



# Statement of Regulatory Approach – version 1.0

Port of Melbourne pricing order

December 2017



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# 1. Introduction

In 2016, the Victorian Parliament passed legislation enabling the Port of Melbourne's (the port) commercial operations to be leased to a private operator for 50 years. The port licence holder commenced operations on 1 November 2016.

A number of services provided by the port are 'prescribed services' for the purposes of the *Port Management Act 1995*. These include:<sup>1</sup>

- the provision of channels for use by shipping in Port of Melbourne waters
- the provision of berths, buoys, or dolphins in connection with the berthing of vessels in the Port of Melbourne
- the provision of short term storage or cargo marshalling facilities in the Port of Melbourne
- the provision of 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 the Port Management Act Regulations.

In setting its prices for the provision of prescribed services, the port is required to comply with requirements in the pricing order — a regulatory instrument made by the Governor in Council under section 49A of the *Port Management Act*.<sup>2</sup>

The *Essential Services Commission Act 2001* requires us to have regard to certain matters in performing our functions, including efficiency in the industry and the long term interests of Victorian consumers. Sections 11 and 13 of the *Essential Services Commission Act* enable us to:

- do all things necessary or convenient to be done in performing our functions so as to enable us to achieve the objectives<sup>3</sup> under the regulatory regime<sup>4</sup>
- publish statements and guidelines relating to performing our functions and exercising our powers.

These provisions enable us to communicate with stakeholders and to assist us to adopt a transparent and predictable approach.

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<sup>1</sup> Port Management Act, s. 49(c)

<sup>2</sup> The pricing order was designed and developed by the Victorian Department of Treasury and Finance.

<sup>3</sup> The objectives of the legislation are in the *Port Management Act 1995*, s. 48 and *Essential Services Commission Act 2001*, s. 8. We provide a summary of the legislative framework in; *Essential Services Commission 2017, Overview of the Port of Melbourne and Essential Services Commission's Regulatory Roles*, March.

<sup>4</sup> Throughout this guidance, 'regulatory regime' refers to the *Port Management Act 1995* and *Essential Services Commission Act 2001*.

## **1.1. Purpose and structure of this statement of regulatory approach**

The statement of regulatory approach sets out our compliance roles, and then provides guidance to the port on how it should demonstrate compliance with the pricing order, including through information provided in its tariff compliance statements.

Our guidance in this statement has been informed by stakeholder consultation and our experience in applying the regime so far when assessing the port's first tariff compliance statement. 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 where any amendment to this statement of regulatory approach is required.

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 and publishing our commentary on those statements
- 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,<sup>5</sup> 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 first commencing in 2021).

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 we will assess 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.

#### **Publishing interim commentary on the port's tariff compliance statements**

We will provide views on the port's tariff compliance statement by publishing interim commentary between the formal five-yearly inquiries. This will help the port and stakeholders to be aware of key issues or concerns in advance of our formal inquiries, and give the port an opportunity to take account of the issues we raise in their 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

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<sup>5</sup> Pricing order, clause 7.1.1

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:<sup>6</sup>

- 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 within six months of 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 46<sup>7</sup>).<sup>8</sup> 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.

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.<sup>9</sup> 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 prior to us preparing a final report on the inquiry.

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<sup>6</sup> Port Management Act 1995, s. 49I(1)

<sup>7</sup> 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.

<sup>8</sup> Port Management Act 1995, s. 49I(2)

<sup>9</sup> Port Management Act 1995, s. 49I(3)

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.<sup>10</sup> We must also include our reasons for those findings.

### **Our final report is appealable**

If our final report finds that the port has been non-compliant with the pricing order in a significant and sustained manner, the port may appeal that decision.<sup>11</sup> The only grounds for appeal are that the decision was not made in accordance with the law, or was unreasonable having regard to all the relevant circumstances.<sup>12</sup> The appeal will be heard by an ESC appeal panel, which comprises of three members chosen by the registrar<sup>13</sup> from a pool of persons appointed by the Governor in Council. The appeal panel may affirm our decision, vary our decision, or set aside our decision and remit it to us for amendment.<sup>14</sup>

### **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<sup>15</sup>, 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'.<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup>

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<sup>10</sup> Port Management Act 1995, s. 49I(4)

<sup>11</sup> Essential Services Commission Act 2001, s. 55(1)(d)

<sup>12</sup> Essential Services Commission Act 2001, s. 55(2)(e)

<sup>13</sup> The Registrar is defined in regulation 11 of the Essential Services Commission Regulations 2011 as the principal registrar of the Victorian Civil and Administrative Tribunal.

