



The Authority's comments on the Draft Tariff Methodology

1. Context

The National Ports Authority (the Authority) is one of five operating divisions of Transnet SOC Ltd. It is responsible for the safe, effective and efficient economic functioning of the national port system, which it manages in a landlord capacity. The Authority provides port infrastructure and marine services at the eight commercial seaports in South Africa. It operates within a legislative and regulatory environment created by the National Ports Act 2005 (Act No. 12 of 2005). In line with the provisions of the National Ports Act, the core functions of the authority are as follows:

- to plan, provide, maintain and improve port infrastructure;
- to provide or arrange marine-related services;
- to ensure the provision of port services, including the management of port activities and the port regulatory function at all South African ports; and
- to provide aids to navigation and assistance to the manoeuvring of vessels within port limits and along the coast.

The National Ports Act requires for the Authority to be responsible for the port regulatory function at the ports - i.e. controlling the provision of port services through licensing or entering into agreements with port operators to ensure that efficient port services are provided. The *National Ports Act* also establishes the **Ports Regulator of South Africa** who is charged with the responsibility of –

- exercising economic regulation of the ports system in line with government's strategic objectives;
- promoting equity of access to the South African commercial seaports and to the facilities and services provided by these ports;
- monitoring the activities of the National Ports Authority to ensure that it performs its functions in accordance with this Act; and
- hear complaints and appeals under the National Ports Act.

The Authority's service offering is targeted at mainly port users (which include terminal operators, shipping lines, ship agents, cargo owners and clearing & forwarding agents). As such, it manages nine commercial seaports along South Africa's 2 954-km coastline. These ports are Richards Bay, Durban, East London, Ngqura, Port Elizabeth, Mossel Bay, Cape Town, Saldanha Bay and Port Nolloth.

Its service offering is divided mainly in two categories:

1. Provision of port infrastructure; and
2. Provision of maritime services which include dredging, aids to navigation, ship repairs and marine operations.

The Port infrastructure is provided mainly in five commodity sectors:

- Containers
- Dry bulk [such as coal, iron ore, manganese, chrome ore, copper, woodchips]
- Liquid bulk [such as petroleum products, chemicals, vegetable oils]
- Break-bulk [such as fruit, steel, scrap steel, Ferro alloys, pig iron, fish & fish products]; and
- The automotive sector.

These are essential infrastructures and services that are critical for economic growth. With the responsibility of providing infrastructure, the Authority's role affirms the developmental agenda of providing high quality competitively priced infrastructure for the purpose of lowering the cost of doing business as well as maximising its broader contribution to supporting economic growth.

2. Introduction

On 31 July 2014 the Ports Regulator of South Africa (“the Regulator”) issued a Regulatory Manual (“Tariff Methodology”). The approved Tariff Methodology is multi-year in its approach (3 years) and allows for an annual review and an annual adjustment of tariffs within the three year period as opposed to fixing the prices for the full period.

The current Tariff Methodology was set to be applicable from FY 2015/16 to FY 2017/18. With the FY 2017/18 tariff application already submitted, the Regulator commenced the review of the methodology by all stakeholders. An invitation was extended to all stakeholders to submit inputs and proposals as part of the revision exercise. It is envisaged that once approved, the revised methodology will be applicable as from FY 2018/19 and subsequent tariff applications.

The Ports Regulator’s process on the Tariff Methodology:

- On 01 July 2016, the Ports Regulator requested for proposals and sharing of insights on the review of the current Tariff Methodology, from interested stakeholders.
- With these insights the Regulator developed a consultation paper on the new proposed Tariff Methodology.
- Stakeholders were consulted on the paper, with roadshow sessions held at the end of October 2016 and early November 2016 for further comments.
- Upon completion of these roadshows and stakeholder engagements/inputs, the Tariff Methodology proposal was due in December 2016.
- The Regulator has since issued a Draft Tariff Methodology on 3rd March 2017 and invited comments from the Authority & Stakeholders to be submitted by 20 March 2017.
- The revised Tariff Methodology will be made available by 31 March 2017 for Tariff Application period FY 2018/19 – 2020/21.

