Port of Melbourne

SUBMISSION TO

ESSENTIAL SERVICES COMMISSION

INQUIRY INTO PRICING ORDER COMPLIANCE

3 September 2021

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Executive Summary

The Port of Melbourne Group (**PoM**) welcomes the 2021 Essential Services Commission (**ESC**) "Inquiry into Port of Melbourne compliance with the Pricing Order" for the review period 1 July 2016 to 30 June 2021 (**Five Year Review**). We see this first review as an important step over the 50-year period of the Port Lease.

The purpose of this document is to outline how PoM has been compliant with its responsibilities since the start of the Port Lease in November 2016. The port of Melbourne (the **Port**) is a growing and dynamic environment and we are pleased that there has been a successful transition of the business from a government owned entity and that PoM has responded to the changing needs of industry.

We also acknowledge that the first five years of the new regulatory framework has been a transition period that naturally has required all parties to understand and evolve their interpretation of the Pricing Order.

PoM has stewardship obligations for the Port to be a major seaborne trade gateway to the benefit of the State's economy

The Port is Australia's busiest container and general cargo port, handling more than one-third of the nation's container trade. The Port is a major business gateway and handles Victorian imports and exports, a number of Tasmanian trades, and cargoes moved to and from South Australia and southern New South Wales.

PoM, via the Port Lease Transaction (**PLT**), has been entrusted by the Victorian Government to manage and enhance the operations of the Port over the term of the 50-year Port Lease. PoM operates the Port within a context of statutory, regulatory and contractual commitments established under the PLT.

The Port Lease establishes PoM's overarching stewardship obligations to manage, maintain, operate and develop the Port consistent with Port Lessor's Port Objective for the Port to be a major seaborne trade gateway to the benefit of the economy of the State.

These stewardship obligations guide PoM's planning and investment. PoM's framework for, and approach to, investment considers what is in the best interests of the Port as a whole. Ultimately, PoM needs to make investment decisions within a regulatory context by ensuring these investments are prudent and efficient and optimise whole-of-Port outcomes for the benefit of the economy of the State.

We have undertaken broad stakeholder engagement to inform our investments

Our planning, investments and services have been informed by engagement with port stakeholders. Over the last five years, PoM has engaged extensively on strategic, long-term plans through the 2050 Port Development Strategy (**PDS**), Rail Access Strategy (Our Plan for Rail), Port Rail Transformation Project (**PRTP**) and annual industry updates.

We have also engaged on specific projects and services, such as with facilitating access for larger vessels up river involving shipping lines, pilots, tug operators and Swanson Dock stevedores.

In addition, PoM's trade development team members located in Melbourne, Tasmania and the Riverina provide direct interaction with cargo owners and supply chain participants.

PoM is committed to continuing to enhance its engagement practices as it transitions through the lifecycle phases of its plans. The Port is part of a competitive national and international transport supply chain. It is a naturally dynamic and competitive environment with multiple customers and users, each with often competing commercial views and interests. It is inevitable that the level of interest and need for information and input will grow among stakeholders over time because individual investment decisions may, at times, deliver different benefits to different customers.

We have made prudent and efficient investments in port infrastructure to meet our obligations and deliver the services Port users want

PoM has invested around $340 million in prescribed services since the commencement of the Port Lease to meet the objectives of the regulatory regime and obligations under the Port Lease and Port Concession Deed. This has achieved positive outcomes for Port stakeholders and the Victorian economy over the first review period:

- Major investments have been made in maintaining and rehabilitating infrastructure, developing rail capability and improving services;

- Service standards have improved through targeted investments and operating solutions and larger vessels are able to be serviced at Swanson Dock with vessels exceeding the vessel size limits that were in place at the time of the PLT in 2016; and
- Our operations are more efficient than pre-PLT.

PoM is strongly incentivised under the Pricing Order to ensure its investments are prudent and efficient, since the cost base used to set tariffs must include only prudent and efficient costs. To do otherwise would put at risk PoM's opportunity to recover its costs, including a return commensurate with the risks involved. In addition, the long-term nature of the Tariff Adjustment Limit (the **TAL**), which limits weighted average annual price increases to CPI until at least 2032, provides price certainty and an incentive for cost efficiency.

We have demonstrated compliance and are committed to continuous improvement

This submission summarises PoM's compliance with the Pricing Order including in relation to the Weighted Average Cost of Capital (**WACC**), operating and capital expenditure, depreciation, forecasts of demand, cost allocation and the treatment of contracts.

PoM has also refined how it demonstrates compliance with the Pricing Order in response to the ESC's interim commentary each year (on PoM's Tariff Compliance Statement (**TCS**) submissions) and the ESC's two Statements of Regulatory Approach.

During this first review period, the ESC and PoM's interpretation of requirements and application of the regulatory regime has evolved. This is understandable given that this is a new regime and new for ports. For example, when new guidance was provided by the ESC on engagement in the interim commentary in December 2020, we acted promptly to respond and enhance our practices. In addition, the evolution of interpretation of the Pricing Order by PoM and the ESC has resulted in our WACC parameter values now being in line with the ranges in the ESC's December 2020 interim commentary.

Given the application of the TAL, this process of refinement of the interpretation and application of the regulatory framework has had no implications for prices paid by Port users during the review period (or for the long-term).

The first review period has established the regulatory regime in practice and the regime is working as intended. PoM has invested consistent with our obligations, the business is more efficient, the WACC is based on well accepted approaches and prices have been set in accordance with the Pricing Order.

Going forward, we will actively leverage the knowledge and understanding gained to date. In anticipation of greater certainty around information requirements for compliance demonstration through this Five Year Review process, PoM expects that there will be an opportunity to minimise the regulatory burden in subsequent periods.

As in our prior submissions, PoM welcomes feedback from the ESC and looks forward to continuing our engagement with the ESC and Port stakeholders for the long-term benefit of all Port users and the Victorian economy.

About This Submission

This document sets out the PoM submission to the Five Year Review and is structured as follows:

- Section 1 explains the role of the Port and an overview of the contractual, legislative and regulatory context in which PoM operates;
- Section 2 outlines PoM's investments over the last five years and describes the naturally competitive dynamic of the Port and the investment framework in which PoM considers its planning and investment decisions;
- Section 3 outlines PoM's approach to consultation and engagement and compliance with regulatory obligations in this context;
- Section 4 provides an overview of the Pricing Order, the interpretation of the Pricing Order and the outcomes achieved; and
- Section 5 demonstrates PoM's compliance with the Pricing Order.

Level 19, 839 Collins Street, Melbourne, Victoria 3000 Australia

1 Role of the Port

1.1 Port of Melbourne in context

The Port is Australia's busiest container port, handling more than one-third of the nation's container trade. It is Australia's largest container, automotive and general cargo port and operates 24 hours a day, 365 days a year. The Port is a major business gateway for Victoria and south-eastern Australia and handles Victorian imports and exports, a number of Tasmanian trades, and cargoes moved to and from South Australia and southern New South Wales.

The Port contributes approximately 19,600 jobs and $6 billion annually to the Victorian economy.[1] The Victorian building, manufacturing, retail, food, agriculture and petroleum industries rely heavily on the Port and its road and rail transport connections and in turn, our day-to-day lives depend on the Port and all the businesses using the Port running well. With Melbourne's growing population and expanding city footprint, the Port is the cornerstone of Victoria's freight transport network and a vital freight hub for Australia.

PoM via the PLT[2], has been entrusted by the Victorian Government to manage and enhance the Port's operations over the term of the 50 year Port Lease. The Port Lease establishes a broad stewardship obligation for PoM to manage, operate, maintain and develop the Port to benefit the Victorian economy.

The Port covers a land area of around 505 hectares and 52km of shipping channels within Port Phillip Bay and the Yarra River. PoM is responsible for maintaining and developing these lands and waters, and overseeing the development of Port facilities and infrastructure, which includes 30 commercial berths and wharves, terminal and trade-handling facilities, and connections to surrounding road and rail networks.

Given the size and operational complexity of the Port, PoM has a broad range of stakeholders with diverse and sometimes differing needs and expectations. Our stakeholder engagement approach is to engage regularly, incorporating feedback at a strategic level and on a day-to-day operational basis. This ongoing engagement informs our investment decision-making process, and is discussed in detail in section 3.

PoM's framework for, and approach to, investment considers what is in the best interests of the Port as a whole. Ultimately, PoM needs to make investment decisions within a regulatory context by ensuring these investments are prudent and efficient and optimise whole-of-Port outcomes for the benefit of the economy of the State.

1.2 Port of Melbourne's framework of obligations

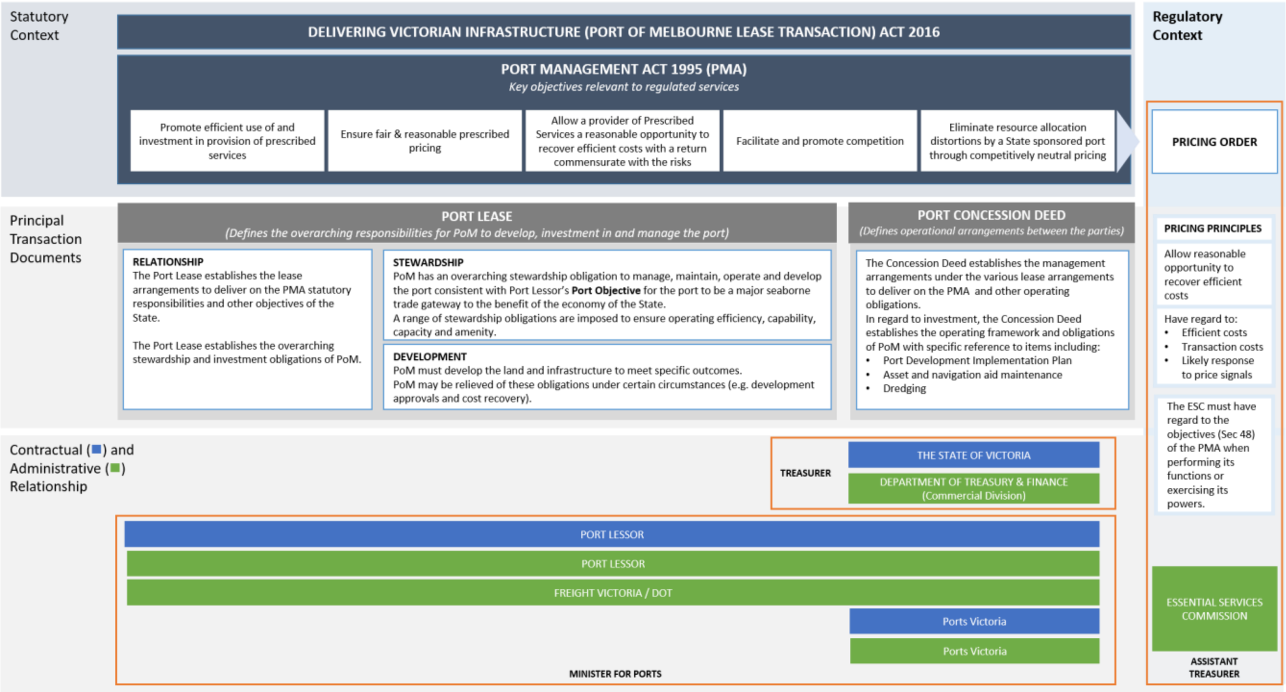
PoM operates the Port within a context of statutory, regulatory and contractual commitments established under the PLT. The PLT delivered several legislative amendments to support the contractual arrangements established with the State.

Figure 1 below describes PoM's obligations under the PLT, which exist in the form of:

- Statutory context, where the PMA sets out the key objectives related to regulation of PoM's services, and an inquiry function for the ESC to review PoM's compliance with the Pricing Order;
- Contractual context, where the PLT transaction documents, which are agreements between PoM and the State, define and provide oversight of PoM's overarching obligations to develop, invest in, and manage the Port; and
- Regulatory context, where the Pricing Order under the PMA sets out the Pricing Principles that PoM must apply when setting prices for prescribed services.

[1] 2050 Port Development Strategy (https://www.portofmelbourne.com/facilities-development/port-development-strategy/)
[2] https://www.legislation.vic.gov.au/in-force/acts/delivering-victorian-infrastructure-port-melbourne-lease-transaction-act-2016/011

Figure 1 – Scope of obligations and working relationships



The stewardship obligations of the Port Lease are of significant importance and guide PoM's planning and investment. As identified in the diagram above, the Port Lease establishes PoM's overarching stewardship obligations to manage, maintain, operate and develop the Port consistent with Port Lessor's Port Objective for the Port to be a major seaborne trade gateway to the benefit of the economy of the State (**Port Objective**).

Under these stewardship obligations, PoM must:

- Manage, operate and maintain the Port in accordance with Good Operating Practice[3];
- Ensure the Port is capable of providing access to shipping including able to reasonably accommodate changing vessel size;
- Ensure port infrastructure is no less capable of access for road and rail than as at the commencement of the Port Lease; and
- Use reasonable endeavours to maintain amenity, manage environment impacts and maintain public open space areas.

The Port Lease also includes a general obligation for PoM to develop the leased area (**Development Obligations**), under which PoM must develop the Port land and infrastructure to:

- Cater for actual and reasonably anticipated growth;
- Provide quality and efficiency standards expected of a major port;
- Maintain the Port's leading position among major Australian ports in terms of its quality, efficiency and effectiveness;
- Comply with good operating practice and applicable laws; and
- Achieve the Port Objective.

[3] Where 'Good Operating Practice' means: adherence to a standard of practice which includes the exercise of that degree of skill, diligence, due care, prudence and foresight which would reasonably be expected of a reasonably experienced, competent, prudent and qualified operator of the Port; and provision of appropriate services and facilities for the ease of access to, expeditious and safe movement in and efficient use of the concession area and port infrastructure by vessels, vehicles and other users of the Port.

PoM may be relieved of its Development Obligations when:

- Development approvals or occupation rights cannot reasonably be secured;
- Development is inconsistent with growing trade in a sustainably manner or optimising port infrastructure;
- Financing market results in uneconomic development; and
- Under the Pricing Order, capital costs incurred by PoM acting prudently, would not be efficient and not able to be reasonably recovered.

