Questions and Responses from the Ports Regulator Tariff Application Road Show 2014

The Ports Regulator held road shows on the proposed tariff application by the National ports Authority from the 15th to the 22nd of September 2014. Meetings were held in Durban, Cape Town, Johannesburg and Port Elizabeth.

The publication of the tariff manual applicable to the 2015/16-2017/18 tariff years resulted in a much more focused discussion with the emphasis mainly on capital expenditure, operational costs and volume forecasts. Unlike previous road shows where the calculation of the weighted average cost of capital (WACC) resulted in much animated and intense discussion and commentating, these issues have been determined for the next three tariff years.

The Road shows followed the same programme in the four cities with two sessions where the Ports Regulator and the National Ports Authority (NPA) respectively presented and then engaged in clarification, and question and answer with attendees. The Regulator's presentation provided an overview of the Ports Regulator and its functions and then focussed on the new three year tariff determination methodology as published, highlighted the tariff strategy process before concluding with key highlights and findings on port costs and pricing from the Global Port Pricing Comparator Study (2012) research. The National Port Authority presented its proposals in the 2015/16 – 2017/18 Tariff Application. The Authority's presentation provided an overview of its responsibilities with regard to service and infrastructure provision in the ports, a description of planned capital and operational expenditure and how they propose to fund it and concluded with a brief update on Operation Phakisa and the new port performance/efficiency monitoring programme. Both presentations can be downloaded from the Ports regulator Website www.portsregulator.org. The comments, questions and responses from the road shows are combined and categorised in two parts: Part 1 captures discussion points on the PRSAs presentation and Part 2 on the Authority's presentation.

Part 1: Ports Regulator of South Africa Presentation

Tariff setting methodology

QUESTION/COMMENT: Regarding asset value in tariff calculation, does NPA use the replacement value, assuming assets are fully depreciated? Also, it seems that the current R67 billion is excessive.

RESPONSE (PRSA): As the return earned on these assets is expressed in real terms, the value of total assets in the RAB is indexed to inflation each year - the Trended Original Cost ("TOC") approach. Each year, estimated capital expenditure and depreciation is added to the closing balance for the previous year to arrive at an updated closing balance for the current year. The expected working capital balance is added to arrive at a total RAB estimate, which is averaged over the year to account for the progressive spending of capital works in progress (CWIP) over the period. In the previous tariff determinations, the Regulator accepted the Depreciated Optimised replacement Cost (DORC) method used by the applicant in certain assets to determine a starting RAB. The Regulator did state, that it had a low level of confidence in the RAB determined through the 2008 DORC method, which gave rise to a steep increase in the asset values, but regulatory certainty was required. In the absence of any alternative the Regulator will be conducting a study to value assets of the NPA. The study will also assist in the defining a methodology for future valuing of the NPAs assets classes. The PRSA will welcome any interrogation of the R67billion by industry in the submissions.

RESPONSE (NPA): The TNPA re-values its assets every 5 years and indexes them in the intervening years. The last valuation resulted in an increase of R13billion on the asset value. On investigation it was found that the large increase was due to the fact that the initial valuation did not factor in full asset value e.g. Engineering Procurement Construction Management cost was left out. Further the rates being used for dredging before were very low, which changed when dredging rates "shot" up with demand after 2005 and an incorrect index was used in between resulting in the R13 billion adjustments after 5 years. Asset valuation is now done every 3 years to mitigate these risks. .

Further Response (PRSA): The PRSA has stated in its Records of Decision that it accepted the 2008 valuation with a trended adjustment going forward, in the absence of an alternative. In the recent past we have clawed back R4.7 million off the RAB on CAPEX that was not spent. A methodology for valuing regulated assets is important and work is being undertaken in this regard.

QUESTION/COMMENT: On the volume forecast – how do you make sure that volumes are accurate?

RESPONSE (NPA): Within the tariff application we have outlined the methodology used to estimate the volumes which includes obtaining volume numbers for the next year from commercial managers at each port, consolidation of these by NPA's Key Account Managers at the NPA head office and obtaining volume forecasts directly from both terminal operators and customers.

QUESTION/COMMENT: What informs the determination of the release of the Excessive Tariff Increase Margin Credit (ETIMC)?