3. Rate of Return with Required Revenues (RR) Methodology

In terms of the Port Directives¹, when considering the tariffs of the Authority, the Regulator must ensure that the tariffs allow the Authority to:

- recover its investment in owning, managing, controlling and administering Ports and its investment in port services and facilities;
- recover its costs in maintaining, operating, managing, controlling and administering Ports and its costs in providing port services and facilities; and
- earn a return commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities.

The Authority is currently regulated by the Regulator on the RR methodology which determines the Authority's revenue needs. The RR methodology is based on the concept of ensuring financial sustainability of the Authority whilst at the same time promoting competitive port tariffs to facilitate cost effective and efficient infrastructure and service delivery. It represents a cost service which gives a full recovery of capital and operating costs to the Authority, which are assumed to be determined on a similar basis that a competitive entity would aim to achieve, whilst protecting customers from paying exorbitant prices. The absence of an agreed methodology and related parameters in the past resulted in significant variations between the revenue applied for and the determinations by the Regulator. The introduction of an agreed methodology has ensured that the method of evaluating the Authority's tariff applications is consistent and reasonable thereby improving regulatory certainty for all stakeholders.

The RR methodology has proven remarkably resilient and useful, as it continues to respond in a pragmatic way to various challenges as they arise. The RR is further complimentary to the developmental agenda of the Authority evidenced within the Transnet Market Demand Strategy ("MDS") which plans to maintain, expand and modernise the port system. It is for this reason that the Authority is supportive of the decision by the Regulator to retain the RR methodology for FY 2018/19 – FY 2020/21 tariff applications.

Within the context of the RR methodology, the Regulator has amended the formula for revenue determination and the following has been proposed:

Revenue Requirement (RR)

= Regulatory Asset Base (RAB) x Weighted Average Cost of Capital (WACC)

+ Operating Costs + Depreciation + Taxation Expense ± Claw-back

± Excessive Tariff Increase Margin Credit (ETIMC) ± WEGO

¹ Port Directives were approved on 13 July 2009 (gazette on 06 August 2009) and amended on 29 January 2010.
PAGE 4 OF 19

The components of the RR formula has been summarised in the Tariff Methodology as follows:

- a) **Regulatory Asset Base (RAB):** *The RAB represents the value of assets that the Authority is allowed to earn a return on. The value of the assets in the RAB is indexed by inflation each year based on the Trended Original Cost ('TOC') approach.*
- b) **Vanilla Weighted Average Cost of Capital (WACC):** *The WACC represents the risk adjusted opportunity costs of capital and is the minimum return for an investment in order to continue to attract capital, given the risks. A real WACC is applied, given that the RAB is indexed by inflation.*
- c) **Operating Costs:** *The Regulator will analyse the operating cost estimates for the period on a detailed line by line basis. The Authority is required to provide a detailed and complete motivation for each of the expenses applied for.*
- d) **Depreciation:** *The depreciation of the assets in the RAB will be calculated as a straight line 40 year on the average balance of the RAB.*
- e) **Taxation Expense:** *The Regulator will use the pass-through tax approach where the vanilla WACC will be applied to the average RAB for the period under consideration, less the interest cost of debt and the corporate tax rate to determine the tax liability to be treated as an expense in the RR calculation.*
- f) **Claw-Back:** *The key purpose of applying the claw-back is to ensure that the Authority or any port user is fairly treated and is not subjected to unfair gains and losses. The Regulator will spread the total impact of over/under recovery of revenue over a period of two tariff determinations.*
- g) **Excessive Tariff Increase Margin Credit (ETIMC):** *The Regulator considers it prudent to avoid future tariff spikes by retaining and increasing the Authority's ETIMC.*
- h) **Weighted Efficiency Gains from Operations (WEGO):** *It is an agreed efficiency gain through operations, excluding the effect of market driven volume growth.*

The Regulator has further proposed amendments to certain components/parameters to be used in the formula whilst maintaining the past approach for the rest. The Authority has assessed the components/parameter proposals of the Regulator and offers a response in the following sections of this submission.

