Ports Regulator of South Africa: Comments on Regulatory Manual

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Presentation to the Ports Regulator of South Africa

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Introduction

- Genesis Analytics is privileged to have the opportunity to comment on the PRSA's Regulatory Manual

- The Regulatory Manual is for the Tariff Years 2015/16 - 2017/18, and outlines the National Ports Authority's tariff setting methodology used to determine annual tariffs

- Our comments on the Regulatory Manual focuses on four key elements:

  - The Regulatory Asset Base (RAB)
  - Weighted Average Cost of Capital (WACC)
  - Operating expenditure
  - Regulatory control period

Regulatory Asset Base (RAB): Introduction and CWIP component

- The Regulator proposes the following equation to determine the closing balance of the RAB:

$$RAB_{c,y} = RAB_{o.y}(1 + CPI_Y) + CWIP_Y - D_y$$

- Definition of the Capital Works in Progress Payable ($CWIP_Y$) and Depreciation (D_y) inputs appear problematic.

- **CWIP payable:** The Regulator proposes to include a provision for capital expenditure into the CWIP payables variable that will be estimated at 1/12th of the capital expenditure for that year. However:

  - Working capital is calculated with regard to trade receivables, inventories and payables only and not lumpy capex. Arithmetically, the CWIP definition assumes that capex occurs evenly throughout the year

  - It is likely that the pre-payments on capital expenditure will outweigh payables on capex projects.

Regulatory Asset Base (RAB): Depreciation

- The proposed Depreciation calculation is as follow:

$$Depreciation = \left(RAB_{(0,y)} + \left(RAB_{(0,y)} . CPI_{(y)} \right) + \left(\frac{Capex_{(y)}}{2. CPI_{(y)}} \right) \right) / 40$$

- We note the following:

  - It is not clear that the weighted average life of Transnet's assets is 40 years. For example, certain assets such as land (a large portion of the RAB) has an infinite life.

  - Capex should be depreciated only when it has been commissioned and not when it is incurred.

Weighted Average Cost of Capital

- **Vanilla WACC v pre-tax WACC:** The Regulator has opted for a separate tax expense in the determination of the revenue allowance rather than including notional tax in the WACC:

  - Significant tax allowances in early years will have significant impact on revenue allowances over life of asset in present value terms

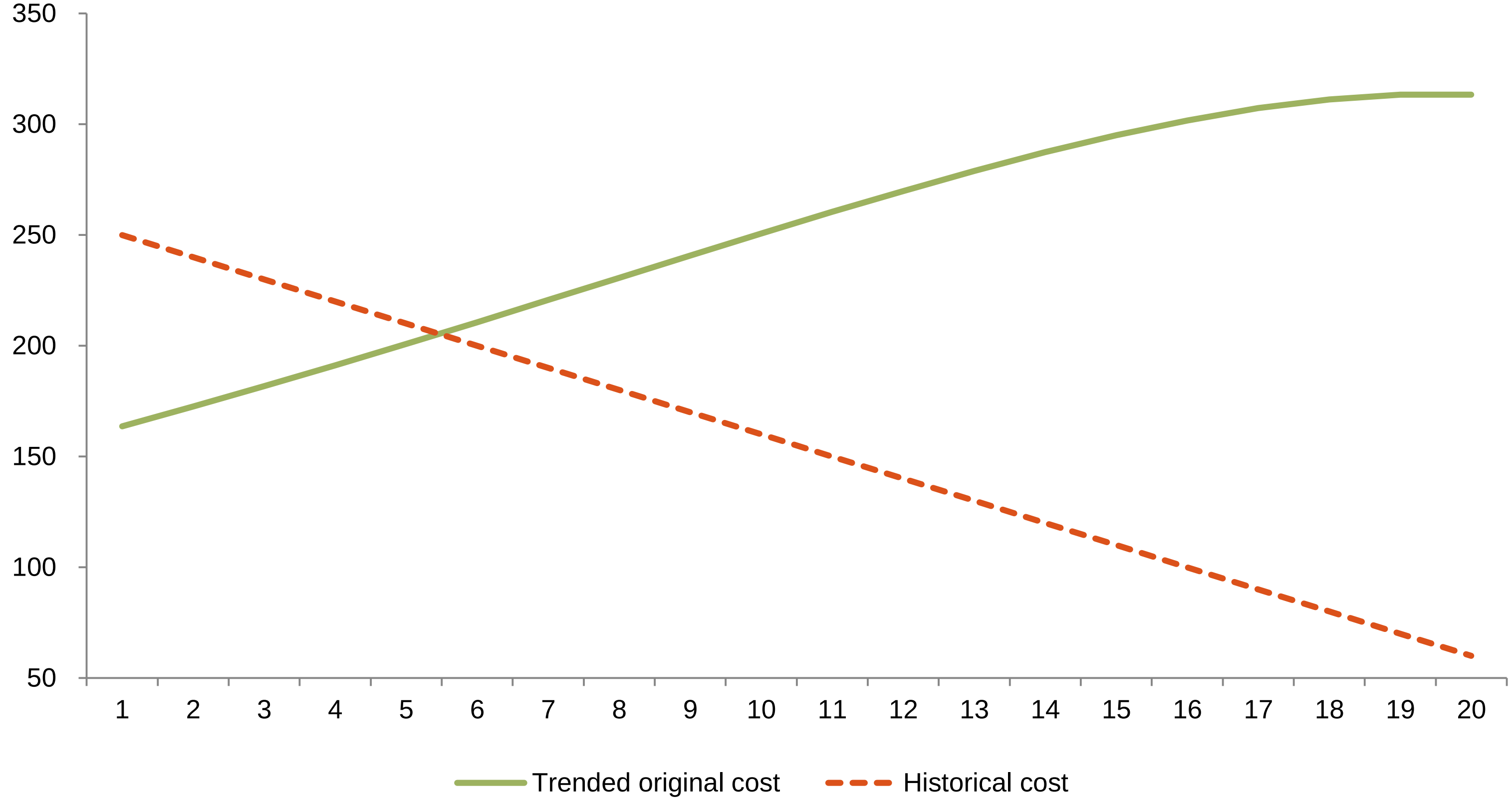
  - Tax allowance calculation (page 16) should include claw-back in latter years