RESPONSE (PRSA): We interrogate the TNPA's revenue request and the members will decide. The use of the ETIMC is also at the discretion of the board – according to the published methodology if what the NPA have asked for is above inflation then the Regulator may consider releasing the ETIMC.

Pricing Strategy

QUESTION/COMMENT: PRSA should reconsider the standardisation of tariffs throughout the port system – can we differentiate in order to incentivise use of ports such as East London for ship repair?

RESPONSE (PRSA): There are too many tariffs in the tariff book so we are looking at rationalisation of tariffs. If the level of service is the same across ports then there should be no difference in tariff. But where the level of service is different then there might be need for differentiation. There are many ways of looking at it but the levelised approach is the correct approach. We think there should be system wide charges as far as possible.

PRSA Price Benchmarking Research

QUESTION/COMMENT: On the PRSA port comparison (benchmarking) research report– are those ports state funded and do they also borrow CAPEX and have to therefore recover it?

RESPONSE (PRSA): This is not a comparison of the same model because you actually don't have the South African model in many other countries however we feel that these are still comparable because the same vessels call here as at those ports. The model is not the idea of the exercise; the idea is that we want to place ourselves as competitive in the global system.

The act provides provision for the retention of capital if NPA were corporatized so it would be difficult to compare the status quo with the intention of the act.

QUESTION/COMMENT: Why have we not looked at liquid bulk in our benchmarking?

RESPONSE (PRSA): The PRSA are currently developing the methodology to include liquid bulk in the next iteration of the study which should be published by the end of the year.

QUESTION/COMMENT: That the PRSA consider, in future, holding colloquium with stakeholders and users in the port sector that will engage with the research that it publishes from time to time. The colloquium can be used to engender a common understanding and parameters for defining areas investigated in the research e.g. "port cost", in the context of global benchmarks where it is difficult to compare apples with apples whilst interrogating with port users, why South African ports stands out like a sore thumb.

RESPONSE (PRSA): The PRSA welcomes the proposal to have discussions with port users on the published studies. The PRSA in conceptualising the studies and its methodological approach takes care to account for differences in various ports which make an "apple for apple" comparison difficult, yet still paint a comparative picture of how South African ports are performing against other countries. The tariff strategy process, which the PRSA is working on with the NPA, also aims to unpack SA port pricing so as to appropriately allocate port costs to the right port users i.e. the size of the cake is determined in the methodology and the strategy will determine how the cake is sliced up and who pays for what. There will be consultations with industry around this. Where there are changes, the tariff strategy will be sensitive to the fact that these cannot be introduced once-off and there will be a need for a managed transition.

Part 2: National Ports Authority Presentation

CAPEX and Asset Values

QUESTION/COMMENT: In order to build trust on the valuation of the Regulatory Asset Base, the PRSA requested that an analysis be done showing how investment in capital assets in each of the years presented (1984/85 – 2021/22) translated into a change in the value of the asset base. The valuation is very important because when the valuation is high the amount of profit earned or the return on equity is very high. This analysis will assist port users to know that the tariffs are providing a return on something that is logically worked out and that in each year the asset base was fully valued taking into account the actual capital expenditure, depreciation and related factors. It will make it clear to all that the revenue collected from them is not just being paid back to Transnet.

RESPONSE (NPA): There may be challenges with historical data due to institutional reforms and the classification of assets during over time. Information may be available for analysis from 1990 and the NPA will endeavour to do the analysis.

QUESTION/COMMENT: With regard to the declining CAPEX over the past three years and the increased planned CAPEX over the next three years (excluding Operation Phakisa), are we not asking for a lot more revenue going forward than has been spent previously? What guarantee do we have that spending will actually increase rather than follow the historical trend of under spend?

Can we expect that NPA will fund Operation Phakisa out of dividends? Last year Transnet made R5.4bn profit and over R2bn of that came from NPA which represents more dividends than the return on equity allowed by the Regulator.

