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The Ports Regulator
The Marine, Suite 1101
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16 September 2019

**Att: Mr. Mahesh Fakir**
**Cc: Mr Chris Lotter**

Dear Sir

# COMMENTS ON THE 2020/21 TARIFF APPLICATION

## INTRODUCTION

1.

The Transnet National Ports Authority ("the TNPA") has applied for an increase in its weighted average tariff of 4.80% for the 2020/21 financial year. Based on forecast inflation of 5.00%, this works out at CPI-0.2%, a small decrease in real terms.

2.

In this note, SAASOA, a major stakeholder in the operations of the TNPA addresses the following issues:

[a] Valuation of the Regulatory Asset Base (RAB)
[b] Price Capping
[c] Depreciation
[d] Operating Expenses
[e] Volume forecasting
[f] Inflation forecasts
[g] Strategic use of the ETIMC

[h] WEGO

[i] Suggested change in the tariff

3.

THE REGULATORY ASSET BASE

On 23 February 2018, the Regulator published a draft methodology and discussion paper in respect of the valuation of the RAB and gave interested parties until 22 March 2018 to make representations in connection therewith. The TNPA submitted representations.

4.

On 28 March 2018, the Regulator adopted a new methodology for valuation of the RAB, in the form of a written document setting the new methodology and the reasons therefor, signed by its Chairperson. The document expressly stated that it was to be regarded as replacing any portions of the March 2017 Tariff Methodology that were in conflict with its provisions and further that it was to apply to the calculation of the Required Revenue in the 2019/20 tariff application.

5.

The objective of the new methodology is to ensure that the RAB is measured using a method that achieves financial capital maintenance, namely ensuring that investors receive their capital back plus an adequate return on capital. The rationale for using a financial capital maintenance system rather than methods aimed at estimating the replacement cost of assets (e.g. physical and economic capital maintenance) is that where many of the regulated entity's assets have in place for a long time, have very long remaining useful lives and are unlikely to be replaced in the foreseeable future, the latter methods will result in capital over-recoveries i.e. they will significantly exaggerate the financial capital invested in the entity with the result that applying an ordinary cost of capital return will perversely result in massive supernormal profits.

6.

The published methodology embodied a decision as contemplated in section 41 of the NPA, which also constituted administrative action that was binding on all role players. That is to say, both the TNPA and the Regulator were bound by this decision.

7.

The TNPA declined to make use of this methodology in its tariff application for the 2019/20 financial year, for the following reasons:

[a] The new methodology would allegedly have the effect of reducing its opening RAB from R83.5bn to R38.1bn;

[b] The new methodology would therefore reduce the alleged revenue attributable to RAB by R3.8bn, from R8.2bn to R4.4bn;

[c] This significant revenue reduction, together with its commitments, would place its financial sustainability at risk.

8.

The main issue arose with the treatment of pre-1990 assets. For assets with capitalisation dates after 1990, the Regulator indicated that the Trended Original Cost ("TOC") approach would be used while for assets capitalised prior to 1990, historical costs would be used. The rationale for this distinction was given as follows:

> "Here the assumption is that assets in existence by 1990 have been in existence for a long period of time and, for most of that time, have been depreciated on a trajectory following the historic cost method." (Methodology, 28 March 2018)

9.

However, the Regulator afforded the TNPA an opportunity to convert pre-1991 assets to the TOC method of measurement by submitting detailed information regarding the capital maintenance of these assets, within 60 days of publication of the new methodology.

10.

As the Regulator noted on page 5 of its record of decision for the 2019/20 financial year tariff application:

> "The NPA did not initially implement the methodology and did not provide the relevant information. ... the Regulator requested a meeting with the Transnet board as well as submission of the relevant information and at this meeting a confidential submission in line with the correct methodology, was made to the Regulator and taken into consideration in the assessment of the NPA's tariff application."

11.

