2017 - 2018 TARIFF COMPLIANCE STATEMENT

(General Statement)

31 May 2017

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Contents

1. Purpose and Structure

This is Port of Melbourne's (PoM)[1] 2017 Tariff Compliance Statement (TCS) that is being submitted to the Essential Services Commission (ESC) for the period 1 July 2017 to 30 June 2018 (2017-18). This TCS relates to PoM's Prescribed Services only, which are defined under section 49 of the *Port Management Act 1995* (Vic) (the Port Management Act) to include, amongst other things, the provision of shipping channels, berthing facilities, the provision of short-term storage and cargo marshalling. Under clause 7 of the Pricing Order[2], PoM is required to submit an annual TCS to the ESC by no later than 31 May of each year that demonstrates how its Prescribed Service Tariffs for the upcoming financial year comply with the Pricing Order.

PoM's 2017-18 TCS comprises this document together with:

- Appendix A –Reference Tariff Schedule which sets out PoM's 2017-18 Prescribed Service Tariffs;
- Appendix B – A regulatory model setting out the detailed calculations supporting the Aggregate Revenue Requirement and Prescribed Services Revenue;
- Appendix C – An expert report from Synergies Economic Consulting Pty Ltd supporting PoM's weighted average cost of capital estimates titled "*Determining a WACC estimate for Port of Melbourne*";
- Appendix D – A copy of a Port User contract;
- Appendix E – A summary of the Port User consultation process undertaken as part of the preparation of this TCS;
- Appendix F – Detailed information on the efficient capital expenditure and operating expenses incurred in the provision of Prescribed Services, depreciation approach, cost allocation approach and avoidable costs; and
- Appendix G – A reference table specifying how PoM has complied with the Pricing Order.

Note - All financial information provided in this TCS is denominated in nominal dollars (referred to as "current price terms" in clause 8.1.1 of the Pricing Order) unless stated otherwise. All clause references in this TCS refer to clauses in the Pricing Order unless otherwise specified, and capitalised terms used in this TCS but not otherwise defined have the meaning given to such terms in the Pricing Order.

2. Regulatory Context

In October 2016, the Victorian Government awarded a fifty year lease of the Port of Melbourne's commercial operations to the Lonsdale Consortium, which commenced its operation on 1 November 2016.

In conjunction with the Port Lease Transaction, a new regulatory regime has been introduced to oversee the pricing arrangements relating to Prescribed Services. The key regulatory instrument is the Pricing Order made pursuant to the Port Management Act and administered by the ESC. The Pricing Order, which took effect on 1 July 2016:

- sets out how PoM must set its Prescribed Service Tariffs; and
- requires PoM to demonstrate on an annual basis how its Prescribed Service Tariffs for the upcoming financial year comply with the Pricing Order.

Under the Port Management Act, the ESC must conduct a public review of PoM's compliance with the Pricing Order every five years. Within six months after each five-year review period, the ESC must report to the Minister on whether PoM has complied with the Pricing Order, and to the extent there has been any non-compliance, whether such non-compliance is "significant and sustained".

As noted above, this TCS sets out, amongst other things, how PoM's Prescribed Service Tariffs for the upcoming 2017-18 financial year comply with the Pricing Order.

[1] The Port of Melbourne consolidated group (PoM).
[2] Made pursuant to section 49A of the Port Management Act.

3. Compliance in the Initial Financial Year

The Initial Prescribed Service Tariffs that applied on and from the Commencement Date (1 July 2016) are set out in the Schedule to the Pricing Order and pursuant to clause 11.1.3 of the Pricing Order are deemed compliant with the Pricing Principles and Cost Allocation Principles for the Initial Financial Year (1 July 2016 to 30 June 2017) (2016-17).

