Port of Melbourne

2018 - 2019 TARIFF COMPLIANCE STATEMENT

GENERAL STATEMENT

31 May 2018

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Abbreviations and acronyms

Abbreviation / acronym	Description
A	Actual
ABBM	Accrual building block methodology
ARR	Aggregate Revenue Requirement
BEE	Benchmark Efficient Entity
BIS Oxford Economics	BIS Oxford
Capex	Capital expenditure
CPI	Consumer Price Index
DAFF	Department of Agriculture, Fisheries and Forestry
ECR	Efficient Cost Recovery
EDI	Electronic Data Interchange
EMT	Executive Management Team
ESC	Essential Services Commission of Victoria
F	Forecast
LOLO	Lift on and lift off charge
Opex	Operating expenses
PCP	Port Capacity Project
PDS	Port Development Strategy
PMA	*Port Management Act 1995* (Vic)
PoM	Port of Melbourne
RAS	Rail Access Strategy
RTS	Reference Tariff Schedule
SoRA	Statement of Regulatory Approach
TAL	Tariffs Adjustment Limit
Tariffs	Tariffs for Prescribed Services
TCS	Tariff Compliance Statement
TEU	Twenty-foot Equivalent Unit
THC	Terminal Handling Charge
VBS	Vehicle Booking System
WACC	Weighted Average Cost of Capital
WATI	Weighted Average Tariff Increase

Supporting documents

The table below lists the supporting documents that are incorporated within, and form a part of, Port of Melbourne's (PoM)[1] 2018-19 Tariff Compliance Statement (TCS).

Table i: 2018-19 TCS supporting documents

Appendix	Title
A	PoM, 2018-19 Reference Tariff Schedule (RTS)
B	PoM, Regulatory model
C	Synergies Economic Consulting, Determining a WACC estimate for Port of Melbourne, April 2018
D	PoM, Contracts with Port Users
E	PoM, Port User and other stakeholder consultation
F	PoM, Overview Paper: Expenditure, Cost Allocation, Depreciation, Performance Standards and Avoidable Costs
G	PoM, Compliance with Pricing Order - Cross-Reference Table
H	BIS Oxford Economics, Port of Melbourne Trade Forecasts – Forecasts to FY 19, April 2018
I	PoM, WACC: Submission on well accepted approaches, 31 May 2018
J	PoM's regulatory brochure
K	PoM's regulatory deep-dive workshop presentation
L	Letter from PoM to Gulf Agency Company explaining time-based berth hire fees
M	PoM, Cost allocation model

[1] The PoM Consolidated Group. The PoM Group shareholders comprise QIC, Future Fund, Global Infrastructure Partners (GIP) and OMERS.

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1. Executive summary

This is PoM's 2018-19 TCS to the Essential Services Commission of Victoria (ESC) for the period 1 July 2018 to 30 June 2019 (2018-19).

In the past year, PoM has broadened and deepened its engagement with Port Users and other stakeholders - being anyone who is exposed to, and or impacted by the port - to understand better their views and priorities. This included engagement with a wide group of other stakeholders from industry, government and across the community. PoM has considered the views and priorities raised by Port Users and other stakeholders and, where relevant, incorporated their feedback into this TCS.

The key positions in this TCS are:

- a one-year regulatory period
- a weighted average increase in Prescribed Services Tariffs (tariffs) of 0.9 per cent from 2017-18
- tariffs for full outbound container wharfage services will decrease by 2.5 per cent from 2017-18, while all other tariffs will increase by the Tariffs Adjustment Limit (TAL) of 1.9 per cent, being the annual change in the Consumer Price Index (CPI) to March
- no tariff re-balancing currently proposed. All tariffs (except tariffs for full outbound container wharfage services) have been adjusted by the same percentage adjustment (1.9 per cent). There are no new or discontinued tariffs, and
- PoM will not recover its full efficient costs of providing Prescribed Services in the 2018-19 regulatory period because the forecast Prescribed Services revenue for 2018-19 (which is subject to the TAL) is less than the Aggregate Revenue Requirement (ARR) (calculated based on the accrual building block methodology (ABBM)).

Table 1 shows that the forecast 2018-19 Prescribed Services revenue of $371.2 million is $812.8 million below the ARR of $1,184.0 million. It also shows that 2018-19 Prescribed Services Revenue is $30.1 million higher than the forecast Prescribed Services revenue for 2017-18 and $38.1 million higher than the actual 2016-17 Prescribed Services revenue.

Table 1: ARR and Prescribed Services revenue (subject to the TAL), $ Million Nominal

	2016-17 (A)	2017-18 (F)	2018-19 (F)
Aggregate Revenue Requirement (ARR)			
Return on capital	481.9	499.8	519.3
Return of capital	297.6	511.8	645.1
Operating expenses (opex)	134.0	128.4	127.8
Indexation allowance	(80.8)	(112.7)	(108.2)
Total ARR	**832.7**	**1,027.4**	**1,184.0**
Prescribed Services revenue (subject to the TAL)			
Weighted Average Tariff Increase (%)	n.a.	1.1	0.9
Tariffs Adjustment Limit (%)	n.a.	2.1	1.9
Total Prescribed Services revenue[i]	**333.1**	**341.1**	**371.2**
Under-recovery of ARR	**(499.5)**	**(686.3)**	**(812.8)**

i. Prescribed Services revenue includes revenue from Prescribed Services in PoM's Reference Tariff Schedule and contracts with Port Users for Prescribed Services.

Table 2 shows the forecast closing 2017-18 capital base, as at 30 June 2018, which becomes the opening 2018-19 capital base, as at 1 July 2018. The forecast closing 2017-18 capital base of $4,479.8 million, submitted in PoM's 2017-18 TCS, has been adjusted for 2016-17 actual values and is therefore $4,475.4 million.

While depreciation is typically deducted from the opening capital base, PoM has set straight-line depreciation to zero and deferred its recovery to future years because, as shown in Table 1 above, in 2017-18 and 2018-19 forecast Prescribed Services revenue (subject to the TAL) is below the ARR. This is recognised by adding back deferred depreciation. This is discussed in sections 7.1.1 and 7.1.4.

Table 2: Capital Base 2017-18 and 2018-19, $ Million Nominal

	2017-18 (F)	2018-19 (F)
Opening Capital Base (1 July)	4,299.6	4,475.4
Plus Indexation Allowance	112.7	108.2
Plus Efficient Capex	67.6	67.7
Less Depreciation	(511.8)	(645.1)
Plus Deferred Depreciation	511.8	645.1
Closing Capital Base (30 June) as per 2017-18 TCS	**4,479.8**	n.a
Adjustment for 2016-17 actual values	(4.4)	n.a
Closing Capital Base (30 June) reflecting 2016-17 actual values	**4,475.4**	**4,651.3**

This TCS contains the following financial information:

- 2016-17 – actual and forecast values. The forecast values were submitted in PoM's 2017-18 TCS.
- 2017-18 – forecast values that were submitted in PoM's 2017-18 TCS. Actual information will be provided in PoM's next TCS because at the time of submitting this TSC PoM does not have a full year of actual information.
- 2018-19 – forecast values only.

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 and the numbers in the tables may not add due to rounding. All clause references are to the Pricing Order, unless otherwise stated, and capitalised terms that are not otherwise defined, have the meaning given in the Pricing Order.

2. About PoM's 2018-19 TCS

PoM is required to submit an annual TCS to the ESC by no later than 31 May each year[2] that demonstrates how its tariffs for the upcoming financial year comply with the Pricing Order.

This is the second annual TCS that PoM has submitted to the ESC. The positions in this TCS are largely in line with the 2017-18 TCS. PoM has actively considered feedback received from the ESC over the last 12 months in formulating its positions. Any changes in positions are explicitly identified and explained.

Specifically, in preparing this TCS, PoM has addressed:

- clause 7.1.2 of the Pricing Order
- the ESC's follow up questions (Information Requests) on PoM's 2017-18 TCS
- the ESC's Interim Commentary on PoM's 2017-18 TCS[3], and
- the ESC's Statement of Regulatory Approach (SoRA)[4] and associated Feedback Paper[5].

Clause 7.1.2 of the Pricing Order provides that PoM's TCS must:

- set out its tariffs for the upcoming financial year
- detail the basis of any adjustments to (i.e. re-balancing of) tariffs, including any new or discontinued tariffs
- explain and justify the cost blocks included in the ABBM and the basis on which the WACC has been estimated
- provide information on contracts with Port Users
- describe how PoM has consulted with and incorporated feedback from Port Users
- explain how tariffs for the upcoming financial year comply with the Pricing Order, including the pricing principles and cost allocation principles
- contain any further supporting information determined by the ESC in accordance with clause 9 of the Pricing Order, and
- comply with the information requirements in clause 8.

Appendix G provides a compliance checklist that provides a cross-reference to where in this TCS the requirements of clause 7 have been addressed. Section 11 of this TCS details where the views and positions outlined in the ESC's Interim Commentary, SoRA and associated Feedback Paper are addressed.

2.1 Regulatory context

PoM operates under a regulatory framework, which came into effect on 1 July 2016. The regulatory framework is set out in the:

- *Port Management Act 1995* (Vic) (PMA), and
- Pricing Order issued by the Governor-in-Council, and made pursuant to section 49A of the PMA.

The Pricing Order relates to Prescribed Services only. These include channel services, berthing services, short-term storage and cargo marshalling facility services and other services that allow access or use of certain port infrastructure[6].

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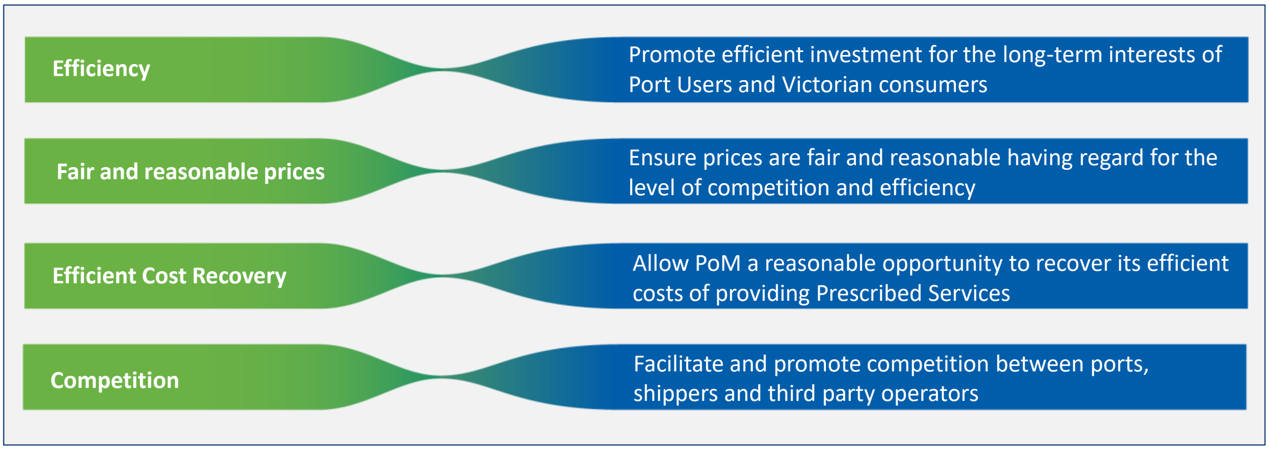
[2] Under clause 7.1.1(a) of the Pricing Order
[3] ESC, 2017-18 Port of Melbourne tariff compliance statement: interim commentary, 9 November 2017 (Interim Commentary)
[4] ESC, Statement of Regulatory Approach – version 1.0: Port of Melbourne pricing order, December 2017 (SoRA)
[5] ESC, Feedback on consultation and other matters: Statement of Regulatory Approach version 1.0: Port of Melbourne pricing order , December 2017 (Feedback Paper)
[6] Prescribed Services are defined in section 49(1)(c) of the PMA

PoM provides various non-Prescribed Services, including leasing of space and facilities on port land. Charges for non-Prescribed Services are not subject to the Pricing Order[7] and are not dealt with in this TCS.