With the utmost respect to the Regulator, this development was and is alarming. In order for there to meaningful public participation in the tariff application process, all affected persons must be afforded a reasonable opportunity to make representations concerning the application. While it is perfectly permissible for the Regulator to allow the application to be supplemented (SAASOA raised this possibility in its submission for the 2019/20 tariff application, a copy of which is annexed hereto, marked "A"), it can hardly be said that stakeholders, such as SAASOA and other industry participants, have been afforded a fair hearing when the terms of the application are *confidentially* revised.

12.

On this ground alone, the 2019/20 record of decision is arguably reviewable and liable to be set aside. We refer to the detailed analysis of legal context in which the Regulator takes decisions that is set out in annexure “A”.

13.

Moreover, in the record of decision, the Regulator resolved - contrary to the express terms of the methodology, to apply the TOC method to all assets "both pre 1990 as well as post 1990". The reason given for doing this was not that the TNPA had satisfied the Regulator that in terms of its capital maintenance projects, the pre-1991 assets should be valued using TOC rather than historical cost. Instead, the Regulator justified this departure as follows:

> "This is because it is aware of the pending intention of the state to incorporate the NPA into a wholly owned subsidiary of Transnet in fulfilment of section 3(2) of the National Ports Act. As such, the NPA is likely to be assessed on a standalone basis from a credit rating perspective rather than as a division, giving credence to its sustainability concerns as substantiated in the relevant tables provided in the Transnet public submission."

14.

With the utmost respect, this smacks of administrative fiat. This is not a valid reason for departing from the methodology.

15.

If the Regulator was concerned that adopting the new methodology would cause an excessive reduction in the tariff, the appropriate method for addressing this concern within the methodology was not to break its own rule shortly after adopting it, but to make use of the ETIMC reserve and advance future revenues to the TNPA (or put another way, allow the TNPA to earn a supernormal profit because of strategic considerations). In its submission last year, SAASOA suggested that the Regulator could extend an ETIMC credit to the TNPA sufficient to maintain the tariff at its nominal level. This approach would have had the following benefits:

[a] There would be certainty about the application of the RAB methodology;

[b] By artificially increasing the value of the RAB by adopting TOC for pre-1991 assets, the Regulator permitted the TNPA to earn a supernormal profit in the form of an artificially increased ROC and Depreciation charge.

[c] Had the Regulator instead offset the decline in ROC and Depreciation by granting a larger ETIMC credit (i.e. granting the TNPA an advance on future revenues or a dispensation to earn some supernormal profits per the model), stakeholders would at least have had the prospect of recovering such funds as a drawdown on the ETIMC reserve at some future point where the TNPA - presumably having engaged in significant restructuring and with the benefit of future economic growth - could be in a position to refund such sum, or in the form of an annual yield.

16.

The "Transnet public submission" referred to is presumably the letter addressed to the Regulator dated 12 October 2018 and signed by the Transnet SOC Ltd's then Group Chief Executive, Mr Siyabonga Gama (his employment was terminated shortly thereafter). A copy of the letter is annexed hereto, marked “B”.

17.

In his letter:

[a] Mr Gama launched an utterly inappropriate attack on the Regulator's Mr Chris Lotter for attempting to explain in simple terms the advantages of the financial capital maintenance approach to valuing a regulatory asset base. The so-called personal view expressed by Mr Lotter was entirely consistent with the views expressed by the Regulator in its draft methodology concerning this methodology, in response to which the TNPA was afforded the opportunity to make and in fact made a submission. Moreover, at the time the public was called on to make submissions in response to the tariff application, Mr Lotter's view was consistent with the methodology that had been officially adopted by the Regulator.

[b] Mr Gama by implication contends that there is nothing wrong with the TNPA including in the RAB, at its estimated 2019 replacement cost albeit reduced by depreciation (likely to be minimal if not non-existent), a lighthouse built in the 1900s, even though the TNPA can have no intention of committing capital to, nor reasonably consider that any part of its financial capital will be necessary for, the replacement of such lighthouse.

[c] Mr Gama points out that the effect of the new RAB methodology would be to reduce the TNPA's cash flow by 30% per annum perpetually, and would entail - in present value terms - a reduction of R32bn in the TNPA's future cash flows (put another way, the value of the TNPA would be reduced by R32bn).

