

# Port of Melbourne Response to ESC Review Findings – Public Summary

Port of Melbourne



20 May 2022

## **Managing the port in the interests of all Victorians**

As Australia's largest port, the Port of Melbourne is a vital trading gateway for south-eastern Australia, facilitating more than one-third of the nation's container trade and playing a critical role as a key driver of economic activity.

Since the Port Lease Transaction in November 2016, Port of Melbourne (PoM) has invested more than \$370m to support trade growth and delivered a \$9.7b benefit to the Victorian community. The Port is focused on providing world-class port facilities and services when they are needed. We have a proposed \$2b pipeline of investment in Australia's supply chain infrastructure over the next 10+ years to drive efficiencies and deliver the productivity that will support the state's economic growth, job creation and social prosperity.

Port of Melbourne and its shareholders have great respect for the regulatory regime that the Government put in place at the time of the port lease and are confident the regime is working and is achieving the Government's policy objectives as intended.

## **Port of Melbourne response to the ESC review of Pricing Order compliance**

The Essential Services Commission (ESC) has completed its inaugural 5-year review of PoM's compliance with the Pricing Order, and its report was released in late January 2022. PoM has prepared a response to the findings of the ESC which can be found within this document - Attachments A and B. The attached response demonstrates actions we have taken to remedy the findings of the ESC and ensure compliance going forward.

PoM's response, including the Undertaking prepared by PoM, has been accepted by the ESC Minister and is legally binding until 30 June 2027, in line with the ESC's next review.

PoM is committed to addressing the findings of the ESC and has implemented a range of measures that respond to matters of compliance and opportunities for improvement.

The Undertaking (Attachment A) responds to matters on which the ESC found significant and sustained non-compliance by PoM. The Undertaking:

- Commits to the approaches that will be applied by PoM to calculate the Weighted Average Cost of Capital (WACC), which addresses the ESC's findings on Return on Capital and Aggregate Revenue Requirement.
- Outlines PoM's commitment to develop and publish a Pricing Order Engagement Protocol which will, among other internal process initiatives, improve PoM's engagement practices under the Pricing Order.

PoM considers that this Undertaking will provide the appropriate degree of certainty to PoM and to port users for the next five years until the ESC completes the next review of PoM's compliance with the Pricing Order.

PoM has also implemented a range of measures that respond to matters that were raised by the ESC which were considered sustained but not significant. A summary of these measures can be found at Attachment B.

### **PoM's commitment to consultation**

As the port leaseholder, we are aligned with the Government in our commitment to invest in and manage the port for the benefit of the State and all Victorians.

We recognise the focus on consultation and the broad stakeholder interests in the port's operations. Over the first five years of the port lease we have undertaken extensive consultation and improved our processes each year, adjusting our approaches in response to feedback from the ESC and we are committed to addressing the findings of the ESC's inquiry report. The following initiatives for example, demonstrate our commitment to consultation with all stakeholders:

- PoM has undertaken extensive detailed consultation on long-term planning through the Port Development Strategy. Feedback from port stakeholders and the ESC indicated that stakeholders wanted more information about delivery of the projects under the Port Development Strategy (PDS). In response we developed the PDS Delivery Program which outlines the indicative timing and sequencing of each of the major projects outlined in the 2050 PDS over the next 15 years. The PDS Delivery Program is available on the PoM website.
- PoM has demonstrated extensive project consultation practices through our consultation on the Port Rail Transformation Project, annual Industry Updates on key projects and regulatory issues and multiple project specific forums. The Port Rail Transformation Project consultation program, for example, involved more than 500 stakeholder interactions of varying forms over 18 months, including two industry forums and an extensive program of targeted 1-1 conversations.
- PoM has improved stakeholder engagement practice and Industry Updates in direct response to the issues raised by the ESC through their interim commentaries (including for example by providing more information on expenditure planning) which has been used as an input to the preparation of the Tariff Compliance Statements. The ESC recognized a 'step change from prior years' in our industry engagement in 2021-22 in its Final Report.

In addition to the matters of consultation over the 5-year review period PoM has also:

- reduced controllable operating costs by more than 40% from pre-Lease levels
- resolved issues on WACC through considering and responding to feedback provided by the ESC in its interim commentaries
- maintained annual price adjustments to CPI.

