Draft Port Tariff Methodology

Ports Regulator of South Africa Roadshow

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Tariff Methodology

- Tariff Methodology ("TM") assists application of the Regulatory framework to determine the Authority's overall revenue requirement
- The TM should aim for simplicity, clarity and certainty
- Rate of Return ("RoR") TM is appropriate as it ensures that the Authority in accordance with the Regulator's Directives:
  - o recovers its investments in port services and facilities;
  - o recovers its cost of operations; and
  - o achieves a return sufficient to recover the opportunity cost of the capital employed in the production of the regulated services.
- provides efficient price signals to market participants and provides the Authority with incentive for efficient investment in infrastructure and services;
- promotes regulatory objectivity and certainty including a system for smoothing tariff adjustments; and
- is commonly used in other regulated industries

Draft Tariff Methodology FY 2021/22 to FY 2023/24

- On 29 November 2019, the Regulator issued a draft Port Tariff Methodology ("Draft TM") applicable for the period FY 2021/22 to FY 2023/24.

- The Draft TM is premised on the RoR methodology, and is based on the following formula:

Revenue Requirement

= Regulatory Asset Base (RAB) x Weighted Average Cost of Capital (WACC) + Operating Costs + Depreciation + Taxation Expense ± Excessive Tariff Increase Margin Credit (ETIMC) ± Weighted Efficiency Gains from Operations (WEGO)

- The proposed TM resembles the last two multi-year tariff methodologies with significant amendments to asset valuation and cost of equity (beta determination)

Components of Draft TM: No Changes Proposed

- Methodology Period;
- The Appropriate Tariff Methodology
- Net Working Capital ("NWC")
- Weighted Average Cost of Capital ("WACC"):
  - Risk Free Rate ("RFR")
  - Market Risk Premium ("MRP")
  - Gearing
- Operating Costs ("OPEX")
- Clawback

Components of TM: Changes Proposed

- Regulatory Asset Base ("RAB") – Valuation of Assets
- Depreciation – No split of depreciation and amortisation
- Capital Work-in-Progress ("CWIP") – RoE during construction
- Cost of Equity - Asset beta
- Cost of Debt: The cost structure and cost of debt to be informed by Transnet policy on debt allocation to divisions.
- Taxation: **(Profit before Tax for Group/ Profit Before Tax for Profit Making OD's)*28%.**
- Excessive Tariff Increase Margin Credit ("ETIMC"): Include rules for use of ETIMC.
- Weighted Efficiency Gains from Operations **("WEGO")**

Financial Sustainability

- Cash Interest Coverage (CIC) Ratio demonstrates liquidity of an enterprise and measures ability to afford interest on its outstanding debt.
- Preferred ratio by credit rating agencies is 2.50 times.
- Transnet's preferred ratio is 3 times in order to mitigate market and operational volatility.
- Application of the past TM has ensured financial sustainability of the Authority:

	Cash Interest cover				
	Actuals				
	2014/15	2015/16	2016/17	2017/18	2018/19
AFS	3.38	3.11	3.36	3.46	5.00

- Improvement in CIC is more a function of lower CAPEX and finance costs as opposed to TM or asset valuation approach

	Actuals				
	2014/15	2015/16	2016/17	2017/18	2018/19
Capital Expenditure	2 907	2 961	2 033	1 194	905
Actual Kd as per AFS	1 789	1 844	1 741	1 908	1 387

Financial Sustainability and Asset Valuation Approach

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- Application of the TOC valuation approach maintains the financial sustainability of the Authority:

	Cash Interest cover								
	Actuals Based on Cash Generated from Operations					Projections Based on EBITDA			
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
TOC: 0.50 Beta	2.63	2.56	2.45	2.61	3.46	4.49	3.87	3.20	2.40
Actual CAPEX and Projections	2 907	2 961	2 033	1 194	905	1 754	3 872	4 921	6 630

- Application of the VoA valuation approach, however, compromises the financial sustainability of the Authority:

	Cash Interest cover								
	Actuals Based on Cash Generated from Operations					Projections Based on EBITDA			
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
VoA: 0.50 Beta	1.80	1.60	1.65	1.65	2.05	2.52	2.49	2.00	1.46
Actual CAPEX and Projections	2 907	2 961	2 033	1 194	905	1 754	3 872	4 921	6 630

Financial Sustainability, Asset Valuation and Asset Beta

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- Asset beta of 0.35 diminishes CIC / financial sustainability of the Authority

	Cash Interest cover								
	Actuals Based on Cash Generated from Operations					Projections Based on EBITDA			
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Scenario 1 - TOC 0.50 Beta	2.63	2.56	2.45	2.61	3.46	4.49	3.87	3.20	2.40
Scenario 2 - TOC 0.35 Beta	2.32	2.31	2.37	2.32	3.09	N/A	3.81	3.15	2.36
Scenario 3 - VoA 0.50 Beta	1.80	1.60	1.65	1.65	2.05	2.52	2.49	2.00	1.46
Scenario 4 - VoA 0.35 Beta	1.62	1.46	1.50	1.48	1.83	2.88	2.26	1.81	1.30

- The Authority proposes that National Treasury should set the level of Cost of Equity ("Ke") for State Owned Enterprises. This would reduce the element of subjectivity for the determination of Ke.

RAB: Concession and Real Estate Assets

- Concession funded assets should be recorded in the Regulatory Asset Base ("RAB") at the value that the Authority would compensate the concessionaire, at a minimum of R1
- A similar RAB treatment should be applied for normal leasing (non-concession) transactions.
- The above is confined for the purposes of TM in alignment with FCM
- However, for Tariff Strategy purposes the "*willing buyer, willing seller"* principle will apply, therefore a natural subsidy of the marine business by real estate business

Weighted Efficiency Gains from Operations (WEGO)

- The Authority is in agreement with the WEGO capping:
  - Increasing of KPI capping shifted from 10% to 15%
  - Efficiency gain/loss cap shifted from 5% to 7.5%
- The Authority does not support the introduction of downtime adjustment:
  - Current KPI calculations take into account downtime including labour and equipment breakdowns.
  - Introduction of this adjustment will be duplication for labour, equipment availability and breakdown.

Conclusion

- New elements /revision of past elements in the Draft TM are considered constructive and progressive to the extent that it maintains the financial sustainability of the Authority and delivers efficient pricing signals for port users.
- Inherent risks of the Draft TM have been raised with the Regulator for further consultation and deliberation.
- Financial sustainability of the Authority is wider than the RoR.
- The Authority supports initiatives to ensure fair pricing of its services through rebalancing of its charges as part of the Tariff Strategy implementation.
- The Authority remains focused on lowering the cost of doing business by improving efficiencies and containing cost.
- In an effort to drive further efficiencies and accountability, in the next TM cycle, the Authority intends exploring Price Cap methodology in conjunction with PRSA.

Thank you