[d] Mr Gama further points out that this raises concerns about the TNPA's ability to raise ring-fenced funding or project financing for future capital investment programmes without government guarantees.

[e] Mr Gama contends that the significant reduction in cash flow from the TNPA's operations could cause the Transnet Group to breach covenant requirements and default on existing loan agreements, damage its credit rating and damage the South African government's credit rating.

18.

With the utmost respect, this letter constitutes a textbook example of rent-seeking. In the face of the Regulator revising its methodology to ensure that the TNPA does not *inadvertently* earn supernormal profits, the TNPA utters dire threats about being deprived of R32bn in supernormal profits, in present value terms.

19.

The great irony is that that the RR approach guarantees that if the TNPA were in fact to embark on a major capital investment programme, it would be guaranteed the required rate of return in respect of such new assets, all of which would be valued using TOC as part of the RAB in years going forward. The simple fact is that use of the DORC method has left the TNPA content to rely on an existing an elderly asset base which it maintains poorly or not all (as is apparent from its actual capital maintenance expenditure), because it can generate economic rents by earning a return on an inflated value of physical capital rather than the actual financial capital notionally invested in its operations.

20.

As for the impact on the Transnet Group, well, that should not be the concern of the Regulator. The Regulator is concerned with the regulation of a monopoly, namely the TNPA, and not the welfare of the Transnet Group. Furthermore, it seems to be inherently contradictory to complain about the effect of the revenue reduction on the TNPA as a division of Transnet and at the same time assert prejudice to the TNPA as a standalone entity.

21.

Moreover, and with respect, it undermines the integrity of the rate of return or RR approach to regulation for the Regulator to tinker with the RAB valuation methodology because it is concerned that the TNPA will not otherwise earn sustainable revenue. The whole point of the RR approach is to determine the required revenue necessary to earn a normal as opposed to supernormal profit.

22.

Thus, with the utmost respect, it is difficult to accept the Regulator's reasons for departing from its own methodology.

23.

We note, however, that in the 2019/20 ROD, the Regulator reserved the right to return to the historical cost method.

24.

Unless the Regulator is in a position to confirm that it has satisfied itself that the conditions set in the methodology for dealing with pre-1991 assets using TOC have been met (detailed evidence of capital maintenance of such assets), we urge it to implement the historical cost method and address any concerns regarding the financial sustainability of the TNPA by advancing future revenues under the ETIMC rather than granting disguised supernormal profits to the TNPA by applying TOC universally.

25.

As it is self-evident that the valuation of pre-1991 assets using TOC rather than historical cost will have a material impact on the RAB, the ROC and the Depreciation allowance, it is submitted that the Regulator must disclose to the public any and all submissions made, and evidence furnished to it, by the TNPA concerning the valuation of pre-1991 assets.

26.

Industry stakeholders can furnish valuable insight into such an assessment. They should not be excluded from participation. It is thus of concern that in the 2019/20 ROD, the Regulator states concerning the assessment of pre-1991 assets only that: "The cooperation of the NPA as well as Transnet will be critical in finalising the matter."

PRICE CAPPING

27.

Notwithstanding the concerns that SAASOA and presumably many other industry stakeholders had concerning the Regulator's compromise on the RAB valuation methodology, the simple fact is that the Regulator decreased the average tariff by 6.27%.

28.

With a CPI estimate of 5.4%, this translated to a price cap of CPI-11.67%, a significant and very welcome reduction in the real average tariff.

29.

In our view, the primary objective in regulating a monopoly is not to prevent - at least in the short run - the monopoly from earning an economic (or supernormal) profit.

30.

The objective in regulating a monopoly should be to ensure that consumer surplus (that is, the difference between aggregate willingness to pay in respect of the quantity of services supplied, and the actual revenue earned in respect of the said quantity) is maximised to the extent that is possible. Our members are, arguably, the primary consumers of the TNPA's services. Other things being equal, consumer surplus is increased when price levels drop and the quantity of a particular good or service supplied increases.

31.