4. Response to Component/ Parameters of the RR formula

*Summary of areas of Alignment and Non-Alignment – Authority’s Proposal 30
September 2016 & Regulator’s Proposal 3 March 2017*

Areas of alignment

- **RAB** – rebasing of RAB by using DORC with inflation trending in the intervening years in the interim until Regulatory Valuation Methodology is released.
- **WACC** – The Regulator proposes a weighted average cost of capital with the cost of equity calculated on the CAPM approach.
- **Inflation** – On the calculation of the clawback for indexing purposes; the actual inflation will be used in the determination of the RAB as well as the weighted average cost of capital (WACC).
- **Gearing** – The Regulator proposes the continued use of the optimal gearing level of 50%.
- **Operating Expenditure** – Corporate plan budget expenditure with amounts not spent clawed back.
- **Clawback** – clawback will be based on actual amounts such as Opex, inflation as well as cost of debt adopted (with exceptions on treatment of tax, as well as capital expenditure which is fixed in a particular control period).

Areas of non-alignment

- **Risk Free Rate (RFR)** – The Regulator prefers to retain SA bond R186 as a proxy for the RFR instead of the proposed R214.
- **Weighted Average Cost of Debt (WACD)** – The Regulator intends to adopt the Authority’s cost of debt (i.e. all the loans raised for the Authority); weighted at Transnet’s short vs long term debt ratio; vs proposed Transnet embedded cost of debt.
- **Market Risk Premium** – The Regulator has not accepted the Authority’s proposal of arithmetic mean, it is intending to retain geometric mean return.
- **Depreciation** – The Regulator retains the current approach of an aggregated asset base at an average of 40 years instead of different asset classes and averages prescribed in the accounting policy used in the Annual Financial Statements.
- **Beta** – The Regulator retains 0.5 as compared to the Authority’s desired 0.63 which was informed by a detailed study of comparatives similar in risk characteristics.
- **Taxation** – The Regulator proposes an approach that will claw back any tax amounts allowed in the Revenue Requirement determination but not paid over to the Tax Authority (i.e. SARS).
- **ETIMC** - The Regulator’s proposals is silent on the request to retain the ETIMC at a cost of debt applicable to other liabilities rather than the cost equivalent to WACC as currently applicable.

5. Discussion on Individual elements of the RR formula

Regulatory Asset Base (RAB)

Regulator's proposed view

The Regulator has indicated that it is currently in the process of developing a Regulatory Valuation Methodology and will provide rules for future valuations of the RAB as well as the rebasing thereof. It is envisaged that these rules will in addition to the valuation of different asset classes, also guide the treatment of CWIP, depreciation, as well as "end of useful life" concerns. The Regulator's approach will make ongoing adjustments to the RAB as a value, on the asset base as it becomes available over the regulatory period. *The Regulator may finalise on assessment on any asset or part of the RAB during the period and will reflect the appropriate changes in the next ROD to effect the RAB value in the following tariff year.*

The Authority's response

In the RR methodology, the determination of tariffs is premised on the total cost of service which is anchored by the RAB with emphasis on valuation methodology. From the Authority's perspective, the key concept behind the RAB is the capital financial maintenance which talks to the issue of whether the financial capability of the Authority is preserved. This is followed by operating capital maintenance where revenues from port services need to provide sufficiently to cover maintenance renewals and new investment in order to guarantee the continuation of the Authority's service offering. An inappropriate asset valuation methodology, where the recovery of the asset and the return on capital are based on an incorrect replacement value of the asset, will erode the value of the financial capital maintenance position of the Authority. Furthermore it will lead to a sustained lower return on asset which will lead to difficulties in raising new financing at reasonable rates. In order to achieve the principles of capital maintenance, the Authority supports the DORC methodology as a more adequate replacement asset valuation. In the DORC framework, the revaluation of the asset base would be conducted every 3 years with inflation trending of the base in the intervening years.