RESPONSE (NPA): Going forward there is actually a spike in labour costs but we require these skills (engineering and associated skills with regard to capital projects delivery). One of the reasons for the under expenditure on CAPEX over past three years is due to delays in the purchase of tugs and a dredger which was moved into later years. We are confident that we will be able to spend requested CAPEX going forward because the demand for capital in the ports is high and urgent.

With regard to dividends we need to discuss this going forward.

One of the large drivers of increased CAPEX will be expenditure on the manganese terminal. It is anticipated that most of the expenditure on Operation Phakisa initiatives will be spread over 5 years. However the details will become clearer when Operation Phakisa report and action plan is publicised.

QUESTION/COMMENT: The PRSA sought to clarify as to whether the Shareholder would obviate the effects of the anticipated rise in port capital expenditure on port users by subsidising some of the capital projects in the application and/or Operation Phakisa projects. This was against the backdrop of the NPA showing port expenditure on a downward trend since 1984/85 through the last few years of the MDS followed by steep increases going forward, into which Operation Phakisa has not been factored. Would it be in the public interest for the Transnet group to subsidise projects? In the absence of direct subsidy, will the shareholder consider retention of Return on Equity of the NPA to actually subsidise projects like Operation Phakisa.

RESPONSE (NPA): Previously it would be difficult to answer the question of whether Transnet would be able to fund the projects. However with the regulatory certainty provided by the 3 year tariff methodology, the NPA is in a better position to make a business case to Transnet regarding funding of projects. Conversations have also started with the Group office to revisit the Transnet prioritisation methodology and the process is assisted by the Port Consultative Committee and National Port Consultative Committee processes, so that the capital programme is endorsed by this legislated structure.

On Operation Phakisa, there are engagements with government and it is clear that reprioritisation will have to happen for it to be affordable. Operation Phakisa is coming into being within a defined revenue space where most of the Transnet MDS commitments have already been made (four years into the MDS) and the MDS is close to reaching its thresholds. The funding thereof will be work in progress especially after the report has been made public and the NPA will engage with the PRSA on the implications of Operation Phakisa on the CAPEX programme in the application.

On the cross-subsidisation question, the Ports Act focuses on ports as but one part of the logistics chain which includes the projects of the Transnet Port Terminal, Transnet Freight Rail etc. A conversation will have to be held on this. Indication was given that from Operation Phakisa, PSP can be utilised to implement; directive to existing Transnet Board to fast track NPA infrastructure project; fast track the Environmental Impact Assessment processes.

QUESTION/COMMENT: For every R1 what is a healthy return i.e. for every R1 revenue generated, what is the profit? Can users be assured that the spike in CAPEX over the next few years is not to guarantee profits for the NPA? How much of the return is ploughed back into capital expenditure?

RESPONSE (PRSA): The regulator implements a claw back mechanism so any CAPEX that was allowed but not spent is clawed back. There is no incentive for increased profit seeking on CAPEX therefore. The Regulator is actively involved with TNPA to make sure that we don't have over or under spend. The global norm for a public service provider it is 10-20% and this year it was 16% therefore 16c on the rand. The multiyear tariff methodology is also up for comment. The PRSA have a very clear statement about how the WACC is calculated and the profit is the equity part of this WACC.

QUESTION/COMMENT: Cargo owners realise and acknowledge the current phase of heavy investment by the NPA which accounts for increased revenue required. Is enough being done though to curb costs and ensure that South Africa's global competitiveness is not negatively affected such that cargo owners lose market share, driving up their costs?

RESPONSE (NPA): With regard to cost containment in the context of an expanding programme, Transnet has succeeded and had failures in the implementation of projects with both scenarios providing lessons that have been used to improve project delivery. Lessons have been learned from other institutions e.g. ACSA, Sasol, Eskom. The NPA has adopted part of the Sasol model which entails having a "scrubbing" reference team to interrogate and evaluate the work done by the internal engineering team. The reference team provides independent assurance to the sponsor through a gateway process that projects are appropriately scoped and delivered.

QUESTION/COMMENT: Should the amount in the capital plan that relates to port operations infrastructure due to there being no operator not be excluded from the CAPEX programme until there is an operator who will pay for such expenditure?

RESPONSE (NPA): As landlord, the NPA is responsible for providing infrastructure and capacity to operate whether or not there is an operator. The cost of providing infrastructure remains that of the NPA, however this does not include the cost of superstructure.