Under the price capping method, the monopoly's prices are limited to a specific rate of increase, typically entailing a specific percentage reduction in real terms. The monopoly is therefore limited in the use of its pricing power.

32.

However, subject to the price constraints imposed by the price cap, the monopoly is free to make an economic or supernormal profit. This can be done by increasing the quantity of services delivered at lower real prices as well as by reducing costs.

At the same time, the monopoly is not guaranteed the recovery of its costs (including the cost of capital). That is to say, the monopoly may make an economic loss.

33.

The approach adopted by the Regulator has elements of the price capping approach, notwithstanding that it is self-described in the tariff methodology as a rate-of-return approach. Having determined the Revenue Requirement, the Regulator uses that as a “building block” in determining a specific price increase applicable to various categories of tariff in the Port Authority’s tariff book.

34.

In light of the recent 7th Annual Global Comparator study published by the Regulator, which shows the TNPA's tariffs remain significantly above global averages (particularly for container ports), it is extremely desirable that tariffs continue to decline significantly in real terms.

35.

In our view, the manner in which the Regulator has implemented the combination of the Revenue Requirement approach and the setting of a specific price increase for tariffs loses out on the benefits of the conventional price capping approach. These benefits are that the monopoly being regulated under such an approach, subject to the price constraints, nonetheless has an opportunity and thus a strong incentive to earn a supernormal profit by (1) optimising the cost of producing the services it provides (an incentive towards increased efficiency on the supply-side), and (2) having improved supply-side efficiency, by considering further price reductions with a view to increasing the demand for (and consequent supply of) services which are price elastic (an incentive to increase consumer surplus).

36.

The problem with the approach implemented by the Regulator lies in the application of the clawback. The clawback is aimed, in part, at ensuring that the TNPA cannot earn (or at least retain) an economic profit by earning more than the revenue requirement. However, if a forecast of the volume of usage of service is based on a particular assumption as to the tariff for a service, it follows that a reduction in that tariff could lead to a significantly higher demand for that service and the earning of additional revenue if demand for the service is relatively price-elastic. This is a good outcome for users of the service (consumer surplus increases), notwithstanding that it will permit economic profit to be earned (an over-recovery).

37.

The application of a clawback means that notwithstanding that the Regulator's decision is expressed in the form of a price cap, the regulatory method is best perhaps still best described as a rate of return approach. However, this categorisation does not take into account the extent to which the Regulator has made and can make use of the ETIMC. We return to this point in more detail when analyzing the strategic use of the ETIMC.

38.

We have previously pointed out that the RR approach has a number of shortcomings:

[a] It creates relatively weak incentives to (1) increase the volume of services provided, (2) to increase its cost efficiencies, and (3) to lower its prices at a faster rate than has been the case, are relatively weak.

[b] The RR is increasingly determined not with reference to objective criteria but largely at the discretion of the Regulator, with a view to balancing competing policy considerations.

39.

To this we can now add the debate and uncertainty over the rate of return methodology occasioned by the valuation of the RAB. As the TNPA pointed out, the change in methodology would result in an abrupt and severe reduction in its cash flows. At the same time, however, it is apparent that the TNPA is focused on maximising the revenue it obtains from its existing, elderly physical asset base rather than committing fully to an investment programme, which by mathematical definition, would be fully funded under the RAB valuation methodology.

40.

Quite simply, it is submitted that the RR approach has failed.

41.

Accordingly, it is submitted that the Regulator should now commit explicitly to a price-capping approach and should annually target a significant reduction in real prices.

42.

In keeping with Vogelsang and Finsinger (1979)'s rule, the effect a targeted, CPI-X price-capping approach, would be to force the TNPA to reduce its operating costs.

43.

In our view, the rate of return methodology, as set out in the regulatory manual as supplemented by the RAB valuation methodology, is best confined to use as an analytical tool rather than as direct method of determining the tariff.

44.

If it were the follow the price-capping approach, the Regulator would be entitled to depart from the RAB valuation method, and indeed, would be at liberty to compare the notional RR obtained using different RAB valuation methods, or using different assumptions for other inputs, and make use of this information in setting a price-cap tariff.

