is using straight line depreciation, we expect it will provide information on:

- the remaining economic asset lives of existing assets and the economic lives for new assets, how these compare to the accounting lives the Port has adopted for the same assets, and an explanation for any divergence
- the value attributable to assets (from which depreciation is calculated)
- the amount of depreciation applicable to each type of asset on a straight-line basis
- all forecast depreciation payments over the entire lives of its assets.

Guidance on different depreciation methods

If the Port is using a different depreciation method, in addition to outlining how it calculated its depreciation payments, we expect it to show how that method is consistent with the Pricing Order and objectives of the regulatory regime. It should also show how it consulted with port users on its proposed depreciation method.

In the case that the Port's different depreciation method defers depreciation, the Port should show how it will recover the deferred depreciation.

¹⁰⁶ Pricing Order 2016, clause 4.4.1(c).

¹⁰⁷ Pricing Order 2016, clause 4.4.3.

¹⁰⁸ Our decision considered that the practical effect of the tariffs adjustment limit may mean that no amount of depreciation can be recovered because the revenue it can collect is less than its aggregate revenue requirement (which includes the efficient level of depreciation costs) due to the tariffs adjustment limits constraint. Our decision on depreciation is confined to the depreciation that was proposed during the 2016-2021 review period.

If the Port uses a different depreciation method to defer depreciation because the tariffs adjustment limit constrains its revenues, we expect the Port will demonstrate that it cannot recover straight line depreciation in the applicable years.

4.5. Operating expenditure

4.5.1. Operating expenditure Pricing Order requirements

Clause 4.1.1 of the Pricing Order allows the Port to recover forecast operating expenses, commensurate with those required by a prudent service provider acting efficiently.¹⁰⁹

Forecast operating expenditure is to include the Port licence fee and any cost contribution amount payable under the Port concession deed in relation to the financial year in which those expenses are incurred. The Pricing Order deems this expenditure to be consistent with that which would be required by a prudent service provider acting efficiently.¹¹⁰

Actions reasonably required to comply with the obligations of the Port under the Port concession deed are taken to be prudent for the purposes of clause 4.1.1(c).¹¹¹

4.5.2. Guidance on operating expenditure

The Port's forecast operating expenditure should be reflective of a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes over the regulatory period.

We consider that a prudent and efficient operating expenditure forecast has the following characteristics:

- it is based on sound forecasting methodologies and is consistent with the capital expenditure forecasts
- economies of scale are realised from higher trade volume growth
- labour cost forecasts reflect realistic expectations that align to wage price indexes such as those provided by the Australian Bureau of Statistics
- material cost forecasts reflect realistic expectations that align to input cost indexes such as those provided by the Australian Bureau of Statistics
- ongoing productivity improvements are accounted for
- expenditure trends relative to actual historical expenditure are identified and any step increases or decreases in operating expenditure are fully explained and justified.

¹⁰⁹ Clauses 4.5.1 and 4.5.2 of the Pricing Order provide specific guidance for the commission and the Port on certain items for which expenditure is deemed prudent and efficient.

¹¹⁰ Pricing Order 2016, clause 4.5.1.

¹¹¹ Pricing Order 2016, clause 4.5.2.

Our approach to assessing operating expenditure will be guided by the materiality of the Port's forecast operating expenditure and how it compares to historical levels. Where operating expenditure is relatively stable, simplified analysis such as trend analysis is likely to suffice. Where a step change in operating expenditure is considered material, we may undertake a more thorough review of the Port's forecasting methodologies, assumptions and scope of services.

Guidance on operating expenditure

Many of the techniques used to show capital expenditure is prudent and efficient from Section 4.2 of this paper can be applied to operating expenditure.