QUESTION/COMMENT: How can you guarantee you are putting in the right superstructure for the manganese terminal?

RESPONSE (NPA): We will go out on section 56 given the terminal specifications we have put in. We have modelled the terminal based on similar manganese terminals in Brazil and other ports and believe the specifications represent best practice.

QUESTION/COMMENT: Is the Liquid Natural Gas (LNG) terminal, as presented in the slides, included in the Tariff Application?

RESPONSE (NPA): The application is for the Richards Bay LNG terminal which is still at exploration stages (FEL 1 and FEL 2) whose expenditure would not reflect in the CAPEX programme. This is likely to happen in 2015.

Tariff incidence and system wide pricing

QUESTION/COMMENT: It seems cargo owners eventually pay for all costs. The R9bn for the manganese terminal development should be ring fenced. Why should general cargo owners pay for that? Similarly, why should cargo owners pay for the development of ship and boat repair (Operation Phakisa), although we agree it is a good development for the port system?

RESPONSE (NPA): The R9bn is the total CAPEX budget for that year (2017/18) and most of this will be spent on the manganese terminal. The NPA must go out on section 56 to find an operator for the new manganese facility. Meanwhile, the NPA must still build the terminal, thus the significant capital outlays to provide the facility. Once the operator is contracted through the section 56 process, these costs will be recovered and brought back into the system. The most of the R9 billion in the application is for the terminal operator. With regard to ship repair, we still need to have a conversation around how that should be funded but we aren’t there yet.

QUESTION/COMMENT: Something needs to be done to encourage more marine activity e.g. decreased port dues. Can the spare capacity not be optimally used first before new infrastructure is developed? Furthermore, if the supporting infrastructure of road and rail isn’t there then you are going in circles e.g. Ngqura. Whilst you have unregulated entities such as rail and road creating high costs for cargo owners, any decreases in cargo dues become irrelevant from a logistics supply chain perspective.

RESPONSE (NPA): Some of the assets associated with vessels are being paid for through cargo dues so port dues are already being subsidized. Internationally the marine infrastructure is paid for by government and these costs don't have to be recovered from port users. With regard to spare capacity, it is not always feasible to move port traffic to where there is spare capacity as capacity needs to be in the right port e.g. Durban containers moving to Ngqura. We anticipate that the proposed single transport regulator will address the challenges of regulating and pricing right at a system level to optimise the impact of decisions taken on the full logistical supply chain.

Beneficiation Promotion Program

QUESTION/COMMENT: There are incentives linked to four levels of beneficiation in the previous tariff strategy proposal in support of government's Beneficiation Promotion Programme (BPP). Is this proposal still being considered and how will the administrative burden in having to incentivise across the four levels be addressed.

RESPONSE (NPA): The NPA acknowledges that the beneficiation promotion programme, could present an administrative nightmare. This is why it is relying on the work done by the Department of Trade and Industry to determine those levels (currently only done for the metal sector). It is the DTI that will identify which commodities fall into which level of beneficiation and do the certification much like is the case with Broad Based Black Economic Empowerment (BBBEE) certification process. The NPA will then use the DTIs certification to assign tariffs and the process will be done in terms of the Tariff Strategy.

Tariff Application Process and Publication Dates

QUESTION/COMMENT: Request for an ROD by the middle of February 2015 because the delay caused problems for industry last year.

RESPONSE (PRSA): The PRSA indicated that its plans for the ROD to be published by the middle February 2015. It is therefore imperative that requisite information from the NPA and from port users – on volumes is provided timeously.

QUESTION/COMMENT: Request for sufficient time to be afforded industry to seek clarification on the NPAs application between the road shows and before the closing date for submissions i.e. the 16th October 2014.

RESPONSE (PRSA): Concurred that further questions of clarity should be submitted to the Regulator by users by the 26th September 2014 to allow the NPA to respond by the 8th of October 2014. All questions and responses will be published on the Ports Regulator website immediately thereafter. The final comments on the tariff application will be published after the 16th October 2014. Submissions made confidentially or elements of the submissions that are confidential should be marked accordingly and will not published

Volume forecasts

QUESTION/COMMENT: (PRSA) Please take the opportunity to submit responses and engage with us on volume forecasts.

