The Ports Regulator of South Africa

Tariff Methodology Stakeholder Workshop

26 October 2016

Town House Hotel, Cape Town

A quick thanks…

- Comments and input on PRSA process:
  - NPCC
  - CAIA
  - SAAFF
  - SAASOA
  - NAAMSA
  - Columbus Steel
  - Atlas Holdings
  - The dti
  - City of Cape Town
  - Cape Chamber of Commerce
  - National Ports Authority
  - Confidential submissions

Role and purpose of the Tariff Methodology

The Tariff Methodology in context:

- What does the legislation require i.t.o. a Tariff Methodology?
- What is the impact of the Tariff Methodology?
  - On port users
  - On the NPA
- How does the Tariff Methodology fit into the rest of the "regulatory framework"?
- What are some of the issues we need to address in this review?
- The process

Role and purpose of the Tariff Methodology

The Tariff Methodology in context:

- What does the legislation require i.t.o. a Tariff Methodology?

National Ports Act interpretation – link between economics/finance & the legislation

- In terms of the Directives, when considering the proposed tariffs for the Authority, the Regulator must ensure that such tariffs allow the Authority to:
  - a) recover its investment in owning, managing, controlling and administering Ports and its investment in port services and facilities;
  - b) recover its costs in maintaining, operating, managing, controlling and administering Ports and its costs in providing port services and facilities; and
  - c) earn a return commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities.

Assessment of Authority's Tariffs

- In terms of the Act, NPA to submit proposed tariffs to the Regulator
- Tariffs cover all NPA activities as a Port Authority
- Elements of tariff application proposed by the NPA should include:
  - Manner of calculation and model
  - All financial information and valuations
  - Reinvestment of profits and revenues
  - Impact on port activity cost structures
- Regulator Publishes NPA application for comment (www.portsregulator.org)
- Regulator holds public hearings and invites submissions on proposed tariff increases
- The Regulator applies the accepted Tariff Methodology and after consideration of its own assessment and public submissions on the application, the Regulator issues a Record of Decision.
- The Tariff Strategy will also begin to be considered within the assessment of the different tariffs as applied to different cargo and user types
- Requires an agreed Methodology