We expect the Port to provide the forms of evidence and tools that are appropriate for showing compliance with the pricing order and the objectives of the regulatory regime are based on the nature and circumstances of its proposed operating expenditure. That is:

- the tariff compliance statement should directly address the key factors identified in the Statement of Regulatory Approach including related to:
 - a. methodology
 - b. productivity improvements, and
 - c. identifying and explaining trends and step-changes.
- once the business has reached a steady state of operations it is reasonable to expect that the Port would establish targets for specific productivity or efficiency improvements, and measure performance against those targets. Consideration could also be given to setting medium-term output-based measures that can be monitored over time.
- the tariff compliance statement should clearly and transparently identify the costs that have been capitalised and show forecast expenditure before and after capitalisation. This should be shown for each relevant cost category, as well as in total. A brief explanation of any change in capitalised costs between years should also be provided, as well as any changes in the capitalisation framework.
- expenditure requirements above the baseline year (adjusted for growth and efficiency improvements) are fully explained and justified.

Key principles we will consider when reviewing the baseline controllable operating expenditure include:¹¹²

- establish efficient recurring controllable costs from the last full year of actual data¹¹³
- remove any non-controllable expenditure

¹¹² Controllable costs are those that can be directly or indirectly influenced by the Port's operational decisions.

¹¹³ The efficient level of controllable costs from the last full year of actual data is established after a prudency and efficiency review, which for the Port occurs on expenditure already incurred every five years.

- remove any one-off or non-recurring expenditure items incurred in that year, or add any normally occurring items that did not occur in that year
- remove any further ongoing cost savings or efficiency commitments that will be realised in the final year of the current regulatory period.

Once the baseline controllable operating expenditure is determined, we will review the Port's forecast expenditure growth assumptions and annual cost efficiency improvement rate (for each year). The Port should also outline the relationship between any growth allowance to operating expenses and efficiency improvement rate.

4.6. Cost allocation

4.6.1. Cost allocation Pricing Order requirements

The pricing order requires the Port to allocate its costs between prescribed services and all other services in a manner consistent with the following cost allocation principles:¹¹⁴

- costs that are directly attributable to the provision of a prescribed service must be attributed to that prescribed service
- costs that are not directly attributable to the provision of a prescribed service, but which are incurred in the course of providing one or more prescribed services and other services, must be allocated to the prescribed service on the basis of its share of total revenue from all services provided by the Port.

4.6.2. Guidance on cost allocation

We consider the following information relevant to demonstrating compliance with the pricing order and the objectives of the regulatory regime:

- explanation of how the Port has implemented the cost allocation principles including the process for defining, capturing and attributing direct and indirect costs across the different prescribed and other services, and to each individual prescribed service
- explanation of any significant changes in the Port's cost allocation method
- showing in detail the cost allocation calculations in the models submitted with the annual tariff compliance statement
- relevant supporting information, including the underlying cost and revenue data supporting the Port's allocations and assurance processes applying to its cost allocation principles.

¹¹⁴ Pricing order 2016, clause 5.2.1.

4.7. Regulatory period

4.7.1. Regulatory period Pricing Order requirements

The pricing order provides that the Port may determine the period of time over which to apply the pricing principles and cost allocation principles.¹¹⁵ The Port is also allowed to adopt regulatory periods of different length over the term of the port lease.¹¹⁶

Towards the end of each regulatory period the Port re-applies the pricing principles and cost allocation principles to the subsequent regulatory period, to reset its aggregate revenue requirement and prescribed service tariffs (to apply in the first year of the subsequent regulatory period) in line with forecast efficient costs.