Section 48 of the PMA sets out the objectives of the regulatory framework, which are summarised in Figure 1.

Figure 1: Objectives of the regulatory framework

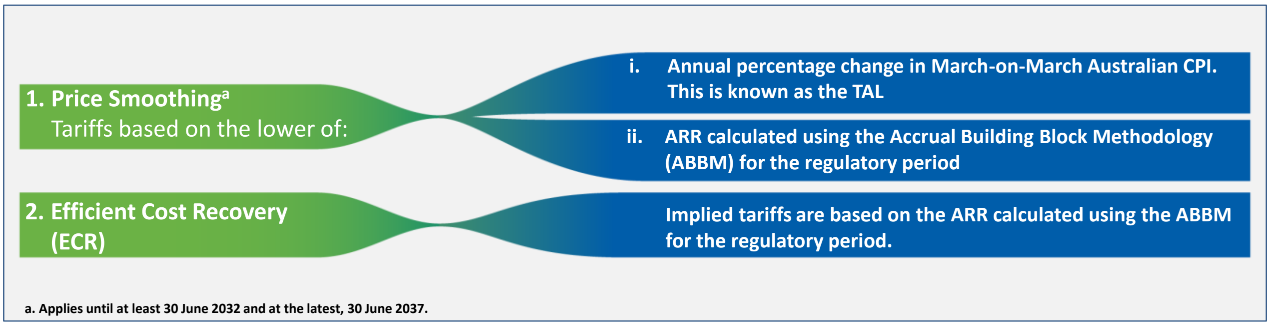


The Pricing Order:

- details the pricing principles and regulatory mechanisms that govern how PoM must set its tariffs for Prescribed Services, and
- requires PoM to demonstrate how its tariffs for the upcoming financial year comply with the Pricing Order.

There are two key pricing principles under the Pricing Order summarised in Figure 2.

Figure 2: Key pricing principles



PoM currently expects that tariffs (except for full outbound container wharfage services) will be subject to price smoothing through the application of the TAL and will therefore change in line with the annual increase in CPI until at least 30 June 2032 and at the latest 30 June 2037. This is because tariffs implied by the ABBM are expected to be higher than tariffs subject to the TAL over this period (TAL period). Price smoothing provides greater certainty and predictability in tariffs for Port Users.

PoM must submit a TCS to the ESC by 31 May each year that explains how its tariffs comply with the Pricing Order.

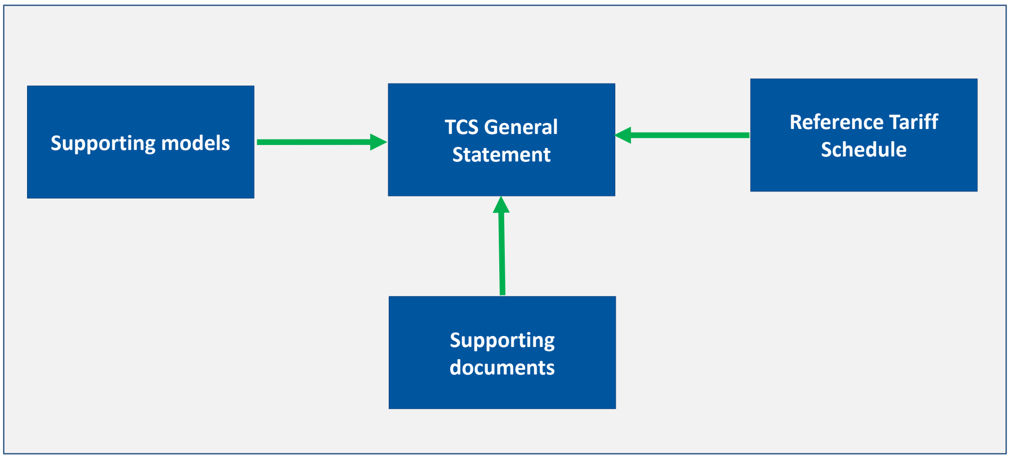
The ESC will undertake a formal public compliance inquiry every five years[8] that will include findings on whether there has been any non-compliance and to the extent there has been, whether any such non-compliance is "significant and sustained". The ESC's first formal compliance review will be undertaken in 2022 for the 2017-2021 review period[9]. The outcomes of the compliance inquiry must be reported to the ESC Minister within six months of each five-yearly review period.

[7] Fees and charges for some non-prescribed services are contained in the Other Fee Schedule of the RTS. Charges for certain other non-prescribed services, such as leasing of space and facilities, are based on commercial agreements.
[8] Under Division 2A of the PMA, s.49I(1)
[9] The Commission must complete the inquiry no later than six months after a review period – clause 49I of the PMA

2.2 Structure of PoM's 2018-19 TCS

PoM's 2018-19 TCS is structured as follows to be as clear and accessible as possible to the ESC, Port Users and other stakeholders.

Figure 3: 2018-19 TCS document structure



The full list of supporting documents and models comprising PoM's 2018-19 TCS is listed in Table i.

2.3 Next steps and stakeholder feedback

Having a better understanding of Port Users and other stakeholders' views and feedback is important for PoM to continue to meet their needs and expectations now and into the future. PoM welcomes feedback through any of the following channels:

Channel	Details
Phone	+61 1300 857 662
Post	GPO Box 2149 Melbourne VIC 3001 Australia
Online	http://www.portofmelbourne.com/contact-us

PoM will continue to engage with Port Users and other stakeholders as part of its business as usual processes as discussed in section 4.

3. Historical performance

3.1 PoM's 2016-17 performance

Given the May 31 submission timeline for the TCS, PoM does not have a full year of actual information for 2017-18 at the time of submitting this TCS – PoM will provide this information in next year's 2019-20 TCS. PoM is therefore providing actual information for 2016-17 only.

Table 3 compares PoM's 2016-17 forecast revenue, capex and opex for Prescribed Services with actual 2016-17 outcomes.

Table 3: Comparison of 2016-17 forecast and actual revenue, capex and opex, $ Million

	2016-17 (F)	2016-17 (A)	Difference (%)	Difference ($)
Revenue	328.4	333.1	1.4	4.7
Capex	68.7	72.4	5.3	3.6
Opex	135.4	134.0	(1.1)	(1.4)

Table 4 compares PoM's 2016-17 forecast volumes with actual volumes.

Table 4: Comparison of 2016-17 forecast and actual volumes

Trades	Units (Million)	2016-17 (F)	2016-17 (A)	Difference (absolute)	Difference (%)
Containers - import	TEU	1.25	1.25	0.00	0.0
Containers – export		0.88	0.90	0.02	2.0
Containers - empty		0.57	0.55	(0.02)	(2.4)
Dry bulk	Revenue tonnes	4.05	4.30	0.25	6.1
Liquid bulk		2.37	2.60	0.23	9.6
Motor vehicles		6.90	6.82	(0.08)	(1.2)
Breakbulk		2.39	2.69	0.30	12.9
Chanel – Melbourne	Gross tons	107.81	111.03	3.22	3.0
Chanel – Shared		120.52	124.59	4.07	3.3

Table 3 and Table 4 show that the difference between 2016-17 forecast and actual information is not significant and falls within PoM's expected range of variance for such forecasts. This supports the robustness of PoM's forecasting capability.

3.2 ESC's feedback on PoM's 2017-18 TCS

The ESC has provided informal feedback on PoM's 2017-18 TCS through the following documents:

- Interim Commentary, and
- the SoRA and associated Feedback Paper.

The ESC has also engaged with PoM through periodic meetings to discuss key matters.

This informal feedback is intended to promote transparency and predictability in the application of the regime and provide broad guidance on the ESC's views and expectations. It is also intended to inform the ESC's five-yearly public review of PoM's compliance with the Pricing Order[10]. The ESC's Interim Commentary states:

> *"This will benefit the formal five-yearly review process by providing opportunities for stakeholders, including the port, to be aware of key issues or concerns in advance of formal inquiries. This will also allow the port to refine the information it provides over time to assist the port to demonstrate compliance ahead of our inquiry"[11].*

PoM welcomes the ESC providing feedback in this way. It is important for PoM to understand any issues or concerns the ESC has about PoM's approach and positions so that PoM can respond to these including by refining or further justifying its positions and approach, where necessary, throughout the review period.

The ESC's Interim Commentary provided the ESC's high-level views on three key areas:

- the WACC
- the length of the regulatory period, and
- treatment of deferred depreciation.

The SoRA provided more detail on the ESC's views and expectations on a broader range of matters. Section 11 consolidates the views and positions raised in the ESC's Interim Commentary and SoRA into a single list of positions and provides a cross-reference to where they are addressed in this TCS.

The ESC's feedback highlights the overall alignment between the ESC's and PoM's views on what constitutes compliance with the Pricing Order and how best to demonstrate compliance. A key difference between the ESC's and PoM's interpretation of the Pricing Order relates to the WACC and in particular what constitutes "well accepted approaches". This matter is addressed in **Appendix I**.

The ESC has not issued PoM with a Supporting Information Determination under clause 9 of the Pricing Order because PoM has provided all necessary information for the ESC to review PoM's 2017-18 TCS and develop its preliminary views.

[10] The public review will occur in 2022 for the 2017 to 2021 review period The public review must be conducted within six months after five yearly each review period

[11] ESC, 2017-18 Port of Melbourne tariff compliance statement Interim Commentary, (Interim Commentary) 9 November 2017, p.4

4. What Port Users and other stakeholders are telling PoM

PoM has built on its 2017-18 consultation program to undertake deeper and broader engagement with Port Users and other stakeholders to prepare this 2018-19 TCS.