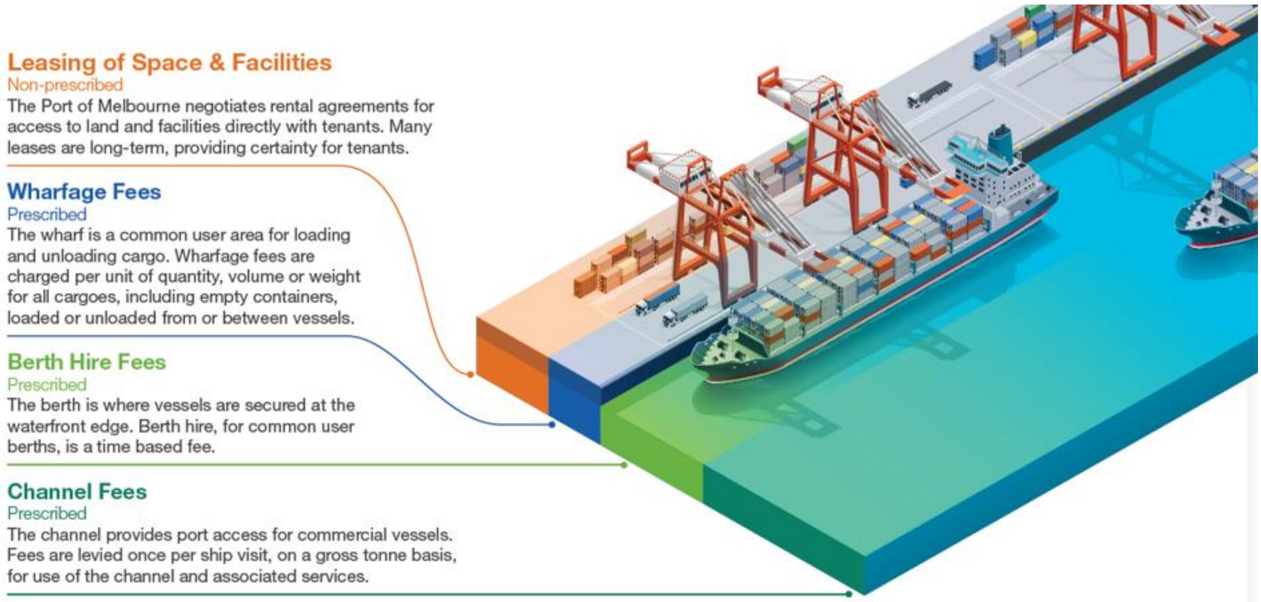
1.3 Regulatory framework

The regulatory framework under the PMA and Pricing Order came into effect on 1 July 2016. The Victorian Government developed the regulatory regime for PoM's unique circumstances. It covers:

- Prescribed Services – these include channel services, berthing services, the provision of short-term storage and cargo marshalling facilities and the provision of access to, or use of, certain places or infrastructure (including wharves, slipways, gangways, roads and rail infrastructure);[4]
- Non-Prescribed Services – includes leasing of space and facilities on port land (e.g. rental agreements for space and facilities on port land); and
- Functions related to any second container port, should one be developed in the future.

The delineation of Prescribed and Non-Prescribed Services is illustrated in Figure 2 below.

Figure 2 – Prescribed and Non-Prescribed Services



The regulatory framework was established as a compliance monitoring regime, where the obligation sits with PoM to apply and demonstrate compliance with the Pricing Order. The ESC plays the important oversight role in monitoring and reporting on compliance.

This regulatory framework was a component of the Victorian Government's framework when leasing the Port through the 50-year PLT. In its submission to the PLT Inquiry, the Victorian Government stated that[5]:

> *… from a Government policy perspective, it is important that PoM's pricing strikes the appropriate balance in:*
>
> *a. promoting the efficient use of, and investment in, regulated port services for the long-term benefit of users, consumers and the Victorian economy;*

[4] Prescribed Services are defined in section 49(1)(c) of the PMA.
[5] Department of Treasury and Finance, Select Committee Inquiry Submission, September 2015 p.40.

b. allowing the leaseholder to recover the cost of providing regulated port services, including a return on the assets employed and commensurate with the risks involved; and

c. facilitating and promoting competition between ports, shippers, and third party operators.

These objectives were subsequently reflected in the regulatory objectives contained in section 48 of the PMA.

In establishing the new economic regulatory regime, the Victorian Government set out the following key principles:

… the regulatory framework for PoM's prices needs to:

a. provide a relationship between prices and underlying costs;

b. address concerns for the potential for anti-competitive pricing of shared channel services;

c. provide arrangements to ensure efficient future capacity expansion;

d. provide a mechanism to enforce compliance with regulatory pricing principles without needing to implement direct price control;

e. provide flexibility to the leaseholder with appropriate oversight, and mechanisms for the State to make future regulatory changes, if needed; and

f. minimise regulatory burden.

An overview of the Pricing Order is provided in the next section and discussed in detail in section 4.

1.4 Pricing Order overview

The Pricing Order is a regulatory instrument issued by the Governor in Council under section 49A of the PMA to regulate and limit the setting of tariffs for prescribed services.

As a core component of the regulatory framework and the Victorian Government's commitment, the purpose of the Pricing Order was to incentivise investment to grow trade and enhance infrastructure and services for the freight, logistics and supply chain participants while creating price certainty for Port customers.

The PMA objectives recognise that the long-term interests of Victorian consumers are important, and that promoting those interests require PoM to have the opportunity to recover its efficient costs, and tariffs charged to users to be fair and reasonable (among other objectives).

To promote those objectives (among other compliance obligations), the Pricing Order defined a 'Pricing Order transition period' which runs until 2032, or latest 2037. During the Pricing Order transition period a price smoothing mechanism applies to limit the tariffs that PoM can charge Port Users to the lesser of two binding constraints, either:

- The Tariff Adjustment Limit (**TAL**), which limits weighted annual prescribed services tariff increases to annual inflation (CPI); or
- To recover no more than PoM's prudent and efficient costs, determined by application of an accrual building block methodology.

After the Pricing Order transition period, the tariffs PoM can charge to Port Users must be set to recover no more than its prudent and efficient costs.

The Pricing Order relates only to Prescribed Services. Charges for non-Prescribed Services are not subject to the Pricing Order[6] and are therefore not dealt with in this ESC Submission.

1.4.1 Compliance monitoring regime

The form of regulation applying to Prescribed Services is a compliance monitoring regime that is applied under a backward looking (ex-post) approach as follows:

- PoM sets tariffs in accordance with the Pricing Order and demonstrates to the ESC how PoM has complied with the Pricing Order through the annual TCS;

[6] Fees and charges for some non-Prescribed Services are contained in the Other Fee Schedule of the Reference Tariff Schedule. Charges for certain other non-Prescribed Services, such as leasing of space and facilities, are based on commercial agreements.

- The ESC monitors PoM's compliance with the Pricing Order and reports on this after the end of each five year review period[7] - which is the subject of this Submission; and
- The ESC Minister considers findings (if any) of significant and sustained non-compliance made by the ESC in its five-yearly reviews, and decides whether to intervene (e.g. by making a re-regulation recommendation or requiring an enforceable undertaking).

The compliance monitoring form of regulatory regime is a more appropriate form than full economic regulation (where the regulator makes ex ante decisions about prices) recognising the dynamic nature of port infrastructure in Victoria, the potential for a second port in the future and competition with other Australian ports.

1.4.2 Flexibility and discretion under the Pricing Order

The Pricing Order is unique as it has significantly different requirements from economic regulation regimes for other regulated industries across Australia. The Pricing Order contains certain matters of prescription and certain areas of flexibility and discretion.

Flexibility and discretion are important as the efficiency of Port infrastructure is materially dependent on matters outside of PoM's control, in particular the quality of road, rail and intermodal infrastructure in the broader freight, logistics and supply chain, which require ongoing infrastructure funding and operational support. Given PoM does not control these aspects, the Pricing Order plays a role to incentivise investment in initiatives to support these, for example those initiatives under the PDS, such as the PRTP.

The matters of prescription include requirements to:

- Apply the Accrual Building Block Model (**ABBM**) and Tariff Adjustment Limit (**TAL**);
- Comply with requirements for setting individual Prescribed Service tariffs (or bundles of service revenue) to ensure tariffs are fair and reasonable and have regard to principles of economic efficiency;
- Deem opex on the Port Licence Fee (**PLF**) and Cost Contribution Amount (**CCA**) to be efficient under the Pricing Order; and
- Deem certain capital expenditure, such as on the Port Capacity Project and PRTP, to be prudent (but still tested for efficiency).

The areas of flexibility and discretion relate to various inputs to the accrual building block methodology used to calculate allowed revenues. These afford PoM the flexibility and discretion to:

- Assess efficient and prudent capex and opex — including in relation to the need for, and timing of, capex which may change to adapt to the circumstances, subject to the provisions referred to above;
- Adopt well accepted approaches to determine the return on capital;
- Use an alternative depreciation methodology to the straight-line methodology if the return of capital calculated using the straight-line methodology cannot be recovered in an applicable financial year, or if the alternative depreciation method is reasonably likely to reduce annual variance in tariffs;
- Determine the length of the regulatory control period;
- Introduce, discontinue and/or rebalance tariffs during the TAL period, subject to consulting with Port Users and approval by the ESC; and
- Choose the form of price control after the TAL period (which runs until at least 30 June 2032 and at the latest, 30 June 2037).

[7] Under the Pricing Order the ESC also has certain triggered roles such as and approving any tariff rebalancing applications made by PoM or application by PoM to end the TAL period after 2032.

2 Port Investment and Competitive Dynamics

2.1 Investment under new Port governance

Since the PLT, PoM has been investing in the Port for the long-term benefit of all Port users, Victoria's economy, and Victorian consumers.

PoM immediately moved towards developing a vision and plan for long-term growth of the Port including:

- The Rail Access Strategy (Our Plan for Rail) – which produced the PRTP, currently under implementation; and
- The PDS which has identified a number of potential investments for PoM to deliver throughout the 30 year planning horizon to 2050;

PoM has invested around $340 million in infrastructure upgrades for prescribed services over the past five years and its ongoing commitment to improving facilities is delivering a more productive and efficient Port for all Port users, Victorian consumers and the wider economy.

A significant proportion of the investment has occurred at Swanson Dock including the rehabilitation of Swanson Dock East and investment to enable access to larger vessels under our big ship strategy. Following extensive engagement and collaboration both projects are delivering enhanced services and efficiencies for the supply chain. Section 3 details PoM's engagement process.

This investment has been undertaken while customers have significant certainty from the TAL.

Therefore, the Pricing Order, as a key component of the regulatory, statutory and contractual obligations of PoM, has been successful in incentivising investment to facilitate trade and enhance infrastructure and services for the freight, logistics and supply chain participants while creating price certainty for Port customers.

The next section addresses how PoM makes its investment decisions in a way that is consistent with the PMA, Pricing Order and Port Lease stewardship obligations.

2.2 Investment framework

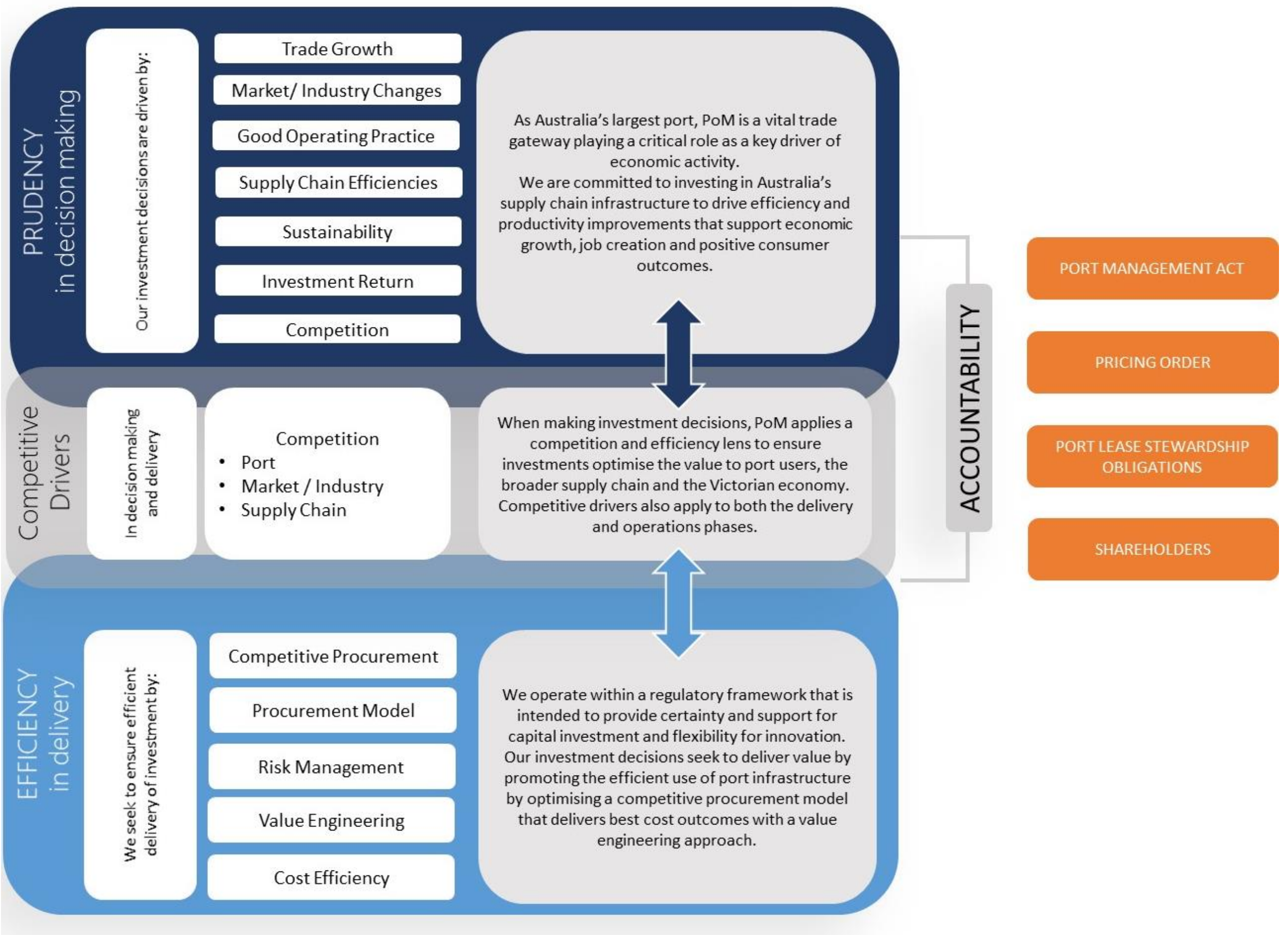
PoM seeks to deliver an optimal level of infrastructure capacity to meet forecast demand, improve service efficiencies and have regard to the opportunity for all Port users to compete. The Pricing Order operates to provide price certainty to customers and consequently PoM's ability to recover on investment by adjusting prices is constrained by application of the TAL.

PoM has adopted an investment framework that is consistent with PMA, Pricing Order and Port Lease stewardship obligations and provides a reasonable opportunity for PoM to recover its efficient costs of providing prescribed services, including a return commensurate with the risks involved. The framework ensures investments are prudent and efficient:

- **Prudent** in delivering supply chain productivity and efficiency improvements that ensure the Port remains a major seaborne trade gateway to the benefit of the economy of the State;
  - Example: when planning for investments, PoM is mindful of the long lead times for major infrastructure works and seeks to invest in additional capacity to ensure trade growth is not constrained and to optimise operational efficiency. PoM develops and assesses multiple delivery options that could achieve the desired outcome. Our planning framework considers an appropriate TEU capacity buffer to accommodate short term trade fluctuations such as through COVID-19 with 14.9% trade growth in FY21.
- **Efficient** in delivery to minimise project risk and deliver best cost outcomes through competitive procurement and value engineering;
  - Example: The PRTP demonstrated a strong working relationship between PoM and rail operators to deliver new port rail and land assets to meet the needs of the growing Port, and to reduce truck movements in Melbourne's inner western suburbs. Under this development, PoM has competitively tendered the construction contracts and allocated risk between delivery partners to deliver efficient outcomes.