The Authority acknowledges that the Regulator is yet to finalise its valuation exercise, and once finalised, either piecemeal or in total, the asset values determined will be reviewed and consulted by the Regulator before being included in the RAB.

Depreciation

Regulator's proposed view

The Regulator has retained the current average depreciation term of 40 years for assets in the RAB. Consideration of asset specific depreciation rates including treatment of assets that have exceeded their expected useful life are to be dealt with in conjunction with the Regulation (Asset) Valuation Methodology.

The Authority's response

The principle of aggregated straight line depreciation with inflation indexed terms is simple but is proving to be too simplistic as the regulation in the port sector is proving to mature with time. The request for a more asset specific depreciation is intended to approximate recovery of capital that is aligned to the useful lives of different asset classes. With the Authority simulating the impact of the change in the depreciation method, it emerges that the change may even lead to a lower recovery in the RAB, although a realistic view of higher prices in the future is possible. Non-asset specific depreciation furthermore conflicts with the user-pay principle advanced in the Tariff Strategy currently being implemented. The Authority is more concerned with the principle of efficient investment where the prices are signalling to the customers the relative "scarcity of resources" used to provide port services, which is not always possible to demonstrate in the current aggregated depreciation approach.

The Authority is supportive of the approach proposed by the Regulator and will actively engage once the Regulatory Valuation Methodology is published.

Inflation Trending

Regulator's proposed view

Retain Consumer Price Index (CPI), with the latest forecast published by the National Treasury or any other reputable forecasts from leading independent institutions or its own forecasts where necessary. This index is used in the conversion of WACC nominal rates to real rates as well.

The Authority's response

The Authority is supportive of the proposals made.

Capital Works in Progress (CWIP)

Regulator's proposed view

The Regulator emphasizes on the detailed projections, per asset class, per service and per project as well as monthly planned expenditure schedules for the tariff period submitted with the annual tariff application. The difference is that any CAPEX which would have been approved and not fully implemented will no longer be taken into account as part of the clawback process (i.e. with the RAB and its return adjusted accordingly). The Regulator proposes that the Authority be given space in implementing its CAPEX projects as set out in the year one of the Tariff Methodology with CAPEX not fully implemented being treated in the clawback every six years and not annually as in the past.

The Authority's response

The Authority's operating environment is one whereby all delivery conditions and dependencies may not always be known in the process of setting tariffs. This dynamic environment is emphasised and becomes increasingly apparent as the Authority embarks on the execution of its capital expenditure program. Fluctuating factors including economic conditions, input costs of a particular project and governmental focal areas may necessitate the reconsideration and rebalancing of projects contained in the Authority's Capital Expenditure portfolio. Given the longer lead times for delivery of the Authority's capital projects, revision of its investment program results in timing differences for project delivery which could span more than one financial year. The previous methodology unfortunately did not accommodate for the practical execution of the Authority's Capital Expenditure. Capital provisioning in the old methodology could almost be seen as diluting the element of certainty which it aimed to achieve in the context of annual tariff application regime.

The Authority welcomes the proposal made by the Regulator in fixing the planned capital expenditure upfront for the next 6 years. This is seen as complementary to the organisation's Market Demand Strategy which has long terms objectives for sustainable development of our country's rail, port and pipeline infrastructure. A Capital Expenditure program underpinned by revenue certainty through an accepted tariff methodology enhances the level of certainty for funders of the organisation.

Whilst the Authority is supportive of the new approach, the past approach and current business practice of the Authority is not accustomed to have detail business cases on hand for the next 6 years.