### **Conclusion**

The integrity of the regulatory regime is critical for the Port, Port Users, broader Stakeholders and Victoria. PoM is committed to the integrity of the regime as originally intended which will enable it to continue to invest in and operate the port in the long-term interest of all Victorians.

We believe that the PoM's response to this first five-year review addresses all the findings of non-compliance identified by the ESC and is consistent with the Government's policy objectives for the regulatory framework and lease of the port. PoM looks forward to continuing to operate and develop the port in the interests of the Victorian economy and Victorian consumers.

## Undertaking to the Essential Services Commission Minister

Given under section 49M of the Port Management Act 1995 (Vic)  
By Port of Melbourne Operations Pty Ltd (as trustee for the Port of Melbourne Unit Trust)  
ABN 83 751 315 034

### Person giving the Undertaking

1. This Undertaking is given to the Essential Services Commission Minister (**ESC Minister**) by Port of Melbourne Operations Pty Ltd (as trustee for the Port of Melbourne Unit Trust) ABN 83 751 315 034 (**PoM**) in accordance with section 49M of the Port Management Act 1995 (Vic) (**PMA**).

### Background

2. In 2016, Lonsdale Asset Property Pty Limited as trustee for the Lonsdale Asset Property Trust was awarded a 50-year lease of the Port of Melbourne by the Victorian Government. The Trust subleased the Port of Melbourne to PoM to operate the Port. PoM is the port licence holder.
3. PoM operates under a regulatory framework which took effect on 1 July 2016. The regulatory framework is set out in the:
  - a. PMA; and
  - b. a pricing order issued by the Governor in Council on 24 June 2016 in accordance with section 49A of the PMA, as amended by the Governor in Council on 20 May 2020 (**Pricing Order**).
4. On 10 June 2021 the Essential Services Commission (**ESC**) commenced an inquiry into PoM's compliance with the Pricing Order as required by section 49I of the PMA in relation to the review period 1 July 2016 to 30 June 2021. On 28 January 2022, the ESC released the final report of the inquiry, which, as required by s 49I(4) of the PMA, identified non-compliance with the Pricing Order that was, in the ESC's view, non-compliance in a significant and sustained manner (**Adverse Compliance Report**).
5. Under section 49M(1) of the PMA, the ESC Minister may accept a written undertaking given by a provider of prescribed services who is the subject of an adverse compliance report in relation to the provider's non-compliance with a Pricing Order if the ESC Minister is satisfied that:
  - a. the terms of the undertaking offered by the provider are appropriate to adequately address the provider's non-compliance with a Pricing Order; and

- b. the provider is reasonably likely to comply with the terms of the undertaking.
- 6. PoM, as the provider of prescribed services who is the subject of the Adverse Compliance Report, has offered to provide this undertaking to the ESC Minister in accordance with section 49M of the PMA.

### **Operation of Undertaking**

- 7. This Undertaking comes into effect when:
  - a. this Undertaking is executed by PoM; and
  - b. this Undertaking so executed is accepted by the ESC Minister (the **Commencement Date**).
- 8. This Undertaking has effect from the Commencement Date until 30 June 2027 or such earlier time as determined in accordance with clause 9 (the **Term**).
- 9. PoM may withdraw or vary this undertaking at any time with the consent of the ESC Minister.

### **Undertaking**

#### ***Consultation Provisions***

- 10. This Undertaking and the consultation provisions contained within it relate to the obligations which PoM has under the Pricing Order. PoM operates under a range of statutory and contractual arrangements with diverse Stakeholder interests and PoM engages with Stakeholders on a range of topics outside the Pricing Order consistent with those other arrangements. PoM is committed to ongoing improvements in its stakeholder engagement practice in relation to the commitments in this Undertaking and its broader stakeholder engagement processes to encourage Stakeholder confidence in the effectiveness of PoM's engagement process and therefore promote the efficient use of, and investment in, the provision of prescribed services..
- 11. By no later than 3 months after the Undertaking is signed, PoM will provide to the Minister for Ports and Freight a draft engagement protocol covering PoM's approach to consulting on regulatory matters under the Pricing Order (**Pricing Order Engagement Protocol**).