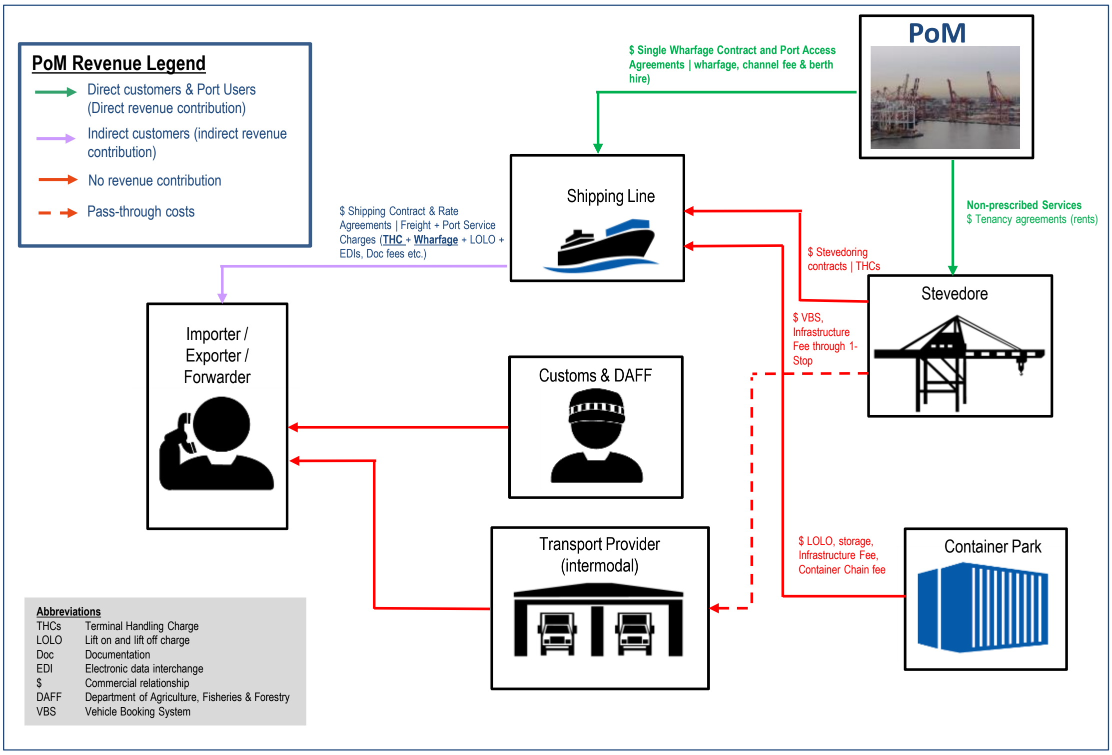
4.1 PoM's Port Users and other stakeholders

PoM's stakeholders include direct Port Users and indirect Port Users (together referred to as Port Users) and other stakeholders:

- **Direct Port Users** have a direct commercial relationship with PoM, such as shipping lines and stevedores.
- **Indirect Port Users** have an indirect commercial relationship with PoM, such as importers, exporters, freight-forwarders, logistic providers and others in the logistic supply chain.
- **Other stakeholders** are exposed to, and or impacted by, the port, such as the Victorian community, local residents, industry associations, the Victorian, Tasmanian and Federal Governments, Victorian local governments and any other interested parties.

Figure 4 shows PoM's relationship with Port Users.

Figure 4: PoM's relationship with Port Users and supply chain



4.2 PoM's commitment to engagement

While clause 7.1.2(d) of the Pricing Order provides a clear regulatory imperative for PoM to engage with Port Users, PoM recognises that best practice engagement should be business-led and an on-going part of its day-to-day operations, rather than a means to an end. PoM is working to achieve this outcome. This is because PoM considers that understanding the key concerns and priorities of Port Users and other stakeholders is fundamental to:

- good business planning and decision making, and
- operating the port in a manner that is consistent with the long-term interests of Port Users and Victorian consumers.

It is important that Port Users and other stakeholders understand the regulatory framework under which PoM operates. This will assist them to participate in the regulatory process so that they can share their views and feedback. PoM has therefore:

- upgraded its website to provide more information about the regulatory framework. Between February and April 2018, there have been 172 unique page views of the regulatory web-page. This demonstrates that Port Users and other stakeholders are becoming aware of information that PoM is providing and are accessing it
- published a regulatory brochure, which explains the regulatory framework and the basis for setting tariffs. This is provided at **Appendix J** and is also available on PoM's website
- raised awareness of the regulatory framework in its day-to-day dealings with Port Users and other stakeholders during which PoM has referred to its website, including the regulatory brochure, as sources of information about the regulatory framework
- provided a high-level overview of the key aspects of the regulatory framework in all of its engagement sessions. **Appendix E** provides a log of PoM's engagement activities from July 2017 to May 2018
- held deep-dive regulatory workshops in Melbourne and Sydney to facilitate detailed discussions with interested Port Users and other stakeholders about the regulatory regime and key proposed positions underpinning PoM's 2018-19 TCS. The workshop presentation is provided at **Appendix K**, and
- sought feedback on a number of key issues from attendees at the deep-dive regulatory workshops through an on-line survey.

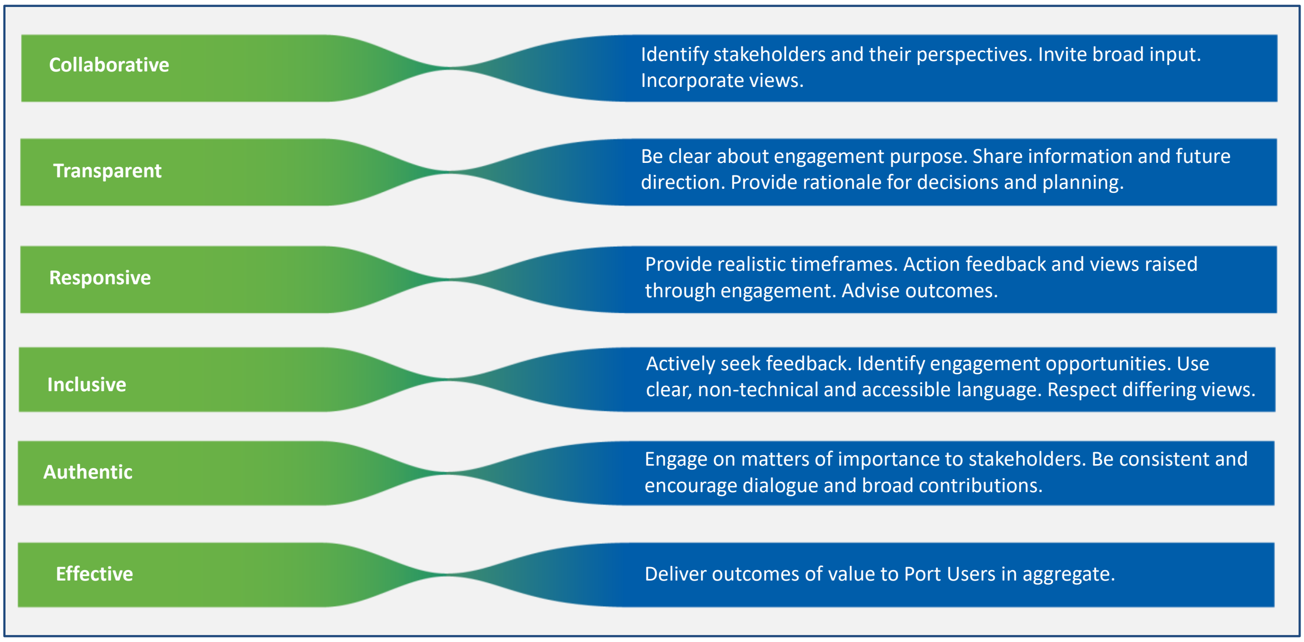
4.3 Importance of two-way engagement

PoM recognises that engagement needs to be two-way to be meaningful. Accordingly, the key objective of PoM's engagement is to establish open communications with Port Users and other stakeholders, in order to:

- provide accessible, relevant and transparent information on PoM's priority investments and future direction and
- understand, discuss and address Port Users and other stakeholders' business needs, insights and requirements on key matters to ensure that we are meeting their expectations now and into the future.

Figure 5 sets out PoM's core engagement principles that underpin and characterise its approach to consultation.

Figure 5: PoM's engagement principles



PoM has applied these core principles in developing and conducting its engagement activities to foster genuine and meaningful discussions with Port Users and other stakeholders.

4.4 What PoM has done

Appendix E includes a log of the engagement activities PoM undertook between July 2017 and May 2018. There were 24 engagement sessions held over this period in Victoria, NSW and Tasmania, including in regional centres such as Wagga Wagga, Griffith and Burnie.

In developing these activities, PoM considered the different interests and levels of knowledge of Port Users and other stakeholders and therefore the most suitable engagement channels. This led to a tailored, multi-channel and integrated consultation approach that covered a range of topics at different levels of detail to gain a more sophisticated knowledge of Port Users and other stakeholders' perspectives. PoM's Executive Management Team (EMT) led the engagement and encouraged Port Users and other stakeholders to engage on any matter of importance to them. The ESC attended some of these engagement activities.

As shown in Figure 6, PoM discussed a broad range of topics during these engagement activities.

Figure 6: PoM's engagement overview

With whom

- Direct Port Users: shipping lines and stevedores
- Indirect Port Users: importers, exporters, freight-forwarders, logistic providers and other in the logistic supply chain
- Other stakeholders: Victorian community, local residents, industry associations, the Victorian, Tasmanian and Federal Governments, Victorian local governments and any other interested parties.

How

Tailored to suit different interests or interactions with PoM:

- Port tours
- One-on-one meetings
- Workshops
- Strategic forums
- Conferences and seminars
- Breakfast, lunch and dinner forums

On what (topics)

- Regulatory framework
- Proposed key positions underpinning PoM's 2018-19 TCS
- Trade development
- Port development and planning
- Ship size
- Rail access strategy
- Supply chain efficiency
- Implications of West Gate Tunnel for PoM

Table 5 shows that the engagement activities informing the development of PoM's 2018-19 TCS involved a significantly wider group of Port Users and other stakeholders from industry, government and across the community, than those informing its 2017-18 TCS.

Table 5: Invitations, acceptances and attendance - engagement activities for PoM's 2017-18 TCS and 2018-19 TCS

Port Users and other Stakeholders	2017-18 TCS	2018-19 TCS
Invited to participate	171	655
Accepted invitations	84	533
Attended the engagement activities	68	452

PoM was grateful that several industry associations participated in the engagement activities that are able to further communicate with their numerous members on the matters discussed at the engagement activities. This promotes greater reach of PoM's engagement activities.

4.5 Key findings of PoM's engagement

Table 6 summarises what PoM heard from Port Users and other stakeholders and the PoM's responses.

