

Port of Melbourne



**Response to Essential Services Commission's
*Regulatory Approach to the Pricing Order -
A Consultation Paper***

3 July 2017

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1. Introduction

The Port of Melbourne¹ (PoM) welcomes the opportunity to make this submission on the Essential Services Commission's (ESC) *Regulatory Approach to the Pricing Order – A Consultation Paper* (Consultation Paper).

The Consultation Paper seeks feedback on the ESC's proposed approach to administering its economic regulatory functions, being compliance monitoring and reporting of PoM's tariffs with the Pricing Order², before it publishes a "statement of regulatory approach"³ in late 2017. The Pricing Order constrains any increases in PoM's tariffs for Prescribed Services⁴ by the lower of the Consumer Price Index (CPI)⁵ or the forecast Aggregate Revenue Requirement (ARR) calculated using an accrual building block methodology⁶ and the ESC is responsible for monitoring PoM's compliance with these tariff constraints⁷.

PoM welcomes the ESC's consultative approach in relation to clarifying any "sufficient supporting information"⁸ that it requires to undertake its compliance monitoring responsibilities. PoM supports an approach whereby any "sufficient supporting information" determinations from the ESC:

- are consistent with the Victorian Government's intent for a compliance monitoring framework that minimises regulatory burden
- are only introduced in response to a specific identified problem and do not pre-empt a potential problem
- follow best practice regulation principles and promote the objectives of the *Essential Services Commission Act 2001 (Vic)* (ESC Act), the *Port Management Act 1995 (Vic)* (PMA) and
- follow clear processes to ensure transparent, objective and fair decision making.

PoM notes that the "guidance", "technical papers" and "models" (collectively referred to as "other regulatory instruments") foreshadowed in the Consultation Paper appear to be beyond what the Commission would require to assist it undertake its compliance monitoring responsibilities. The above matters are discussed in sections 3 to 7 below. Section 8 responds to the questions posed in the Consultation Paper.

In relation to PoM's responsibilities for Port User consultation, PoM is committed to working collaboratively with the ESC to identify ongoing improvements as we work through the implementation of the Pricing Order.

PoM would welcome the opportunity to discuss this submission further with the ESC or provide further detail regarding the matters raised.

2. Background and Context

In March 2016, the Victorian Government launched the transaction process for the 50 year lease of PoM's commercial operations⁹ (Port Lease Transaction, or PLT). In September 2016, the Lonsdale Consortium was announced the successful bidder for the 50 year lease of PoM's commercial operations and commenced its operations on 1 November 2016.

¹ The Port of Melbourne Consolidated Group

² Made by the Governor in Council pursuant to the *Port Management Act 1995(Vic)* (PMA). Effective from 1 July 2016.

³ ESC, *Regulatory Approach to the Pricing Order – A Consultation Paper (Consultation Paper)*, May 2017, p. X

⁴ Prescribed Services are defined under section 49 of the PMA and include shipping channels, berthing facilities, the provision of short-term storage and cargo marshalling. The Victorian Government stated that revenue from Prescribed Services accounts for around 86 per cent of PoMC's total revenue – see Victorian Government Inquiry Submission, p. 41

⁵ The percentage change in the 12 month March quarter CPI (All Groups Index Number, weighted average of eight capital cities published by the Australian Bureau of Statistics) immediately preceding the financial year for which the tariffs apply

⁶ As described in clause 4 of the Pricing Order

⁷ The CPI constraint on PoM's Prescribed Service Tariffs applies for at least the first 16 years of the 50 year lease of PoM's commercial operations (see section 2) after which time only the accrual building block methodology applies

⁸ Under clause 9 of the Pricing Order

⁹ Prior to the lease commencing, PoM was operated by the Port of Melbourne Corporation (PoMC), a statutory body established by the Victorian Government in 2003. As part of the PLT, Port of Melbourne Corporation was restructured into two businesses, PoM which was the subject of the lease and Victorian Port Corporation Melbourne (VPCM).

The long term lease of PoM is consistent with the recommendations of the National Ports Strategy (NPS)¹⁰. The NPS calls for a nationally coordinated approach, between industry, Government, legislators and regulators, to improve the efficiency and productivity of the port and logistics industry. The NPS seeks to achieve this through commercial decision making in relation to the operation, investment and future planning of port infrastructure. The PLT follows a number of transfers, from public to private operation, of major city ports in Australia including Flinders Port (2001), Port of Brisbane (2010), Port Botany and Port Kembla (2013), the Port of Newcastle (2014) and the Port of Darwin (2015).