12. The **Pricing Order Engagement Protocol** will apply to PoM's engagement with Port Users as defined in the Pricing Order. The Pricing Order Engagement Protocol is not intended to limit the range of Stakeholders that PoM will engage with, and the PoM will continue to engage with other Stakeholders who are not Port Users where appropriate having regard to the subject matter of the consultation and the legitimate interests of those Stakeholders.
13. The Pricing Order Engagement Protocol will set out the process by which PoM effectively consults with and has regard to comments provided by Port Users and will:
- a. describe PoM's commitment to ensure a reasonable opportunity for Port User engagement on matters arising under the Pricing Order;
  - b. set out the way in which PoM will have regard to Port User feedback in decision making relevant to the Pricing Order;
  - c. outline the steps of engagement PoM will undertake, which may include (but which will not be limited to) how PoM will:
    - i. identify Port User engagement needs tailored to suit the topic on which it seeks to engage;
    - ii. determine the appropriate engagement approach taking into account how it will identify priority matters relevant to the Pricing Order that might have a significant impact on Port Users;
    - iii. plan engagement activities including the preparation of materials for engagement to provide appropriate information outlining the purpose, form and content of engagement so that Port Users can provide informed and meaningful feedback;
    - iv. implement engagement and the determination of a reasonable time period for engagement to ensure Port Users are given a reasonable opportunity to participate taking account of their engagement requirements;
    - v. encourage Port Users to provide written feedback, and will also allow alternative acceptable means of providing feedback;
    - vi. use feedback obtained during its engagement activities and any written responses to inform decision making and ensure PoM has had regard to Port User feedback;

- vii. provide for complaints on engagement matters to be directed to PoM in the first instance; and
  - viii. keep Government informed about any material feedback and how that feedback is to be addressed.
14. PoM will take into account all feedback received from the Minister for Ports and Freight on the draft **Pricing Order Engagement Protocol** and will by no later than 3 months after all feedback is received from the Minister publish a final **Pricing Order Engagement Protocol**.
15. The **Pricing Order Engagement Protocol** may be amended by PoM from time to time. PoM undertakes to engage with the Minister for Ports and Freight and take into account all feedback received prior to publishing updates to the **Pricing Order Engagement Protocol**. Any proposed changes to the Pricing Order Engagement Protocol will be consistent with the principles set out in this Undertaking.
16. PoM will undertake all consultations required under, or relating to compliance with the Pricing Order in a manner consistent with the **Pricing Order Engagement Protocol**.

#### **WACC Commitments**

17. PoM undertakes that for the Term, in determining a rate of return on capital commensurate with that which would be required by a benchmark efficient entity providing services with a similar degree of risk for the purposes of clause 4.1.1(a) (and 4.3) of the Pricing Order, PoM will:

- a. apply a well accepted approach to estimating the return on capital parameters in that:
  - i. all parameter values will be calculated in an internally consistent manner that has regard to the interrelationships between parameters; and
  - ii. the parameters will be estimated using methods and approaches applied by Australian and New Zealand regulators and courts for the purposes of calculating a revenue requirement; and
- b. apply the following formula when calculating the nominal pre-tax WACC:

$$\text{Nominal pre tax WACC} = \frac{1}{1 - \text{Tax rate} \times (1 - \text{Gamma})} \times (1 - \text{Gearing}) \times R_e + \text{Gearing} \times R_d$$

where

$R_e$  is the return on equity

$R_d$  is the return on debt

- c. apply the approaches set out in clauses 18 to 27, and, to the extent the PoM changes or adjusts the approach it applies, the PoM will detail the change and the reasons for that change in the relevant TCS.
18. When calculating cost of equity for the purpose of clause 17 of this undertaking, the only approach that PoM will use will be the Sharpe-Lintner Capital Asset Pricing Model (**SL CAPM**).
  19. When calculating the return on debt for the purpose of clause 17 of this undertaking, the only approach that PoM will use is a transition to an arithmetic trailing average cost of debt, starting in 2017/18.
  20. When calculating the risk free rate for the purpose of clause 17 of this undertaking, PoM will:
    - a. estimate the risk free rate by reference to the effective annual yield on government bonds using a ten-year term;
    - b. apply the following calculations to estimate the risk free rate:
      - i. arithmetic average of the daily annualised yield on the 10-year Commonwealth Government Securities (CGS) over 20 business days ending 31 March in the year the TCS is submitted;
      - ii. the 10 year yields are derived by interpolating CGS with maturity dates that straddle a 10-year term as published by the Reserve Bank of Australia (RBA); and
      - iii. the 10-year CGS yields are reported on a semi-annual basis, PoM will convert the reported yield to an annualised yield by applying the following formula:

$$r_a = \left(1 + \frac{r_s}{2}\right)^2 - 1$$

where

$r_a$  is the annualised yield on the 10 year CGS; and

$r_s$  is the semi-annual yield on the 10 year CGS.