The Authority aims to achieve this over time and therefore proposes the following phased delivery of business cases being called upon by the Regulator:

- 1. For the FY2018/19 tariff application, business cases for only one year will be submitted, i.e. FY2018/19;*
- 2. For the FY2019/20 tariff application, business cases for two years will be submitted, i.e. FY2019/20 & FY2020/21; and*
- 3. For the FY2020/21 tariff application, business cases for three years will be submitted, i.e. FY2021/22, FY 2022/23 & FY2023/24.*

The nature of the content and detail of business cases needs to be established between the Authority and the Regulator. The Authority envisages that only business cases for projects in excess of R10m should be submitted to the Regulator. Furthermore the nature and content of the business case submissions would be summarised to focus on the more salient aspects including:

- Objective of project*
- Demand to be addressed*
- Alignment to Port Development Plans*
- Solution alternatives*
- Project Costing*
- Financial Returns and Payback periods*
- Timing of Delivery*
- Key Risks*

Projects emanating from the Authority's fleet management plans, road network masterplans, water reticulation master plans, electricity supply master plans and other similar plans may not necessitate detail business cases. The Authority's need for such projects would be clearly articulated in the respective master plans and the sharing of these with the Regulator could probably suffice. Based on the agreement of the format and content of the business cases called upon by the Regulator, the Authority is of the view that the proposed phased approach of delivery mentioned above could be accelerated in due course.

Working Capital

Regulator's proposed view

The working capital element of the RR approach is meant to address the concept of the time value of money where an allowance is made for the time difference, as revenues and expenses cannot be incurred at the same time. This covers areas such as CAPEX requirements, CWIP payable with volume and inflation forecasts used as adjusting factors where necessary.

The Authority's response

Aligned with no further comments.

Weighted Average Cost of Capital (WACC) – Vanilla WACC

Elements of the WACC:

Risk Free Rate (RFR)

Regulator's proposed view

The Regulator is concerned with the interest rate risk, as well as the contribution of the cost uncertainty and the perceived regulatory risk in the profile of the regulated entity being the Authority. The Regulator is of the view that both cost uncertainty is adequately covered in the RR methodology as the operating expenditure is fully allowed. The perceived regulatory risk is mitigated by the transparent tariff methodology which fully compensates the Authority for the revenue it needs. Also, there is a need to compensate for the interest rate risk. The approach proposed would be to align with other regulators in using long dated government bonds in calculating the RFR on the basis of consistency with other variables in CAPM and notably the MRP. The other aim would be to ensure alignment with the length of the remaining life of an asset in the RAB or at least the remaining debt maturities. The Regulator therefore proposes to continue to use the twenty year government bond R186 as an appropriate measure of the RFR.

The Authority's response

The principles proposed by the Regulator on the determination of the RFR are sound. Whilst supporting the principles regarding risk elements and matching of asset lives and/or debt maturities, the Authority is however not convinced that R186 bond instrument as an appropriate measure of RFR. The R186 bond matures in 2026 and therefore is becoming less actively traded and increasingly illiquid and therefore not necessarily a fair reflection of the market.

The Authority still maintains that the R214 South African government bond, which supports the principles highlighted by the Regulator, maturing in 2041 is more reflective of RFR.

Market Risk Premium

Regulator's proposed view

The Regulator intends to retain the use of the geometric mean of the Dimson Marsh and Stanton (DMS) MRP as it is of the view that the arithmetic mean is exposed to the existence of the negative serial correlation result in overstating the MRP.

The Authority's response

The MRP is a concept that relates to the level of risk faced by regulated entities. The Regulator intends to retain the use of the geometric mean based on the DMS studies of observing the MRP on a period of time over 100 years. The Authority acknowledges that the arithmetic mean return may overstate the MRP given the recent volatilities in the markets; however by the same token the Geometric mean return understates the MRP. It is common for regulators to use the arithmetic mean return but apply a discounting factor to compensate for possible over-provisioning. The Authority acknowledges the difficulty of establishing an objective discounting factor to be used in conjunction with the arithmetic mean determination.

The Authority therefore proposes that in order to avoid the risk of overstatement and understatement risk mentioned above, averages of the Geometric and Arithmetic means returns be used for the determination of the MRP.

Beta (B)

Regulator's proposed view

The Regulator will continue to apply an asset beta of 0.5 in the current methodology with a review in the next window of revising the methodology.