The Victorian Government recognised that ensuring a fit-for-purpose post-transaction regulatory framework was vital given the economic importance of PoM to the state of Victoria and the competitive environment in which it operates. PoM is a critical State asset - it is Victoria's only international container port and supports the movement of freight for the Victorian economy. Therefore, the Victorian Government recognised that the new economic regulatory regime to apply post-transaction should ensure that PoM "continues to support the long-term competitiveness of the Victorian economy while providing regulatory certainty for the leaseholder"¹¹.

3. The Victorian Government's Intent for the Regulatory Framework

The Victorian Government began developing a new post-transaction regulatory framework by reviewing the (then) existing economic regulatory framework. This framework involved applying light-handed price monitoring to limited services only and was administered by the ESC. The regime was consistent with the light-handed (or no) economic regulation of ports in all other Australian jurisdictions.

In establishing the new economic regulatory regime, the Victorian Government was guided by the following key principles¹²:

...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.*

Importantly, the Victorian Government did not make wholesale changes to the regulatory framework. Rather, it described the new arrangements as a "strengthened framework", which incorporates "enhancements" to the existing regime. In particular, it stated¹³:

The proposed strengthened ESC regime will mean future PoM prices are set against more clearly established pricing principles.

The enhancements were enshrined through amendments to the PMA and the ESC Act. In particular, the objectives under section 48 of the PMA (set out in Box 3 below) were modified to give effect to the new economic regulatory regime. Section 6 discusses that the ESC must promote these objectives, which focus on: maximising efficiency and net benefits to Victorian consumers including Port Users; and promoting competition, in performing its functions.

¹⁰ Australian Government (Infrastructure Australia) and National Transport Commission, *National Ports Strategy – Infrastructure for an economically, socially and environmentally sustainable future* (National Ports Strategy or NPS), December 2010. Found at [Link](#)

¹¹ Victorian Government, Select Committee Inquiry Submission (Victorian Government Inquiry Submission), September 2015 p. 45

¹² Victorian Government Inquiry Submission p. 40

¹³ Victorian Government Inquiry Submission, p. 41

The PMA was also amended to provide for the introduction of a Pricing Order developed by the Governor in Council. The Victorian Government described the purpose of the Pricing Order “to establish the regulatory regime, and the requirement for the leaseholder to comply with pricing and cost allocation principles utilising a ‘building block’ methodology”¹⁴.

The Victorian Government went on to say that¹⁵:

The Pricing Order will set out the following matters relating to price setting:

- a. *Prescribed Service Tariffs Pricing Principles, i.e. utilising the ‘building block’ approach;*
- ...
- d. *Tariff Adjustment Limit (TAL) - tariffs can only increase at the lower of CPI and the maximum allowable revenue. It is expected tariffs will increase by CPI for the next 15 years, but no longer than 20 years;*
- e. *Re-balancing - the leaseholder can re-balance charges provided they do not exceed the TAL;*
- ...

As a result, the Pricing Order constrains any increases in PoM’s tariffs for Prescribed Services by the lower of CPI or the forecast ARR (calculated using an accrual building block methodology) for at least the first 16 years of the lease.

Importantly, the Victorian Government was clear that the new post-transaction economic regulatory regime should¹⁶:

- provide for compliance monitoring of PoM’s tariffs with the Pricing Order
- provide a relationship between prices and underlying costs
- minimise the regulatory burden on PoM
- not provide direct price control
- facilitate and promote competition between ports, shippers, and third party operators.

Under the new regulatory regime, the ESC Minister retains a residual power to issue a “show-cause” notice to PoM. PoM would be provided with an opportunity to respond to any such “show-cause” notice, including explaining why it believes it has not been in significant and sustained non-compliance with the Pricing Order.

The Victorian Government’s decision on the nature of the new post-transaction economic regulatory regime is consistent with:

- Victoria’s commitments under the Council of Australian Governments’ (COAG) 2006 “Competition and Infrastructure Reform Agreement” (CIRA)¹⁷. The CIRA commits jurisdictions to a simpler and consistent national approach to economic regulation of port services. In particular, it states¹⁸:

ports should only be subject to economic regulation where a clear need for it exists in the promotion of competition in upstream or downstream markets or to prevent the misuse of market power.