4. Annual TCS Compliance Requirements

The Pricing Order requires that PoM's annual TCS must:

- set out its Prescribed Service Tariffs for the upcoming financial year (clause 7.1.2(a));
- detail the basis on which PoM has (a) made any adjustments to its Prescribed Service Tariffs and / or (b) introduced any new Prescribed Service Tariffs (clause 7.1.2(b));
- provide information on all contracts with Port Users in accordance with clause 6.2.1 (clause 7.2.1(c));
- describe how PoM has consulted and incorporated feedback from Port Users in developing this TCS (clause 7.2.1(d));
- explain how Prescribed Service Tariffs for the upcoming financial year comply with the Pricing Order (clause 7.1.2(e));
- contain any further supporting information determined by the ESC in accordance with clause 9 of the Pricing Order (clause 7.2.1(f)); and
- comply with the information requirements set out in clause 8 (clause 7.2.1(g)).

Each of these matters is addressed in sections 5 to 10 below.

5. 2017-18 Prescribed Service Tariffs

PoM's 2017-18 Prescribed Service Tariffs are set out in the Reference Tariff Schedule provided at Appendix A of this TCS. These tariffs are effective from 1 July 2017 and have been calculated by applying the Tariffs Adjustment Limit (TAL) to the Initial Prescribed Service Tariffs that are set out in the Schedule to the Pricing Order[3] - this is discussed in section 9.2 below. In preparing its 2017-18 Prescribed Service Tariffs, PoM has:

- not Rebalanced the Initial Prescribed Service Tariffs – this is discussed in section 6 below;
- not used the Aggregate Revenue Requirement derived using the accrual building block methodology to adjust its Initial Prescribed Service Tariffs – this is discussed in section 9.1 below; and
- complied with the Export Pricing Decision for full outbound container wharfage services in accordance with clause 2.3.1 of the Pricing Order. In particular, PoM's 2017-18 Prescribed Service Tariffs show a 2.5 per cent reduction in the "full outward containerised wharfage tariff" to $98.26 from the $100.78[4] level that applied for 2016-17 - this is discussed in section 9.2 below.

PoM has calculated its 2017-18 forecast Prescribed Services revenue based on the 2017-18 Prescribed Service Tariffs (at Appendix A) and forecast trade volumes[5]. PoM notes that this forecast revenue from 2017-18 Prescribed Service Tariffs is below the Aggregate Revenue Requirement determined under the accrual building block methodology.

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[3] Other than tariffs for outbound container wharfage services.
[4] Comprising $63.28 plus the infrastructure fee of $37.50.
[5] PoM's 2017-18 forecast trade volumes were developed on a disaggregated basis which mapped cargo type to the underlying import / export trade demand drivers.

6. Prescribed Service Rebalancing

Under clause 3.2.4 of the Pricing Order, PoM can make an application to the ESC to make the following adjustments to its Prescribed Service Tariffs (other than those that are subject to the Export Pricing Decision):

- revise certain Prescribed Service Tariffs by a different percentage adjustment;
- introduce a new Prescribed Service Tariff; or
- discontinue the provision of an existing Prescribed Service Tariff.

Rebalancing Applications are due to the ESC prior to 1 January of any financial year commencing on or after 1 July 2017. PoM has not made a Rebalancing Application to the ESC in relation to its 2017-18 Prescribed Service Tariffs. As discussed in sections 5 and 9.2, PoM has adjusted the Initial Prescribed Service Tariffs by the same percentage adjustment[6] consistent with clause 3.2.1 of the Pricing Order.

7. Contracts with Port Users

PoM confirms that in accordance with clause 6.2.2(b) of the Pricing Order, the revenue associated with contracts has been included in the calculation of the Aggregate Revenue Requirement in accordance with clause 2.1.1 but has not been included in the Weighted Average Tariff Increase calculation for PoM's 2017-18 Prescribed Service Tariffs.

8. Feedback from Port Users

PoM has undertaken comprehensive consultation with Port Users in preparing this TCS. This is PoM's first Port User consultation process following the commencement of the Pricing Order. In designing the consultation process, PoM has sought to build on its existing consultation processes, having regard to the requirements of clause 7.1.2(d) of the Pricing Order.