Table 6: Summary – Port Users and other stakeholder's feedback and PoM's responses (including actions)

Topic	Port Users' and other Stakeholders' feedback	PoM's response	Queries raised	Actions for PoM	Actions Addressed	Actions to be completed / ongoing
Tariffs	• Requested information to better understand PoM's tariffs. • Queried whether infrastructure and channel deepening fees still apply as they continue to be listed on some freight forwarders' invoices.	• Explained the basis and rationale for existing and future tariffs and committed to undertaking a review and making future changes (including rebalancing options), where appropriate. • Will publish a "know your bill" fact sheet that confirms what PoM's charges do and do not include.	7	10	5	5
Ship size	• Supported the port's role in accommodating larger container vessels.	• Explained current and future work to accommodate larger container vessels.	1	1		1
On-port rail access	• Supported alternatives to road transport and encouraged an open-access regime for the port rail network.	• Explained the objectives of, and the timeframes for developing, its Rail Access Strategy.	1	2	1	1
Efficient future investment	• Queried whether the regulatory framework would promote "gold plating". • Queried PoM's incentives to invest if it cannot recover its efficient costs.	• Explained the protections built into the regulatory framework for Port Users. • Explained that new investment requires Port Users' support and suitable arrangements being established for cost recovery.	2	2	1	1
Communication	• Encouraged open communication about certain matters that can impact the port's operations.	• Reviewed relevant engagement and communication activities, processes and protocols and made improvements where necessary. • Will continue to review and refine as required.	3	5	4	1
Total			**14**	**20**	**11**	**9**

Appendix E expands on the matters raised by Port Users and other stakeholders and provides further detail on PoM's responses to this feedback including the relevant actions that it has taken, or is taking, to support its responses.

4.6 How PoM will continue its engagement activity

As demonstrated over the past year, PoM greatly values the relationships it has with Port Users and other stakeholders and is committed to collaborating with them to better understand their needs and expectations. This will assist PoM to make decisions that focus on the best possible outcomes for the long-term interests of Port Users and Victorian consumers.

As PoM prepares its 2019-20 TCS over the next 12 months, and in subsequent years, PoM will continue to engage with Port Users and other stakeholders about matters such as performance standards, larger container vessels and on-port-rail access. This engagement will be underpinned by the engagement principles outlined in Figure 5 above, which will encourage genuine listening and responsiveness.

With the help of Port Users and other stakeholders, PoM will continue to improve its engagement capability and effectiveness by:

- understanding the priority matters Port Users and other stakeholders want to talk about and establishing open, transparent and inclusive processes in which to discuss them
- reviewing the engagement practices and process initiatives undertaken by other Australian and international ports and infrastructure industries, such as water, energy and telecommunications so PoM can learn from them
- continuing to build the capacity of Port Users and other stakeholders to participate in the regulatory process
- continuing to provide clear, easy to understand communication materials that explain complex issues. This will assist in making these issues tangible to ensure feedback is meaningful
- reviewing PoM's engagement activities, practices and evaluation framework to ensure that they remain valuable and relevant
- seeking feedback from Port Users and other stakeholders, verbally and through formal channels, on whether recent engagement activities and practices provide the right opportunities for them to input into PoM's decision making processes, and
- re-affirming PoM's commitment to engage with Port Users and other stakeholders on an ongoing basis.

PoM will share the details of its engagement activities with Port Users and other stakeholders on an ongoing basis.

5. The length of the regulatory period

Under clause 13 of the Pricing Order, PoM must nominate the regulatory period for the purposes of calculating Prescribed Services revenue (subject to the TAL) and the ABBM, as well as the associated tariffs.

Consistent with its 2017-18 arrangements, PoM has nominated a one-year regulatory period for 2018-19.

At this early stage of the application of the regime, a one-year regulatory period remains the best option for Port Users and PoM. This is because a longer regulatory period requires robust long-term expenditure forecasts across the regulatory period. PoM is in the process of developing, in conjunction with Port Users, strategies and performance standards, which will be critical to inform these forecasts:

- **Port Development Strategy (PDS)** – a public exhibition draft PDS is due to the Minister for Ports by 31 December 2018. This will set out PoM's long-term (approximately 30 years through to 2050) vision for the growth and development of the port. It will contain a range of feasible future port development concepts to address current and emerging strategic issues, such as continued trade growth, trends in ship size growth and landside transport issues and opportunities, including on-dock rail. Key drivers of these emerging issues are continued population and economic growth, industry and market sector changes, agricultural climatic conditions and international commodity prices for exports.
- **Rail Access Strategy (RAS)** – this is due to the Victorian Government in October 2019[12]. The RAS will set out on-dock rail terminal infrastructure options for the movement of freight into and out of the port that provide viable, cost effective and sustainable alternatives to road transport. This is becoming a critical issue as the population and trade volumes continue to grow driving both road congestion and high road transport costs. Efficiency of the port interface is essential to promote investment in efficiency and productivity across the broader port supply chain.
- **Performance standards** – these outcome measures will allow the ESC, Port Users and other stakeholders to assess whether PoM is meeting service outcomes in an efficient, consistent and timely manner. They also facilitate assessment of whether cost savings are driven by a reduction in service quality or productivity, innovation and efficiency. PoM is currently consulting Port Users and other stakeholders on the level of performance it currently provides. The current draft of these performance standards is provided at **Appendix F**.

PoM has undertaken, and will continue to undertake, detailed and broad consultation with industry, government and the community on its PDS and RAS to test and refine these strategies and make sure that they are aligned and meet the needs of different stakeholders. The feasible options presented will take account of factors including cost, community and environmental impacts, planning considerations and technical feasibility. In summary, PoM will use the following forums to consult stakeholders on the development of its RAS and PDS:

- industry – workshops and meeting, discussions on key areas of interest, collaboration
- State and Commonwealth Government – meetings and briefings to discuss specific issues, opportunities and or draft documents, and
- local community and the general public – public exhibition of PDS terms of reference and draft PDS documentation.

PoM considers that it is more appropriate to propose a longer regulatory period once it settles positions on the PDS, RAS and performance standards, as they are critical to determining the future investment and performance outcomes that PoM will undertake to meet Port Users and other stakeholders' long-term needs. PoM will consult Port Users on the benefits and practicalities of applying longer regulatory periods in the future once these three initiatives are settled.

[12] In accordance with section 91Q of the PMA and clause 27 of the Port Lease

6. 2018-19 trade volume forecasts

PoM engaged BIS Oxford Economics (BIS Oxford) to forecast its 2018-19 trade volumes. BIS Oxford uses economic modelling to derive the forecasts for the following cargo types: containers; dry bulk; liquid bulk; motor vehicles; breakbulk; and wheeled units. Forecasts are further prepared in terms of trade segments (exports, imports, domestic trade and international trade) where appropriate. PoM forecasts channel fee volumes by applying historical correlations between ship tonnage and trade volumes to BIS Oxford's forecast trade volumes.

In 2017-18, PoM has experienced higher than anticipated growth in its trade volumes for the nine months ending 31 March 2018. For example, full container import (excluding Bass Strait) growth was 8.1 per cent and full container exports (excluding Bass Strait) was 11.4 per cent. This above trend growth is reflective of general positive economic activity and population growth in Victoria.

BIS Oxford is forecasting that annual trade growth in 2018-19 will return to be in line with longer term trends.

6.1 BIS Oxford forecasting methodology

BIS explains in **Attachment H,** titled *"BIS Oxford Economics, Port of Melbourne Trade Forecasts – Forecasts to FY 19"*, the following approach to forecasting each cargo type:

Step 1 – For containerised trade only, acknowledge the common characteristics between major Australian container terminals:

- Being the only container terminal servicing the State at present
- Imports being the dominant full container trade
- Strong growth between 1990 and mid 2000 with slower growth since the global financial crisis.

These common characteristics inform trade analysis. In particular, for containerised imports, the outlook tends to track the national macroeconomic outlook with state-specific demand factors. For containerised exports, BIS Oxford overlays the national production outlook with local specialisation from within PoM.

Step 2 – For each commodity, identify the macroeconomic or industry drivers.

Step 3 – Explain any variances (sudden shifts in volumes) from the macroeconomic or industry drivers. These variances, which may reflect a change in modal choice, port facilities or local production factors, are examined to explain any variances.

Step 4 – Apply macroeconomic drivers. Once the relationship between the trade volumes and macroeconomic drivers are established, and future structural changes are identified, the forecast trade volumes reflect the macroeconomic outlook. The macro-economic drivers include: Victorian, Tasmanian and Australian population growth; Victorian and Australian domestic final demand; Victorian, Tasmanian and Australian retail growth; Victorian machinery and equipment investment growth; Australian building (dwelling and non-dwelling) construction.

Attachment H provides further information on BIS Oxford's trade forecasts including the macroeconomic or industry drivers used to forecast each cargo type and trade segment.

7. 2018-19 ARR and Prescribed Services revenue (subject to the TAL)

The price smoothing pricing principle requires PoM to set its tariffs based on the lower of those implied by the ARR or those subject to the TAL until at least 30 June 2032 and at the latest, 30 June 2037. The Pricing Order requires that:

(i) In relation to the ARR:

"*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*" (see clause 2.1.1(a)).

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) In relation to the TAL:

"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" (see clause 3.1.1)

This section compares the ARR (calculated under the ABBM) with Prescribed Services revenue (subject to the TAL).

7.1 2018-19 ARR (calculated under the ABBM)

PoM has calculated the ARR in accordance with the ABBM 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 ABBM and parameters for both Dedicated and Shared Channels.

Figure 7: ABBM approach

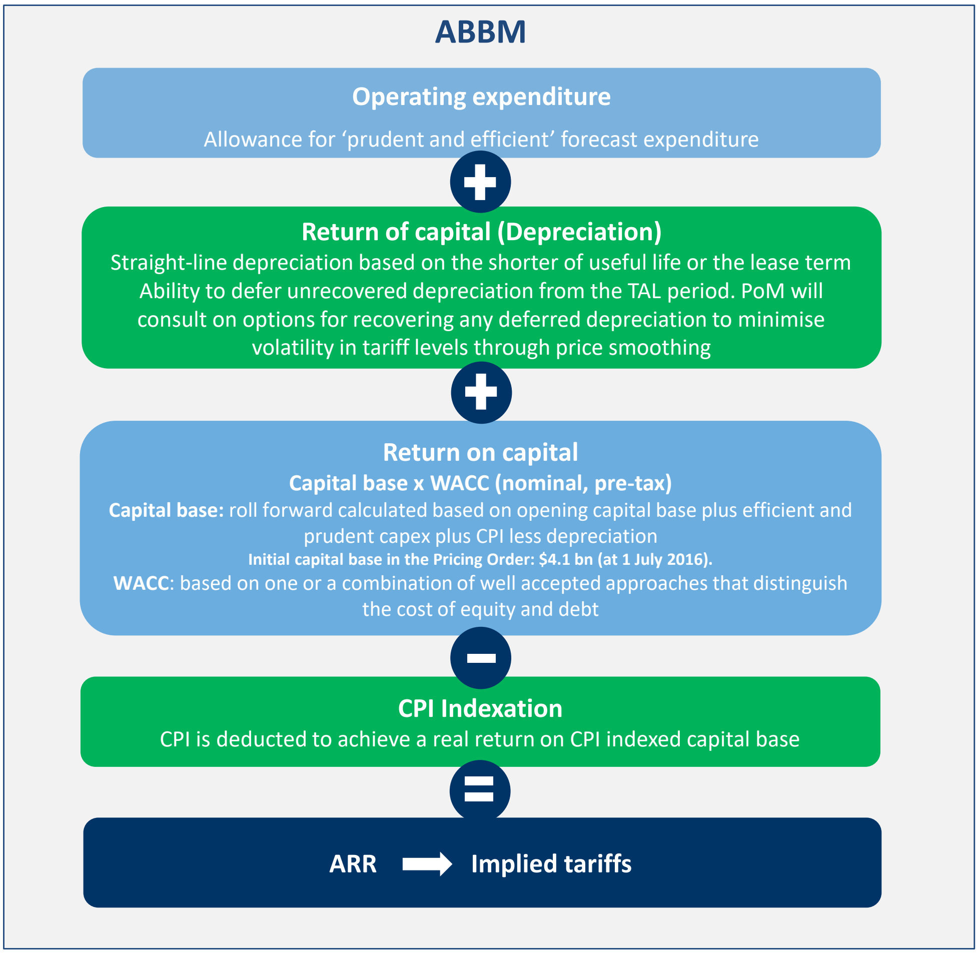


Table 7 sets out 2018-19 ARR (calculated using the ABBM).