The CIRA sets out principles for Government in determining how to regulate services at “significant ports” including¹⁹:

- third party access to ports and related infrastructure facilities should be based on commercial agreements

¹⁴ Victorian Government Inquiry Submission, p. 40

¹⁵ Victorian Government Inquiry Submission, pp. 41-42

¹⁶ Victorian Government Inquiry Submission, pp. 40-41

¹⁷ COAG, *Competition and Infrastructure Reform Agreement*, 10 February 2006 (COAG CIRA) p 42. Found at [Link](#)

¹⁸ COAG CIRA p. 42

¹⁹ COAG CIRA, p. 42

- commercial outcomes should be promoted by establishing competitive market frameworks that allow competition rather than economic regulation
- regulatory oversight of prices should be undertaken by an independent body
- the light-handed (or no) economic regulation that interstate governments have applied to comparable port businesses, which has been informed by the CIRA
- the key priorities identified in the 2010 NPS (which was endorsed by COAG in July 2012) include achieving “improved consistency in legislative and regulatory outcomes” for Australian ports and that “all legislation and regulations pertaining to ports should follow best practice principles”²⁰
- the increasingly competitive nature of the market in which PoM operates. It is well recognised that PoM faces competition from ports in New South Wales, South Australia and Queensland. The implications of this were recognised by the Victorian Parliament Select Committee (Select Committee) who stated²¹:

Today, the Port of Melbourne faces potential competition from New South Wales and South Australia. The prospect of increased competition from New South Wales is most significant...

The Select Committee went on to state²²:

Around 16 per cent of PoMC’s export trade originates in New South Wales. This trade can now reach Sydney by duplicated highways and a direct rail link. Similarly, import containers destined for this catchment will clear Port Botany via its intermodal hub for prompt delivery.

...

...a further 14.2 per cent of the Port’s export trade originates from Tasmania. Tasmania has some container handling capacity at Burnie, Devonport, Bell Bay and Hobart, but currently, the Port of Melbourne dominates its export container trade. South Australia also contributes 2.2 per cent of export containers. All of these revenue streams are now contestable to some extent.

Contestability is not restricted to neighbouring states or to exports. In the case of imports, many retailers and distributors operate on a nationwide basis, and make commercial choices about where to locate their distribution centres. These are often connected by long haul trucks to distant markets. The Port’s competitiveness will continue to be an important factor when firms make location decisions for these centres and related supply chains. This is an issue of importance to the whole Victorian economy, not just to the Victorian future lessee.

The Victorian Government appropriately had regard for the market characteristics including market structure, market power, the level of actual and potential competition as well as the nature of regulation (or lack thereof) applied to comparable interstate businesses when developing the new compliance monitoring regulatory regime. This approach recognises that prescriptive and deterministic regulation would not promote:

- a competitive or commercial environment for the provision of port services
- consistency in the regulatory regimes applied to comparable container ports
- economically efficient costs or capital investment by the leaseholder
- the long-term interests of Victorian consumers or Port Users.

²⁰ Australian Government, NPS, p. 9 and p. 23

²¹ Select Committee Final Report, p. 30

²² Select Committee Final Report, p. 31-32

4. The ESC's Role

As discussed in section 3, the Victorian Government defined the ESC's role in the new post-transaction economic regulatory regime as a compliance monitoring role. In particular, it stated²³:

The key enhancements under the strengthened framework include:

- f. the ESC continuing as the independent economic regulator, providing ongoing compliance monitoring of the leaseholder with the Pricing Order*

Division 2A of the PMA, "Monitoring compliance with the Pricing Order", gives effect to this by requiring that the ESC conduct a public review of PoM's compliance with the Pricing Order every five years. Within six months after each five year review period, the ESC must report to the ESC Minister on whether PoM has complied with the Pricing Order, and to the extent there has been any non-compliance, whether such non-compliance is "significant and sustained".

Clause 9 of the Pricing Order provides for the ESC to issue, from "time to time", "sufficient supporting information" determinations to assist it undertake its compliance monitoring responsibilities.

