South African Association of Ship Operators and Agents

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The Chairman
Ports Regulator
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Dear Sir/Madam

SAASOA RESPONSE TO THE TRANSNET NATIONAL PORTS AUTHORITY PROPOSED TARIFF METHODOLOGY

The South African Association of Ship Operators and Agents ("SAASOA") a Section 21 Association was formed amongst other objectives to collaborate with its members in their efforts towards the continuous improvement of shipping standards for the mutual benefit of all stakeholders, and to be an active participant in the development and maintenance of a world class Shipping industry in South Africa.

It is against this background that SAASOA embraced the invitation to comment on the Transnet National Ports Authority (TNPA) Proposed Tariff Methodology.

A Tariff methodology based on a revenue requirement formula as is the previous Tariff applications made by the authority, which attempts to determine the revenue that the authority requires by ensuring that recovery in investment in port services and facilities and operation costs are sufficient return to recover the cost of the capital employed in the production of the regulated services provided.

The proposed formula for calculating the allowed revenues, using a revenue requirement methodology is as follows:

Revenue Requirement = (cost of capital * regulatory asset base) + operating cost + depreciation + taxation expense + claw-back + excessive tariff increase margin credit, adjusted for an allowance for financing requirements.

This submission therefore sets out to analyze the components that the proposed methodology is founded upon and provide recommendations on each.

The ongoing concern with the proposed methodology is that it is based on reimbursing TNPA for costs incurred and therefore does not promote the efficient use of assets, and does not incentivize the reduction of costs and greater efficiencies in general. These costs can be drawn through various examples emanating from poor TNPA management , in respect of asset additions that are not based on sound commercial decisions and as a result the users are expected to pay for poor decision making. An example of this is TNPA's decision to invest in the widening and deepening of the Durban harbour mouth so far in advance of equivalent work alongside the berths taking place.

The proposed formula seems to indicate that TNPA sees the ports as profit making structures. A question that needs defining is to determine whether the profits realized are in fact invested back into the port structures or being employed elsewhere. The profit making however would appear to be a focal point with reference to keeping the charges of national ports competitive and in keeping with its international competitors and stimulating the economy.

Regulatory Asset Base (RAB)
The intention as per the Tariff Methodology is to include capital work in progress in the RAB. The rationale behind this "approach'' avoids a significant increase in the regulated prices once the completed investments are brought into use".

Our concern, however is that current users of the Port are being charged for benefits that future users will enjoy, and are essentially funding TNPA's future expansion plans.

The only capital work in progress that will be operational in the period should form part of the RAB. An example of this would be TNPA's decision to invest in the widening and deepening of the Durban harbour mouth so far in advance of deepening the berths. The net result is around R 3.6 billion and has been added to the RAB yet there has to date (since 2010) not been a single Rand in economic benefit enjoyed by the users. Further, the inclusion should not be based on a weighted average approach but should be calculated based on the expected dates that the assets would be commissioned. This would prevent an overstatement of the RAB. Also, as suggested on the previous tariff application submission, a project finance funding model should be considered and looked into when future major port projects are being considered. This will lower the TNPA overall capital expenditure as the funding will be provided by external investors. The user will pay towards the development but projects that lack sound economic reasoning will not be undertaken, and thus eliminating wasteful expenditure.

The annual adjustment to the RAB reflects a reduction for depreciation, which we would concur with. However, this charge would need to be adjusted for inflation annually, so to be consistent with the adjustment being made to the RAB opening balance. Should the RAB opening balance be increased by inflation, and the depreciation figure remain static, there is a possibility that the depreciation figure in this calculation could be understated.

The calculation also does not address inherent inefficiencies within the RAB. A mechanism needs to be in place to discount the RAB for situations where TNPA invests in assets that are not as efficient as similarly priced assets, i.e. only assets that are efficiently utilized should be included in the calculation under the proposed Tariff Methodology as these inefficiencies are passed onto the end user, with no impact on TNPA.

The proposed methodology also does not protect the consumers against poorly managed capital projects. These projects can result in significant cost overruns from the amounts originally budgeted. There should be a mechanism in place whereby these overruns are excluded from the RAB.

Weighted Average Cost of Capital (WACC)
In this calculation it is noted that equity beta is based on the JSE Top 40 Companies. Clearly it is completely inappropriate to use the equity beta from the JSE top 40 as clearly business whose revenue is calculated in advance on a revenue requirement model with a claw back is a low risk one. TNPA as a monopoly in the South African ports system and operates in a fairly risk-free investment for its investors. The beta must therefore be significantly less than 1 to reflect this.