The key objectives of PoM's engagement with Port Users include:

- informing Port Users of the new regulatory regime pursuant to the Port Management Act and the Pricing Order;
- explaining the key Pricing Principles, including the application of the TAL and the accrual building block methodology; and
- setting clear expectations about PoM's commitment to ongoing engagement with its Port Users.

[6] Other than tariffs for outbound container wharfage services

In addition and as part of PoM's broader engagement process, PoM has consulted Port Users on a range of topics important to them in order to assist PoM to continue to improve its supply chain efficiency, productivity and capacity. This process informs PoM on its future development and investment plans. Overall PoM's Port Users:

- did not raise any material queries about the introduction of the new regulatory arrangements including the Pricing Order; and
- did not object to Initial Prescribed Service Tariffs generally increasing in line with the CPI.

A summary of PoM's consultation process and activities and feedback from Port Users is provided at Appendix E of this TCS.

9. Prescribed Service Tariffs – Compliance with the Pricing Order

The Pricing Order sets out two requirements in relation to the adjustment of the Initial Prescribed Service Tariffs, being:

(i) Aggregate Revenue Requirement

Clause 2.1.1(a) of the Pricing Order provides that "*Prescribed Service Tariffs must be set so as to allow the Port Licence Holder a reasonable opportunity to recover the efficient cost of providing all Prescribed Services determined by application of an accrual building block methodology of the type described in clause 4*".

Clause 2.1.5 goes on to say that "*…a Port Licence Holder will not be in breach of this Order if it sets actual tariffs for Prescribed Services at a level that is lower than permitted under clause 2.1.1(a) in any relevant period*".

(ii) Tariffs Adjustment Limit (TAL)

Clause 3.1.1 of the Pricing Order provides that *"in addition to complying with clause 2, the Weighted Average Tariff Increase implied by the Prescribed Service Tariffs set by the Port Licence Holder in respect of any Financial Year commencing on or after 1 July 2017 must not exceed the Tariffs Adjustment Limit"*

The Pricing Order defines the TAL as *"…the percentage change in CPI between the March quarter immediately preceding the relevant Financial Year and the March quarter in the Financial Year two years preceding the relevant Financial Year."*

The TAL applies for up to 21 years from the Pricing Order commencement date of 1 July 2016, after which time only the accrual building block methodology will apply. PoM has derived and compared forecast 2017-18 revenue using both these approaches. This analysis is set out in sections 9.1 and 9.2 below.

9.1. Aggregate Revenue Requirement

Table 1 below sets out the Aggregate Revenue Requirement for PoM's Prescribed Services[7] calculated in accordance with the accrual building block methodology described in clauses 4 and 2.1.1 of the Pricing Order and using PoM's regulatory model provided at Appendix B. In accordance with clause 2.2.1 of the Pricing Order, PoM confirms that it has used the same accrual building block methodology and parameters for both Dedicated and Shared Channels.

[7] PoM has used the accrual building block methodology to determine the Aggregate Revenue Requirement associated with all Prescribed Services as defined under section 49 of the Port Management Act. This ensures no discrimination between Port Users on the basis of port or berth (clause 2.2.1).

Table 1: Aggregate Revenue Requirement

	2016-17 ($ Million)	2017-18 ($ Million)
Return on Capital	481.7	499.8
Return of Capital	297.7	511.8
Operating Expenses	135.4	128.4
Indexation Allowance	(88.8)	(112.7)
Aggregate Revenue Requirement	**826.0**	**1,027.4**

For the avoidance of doubt, PoM has not used the Aggregate Revenue Requirement derived using the accrual building block methodology to adjust the Initial Prescribed Service Tariffs. Rather, the Aggregate Revenue Requirement demonstrates the revenue that PoM would need in order to recover its efficient costs of providing Prescribed Services in 2017-18.

The key inputs into, and assumptions relating to, the calculation of the Aggregate Revenue Requirement are discussed in sections 9.1.1 to 9.1.7 below.