4.7.2. Guidance on the regulatory period

The Port should explain its reasoning and outline the factors influencing its choice of regulatory period. These factors may include the change in risks to the Port and port users from the adoption of a shorter or longer regulatory period, together with the incentives created by the change in the length of the regulatory period. We would expect the Port to address, for example:

- how its chosen regulatory period length will achieve the objectives of the regulatory regime
- comparative benefits of longer versus shorter regulatory periods to the Port and/or port users, including:
 - providing certainty for port users and stakeholders about the outcomes to be delivered and prices to be charged
 - providing a longer term view of the Port's proposed capital investments and, consequently, the services that may be provided to port users by those investments
 - demonstrating efficient compliance with the in-period tariff compliance statements and effective engagement with the stakeholders
 - avoiding unwarranted continuation of any non-compliance that we identify during a compliance review.¹¹⁷
- any implications of the length of the regulatory period for forecasts and estimates and in particular on the level of confidence that forecasts have been arrived at on a reasonable basis and are robust. This includes:

¹¹⁵ Pricing order 2016, clause 13.1.1.

¹¹⁶ Pricing order 2016, clause 13.1.1.

¹¹⁷ For example, a longer than one-year regulatory period will provide the Port sufficient time to review our findings and be efficient in adopting approaches to address them before starting the new regulatory period.

- ensuring adequate time for the Port to engage effectively and consider port users and stakeholder feedback in their decision making and forecasts.
- how the risks of the Port making forecast errors (for example, overestimating demand forecasts) are allocated between the Port and port users
- how to deal with the uncertainty of major unforeseen events that may affect its aggregate revenue requirement, noting that the pricing order does not provide for the typical uncertainty and unforeseen events found in regulatory instruments in other sectors (discussed further below)
- port users' views on the proposed length of regulatory period
- ensuring appropriate opportunity provided to port users to effectively consult with the Port during the proposed regulatory period.

The Port's choice of regulatory period should also consider promoting stability and predictability of tariffs for port users. To prevent the unnecessary continuance of any non-compliance that we identify during a specific compliance review, the timing of the start of each regulatory period is crucial. The Port should be guided by the interests of its stakeholders, particularly the Victorian consumers, when considering the length of regulatory period by addressing the five-yearly review results and resetting the aggregate revenue requirement as soon as feasibly practicable. This may mean that the Port's proposed length of regulatory period will not be aligned to the five-yearly review period.

When considering the Port's proposals and 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. The longer the regulatory period, the more difficult it will be to ensure that forecasts are accurate and the greater is the risk of cost over-recovery or under-recovery. We will also place considerable weight on port users' views on the length of regulatory period and how the feedback has been taken into account.

During a regulatory period

The Port should also consider whether it anticipates that its aggregate revenue requirement, and in turn, all or some of its tariffs, may require adjustment during the course of any regulatory period that exceeds one year in length, including for uncertain and unforeseen events, and how this might be managed. Our view is that the regulatory regime contained in the pricing order does not provide for pass-through events or for the reopening of the aggregate revenue requirement once it has been set at the commencement of the Port's regulatory period. The pricing order simply provides for the calculation of an aggregate revenue requirement at the commencement of the regulatory period based on forecast amounts with no mechanism to adjust revenue amounts for uncertain or unexpected events that might occur during the regulatory period.

Further, the regulatory regime does not provide for the calculation of the aggregate revenue requirement based on differences between forecast amounts and actual amounts in a previous regulatory period. That is, it does not provide for the carryover or carry-forward of such amounts from one regulatory period to a future regulatory period or periods. As such, we do not consider that the Port is permitted under the pricing order to use any deferred depreciation amount as an adjustable value or balancing item to recover amounts assessed to be prudent and efficient on an ex-post basis and to carry those 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 or restate the aggregate revenue requirement from the relevant regulatory period with a view to recovering amounts associated with those events in a future regulatory period or periods via the deferred depreciation amount.¹¹⁸

The pricing order does provide for the roll-forward of the capital base from one regulatory period to the next, whereby actual capital expenditure over the previous regulatory period is rolled into the capital base for the purpose of determining the aggregate revenue requirement in the subsequent regulatory period.

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 changing 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.

In our Statement of Regulatory Approach v3.0 we outlined that under the tariffs adjustment limit, we consider that the deferral 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 intended to be a reference 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. The ability to roll in actual capital expenditure at the commencement of a regulatory period provides a mechanism for recovery of efficient costs from the point at which those costs are added to the capital base.

