THE SOUTH AFRICAN ASSOCIATION OF FREIGHT FORWARDERS

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Submission to the National Ports Regulator

SUBJECTS:

COMMENT ON THE NATIONAL PORT AUTHORITY'S CURRENT MULTI-YEAR TARIFF METHODOLOGY

AND

THE NATIONAL PORT AUTHORITY TARIFF APPLICATION FOR THE 2017 / 2018 FINANCIAL YEAR

PREAMBLE:

The South African Association of Freight Forwarders (the Association) makes this submission on behalf of its members and its member's clients.

This is the 8th annual submission by the Association to the Regulator on the National Port Authority's tariff applications. Annexures relating to the Freight Forwarding Industry globally and SAAFF's position as the sole voice of the industry in South Africa have been omitted as there is no material change to those previously supplied.

STRUCTURE OF SUBMISSION:

Part 1 of this submission addresses the Tariff Methodology as utilised by the Authority and Regulator during the financial years 2016 through 2018.

Part 2 addresses the Authority's tariff application for the 2018 financial year. It does not address the indicative tariff increases the Authority included in its application for the following

two financial years, 2019 and 2020, as any changes to the methodology will perforce affect the level applicable to those years. However the Association must register its grave concern over the “indicative” levels tabled for both those years the quantum of which if granted would see an increase in tariff over that period of 37.04% which is clearly counter to the Regulator’s position that tariff increases should be below the inflation trajectory as per the 2015 / 2016 Record of Decision (ROD) This extraordinary element of the application suggests that the Authority does not recognise the necessity for real reductions in this country’s supply chain costs.

SUBMISSION:

Part 1: Tariff Methodology:

That the Authority is not an autonomous body places a considerable burden on the Regulator when attempting to assess the true financial situation, actual level of borrowing versus equity, real cost of debt, available cash resources, asset and equity *beta*, etc. many of which are by necessity estimates and a major element in final tariff setting decisions. These difficulties were recognised by the drafters of the NPA Act No 12 of 2005 where the incorporation of the Authority as a company was legislated. (NPA Act Chapter 2 3). Had this requirement been fulfilled at the time all aspects of tariff pricing would be not only simpler but more accurate,

Revenue Requirement Formula:

The Association does recognise that a Revenue Requirement formula is an appropriate process for advance tariff setting for monopoly utilities and is common practice globally where either private sector or State owned utilities are in a regulated environment as is the case with the National Ports Authority. Whilst the process can address the needs of the utility and those of its customers there are critical areas in the formula which if not accurate can and do result in misstated tariff requirements. Outlined below are some of the issues relevant to the NPA which we believe must be addressed in any process of reassessing the current tariff methodology.

Regulatory Asset Base (RAB):

The valuation of the Regulated Asset Base has been a matter of contention for port users since it was determined in 2008. The Regulator has expressed reservations regarding the

recalculated RAB and the use of the Depreciated Original Replacement Cost (DROC) method which was used by the Authority at that time. The Association understands that a process of independent valuation of some of the Authority's assets is under way and questions whether assets which had been completely depreciated over time were included in the opening RAB in 2008 and consequently skewed the basis of the Authority's annual tariff applications.

The Association and all port users should have an understanding of the basic process used in valuing assets. In particular does the Regulator believe that the DROC is indeed an appropriate means of arriving at a valuation and consequent return on that valuation? Would such valuation, when utilised as the basis for pricing, allow the Authority sufficient reserves to finance replacement of obsolete infrastructure when necessary without placing an unacceptable burden on port users or exceeding the return a monopoly such as the Authority would earn were it in a competitive market?.

Weighted Average Cost of Capital (WACC):

There are a number of issues in the current formulae used in determining the Authority's WACC which need to be reviewed, among them are:

Gearing: In the Regulatory Manual for the concurrent tariff year the Regulator indicated that gearing of 50% would be appropriate. Gearing has a direct impact on the WACC calculation and therefore should be reassessed taking into account the Authority's actual level of borrowing versus equity rather than that of the Group.

Beta: Over past years there have been comments tabled by industry on the use of an asset *beta* of 0.50 and consequent equity *beta* of 0.86. The points raised were invariably that as a state owned monopoly with a captured customer base that has no other options there is virtually no risk and that a *beta* of zero would be more

appropriate. Any arguments that reduced volumes or competition from other ports in the region represent material risks can be countered. The Revenue Requirement process presently shields the Authority and it's shareholder from the impact of lower volumes either by increasing tariffs or using claw back and the ETIMC. On intraregional competition the Authority has acknowledged that if anything improved performance by other ports in the region is a positive development for it and this attitude is demonstrated by the practical assistance provided to ports in Mozambique and more recently Benin. The Association believes the Authority should clearly outline its thinking

on the actual level of risk it believes should be applied to *beta* calculation and how such thinking is rationalised. We assume the Authority has assessed any potential loss of volumes to neighbouring ports.