Table 7: ARR, $ Million

	2018-19 (F)
Return on capital	519.3
Return of capital	645.1
Operating expenses (opex)	127.8
Indexation allowance	(108.2)
ARR	**1,184.0**

The ABBM inputs, and the calculation of each cost block comprising the ABBM, are discussed below.

7.1.1 Capital base

PoM has determined the forecast rolled forward values of its capital base, at 1 July 2017, to be $4,299.6 million and, at 1 July 2018, to be $4,475.4 million in accordance with clause 4.2.1 of the Pricing Order by:

- adding indexation in accordance with clauses 4.2.1(b) and 4.6.1(a) of the Pricing Order. Clause 4.6.1(a) provides that opening capital base must be indexed by the percentage change in CPI[13] for the relevant financial year
- adding prudent and efficient capex in accordance with clause 4.2.1(c) and 4.6.1(b) of the Pricing Order. Clause 4.6.1(b) provides that capex is indexed by half a year's inflation[14] (i.e. one half of the percentage change in CPI) for the relevant financial year. This assumes capex is incurred mid-year or halfway through the financial year, and
- deducting depreciation (i.e. the return of capital allowance). However, because in 2017-18 and 2018-19 PoM's Prescribed Services revenue (subject to the TAL) is below the ARR, as shown in Table 1 above, PoM has used the alternative depreciation methodology, which involves setting straight-line depreciation to zero and deferring its recovery to future years. This is recognised by adding back "deferred depreciation". This is discussed in 7.1.4.

The forecast closing 2017-18 capital base of $4,479.8 million submitted in PoM's 2017-18 TCS has been adjusted for 2016-17 actual values and is therefore $4,475.4 million.

Table 8 sets out PoM's forecast closing capital base as at 30 June 2018 and 30 June 2019.

Table 8: Capital Base 2017-18 and 2018-19, $ Million

	2017-18 (F)	2018-19 (F)
Opening Capital Base (1 July)	4,299.6	4,475.4
Plus Indexation Allowance	112.7	108.2
Plus Efficient Capex	67.6	67.7
Less Depreciation	(511.8)	(645.1)
Plus Deferred Depreciation	511.8	645.1

[13] PoM has used the June all capital cities CPI for the relevant Financial Year in accordance with clause 4.6 of the Pricing Order
[14] PoM has used the June all capital cities CPI for the relevant Financial Year in accordance with clause 4.6 of the Pricing Order

	2017-18 (F)	2018-19 (F)
Closing Capital Base (30 June)	**4,479.8**	n.a
Adjustment for 2016-17 actual values	(4.4)	n.a
Closing Capital Base (30 June) reflecting 2016-17 actual values	**4,475.4**	**4,651.3**

Appendix B, PoM's regulatory model, provides further details on the capital base roll forward.

7.1.2 Capex

Table 9 sets out PoM's 2018-19 forecast capex for Prescribed Services. Expenditure on wharves and channels are the largest categories of capex comprising 75 per cent of total capex.

Appendix F explains the method that has been used to prepare PoM's 2018-19 capex forecast and why the forecast is prudent and efficient. It also explains the basis on which capex has been allocated between Prescribed Services and shared or non-Prescribed Services.

Table 9: Forecast 2018-19 capex, $ Million

Capex category	2018-19 (F)
Port Capacity Project (PCP)	0.0
Channel	12.9
Wharves	38.0
Road	4.1
Rail	5.9
Plant	3.4
Other	3.5
Total	**67.7**

7.1.3 Rate of return on capital

The rate of return on capital (referred to as the WACC) aims to compensate PoM's debt and equity holders for the opportunity cost of either lending or investing their funds in the port.

The Pricing Order provides that the return on capital, required to calculate the ARR under the ABBM, 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).*

It goes on to add:

> *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).*

In summary, the key Pricing Order requirements relating to the WACC are that it must be:

- calculated on a pre-tax nominal basis
- commensurate with that required by a benchmark efficient entity (BEE) with a similar degree of risk to PoM in providing Prescribed Services, and
- estimated using one or a combination of well-accepted approaches that distinguish the cost of equity and debt.

These requirements must be interpreted in accordance with the objectives of the regulatory regime discussed in Figure 1. Critical to promoting the regulatory objectives is:

- the need for efficient investment in the long-term interests of Port Users and Victorian Consumers, and
- providing a reasonable opportunity for PoM to recover its efficient costs (i.e. the costs that would be incurred by an efficient business in a workably competitive market).

The pre-tax nominal WACC formula is expressed in Figure 8:

Figure 8: pre-tax nominal formula

$$\frac{R_e}{\left(1-t_c\left[1-\gamma\right]\right)} * \frac{E}{E+D} + R_d \frac{D}{E+D}$$

Where:

Re = post-tax return on equity
Rd = pre-tax return on debt
D = proportion of debt within the assumed capital structure
E = proportion of equity within the assumed capital structure
t = corporate tax rate
γ = gamma (value of imputation credits)

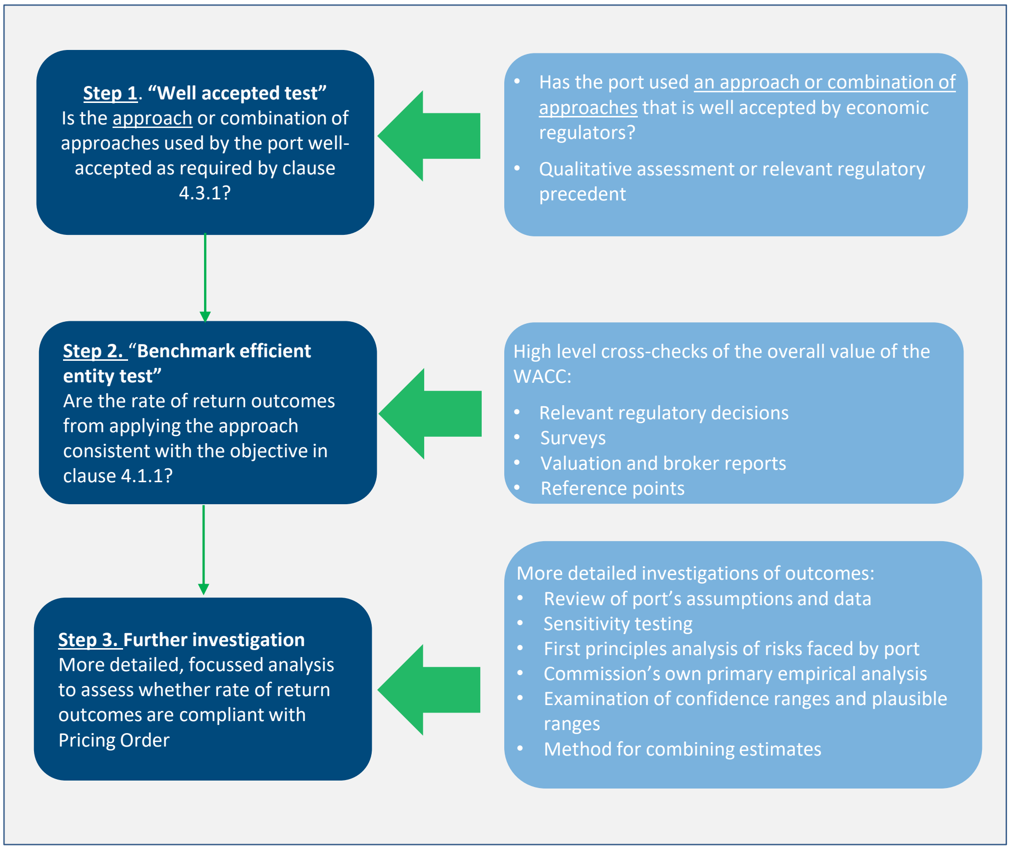
PoM has estimated its pre-tax nominal WACC[15] for 2018-19 to be 11.52 per cent based on a pre-tax return on debt of 5.37 per cent, a pre-tax return on equity of 14.16 per cent and gearing of 30 per cent. This compares to its 2017-18 pre-tax nominal WACC of 11.54 per cent calculated using the same formula.

Table 10 below explains that PoM has made limited modifications to its approach to calculating its 2018-19 WACC, compared to the approach that it used to calculate its 2017-18 WACC. In particular, PoM has commenced a trailing average approach to estimate the return on debt because this is more consistent with the debt management practices of a BEE. PoM has also made minor modifications to address the ESC's feedback in its Interim Commentary and SoRA, such as removing the US$100 million market capitalisation BEE threshold.

The ESC's SoRA sets out a three-step WACC Compliance Assessment Test that is replicated in Figure 9. This Test details the ESC's views on how PoM should demonstrate compliance with the Pricing Order requirements relating to the WACC.

[15] Clause 4.3.2 of the Pricing Order requires the rate of return to be calculated on a pre-tax nominal basis

Figure 9: ESC WACC Compliance Test



As shown in Figure 9, the three steps are as follows:

- **Step 1** – The "well accepted" test is a qualitative assessment of whether the approach or combination of approaches used to estimate the WACC are well accepted.
- **Step 2** – The BEE test is a quantitative assessment focusing on the reasonableness of the overall value and whether it is commensurate with the value required by the BEE with a similar degree of risk.
- **Step 3** – The further investigation test involves investigating the reasonableness of individual parameter values.

In principle, PoM supports the intent of the WACC Compliance Assessment Test as being a useful tool to apply the Pricing Order requirements. However, PoM has strong concerns with the ESC's interpretation of "well-accepted approaches" in relation to estimating the WACC, in particular the return on equity component. The "well accepted" test is the first step in the ESC's WACC Compliance Assessment Test. PoM has outlined its position on this matter in **Appendix I.**

In summary, PoM considers that the ESC's interpretation of "well accepted", which requires that for the approach or combination of approaches to be "well accepted" it/they must be used by at least one regulator (Australian or international), or a review body overseeing the decisions made by economic regulators:

- is not consistent with the requirements of the Pricing Order or the objectives of the regulatory regime
- is beyond the intent of the Pricing Order. The Pricing Order does not contemplate the ESC constraining PoM from considering approaches that are well accepted by other relevant parties including financial and academic communities, and
- unduly restricts PoM's discretion intended by the regime by removing flexibility that is and should be built into the Pricing Order.