PoM's consultation and engagement approach, discussed further in section 3, ensures stakeholders' current and future needs are incorporated into investment decision making. In doing so, PoM ensures value is optimised for all Port users and the broader supply chain and, consistent with the PMA, has regard to the opportunity for all Port users to compete. The diagram below illustrates PoM's investment framework in more detail.

Figure 3 – PoM Investment Framework



Under an investment framework which provides prudent and efficient investments, PoM can deliver an optimal level of infrastructure capacity to meet forecast demand, improve service efficiencies and support market competition while remaining accountable under the PMA, Pricing Order and Port Lease stewardship obligations. PoM is strongly incentivised to ensure opex and capex are prudent and efficient as it is unable to increase prices to recover the full efficient costs of its investments due to the weighted average annual CPI price cap (i.e. the TAL) that applies until at least 2032 during the Pricing Order transition period under the Pricing Order.

2.3 PMA objective to facilitate and promote competition

The Port is part of a competitive national and international transport supply chain. As outlined in section 1.2, a key objective of the PMA relating to prescribed services is to facilitate and promote competition. Competition exists at several levels, each of which are identified in the PMA:

- Port Competition (between ports);
  - Port of Melbourne actively competes in contestable trade regions over the longer term to attract greater supply chain investment and to grow trade volumes;
- Market / Industry Competition (between service providers at the Port);

- Day to day operation at the Port is largely undertaken by private businesses including the provision of stevedoring, pilotage, towage and bulk storage and handling facilities. Competition between these parties has been a consistent theme throughout the history of the Port and the Australian waterfront. In particular, the introduction of a third stevedore to Australian East Coast ports has resulted in a greater level of competition; and

- Supply Chain Competition (between access seekers / product owners);
  - Access seekers with broader supply chain logistic operations include cargo shipping, logistics operators and road and rail transport services.
  - Product owners represent the end customer (for imports) or exporters (such as those from regional Victoria). These include cement importers, liquid build importers and grain exporters
  - PoM gives consideration to competition across the supply chain and, while its level of influence could be limited, PoM enables participation and investment facilitates efficient and open access to Port infrastructure and promotes competition between transport modes.

Therefore, Ports are naturally dynamic and competitive environments with multiple customers and users each with often competing commercial views and interests. This is evidenced by recent market engagement processes, which illustrate that there is a diversity of views and not all stakeholders will be supportive of all investments all of the time.

Within this context, PoM remains focused on the overall performance of the Port over a long-term planning horizon and, during the five-year review period, PoM has demonstrated through its port-wide investments that it invests in a way that is consistent with the PMA objective to facilitate and promote competition.

Port of Melbourne

3 Consultation and Engagement

3.1 Role of stakeholder engagement

PoM has a broad range of stakeholders and customers with diverse and often conflicting needs. Our customers and Port users include shipping lines, transport operators (road and rail), cargo owners, freight forwarders, empty container parks, and terminal operators, who (like us) ultimately serve Victorian consumers. Our engagement approach has been tailored to identify and understand their respective needs, whilst transparently developing port-wide plans that best meet PoM's obligations to develop, invest in, and manage the Port.

The first five years of the Port Lease has seen a focus on engagement with our stakeholders on long-term planning through the PDS, PRTP, annual industry updates on key projects and regulatory issues and multiple project specific forums.

Our engagement has been:

- Broad in both scope and length of the planning time horizon (with the PDS covering a 30-year time horizon);
- Transparent, with our strategic infrastructure plans published and consulted on at key stages in their development; and
- Genuine, with feedback from stakeholders directly shaping the long-term plans for the Port.

We are committed to continuing to engage as we transition into the delivery phase of our plans. We have a number of PDS projects in execution and others in the early planning phase. These investments are lumpy, have different benefits to different customers, and cause disruptions to some customers as they are implemented. It is inevitable that the level of interest and need for information and input will grow among our stakeholders over time because investments that benefit one tenant may impact the interests of another in the short term.

Good practice engagement will not result in pleasing every single stakeholder. PoM seeks to use feedback to guide decisions that promote the achievement of PoM's obligations to develop, invest in, and manage the Port.

Consistent with our stewardship obligations, we adopt a long-term, port-wide view of the necessary scale, scope and sequencing of investment. That is what we are doing, for the long-term benefit of all Port users, the Victorian economy, and Victorian consumers.

3.2 Overview of compliance requirements

As a landlord port and asset manager, PoM operates within a complex supply chain. We do not work in isolation to Port users because our businesses are interrelated. This means engagement with Port users operationally and strategically is a key part of what we do.

This section identifies the regulatory compliance obligation PoM faces, and highlight how PoM has responded to the ESC's evolving guidance on this obligation since the Port Lease commenced in November 2016.

The Pricing Order requires that our annual TCS should '*set out the process by which the Port Licence Holder has effectively consulted and had regard to the comments provided by Port Users*'.

PoM has met this obligation by engaging on both strategic port planning and works delivery matters, and also on issues specific to the regulatory regime and our annual TCS submissions. Every year our TCS has included a dedicated appendix explaining our engagement process, what we heard, and how we responded.[8]

Over the course of the last five years, the ESC has provided guidance and feedback on its engagement expectations via its Statements of Regulatory Approach (in 2017 and 2020), and incrementally through its interim commentaries.

The Statement of Regulatory Approach[9] stated that the ESC will be guided by the following questions:

[8] See 2017-18 TCS Appendix E, 2018-19 TCS Appendix E, 2019-20 TCS Appendix I, 2020-21 TCS Appendix I, and 2021-22 TCS Appendix I. These appendices are in addition to the overview of engagement included in each TCS submission and discussion of relevant engagement outcomes on particular topics covered in those TCS submissions.

[9] ESC, Statement of Regulatory Approach – version 1.0, Dec 2017, p.14.

1. *Has the port's form of engagement been tailored to suit the topic on which it seeks to engage?*
2. *Has the port provided port users with appropriate information outlining the purpose, form and the content of the engagement?*
3. *Has the port provided port users with a reasonable opportunity to participate?*
4. *Does the port's engagement program give priority to matters that could have a significant impact on port users?*

Our engagement approach and response to engagement outcomes has met the ESC's guidance. This chapter provides a brief overview of our engagement that illustrates this. It is not exhaustive given everything PoM has engaged on and responded to over the last five years as documented in our annual TCS submissions. We have also provided extensive evidence on stakeholder engagement processes to the ESC via the information and input provided to review processes, which includes (among other things), stakeholder engagement plans, materials provided to stakeholders, minutes of meetings and discussions with stakeholders, minutes from joint project planning and delivery teams established with our customers, and Board papers (all of which include commentary on stakeholder issues).

We responded to ESC engagement feedback in its interim commentaries, which has evolved over the course of the review period. The first two of these did not comment on our engagement process but rather flagged specific regulatory issues where PoM should consult with Port users. These were the length of the regulatory period (2017-18 interim commentary) and deferred depreciation (2017-18, 2018-19, 2019-20, 2020-21 interim commentaries). PoM's subsequent TCS submissions showed how these issues were responded to each year.

We welcomed the ESC's first feedback on our engagement process, which occurred in its 2019-20 interim commentary (see Box 1[10]) published one month before the start of the COVID-19 pandemic.

Box 1 | ESC 2019-20 interim commentary on 'Effectiveness of the engagement program', December 2019

The port has demonstrated an effective engagement program with port users and other stakeholders.

The 2019-20 tariff compliance statement has clearly outlined the port's engagement program with port users and other stakeholders over the course of 2018-19, which covered: (1) business plans as set out in its 2050 Port Development Strategy (PDS), including for the accommodation of larger vessels; (2) rail project; and (3) broad business engagement on the markets in which the port provides its prescribed services and charges its tariffs.

We are satisfied with the port's engagement program based on the detailed information it provided in Appendix I. The port had listed the type of engagement activities for a wide range of issues, the feedback from port users and other stakeholders on those issues, and the port's responses to the feedback. We are encouraged by this open and ongoing dialogue between the port and its stakeholders and customers which over time should equip the port to respond to the ongoing needs of its customer base.

The following year in December 2020, the ESC noted that PoM had clearly outlined its engagement program with Port users and other stakeholders over the course of 2019 and early 2020. However, the 2020-21 interim commentary questioned whether our engagement approach had been sufficiently 'collaborative', stating: '*it is not clear if stakeholders have collaborated on the prudency and efficiency of key investments that have a direct impact on port stakeholders*' and that '*the port should do more to demonstrate that the processes it has undertaken throughout its engagement consultation are effective in ensuring stakeholders are able to effectively collaborate on key issues and inform outcomes*'[11]

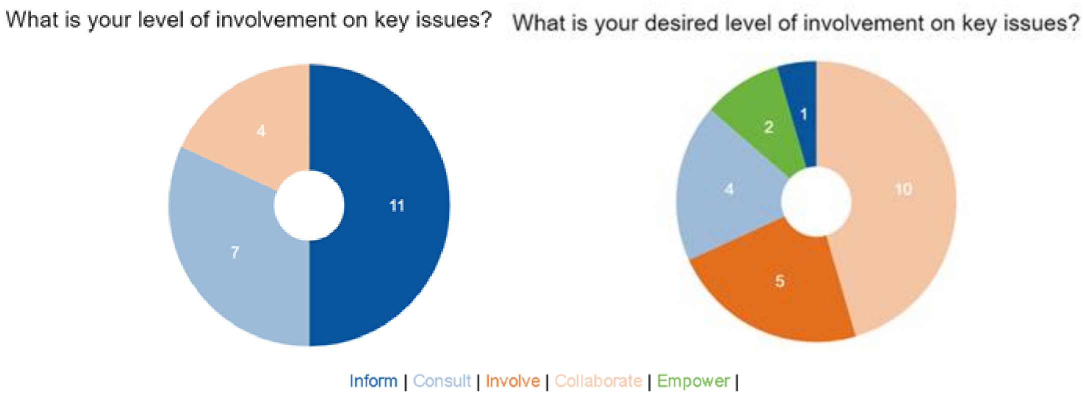
We have engaged extensively over the last five years with stakeholders at the strategic, project and operational levels. For the reasons set out in our TCS submissions and summarised in this submission, we are confident that our engagement approach is fit for purpose and compliant.

In responding to the ESC's feedback, PoM engaged expert consultants RPS Group (Industry Update 2021) to assist it in further understanding stakeholder perceptions of the current level of involvement in key issues, and their desired level

[10] ESC, Interim commentary - Port of Melbourne tariff compliance statement 2019-20, 16 December 2019, p.2.
[11] ESC, Interim commentary - Port of Melbourne tariff compliance statement 2020-21, 16 December 2020, p.28.

of involvement, based on the IAP2 framework. As shown in the figure below, respondents indicated that they are currently informed, consulted or collaborated with on key issues. Respondents also indicated a desire for more involvement or collaboration on key issues.

Figure 4 – Current and desired level of involvement from survey and questionnaire responses[12]



In considering the feedback provided by stakeholders, RPS Group noted:[13]

> *While it is important to recognise the desired engagement level of stakeholders, it should be noted that in many cases it will not be appropriate for Port of Melbourne to collaborate directly with individual stakeholders given many stakeholders have commercial relationships with each other and often directly compete with each other. The Port of Melbourne also has contractual obligations to the Victorian Government to develop the port for the benefit of Victorian consumers and must take care not to put the commercial interests of individual parties operating in and around the port ahead of those obligations.*

Port of Melbourne has different characteristics to other regulated utilities and this results in a different competitive dynamic. The Port is not a simple operating environment, and our relationship with individual stakeholders often crosses a number of different levels and purposes.

The centralised and customer or tenant specific nature of port assets means that stevedores, for instance, compete within the Port and, as competitors, will take interest in investments at other terminals. This competitive market dynamic has the ability, at times, to result in competing views on infrastructure priorities, not just between stevedores but also directed at PoM as port manager and decision maker. Within this context and within the complexity of stakeholder interests it is important to recognise that not all projects will get unanimous support.

3.3 PoM's approach to consultation and engagement

3.3.1 PoM's engagement is tailored to whom we are engaging with and what we are engaging on

We value our engagement with a broad range of stakeholders. While the Pricing Order defines Port User as those who request or receive Prescribed Services, we apply a broader approach when designing and applying our engagement. PoM identifies its stakeholders as those:

- Affected by Port operations;
- We are affected by; or
- To whom we have legal, financial or operational obligations.

[12] RPS Group.
[13] Appendix I to the 2021-22 TCS, RPS 2021 Stakeholder Engagement - Summary Report, p.14.

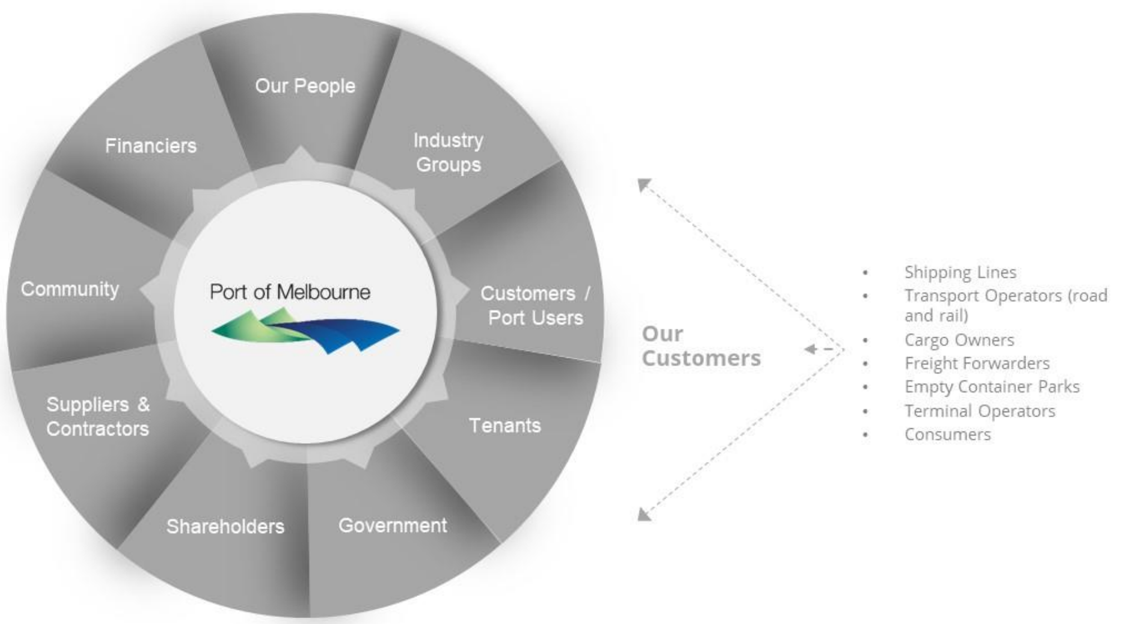
Our approach to consultation and engagement starts with understanding the nature and diversity of our stakeholders and how our prescribed services, operations and pricing affect them and the markets within which they operate. The Port provides business to business services within a broader logistics supply chain. These services are not provided directly to retail customers. Rather, services are delivered to large logistics service providers, many of whom compete with one another both for business that transacts through the Port as well as in other Australian ports.

These features of our operating and investment environment that when it comes to engagement:

- We have a shared interest in assets with a number of stakeholders;
- We have commercial, contractual and operating relationships with different stakeholders;
- There are different levels of competition between different stakeholders; and
- We have different stakeholders with varying levels of sophistication, influence and countervailing power.