As discussed above, the Consultation Paper foreshadows that the ESC intends to publish a "statement of regulatory approach" in late 2017 in time for PoM's 2018-19 Tariff Compliance Statement (TCS) (due by 31 May 2018). PoM is concerned that this will include instruments that appear to be beyond what constitutes "sufficient supporting information". In particular, the Consultation Paper foreshadows that the ESC will issue:

- "guidance as to what it would likely consider compliant (or non-compliant) on key compliance issues"²⁴
- a technical paper for assessing the efficiency and prudence of PoM's capex²⁵
- a technical paper for the rate of return²⁶
- a roll forward model²⁷.

These foreshadowed instruments (collectively referred to as "other regulatory instruments") do not appear (based on the information provided in the Consultation Paper) to relate to information that the ESC requires to assess compliance of PoM's annual TCS or any Tariff Rebalancing Application with the Pricing Order.

PoM is concerned that these "other regulatory instruments" may be used to interpret and further define key elements of the Pricing Order. PoM considers that this would be:

- beyond what constitutes "sufficient supporting information" and therefore beyond the ESC's role under the Pricing Order
- inconsistent with the Victorian Government's intent that the new regulatory regime is a compliance monitoring regime as discussed in section 3
- inconsistent with the high-level drafting of the Pricing Order, which is intended to afford PoM the discretion to interpret, and demonstrate compliance with, the Pricing Order in the first instance. PoM's interpretation will be guided by the objectives of the PMA and ESC Act and in accordance with the natural meaning of the words in the Pricing Order. PoM notes that should the Victorian Government have wanted a more prescriptive regulatory approach, or for the ESC to develop supporting guidelines to assist with the interpretation of the Pricing Order, then it would have specifically provided for this in its drafting of the Pricing Order

²³ Victorian Government Inquiry Submission, p. 40

²⁴ ESC, Consultation Paper, p. 14

²⁵ ESC, Consultation Paper, p. 35

²⁶ ESC, Consultation Paper, p. 42

²⁷ ESC, Consultation Paper, p. 33

- inconsistent with the objectives of the PMA to promote the long term interests of Port Users and Victorian consumers because it could lock the ESC into positions that constrain its ability to make more informed and better decisions as more relevant information becomes available.

Further detail regarding PoM's views on the various proposed "other regulatory instruments" is provided in section 8, which addresses the nine questions posed in the ESC's Consultation Paper.

5. Premature to Develop "Sufficient Supporting Information" Determinations

As noted above, the Lonsdale Consortium only commenced its management of PoM eight months ago and PoM has only just (on 31 May 2017) submitted its first 2017-18²⁸ TCS to the ESC. Since commencing management, PoM has sought to engage proactively and collaboratively with the ESC.

PoM understands that the ESC is currently reviewing PoM's 2017-18 TCS, however PoM has not yet received any questions or clarifications about its TCS²⁹. The ESC has indicated that it will issue questions and organise meetings to discuss PoM's TCS over the coming months. PoM welcomes this type of engagement and supports ongoing and regular dialogue with the ESC. PoM considers that, in the first instance, this is the best way to understand and be able to respond to the ESC's views and expectations as they develop over time.

On this basis, to the extent that the ESC proposes to issue any "sufficient supporting information" determinations, PoM encourages the ESC only to do this:

- once it has reviewed PoM's 2017-18 TCS and discussed any information gaps with PoM
- once PoM has submitted a Tariff Rebalancing Application³⁰ (to the extent that the "sufficient supporting information" relates to tariff rebalancing)
- after allowing a reasonable timeframe for PoM to respond fully to the regime and evidence of how the regulatory regime is working
- once it has identified or established that there is a specific issue or problem that needs to be addressed. This will ensure that any "sufficient supporting information" determinations are tailored to address the specific circumstances of PoM
- after considering other available options (including direct engagement with PoM).

Both COAG's³¹ and the Victorian Government's³² best practice regulation principles (discussed in section 6) require that before issuing any "sufficient supporting information" determinations the ESC should establish that:

- there is a specific problem that needs to be addressed³³
- if a specific issue has been identified, the first response should consider direct engagement between the ESC and PoM or self-regulation before consideration of a formal regulatory response.

PoM considers that the ESC has not demonstrated a need to issue any "sufficient supporting information" determinations at this early stage of administering the regime. Therefore, it would be inconsistent with best practice regulation principles for the ESC to be acting now to develop any such determinations and would require the ESC to pre-empt what "sufficient supporting information" it will need before it has identified or established that there is a specific issue or problem that needs to be addressed.