Based on expert legal and regulatory advice, PoM considers "well accepted approaches" is not confined to economic regulators and includes also those approaches used by financial and academic communities.

PoM is also concerned about the "gateway" nature of the ESC's WACC Compliance Assessment Test. PoM considers that to determine whether PoM's WACC estimate satisfies the Pricing Order and the objectives of the regulatory regime, it must consider the outcomes of all three steps together. PoM is concerned that the current "gateway" nature of the test, which means that progressing to step two is conditional on satisfying step one, could result in unintended practical consequences. For example, the ESC could potentially find PoM's WACC estimate is not compliant with the Pricing Order based on the outcome of step one alone whereas consideration of the outcomes of all three steps could result in the ESC finding that overall PoM's WACC estimate is compliant with the Pricing Order. PoM considers that the ESC should have regard to the outcomes of all three steps in undertaking its compliance assessment in relation to its WACC estimate.

An expert report from Synergies Economic Consulting titled "*Determining a WACC estimate for Port of Melbourne*" is provided at **Appendix C**. This sets out PoM's 2018-19 pre-tax nominal WACC, the detailed calculations underpinning the WACC and how PoM's 2018-19 WACC satisfies the ESC's WACC Assessment Test.

PoM's approach to calculating the 2018-19 WACC

Table 10 overviews the key components of the WACC formula and PoM's approach to estimating each of these components for the purposes of its 2018-19 WACC. Further detail is provided at **Appendix C.**

Table 10: Pre-tax nominal rate of return

Element	Definition and estimation approach	Consistent with 2017-18 approach
Return on equity (pre-tax)	The return on equity is the return required by shareholders when providing equity capital. There is no immediate and direct means for observing, on an ex ante basis, what investors require by way of equity returns. Accordingly, estimates of the rate of return on equity have to be derived from market data and other evidence, making use, in general, of asset pricing models and other methods. PoM has adopted the equal weighting of three well accepted approaches: Sharpe-Lintner Capital Asset Pricing Model (SL CAPM); Black CAPM; Fama French Model (FFM) (the multi-model approach). This is because there are no substantive grounds to favour one approach over the other. Based on expert legal and regulatory advice, PoM considers that these approaches are well-accepted within the meaning of the Pricing Order for estimating the cost of equity.	Yes – no change
Return on debt (pre-tax)	The return on debt is the required yield (or interest) on issued debt. The cost of debt is the sum of the risk-free rate (Rf) and an estimate of the debt risk premium (DRP) consistent with the risk profile of the BEE. In its 2017-18 TCS, PoM estimated its return on debt using the "on-the-day approach," which was appropriate for the first TCS given the recent lease transaction. For the 2018-19 TCS, PoM has commenced a 10-year trailing average approach, which places 90 per cent weight on the 2017 and 10 per cent on the 2018 on-the-day estimates. In each subsequent year, 10 per cent of the return on debt estimate will be refreshed with the prevailing on-the day estimate for the given year. This method will result in less volatility over time and is more consistent with the debt management practices of a BEE. The trailing average approach is well accepted and is applied by more than one Australian economic regulator.	Transition to the trailing average approach
Capital structure (gearing)	The capital structure (gearing) is needed to distinguish the relative proportion of equity and debt in the financing arrangements of a BEE. PoM has assumed a benchmark gearing ratio of 30 per cent based on the mid-point of domestic and international comparator entities' capital structures, which range from 20 per cent (based on the average and median of listed comparators) to 42 per cent (average and median of the acquisition comparators).	Yes – no change
Gamma	Gamma is an estimate of the expected proportion of company tax which is returned to	Yes – no change

Element	Definition and estimation approach	Consistent with 2017-18 approach
	investors as a tax credit through utilisation of imputation credits. PoM has calculated gamma based on an equal weighting of the estimates derived from three well-accepted approaches: finance theory; an equity ownership approach; and the market valuation studies.	

Table 11 details the parameter estimates calculated for each element of its 2018-19 WACC. Figure 8 above shows the pre-tax nominal WACC formula, which comprises the pre-tax return on equity plus the pre-tax return on debt, where:

Re = Return on equity (pre-tax) = Return on equity (post-tax) ÷ (1- corporate tax X (1- gamma)), where
Return on equity (post-tax) = (Market Risk Premium X Equity Beta) + Risk Free Rate

E / (D+E) = (share of equity) (1-gearing)

Plus

Rd = Pre-tax return on debt = Risk free rate + Debt risk premium + Debt raising costs

D / (E+D) = (share of debt) (gearing)

The return on equity in Table 11 is based on the multi-model approach rather than the direct application of the numbers in this table using the above formula. A more detailed discussion of the parameters relevant to the WACC estimate is at **Appendix C**.

Table 11: Cost of capital parameters values underpinning PoM's 2018-19 WACC estimate

Element	2018-19 (F)
Return on equity (pre-tax) (**Re**)	14.16%
Market risk premium	7.71%
Equity beta	1.00
Risk free rate	2.74%
Corporate tax ($\mathbf{t_c}$)	30%
Gamma (γ)	0.25
Return on debt (pre-tax) (**Rd**)	5.37%
Risk free rate	2.74%
Debt risk premium	2.53%
Debt raising costs	0.10%
Capital structure (gearing)	
Share of debt (D/(E+D))	30%
Share of equity (E/(E+D))	70%
Pre-Tax Nominal WACC	**11.52%**

7.1.4 Depreciation and economic asset lives

Table 12 shows the economic lives for new capex. PoM's asset categories and economic lives are the same as those set out in its 2017-18 TCS, with the exception of the following modifications which have been introduced to more accurately reflect the diversity of PoM's assets and their associated asset lives. PoM has:

- broken channels down further into the following categories: Melbourne channel; Melbourne channel over dredge; shared channels and shared channel over dredge. The over dredge categories, which contain expenditure for maintenance dredging activities including dredging, sweeping, water injection, material transport and placement, bunding, capping and associated environmental testing and monitoring functions, have been assigned a three year life, and
- broken plant down further into: buildings, utilities, civil and minor-capital works. Plant now largely contains expenditure related to IT and survey equipment and therefore the life has been reduced to 10 years to better reflect the life of these assets.

PoM must depreciate its assets over a period no shorter than the economic life or the remaining term of the lease (whichever is shorter).

Table 12: Economic lives for new capex

Asset category	Economic lives for new capex
Melbourne Channel	50
Melbourne Channel Over Dredge	3
Shared Channels	50
Shared Channel Over Dredge	3
Channel Service Protection	40
Roads	20
Rail	30
Buildings	25
Wharves	25
Plant	10
PCP - Wharves	50
PCP - Civil	30
Navigational Aids	25
Utilities	30
Civil	40
Minor capital works	25

To calculate its forecast straight-line depreciation, PoM has used the capital base values described in section 7.1.1 and the economic and average remaining asset lives.

PoM has also used the alternative depreciation methodology permitted by clause 4.4.2(a) of the Pricing Order, rather than straight-line depreciation under clause 4.4.1 of the Pricing Order. This is because the application of the TAL prevents PoM increasing tariffs to the level whereby PoM could recover its ARR (calculated under the ABBM) with the application of straight-line depreciation. On this basis, in accordance with clause 4.4.2(a) of the Pricing Order, PoM has applied the alternative depreciation methodology, which only applies depreciation to the extent that revenue from Prescribed Services (subject to the TAL) exceeds the ARR excluding the depreciation allowance. Given that in 2018-19 PoM's forecast Prescribed Services revenue (subject to the TAL) is below the ARR, PoM has set 2018-19 straight-line depreciation to zero and deferred its recovery to future years. This method complies with the Pricing Order provisions relating to depreciation, including clause 4.4.3, which requires that the depreciation allowance is not below zero.

PoM's forecast straight-line depreciation is set out in Table 8. PoM's regulatory model, provided at **Appendix B**, contains the depreciation calculations and **Appendix F** contains further information on PoM's depreciation methodology.

As requested, PoM has also provided the ESC with a calculation schedule which demonstrates that its methods for calculating deferred and straight-line depreciation only recover depreciation once. This means that the amount by which each asset, or group of assets, is depreciated over the depreciation period does not exceed the value of the asset, or group of assets, at the time of its or their inclusion in the capital base.

Given this is only the second year of the regulatory regime (and the TAL period), PoM cannot, at this stage, provide a precise indication as to the timing and approach to recovering its deferred depreciation. PoM acknowledges that this is a matter of keen interest for Port Users and it is also of significant importance to PoM. Factors that will affect the amount of deferred depreciation include:

- future import volumes that are driven by domestic demand, population growth and the value of the Australian dollar, levels of domestic manufacturing and the location of domestic manufacturing (imports are primarily driven by domestic consumption)
- future export volumes that are driven by the economic growth of Victoria's trading partners (exports are primarily driven by foreign demand for Victorian products)
- the level of new capital investment during the TAL period such as for example to accommodate larger ships or enable on-port rail access, and
- the length of the TAL period.

PoM will consult Port Users on options for recovering any deferred depreciation to minimise volatility in tariff levels through price smoothing closer to the end of the TAL period, if deferred depreciation is yet to be recovered at such time. PoM will continue to engage with Port Users on the key principles underpinning its approach to recovering deferred depreciation in the future, including its commitment to smooth prices.

7.1.5 Opex

Table 13 sets out PoM's 2018-19 forecast opex for Prescribed Services. Around 78 per cent of PoM's 2018-19 forecast opex is non-controllable and relates to two items – the Port Licence Fee and the Cost Contribution Amount. These items are required by, and calculated in accordance with the relevant requirements in, the PMA[16] and the Port Concession Deed[17] respectively and are deemed to be prudent and efficient under clause 4.5 of the Pricing Order. As a result, only 22 per cent, or $27.8 million, is controllable by PoM.

Appendix F explains the method that has been used to prepare PoM's 2018-19 opex forecast and why the forecast is prudent and efficient. It also explains the basis on which opex has been allocated between Prescribed Services and shared or non-Prescribed Services.

[16] The Port Licence Fee has been calculated in accordance with sections 44K and 44J of the PMA
[17] The Cost Contribution Amount has been calculated in accordance with clause 27.1 of the Port Concession Deed

Table 13: Forecast 2018-19 opex, $ Million

Opex categories	2018-19 (F)
Port Licence Fee	84.4
Cost Contribution Amount	15.6
Labour	10.0
Repairs and Maintenance	4.0
Other	13.8
Total	**127.8**

7.1.6 Indexation allowance

The indexation building block, as required under clause 4.1.1(d) of the Pricing Order, impacts the overall ABBM by its inclusion as a negative building block. This deduction from the ABBM is made to maintain a real rate of return given that a nominal rate of return, discussed in section 7.1.3, is applied to an inflation-adjusted capital base[18], discussed in section 7.1.1. The indexation building block is the sum of the following as disused in section 7.1.1 above:

- the indexation of the opening capital base (clause 4.6.1(a) of the Pricing Order), and
- half a year's inflation on capex (clause 4.6.1(b) of the Pricing Order).