45.

We must point out that in section 4 of GN.824 of 6 August 2009 (GG 32480), the "Regulatory Principles of the Ports Regulator, 2009" the Regulator committed to precisely the approach we recommend:

> "The Ports Regulator will utilise a price cap form of regulation, and incorporate rate-of-return approaches, among others, in its tariff rebasing processes. The price cap emphasis is favoured, on balance, because, amongst other things, of the incentives which it provides to organisations to devise and implement cost minimising/productivity enhancing strategies, as well as the information asymmetries that abound in the initial phases of the Regulator's existence.
>
> The Ports Regulator will place great emphasis in its evaluation of proposed tariffs on evidence that such strategies are being implemented to good effect. The Ports Regulator will not permit tariff increases to subsidize poor management practices, sub-standard management information systems, any other

inefficiencies including those which are associated with monopolistic or quasi-monopolistic industry structures and/or practices, and so on."

DEPRECIATION

46.

The Regulator's Methodology prescribes a formula for depreciation, in terms of which depreciation is a function of the RAB, expected inflation and projected capital expenditure.

47.

The Regulator states in the Methodology that "the fundamental contextual decision for the Regulator in determining the appropriate application of depreciation centres around the aim of regulation, specifically the intention to satisfy the principle of financial capital maintenance."

48.

Depreciation is an important component of the Revenue Requirement, and in the record of decision for the financial years 2016/17 to 2019/20, it has on average constituted 16.90% of the RR.

49.

However, the Depreciation allowance granted by the Regulator has not been matched by capital expenditure on maintaining the asset base. This goes completely against the principle of financial capital maintenance that underpins "the appropriate application of depreciation".

50.

This can be seen in the table below:

| | FINANCIAL YEAR | 16/17 | 17/18 | 18/19 | 19/20 |
|---|---|---|---|---|---|
| I. | DEPRECIATION ALLOWED | 1948 | 2031 | 2099 | 2074 |
| II. | PROJECTED CAPEX (MAINTENANCE EXPENDITURE) | 2417 | 2219 | 1692 | 2267 |
| III. | ACTUAL (OR LATEST ESTIMATE) CAPEX (MAINTENANCE EXPENDITURE) | 1659 | 1110 | 1347 | 872 |
| IV. | DEPRECIATION LESS ACTUAL CAPEX (ME) (I – III) | -289 | -921 | -752 | -1202 |
| V. | ACTUAL (OR LE) CAPEX (ME) AS % OF DEPRECIATION | 85,16% | 54,65% | 64,17% | 42,04% |

51.

The TNPA systematically projects that it will incur capital expenditure in respect of maintenance expenditure that is fairly close to the depreciation allowance it claims. However, in reality it only incurs about half of the allowed depreciation as maintenance capital expenditure.

52.

This points to one of two possibilities.

53.

First, this may point to the benefit of using a historical cost approach to estimating older assets in the RAB. If capital assets have a long remaining useful life and don't require replacement or maintenance, then depreciating such assets using a trended cost or depreciated optimised replacement cost method will systematically result in the depreciation allowance exceeding capital maintenance expenditure. We note that the depreciation charge estimated by the TNPA under the historical cost method for the 2019/20 tariff is considerably closer to the latest estimate of its capital maintenance expenditure for that year (see in this regard Annexure “B”, page 3, final paragraph).

54.

The second possibility is that the TNPA is failing to adequately maintain or replace outdated capital equipment and is thus is failing to make use of the cash granted to it in the form of the depreciation component of the RR to replace and / or maintain capital equipment.

55.

In the premises, we would suggest that the Regulator either apply the historical cost method or limit the Depreciation allowance to about 60% of the amount claimed.

OPERATING EXPENDITURE

56.

In its record of decision in respect of the 2019/20 financial year tariff application, the Regulator commented:

"The National Ports Authority has applied for R6 291 million in operating costs. Port users have expressed concern regarding the need for the Authority to implement cost saving measures under the current economic conditions. The Regulator supports the views of ports users.