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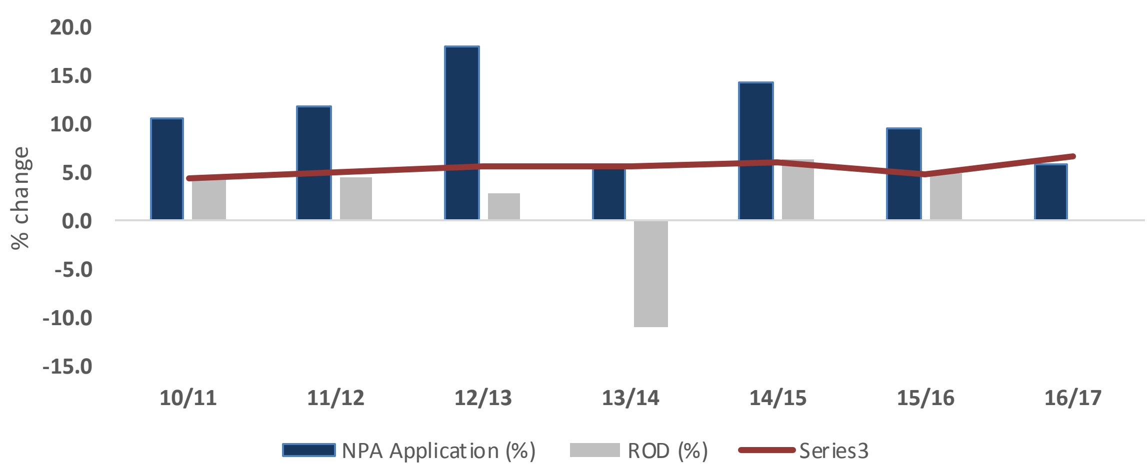
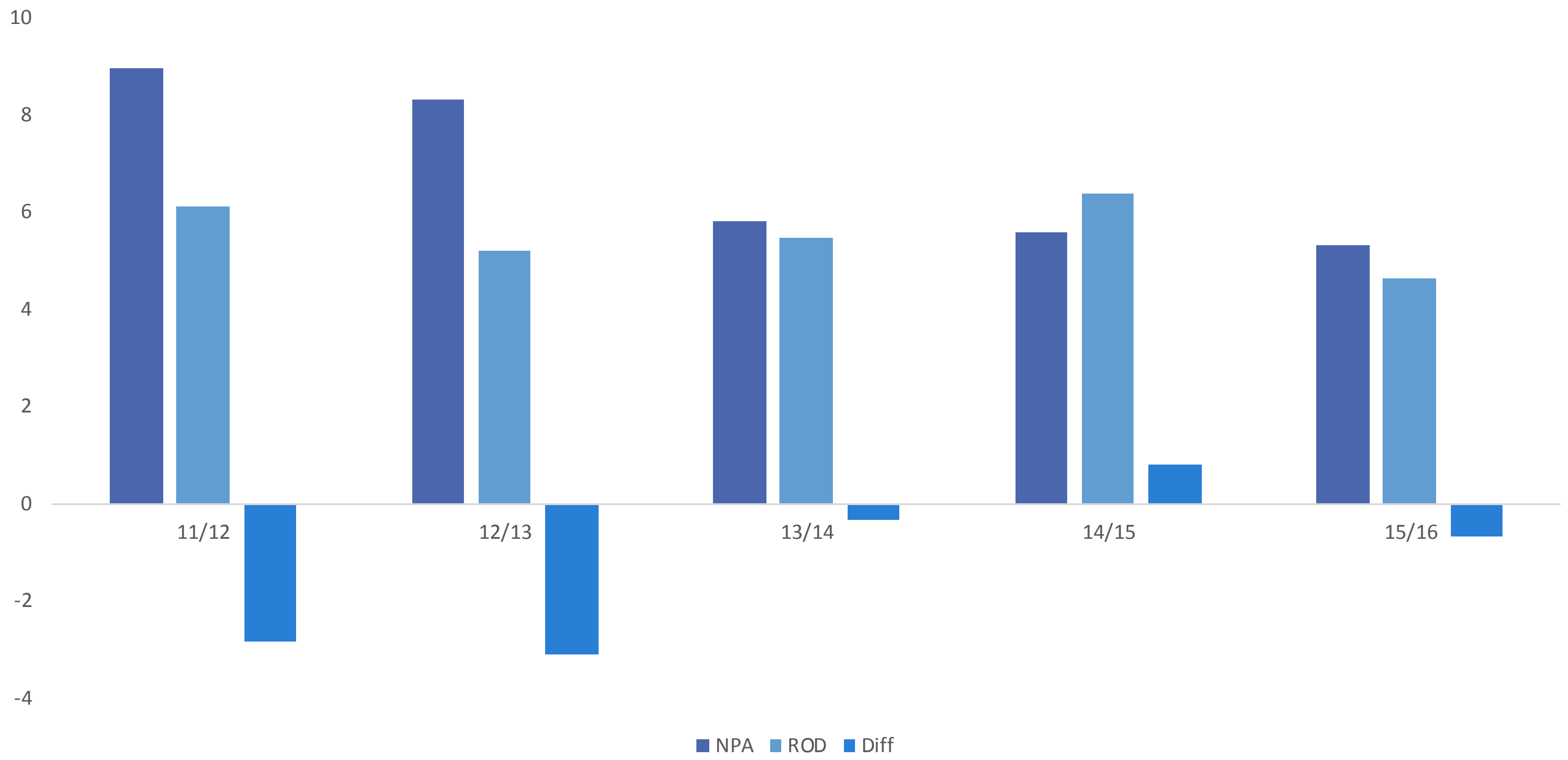
Previous records of Decision