This operating context means PoM has a broad range of stakeholders with diverse and sometimes conflicting needs and expectations (illustrated below).

Figure 5 – Range of PoM Stakeholders

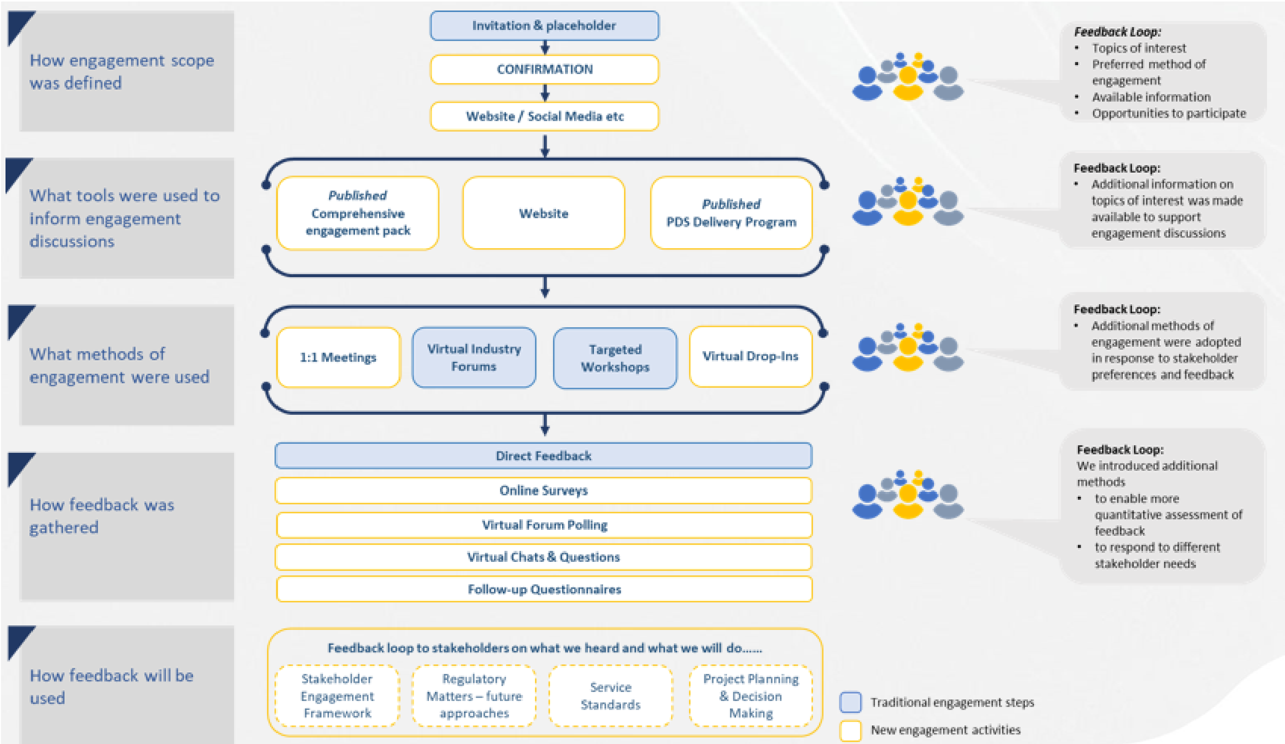


Recognising this stakeholder diversity, we have evolved our engagement approach over the last five years to increasingly use a diverse range of engagement channels (including confidential one-on-one meetings attended by our executive team) that let us gain important feedback from our customers. We appreciate the importance of providing engagement channels where our customers can share their feedback without prejudicing their competitive positions in the markets in which they operate. These competition issues are recognised explicitly in our engagement activities, where we set out clearly that participants should not discuss with competitors pricing, tenders, terms of supply and any other commercially sensitive information that may be connected with anti-competitive behaviour.[14] We also regularly arrange and deliver specific competition law training for our staff.

The figure below illustrates how our process for the 2021 Industry Update and TCS consultation ensured that our form of engagement was tailored to suit both the topics we engaged on and the stakeholders we engaged with.

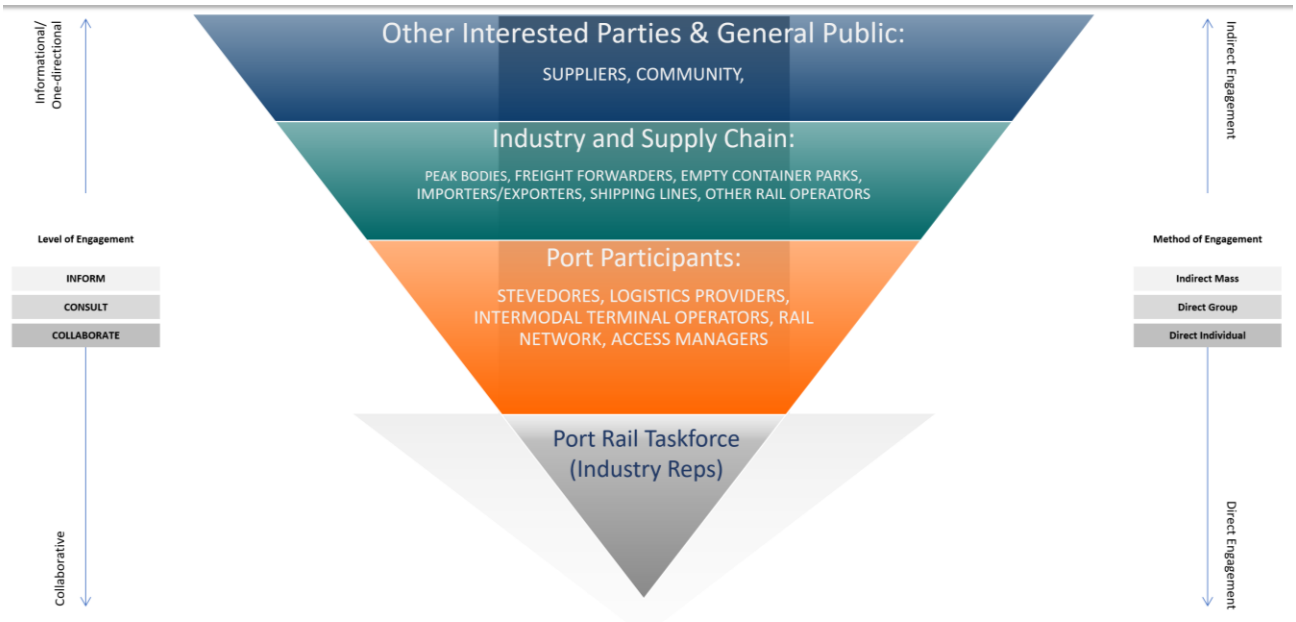
[14] See for example, the Anti-Competitive statement contained in our 2021 Industry Update presentation, available on our website: https://www.portofmelbourne.com/news-publications/industry-consultation-2021/

Figure 6 – Engagement Approach for 2021 Industry Update and TCS Consultation



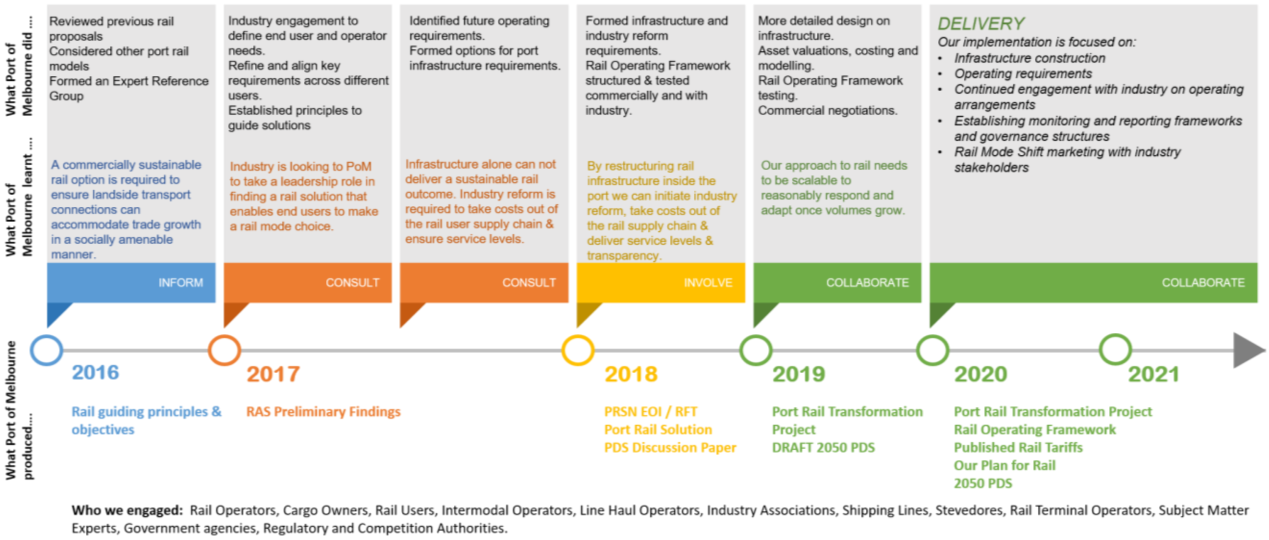
The following diagram shows the equivalent tailoring of our engagement approach for the Rail Access Strategy and PRTP.

Figure 7 – Engagement for Rail Access Strategy and Port Rail Transformation Project



This tailoring of approach was continued throughout the delivery of the engagement on the Rail Access Strategy and PRTP as illustrated below.

Figure 8 – Engagement during Delivery of Port Rail Transformation Project



This tailoring of engagement channels was not limited to these two examples. It has been a feature of our major engagements over the past five years, as shown in the figure below.

Figure 9 – Type of Engagement for Major Projects

Program	Workshop Briefings	Written Submissions	1:1 Meetings	Drops Ins	Virtual Workshops (2020-21)	Surveys / Questionnaire (2020-21)
2050 Port Development Strategy	✓	✓	✓	✓	N/A	N/A
Port Development Implementation Plan	N/A	✓	✓	N/A	N/A	N/A
Big Ship Program	✓	✓	✓	N/A	N/A	N/A
Port Rail Transformation Project	✓	✓	✓	N/A	N/A	N/A
Swanson Dock Upgrades	N/A	N/A	✓	N/A	N/A	N/A
Tariff Rebalancing Strategy	N/A	✓	✓	N/A	✓	✓
Annual Industry Update	N/A	✓	✓	N/A	✓	✓

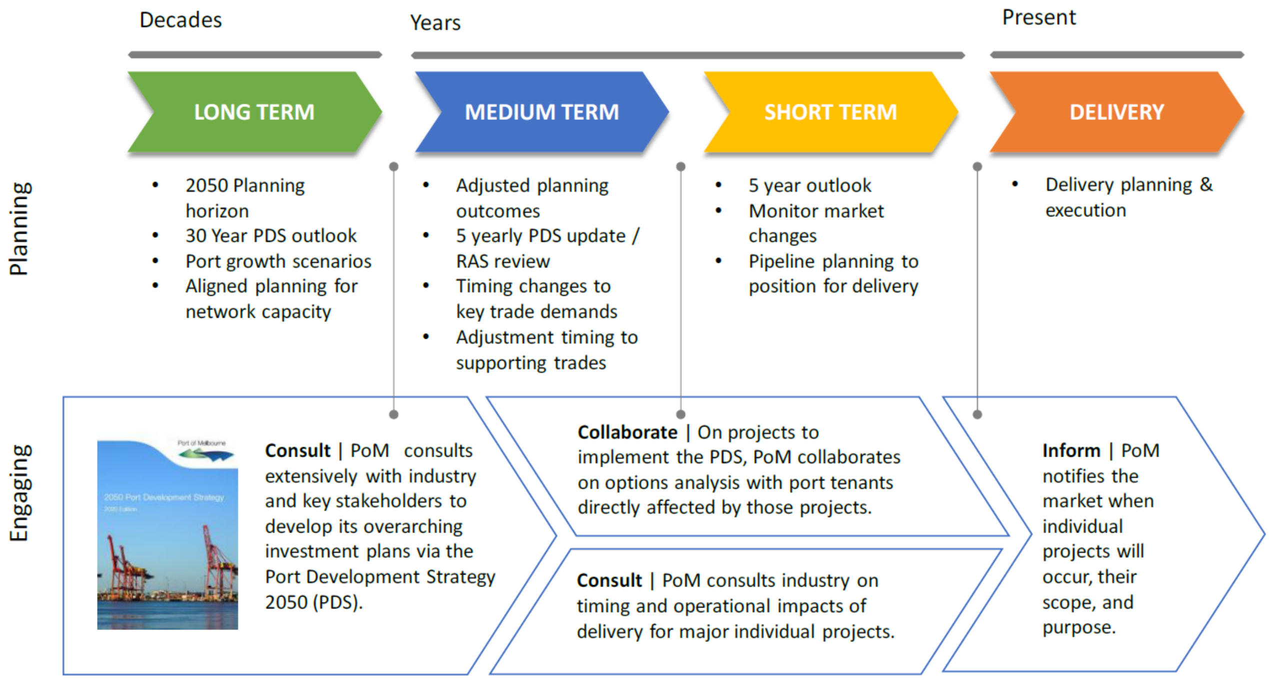
By tailoring our engagement channels and engaging with sufficient lead times to the business decisions that the engagement is informing, we have ensured that:

- Our stakeholders are provided with a reasonable opportunity to participate; and
- Our engagement is genuine, because we seek input in a timely way to inform our planning and decision making.

3.3.2 PoM's engagement is tailored to the time horizon of the decisions it is informing

Our engagement and relationships with stakeholders underpins our ability to deliver on our Vision and Mission and stewardship obligations to the State. These stewardship obligations affect how we plan and execute our investments over time. The figure below illustrates the planning and engagement horizons, and our associated activities.[15]

Figure 10 – Planning and Engagement Horizons

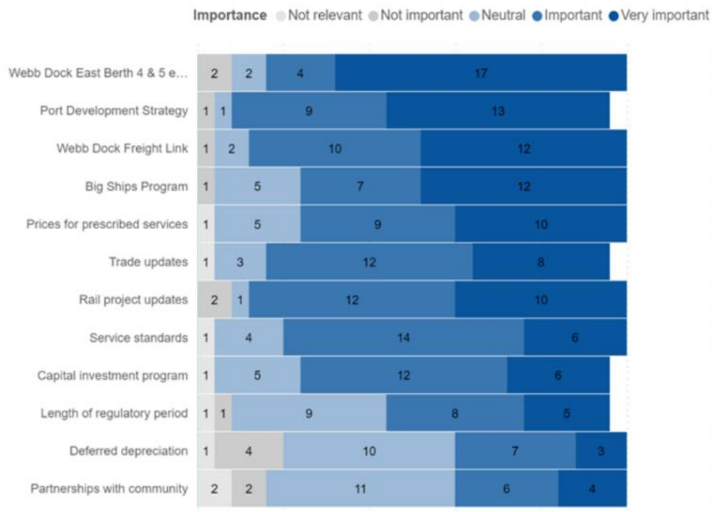


3.3.3 PoM's engagement is focused on what matters to customers

PoM has consulted and worked with all Port stakeholders and wider port and supply chain participants to assist in their awareness, knowledge and understanding not only of the regulatory regime, but also on our investment decisions, planning and general operations as relevant. We ensured that our engagement gave priority to matters that were or interest to Port users and other stakeholders.