9.1.1. Regulatory Period

PoM has determined a Regulatory Period of one year in accordance with clause 13.1.1 of the Pricing Order for the purposes of calculating the 2017-18 Aggregate Revenue Requirement. PoM considers that the Pricing Order would permit it to determine a much longer Regulatory Period up to the term of the Port Lease. PoM intends to further consult with the ESC on the practicalities of longer Regulatory Periods and subject to that consultation, proposes to further consult with Port Users.

9.1.2. Capital Base

PoM has forecast an opening 1 July 2017 capital base and a closing 30 June 2018 capital base as follows:

1 July 2017 opening capital base

To forecast the opening capital base, PoM has rolled forward the opening 2016 capital base of $4,142.0 million[8] in accordance with clause 4.2.1 of the Pricing Order by:

- indexing this value in accordance with clauses 4.2.1(b) and 4.6.1(a) of the Pricing Order. Appendix B provides further details on this calculation;
- adding capex of $68.7 million forecast to be incurred between 1 July 2016 and 30 June 2017 in accordance with clause 4.2.1(c) and 4.6.1(b) of the Pricing Order. Capex is discussed in section 9.1.4 below and further details are provided at Appendix B and Appendix F; and
- deducting depreciation (the return of capital allowance). This has been determined to be zero as discussed in section 9.1.3 below.

[8] As set out in clause 4.7.1 and Port Capacity Project capex in the definitions of the Pricing Order: $3,505 million + $637 million = $4,142 million.

Table 2: Capital Base for 2016-17

	2016-17 ($ Million)
Opening 1 July 2016 Capital Base	4,142.0
Plus Indexation Allowance	88.8
Plus Efficient Capex	68.7
Less Depreciation	0.0
Closing 30 June 2017 Capital Base	**4,299.6**

Note: 2016-17 capex is based on 9 months of actual and 3 months of forecast.

The closing 30 June 2017 capital base provides the forecast 1 July 2017 capital base.

Closing 30 June 2018 capital base

PoM has rolled forward the 1 July 2017 capital base using the same method as described above to forecast the closing 30 June 2018 capital base.

Table 3: Capital Base for 2017-18

	2017-18 ($ Million)
Opening 1 July 2017 Capital Base	4,299.6
Plus Indexation Allowance	112.7
Plus Efficient Capex	67.6
Less Depreciation	0.0
Closing 30 June 2018 Capital Base	**4,479.8**

Capex is discussed in section 9.1.4 below and further information on how PoM has derived its 2017-18 capex and indexation allowance is provided in its regulatory model at Appendix B. Appendix F explains why PoM's capex is prudent and efficient.

9.1.3. Depreciation

PoM's existing assets are depreciated over their design life[9] and remaining useful life consistent with the *CH2M Technical Memorandum No: DORC 03* (CH2M Report) provided at Appendix F to this TCS[10]. The average remaining lives for the assets in the initial capital base are set out in Table 4 below.

Table 4: Asset lives for assets in the initial capital base

Asset Class	Remaining Asset Life (years) as at 1 July 2016
Wharves	23
Channels (to declared depth)	50
Channels (over-dredged zone)	1.5
Channel Protection Assets	23
Channel Service Protection	14
Plant	18

[9] The design life is determined based on the lowest life cycle cost.
[10] The CH2M Report was commissioned by the Victorian Government as part of the Port Lease Transaction vendor due diligence process, which provided the technical analysis and valuation of the initial capital asset values.

Asset Class	Remaining Asset Life (years) as at 1 July 2016
Roads	8
Rail	18
Buildings	26

The standard lives for new assets are based on their design lives (for wharves and plant) and economic lives (for road, rail and channels) consistent with the CH2M Report. These standard lives are set out in Table 5 below.