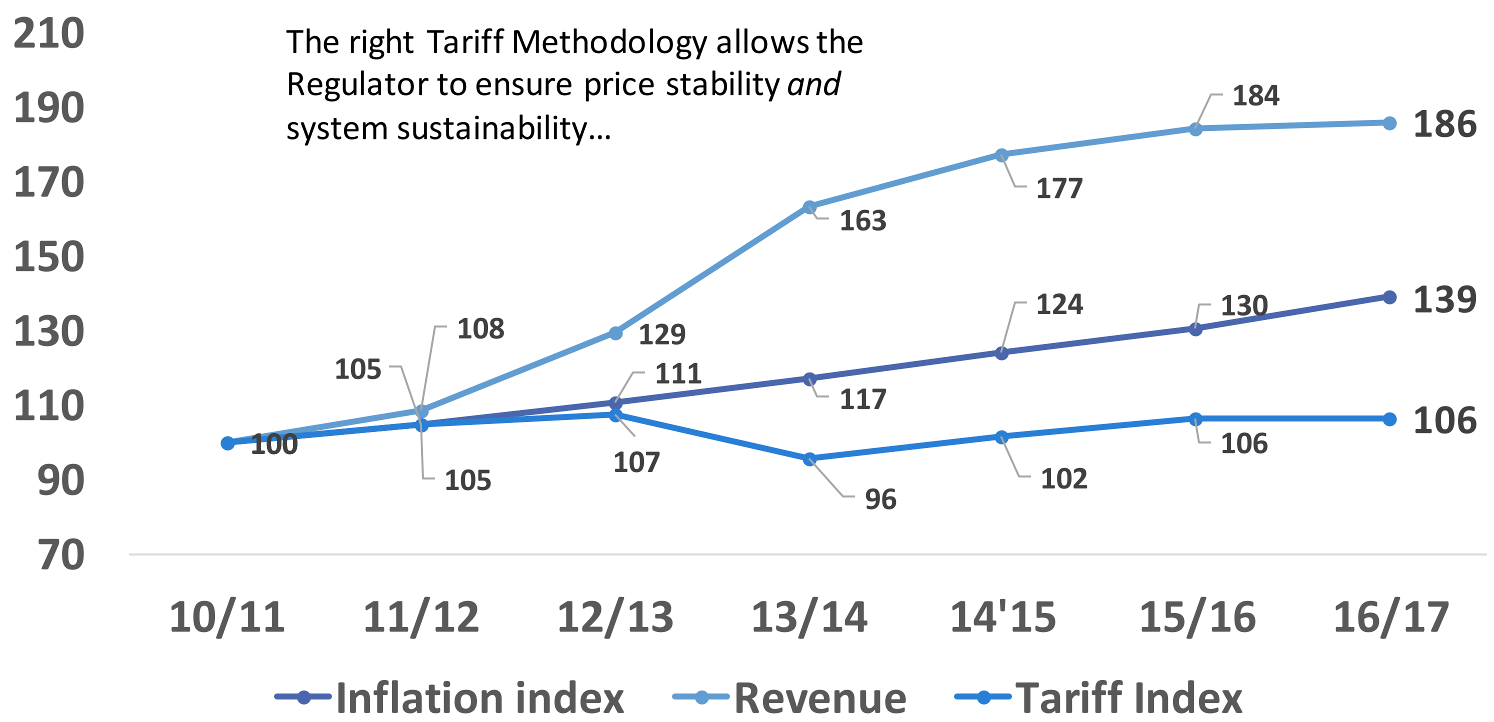
Tariff Year	NPA Application (%)	ROD (%)	Inflation (%)
10/11	10.6	4.4	4.3
11/12	11.9	4.5	5.0
12/13	18.1	2.8	5.6
13/14	5.4	-11.1	5.7
14/15	14.4	6.4	6.1
15/16	9.5	4.8	4.8
16/17	5.9	0.0	6.6



Why a Tariff Methodology?
Return on Capital



Over time…impact of regulatory decisions



Role and purpose of the Tariff Methodology

The Tariff Methodology in context:

- How does the Tariff Methodology fit into the rest of the “regulatory framework”?

Evolution of Regulatory Framework

Different tariff methodologies available	Non-Transparent and unclear tariff setting	Tariff Methodology Published
Price Benchmarking Studies	Severe Price imbalances	Tariff Strategy published
Efficiency benchmarking Studies	Efficiency incentives lacking in tariff setting	Review of Methodology to include efficiency incentives

PORTS REGULATOR OF SOUTH AFRICA

Evolution of Regulatory Framework

Capacity utilisation Research published	Under utilised infrastructure	Pricing investment signals/Capex methodology review
Asset value questions	Impact on tariff, regulation vs Accounting principles	Valuation project-valuation methodologies and regulatory accounts
Ongoing Compliance Monitoring	Findings	Ongoing engagement with NPA (timeframes, corrective measures)

Tariff Methodology vs. Tariff Strategy

- Tariff Methodology
  - 2013 Interim methodology
  - 2014 Multi-year methodology (applicable to 2017/18)
  - Overall Revenue Requirement
  - Determines the "size of the cake"
  - Calculates the *average* tariff change
  - ROD is the implementing mechanism for the Tariff Strategy

Tariff Methodology vs. Tariff Strategy

- Tariff Strategy
  - Answers the question: Who pays for what? And why?
  - Determines “how the cake should be cut”
  - Sets the structure of the tariff book
  - Must be considered with the RR methodology in mind – “zero-sum game”
  - Formalisation of existing tariff trajectory
  - Aims to “clean up the tariff book” – status quo
  - Current tariff application already proposes tariff differentiation in line with the Tariff Strategy
  - Tariff Simulations planned for 2016/17

Role and purpose of the Tariff Methodology

The Tariff Methodology in context:

- What are some of the issues we need to address in this review?

PLEASE NOTE!

- IMPORTANT: Please do not read anything into these comments…they are to help stimulate the discussion and assist in your commenting processes.
- They are not the Regulator's view!