QUESTION/COMMENT: (To NPA) Can we have half year volumes please for end September.

RESPONSE (NPA): Yes

Operational Costs

QUESTION/COMMENT: There is a high cost related to section 56 consultants. Will the NPA be building internal capacity for these costs in future?

RESPONSE (NPA): The NPA hoped to use the first section 56 to gain skills and then wean ourselves off the consultants but while this has happened we still need to employ industry specific consultants because each section 56 is unique. It is also tricky because the requisite operational expertise which rests with Transnet Port Terminals is lost because NPA must exclude Transnet Port Terminals from the section 56 process, hence the need for external expertise.

QUESTION/COMMENT: Request to clarify what the cost allocated to marine engineering requirements is exactly? Request to clarify the helicopter related spending. NPA are currently outsourcing whilst training up internal capacity. At what point will NPA no longer need to outsource this function?

RESPONSE (NPA): Marine engineering charges are for expert marine engineering consulting around sand banks, breakwaters etc. With regard to helicopter training, we have employed the first year of cadettes and we are now looking at 4 years where our cadettes will be equipped and we can do away with outsourcing as part of our development agenda. The NPA also plans to stop outsourcing of maintenance on helicopters and are training internal staff to perform this function, however, there are far more trainee pilots than trainees on the maintenance side.

QUESTION/COMMENT: PRSA: It would be more useful to show the Compound Annual Growth Rate from the current base year (i.e. over four years) than from next year for three years.

RESPONSE (NPA): Emphasis of 6% annual average growth rate.

User affordability

QUESTION/COMMENT: Have the NPA done any research around what industry can actually afford?

RESPONSE (NPA): We do industry consultation and balance that with the high demands for capacity in the ports. We can delay CAPEX expenditure if it is too expensive for users. However, this is also the opportunity to give us your industry knowledge. If it is unaffordable then our CAPEX will have to be shifted but we need to know why and will welcome your submissions to reflect this.

QUESTION/COMMENT: Delaying CAPEX expenditure is just delaying the cost. What cost cutting measures are you actually going to put in place to counter this?

RESPONSE (NPA): Since 2005 we have borrowed but with no guarantees from government. When Moody downgrades our credit rating the NPA is also affected. Year on year volumes are under now and the economy is bad. The cost cutting measures of the National Treasury are directly applicable to the NPA.

QUESTION/COMMENT: Does the Regulator conduct sufficient research to assess the impact of its decisions on the total supply chain costs and competitiveness? What is the collective increase in the supply chain and its impact on supply chain competitiveness? Historically, cargo owners experienced high operational costs due to lack of investment in infrastructure and lack of maintenance. There has not been substantial investment in infrastructure and maintenance which means there should be substantial reduction in operational costs and thus more competitive. Is this factored into the regulatory system or will costs just continue to increase?

RESPONSE (PRSA): The Regulator's budget and capacity has at this stage has been focused on providing an overview and exposure that talks to pricing in the South African system. The research conducted to date has contributed to the savings accruing to the port sector within the constraints it operates in. The PRSA will be keen to undertake such studies and to partner with associations.

Complaints process in the ports system

QUESTION/COMMENT: We only get to talk to the Ports regulator once a year and our issues are *now* issues so we need to understand the avenues open to us during the rest of the year.

RESPONSE (PRSA): Encouraged stakeholder to look at the act and send a complaint to the ports regulator. Informal discussions with the Ports Regulator and TNPA can also be beneficial.

RESPONSE (NPA): Request all other stakeholders to please come through to us as NPA. We have port managers in each of our ports and our door is open.

RESPONSE (NPA): Ports regulator is open to any complaint against TNPA.

Tariff Strategy

QUESTION/COMMENT: What sort of time frame are we looking at in trying to address cross commodity subsidy. Also, what processes are we going to put in place to make sure that the rental won't just be put straight back onto the terminal dues.

RESPONSE (PRSA): We are embarking on a tariff strategy that looks at how the cake should be cut up. This tariff strategy will come back here and be consulted by stakeholders. The application of the strategy will be a phased approach.