Table 5: Standard life for new capex

Asset category	Standard Life (years)
Wharves	25
Port Capacity Project (PCP) - wharves	50
PCP - civil (average life)	30
Channels	50
Plant	40
Road	20
Rail	30
Navigational aids	25

PoM has not applied straight line depreciation required under clause 4.4.1 of the Pricing Order, but rather used the alternative methodology provided under clause 4.4.2(a) of the Pricing Order. This is because the application of the TAL prevents PoM increasing prices to the level whereby PoM could recover its Aggregate Revenue Requirement calculated under the accrual building block methodology with the application of a straight line depreciation methodology. To this end, pursuant to clause 4.4.2(a), PoM has applied the alternative depreciation methodology which only applies depreciation to the extent that revenue from Prescribed Services exceeds the Aggregate Revenue Requirement absent the depreciation allowance. This method complies with the Pricing Order provisions relating to depreciation including that the depreciation allowance is not below zero in accordance with clause 4.4.3 of the Pricing Order.

PoM’s forecast depreciation, set out in Table 2 and Table 3 above, reflects:

- the capital base values described in section 9.1.2 above;
- the standard and remaining asset lives set out in Table 4 and Table 5 above; and
- the use of the alternative depreciation methodology permitted by clause 4.4.2(a) of the Pricing Order.

Appendix F contains further information on PoM’s depreciation methodology including how the remaining asset lives for new and existing assets have been determined.

9.1.4. Capital Expenditure (Capex)

PoM's forecast 2016-17 and 2017-18 capex for Prescribed Services is detailed in Appendix F. In particular, Appendix F details how this capex is prudent and efficient. Table 6 summarises PoM's forecast capex by category.

Table 6: 2016-17 and 2017-18 capex

Capex category	2016-17 ($ Million)	2017-18 ($ Million)
PCP	37.5	4.2
Channel	8.2	7.6
Wharves	18.9	47.7
Other	4.1	8.1
Total	**68.7**	**67.6**

Further details about PoM's 2016-17 and 2017-18 capex program are detailed in Appendix F.

9.1.5. Rate of Return on capital

PoM has determined a pre-tax nominal weighted average cost of capital (WACC) of 11.54 per cent for 2016-18.

The Pricing Order provides that the return on capital, required to calculate the Aggregate Revenue Requirement, should be:

> *An allowance to recover a return on its capital base, commensurate with that which would be required by a benchmark efficient entity providing services with a similar degree of risk as which applies to the Port Licence Holder in regards to the provision of Prescribed Services (clause 4.1.1(a) of the Pricing Order).*

And:

> *in determining a rate of return on capital for the purposes of clause 4.1.1(a) the Port Licence Holder must use one or a combination of well accepted approaches that distinguish the cost of equity and debt, and so derive a weighted average cost of capital (clause 4.3.1 of the Pricing Order).*

The Pricing Order also clarifies that the rate of return must be calculated on a pre-tax nominal basis (clause 4.3.2 of the Pricing Order).

An expert report from Synergies Economic Consulting titled "*Determining a WACC estimate for Port of Melbourne*" is provided at Appendix C of this TCS. This report is the basis for PoM's estimated rate of return on capital, which is consistent with the Pricing Order requirements set out above. PoM's estimated rate of return is based on the average WACC using three well accepted cost of equity approaches being: the Sharpe-Lintner Capital Asset Pricing Model (SL CAPM); the Black CAPM; and the Fama-French three factor model (FFM). Table 7 below details the parameter estimates calculated under each of these approaches.

Table 7: Cost of capital parameters under the SL CAPM, Black CAPM and FFM approaches

Element	SL CAPM	Black CAPM	Fama French
Return on equity (pre-tax)	13.66%	13.66%	15.12%
Return on debt (pre-tax)	5.45%	5.45%	5.45%
Gearing	30%	30%	30%
Gamma	0.25	0.25	0.25
Pre-Tax Nominal WACC	**11.20%**	**11.20%**	**12.22%**
Average Pre-Tax Nominal WACC	**11.54%**		

9.1.6. Operating Expenses (Opex)

PoM's forecast 2016-17 and 2017-18 opex for Prescribed Services is detailed in Appendix F. In particular, Appendix F details how PoM's opex is prudent and efficient and explains the basis on which opex has been allocated between Prescribed Services and Non Prescribed Services. Table 8 summarises opex by category.