When our research firm RPS Group[16] recently polled our engagement participants on what mattered to them, our planning and works delivery topics were rated as much more important by our stakeholders relative to regulatory issues.

Topics considered least important by stakeholders were the length of the regulatory period, deferred depreciation and partnerships with the community.



[15] Further information on these planning horizons and associated engagement is in Attachment 2 of POM's 2021-22 TCS.
[16] The full research report submitted was as Appendix I to our 2021-22 TCS.

In the context of our prices being capped at inflation until at least 2032 and likely 2037, it would appear that some of the more complex regulatory issues that had no consequence on our prescribed service tariffs during the last five years (and will have no impact for many years to come) were not a high priority for stakeholders. Recognising their potential future importance and the ESC's interim commentary feedback on areas it expected us to engage on, we included regulatory topics such as deferred depreciation and length of the regulatory period in our engagement.[17]

3.4 What we have heard and how we have responded

Through our engagement in both planning activities and annual industry updates for the TCSs we have gained a rich source of information that has informed our business decisions.

By way of example, the following key sources set out what we heard and how we responded on a range of important topics (all of which are available on our website):

- Our annual Tariff Compliance Statements. The TCSs outline PoM's engagement activities, the views and feedback provided by Port Users and other stakeholders, and how we have, or will, respond to address this feedback; and
- The PDS Consultation Summary Report. This report summarises what we heard during the PDS consultations (pages 9-10), and how we responded, including consideration of what PoM can do, how PoM can work with others and what changes were made to the PDS as a result (page 12).

Outcomes of our engagement with stakeholders during day-to-day operations and during formal engagement activities have:

- Enabled us to refine and develop our plans for the future development of the Port, such that the PDS presented a single, clear and logical sequence of development as a result of stakeholder feedback;
- Supported the expansion of our PDS to address environment and sustainability considerations in direct response to community interests and our city port location;
- Confirmed our priority focus on developing a rail solution in response to community support to reduce road use, and collaboratively ideated the problem definition to underpin development of the Rail Access Strategy;
- Enabled us to add, remove or refine investment and development options considered in our planning, as illustrated by refinement of options for long-term capacity plans at Swanson Dock (e.g. consideration and removal of the river berth option for future container capacity following feedback from the stevedores);
- Informed our approach to longer-term regulatory matters (i.e. for implementation after the end of the Pricing Order transition period), as illustrated by our approach to smoothing prices via the depreciation approach to apply after the TAL period, which has been supported by stakeholder engagement and verified by independent experts; and
- Shown Port user support for facilitating the ability of international container terminal operators to compete.

3.5 Engagement on long-term matters as part of the Strategic Planning cycle

PoM's engagement has a focus on investment over an extended 30-year planning horizon. Our planning cycle establishes these long-term port development plans and reviews them periodically in consultation with stakeholders. The PDS was developed over a two-year period of engagement with our stakeholders, and will be periodically reviewed (i.e. every five years) using a similar engagement approach.

The first five years of the Port Lease has necessarily seen a focus on strategic engagement on long-term planning through the PDS and PRTP. The PDS started with stakeholder engagement in 2018, including high level planning with Government to confirm investment timing and capacity sequencing. We then undertook tenant and public engagement through 2019 to refine the plans for future development of the Port, which led to the final version of the PDS which was then published in 2020.

We are committed to continuing to engage as we transition through the lifecycle phases of our plans.

[17] The breadth of our engagement topics and information used to inform customers' participation in that engagement can be found in our annual industry updates. The most recent Industry Update is available on our website: https://www.portofmelbourne.com/news-publications/industry-consultation-2021/

We note that individual project decisions may, at times, pose different outcomes to different customers. However, consistent with our stewardship obligations, we adopt a long-term, port-wide view of the necessary scale, scope and sequencing of projects. That is what we are doing, for the long-term benefit of all Port users and the Victorian economy.

4 Pricing Order Requirements

4.1 Overview

The PMA and the Pricing Order established under the PMA set out the regulatory framework applying to PoM.

The incentive properties of the Pricing Order combined with the commitment of PoM to meeting the objectives of the regulatory regime and its obligations under the Port Lease and Port Concession Deed have achieved positive outcomes for Port stakeholders and the Victorian community in the first review period:

- Major investments have been made in renewing and rehabilitating infrastructure, developing rail capability and improving services;
- Service standards have improved through targeted investments and operating solutions, including Swanson Dock investments to support handling of vessels that exceed the vessel size limits in place at the time of the PLT in 2016; and
- Our operations are more efficient than pre-lease with operating costs well below prior levels.

This has been achieved in an environment where users have certainty over prices, which have generally remained unchanged in real terms.

At the same time, while PoM has been committed to meeting the objectives of the regulatory regime, the understanding of what is a unique regulatory regime has evolved over the last five years. Both PoM and the ESC have been on a journey to interpret and implement the requirements of the regulatory framework and this new understanding has needed time.

This chapter provides an overview of the Pricing Order, its attributes and requirements, and PoM's regulatory approach. Chapter 5 sets out how PoM has complied with specific elements of the Pricing Order.

4.2 Overview of the Pricing Order

The objectives of the regulatory framework are set out in s48 of the PMA, and include (in summary):

- Promoting the efficient use of, and investment in, the provision of prescribed services for the long-term interests of users and Victorian consumers;
- Protecting the interests of users by ensuring that prescribed prices are fair and reasonable;
- Allowing PoM a reasonable opportunity to recover the efficient costs of providing prescribed services, including a return commensurate with the risks involved; and
- Facilitating and promoting competition between ports, between shippers, and between other persons conducting commercial activities in ports.

At an overarching level, the Pricing Order is designed to meet these objectives. It provides that PoM is regulated under a retrospective compliance monitoring regime whereby:

- PoM sets tariffs in accordance with the Pricing Order (which limits overall increases to CPI as outlined in section 1.4) and is required to demonstrate to the ESC how it has complied with the Pricing Order through the annual TCS;
- The ESC monitors compliance with the Pricing Order and reports on this at the end of each five-year review period; and
- The ESC reports to its Minister on compliance and the Minister considers any findings of significant and sustained non-compliance and decides whether to intervene.

4.3 Incentives under the Pricing Order

The Pricing Order, together with other obligations under the Port Lease, form a key part of the investment incentives for PoM.

PoM's obligations under the Port Lease are to develop, invest in and manage the Port to the benefit of the economy of the State. These contractual obligations, which provide the basis for the performance and services standards of the Port, are described in section 1. They ensure that PoM devotes the resources necessary to continue to improve services over time.

At the same time, the Pricing Order provides that:

- Tariffs must be set to provide PoM with a reasonable opportunity to recover the efficient costs of providing services;
- The level and structure of tariffs must be set having regard to the efficient costs caused by Port Users, transaction costs and the extent to which Port Users are able or likely to respond to price signals; and
- The cost base used to set tariffs must be determined using an 'accrual building block' method, which, among other things, is to include only the prudent and efficient costs incurred by PoM.

In addition, the TAL limits weighted average annual price increases to CPI during the Pricing Order transition period, independent of the actual costs of providing services. The Pricing Order transition period runs until at least 30 June 2032 and no later than 30 June 2037.

Therefore, the Pricing Order incentivises PoM to be highly prudent and efficient in making expenditure decisions for the entire term of the Port Lease, or otherwise put at risk its opportunity to recover its costs, including a return commensurate with the risks involved.

4.4 Outcomes

PoM considers that the regulatory regime, including the Pricing Order, has achieved the outcomes and objectives set out in section 48 of the PMA. Under the regulatory regime and PoM's stewardship:

- Users have been provided with fair and reasonable prices for prescribed services (as sought in s48(1)(b) of the PMA). Prices, on average, have increased by no more than CPI each year – the only exceptions being the Export Pricing Decision set out in the Pricing Order which decreased wharfage for full export containers for the first four years and the Government's decision to increase wharfage for full container imports to fund the PRTP;
- PoM has made efficiency enhancing investments in port infrastructure (s48(1)(a)). In the first five years prescribed services capex totalled around $340 million, including on wharf remediation, developing rail infrastructure and enabling larger vessels to enter the Port. Projects have sought to optimise the use of built infrastructure to defer or minimise new capital spend – ensuring that users do not have to pay for unnecessary investments. Most capex has been spent on maintaining and rehabilitating assets, and the efficient rehabilitation spend, including at Swanson Dock East in particular, has been much larger than forecast by the State at the time of the PLT in 2016. PoM is planning a $186 million investment program for 2021-22, the largest since the commencement of the Port Lease. Longer term planning for major projects continues to occur in conjunction with stakeholders through the PDS, which foresees a program of works estimated at $1.5 billion;
- Service standards have improved. The deployment of larger vessels has occurred faster than anticipated at the time of the PLT in 2016 (due to, for example, shipping mergers, cost pressures, new sulphur emission standards). Therefore, the need to cater for larger vessels has occurred earlier than forecast. Through PoM's response to these trends, which include both targeted investments and operational solutions that have enabled large capital costs to be avoided, Swanson Dock has had upgrades to handle vessels that exceed the vessel size limits in place at the time of the PLT. Swanson Dock is now capable of accommodating nearly all vessels that visit the Port, including vessels of 9,600 TEU in 2020. PoM continues to meet the performance standards set out in its 2020-21 TCS which cover safety and environment, reliability/availability/capacity, infrastructure planning and strategies, customer and community engagement and major project delivery; and
- PoM has achieved significant efficiencies in the provision of prescribed services (s48(1)(a)). This can be seen by comparing operating expenditure levels in the years before and after the Port Lease Transaction. Comparable controllable operating expenditure in the six years since the Port Lease commenced has, on average, been around $20 million per year lower than average annual operating expenditure in the five years prior.

4.5 Interpreting the Pricing Order

Regulatory regimes that are new, unique and complex take time for the regulator and regulated entity to understand and work through. As set out in more detail in Chapter 5, it is important that the ESC's assessment of compliance takes into account the way in which the PLT introduced new regulation, and assesses compliance against what was understood at the time of each TCS, and reflects PoM's response to address interim guidance (noting that guidance has evolved during the period).

4.5.1 A new and unique regime

The regulatory regime is new. This review, five years after the Pricing Order came into effect, represents the first time that the ESC will provide a formal interpretation of the requirements of the Pricing Order, whether PoM has complied, and the nature and reasons for any non-compliance. In the interim, the onus is on PoM to interpret the Pricing Order and determine what is required to ensure and demonstrate compliance.

Just as the ESC has done, PoM has sought to inform itself on the requirements of the Pricing Order to ensure it meets its regulatory compliance requirements.

PoM recognises that the ESC has provided some guidance over the period in the form of its Statements of Regulatory Approach and interim commentaries on PoM's annual TCSs.

PoM has been responsive to the issues raised and guidance provided by the ESC and achieved alignment on the material issues that have arisen (see Chapter 5 for more discussion on this point). For example, following the ESC's interim commentary on its 2020-21 TCS, and in the lead-up to its 2021-22 TCS, PoM engaged experts to further strengthen its interaction with stakeholders. In our 2021-22 TCS, we responded to the 2020-21 commentary by:

- Indicating agreement with the ESC's position that a longer regulatory period has merit;
- Specifically consulting Port users and other stakeholders on future prices and the impacts of deferred depreciation; and
- Converging WACC parameters to the ranges in the ESC's commentary.

PoM submitted each TCS based on the information available at the time, taking into account the interim views provided by the ESC up the date of the relevant submission. It is therefore inappropriate to assess the adequacy of compliance demonstration in earlier years against the guidance and standards that have only developed with the benefit of experience and hindsight, by all parties.

In addition, given that prices are set in accordance with the TAL until the end of the Pricing Order transition period (at least 2032, and latest 2037), a number of the compliance requirements set out in the Pricing Order currently have no impact on user prices.

4.5.2 Compliance demonstration requirements

The information that PoM has provided to demonstrate compliance on an annual basis, and as part of this Five Year Review is extensive. PoM's 2021-22 TCS comprised around 80 pages in the main submission, plus 21 separate documents, including 8 reports from independent expert consultants, and several Excel models and user guides. The level of detail in the annual TCS has grown each year as PoM has responded to the ESC's interim commentaries. PoM's submission in response to a request for information issued by the ESC under section 56 of the PMA as part of this five year review includes more than 2,000 documents.[18]

PoM also notes that many of the compliance demonstration requirements of the Pricing Order require interpretation. For example, the term 'well accepted approach' (as it relates to the calculation of the WACC) is not defined in the Pricing Order or elsewhere in the regulatory regime. Several elements of the Pricing Order require PoM to provide 'sufficient supporting information' without specifying what this information should include. We also note that the ESC has not

[18] In responding to the ESC's s56 request for information that has formed part of this five-yearly compliance review PoM has provided more than 2,000 documents including Board papers, minutes from Board meetings, minutes from Project Control Group meetings, 20 years' worth of expenditure data and other reports in response to a request for 'financial and business records' containing or relating to broad topics and issues.

used its information determination powers under the Pricing Order to clarify what constitutes 'sufficient supporting information'.

Given these uncertainties, it is not surprising that some effort has been required by both PoM and the ESC to interpret the regime and determine the information requirements for compliance demonstration. Going forward, and in the anticipation of greater certainty around information requirements for compliance demonstration through this Five Year Review process, PoM expects that there will be an opportunity to 'minimise the regulatory burden', consistent with the intent expressed by the Victorian Government.[19]

The recent s56 information request along with the outcomes of this compliance review will be helpful in providing more certainty on how to demonstrate compliance beyond this first five year period. PoM will take the lessons and outcomes of this first review and use them to refine its approach in the second five year period.

4.5.3 Evolution of Pricing Order interpretation and guidance

PoM has been committed to developing relevant approaches to compliance since the commencement of the Port Lease. PoM has worked with the ESC to refine the interpretation and application of the regulatory framework, and it seems reasonable that both organisations' interpretation of the Pricing Order has evolved over time:

- The ESC's first Statement of Regulatory Approach was issued in December 2017;
- PoM was required to prepare its first TCS in May 2017;
- In response to the Statement of Regulatory Approach and interim commentary on the 2016-17 TCS, we provided substantially more information on compliance in our 2017-18 TCS. This included provision of a regulatory model and discussion on the cost of capital and in particular what constitutes 'well accepted approaches';
- In its October 2018 interim commentary on the 2017-18 TCS, the ESC asked for certain information on opex, capex, cost allocation, asset lives and demand forecasts to be included in future TCSs (which PoM has provided). The ESC also made comment on the WACC, but advised that it would provide more guidance in its upcoming revision to its Statement of Regulatory Approach. The ESC noted it would continue to engage with the Port, Port users and other interested stakeholders on its approach to interpretation of the pricing order provisions in relation to WACC;
- In its October 2018 interim commentary, the ESC indicated that the Pricing Order required both the costs and revenues associated with (all) contracts to be included in the Aggregate Revenue Requirement (**ARR**). However, the ESC later amended its position to clarify that only legacy contracts should be included in the ARR, whereas new contracts should be ring-fenced;
- In its December 2019 interim commentary on the 2018-19 TCS, the ESC indicated it "was satisfied with the port's engagement program." However, in its December 2020 interim commentary the ESC expressed some concern with PoM's approach (which were addressed in PoM's subsequent TCS);
- In relation to the cost of capital, version 2.0 of the Statement of Regulatory Approach (released in April 2020) revised the ESC's interpretation of the Pricing Order including amendments to the ESC's interpretation of well accepted approaches to determining the cost of capital and certain parameter values;
- In its s56 information request, the ESC also appears to be seeking an additional set of information relating to demonstrating compliance.