<sup>14</sup> Essential Services Commission Act 2001, s. 56(7)(e)

<sup>15</sup> 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.

<sup>16</sup> Port Management Act 1995, s. 49K(1)

<sup>17</sup> Port Management Act 1995, s. 49K(2)

<sup>18</sup> Port Management Act 1995, s. 49M

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).<sup>19</sup>

## 2.2.2. Guidance on conducting the five yearly inquiry

### We will consider information from a number of 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 will also take into consideration:

- 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)
- any other information we consider relevant to our inquiry.

### 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 context of the pricing order. 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 in light of any relevant facts and circumstances.

For the benefit of transparency and predictability, when assessing whether non-compliance is 'significant and sustained' during our formal inquiry, we may take into account:

- 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
- the adequacy and timeliness of the port's responses to any non-compliance that we have identified or raised

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<sup>19</sup> Port Management Act 1995, s. 49L(3)

- whether harm to port users or Victorian consumers is ongoing or whether the harm can be reversed (at all or retrospectively)<sup>20</sup>
- the future effects of the non-compliance, not just past impacts
- whether it may, or will, affect future prescribed service tariffs.

## 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 it submits a rebalancing application to us for approval.<sup>21</sup> If we approve 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.<sup>22</sup>

The port must submit a rebalancing application prior to 1 January for tariffs to apply in the upcoming financial year.<sup>23</sup> 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.<sup>24</sup>

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.<sup>25</sup> 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.<sup>26</sup>

After receiving a rebalancing application, we must notify the port of our intention to accept or reject the application before 1 March.<sup>27</sup> If we have not notified our interim decision by that date, we are

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<sup>20</sup> 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.

<sup>21</sup> Pricing order, clause 3.2.1

<sup>22</sup> Pricing order, clause 3.3

<sup>23</sup> Pricing order, clause 3.2.4

<sup>24</sup> Pricing order, clause 3.2.4

<sup>25</sup> Pricing order, clause 3.2.5

<sup>26</sup> Pricing order, clause 3.2.6

<sup>27</sup> 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

deemed to have given interim acceptance to the application.<sup>28</sup> In the event that we make an interim decision to reject the application, the port may submit an amended rebalancing application within 30 days.<sup>29</sup>

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 Statistic's 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.<sup>30</sup> We must notify the port of our final acceptance or rejection of their application within seven days of receiving the final rebalancing application.<sup>31</sup> If we do not notify the port of our decision, we are deemed to have accepted the application.<sup>32</sup>

### **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 outlined above, we consider it should be clear to the port prior to submitting an application what information we expect in order to assess the port's rebalancing application. We would expect the port to provide:

- information sufficient to demonstrate compliance with clause 2 (general pricing principles) and clause 3.1.1 (tariff adjustment limit) of the pricing order

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starting on the day we request further information and ending on the day the port complies. Source: Pricing order, clause 3.2.9.

<sup>28</sup> Pricing order, clause 3.2.8

<sup>29</sup> Pricing order, clause 3.2.13

<sup>30</sup> Pricing order, clause 3.2.15

<sup>31</sup> Pricing order, 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 (clause 3.2.19).

<sup>32</sup> Ibid.

- a comprehensive overview of its consultation process with port users about its rebalancing proposals including port users' views regarding the proposals.

We may issue a determination, detailing the form and content of sufficient supporting information required to be submitted as part of the rebalancing application.<sup>33</sup>

### **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. We expect the port to consult its port users on rebalancing proposals in a comprehensive manner 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.

### **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.<sup>34</sup> 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.

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<sup>33</sup> Pricing order, clause 9.1.1

<sup>34</sup> Pricing order, clause 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 order<sup>35</sup>
- assess a rebalancing application and verify whether those tariffs comply with other clauses in the pricing order<sup>36</sup>
- assess an application for the cessation of clause 3, which includes the tariffs adjustment limit and price rebalancing provisions<sup>37</sup>.

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 contains a range of obligations on the port to provide us with information.

We will consider exercising our 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. 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.

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<sup>35</sup> Pricing order, clause, 7.1.2 (f)

<sup>36</sup> Pricing order, clause 3.2.7, which further refers to clauses 2, 3.1.1, 4 and 5

<sup>37</sup> Pricing order, clause 3.3.2

## 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.<sup>38</sup> 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.<sup>39</sup> 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.<sup>40</sup>

The pricing order defines the weighted average tariff increase as:<sup>41</sup>

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

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<sup>38</sup> This is a non-exhaustive list and reflects our experience with the port's first tariff compliance statement.