Despite the above, some within period adjustments are provided for in the pricing order, such as the Port Licence Fee and Cost Contribution Amount payable under the Port Concession Deed.¹¹⁹ If

¹¹⁸ 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 section 49S of the Port Management Act 1995.

¹¹⁹ Clause 4.5.1 pricing order

these amounts differed from forecast amounts over a regulatory period, the pricing order indicates that there would be a recalculation of operating expenditure and aggregate revenue requirement, to provide for the actual amounts.

Another within period adjustment that may be allowed is the annual adjustment of the cost of debt based on the trailing average approach, as it is an update to the aggregate revenue requirement initially calculated based on the notional cost of debt at the beginning of the regulatory period.

We consider that there are likely to be benefits associated with regulatory periods that are longer than one or two years. In Australian regulatory regimes, such as those applying to gas and electricity networks, regulatory periods are typically in the order of five years.

The benefits of regulatory periods exceeding one or two years include:

- a more stable rate of return estimate relative to single year regulatory periods—that is, a rate of return estimate that does not vary significantly from year to year
- have the capacity to better draw out the properties of the building blocks framework as it incentivises the Port to outperform its expenditure and demand forecasts
- result in aggregate revenue requirements based on longer-term demand and expenditure forecasts
- reduces resourcing costs in the preparation of annual statements. For example, in a multi-year regulatory period a short tariff compliance statement, that is consistent with the pricing order requirements, may be more appropriate. This means that the Port will not need to reforecast its aggregate revenue requirement once the forecast has been set at the beginning of the regulatory period.

These factors, coupled with greater insight into the Port’s forward capital planning, could help to provide increased certainty for port users and support their longer-term investment decisions compared to rolling one-year regulatory periods.

Regulatory regimes that provide for regulatory periods greater than one year will often contain mechanisms that cater for events that can occur during a regulatory period which were, for some reason, not taken account of in the process of setting or determining allowed revenues or prices at the commencement of the regulatory period. Two such mechanisms that are found in a number of regulatory regimes in Australia are “pass-through events” and “reopeners”.

The primary difference between the two is that pass-through events allow prices or revenues to be adjusted throughout a regulatory period for specified events using specified formula, methodologies or approaches, and after following specified processes, and without recourse to changing the pricing determination. Reopeners involves a complete resetting of revenues and/or prices, and the making of a new price determination, following an event, the effects of

which are so material that the revenue or pricing determination process must be undertaken afresh.

Pass through events are generally events, or types of events, that may occur during a regulatory period, of which the timing or duration of impact may be uncertain or the expenditure associated with the event may be uncertain.

Due to this uncertainty, it can be undesirable to forecast expenditure associated with such events as part of the revenue or pricing determination made prior to the commencement of the regulatory period, as it may result in under-recovery of otherwise efficient expenditure (if the event occurs earlier than anticipated or costs more than expected) or over-recovery of otherwise efficient expenditure (if the event occurs later than anticipated (or not at all) or costs less than expected).

An example of a pass-through mechanism is that found in the commission's South East Water Determination 1 July 2018–30 June 2023, which provides that South East Water may apply to the commission for the amendment of the Determination and/or the adjustment of the scheduled prices to reflect increased or decreased costs incurred by South East Water and/or increased or decreased revenue received by South East Water as a result of events which were uncertain or unforeseen at the time the Determination was made (termed an “uncertain events application”).¹²⁰ The South East Water Determination provides some examples of uncertain and unforeseen events, which include: where actual licence fees or contributions payable by South East Water under various Victorian Acts, differ from the forecast licence fees; changes in the timing or scope of expenditure by South East Water on major capital projects; instances where there is a material difference between forecast demand levels and actual demand levels; and changes to regulatory obligations or taxes.¹²¹

Reopener provisions may be included in regulatory regimes to guard against the possibility of major events occurring, which would require a service provider to incur such significant amounts of expenditure above the original pricing and/or revenue determination, in response to the major events. That is, the service provider cannot be expected or required to respond to the event without a resetting of revenues and/or prices to allow for the expenditure required to respond to the event. In contrast to pass through mechanisms, which may operate several times during a regulatory period, a reopening would be expected to apply in a very rare event.