Importantly, this process of refinement of the interpretation and application of the regulatory framework by both PoM and the ESC has occurred without adverse consequence for Port Users. For example, our approach to estimating the WACC has evolved in response to careful consideration of the ESC's interim commentaries in the prior years of the Port Lease, however, the WACC estimates adopted in previous regulatory periods have had no impact on the RAB and therefore will have no impact on future prices.

At the same time, as the ESC and PoM's interpretation of requirements of the regulatory regime has evolved over time, PoM considers it appropriate to assess the adequacy of compliance demonstration in earlier years against the guidance and standards at the time, rather than those that have only developed afterwards.

[19] Department of Treasury and Finance, Select Committee Inquiry Submission, September 2015 p.40.

5 Demonstrating Compliance

5.1 Overview

As noted in Chapter 4, the Pricing Order and other elements of the regulatory framework provide for a unique compliance framework whereby PoM sets tariffs in accordance with the Pricing Order and other elements of the regulatory framework and demonstrates to the ESC how it has complied with the Pricing Order through the TCS. The ESC subsequently assesses compliance at the end of each five year review period.

PoM treats its compliance obligations very seriously and has been compliant with the Pricing Order at all times. PoM has continuously refined how it demonstrates compliance with the Pricing Order in response to the ESC's interim commentary each year on PoM's TCS submissions and the ESC's two Statements of Regulatory Approach.

The following sections summarise PoM's compliance with major elements of the Pricing Order including in relation to the cost of capital, operating and capital expenditure, depreciation, forecasts of demand, cost allocation and the treatment of contracts. More detail on our compliance can be found in the 2021-22 TCS and its Appendices, which are publicly available on the ESC's web site.

5.2 Rate of return on capital

5.2.1 Requirements

The rate of return on capital (referred to as the weighted average cost of capital, or WACC) aims to compensate debt and equity holders for the opportunity cost of either lending or investing their funds in the Port. The key Pricing Order requirements relating to the return on capital required to calculate the ARR are that it must be:

- Commensurate with that required by a benchmark efficient entity providing services with a similar degree of risk in providing the Prescribed Services (clause 4.1.1(a) of the Pricing Order);
- Estimated using one or a combination of well accepted approaches that distinguish the cost of equity and debt (clause 4.3.1(a)) – noting that the phrase 'well accepted approach' is not defined; and
- Calculated on a pre-tax nominal basis (clause 4.3.1(b)).

These requirements must be interpreted in the context of the objectives of the regulatory regime, which include:

- The need for efficient investment in the long-term interests of users and Victorian consumers; and
- Providing a reasonable opportunity for PoM to recover its efficient costs of providing the Prescribed Services (i.e. the costs that would be incurred by an efficient business in a workably competitive market, providing services with a similar degree of risk).

The ESC has provided guidance on the return on capital in its Statements of Regulatory Approach and its interim commentaries. On 28 April 2020, the ESC published version 2.0 of its Statement of Regulatory Approach which included amendments to its interpretation of well accepted approaches to determining the cost of capital and updated guidance on well accepted approaches. These amendments included:

- Removing the previous requirement that at a minimum, at least one economic regulator should be using (or should have recently used) an approach for it to be considered 'well accepted'; and
- Recognising that the views and practices of other professionals, such as academics and economists, may also be informative in considering whether an approach is generally recognised as being used or appropriate for use in the estimation of rates of return on capital.

As set out in 2020-2021 TCS General Statement[20], our view is that ESC's interpretation may unduly restrict the interpretation of clause 4.3.1 of the Pricing Order. However, we consider that the view expressed by the ESC in version 2.0 of the Statement of Regulatory Approach is a more appropriate view than expressed in the previous version 1.0.

[20] PoM, 2020 – 2021 Tariff Compliance Statement - General Statement, 31 May 2020, pp.39-41

5.2.2 Overview of compliance

POM has complied with the Pricing Order in relation to the rate of return at all times throughout the review period.

Each of our TCSs has set out in detail our calculation of the rate of return for the upcoming regulatory year, and provided extensive analysis and supporting analysis from independent expert consultants to support our view that the rate of return is consistent with the Pricing Order requirements.

While many aspects of the Pricing Order require subjective interpretation, estimating the WACC is a particularly complex and imprecise exercise, especially with respect to the cost of equity, which can only be inferred, not observed. In the absence of a consensus among regulators, academics and finance practitioners on both the most appropriate model to infer the cost of equity and the most appropriate parameter values for each model, it is not surprising that this has been an issue of focus for the ESC and PoM in the first review period. In each TCS, we have carefully considered and responded to feedback provided by the ESC in its interim commentaries. Among the many refinements made by PoM in response to the ESC's guidance over the review period, key changes have included:

- Adjusting the weightings on alternative cost of equity approaches and ultimately relying solely on the Sharpe–Linter CAPM approach;
- Adjusting the weightings on alternative approaches to estimating the market risk premium and ultimately removing the Wright approach; and
- Adjusting the weightings on alternative approaches to estimating gamma and ultimately relying solely on the equity ownership (utilisation) approach.

Our 2021-22 TCS sets out our most contemporary WACC estimate and explains why it is compliant with the Pricing Order. It has been informed by a range of expert consultants, including reports from Synergies Economic Consulting, HoustonKemp and Incenta Economic Consulting (**Incenta**), each of which have been provided to the ESC. We consider that our 2021-22 WACC estimate is compliant with the Pricing Order on the basis that:

- The WACC has been determined using well accepted approaches, which have been refined in successive TCS submissions in response to the ESC's interim commentaries. The approaches used are consistent with the ESC's preliminary views on well accepted approaches as set out in its 2020-21 interim commentary;
- The estimates adopted for the key parameters of the MRP, asset beta and gamma are within the value ranges suggested by the ESC in its 2020-21 interim commentary; and
- Independent expert advice from HoustonKemp demonstrates that our WACC satisfies the cross checks identified by the ESC in its Statement of Regulatory Approach to ensure that the overall estimate is commensurate with the risks of operating the Port.

PoM considers that the engagement between PoM and the ESC on the rate of return during the first review period has been constructive, with the positions of both PoM and the ESC evolving over time in response to changes in regulatory precedent and evolving interpretation.

Through this constructive process, the estimated values provided by PoM and the ESC for key parameters, and for the WACC itself, have converged over the review period (refer Table 1 below).

Table 1PoM's estimates for TCS 2021-22 are within the ranges provided by the ESC for market risk premium, asset beta, gamma and overall pre-tax nominal WACC (when the ESC range is updated for March 2021 market data). Our estimates sit at various points in the range, sometimes at the higher end (beta), sometimes at the lower end (gamma) and sometimes in the middle (MRP).

Table 1 – Estimates of WACC and key WACC parameters from PoM's TCSs and ESC's interim commentaries

	2017-18 TCS	2018-19 TCS	2019-20 TCS	2019-20 ESC interim commentary	2020-21 TCS	2020-21 ESC interim commentary	2021-22 TCS
MRP	7.77%	7.71%	7.77%	None provided	7.57%	6.0% to 7.1%	6.54%
Asset beta	0.70	0.70	0.70	0.39	0.70	0.60 to 0.70	0.70
Gamma	0.25	0.25	0.25	0.25 to 0.4	0.33	0.35 to 0.5	0.50
Pre-tax nominal WACC	11.54%	11.52%	10.46%	7.5% to 8.0%	8.93%	6.3% to 7.90% (March 2020 market data) 6.93% to 8.49% (updated by PoM for March 2021 market data)	8.23%

As detailed in PoM's 2021-22 TCS, refinements to our approach to estimating the WACC over the first five years of the Port Lease have:

- Had no impact on tariffs during the review period due to the operation of the TAL; and
- Had no impact on the port's capital base (and therefore future tariffs) because the refinements do not affect the amount of depreciation that PoM deferred across the review period.

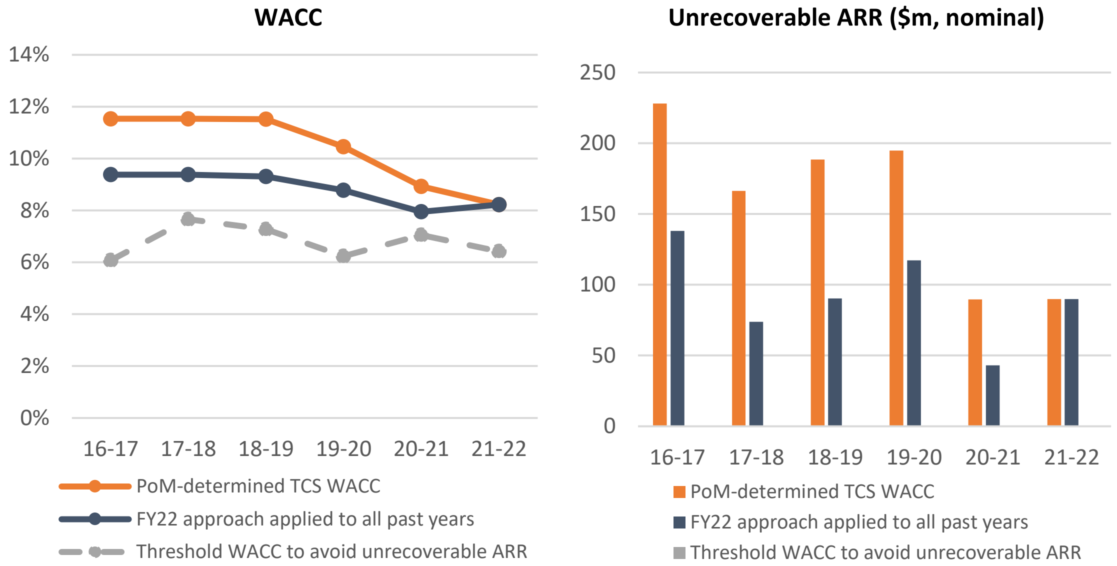
To demonstrate the latter point we recalculated the ARR for previous regulatory periods using the same approach as for the 2021-22 WACC to identify whether doing so would have had any impact on the port's capital base). If applying the lower WACC reduced the ARR to a level where some depreciation could be recovered under the TAL revenues, then prices after the end of the Pricing Order transition period (earliest 2032 and latest 2037), could be expected to be lower (ceteris paribus).

The operation of the TAL has meant that in each of the first five years of the Port Lease some share of our ARR has been unrecoverable, despite fully deferring the return of capital. As Figure 11 shows, if our approach to determining the WACC in 2021-22 had been applied in all prior years of the Port Lease, the calculated return on capital would have been lower, but in no year would it have lowered the ARR sufficiently to allow the recovery of any depreciation (and hence would still result in a shortfall creating unrecoverable ARR).

Our 2021-2022 TCS WACC parameter values are in line with the ranges in the ESC's December 2020 interim commentary.

As illustrated by the grey dotted line in Figure 11 below, the threshold WACC required to avoid any unrecoverable ARR is well below this level in each of the first five years of the Port Lease. This means that if we had applied the current approach to estimating the required rate of return in all prior years, the closing capital base in 2021-22 would be no different. What this means in effect is that the differences between the POM and the ESC over WACC to date have had no long-term implications for prices.

Figure 11 – Pre-tax nominal WACC & associated unrecoverable ARR under alternative scenarios, 2016-17 to 2021-22



Note: The 'FY22 approach' involved recalculating the WACC for all prior years as if the gamma value, market risk premium weightings and cost of equity model weightings adopted in this 2021-22 TCS had also applied in all prior years. This approach implies a 15% weighting on a market risk premium (MRP) calculated using Dividend Discount Models (DDMs). Since DDM estimates are not available for the years prior to 2019-20, we have used the DDM MRP for 2021-22 for 2016-17 to 2018-19 instead. This is a conservative estimate as the 2021-22 DDM MRP is the lowest of the three years for which data are available (2019-20, 2020-21 and 2021-22). For years prior to 2020-21, the threshold WACC and unrecoverable ARR are calculated based on actual values rather than forecast values. Values for 2020-21 and 2021-22 are based on the forecasts presented in the 2021-22 TCS.

Further information on our calculation of the WACC can be found in Chapter 8 and Appendices N, Q and R of our 2021-22 TCS.

5.3 Prudency and efficiency of opex

5.3.1 Requirements

Operating expenditure (opex) is an important element of the building block methodology.

The Pricing Order allows the Port to recover forecast opex commensurate with that required by a prudent service provider acting efficiently. Forecast opex is to include the port licence fee and any cost contribution amount payable under the Concession Deed in relation to the financial year in which those expenses are incurred. The Pricing Order deems this expenditure to be consistent with that which would be required by a prudent service provider acting efficiently. Similarly, actions reasonably required to comply with the obligations under the Port Concession Deed are taken to be prudent.

5.3.2 Overview of compliance

POM has complied with the Pricing Order in relation to prudent and efficient opex at all times throughout the review period.

As discussed in Chapter 4, PoM has a strong incentive to constrain opex to prudent and efficient levels, via the application of the building block approach to determining the cost base for setting tariffs. The TAL operates like a price cap form of price control, and PoM is therefore strongly incentivised to be highly prudent and efficient with respect to its operating costs. Arguably, the long-term nature of the TAL provides greater incentives for cost efficiency than other regulatory regimes where prices (or revenues) are typically only set for periods of 5-years, before being re-set having regard to actual cost outcomes. Accordingly, PoM's Board and executive team are highly focussed on reducing costs to the optimum level possible to meet the obligations under the Port Lease and achieve a return commensurate with the risks involved.

A range of new systems and processes have been introduced to reduce costs and ensure the Port successfully transitioned from a government owned and operated entity to an efficient private sector infrastructure manager. Annual forecasts of opex, as shown in the annual TCS, are subject to detailed review by PoM's Executive, Shareholders and Board. Forecasts reflect the most recent actual opex, which provides the best available information, or outcomes from competitively tendered contracts.