The Authority's response

Beta is the only company-specific element required by the Capital Asset Pricing Model. The Authority acknowledges that the calculation of an appropriate beta for a regulated company is complex as it requires steps such as identifying relevant comparator datasets, the relevant gearing as well as the debt beta. The Authority's undertaken of the calculation exercise resulted in a beta outcome of 0.63.

Given the complexities involved in the determination hereof, the Authority is supportive of the Regulator's proposal to revisit this matter prior to the review of the Tariff Methodology in 2019/20.

Gearing (g)

Regulator's proposed view

The 50% gearing reflects a median position in a sample of ports as well as adequately signalling a required reinvestment of profits into the port system whilst balancing costs with a lower cost of debt.

The Authority's response

The Authority is aligned with the Regulator.

Cost of Debt

Regulator's proposed view

The Authority's actual, embedded (adjusted for an effective weighted) debt costs should be used to determine the cost of debt applied within the WACC. The use of Transnet Group short term vs long term structure will be applied to determine an efficient deemed short term vs long term ratio for the Authority.

The Authority's response

The decisions on funding, raising of debt and maintenance thereof are matters handled by Transnet Treasury housed within Transnet Group office. Transnet Treasury experience has demonstrated that sourcing of funds for the Transnet organisation as a group results in more favourable and competitive pricing than asset backed/divisional financing. The rationale for this is explained by the shared diversified risk profile of the group. Hence the Authority is supportive of the Regulator's proposal to use Transnet debt structure of long and short term funding. The Authority however is not in agreement with the Regulator's proposal to use the entity's actual embedded debt costs. Whilst the detail hereof has been availed to the Regulator at their request, the Authority is of the firm view that the nature of the entity's loan book structuring and embedded costs is merely for the purposes of financial accounting and reporting. The current funding book of the Authority and embedded cost of debt is not in any form reflective of the true funding requirements of the Authority in the context of its Capital Investment program nor operational day-to-day needs. The approach by the Authority supports the regulatory principles as the approach up to now, i.e. the use of Transnet cost of debt, is considered to be the only fair representation of the entity's funding costs.

The Authority therefore supports the Regulator's proposal to use the Transnet's debt structuring of long and short term funding but proposes further that the associated Transnet's cost of these funds be used for the purposes of determining Cost of Debt.

Taxation Expense

Regulator's proposed view

The Regulator will accept the current corporate tax of 28% (to be adjusted if amended by the National Treasury) adjusted for an effective Transnet Group Taxation rate for the period. As the current corporate structure enables Transnet Group netting off profits and losses amongst the divisions within the Group, an allowance for tax granted to the Authority may result in increased revenue whilst no liability exists for the Group. An effective tax rate based on the assumption that the Authority is treated as an operating division as opposed to a subsidiary of Transnet Group and will be calculated through the clawback mechanism.

The Authority's response

One of the primary objectives of Economic regulation is to communicate efficient price signals to the market, thereby bringing certainty and encouraging sustainable growth and development. The RR methodology is a pricing approach of an economic nature for the medium to long term which considers all operational costs to deliver sustainable services including replacement cost of assets, funding of investments and opportunity cost of capital. The building blocks of the RR methodology therefore includes a provision for taxation expense and is accommodated for in terms of the Regulator's proposal. This expense is provided for at the statutory rate currently pegged at 28%.

The Regulator's proposal however seeks to clawback taxation based on the Transnet Group current tax liability arising from closure of a particular financial year. In cases where Transnet's tax liability is calculated lower than the statutory tax rate, the Regulator would seek to reduce the tax allowed to the Authority by means of clawback to port users. Whilst this may sound attractive as it would reduce the revenue required level of the Authority, by implication, where Transnet's tax liability is calculated higher than the statutory tax rate, the Regulator should afford the Authority a higher tax provision by means of clawback in favour of the entity. This surely does not make sense where tax matters, exogenous to port users, impact the level of economic port pricing.