An example of a reopening provision is that which applies to electricity transmission networks under Chapter 6A of the National Electricity Rules. Clause 6A.7.1 provides that a transmission network service provider may apply to the Australian Energy Regulator to revoke and

¹²⁰ South East Water Determination 1 July 2018–30 June 2023, 29 May 2018, cl 4.1(a).

¹²¹ South East Water Determination 1 July 2018–30 June 2023, 29 May 2018, cl 4.2.

substitute a revenue determination that applies to it where an event that is beyond the reasonable control of the service provider has occurred (the occurrence of which could not reasonably have been foreseen at the time of the making of the determination), no forecast capital expenditure in relation to that event is included in the determination, and the service provider proposes to incur capital expenditure to rectify the adverse consequences of the event and the total of that expenditure in the regulatory control period exceeds 5 per cent of the value of the service provider's regulatory asset base.¹²²

The commission recognises that providing for pass-through events and reopening provisions in regulatory regimes can play an important role in supporting regulatory periods that exceed one year in length as they operate to manage the risk of such events arising.

If the Port considers it requires pass-through mechanisms or reopener provisions in order to adopt regulatory periods that are longer than one year, our view is that it is up to the Port to make the case for such mechanisms to Government. This would include addressing the circumstances that would permit a pass-through of amounts arising from uncertain or unforeseen events, or that would trigger a reopening or variation to the regulatory period.

A pass through or reopening mechanism could be designed to allow the Port to reopen components of the building blocks (which together set the aggregate revenue requirement) that are no longer reasonable (for example, it could allow for unexpected and material cost changes to be passed through to customers). It may also occur where the result of an unforeseen event (usually specified up front), causes the 'within period' effects to differ materially from what was intended when the aggregate revenue requirement was originally calculated.

¹²² National Electricity Rules, cl 6A.7.1.

Appendix A: High level cross-checks that we may employ

Our first step in assessing compliance of rate of return outcomes is to employ high-level cross-checks to assess whether the return on capital used by the Port is likely to be with the returns required by a benchmark efficient entity. Examples of the cross-checks that we may use include the following:

- Other regulatory decisions for similar industries, such as transport infrastructure primarily used for freight, or other industries with similar risk characteristics. Such regulatory decisions often set out detailed reasons and analysis and so are a rich source of information from which we may draw.
- Appropriately specified surveys of practitioners, with transparent methodologies, relating to particular market-wide¹²³ components of a weighted average cost of capital, or WACC, which can then be combined into an overall WACC point estimate or WACC range.
- Examination of the estimates of individual WACC parameters used by independent valuation experts, brokers and analysts in valuation reports. These valuation reports would ideally relate to firms with comparable characteristics to the Port. However, expert valuation reports that do not relate directly to comparable companies can still be useful for cross-checking market wide WACC components.
- Qualitative assessments of whether the systematic risk of the benchmark efficient entity is higher or lower than the systematic risk of the average firm in the market. If the benchmark efficient entity is assessed to be of lower risk than the average firm in the market, then the cost of equity used by the Port should be lower than the cost of equity of the average firm in the market, and vice versa.
- Assessment of whether the cost of debt used by the Port is less than the cost of equity—which should be the case for most firms, unless the firm is in financial distress.

¹²³ Market wide components are those not related to the individual characteristics of the benchmark efficient entity but relating to general economic conditions. For example, the market risk premium, risk-free rate or the value of imputation tax credits (also referred to as 'gamma').