²⁸ The financial year 1 July 2017 to 30 June 2018

²⁹ PoM understands that this is due to the short time between the ESC receiving PoM's TCS (on 31 May 2017) and PoM making this submission (3 July 2017)

³⁰ PoM did not submit a Tariff Rebalancing Application for 2017-18

³¹ COAG, *Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies*, October 2007 (Best Practice Regulation). Found at [Link](#)

³² Victorian Government, *Victorian Guide to Regulation – A handbook for policy makers in Victoria*. Found at [Link](#)

³³ Having regard to (i) the Victorian Government's intent of the regulatory framework (ii) the "open" and "high level" drafting of the Pricing Order and the discretion this is intended to provide PoM (iii) the objectives of the PMA, ESC Act, as well as the CIRA and NPS

6. Principles-based Regulation

In the event that in the future, the ESC assesses that there is a problem which requires a “sufficient supporting information” determination, then PoM considers that the ESC should follow COAG’s and the Victorian Government’s principles of best practice regulation.

COAG’s best practice regulation principles are summarised in Box 1 below. Importantly, “COAG has agreed that all governments will ensure that regulatory processes in their jurisdiction are consistent with [its best practice regulation] principles”³⁴. This “reflects ... [COAG’s] commitment to establish and maintain effective arrangements to maximise the efficiency of new and amended regulation and avoid unnecessary compliance costs and restrictions on competition...”³⁵.

Box 1: COAG’s best practice regulation principles³⁶

- (i) establish that there is a problem (that needs to be addressed)
 - (ii) assess a range of feasible options (including self-regulatory and non-regulatory approaches).
- The preferred option must:
- (iii) maximise net benefits (efficiency)
 - (iv) not inhibit competition
 - (v) have a clear policy intent
 - (vi) remain relevant and effective over time
 - (vii) reflect effective stakeholder consultation
 - (viii) be proportionate to the problem.

The Victorian Government’s best practice regulation principles are set Box 2. These support and complement COAG’s best practice regulation principles. The Department of Treasury and Finance followed these principles when conducting its recent strategic review of the ESC Act.

Box 2: Victorian Government best practice regulation principles³⁷

- (i) Effective - support and achieve government policy objectives with minimal side-effect. Encourage innovation and complement market efficiency
- (ii) Transparent - developed and enforced in a transparent manner. Promote information sharing and integrity in government decision making
- (iii) Proportionate - to the problem
- (iv) Flexible and appealable - transparent and robust mechanism to appeal regulatory decisions
- (v) Accountable - the regulator must explain its decisions and be subject to public scrutiny
- (vi) Consistent and predictable - consistent with the objectives of government policies, laws and agreements

Following these principles will assist in ensuring that the regulatory framework remains fit-for-purpose. Regulation should be shown to be necessary, proportionate, targeted, efficient and in the public interest.

The ESC should also demonstrate how any “sufficient supporting information” determination that it issues promotes the objectives of the PMA and the ESC Act, set out in Box 3 and Box 4 below. Importantly, the objectives of these Acts focus on: maximising efficiency and net benefits to Victorian consumers including Port Users; and promoting competition. These objectives therefore complement COAG’s and the Victorian Government’s best practice regulation principles.

³⁴ COAG, *Best Practice Regulation*, p. 4

³⁵ COAG, *Best Practice Regulation*, p. 1

³⁶ COAG, *Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies*, October 2007. Found at [Link](#)

³⁷ Victorian Department of Treasury and Finance, *Review of the Essential Services Commission Act 2001 – report to the Minister for Finance*, December 2016, p. 4 Found at: [Link](#)

Box 3: PMA objectives

- (a) to promote efficient use of, and investment in, the provision of prescribed services for the long-term interests of users and Victorian consumers; and
- (b) to protect the interests of users of prescribed services by ensuring that prescribed prices are fair and reasonable whilst having regard to the level of competition in, and efficiency of, the regulated industry; and
- (c) to allow a provider of prescribed services a reasonable opportunity to recover the efficient costs of providing prescribed services, including a return commensurate with the risks involved; and
- (d) to facilitate and promote competition—
 - (i) between ports; and
 - (ii) between shippers; and
 - (iii) between other persons conducting other commercial activities in ports; and
- (e) to eliminate resource allocation distortions by prohibiting a State sponsored port operator from providing a relevant service at a price lower than the competitively neutral price for that service