The Regulator's proposal if implemented could have unintended consequences. The current incentive for Transnet to be more tax efficient in its processes will be diminished as a proportion of positive gains will be lost to port users whilst any losses will be proportionally funded by port users. One of the key outcomes of this proposal is therefore a cross subsidy between the Authority and other Transnet business which the spirit of the National Ports Act aims to avoid. Given the real possibility of a volatile Transnet

tax liability position by virtue of other Transnet divisions tax positions relative to that of the Authority, the Regulator's proposal runs the risk of disruptive pricing signals which could have a negative impact on the affordability and provisioning of infrastructure in the medium to long term. This would clearly undermine the objectives of economic regulation.

Based on the Authority's interpretation of what the Regulator aims to achieve, it proposes an alternative mechanism that preserves the objective of economic regulation and the communication of efficient pricing signals to port users. In order to share the benefit of the Authority being a division of Transnet, the Authority proposes that to the extent the effective rate calculation as described in the Regulator's proposal yields a tax rate lower than the statutory rate, the resultant difference be retained within the Authority to fund its Capital Expenditure program. The outcome of such a proposal will reduce the dependency on borrowing and hence the Cost of Debt thereby benefiting port users.

Operating Costs

Regulator's proposed view

The Regulator currently analyses the operating cost estimates for the period on a detailed line by line item basis. The Authority is requested to provide detailed and complete motivation for each of the expenses applied for, especially on large items such as labour and energy costs. The expenses include Transnet Group costs. In addition the Authority shall provide audited financial report on these costs.

The Authority's response

Unlike the markets, where if investments turn out to be extremely effective in lowering costs, the market would yield super-normal profits, under regulation with a RR methodology, the regulated entities are restrained to earn only normal profits and at best earn a temporary profit due to the lag in tariff adjustments. Where costs are deemed not to be prudent, leading to uncompetitive pricing, the Regulator would penalise the Authority and disallow these costs. The RR methodology has a mechanism that ensures that only costs needed by the Authority are allowed. Similarly where the Authority is demonstrating efficient operations and making gains, the Regulator should incentivise and affords sharing of gains. The Tariff Methodology must accommodate for such events on a case by case to be motivated by the Authority to the Regulator and various stakeholders in the industry when such situations arise.

Claw-back

Regulator's proposed view

Claw back's main application is to reduce the impact of differences between allowed revenue (based on a number of forecasts and assumptions) calculated at the time of the tariff application, and actual audited figures, and is intended to ensure the coherence and integrity of the regulatory regime. The current approach of forecasting or estimating these variables as conducted annually, with the actual data used to determine the clawback pertaining to the previous tariff year where the 50% rule applies. The final clawback is determined in the following year when actual numbers are available. This approach will be retained.

The Authority response

The determination of tariffs is based on the forecasted normal costs of providing various service offerings. Where actual costs prove to be different from the forecasts, it becomes appropriate to allow prudent costs to be passed on retrospectively. The clawback mechanism allows for such a reconciliation.

The Regulator's approach is supported. However the Authority continues to reiterate a desire to use the actual and not the forecasted CPI (in asset trending, real cost of equity and cost of debt rates). Also, the actual Transnet WACD should be used (described full above in the Cost of Debt section).

Excessive Tariff Increase Margin Credit (ETIMC)

Regulator's proposed view

As the ETIMC is "revenue collected from port users" before the Authority is entitled to it, it should yield a return for users to compensate them for the opportunity cost of their capital. The Regulator proposes to retain the current return on ETIMC which is equivalent to the WACC allowed to the Authority.

The Authority's response

The Regulator's approach is supported. However the Authority continues to reiterate its preference to have this ETIMC attract a funding cost equating to Cost of Debt.

Volume Forecast

Regulator's proposed view

The volume forecasts are based on the forecasted volumes and current tariff levels as well as proposed tariffs.

The Authority's response

The Authority is aligned with no further comments.