PoM has used the June all capital cities CPI in accordance with clause 4.6 of the Pricing Order to calculate the indexation allowance. The detailed calculations are contained in PoM's regulatory model provided at **Appendix B**.

Table 14: Indexation allowance, $ Million

	2018-19 (F)
Indexation Allowance	108.2

7.2 Prescribed Services revenue (subject to the TAL)

The TAL is defined by the Pricing Order 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 2018-19 TAL is based on the percentage change in the 2017 March quarter[19] and 2018 March quarter CPI[20] (All Groups Index Number, weighted average of eight capital cities published by the Australian Bureau of Statistics) and is 1.9 per cent.

The 2018-19 Prescribed Services revenue is derived by applying the TAL of 1.9 per cent to the tariffs set out in PoM's 2017-18 RTS (other than full outward containerised wharfage tariffs, which are decreased by 2.5 per cent), multiplying these tariffs by the 2018-19 forecast trade volumes prepared by BIS Oxford and PoM, in relation to channel volumes only (discussed in section 6 and **Appendix H)** and then adding forecast 2018-19 revenue from contracts with Port Users for Prescribed Services (see **Appendix D**).

[18] The capital base includes an allowance for indexation
[19] Twelve month March quarter CPI.
[20] 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*.

The Weighted Average Tariff Increase (WATI), which is the weighted average rate of change in all tariffs (including full outward containerised wharfage tariffs) calculated using weightings based on its 2016-17 audited revenue, is 0.9 per cent. The WATI does not include revenue from contracts with Port Users for Prescribed Services.

7.3 Comparison of the ARR and Prescribed Services revenue (subject to the TAL)

Table 15 compares the 2018-19 ARR (calculated under the ABBM) and Prescribed Services revenue (subject to the TAL).

Table 15: Comparison of 2018-19 ARR Prescribed Services (subject to the TAL), $ Million

	2018-19
ARR	1,184.0
Prescribed Services revenue	371.2
Under-recovery of ARR	**(812.8)**

Table 15 shows that the 2018-19 Prescribed Services revenue (subject to the TAL) of $371.2 million is $812.8 million below the ARR of $1,184.0 million. This means that PoM's efficient costs of providing Prescribed Services are more than its forecast Prescribed Services revenue in that year. Further discussion of this in terms of PoM's ability to satisfy the "efficient cost recovery" Pricing Principle is in section 9.

8. PoM's 2018-19 Tariffs

As outlined in section 7.2, the forecast 2018-19 Prescribed Services revenue (subject to the TAL) is lower than the ARR (calculated under the ABBM). PoM's 2018-19 tariffs are, therefore, subject to the TAL and PoM also confirms that it has:

- increased its tariffs by a WATI of 0.9 per cent from 2017-18
- not rebalanced its tariffs. All tariffs (except tariffs for full outbound container wharfage services) have been adjusted by the same percentage adjustment (i.e. the TAL of 1.9 per cent) consistent with clause 3.2.1 of the Pricing Order. There are no new or discontinued tariffs
- 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 2018-19 "full outward containerised wharfage tariff" shows a 2.5 per cent reduction to $95.80 from the $98.26 level that applied for 2017-18, and
- included contract revenue in its Prescribed Services revenue (subject to the TAL) and the ARR but not in the WATI calculation.

PoM's 2018-19 tariffs are set out in the RTS provided at **Appendix A** of this TCS and are effective from 1 July 2018.

8.1 Upper and lower Bounds

Clause 2.1.1 of the Pricing Order requires that revenue for each Prescribed Service Bundle should be on or between the upper bound (clause 2.1.1(b)(i)), which represents the stand-alone cost of providing each Prescribed Service Bundle, and the lower bound (clause 2.1.1(b)(ii)), which represents the avoidable cost of not providing the Prescribed Service Bundle. This is commonly known as the "efficient pricing band".

Consistent with its 2017-18 TCS, PoM has not sought to estimate the stand alone cost for providing each Prescribed Service Bundle. This is because, regardless of what the stand alone cost for providing each Prescribed Service Bundle might be, PoM would be in compliance with clause 2.1.1(b)(i) of the Pricing Order during the period in which clause 3.1.1 applies and any subsequent increase to any Initial Prescribed Service Tariff (as may be varied from time to time due to the acceptance of a Final Rebalancing Application under clause 3.2.18) does not exceed the TAL.

For example, if the revenue for each Prescribed Service Bundle was below the stand alone cost of providing that Prescribed Service Bundle, then PoM would be in direct compliance with clause 2.1.1(b)(i). On the other hand, if the revenue for each Prescribed Service Bundle was above the stand alone cost of providing that Prescribed Service Bundle, then in accordance with clause 2.1.4 of the Pricing Order, the upper bound principle in clause 2.1.1(b)(i) would not apply as clause 3.1.1 applies and the subsequent increase in Initial Prescribed Service Tariffs for 2018-19 does not exceed the TAL. PoM will therefore be in compliance with the upper bound principle in clause 2.1.1(b)(i) for the 2018-19 regulatory period.

PoM has demonstrated that its forecast revenue for each Prescribed Service Bundle is greater than its estimated average annual short-term avoidable costs of not providing the relevant Prescribed Service Bundle. **Appendix F** provides further information on PoM's avoidable costs.

9. Efficient Cost Recovery (ECR)

The ECR is required to promote the objectives of the regulatory regime, which include:

- that PoM should have a reasonable opportunity to recover its efficient costs of providing Prescribed Services, including a return commensurate with the risks involved, and
- to promote efficient investment for the long-term interests of Port Users and Victorian consumers.

Clause 2.1.1(a) of the Pricing Order reinforces these objectives through the ECR principle which requires:

Prescribed Service Tariffs must be set so as:

(a) 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 (Aggregate Revenue Requirement)

Importantly, there is no express qualifier on this principle in relation to the application of the TAL. This means that the principle that PoM should have a "reasonable opportunity" to recover its efficient costs and commensurate return is independent of the obligation to apply the TAL during the period until at least 2032 and at the latest 2037.

Allowing PoM to recover its efficient costs of, and commensurate return on, investment is important to avoid compounding PoM's under-recovery of its efficient costs and having a higher capital base and tariffs at the end of the TAL period. These matters are particularly important because the Pricing Order constrains the depreciation period to the end of the lease.

PoM is also required to promote efficient investment. It is not reasonable to expect that any port operator (whether regulated or unregulated) would undertake investment where it is not commercially sustainable, due to an inability to recover efficient costs and commensurate return.

PoM's previous and current TCS show that because PoM's tariffs are subject to the TAL in 2017-18 and 2018 -19, PoM will not recover its efficient and prudent costs of providing Prescribed Services as calculated by the ABBM in these years. Current analysis also indicates that PoM will not recover its efficient costs and commensurate return of providing Prescribed Services for the remainder of the TAL period (until at least 30 June 2032 and at the latest 30 June 2037).

Recent consultation with Port Users indicates that some Port Users support significant new investment to accommodate larger ships and establish on-port rail infrastructure. PoM is still consulting with Port Users to better understand their requirements in relation to their future investment needs and priorities. The outcomes of this consultation will be reflected (as potential feasible investment options) in PoM's RAS and PDS which will present PoM's long-term vision for the growth and development of the port. Section 5 provides further detail on PoM's PDS and RAS.

PoM will engage on the scope and timing of the investment with the ESC, the Victorian Government, Port Users and other stakeholders, and will seek to explore options, with the ESC and Port Users, for recovering its efficient costs of this investment during the TAL period.

10. Confidentiality

This TCS is submitted to the ESC under clause 7 of the Pricing Order and sets out the details and provides the information and explanations required under that provision. This TCS is confidential and commercially sensitive and is provided to the ESC on a strictly confidential basis. The Pricing Order does not require the ESC to publish this TCS or to otherwise disclose confidential and commercially sensitive information contained in this TCS. To this end, PoM seeks the ESC to treat this TCS as strictly confidential unless otherwise agreed by the PoM.

11. Summary of ESC's views and positions – Interim Commentary and SoRA

Table 16 provides a consolidated list of the ESC's views and positions, in its Interim Commentary and SoRA, on what PoM should include in its TCS to demonstrate Compliance with the Pricing Order.

Table 16 also:

- shows, with two exceptions, that the TCS addresses the information required by the ESC, and
- provides a cross-reference to where in PoM's 2018-19 TCS the ESC's views and positions are addressed.

Table 16: The ESC's views and position in its SoRA and Interim Commentary

No.	Issue and requirements	Addressed	TCS cross-reference
(i)	**WATI**		
•	Provide visible formulae and identify data sources	✓	Actioned. See Appendix B, regulatory model.
•	For existing tariffs – use audited revenues from the most recent financial year (i.e. T-2)	✓	In the absence of audited revenue at the detailed commodity level, PoM has relied on audited 2016-17 volumes (at the commodity level), which is the best available information it has to calculate the WATI. PoM has: (i) confirmed these volumes by multiplying them by the 2016-17 tariffs and reconciling the total resultant revenue against total revenue in the audited PoM Unit Trust accounts; and (ii) applied the audited 2016-17 volumes to its 2017-18 and 2018-19 tariffs respectively to calculate the weighted average revenue in each year. See section 7.2 of PoM's 2018-19 TCS General Statement and Appendix B, regulatory model.
•	For new tariffs – use estimated demand to derive the associated revenue	N/A	No new tariffs in 2018-19.
•	Round tariffs to four decimal places.	✗	Not actioned. Consistent with tariff rounding in the Pricing Order Schedule (Initial Prescribed Service Tariffs) and PoM's 2017-18 RTS, PoM has rounded its tariffs to either two or four decimal places. For example, wharfage fees are rounded to two decimal places, whereas channel fees are rounded to four decimal places. Further, rounding wharfage fees to two decimal places is consistent with PoM's invoicing practices which are based on two decimal places.
(ii)	**Contract revenue**		
•	Exclude contract revenue from the WATI	✓	Actioned. See section 7.2 of PoM's 2018-19 TCS General Statement and Appendix B, regulatory model.