... Whilst the gap between applied for and actual spend on the various OPEX items has minimised over time, the Regulator urges the Authority to implement cost-saving measures as well as implement its maintenance plans in order to maximise port efficiency and minimise downtime.

... Whilst some of the underspending on operational expenditure is as a result of cost savings and higher operational and management efficiency, an apparent inability to implement projects will impact in the long run on the sustainability of the ports system. The Ports Regulator will further address any over allowance on operational expenses through the clawback mechanism in the next tariff year."

57.

SAASOA welcomes these views. In our submission in respect of the 2017/18 financial year application, a copy of which is annexed hereto, marked "C", we specifically drew attention to these concerns.

58.

However, notwithstanding the Regulator's comments, it is apparent from the 2020/21 tariff application that the TNPA is paying lip service to the concerns raised by stakeholders as well as the Regulator concerning operating expenditure claims.

59.

For this tariff application, the TNPA has claimed for operating expenditure of R6 149m. Although the estimated operating expenditure for 2020/21 is R142m less than that claimed for 2019/20 (a reduction of 2.26%), this hardly constitutes evidence of any convincing commitment to reducing operating costs. Furthermore, it still constitutes an increase of R1 635m over the last confirmed operating cost figure for 2018/19 of R4 514m (that is, a 36.22% increase over two years, or a compounded annual increase of

16.7%), and an increase of R779m or 14.51% over the latest estimate of operating expenditure for the 2019/20 financial year of R5 370m (see page 56 of the tariff application).

60.

At a minimum, we would suggest that a commitment to reducing operating expenditure in a difficult operating environment entails fixing operating expenditure in real terms. As the TNPA itself notes in its application (at page 35), "most of the Authority's operating costs are largely of a fixed nature."

61.

Based on the estimated inflation rates for the 2019/20 (5.4%) and 2020/21 (5%) financial years, we would suggest that operating expenditure for 2020/21 should be no more than the actual expenditure for 2018/19 inflated over the two intervening years at the expected inflation rates: R4 996m (R4 514m x 1.054 x 1.05).

62.

Other factors remaining equal, this would have the effect of reducing the claimed RR to R11 992m. The capped operating expenditure of R4 996m would constitute 41.66% of this revised claimed RR. This is more in line with the proportion of RR made up by OPEX prior to the 2015/16 financial year. From the 2010/16 financial year to the 2019/20 financial year, the Regulator has allowed operating expenditure to increase from around 40% to about half of the RR in its records of decision, with a noticeable uptick from 2015/16 onwards:

| FINANCIAL YEAR | 10/11 | 11/12 | 12/13 | 13/14 | 14/15 | 15/16 | 16/17 | 17/18 | 18/19 | 19/20 |
|---|---|---|---|---|---|---|---|---|---|---|
| RR (ROD) | 6020 | 6523 | 7793 | 9838 | 10674 | 11109 | 11064 | 12185 | 12419 | 12563 |
| OPEX (ROD) | 2364 | 2672 | 2986 | 3876 | 4329 | 5020 | 5487 | 5961 | 5938 | 6291 |
| OPEX / RR % | 39,27 | 40,96 | 38,32 | 39,40 | 40,56 | 45,19 | 49,59 | 48,92 | 47,81 | 50,08 |

## VOLUME FORECASTING

63.

According to the tariff application (page 23):

> "Projections for the Authority's volume budget process, on an annual basis, usually commence in October and continues to be refined until the Transnet Board approves the budgets in February of the following year. These forecasts present the annual probable demand, on commodities which are handled through the Authority's infrastructure within the port system. This process normally depicts the current year's latest estimates, taking into account the previous year's performance. Forecasts extend to the following year's volumes (budget period) with projected volumes for the next six years. This volume demand is one of the critical elements as it guides the organisational planning to ensure the availing of capacity ahead of demand whilst at the same time facilitating efficient and optimal utilisation of current capacity.

64.