Introduction of an efficiency Incentive

Regulator's proposed view

In incentivising efficiency on the RR methodology, the Regulator has decided to introduce an approach which aims to identify and differentiate between volume gains (or volume losses) due to efficiency impacts and markets effects. Through the performance standards TOPS, ROPS, HOPS as well as MOPS the Regulator is of the view that these standards should play a part in the tariff system as a result it has designed a measure called Weighted Efficiency Gains from Operations (WEGO). Where there will be an agreed efficiency gain through operations, which will exclude the effect of market driven volume growth. The WEGO will be signed off by the PCC's at the port level and agreed to with the Regulator.

The Authority's response

The Authority welcomes the approach by the Regulator to evolve the efficiency discussions held by the respective offices into monetary terms and incentive programs. There are a range of incentive regulation programs that could be adopted such as targeted incentives, general incentives or even a fluctuating tariff structure on the basis of the profit level achieved. In general the incentive regulatory regimes are desirable in a typical rate of return regime regulation.

Whilst the concept proposed by the Regulator is generally supported, the extent of the risk to revenues i.e 5% of the Cost of Equity relative to industry gains from improved level of efficiency, as well as the effectiveness of the regime proposed is yet to be established by the Authority. . It is important to note the differential lines of impact between the Ports Regulator WEGO mechanism and the corresponding efficiency management tools (TOPS, ROPS, MOPS and HOPS) and successively between the Ports Authority and Port Users. It follows that the policy environment enabling port efficiency must be supportive of WEGO objectives. In this regard, one must consider that provision for penalties is made in the Terminal Operator Licence, however there is no similar mechanism for road, rail or waterside service providers. The Authority needs to consider further proposed KPIs per port, consistency and weighting

whilst at the same time understand the sharing of gains and losses with operators. The timing of the various planning and execution elements of port efficiency mechanisms must be simulated and necessary changes made to align with the annual Tariff submission timelines. Furthermore, remedial measures for efficiency improvement may straddle across tariff periods and such factors must be catered for otherwise the model is at the risk of promoting the wrong behaviour.

At this stage the Authority is of the view that the timing to give effect to this element in the methodology is appropriate and will work closely with the Regulator to tackle the specifics.

6. Conclusion

A mutually agreed upon Tariff Methodology lies at the heart of economic regulation. By affording both the regulator and regulated entity a formal guideline for revenue determination, it eliminates debate around revenue calculation and promotes focused emphasis on the real fundamentals and objectives of economic regulation. In doing so, this brings about regulatory certainty not only for the regulator and regulated entity, but the associated industries and stakeholders alike.

The Authority welcomes the proposal by the Regulator to retain the RR methodology for the next three tariff applications. This certainly supports the SA governmental focus on infrastructure development to achieve economic growth and social upliftment through SOEs such as Transnet and its divisions in a financially responsible manner.

Within the confines of the proposed RR methodology, the Regulator has amended some of the parameters as a means of evolving the regulatory regime within which the Authority operates. Whilst each stakeholder to the current process has their own particular biasness, it is critical that all involved acknowledge the importance of maintaining regulatory objectivity for the benefit of all port users and other partner industries. Therefore, whilst various views may be expressed to the amendments or non-amendments proposed by the Regulator for new the tariff methodology, the Authority respects that the Regulator needs to finalise the process by end March 2017. However the aspect of taxation and more specifically the proposed clawback thereof is a relatively new discussion point compared to almost all else covered in the proposed methodology. The Authority has clearly articulated the inherent risk of the proposed amendment especially volatility to port pricing arising from factors exogenous to the port industry. This risk could have unintended consequences in the medium to long term if not simulated and considered carefully. The Authority has afforded the Regulator an alternative to achieve the benefit-sharing emanating from the Authority being a division of Transnet without having to compromise port economic pricing principles. A similar careful consideration should be afforded by the Regulator with respect to the Cost of Debt determination. Given the importance of the port pricing for the SA economy it is critical that the Regulator reconsiders its position hereon and if needs be hold further consultations on this aspect which may imply conclusion on these matters for the Tariff Methodology beyond March 2017.