21. When calculating the market risk premium (MRP) for the purpose of clause 17 of this undertaking, PoM will:

- a. apply an estimate that is consistent with the estimated value for gamma as determined according to clause 22, in accordance with the approaches of Australian and New Zealand regulators and courts;
- b. not use the Wright method;
- c. have regard to forward looking and Historical Excess Returns (HER) estimates of the prevailing market risk premium in line with approaches well accepted by Australian and New Zealand regulators and courts;
- d. when estimating the forward looking estimates of the MRP, such as Dividend Discount Models (DDMs):
  - i. use only a selection of forward looking approaches or estimates of the MRP that are used by Australian and New Zealand regulators and courts;
  - ii. where possible implement those models in a manner, and using inputs, that is consistent with the approach used by the relevant regulator; and
- e. when implementing the HER approach will rely on approaches to estimating the HER that are adopted by Australian and New Zealand regulators and courts and, in doing so:
  - i. rely equally on NERA-adjusted and Brailsford Handley Maheswaran-adjusted stock market data unless an alternative weighting is more appropriate having regard to the requirements of the Pricing Order; and
  - ii. have regard to stock market data from the periods starting 1883, 1937, 1958, 1980 and 1988, using arithmetic averages to estimate the MRP.

22. When calculating gamma for the purpose of clause 17 of this undertaking:



- a. PoM will adopt the utilisation approach based on an equity ownership methodology, and not use the market valuation or finance practitioner (zero-gamma) approaches; and
  - b. PoM will use well accepted approaches (and/or estimates) used by Australian and New Zealand regulators and courts for the distribution rate and utilisation rate.
23. When calculating gearing levels for the purpose of clauses 17 and 25 of this undertaking, PoM will determine gearing levels based on the average gearing of the comparator set. In doing so, PoM will first refer to the benchmark gearing that currently applies, and then refer to the average gearing of the comparator sample as cross checks.
24. When calculating credit rating for the purpose of clause 17 of this undertaking, PoM will determine credit rating based on the average credit rating of the comparator set. In doing so, PoM will first refer to the benchmark credit rating that currently applies, and then refer to the average credit rating of the comparator sample as cross checks
25. When selecting a suitable sample of comparator firms for the purpose of clause 17 of this undertaking:
- a. PoM will select a sample of comparators consistent with the general principles adopted by Australian and New Zealand regulators and courts;
  - b. in selecting suitable comparator firms PoM will prioritise:
    - i. obtaining a sample size that is sufficiently large to generate robust estimates that are not influenced excessively by individual observations, having regard to the comparability of businesses in the sample;
    - ii. excluding comparators for which good quality data cannot be obtained, such as due to poor liquidity; and
    - iii. including comparators with similar economic and systematic risk characteristics to PoM, ie, companies that own and operate container port and channel infrastructure; and
  - c. PoM will select the sample of comparator firms using the following steps:

- i. search Bloomberg's equity screening function (EQS) to identify potential comparators according to the relevant industry classifications, such as the Bloomberg Industry Classification Systems (BICS) and the Global Industry Classification Standard (GICS);
- ii. apply appropriate filters to exclude companies with insufficient data or illiquid data, or whose market capitalisations are too small to serve as appropriate comparators;
- iii. analyse the remaining companies manually to remove those that are not appropriate comparators, including reviewing their Bloomberg descriptions and carrying out desktop research; and
- iv. If the above process does not generate a sample of comparable firms of sufficient size, then PoM will repeat the steps using search criteria that are less restrictive.