<sup>39</sup> Pricing order, clause 3.1.1

<sup>40</sup> Pricing order, clause 3.1.1

<sup>41</sup> Pricing order, 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.<sup>42</sup>

### **3.1.2. Guidance on compliance with tariff increase requirements**

In showing compliance with the tariff adjustment limit, the port should provide models showing its calculation of the weighted average 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.

## **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

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<sup>42</sup> Pricing order, clause 3.3.5

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 if:<sup>43</sup>

- it has offered to provide prescribed services in accordance with its reference tariff schedule<sup>44</sup>
- the prices in the contract provide the port with a reasonable opportunity to recover the efficient cost of providing the prescribed services<sup>45</sup>
- the prices in the contract for prescribed services are no lower than their avoidable cost and no higher than their standalone cost<sup>46</sup>
- the prices in the contract comply with the export pricing decision.<sup>47</sup>

In addition to these requirements, the pricing order states 'revenue from prescribed services provided under contract must be included in the port licence holder's calculation of its aggregate revenue requirement'.<sup>48</sup>

### 3.2.2. Guidance on contract revenue

For the purpose of showing compliance with the tariff 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.<sup>49</sup>

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
- 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.<sup>50</sup>

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<sup>43</sup> Pricing order, clause 6.2.1(a)

<sup>44</sup> Pricing order, clause 6.2.1(c)

<sup>45</sup> Pricing order, clause 6.2.1(d)

<sup>46</sup> Pricing order, clause 6.2.1(d)

<sup>47</sup> Pricing order, clause 6.2.1(d)

<sup>48</sup> Pricing order, clause 6.2.2(b)

<sup>49</sup> Pricing order, clause 6.2.2(b)

### **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.<sup>51</sup>

#### **3.3.2. Guidance on customer consultation**

The onus is on the port to demonstrate that it has consulted effectively with port users. 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.

It is not our role to prescribe how the port should engage port users nor is it our role to consult port users on behalf of the port. It is the port's discretion to design its own engagement program according to its business requirements.

In assessing the port's compliance, we will be guided by the following questions:

- has the port's form of engagement been tailored to suit the topic on which it seeks to engage?
- has the port provided port users with appropriate information outlining the purpose, form and the content of the engagement?
- has the port provided port users with a reasonable opportunity to participate?
- does the port's engagement program give priority to matters that could have a significant impact on port users?

### **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.<sup>52</sup> A forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the

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<sup>51</sup> Pricing order, clause 7.1.2(d)

<sup>52</sup> Pricing order, clause 8.2.1

circumstances.<sup>53</sup> 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.<sup>54</sup>

### 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.

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.

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<sup>53</sup> Pricing order, clause 8.2.2

<sup>54</sup> Pricing order, clause 8.3.1

## 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 will 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 year<sup>55</sup>
- adjusting the capital base for the effect of inflation<sup>56</sup>
- 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 inflation<sup>57</sup>
  - capital expenditure on the port capacity project<sup>58</sup> may be added if it is efficient<sup>59</sup>
  - public sector capital contributions must not be included in the capital base<sup>60</sup>
- deducting depreciation expenses.<sup>61</sup>

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<sup>55</sup> Pricing order, clause 4.2.1(a)

<sup>56</sup> 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, clause 4.2.1(b) and 4.6.1 (a).

<sup>57</sup> This is done by multiplying new capex by half the percentage change in the consumer price index for that financial year. Pricing order, clause 4.2.1(c).

<sup>58</sup> 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.

<sup>59</sup> Pricing order, clause 4.2.3 to 4.2.5

<sup>60</sup> Pricing order, clause 4.2.6

### 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.

#### 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.<sup>62</sup>

#### 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. We also expect the port to be consistent in adopting its nominated approach when subsequently performing the roll forward for that period.

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<sup>61</sup> Pricing order, clause 4.2.1(d)

<sup>62</sup> 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.

## 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.<sup>63</sup>

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 interest 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
- for actual capital expenditure, explaining how and why the actual expenditure has differed from the forecasts provided in the 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.

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<sup>63</sup> Pricing order, clause 4.2.1(c)

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.

### 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.<sup>64</sup>

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.<sup>65</sup>

The pricing order specifies that the return on capital be determined on a pre-tax, nominal basis.<sup>66</sup>

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<sup>64</sup> Pricing order, clause 4.1.1(a)

<sup>65</sup> Pricing order, clause 4.3.1

<sup>66</sup> Pricing order, clause 4.3.2

### 4.3.2. Guidance on return on capital

#### Guidance on well accepted approaches

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

- the approach or combination of approaches must be well accepted for the purpose of setting an allowed return for use within an accrual building block methodology
- a view on the meaning of ‘well accepted’ that would be consistent with the regulatory regime would be approaches that are accepted by those entities that normally determine the inputs to an accrual building block methodology – that is, economic regulators<sup>67</sup>.