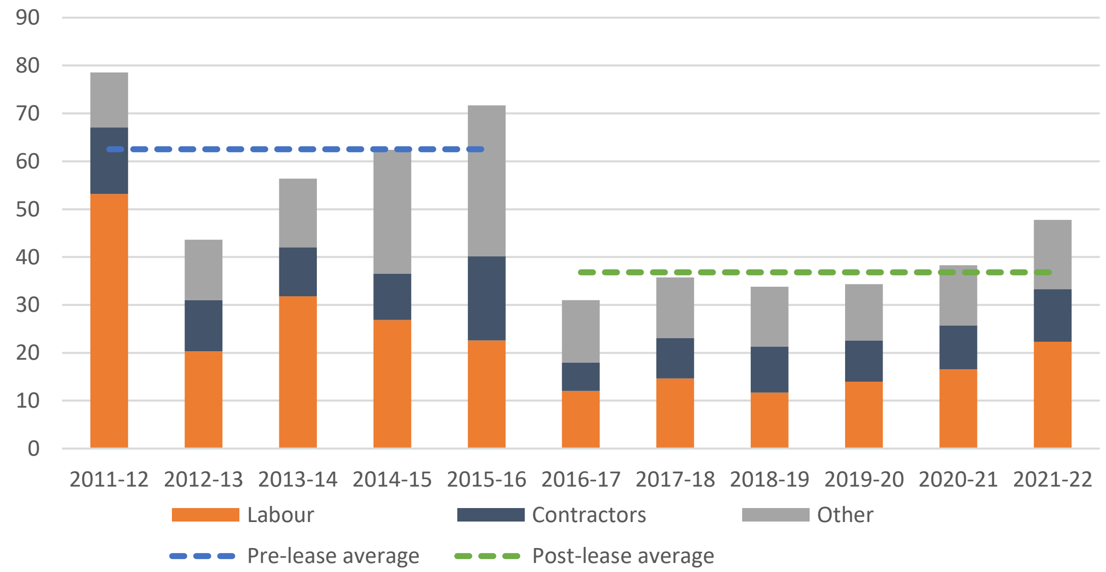
The following controls, practices and procedures ensure all aspects of opex are prudent, efficient and deliver value for money:

- Procurement policy and approach – our Procurement and Contract Management Policy drives commercial outcomes through competitive tendering (appropriate to the value of the contract engagement) to identify preferred suppliers;
- Internal audit – we have an ongoing internal audit function in order to assess whether the necessary controls and processes are in place, and are being followed, and to identify areas for improvement;
- Contract structure – our repairs and maintenance contracts are structured based on fixed and variable cost components to ensure only necessary works are undertaken with all additional works subject to inspections or reviews and different rate schedules;
- Budget approval – A detailed opex forecast provided to the Board for approval;
- We have appropriate HR management policies and practices in place to ensure labour costs remain efficient and prudent and reflect current market practice;
- Opex forecasts reflect the application of our asset management system, which as noted above has been certified to International Standards Organisation (**ISO**) 55001:2014 - Asset Management.

Our emphasis on cost efficiency is borne out by a comparison of operating expenditure in the years immediately before and after the Port Lease Transaction. To ensure a reasonable comparison, we have excluded once off costs (e.g. Port Lease Transaction), uncontrollable costs (e.g. the Port Licence Fee) and costs related to the Harbour Master function which now sits with Ports Victoria. As shown in Figure 12, controllable operating expenditure in the six years since the Port Lease commenced has been, on average, around $20m per year lower (in real, December 2020 terms) than operating expenditure in the five years prior. Reductions in labour and contractor costs account for most of this difference.

Further information on our opex can be found in Chapter 8 and Attachment 1 to our 2021-22 TCS.

Figure 12 – Controllable Operating Expenditure



Note: 'Other' includes insurance, rates, taxes, repairs and maintenance, utilities, admin, rental and IT. 2020-21 and 2021-22 is based on forecast data.

Over the later years of the review period, there has been some upward movement in certain expenditure items, reflecting various actions such as:

- Augmentation of capability and systems to meet our compliance obligations under the Port Lease, Port Concession Deed and Pricing Order;
- Increases in planning activity to deliver the significant capital program outlined under the PDS; and
- The development of core corporate functions required for an efficient business and regulatory compliance in an environment of strong growth in volumes and capex (e.g. consultation).

It is important to note that the business is not yet even five years old and to that end, has been implementing a range of initiatives and refinements to its operations. While there may be some further transition to occur for the business to reach a 'steady state', we note that key cost areas (labour costs and contractor costs) continue to remain below pre-PLT levels.

5.4 Prudency and efficiency of capex

5.4.1 Requirements

Clause 4.2.1 of the Pricing Order requires that actual or forecast capital expenditure (capex) that is added to the capital base be efficient and reflects prudent actions in the provision of Prescribed Services. It also provides that the efficient provision of capex as part of completing the Port Capacity Project and PRTP or any other works to comply with requirements of the PLT is deemed to be prudent.

In version 2.0 of its Statement of Regulatory Approach, the ESC has set out its interpretation of the characteristics of prudent and efficient capex and the information that it believes PoM needs to provide to demonstrate prudency and efficiency.

5.4.2 Overview of compliance

POM has complied with the Pricing Order in relation to demonstrating capex is efficient at all times throughout the review period.

As described in Chapter 1, PoM has obligations under the Port Lease to develop, invest in and manage the Port to the benefit of the economy of the State. It is required to undertake certain projects under the Port Lease.

At the same time, and as with opex, PoM is strongly incentivised to ensure capex is prudent and efficient under the Pricing Order, since cost base used to set tariffs must include only prudent and efficient costs. To do otherwise would put at risk PoM's opportunity to recover its costs, including a return commensurate with the risks involved.

To ensure capex is prudent and efficient PoM adopts a long-term, port-wide view of the necessary scale, scope and sequencing of capex that ensures PoM can deliver on its obligations which span long time horizons. PoM employs fit for purpose engagement with stakeholders as well as internal governance processes consistent with each of these planning, scoping and works delivery horizons. An overview of the planning horizons and stakeholder engagement process is described in Chapter 3.

PoM uses an Integrated Management System that encompasses quality, safety, environmental and asset management systems. This system demonstrates how we meet the requirements of four ISO standards: ISO 55001:2014 – Asset Management, ISO-9001:2015 - Quality Management Systems, ISO 14001:2015 - Environmental Management and ISO 45001:2018 – Occupational Health and Safety.

Long-term planning primarily occurs via the PDS. The PDS outlines the high-level plans and approach for developing the capacity and efficiency of the Port for the next 30 years, while also providing a planning framework which is adaptable and responsive to changing needs over time. It outlines key projects that will improve infrastructure at the Port and respond to the needs of a growing Victoria. The PDS is available on our website and is provided as Appendix S to our 2021-22 TCS.

Investment by PoM in port infrastructure has been strong, totalling around $340 million (prescribed services) over the first five years, with a substantial proportion of this amount being spent on renewal and rehabilitation. In general, some assets were found to be in a more degraded state than was understood to be the case at the time of the PLT. This made capex forecasts challenging in the first few years. In particular, the Swanson Dock East berth rehabilitation requirement was much bigger than forecast by the State. Nevertheless, PoM proceeded with the projects as it was our obligation to meet Port Concession Deed asset management standards in the renewal works.

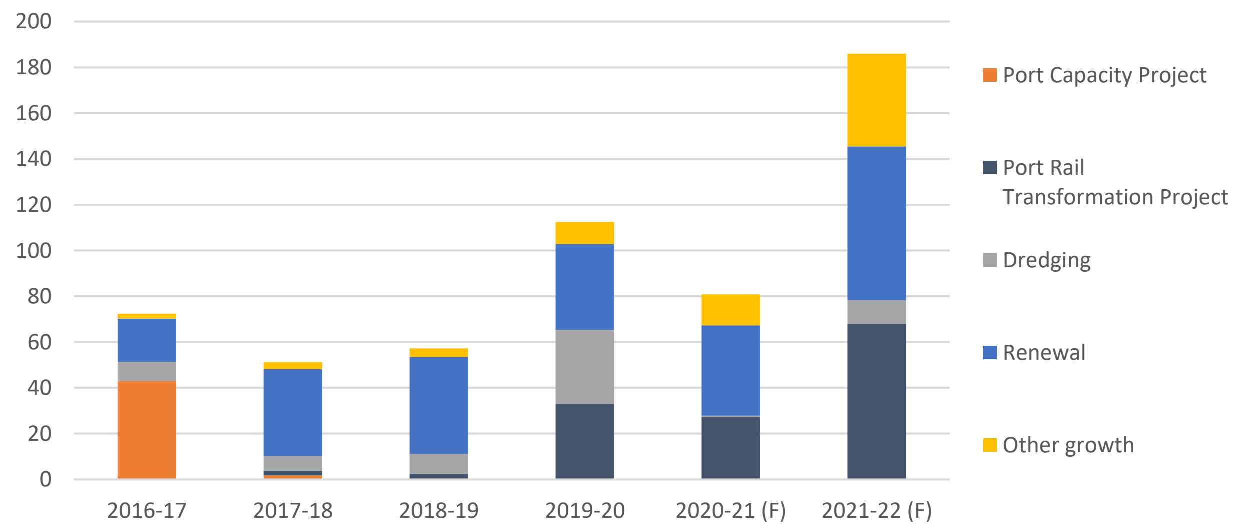
In addition, the PLT imposed some important short-term obligations that the Government required as a priority. For instance, PoM had to:

- Commence work on Rail Access Strategy. This strategy produced the PRTP which is now in implementation stage;
- Prepare the PDS;
- Gain ISO Asset Management certification; and
- Comply with a new set of obligations in the form of the Port Concession Deed and Port Lease.

With the exception of the PRTP, growth capex (i.e. not renewal or rehabilitation) has comprised a relatively minor component of the overall capital program during the review period. Other growth expenditure was primarily comprised of the bollards at Swanson Dock East and Swanson Dock West which have been delivered as part of our strategy to respond to changing composition of the shipping fleet visiting at Melbourne (our Big Ships Strategy). Trends in shipping occurred faster than anticipated at the time of the PLT in 2016 (e.g. shipping mergers, cost pressures, new sulphur emission standards) including the need to cater for larger vessels earlier than forecast. Through PoM's response to these trends, which include both targeted investments and operational solutions that have enabled large capital costs to be avoided, Swanson Dock has been upgraded to handle vessels that materially exceed the vessel size limits in place at the time of the PLT. Swanson Dock is now capable of accommodating the vast majority of vessels that visit the Port, including vessels of 9,600 TEU in 2020. At the time of the PLT, vessels of this size were not anticipated at the Port for another 30 years, and it was thought that Swanson Dock would never be able to handle vessels in excess of 8,500 TEU.

Forecast expenditure for 2021-22 is the highest of any year since the PLT, at $186 million. The main driver of the increase in capex is the growth expenditure under the PRTP and Webb Dock East Berth 4 & 5 Extension, plus the commencement of Wharf Rehabilitation works at Swanson Dock West. Figure 13 below provides a breakdown of capex by driver.

Figure 13 – Capex FY17 to FY22(F) ($m)



At an individual project level, capex has generally been delivered to schedule, within-budget and within scope. The table below summarises outcomes for major projects completed across the 2016-17 to 2020-21 period. Further information on our capex processes and projects can be found in Chapter 8 and Attachment 2 to our 2021-22 TCS.

Table 2 – Delivery of Major Capital Projects

Project name	Project description and commentary	Project approved budget	Actual cost	Timing
Port Capacity Project	The PCP objectives are to give certainty to the provision of international container capacity in Victoria in the short and medium term and to achieve the benefits of competition in the Victorian international container stevedoring market. The PCP has redeveloped the Webb Dock precinct and delivered additional container capacity, automotive and Pre-Delivery Inspection facilities, improved access and amenity.	$892.0m	$681.5m	Completed early-2017
Swanson Dock East Remediation	The Swanson Dock East (SDE) Remediation consisted of major remediation to Berths 1 & 2. Condition Inspections identified severe crane rail deflection and various asset elements that required immediate attention as per the WSCAM rating. The Port Lease and PCD Obligations and the contractual lease obligations require PoM to maintain the SDE infrastructure to the Port load Chart standards. In particular, it is incumbent on PoM to maintain the assets for the term of the Port Lease ensuring the residual asset life remains in accordance with PCD requirements. The project was undertaken in full consultation with the terminal operator Patrick to ensure operational impact was minimal.	$97.8m	$83.0m	Completed FY2021
Big Ships Program	The key objectives of the Big Ships Strategy are to support port users to deliver productivity improvements through the ability to service larger vessels and maintain PoM's competitive position as a port of choice for international container freight. Investments during the review period aim to maximise the built infrastructure at Swanson Dock and Yarra River Channel capability via: • Shipping and Dredging Optimisation works; • Swanson Dock East and Swanson Dock West Mooring Bollards Upgrades At Webb Dock East, the Southern Mooring Dolphin Design and Construction.	$15.4m	$14.0m	Ongoing
Dredging (maintenance and capital)	Annual program of maintenance dredging, plus capital dredging under the Big Ships Program to accommodate larger vessels at Swanson Dock. Capital dredging improved navigability of larger vessels up the Yarra River Channel and also included some dredging of the Gellibrand turning basin to reduce manoeuvring risks associated with Suezmax tankers utilising 14.7m draught Forecast costs / budget reflected estimates of the revised program utilising the large dredge Magnor (bringing forward some work to FY20). Under this revised program, PoM is targeting savings in Maintenance Dredging of $10.7m by 2024.	$60.4m	$55.6m	Annual program of works
Port Rail Transformation Project	The PRTP is designed to improve rail access at Swanson Dock through the development of a new East Swanson Rail Terminal and delivery of upgraded rail access, connections and sidings within the Port. Once delivered, this work will provide direct on-dock rail connections into the Swanson Dock container terminals. The project remains on track for finalisation in Q2 of 2023. However, PoM is revisiting the project scope and forecast costs in light of the results of brownfield site investigations and construction market conditions.	$125.0m	$47.1m (to-date)	Forecast completion by Mid 2023

5.5 Depreciation

5.5.1 Requirements

The Building Block methodology used to determine the ARR in the Pricing Order specifies the default approach for depreciation as straight-line depreciation. However, clause 4.4.2 enables PoM to use a different approach if either:

- The TAL prevents the Port from being able to recover the full amount of straight-line depreciation for that financial year; or
- A depreciation method, other than straight-line depreciation, would reduce the expected variance in prescribed service tariffs until the end of the Port Lease.

The Pricing Order also provides that an asset cannot be depreciated by an amount that exceeds its value, and that negative depreciation is not permitted.

In version 2.0 of its Statement of Regulatory Approach, the ESC suggested that if PoM is not using straight line depreciation, it should show how the method adopted is consistent with the Pricing Order and objectives of the regulatory regime. The ESC also asked that PoM demonstrates how it consulted with Port users on its proposed depreciation method and how deferred depreciation will be recovered.

5.5.2 Overview of compliance

PoM has been compliant with the Pricing Order in relation to depreciation at all times. The TAL has prevented PoM from being able to recover any amount of straight-line depreciation in each year of the review period. Therefore, consistent with clause 4.4.2 of the Pricing Order, PoM has set depreciation to zero in each year to date.

Our core principle for the recovery of depreciation is that we will comply with the Pricing Order and recover depreciation in a way that seeks to reduce price shocks (i.e. pursue price stability). This has been a consistent position in our TCSs.