26. When calculating the asset beta and leveraging beta for the purpose of clause 17 of this undertaking, PoM will:

- a. apply Ordinary Least Squares (OLS) regression analysis to estimate all betas from market data;
- b. use well accepted approaches adopted by Australian and New Zealand regulators and courts in assessing:
  - i. the frequency of beta estimates, for example, daily, weekly, four-weekly or monthly betas;
  - ii. the use of end of period beta (eg: weekly beta ending on Fridays) or average of each day of the period beta (eg: for the weekly beta, the average of weekly betas ending Monday, Tuesday, Wednesday, Thursday and Friday); and
  - iii. the mean, median and portfolio of the sample betas; and

- c. adopt the Brealey-Myers formulae to de-lever and then re-lever betas, unless an alternative approach is more appropriate having regard to the requirements of the Pricing Order.

27. When calculating the return on debt for the purpose of clause 17 of this undertaking PoM will:

- a. transition to use an arithmetic trailing average cost of debt and will adopt a ten-year debt term;
- b. calculate the allowed return on debt using the following formulae:
- i. for the period 2022/23 to 2026/27 using the following formula:

$$r_t^d = \frac{10 - (t - 2018)}{10} R_{FY18} + \frac{1}{10} \sum_{j=t-FY18+1}^t R_j$$

- ii. for the period starting 2027/28 using the following formula:

$$r_t^d = \frac{1}{10} \sum_{j=t-9}^t R_j$$

where:

- $r_t^d$  is the allowed return on debt for financial year  $t$ ;
- 2018 is the financial year 2017/18 and is the first year of the transition period;
- $j$  indexes a series of financial years for summation;
- $R_j$  is the on-the-day cost of debt estimate in any financial year in the series  $j$ , where:
- $R_{FY18}$  is the on-day cost of debt estimate for 2017/18 and is 5.45 per cent;
- $R_{FY19}$  is the on-day cost of debt estimate for 2018/19 and is 4.58 per cent;
- $R_{FY20}$  is the on-day cost of debt estimate for 2019/20 and is 4.21 per cent;

$R_{FY21}$  is the on-day cost of debt estimate for 2020/21 and is 3.42 per cent;

$R_{FY22}$  is the on-day cost of debt estimate for 2021/22 and is 3.12 per cent;

- iii. the on-the-day cost of debt will be the arithmetic average of the 20 business days ending 31 March in financial year  $t$ , and
- iv. the on-the-day cost of debt will be estimated as the average annualised yield on benchmark debt from the following third party data sources:
  1. RBA published estimates of the Australian corporate debt yield;
  2. Bloomberg AUD BVAL curve;
  3. a benchmark credit rating of BBB+ will be calculated using 1/3 A rated bond yields and 2/3 BBB rated bond yields; and
  4. a benchmark credit rating of A- will be calculated using 2/3 A rated bond yields and 1/3 BBB rated bond yields.

## Acknowledgments

28. PoM acknowledges that:

- a. the ESC Minister will make this Undertaking publicly available by causing it to be published on the Department of Transport website;
- b. the ESC Minister may, from time to time, make public reference to this Undertaking, including in news media statements and in publications;
- c. the ESC Minister may apply to the Supreme Court for an order under section 49N of the PMA if the ESC Minister considers that PoM has breached any of the terms of this undertaking; and
- d. the terms “benchmark efficient entity” and “well accepted approach” used in this Undertaking are to be interpreted in accordance with the decisions of Australian Courts (which, for the purposes of this undertaking, includes the Australian

Competition Tribunal) and will be applied consistently with those decisions, and Australian and New Zealand regulatory practice, as applicable at the time.

29. PoM further acknowledges that the ESC will conduct and complete an inquiry into PoM's compliance with the Pricing Order as required by section 49I of the PMA in relation to the five-year review period commencing 1 July 2021.