RESPONSE (NPA): This is a real risk and something we acknowledged when we work shopped the strategy in May 2013. We are having this conversation internally with TPT but TPT are not the only operators. We need to pick this up with the PRSA with regard to how we are going to implement this.

QUESTION/COMMENT: Does the Regulator's mandate allow for the PRSA to address pricing and cross-subsidisation between NPA and TPT?

RESPONSE (PRSA): In terms of the National Ports Act of 2005, the Ports Regulator only has mandate over the NPA and not TPT. The DOT is currently investigating the form and content of a Single Transport Economic Regulator which would be cross-sectoral, thus may empower port economic regulation wider than is currently provided for in the National Ports Act.

QUESTION/COMMENT: Further clarity was sought regarding the mandate of the NPA in relation to tariffs charged by terminal operators in relation to a non-negotiable tariff increase of 9.25% on the automotive industry by Transnet Port Terminals in 2014/15 and what has been stated in the past the NPA is empowered to curb excessive tariff increase by their tenants.

RESPONSE (NPA): In discussions on the tariff strategy the NPA has indicated that it does not want to see the pass through of costs from one entity to the next. The reality of this pass through would prevail with other operators which would account for system costs increasing or staying the same despite initiatives to reduce costs on the NPA side. The NPA is still working out the mechanisms to ensure that systems are put in place and the users benefit, including the work done on the tariff strategy.

RESPONSE (PRSA): The tariff strategy deals with how the cake is cut. Where there is pass through, that should be factored in when the tariff book is rebalanced, so that the end game is not for users to sit with the same situation with charges just coming from a different source. The challenge will be to find the mechanism that allows for this to be achieved.

QUESTION/COMMENT: Does the current tariff application bring into effect the tariff strategy proposals from 2014/15 where revenue raised from tenants were proposed to increasing from 19% to 31%, with adjustments to the revenues to be raised from shipping lines and cargo owners? As an example, the expected revenue from rentals for the period 2014/15 to 2015/16 shows an increase of about 15.9%.

RESPONSE: The tariff application does not implement the proposal in the 2013/14 tariff strategy. Work on the tariff strategy is still carrying on as highlighted. If the strategy is completed by the end of this financial year, some of the elements will be factored into the tariff application and tariff book in 2016/17. The overall process is one of gradual and managed changes to the existing tariff book.

The 15.9% increases are due to adjustments that are being made when leases are renegotiated including some of new leases based on market rates being entered into on expiry of old leases which were not market related.

QUESTION/COMMENT: It isn't sending the right message to the ship owner when the rate goes up 9%, especially with regard to transhipment. TOPS is a huge positive but we cannot lose sight of cost effectiveness. We just lost 250,000 containers to Valencia. Is there any way we can structure the port of Ngqura's marine tariffs differently to the rest?

RESPONSE (NPA): The difficulty for the authority is that port tariffs are a zero sum game so when we discount one user, we must increase the tariffs for another user. We have to find a balance between user pay and subsidy. There are many factors going into subsidy decisions but what has stalled us with regard to marine discounts is that we are actually under-recovering at the moment. To what extent then can this under recovery be subsidised? We are working on these principles as part of the pricing strategy.

QUESTION/COMMENT: In the context of the tariff strategy not being finalised as yet, and against the previous reductions on various tariff book lines, what is the motivation for the proposed differentiated tariffs?

RESPONSE (NPA): With the manual allowing for the NPA to propose a differentiated tariff, the key driver to the proposal was the recognition that the 9.47% adjustment may be high. The specific lower increases on those tariff lines are meant to curtail/reduce this increase on export of beneficiated goods and import of components for the manufacturing of export goods. On marine tariff and break bulk tariffs the NPA is aware that those should be increasing therefore the 9.47% increase.

QUESTION/COMMENT: Can the regulator provide its definition of public interest as it relates to NPA?

RESPONSE (PRSA): Noting that a provision in the National Ports Act of 2005 alludes to what may be considered as public interest without necessarily defining public interest; the PRSA concurs with the need for such a definition which will clarify, amongst others, the basis for cross-subsidisation within the NPA and Transnet.

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