We further consider that:

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

#### 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

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<sup>67</sup> Or review bodies that have the task of overseeing the decisions of economic regulators, such as the Australian Competition Tribunal.

- 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 the 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 presenting ranges for individual weighted average cost of capital parameters and the overall return on capital, and justifying the reasonableness of the point estimates chosen from within these 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 compliance with the accrual building block methodology

## 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:

1. First, we will assess whether the approach or combination of 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 compare the approach or combination of approaches used by the port to the principles we have described above under 'guidance on well accepted approaches'.
  - 1.1. If the port has used an approach or combination of approaches that is well accepted, it would have passed the well accepted test, and the port may be compliant with the requirements of the pricing order.
  - 1.2. If the port has not used an approach or combination of approaches that are well accepted, then the port may not be compliant.
2. 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 the provision of the prescribed services. We refer to this as the '*benchmark efficient entity test*'. We would apply this test using two steps:
  - 2.1. First, 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 employ are set out in our *Feedback on consultation and other matters: Statement of regulatory approach version 1.0* paper. 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 would be considered compliant
  - 2.2. 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 identify specific areas of 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.
3. 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.

The feedback on consultation and other matters paper contains examples of cross-checks we may employ, and of more detailed analysis which we may undertake.

## **4.4. Depreciation (return of capital)**

### **4.4.1. Depreciation pricing order requirements**

The accrual building block methodology allows for the port to determine 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 assets<sup>68</sup> or the remaining term of the port lease, whichever is shorter.<sup>69</sup>

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

- the tariffs adjustment limit<sup>70</sup> 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)).

In addition to this, the amount by which an asset is depreciated over its life must not exceed the value of the asset<sup>71</sup> and negative depreciation is also not permitted.<sup>72</sup>

### **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 their depreciation costs over time. In particular we will

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<sup>68</sup> 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.

<sup>69</sup> Pricing order, clause 4.4.1

<sup>70</sup> 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.

<sup>71</sup> Pricing order, clause 4.4.1(c)

<sup>72</sup> Pricing order, clause 4.4.3

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 alternative method defers depreciation, it should show how it will recover the deferred depreciation.

If the port uses a different depreciation method to defer depreciation because the tariffs adjustment limit constrains its revenues, we expect it 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.<sup>73</sup>

Forecast operating expenditure is to include the port licence fee and any cost contribution payable under the port concession deed in relation to the financial year in which those expenses are

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<sup>73</sup> 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.

incurred. The pricing order deems this expenditure to be commensurate with that which would be required by a prudent service provider acting efficiently.<sup>74</sup>

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.<sup>75</sup>

#### **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.

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.

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<sup>74</sup> Pricing order, clause 4.5.1

<sup>75</sup> Pricing order, clause 4.5.2

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.

## **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:<sup>76</sup>

- 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, must be allocated to that 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 for the port when seeking to demonstrate compliance with the pricing order and the objectives of the regulatory regime:

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

## **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.<sup>77</sup> The port is also allowed to adopt regulatory periods of different length over the term of the port lease.<sup>78</sup>

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<sup>76</sup> Pricing order, clause 5.2.1

#### 4.7.2. Guidance on the regulatory period

When choosing the length of regulatory period, we expect the port to outline the factors influencing its choice. These factors could include:

- how its chosen regulatory period length will achieve the objectives of the regulatory regime
- consistency with past approaches to selecting regulatory period lengths
- comparative benefits of shorter versus longer regulatory periods
- how the risks of the port making forecast errors (for example, overestimating demand forecasts) are allocated between the port and port users
- confidence that forecasts are efficient and robust
- service level outcomes to be delivered over the regulatory period
- how to deal with the uncertainty of major unforeseen events that may affect its annual revenue requirement
- port users' views on the proposed length of regulatory period and the port's reasoning for choosing the length of that period.

The port's choice of regulatory period should also consider promoting stability and predictability of tariffs for port users.

When considering the port's reasons for its choice of regulatory period we will pay particular attention to the interaction between the length of regulatory period and the expected accuracy and reliability of forecasts. 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 or under-recovery. We will also place considerable weight on port users' views on the length of regulatory period.

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<sup>77</sup> Pricing order, clause 13.1.1

<sup>78</sup> Pricing order, clause 13.1.1