  - Calculating tax separately is complex, even more so on an ex-ante basis

  - Applying pre-tax WACC to the RAB will remove the circularity

Weighted Average Cost of Capital

- **Real v Nominal WACC**: The PRSA is correct in employing a Real WACC against the trended historical cost of assets to calculate the annual tariffs. This approach allows for a smoother and more reasonable upward moving tariff path over the life of the asset.



Weighted Average Cost of Capital

- However the Regulator's proposed approach to calculating the real WACC is incorrect.

  - There are two ways to calculate the real WACC, namely the:

    - Reverse transformation approach that starts with a real risk free rate (adopted by the PRSA)

    - Market transformation approach that converts the nominal WACC into real terms using the Fisher equation.

- The Reverse transformation approach will result in an over-recovery of capital costs over the life of the assets.

- Under the Market transformation approach, there is PV revenue parity between the nominal WACC @ HC RAB and real WACC @ TOC RAB.

Weighted Average Cost of Capital

- **Incorrect approach to the cost of debt:** There are three main shortcomings of the PRSA's proposed approach to the cost of debt calculation:

  - The yield on market traded debt should be used and not the interest rate on Transnet Group's accounting interest costs

  - Transnet Group cost of debt will be influenced by group factors and sovereign debt ratings that is not specific to the NPA business

  - Should be clear link between the cost of debt and the assumed gearing ratio (i.e. 50%). Cost of debt for a firm with a 50% gearing ratio can be obtained from the credit rating agencies

Operating Expenditure

- PRSA has stipulated that it would analyse the operating expense estimates on a line by line basis, including requesting “detailed and complete” motivations from the NPA.

- Role of regulator is not to micro manage a regulated entity by scrutinising every cost item line by line. Rather, a holistic approach to operating cost determination is preferable to allow NPA flexibility to structure its operations as it sees fit.

- Opex largely made up of labour, maintenance, energy, rates and taxes, and group costs

  - Energy and rates and taxes are largely uncontrollable

  - Group cost allowance should be set at incremental/avoidable costs levels, not full allocation

  - For labour and maintenance, PRSA must describe how it will determine “efficient” level – quantitative benchmarking techniques?

Regulatory control period

- The PRSA has indicated that a three year tariff control period with annual adjustments will provide sufficient certainty from a planning and investment perspective. We suggest removing the annual review process and adopt a longer regulatory control period with the option for a "re-opener" of the tariff determination under exceptional circumstances. Advantages include:[1]

  - **Greater incentives to improve performance:** Gains early in the period are retained for a longer period of time.

  - **Improved financebility:** A longer control period will increase the planning horizon for capex and the associated funding arrangements.

  - **Lower regulatory risk:** PRSA is committing to the revenue decision over a longer period of time, which reduces cost of capital.

  - **Innovation and dynamic efficiency:** Firms encouraged to seek innovative solution to achieve efficiencies at the start of a longer control period. Thereby promoting dynamic efficiency

[1] Sources: Regulated Industries Commission. 2011. Determining the length of regulatory control period, p. 4, Reckon on behalf of Ofgem. 2009. Longer-term price controls, p.5-6. Northumbrian Water. The duration of price controls: To change or not to change?, p. 2-3