Table 8: 2016-17 and 2017-18 Opex

Opex categories	2016-17 ($ Million)(1)	2017-18 ($ Million)
Port Licence Fee and Cost Contribution Amount	96.3	97.9
Insurances, rates and taxes	1.0	0.9
Repairs and maintenance	9.9	5.8
Labour	12.7	9.6
Other support (including security)	8.9	8.1
Other Discretionary(2)	3.5	3.6
Transition	3.1	2.5
Total	**135.4**	**128.4**

Note:
(1) 2016-17 opex is based on 9 months of actual and 3 months of forecast.
(2) This relates to the engagement of professional services such as contractors and consultants

9.1.7. Indexation allowance

PoM has calculated the indexation allowance in accordance with clause 4.6.1 of the Pricing Order. The detailed calculations are contained in PoM's regulatory model provided at Appendix B.

Table 9: Indexation allowance

	2016-17 ($ Million)	2017-18 ($ Million)
Indexation Allowance	88.8	112.7

9.2. Tariffs Adjustment Limit (TAL) and Revenue from Prescribed Services

PoM has determined its 2017-18 Prescribed Service Tariffs by applying the TAL to the Initial Prescribed Service Tariffs as discussed in section 5 above[11]. The TAL is based on the percentage change in the 2016 March quarter[12] and 2017 March quarter CPI[13] (All Groups Index Number, weighted average of eight capital cities published by the Australian Bureau of Statistics) and is 2.1 per cent. The detailed calculations on how the TAL has been used to escalate Initial Prescribed Service Tariffs are contained in PoM's regulatory model provided at Appendix B.

[11] Other than tariffs for outbound container wharfage services.
[12] Twelve month March quarter CPI.
[13] This is consistent with the TAL as defined in the Definitions section of the Pricing Order being "*the percentage change in CPI between the March quarter immediately preceding the relevant Financial Year and the March quarter in the Financial Year two years preceding the relevant Financial Year*."

Applying the TAL of 2.1 per cent to the Initial Prescribed Service Tariffs[14] results in the following price impact for 2017-18:

- 2.5 per cent reduction for full outward containerised wharfage tariff;
- 2.1 per cent increase for all other Prescribed Service Tariffs; and
- a Weighted Average Tariff Increase of 1.1 per cent.

PoM has calculated its forecast revenue based on its 2017-18 Prescribed Service Tariffs (at Appendix A) and its 2017-18 forecast trade volumes. The revenue is set out in Table 10 below. PoM's 2017-18 forecast trade volumes were developed on a disaggregated basis which mapped cargo type to the underlying import / export trade demand drivers.

Table 10: Comparison of revenue from 2017-18 Prescribed Services and the Aggregate Revenue Requirement

	2016-17 ($ Million)	2017-18 ($ Million)
Revenue from 2017-18 Prescribed Service Tariffs	328.4	341.1
2017-18 Aggregate Revenue Requirement	826.0	1,027.4
Difference	497.6	686.2

Table 10 shows that the revenue PoM expects to recover by applying its 2017-18 Prescribed Service Tariffs is $686.2 million below the forecast Aggregate Revenue Requirement derived using the accrual building block methodology. This means that the cost to PoM of providing Prescribed Services in 2017-18 is greater than the revenue it expects to recover in that year.

10. Other matters

10.1. Upper and Lower Bounds

In accordance with clause 2.1.4 of the Pricing Order, the upper bound principle in clause 2.1.1(b)(i) does not apply during the period in which the TAL applies. PoM has demonstrated compliance with the lower bound principle in clause 2.1.1(b)(ii) which allows PoM a reasonable opportunity to recover, for each Prescribed Service Bundle, revenue that does not fall below a lower bound representing the avoidable cost of not providing the Prescribed Service Bundle. Appendix F provides further information on PoM's approach to avoidable costs.

[14] Other than tariffs for outbound container wharfage services.