**Port of Melbourne Operations Pty Ltd (as trustee for the Port of Melbourne Unit Trust) ABN 83 751 315 034**

Executed by

*sign here* ►



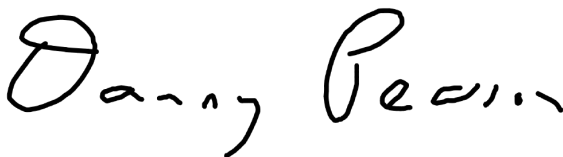
*print name*

Saul Cannon

**Essential Services Commission Minister**

Accepted pursuant to section 49M of the Port Management Act 1995 (Vic) by

*sign here* ►






*print name*

**The Hon. Danny Pearson MP**

*Commencement  
Date*

20 May 2022

## Attachment B - Summary of PoM response on ESC findings of sustained but not significant non-compliance

<b>Issue raised</b> 	<b>How PoM has responded and what port users will see</b> 	<b>Outcome</b> 
<b>Operating expenditure</b>	<p>We have adjusted our approach to forecasting operating expenditure by:</p> <ul style="list-style-type: none"> <li>Identifying and considering the reasons for variations between forecasts and actuals;</li> <li>Reviewing and seeking to improve the operating expenditure forecasting methodology.</li> </ul> <p>Key actions to address the issues raised by the ESC include:</p> <ul style="list-style-type: none"> <li>Annually reviewing forecast accuracy and addressing any material inaccuracies in the Tariff Compliance Statement</li> <li>Reviewing and improving the forecasting methodology used by PoM for the 2022-23 Tariff Compliance Statement, including by augmenting the current forecasting approach with a ‘base, step, trend’ calculation, including an appropriate efficiency factor, to ensure our forecasts are prudent and efficient</li> <li>Undertaking additional analysis for the 2023-24 Tariff Compliance Statement, including further refinement of the ‘base, step, trend’ calculation, and benchmarking our operating expenditure with other businesses to ensure consistency with appropriate industry benchmarks.</li> </ul>	<p>These response measures will directly address the observations of the ESC and will be reflected in our Tariff Compliance Statement in 2022-23 and beyond.</p> <p>PoM’s operating expenditure is already more than 40% below pre-privatisation levels.</p> <p>Neither actual expenditure nor forecast expenditure has had any impact on port users during the review period, because prices are set by the Tariff Adjustment Limit under the Pricing Order.</p> <p>After the Tariff Adjustment Limit period ends (in 2037, or at the earliest, 2032), PoM’s prices will be set using prudent and efficient operating expenditure forecasts (in addition to the other building block components under the Pricing Order).</p>
<b>Cost allocation</b>	<p>We have corrected the cost allocation issues raised by the ESC and made changes to the Regulatory Model in relation to road and rail cost allocation to specifically address the findings.</p> <p>We have also taken steps to improve our cost allocation processes and developed a process for annual reviews of cost allocation to ensure future compliance.</p>	<p>All cost allocation issues have been corrected for the 2022-23 TCS.</p> <p>PoM’s cost allocation had no impact on port users during the review period because prices were set by the Tariff Adjustment Limit. There will be no future</p>

		<p>impact because the cost allocation issues have been resolved.</p> <p>Going forward, PoM can only change from the Initial Prescribed Service Tariffs during the TAL period if the ESC approves a tariff rebalancing application, which requires the ESC to be satisfied that PoM is compliant with the cost allocation requirements.</p>
<b>Prescribed service tariffs</b>	<p>PoM has amended its approach to the calculation of the Weighted Average Tariff Increase (WATI) to ensure consistency with the definition of the WATI. That is, the WATI will be based on historical revenues from the most recent financial year for which audited revenue is available.</p>	<p>PoM's Weighted Average Tariff Increase (WATI) calculation had no impact on port users during the review period because prices were set by the Tariff Adjustment Limit. That is, the WATI was irrelevant to price setting since all prices have been increased by the same CPI adjustment, as required by the Pricing Order, under the Tariff Adjustment Limit.</p> <p>As PoM has resolved this issue there will be no future impacts.</p>
<b>Content of the tariff compliance statement (TCS)</b>	<p>PoM will continue to improve the documentation provided in its annual Tariff Compliance Statement submissions, including (noting that some of these materials will be confidential):</p> <ul style="list-style-type: none"> <li>• Additional detail on operating expenditure forecasting</li> <li>• Additional detail on capital projects.</li> </ul> <p>The Port Development Strategy (PDS) Delivery Program (published in 2021) provides a pipeline of projects, which will be updated as required and respond to changing circumstances.</p>	<p>The improved documentation will address the observations of the ESC and will be reflected in our Tariff Compliance Statements.</p> <p>Impacts on port users from the content of Tariff Compliance Statements during the review period were found by the ESC to be immaterial.</p>