South African Association of Ship Operators and Agents

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The Ports Regulator
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19 October 2015

Att: Mr. Mahesh Fakir
Cc: Mr Chris Lötter

Dear Sir

RESPONSE TO THE TRANSNET NATIONAL PORTS AUTHORITY ON THEIR TARIFF APPLICATION FOR FINANCIAL YEAR 2016/17

My concerns with the Transnet National Ports Authority tariff application to the Ports Regulator for the year 2016/17 are two fold. In my comments that follow I will refer to the use of the appropriate WACC and the intended reallocation of the capital base in the pricing of services to the shipping lines.

A. WHICH WACC SHOULD THE REGULATOR USE?

1. In past responses to applications for tariffs by Transnet it was pointed out that in evaluating the cost of capital the regulator is faced with a number of issues to contend with in the use of the WACC, the weighted average cost of capital which is then applied to the capital base. The cost of capital continues to give regulators difficulty all around the world and not only in South Africa. As the economy continues to experience inflation rates in excess of its major trading partners particularly in the West, depreciation of the currency is also adding to the rate of inflation. So it is particularly noteworthy that the Regulatory Asset Base is indexed to inflation each year hence preserving the real value of the capital base. However, the deflator used is the CPI, the

consumer price index which raises questions as to the appropriate deflator. Perhaps consideration ought to be given to the appropriate producer price index given that the capital base consists of capital goods not consumer goods.

2. Then a real WACC is used to estimate the cost of capital but in vanilla terms. I refer the Regulator to the appended document complied by OXERA an international consulting firm specializing in regulation and competition issues. This document deals with inflation and taxation.

3. OXERA concludes that use of a real WACC has the advantage that customers today and customers tomorrow pay the same amount for use of the asset. However, the disadvantage of this approach is that the regulated company remunerates investors differently to the way customers remunerate the firm. This occurs because interest on debt is as a rule in nominal terms. Interest costs are therefore front end loaded whereas the remunerated costs provided by the regulator is back end loaded (See Figure 1 in the appendix) . The implication is that financing the capital base can be problematic.

4. Taxation also raises concerns in the OXERA document in the setting of prices such that the regulated company is provided with the funds to pay their tax liability. The vanilla WACC typically abstracts from tax. The tariff document assumes a vanilla WACC but it is not a true vanilla as it applies a post-tax cost of equity. I refer the Regulator to the equations in the OXERA document. OXERA conclude echoing the views of OFCOM, the UK regulator, that the costs of setting too low a cost of capital outweigh those of setting the cost of capital too high.

5. Despite the arguments for and against setting the appropriate WACC I am of the view that in the short term it will not make a fundamental difference which WACC is used as they all suffer from disadvantages. More importantly for the shipping lines is the value of the capital base and its allocation.

B. REALLOCATION OF THE COSTS OF THE CAPITAL BASE

1. In June 2015 the Regulator suggested the application of average cost pricing of services to customers and reallocation of the capital base between users of the ports. The intended reallocation of the capital base resulted in the following cost reallocation.

Table 1: Cost Reallocation: Current and Long term (%)

User	Current	Long term
Tenants	22	29
Cargo Owners	60	35
Shipping lines	18	36

2. This reallocation reduces the share of cargo owners from 60 per cent to 35 per cent. And more importantly increases that of shipping lines from 18 per cent to 36 per cent with a small increase in the share for tenants. An earlier report pointed out that this would impose a 7.2 per cent annual increase in real prices charged to shipping lines. Despite a ten year phase-in this is a severe annual shock to the shipping lines and their profitability.
3. It is not clear how this reallocation of asset usage was determined when much of the assets are shared between users. Earlier the Regulator had conducted a Global Study of comparative ports pricing which may have resulted in this reallocation. Alternatively assets could have been reallocated on the basis of their usage. Transnet in their application takes on board the Regulator's share of assets with the following suggested changes:

   Cargo owner's prices decrease in real terms by 5.2 per cent. Shipping line prices increase by 7.2 per cent in real terms and tenants a smaller increase of 2.8 per cent in real terms. Given the uptake in the CPI this translates to a nominal increase in prices to shipping lines of 13 per cent. The implication for the shipping lines is a doubling in nominal prices in 5 years. In real terms prices will double in 10 years. These increases occur irrespective of market conditions and are far in excess of the rate of inflation.

4. Any economist would question such increases in pricing to shipping lines. What would be the competitive effects for example? Is it likely to affect transshipment trade with ports such as Maputo being incentivized to compete more aggressively? Is Transnet been allowed to exercise market power?
5. There is a suggestion in the application that the shipping lines by virtue of mergers and alliances will be driving the capital base in the future. It is unclear whether Transnet is suggesting that the shipping lines are exerting countervailing power or whether the large conglomerates will be using larger vessels requiring special capital investment. If the latter this can recouped in the future through the allocated new capital base.
6. The application refers to intended organizational changes by Transnet that will result in improved efficiency gains and cost savings. The shipping lines welcome such changes with these cost savings softening any price increases.
7. Transnet is also concerned about price discrimination between the different ports and running foul of Section 9 of the Competition Act 1998. In the event of a challenge Transnet will be required to show that the cost of providing services at the different ports are indeed not comparable. In my view appropriate reallocation of the asset base on a port by port basis will be critical for a dominant firm such as Transnet to demonstrate.
8. The present state of the South African economy is poor with another recession looming and stubborn excessively high levels of unemployment and depressed investment. Commodity prices have fallen, electricity supply constrained, labour unrest and declining export and import volumes have increased the uncertainty of trading and investing. An increasingly protectionist stance is being adopted by government in an attempt to stem the declines in certain sectors and halt deindustrialization to protect jobs. All these factors have impacted deleteriously on shipping lines who are involved in the international economy.
9. Finally there is the China factor. China is South Africa's major trading partner with Chinese exports to South Africa exceeding its imports from South Africa. Last year the

rate of growth in China declined from a high of 10 per cent to 7 per cent. Although this rate of growth is still outstanding its deceleration is creating problems among China's trading partners and the broader world economy. China next to the USA is the second largest economy in the world and heavily involved in world trade. The recent devaluation of the yuan and intervention in the Chinese stock market combined with a rebalancing of the economy away from the export led growth model has added to the pressure faced by shipping lines.

CONCLUSION AND RECOMMENDATIONS

1. Despite the problems that regulators face in choosing an appropriate weighted average cost of capital (WACC) aside from the financing issues in an inflationary environment, in my view the sensitivity of the pricing regime is likely to be low to different WACCs.
2. The reallocation of the capital base to the detriment of shipping lines is fundamental. With the stroke of a pen it has resulted in price increases in excess of the rate of inflation.
3. Present economic circumstances are very unfavourable at the present time in South Africa. The world economy is uncertain and increasing the price charged to shipping lines is likely to impact not only on shipping lines but users of the lines as they attempt to pass on such price increases.

Prepared by Professor Merle Holden

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APPENDIX

OXERA AGENDA

WHICH WACC WHEN? A COST OF CAPITAL PUZZLE

(Please see attached document)

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Regards,

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(CEO of SAASOA)

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