No.	Issue and requirements	Addressed	TCS cross-reference
•	Include contract revenue in the ARR	✓	Actioned. See section 7.2 of PoM's 2018-19 TCS General Statement and Appendix B, regulatory model.
•	Only enter into contracts for Prescribed Services, on different terms to the RTS, subject to: ○ firstly offering to provide Prescribed Services in accordance with its RTS ○ PoM being able to reasonably recover its efficient costs of providing the services.	✓	Actioned. See section 7.2 of PoM's 2018-19 TCS General Statement and Appendix D, Contracts with Port Users. PoM's RTS is a standing offer available on its website to all Port Users that have not negotiated and entered into a separate agreement with PoM.
•	Contract prices must reflect the efficient cost recovery principles in clause 2.1.1(b) of the Pricing Order. This requires prices to be no lower than the avoidable costs of not providing, and no higher than the standalone cost of providing Prescribed Services	✓	Actioned. See Appendix D, Contracts with Port Users.
(iii)	**Export pricing decision**		
Comply with the export pricing decision		✓	Actioned. See section 8 of PoM's 2018-19 TCS General Statement and Appendix B, regulatory model
(iv)	**Stakeholder engagement**		
Demonstrate that PoM has "consulted effectively with port users"			
•	Explain the following: ○ the nature of the consultation process ○ the issues raised and feedback received ○ how port users' views have been taken into account.	✓	Actioned. See section 8 of PoM's 2018-19 TCS General Statement and Appendix E, Port User and other stakeholder Consultation. Also, see Appendix J, PoM's Regulatory Brochure, Appendix K, PoM's regulatory deep-dive workshop presentation and Appendix L, Letter from PoM to Gulf Agency Company explaining time-based berth hire fees.
•	Consultation topics should address: ○ the drivers and levels of costs and proposed service level performance standards ○ the approach to setting prices ○ matters affecting the long-term interests of port users including future prices ○ PoM's compliance with the Pricing Order.	✓	
•	The consultation approach must be: ○ tailored to suit the topics and audience ○ accessible – has a clear purpose, instruction and information ○ inclusive – provides a fair and reasonable opportunity for participation ○ focused on priority matters.	✓	
(v)	**Forecasts and information provision**		
•	Forecasts / estimates must be transparent, replicable and supported by (i.e. be able to traced back to) primary information	✓	Actioned. • Capex and Opex – see section Appendix F (sections 2 and 3) • Trade volumes – see section 6 of PoM's 2018-19 TCS General Statement and Appendix H, BIS Oxford Economics 2018-19 Trade Volume Forecasts.
•	Explain the forecasting methodology	✓	
•	Explain the assumptions underpinning its forecasting methodology	✓	
•	Provide the data underlying the forecasts	✓	

No.	Issue and requirements	Addressed	TCS cross-reference
	• Provide attestations verifying that the forecasts and estimates are fit-for-purpose[21]	✘	Not directly addressed. However, the 2018-19 capex and opex forecasts are based on PoM's internal budget, which is approved by PoM's Board of Directors. Attestations are not required under the Pricing Order.
	• Provide any consultants' reports including models and data underpinning the consultants' forecasts, where PoM's forecasts are based on consultants' reports.	✓	Actioned. • Capex and opex – prepared internally by PoM • Trade volumes – prepared by BIS Oxford Economics. See Appendix H, *BIS Oxford Economics 2018-19 Trade Volume Forecasts*
(vi)	**Capital base roll forward**		
	• Submit the capital base roll-forward model as part of the TCS	✓	Actioned. See Appendix B
	• The capital base roll-forward model must:		
	○ be unlocked and include all formulae underlying the calculations (these should be visible).	✓	Actioned. See Appendix B
	○ account for asset disposals and capital contributions by deducting these from the capital base (or confirm zero value where no disposals or contributions have occurred).	✓	Actioned. See Appendix B
	○ deduct either actual or forecast depreciation – the ESC expects PoM to nominate whether it has used forecast or actual depreciation to roll forward the capital base at the beginning of each regulatory period and consistently apply this approach throughout the regulatory period.	✓	Actioned. See Appendix B. PoM has deducted actual depreciation for 2017-18 to roll forward the capital base
	○ treat capex as "mid-year"[22] and net of capital contributions.	✓	Actioned. See Appendix B
(vii)	**Capex**		
	• Capex forecast must be based on:		Actioned. See section 3 of Appendix F
	○ robust asset planning, management and governance	✓	
	○ sound forecasting methodologies including: – market tested costs and transparent cost escalators where relevant	✓	
	– robust asset planning, management and governance	✓	
	– transparent contingency allowances	✓	
	– efficient contractual agreements which manage delivery risk.	✓	
	• Provide the following (proportionate to the materiality and lumpiness):		

[21] See pp. 22-23 of the ESC's Feedback Paper, which states that the information supported by attestation can improve compliance monitoring by (i) ensuring key decision makers are aware of the data underpinning the tariff compliance statement and have approved the information for submission and (ii) providing confidence to the ESC and other stakeholders that they can immediately rely on the information (i.e. it reduces the need for the ESC to test and verify the accuracy of the underlying data)

[22] Capex is assumed to occur halfway through the financial year. This means PoM earns a half year WACC allowance in the first year of the regulatory period.

No.	Issue and requirements	Addressed	TCS cross-reference
	○ An overview of investment governance and asset management processes, frameworks and systems	✓	Actioned. See section 3.2 of Appendix F
	○ PoM's capitalisation policy	✓	PoM's Capitalisation Guideline can be provided on request to the ESC on a confidential basis. See section 3.5 of Appendix F
	○ an explanation of the variance between actual and forecast capex	✓	Actioned. See section 3.1 of PoM's 2018-19 TCS General Statement
	○ benchmarking analysis including: trend analysis; productivity assessments; unit rate analysis or activity based costing	N/A	Not provided because not necessary to support the prudence and efficiency of PoM's capex.
	○ independent demand and cost escalation forecasts.	✓	Actioned. Trade volumes – see section 6 of PoM's 2018-19 TCS General Statement and Appendix H, BIS Oxford Economics 2018-19 Trade Volume Forecasts.
(viii)	**Performance Standards**		
•	Provide the service performance outcomes (measures) that forecast / actual capex is intended to deliver. These should be developed in conjunction with port users.	✓	In progress. See section 4 of Appendix F. PoM is currently consulting Port Users on draft performance standards which are consistent with tariffs subject to the TAL.
(ix)	**Opex**		
•	Provide evidence that opex is prudent and efficient - the lowest cost of delivering service outcomes over the regulatory period.	✓	Actioned. See section 2 of Appendix F.
•	Opex must be based on a sound forecasting methodology	✓	
•	Where opex is relatively stable, prudency and efficiency explained by:	✓	
	○ historical trends - the variance between actual and forecast opex and any step changes in expenditure	✓	
•	Where opex is lumpy, prudency and efficiency explained based on the following (proportionate to the materiality and lumpiness):	N/A	PoM's opex is relatively stable – there are no material cost increases. PoM has based its opex forecast on a bottom up build.
	○ any productivity / efficiency improvements		
	○ market tested costs and transparent cost escalators (labour and materials) where relevant		
	○ historical trends - the variance between actual and forecast opex and any step changes in expenditure		
(x)	**Depreciation**		
•	For straight-line depreciation, provide: ○ the remaining economic asset lives of existing assets ○ the economic lives of new assets ○ a comparison of economic lives with accounting lives and an explanation of any variances ○ the depreciation by asset type (i.e. value attributable to each asset)	N/A	PoM has applied the alternative depreciation methodology.

No.	Issue and requirements	Addressed	TCS cross-reference
	○ forecast depreciation schedules for the entire (remaining) life of the asset (i.e. remaining asset lives) in the opening capital base. • For the alternative methodology:		
	○ provide depreciation calculations	✓	Actioned. See Appendix B, regulatory model.
	○ explain how the method is consistent with the Pricing Order and the objectives of the PMA	✓	Actioned. See section 7.1.4 of PoM's 2018-19 TCS General Statement and section 7 of Appendix F.
	○ evidence / demonstrate that depreciation would not be recovered more than once[23]	✓	Actioned. Assets are depreciated only once. PoM's full depreciation schedules for its initial capital asset base demonstrate this. See also section 7 of Appendix F and Appendix B, the regulatory model.
	○ explain when PoM intends to recover deferred depreciation (i.e. what are the trigger events)	✓	Under consideration. Given this is only the second year of the regulatory regime (and the TAL period), PoM cannot at this stage provide a precise indication as to the timing and approach to recovering its deferred depreciation. PoM will consult Port Users on options for recovering any deferred depreciation to minimise volatility in tariff levels through price smoothing closer to the end of the TAL period if deferred depreciation is yet to be recovered at such time. See section 7.1.4 of PoM's 2018-19 TCS General Statement and section 7 of Appendix F.
	○ explain how PoM intends to recover deferred depreciation so as to manage any tariff volatility (i.e. how it will smooth tariffs)[24]	✓	
	○ provide forecast depreciation schedules for the entire (remaining) life of the asset (i.e. remaining asset lives) in the opening capital base	✓	Actioned. PoM has provided the ESC with depreciation schedules for its initial capital asset base which demonstrate that its methods for calculating deferred and straight-line depreciation only recover depreciation once. See section 7 of Appendix F and Appendix B, the regulatory model.
	○ explain how port users have been consulted on this matter.	✓	Actioned. See section 8 of PoM's 2018-19 TCS General Statement and Appendix E, Port User and other stakeholder Consultation. Also see Appendix J, PoM's Regulatory Brochure, Appendix K, PoM's regulatory deep-dive workshop presentation.

[23] The ESC expressed concern in its Feedback Paper that PoM's 2017-18 TCS was not clear that depreciation method would only recover costs once as required by clause 4.4.1(c) of the Pricing Order

[24] The ESC is concerned that deferring depreciation has the potential to lead to tariff volatility in later regulatory period.

No.	Issue and requirements	Addressed	TCS cross-reference
(xi)	**Cost Allocation**		
•	Explain how the cost allocation principles have been implemented, including the process for defining, capturing and attributing direct and indirect costs across the different prescribed and non-prescribed services and to each individual prescribed service	✓	Actioned. See section 5 of Appendix F.
•	Explain any changes in PoM's cost allocation approach (between regulatory periods)	✓	Actioned. See section 5 of Appendix F.
•	Provide the cost allocation calculations (i.e. its models)	✓	Actioned. See Appendix M.
•	Provide supporting information / underlying inputs such as costs and revenue data supporting its calculations.	✓	
(xii)	**Regulatory Period**		
	Explain the following in relation to the choice of the length of the regulatory period:		Actioned. PoM is proposing a one year regulatory period consistent with its 2017-18 TCS. See section: • 5 of PoM's 2018-19 TCS General Statement, • 2.3 of Appendix K, PoM's regulatory deep-dive workshop presentation
	○ the reasons for the length of period chosen and the factors influencing its decision	✓	
	○ consistency with the objectives of the regime	✓	
	○ consistency with PoM's previous approach on this matter	✓	
	○ the benefits for port users (of shorter versus longer periods)	✓	
	○ the impact on risk and uncertainty and how this is managed	✓	
	○ the impact on the robustness and accuracy of forecasts and how port users can be confident that the forecasts are robust and accurate	✓	
	○ port users' views on the length of the regulatory period (and the nature of consultation undertaken)	✓	
	○ the impact on tariffs – i.e. stability and predictability.	✓	
(xiii)	**Return on capital**		
•	Demonstrate compliance with the Pricing Order and the objectives of the regulatory regime	✓	Actioned. PoM has estimated its 2018-19 WACC using the same approach used to estimate its 2017-18 WACC. See: • section 7.1.3 of PoM's 2018-19 TCS General Statement • Appendix C, Synergies, Determining a WACC estimate for the Port of Melbourne • Appendix I, PoM, WACC: Submission on well accepted approaches.
•	Apply the following three-step WACC compliance test.	✓	