In the 2020-21 TCS (and in TCSs of previous years), we set the return of capital to zero and deferred recovery of straight-line depreciation to future years on the basis that the return of capital was not capable of being recovered due to the application of the TAL. We also set out a number of principles for the recovery of depreciation, including that:

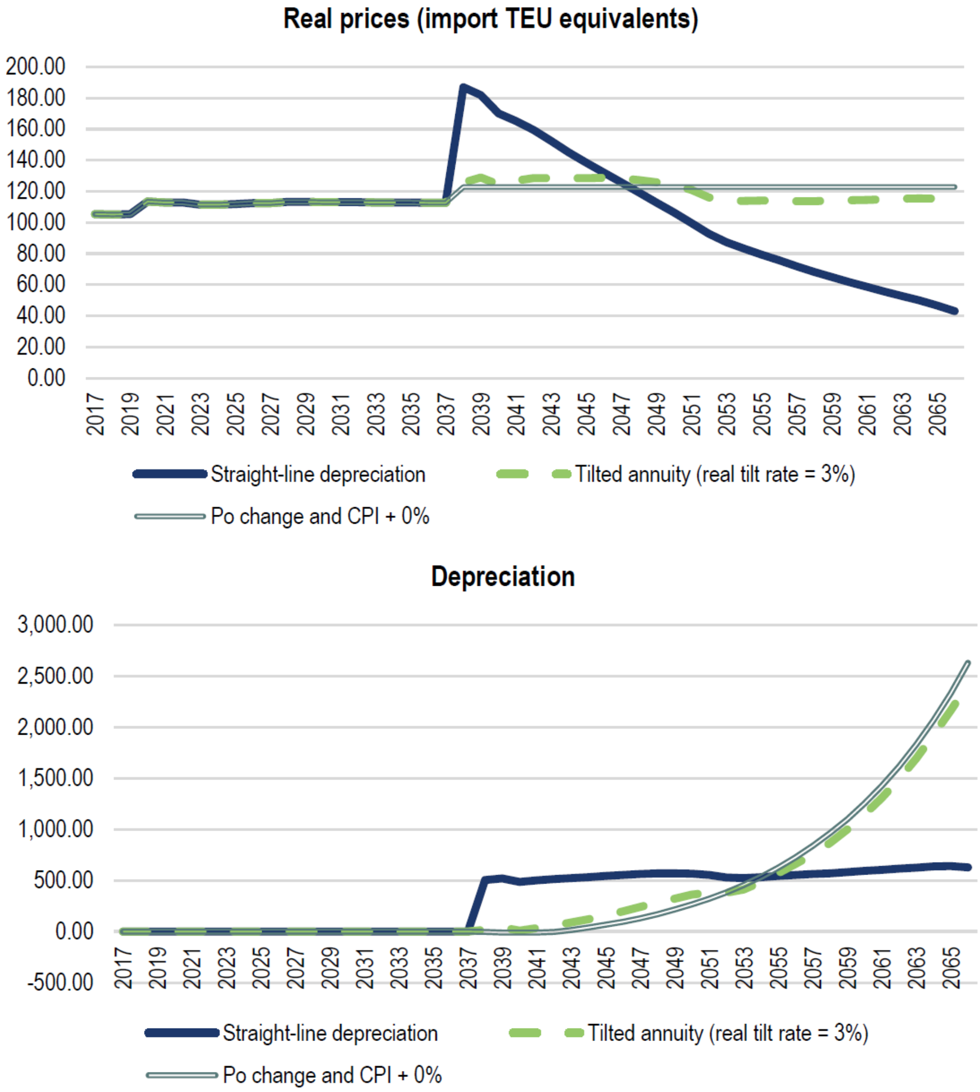
> *… deferred depreciation will be recovered in a manner that is consistent with clause 4.4.2(b). That is, where the depreciation method would be reasonably likely to reduce the variance in the expected annual percentage changes in the tariffs through to the end of the Port Lease.*

This principle has been tested with Port Users and other stakeholders and received support. To achieve this principle and provide further transparency on PoM's approach to recovering depreciation after the Pricing Order transition period, we also drew on advice from independent experts, Incenta, and guidance from the ESC to adopt the following depreciation methodology:

- For the next regulatory period (and for the remainder of the TAL period) we will apply straight-line depreciation with an unrecovered depreciation account, with uncharged depreciation recorded as a separate asset with a life equal to the remaining lease term;
- After the TAL period ends a 'tilted annuity' depreciation method will be applied, with the tilt factor designed to reduce the variance in the expected annual percentage change in the level of tariffs until the end of the Port Lease.

The figure below illustrates the effect on the depreciation profile and price path of straight-line depreciation and tilted annuity depreciation in the period after the TAL expires (assumed to be 2037 for this purpose), where both options entail straight-line depreciation with an unrecovered depreciation account applied during the TAL period. Back-solved depreciation is presented as 'P0 change and CPI + 0%'.

Figure 14 – Effect of Depreciation



Incenta advised that this approach would "*result in a preferable trajectory in prices than the application of the standard straight-line depreciation*" in so far as achieving the objective of reducing the variance in annual price changes. Incenta is confident, as are we, that our approach is entirely consistent with clause 4.4.2 of the Pricing Order, which provides that an alternative to the straight-line depreciation methodology may be applied if:

a) the application of clause 3.1.1 [the Tariff Adjustment Limit] means that the return of capital derived using a straight-line depreciation methodology is not capable of being recovered in the applicable Financial Year; or

b) the alternative depreciation methodology is reasonably likely to reduce the variance in the expected annual percentage changes in the level of Prescribed Services Tariffs through to the end of the Port Lease.

We are open to further feedback from the ESC on the proposed 'tilted annuity' approach to recovery of depreciation post-2037, but note that regardless of how depreciation post-TAL is framed the impact on Port users and the achievement of the objectives of the regulatory regime during the review period is the same. That is, there is no difference in the depreciation and price outcomes between the two methods in the period from now until the end of the Pricing Order transition period.

In the 2020-21 interim commentary, the ESC asked that we provide more clarity on how we will unwind deferred depreciation and manage tariff shock on Port users post the TAL period. Accordingly, in the 2021 Industry Consultation, we sought feedback from Port Users and other stakeholders on the approach to recovering deferred depreciation.

In these consultations, we:

- Explained to Port Users and other stakeholders how treatment of deferred deprecation would affect them – specifically, that recovery of deferred depreciation would have an impact on prices for prescribed services from the end of the TAL period (earliest 2032, likely 2037) until the end of the Port Lease;
- Described alternative approaches to depreciation recovery and provided illustrative depreciation profiles and price paths to demonstrate how Port Users and other stakeholders would be affected;
- Described our proposed approach to recovering depreciation during the TAL (when forecast revenue is sufficient to do so) and after the end of the TAL period (in a manner that minimises price shocks and achieves price stability); and
- Sought feedback from customers on the importance of post 2037 prices on their businesses, their views on our proposed objectives and approach to recovering deferred depreciation. This topic was covered both in discussions in the 1:1 meetings and industry workshops, and through the consultation questions provided to Port Users and other stakeholders in a follow-up questionnaire.

Feedback on future prices (via depreciation methodologies) was provided by Port Users and generally indicated a clear preference for our proposed approach to minimise price shocks (pursue price stability) in recovering deferred depreciation.

Further information on the approach to depreciation can be found in Chapter 8 and Appendix R (the Incenta report) to our 2021-22 TCS.

5.6 Cost allocation

5.6.1 Requirements

Clause 5 of the Pricing Order requires that PoM's costs be allocated in a manner consistent with the following cost allocation principles:

- Costs that are directly attributable to the provision of a prescribed service must be attributed to that prescribed service;
- Costs that are not directly applicable to the provision of a prescribed service, but which are incurred in the course of providing one or more prescribed services and other services, must be allocated to the prescribed service on the basis of its share of total revenue from all services provided by the Port.

5.6.2 Overview of compliance

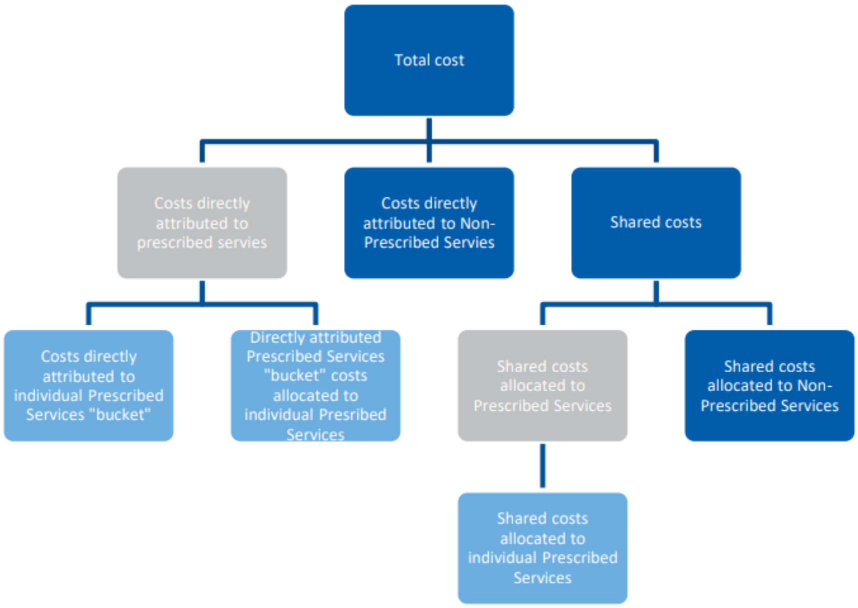
POM has complied with the Pricing Order and ESC's information requirements in relation to cost allocation at all times.

Each year PoM's TCS has provided information on its cost allocation process, demonstrating how it complies with the TCS. A detailed statement on its cost allocation methodology is set out in the 2018-19 TCS. Following commentary from the ESC on the 2018-19 TCS seeking more detail on PoM's approach, PoM provided a cost allocation excel model and accompanying cost allocation model user guide in its 2019-20 (and subsequent) TCS. They demonstrate and explain how PoM attributes and allocates its costs:

- Between Prescribed Services, non-Prescribed Services and shared services; and
- Between individual Prescribed Services.

An overview of the cost allocation methodology is provided in Figure 15 below. Opex is attributed to prescribed, non-prescribed or shared services at the level of 'responsibility centre' within each board reporting category. Responsibility centres define the area of the business in which expenditure takes place (such as land use planning or legal services) and board reporting categories define the type of expenditure (such as rental expenses or salaries). Similarly, capex is attributed to prescribed, non-prescribed or shared services at the level of 'capital activity'. A capital activity is a capital project such as a wharf rehabilitation or berth extension. Opex and capex attributed to shared services are then allocated to prescribed or non-prescribed services according to the share of revenue attained from each in a given year.

Figure 15 – Cost Allocation Methodology



Further information on cost allocation can be found in Appendices D, E, F and G of our 2021-22 TCS.

5.7 Demand forecasts

5.7.1 Requirements

Forecast trade volumes are an important element of the building block methodology, although there are no specific provisions in relation to forecast volumes in the Pricing Order. Rather, the Pricing Order requires that:

- Information in the nature of an estimate or forecast must be supported by a statement of the basis of the forecast or estimate;
- A forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances;
- Information in the nature of an extrapolation or inference must be supported by the primary information on which the extrapolation or inference is based.

In version 2.0 of its Statement of Regulatory Approach, the ESC indicated that it will focus on whether forecasts are transparent, replicable and able to be traced back to primary information. It requested that it be provided with any consultants' report that are prepared, including models and data underlying the consultants' forecasts.

5.7.2 Overview of compliance

POM has complied with the Pricing Order in relation to demand forecasts at all times.

Since 2017-18 TCS, PoM has engaged expert economic forecasters BIS Oxford Economics (**BIS Oxford**) to forecast trade volumes while PoM forecasts vessel channel volume data internally.

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 vessel tonnage and trade volumes to BIS Oxford's forecast trade volumes and having regard to independent expert forecasts on vessel profile trends.

In the past two years, COVID has significantly impacted demand. Actual demand was well below forecast in 2019-20 for all categories except dry bulk, whereas in 2020-21 throughput was higher than forecast as the early impact of COVID unwound and imports were driven up by strong consumer spending.

In its commentary on the 2018-19 TCS, the ESC indicated that it was seeking additional information on the demand forecasts, including an explanation of the models used, how forecasts for the cargo type categories used translate into the different categories used in the Port's regulatory model, and copies of the consultants' models. In response, PoM provided this information in its 2019-20 TCS, including the forecasting model prepared by BIS Oxford and a handbook to be read in conjunction with the model. This information was provided again in the 2020-21 and 2021-22 TCSs.

Further information on demand forecasts can be found in Chapter 6 and Appendices K, L and M of our 2021-22 TCS.

5.8 Contracts

5.8.1 Requirements

Under the Pricing Order PoM is required to set tariffs in accordance with its Reference Tariff Schedule for Prescribed Services. These set out its standing offer for berth hire, channel access and wharfage charges.

Clause 6.2 of the pricing order sets out the conditions under which the Port may enter into contracts to provide prescribed services on terms that differ from the Reference Tariff Schedule, which include if, amongst other things:

- It has offered to provide prescribed services in accordance with its reference tariff schedule;
- The prices in the contract provide the Port with a reasonable opportunity to recover the efficient cost of providing prescribed services;
- The prices in the contract for prescribed services are no lower than their avoidable cost and no higher than their standalone cost;
- The prices in the contract comply with the export pricing decision.

Under clause 2.1.1.(b) of the Pricing Order prices for contracts must not exceed the stand-alone cost of providing services, and must not fall below the avoidable cost of not providing the contract.

The Pricing Order also provides that revenue from prescribed services provided under contract must be included in the Port Licence Holder's calculation of its ARR.

The ESC has indicated that it expects contract revenue to be excluded from the weighted average tariff increase calculation but that revenue from Prescribed Services under contract must be included in the Port's calculation of its ARR.

In version 2.0 of its Statement of Regulatory Approach, the ESC has asked that the TCS show:

- How PoM offered to provide Port users Prescribed Services in accordance with the Reference Tariff Schedule as a first option before negotiating contracts
- How the contracted terms and conditions outlined in the contract comply with the Prescribed Service tariff pricing principles
- How PoM has accounted for contract revenue.

5.8.2 Overview of compliance

POM has complied with the Pricing Order in relation to contracts at all times.

PoM's contracts relate to situations where either:

- PoM has agreed different prices for bespoke Prescribed Services for individual customers that do not have a corresponding tariff. This typically occurs where bespoke services have been requested by a user and the direct benefits accrue exclusively to the Port user; or

- PoM charges less than the Reference Tariff, which typically occurs where there were legacy contracts for Prescribed Services that were in place at the time of PLT, or there are competitive pressures from other ports. In these cases, users pay the Prescribed Tariff but PoM then provides a rebate.

In accordance with the Pricing Order and the ESC's guidance, in our TCS Prescribed Services revenue (subject to the TAL) does not include revenue associated with contracts for Prescribed Services. The ARR is inclusive of revenue associated with contracts.

PoM disclosed details of its contracts to the ESC in the 2021-22 TCS. This information is included in (confidential) Appendix O. In response to the ESC's s56 request, we have also provided information to demonstrate that the revenue from these contracts falls within the efficient cost bounds of providing services.

6 Abbreviations

Abbreviations

Abbreviation	Definition
ABBM	Accrual Building Block Model
ARR	Aggregate Revenue Requirement
CCA	Cost Contribution Amount
CPI	Consumer Price Index
ESC	Essential Services Commission
Incenta	Incenta Economic Consulting
ISO	International Standards Organisation
PDS	2050 Port Development Strategy
PLF	Port Licence Fee
PLT	Port Lease Transaction
PMA	Port Management Act 1995
PRTP	Port Rail Transformation Project
SDE	Swanson Dock East
SDW	Swanson Dock West
TAL	Tariff Adjustment Limit
TCS	Tariff Compliance Statement
TEU	Twenty-Foot Equivalent Units
WACC	Weighted Average Cost of Capital