Expenses
In an economic climate where the majority of companies are looking at costs and efficiencies, there are concerns whether the current methodology will simply continue to mask inefficiencies in TNPA's operations. Also, if TNPA is willing to consider current inefficiencies in its cost structures as acceptable where no effort is being made to investigate whether expenses are justifiable. The statement " increases in excess of inflation will certainly be described fully in the tariff application for the Port Regulator's consideration "does'' not indicate any working towards efficient spending. Expenses should be interrogated for inefficiencies not just those in excess of inflation.

There is also strong concerns relating to wasteful expenditure by Transnet and a fear that certain of these costs are incorporated in the costs that TNPA is seeking to recover as part of this formula. It should be noted that it has been reported that Transnet's 2011/2012 annual report shows that R89,6 million was classified as fruitless and wasteful spending and R79,6 million was lost to criminal conduct. It should further be noted that as per reports "the figures published in the 2011/2012 annual report for fruitless spending and losses to criminal conduct did not include transactions worth less than R25 million each as they were below the materiality limit and were only reported internally".

Therefore, prior to expenditure being increased by inflation, it should be reduced by wasteful and inefficient expenditure and that TNPA should disclose full details of such expenditure to the Port Regulator when submitting applications for tariff increases.

Depreciation
We question the appropriateness of the useful lives used to determine the depreciation of the RAB. The reason for this is that history has shown that assets are frequently employed for significantly longer periods than their useful lives for accounting purposes. Similarly, the residual values of the RAB should be reviewed at the end of every reporting period. These two factors impact the depreciation charge factored into the value of the RAB and the depreciation adjustment in the revenue requirement formula.

Claw-back Mechanism
There are also concerns with the Claw-back Mechanism in the Tariff Methodology. Whilst this appears reasonable in theory, it is of major concern that this could again be used to mask inefficiencies in TNPA's management of its own costs. It appears as though the claw-back mechanism is in place to further reduce TNPA's risks of under-recovery, through inefficiencies or other reasons. It is also noted that TNPA is requesting a return on the assets it employs which is increased by a risk factor, yet the claw-back mechanism would seem to eliminate a great deal of the TNPA's risk.

Financial Factor

The finance factor is in place to compensate consumers for additional revenue that may be required to fund future operations and is calculated using the WACC. This would surely prejudice consumers as the WACC is likely to be lower than market-related rates. Therefore this should be calculated at market-related rates and not using the WACC.

Taxation

We question the appropriateness of the inclusion of the taxation adjustment in the formula. According to the NPA's Q&A publication on the proposed methodology, the tariffs should allow the TNPA to, inter alia, "Make a profit commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities". We submit that since taxation is based on profits, is it not correct to include the taxation in the revenue requirement formula. This is in essence simply passing the taxation onto users, and eliminating the cost of tax to TPNA. It is not necessary to include a taxation adjustment in the revenue requirement formula in order to make a commensurate profit. This further indicates that TNPA regards the ports as profit making structures, and even more at odds with keeping the charges of national ports competitive with international competitors and thereby stimulating the economy.

Summary and recommendations

The revenue requirement methodology proposed by TNPA is not an inappropriate methodology to determine tariff increases, as it is used by authorities both in South Africa and internationally. However, the following adjustments need to be made to the implementation of the methodology:

- Only capital work in progress that will be operational in the period should be included in the RAB and the inclusion should be based on the expected date the assets will be commissioned.
- The depreciation charge used in this calculation of RAB is to include both the useful lives and residual value of the underlying asset it relates to.
- An adjustment should also be made in respect of inefficient assets and overspending on poorly managed capital projects.
- An adjustment should be made to reduce the required return for investors, to properly reflect that the port is a national key-point with a primary aim of stimulating the economy, and is not solely a profit making operation.
- The required expenditure should not be calculated/based on the prior year plus inflation, but rather a proper analysis made of necessary expenditure. Furthermore an adjustment should be made to remove fruitless and wasteful spending from the calculation.
- This should be removed from the equation for the reasons specified in the body of the report.
- This should be calculated using market-related rates and not the WACC.

Taking all of the above into consideration it is proposed that the formula be amended as follows:

{(RABy-IAy-1–POy-1) x (WACCyxDFy)} + (Ey–WEy-1) + Dy+Ty + (-) ETIMC - {Fy- 1 x (1+MRy-1)}+Fy

Where:

IAy-1 is an adjustment for the inefficient use of assets or the acquisition of inefficient assets.

POy-1 is an adjustment for cost overruns on capital projects.

DFy is the discounting factor to the expected return by Transnet to reflect the port as a national key-point.

WEy-1 is an adjustment for wasteful and fruitless expenditure.

MRy-1 is a market-related borrowing rate to be used for the financing factor.

Regarding the opinions determined, this association supports the National Ports Authority in any initiative where efficiency, productivity and cost are of benefit to the port users.

Regards,

Peter Besnard
SAASOA Acting CEO