The cargo volumes budget compilation follows a bottom-up approach from the port level to the Authority's validated budget. The process starts with the Authority's Key Account Managers (KAM's) communicating and liaising with customers on their operational and strategic plans (i.e. how this translates into volume forecasts for the tariff period under review). The KAM's also liaise across the port system with Port Terminals and other operators, to achieve alignment within all cargo categories."

65.

It would appear that the TNPA uses what **to some extent** is an a priori approach to determining the forecast, in the sense that it does not seem that the TNPA makes extensive use of historical data (reference is made only to the last year's performance) but rather of externally supplied inputs (which appear at least in part to be qualitative) into a theoretical model of future demand.

66.

Put another way, there is no indication that the TNPA makes use of time-series econometric models to forecast demand.

67.

As a point of departure, a basic ARMA (p,q) time-series forecasting model could be used to forecast changes in volume (as it is changes in volume being measured, the model would strictly speaking be an ARIMA (p,1,q) model in relation to volume). In this regard, we assume that changes in volume represent a stationary process.

68.

Enhancements to this model could make use of corrections for autoregressive conditional heteroscedasticity (ARCH or GARCH models).

69.

It is not clear what sort of data set is available in this regard. Presumably, the TNPA records cargo volumes at regular intervals. Model accuracy increases with the number of historical observations.

70.

While we do not say an econometric forecasting model should necessarily replace the bottom-up analysis conducted by the TNPA, it would offer a useful analytical tool and a means of comparison.

## INFLATION FORECASTING

71.

The Regulatory Manual permits the TNPA to make use of either the inflation forecasts published by National Treasury or the Bureau of Economic Research.

72.

We would suggest that a basket of forecasts be used. For instance, the Reuters Econometer survey could also be added to the mix.

73.

We note that the Monetary Policy Committee of the Reserve Bank makes use of the BER forecast and Reuters Econometer survey in conjunction with its own Quarterly Projection Model.

## STRATEGIC USE OF THE ETIMC

74.

The Regulator, in the most recent Tariff Methodology, has defined the use of the ETIMC as follows:

> "The Regulator may authorise the release of part, or the whole, of the value of the ETIMC facility to influence tariff levels whenever it deems necessary including, but not limited to, spikes in tariffs (defined as an average tariff increase in excess of the CPI inflation forecast) due to a sharp increase in capital expenditure, volume volatility, or any market related factor. Further, the Regulator may consider national objectives when making decision to add to, or to utilise the ETIMC facility to adjust tariffs."

75.

It is apparent therefore that the Regulator effectively uses the ETIMC as a balancing item in the rate-of-return methodology to obtain the RR and thus tariff it believes is suitable.

76.

We have previously suggested that application of the ETIMC should be subject to strict rules. However, we have softened this view more recently.

77.

We now consider that there is some justification for the discretionary manner in which the Regulator uses the ETIMC, because this allows the Regulator – at least to some extent - to escape the limitations of the rate-of-return approach and effectively follow a price-capping method, which ostensibly it is supposed to do in terms of its own declared Principles of Regulation.

78.

We would prefer the Regulator to explicitly adopt a price-capping approach with the rate-of-return methodology used purely as an analytical tool. In such a case, the ETIMC would be indicative not so much of future revenues being advanced to the TNPA (how it is characterised in the Tariff Methodology) but rather of the extent to which the TNPA is projected to earn supernormal profits under the price-cap, on the assumption that the RR correctly measures the normal profit. This could then be compared to actual supernormal profits earned, measured using an ex post specification of the model, which could offer an indication of whether the TNPA is responding to the incentives afforded by the price-capping approach. The clawback would not play a role in this implementation of the model.

79.

In a particularly aggressive approach, the Regulator could follow a price-capping strategy that ensures a negative projected ETIMC. This would force the TNPA to adopt cost-saving and other measures in order to earn a normal profit and potentially a supernormal profit.

80.