Box 4: ESC Act objectives

- (1) *In performing its functions and exercising its powers, the objective of the Commission is to promote the objective of the Commission is to promote the long term interests of Victorian consumers.*
- (2) *... the Commission must in seeking to achieve the objective specified in subsection (1) have regard to the price, quality and reliability of essential services.*

Note The ESC must have regard for the matters specified in section 8A of the ESC Act in seeking to achieve these objectives

The ESC has itself acknowledged that it must promote these objectives in performing its functions. The ESC stated in its March 2017 Overview Paper³⁸:

Section 48A specifies that the Commission must have regard to these objectives in performing its functions or exercising its powers. In addition, the Commission must have regard to the objectives of section 8 of the Essential Services Commission Act.

Both the PMA and ESC objectives are consistent with the following NPS governance related best practice guidelines in Box 5 below. These support the NPS objective “to facilitate trade growth and improve the efficiency of port-related freight movement across infrastructure networks through a commitment to the application of best practice policy-making and planning”³⁹.

Box 5: NPS Best Practice Guidelines – Ports governance⁴⁰

- Action 3.2 - Other principles for authorities in control of a relevant port or a freight facility include that they should:*
- (i) *behave in a commercially sustainable manner, including recovering from port users and tenants sufficient revenues to cover operating costs and provide an appropriate return on the capital invested and to be invested in the port*
 - (ii) *undertake commercially prudent investments to improve the efficient conduct of trade and to avoid a gap between forecast trade and capacity;*
 - (iii) *be able to undertake investments outside of the port precinct, provided they are consistent with competition policy principles;*
 - (iv) *seek to recover government financial investments; and*
 - (v) *act in a transparent and even-handed manner in dealings with stakeholders.*
- Action 3.5 - All legislation and regulations pertaining to ports should follow best practice principles*

³⁸ ESC, The Port of Melbourne Regulatory Regime - Overview of the Port of Melbourne and the Essential Services Commission’s Regulatory Roles (ESC Overview Paper), March 2017 p. 12

³⁹ Australian Government, NPS, p. 8

⁴⁰ Australian Government, NPS, p. 23

7. Process for Developing “Sufficient Supporting Information”

PoM considers that the ESC should set out the process that it intends to follow whenever, in the future (refer to timing in section 5), it issues any “sufficient supporting information” determinations under clause 9 of the Pricing Order. COAG’s and the Victorian Government’s best practice regulation principles (discussed in section 6) require that in relation to issuing any “sufficient supporting information” the ESC should:

- follow clear processes to ensure objective and fair decision making (i.e. transparent and accountable)
- ensure that its decisions are reviewable (i.e. flexible and appealable).

Transparent, objective and fair decision making is necessary to promote investor confidence and commercial decisions. It is therefore also required to promote the objectives of the PMA with respect to the long-term interests of Port Users and Victorian consumers.

On this basis, PoM requests the ESC to clarify the following:

- whether it intends to publish issues papers and canvass the specific issues being considered, ahead of issuing draft “sufficient supporting information” determinations
- whether it intends to publish draft “sufficient supporting information” determinations for comment
- what timeframes and processes it intends to provide for making submissions on any issues papers and draft “sufficient supporting information” determinations
- how it proposes to actively engage PoM in developing its “sufficient supporting information” determinations
- how the timeframes for partial and full compliance with any “sufficient supporting information” determinations will be established
- whether it will incorporate review processes to ensure any “sufficient supporting information” determinations continue to be relevant.

8. Responses to the ESC’s Questions

PoM’s responses to the nine questions posed in the Consultation Paper are set out below:

1. Which aspects of the Pricing Order should the Commission develop and publish guidance on?

For the reasons discussed in:

- section 0, PoM considers “other regulatory instruments” appear to be beyond what constitutes “sufficient supporting information” and are therefore beyond the ESC’s role under the Pricing Order
- section 5, PoM considers that it would be inconsistent with best practice principles for the ESC to be acting now to develop any “sufficient supporting information” determinations, particularly prior to engaging directly with PoM in any such areas.

2. Do stakeholders support the ESC’s proposal to provide interim commentary within the five year inquiry period on the port licence holder’s compliance with the Pricing Order?