Weighted Average Cost of Debt:

The Association questions the use of Transnet's Weighted Average Cost of Debt (WACD) when reaching the vanilla WACC. It believes that the group WACD is moderated due to the Authority's position as the only true monopoly in the Transnet group with an extremely low or zero element of risk. As an autonomous body it is likely that bond holders and other investors would view the Authority as a better risk and consequently accept lower rates of interest than those applied to the group as whole or the other divisions, were they autonomous.

Conclusion to comment on Tariff Methodology:

The aforementioned comments on the review of the current Tariff Methodology represent some of the issues the Association has with the Revenue Requirement process. It looks forward to its involvement in forthcoming public consultation workshops where additional issues will be addressed.

Part 2: Tariff Application for 2017 / 2018:

Apart from those under “Structure of Submission” above there will be no comment on the indicative tariff rates for years 2019 to 2020 pending possible changes to the Tariff Methodology for years subsequent to financial 2018.

Regulatory Asset Base (RAB):

In view of the Regulator’s announcement that certain major asset valuations are to reviewed and possible changes to the tariff methodology implemented post financial 2018 the Association has no comment on the RAB used in this tariff application.

Cargo Volume Forecast:

The Association understands the difficulty of accurately estimating in advance volume growth. The global and local economies continue to experience low GDP growth and consequent declines in demand and trade growth. The Authority’s volume growth table does however have some fairly arbitrary estimates, the 2% across the board growth in revenue rich container traffic does not appear to be based on any in-depth research. The estimated volume growth of 1.8% applied is, in the Association’s opinion, low considering the Authority’s estimates in Table 12 where all modes show potential growth of over 2%. The Association considers volume 2.5% growth would be a more appropriate forward view. This would reduce the increase applied for to 7.3%.

Bilateral Contracts

In the Record of Decision (ROD) for 2015/16 the Regulator took a position to “*exclude the impact of all bilateral contracts between the NPA and port users in general*”, meaning that revenue would, for the purposes of tariff calculation, be increased by such shortfall, (R151 million in 2015/16). In the Authority’s executive summary for 2016/17 the following statement appeared “*The Authority has adopted the aforementioned approach of the Regulator on the assumption that the recovery of the revenues based on tariff book rates would be legally enforceable”* The current application does not address this matter or indicate whether a legal opinion has been

obtained and if revenues from any outstanding bilateral agreements have been treated similarly in this application.

<u>Operating Expenditure:</u>

Over the past seven years the level of operating expenditure increase has been addressed regularly in the Association's submissions to the Regulator. Annual increases of over 13% have been the mean average year-on-year with only a planned reduction of 22% in Group costs for 2017/18 alleviating what would have otherwise been a 15% increase. The Association continues to be concerned that the Authority's management does not view cost control as a significant issue which, during the current medium term downturn, should be an essential executive responsibility. The Authority's contribution to Transnet Group Head Office is still considered to be too high in terms of value derived from that expenditure, and we remain convinced that corporatisation of the NPA would demonstrate this convincingly.

<u>Energy:</u>

In the Association's submission on the 2016/17 Tariff Application the matter of alternative energy sources was raised with a request that future applications include an indication of any efforts the Authority is making in this regard. As this matter is not mentioned in the current application we presume the Authority does not consider energy saving a priority.

<u>Sundry Operating Costs:</u>

The Association once again questions the substantial revenue items listed in sundry expenses and asks that a detailed explanation be included in future applications and provided to the Regulator in this instance.

<u>Requested Tariff Increase 2017 / 2018:</u>

The Regulator has indicated in previous Records of Decision that overall increases should be within in the SA Reserve banks inflation target band; 3% - 6%. Where

increases over the band are unavoidable due to exceptional capital expenditure or low volume growth there is the potential to utilise the ETIMC to keep increases within the target. It appears from the current application for 2018 financial year and the indicative increases for the two following years that the Authority is simply not getting the message. Reference the Executive Summary; Page 9: "***The Authority has maintained its position (as guided in previous tariff applications) that in order to successfully deliver on the Transnet MDS a tariff adjustment of CPI + 3% would be required".***

The Association has real difficulty in understanding the Authority's attitude in this regard. The impact of increases at levels of up to 50% higher than inflation will see overall tariffs double in 8 years. The impact of tariff increases at this level will clearly impact on market demand. The Authority must indicate whether it has taken into account such a substantial potential increase in tariff when interrogating market demand with customers.

Submission Conclusion

Since the introduction of the Regulatory Principles in August 2009 industry has relied on the Ports Regulator to ensure that the Authority fulfils its obligations to South Africa not only to ensure the proper provision of both facilities and service to port stakeholders and the wider population but to do so at prices which allow the countries global supply chain to become competitive. This Association has no doubt that without the Regulator's positive interventions over the preceding eight years the Authority's tariff would be substantially higher. We have no doubt that this will continue to be the case when assessing the current application and the review of the Tariff Methodology.

D.H. Watts,

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South African Association of Freight Forwarders *September 2016*