This could also re-cast the present dispute between the TNPA and the Regulator regarding the valuation of the RAB purely as one concerning the measurement of supernormal profit with respect to a particular price-cap. On the approach we have taken with respect to that dispute, we have suggested that rather than perform an about-turn, the Regulator should persist in using historical cost but make up the perceived shortfall by crediting the ETIMC. Under an explicit price-capping approach, both the partial historical cost-partial TOC and the exclusively TOC valuation methods could be used as analytical tools and the resultant ETIMCs compared to measure the extent to which the exclusively TOC method could result in additional supernormal profits inadvertently being earned. Similarly these results could be compared to a model based on a DORC valuation method.

81.

Still another way of looking at the ETIMC in the present model is to compare it to the clawback. The clawback entails the recovery of supernormal profit earned by the

TNPA, whether this is through unexpectedly higher volumes or lower than expected operating costs.

82.

For example, the basic clawback for the 2018/19 financial year shows that the AFS revenue for the TNPA was broadly similar to the ROD Revenue Allowed. The difference between the two is primarily made up of substantially lower than projected operating costs. The ETIMC can therefore also be read as that proportion of the supernormal profits embodied in the clawback which the Regulator permits the TNPA to retain. To the extent that the clawback is generated by better operating performance (relative to the forecasts, which in this light might be regarded as benchmarks rather than true forecasts), the fraction of the clawback retained as ETIMC would tend to indicate the strength of an incentive to the TNPA to improve its operating performance relative to the forecasts or benchmarks.

83.

We note that the Tariff Methodology provides for ports users to earn a return on the accumulated funds in the ETIMC. However, this is more apparent than real, because there is no commitment on the part of the Regulator to automatically "disburse" this yield on an annual basis with a view to reducing the RR, other things being equal. To the extent that the Regulator is committed to a strict of rate-of-return approach and regards the ETIMC purely as accumulated advanced earnings (in other words, as a source of off-balance sheet financing to the TNPA provided by ports user), then it should consider deducting from the RR an annual yield equivalent to the annual capital charge imposed rather than simply capitalizing this return.

WEGO

84.

We have previously commented that the introduction of efficiency incentives in the form of WEGO is an excellent idea. However, we have also pointed out that the incentives provided for in the present formulation of WEGO are relatively weak.

85.

This is borne out by the WEGO revenue gain calculated by the TNPA, which is comparatively insignificant relative to the balance of the RR.

86.

The further problem with WEGO is that, under the RR approach, it is not balanced against any increases in operating and capital expenditure that may result in increased operating efficiency. Increases in operating and capital expenditure which result in greater port efficiency mean that under the RR approach, not only would the TNPA benefit from WEGO but it is also able to pass the full cost of achieving these gains onto ports users due to a separate increase in RR.

87.

For this reason, we would contend that WEGO is a far more effective tool when used in conjunction with an explicit price-capping model. This is because under a price-capping model, the TNPA would bear the costs of achieving the increased operating efficiency rather than passing them onto to ports user.

88.

The benefit of the efficiency incentive in a price-capping context would be to incentivise the TNPA to achieve an acceptable service level while seeking to maximise its profits under the set tariff.

ASSESSMENT OF THE TARIFF INCREASE

89.

The TNPA has calculated that it should be allowed Revenue of R13 145m.

90.

Based on the analysis above, we would suggest that:

[a] Any dispute over the RAB valuation can be resolved by increasing ETIMC; we therefore treat this dispute as having a neutral effect and make no adjustment to the TNPA's claimed ROC and Depreciation allowance (save in the latter case as set out below)

[b] The TNPA only be allowed 60% of the depreciation claimed, or R1 398.6m

[c] The TNPA be limited to operating expenditure of only R4 996m.

[d] The TNPA be allowed to retain in full the clawback, in the form of allowed supernormal revenue under the ETIMC.

91.

This results in allowed revenue of R12 278.6 m and allowed marine revenue of R8 730.6m. Adjusting for volume, this entails a 4.66% reduction in the nominal tariff, or a tariff change of CPI-9.66%.

92.

We would therefore suggest a change to the tariff of between CPI-9% and CPI-10%. This would be in keeping with the current trend of the Regulator's decisions as well as the imperative of achieving sustained, significant reduction in the average tariff level to render our tariffs more in line with global comparators.

**Prepared by Advocate Andrew Christison**

Kind regards

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