In a nutshell: Considerations for the Regulator The RAB and Return calculations

- The overall methodological approach
  - What do we need to do to keep the momentum towards regulatory accounting? Is a Revenue Requirement still the best fit? Alternatives? Price cap etc.
- If we retain the RR approach
  - Lets relook at the cost of equity (Profits allowed)
    - Capital asset pricing model CAPM - Risk/return
    - Systemic risk when Claw Back in play? Appropriate Beta?
    - Risk free rate
    - MRP (calculation/period etc)
  - Gearing (Everyone seems happy with the 50/50 gearing ratio)
  - Reinvestment of profits (return on equity)
  - What incentives could we use to increase reinvestment?
  - Approach to the cost of debt conundrum
- Trending of the RAB
    - Appropriateness of investment (role of the PCC process?)
    - Treatment of Capex
    - Valuation of the asset base

Questions around the valuation of the RAB

- History of uncertainty around valuation of the RAB
- Regulatory valuation of asset bases problematic for many regulators
- Must be the cornerstone for regulatory accounting
- No clear approach-many regulators use the RAB as buffer or tool to in/decrease cash flow
- Importance of the RAB and depreciation
  - Return and depreciation depends on the RAB
  - Depreciation periods affect cash flow (especially if capex exceed depreciation allowances)
  - RAB serves as benchmark for investors (uncertainty etc)
  - RAB in regulatory accounts differ from statutory accounts

Approaching the valuation of assets

- A few basic approaches:
  - How much did it cost to build?
  - How much would it cost to rebuild?
  - How much profit can it generate in its current use?
  - How much can I make out of selling or renting it out?
- Financial capital maintenance
- Physical capital maintenance
- Economic maintenance

Regulatory approach

- Regulators objective:
  - Reflect capital invested-allocative efficiency
    - Value of the investment
  - Replicate “competitive signals”-productive efficiency
    - Replacement costs
  - Maintain low tariffs-“social” efficiency
    - Historic costs
- Different incentives within different methodology designs to pursue
  - Expanding capacity
  - “sweating” existing capacity (how do you deal with maintenance)
- All of this needs to take place within a broader strategic approach to port use

- No one-size-fits-all approach

VoA Project Objectives

- Development of suite of valuation methodologies for different asset classes and the effect/impact on RAB
- Development of appropriate of valuation methodologies for different asset classes and the effect/impact on RAB
- Depreciation periods
- Defining the correct incentives…and be clear and transparent about it
- How do we then deal with the valuation going forward?

Considerations continued

- Tax…pass-through or taking into account annual revenue effects? What should the Regulators approach be w.r.t. volatility?
- How should OPEX be approached. Balance between operational efficiency and lowering the cost of doing business. Should the NPA cut costs or work more efficient? Maybe both?
  - Need for efficiency incentives
- Three year rolling Claw-Back mechanism-still the best option?
- Intertemporal equity?
- ETIMC…the purpose and intention of the instrument? Unintended effects?
  - Triggers
  - Proposal (Atlas) – use ETIMC to fund medium term capex or expedite Tariff Strategy
- Methodology period…3 yrs. rolling?
- Bringing in an efficiency variable(s)…
  - Operational efficiency
  - Financial efficiency

Efficiency Incentive

- The incentives build in to the RR methodology **do not** favour increased efficiency or competitiveness
  - as the claw back mechanism takes away the gains from higher efficiency with additional market volume effects.
- Need for inclusion of an efficiency measure within the RR methodology.
- Tariff Strategy should yield some positive effects,
  - only impact over the long term.
- An approach is then required to:
  - identify and differentiate between volume gains (or volume losses) due to efficiency impacts and market effects.
  - promote financial efficiency, especially that related to the efficient planning and spending of CAPEX and operational expenditure, must be considered.

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The Tariff Methodology in context:

- The process

Process

Step 1: Commenting deadline 30 September 2016 Comments to be published on PRSA website

Step 2: Methodology Workshops to be held end of October.

Step 3: Draft Methodology Published for Comment (December 2016)

Step 4: Comments will be published on PRSA Website

Step 5: Final Tariff Methodology applicable to the 2018/19 Tariff Year published by 31 March 2017.

Resources

- The Regulator website can be accessed at www.portsregulator.org
- All research, Records of Decision and documentation w.r.t. the Application (including comments) can be found under the Economic Regulation drop down menu.
- Tribunal ROD's available online with compliance reports.
- To be added to the PRSA data base (mailing list) please send an email with your request to info@portsregulator.org
- Submit comments to tariffcomments@portsregulator.org
- Contact details:
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