PoM supports transparency and a “no surprise” approach to the ESC’s ongoing monitoring of its compliance with the Pricing Order. In particular, PoM supports clear and regular dialogue with the ESC to allow it to understand and be able to respond to the ESC’s views and expectations as they develop over time.

PoM expects that the ESC will raise any concerns about compliance with PoM directly, before making any public statements. This would provide PoM with a reasonable opportunity to address any potential compliance issues as they arise. PoM believes that this is consistent with the intent of the PMA, which provides PoM with the opportunity to clarify, remedy or respond to any “show-cause” notice. “Surprise” public statements could significantly impact PoM’s financial market position, undermine investor and industry confidence or impact on

commercial decisions and therefore affect the provision of prescribed services. Given the strategic importance of PoM to the Victorian economy, PoM considers this would not be in the long-term interests of Port Users or Victorian consumers and would therefore not be consistent with or promote the objectives of the PMA.

Within this context, PoM supports annual interim commentary from the ESC.

3. Do stakeholders support the ESC's proposed approach to assessing whether any non-compliance with the Pricing Order is 'significant and sustained'?

As discussed in response to question 2 and section 5 above:

- PoM supports annual interim commentary and considers that this will provide ongoing feedback on the ESC's assessment of "significant and sustained" non-compliance
- PoM welcomes ongoing and regular dialogue with the ESC. PoM considers that this is the best way to understand and be able to respond to the ESC's views and expectations as they develop over time, including how to assess any "significant and sustained" non-compliance, should it arise.

However, PoM does not consider "guidance"⁴¹ on how the ESC will assess "significant and sustained"⁴² non-compliance is required. The high-level drafting of the Pricing Order is intended to afford PoM the discretion to interpret, and demonstrate compliance with the Pricing Order in the first instance. PoM notes that should the Victorian Government have wanted a narrower meaning of "significant and sustained" then the Pricing Order would have been drafted to specify the narrower meaning. As discussed in section 0, PoM considers "other regulatory instruments" (including "guidance") appear to be beyond what constitutes "sufficient supporting information" and are therefore beyond the ESC's role under the Pricing Order.

Further, PoM agrees with the ESC's views in the Consultation Paper that:

- any assessment of "significant and sustained" non-compliance should have regard to the "relevant facts and circumstances"⁴³ specific to the event. An assessment of "significant and sustained" non-compliance (should it arise) cannot be undertaken in the abstract. Therefore, PoM considers that it would not be appropriate for the ESC to issue "one size fits all" ex-ante guidance on how any assessment of "significant and sustained" non-compliance would be undertaken
- any interpretation of "sustained" non-compliance should (in accordance with the ordinary meaning of the word sustained) focus on⁴⁴:
 - repeated action and "failure to implement adequate processes to prevent recurrent non-compliance"
 - "...adequacy and timeliness of the port licence holder's responses to any non-compliances..."

"Sustained" is defined as "cause to continue for an extended period or without interruption"⁴⁵. PoM does not consider that, as suggested by the ESC, any consideration of "whether the harm can be reversed (at all or retrospectively)"⁴⁶ is appropriate given the natural meaning of the word.

For the avoidance of doubt, the natural meaning of the word would suggest that if any non-compliance was one-off and subsequently remedied in a timely manner, then it is not sustained.

⁴¹ ESC, Consultation Paper, p. 14 and 21. The Consultation Paper states that the ESC is considering issuing "guidance as to what it would likely consider compliant (or non-compliant) on key compliance issues"

⁴² ESC, Consultation Paper, p. 2. See also section 45 (Definitions) of the PMA "adverse compliance report". Note, the term "significant and sustained" is not defined in the PMA

⁴³ ESC, Consultation Paper, p. 21

⁴⁴ ESC, Consultation Paper, p. 20

⁴⁵ Online English Oxford dictionary. Found at: [Link](#)

⁴⁶ ESC, Consultation Paper, p. 20

4. Do stakeholders support the ESC's proposal to require PoM to publish and consult on a tariff rebalancing strategy to accompany any Tariff Rebalancing Application? If so, what issues would Port Users expect the strategy and engagement to cover?

The Consultation Paper invites views on the ESC's proposal that PoM should be required to consult on and publish a tariff rebalancing strategy should it seek to rebalance its tariffs. The tariff rebalancing strategy would be submitted to the ESC together with any Rebalancing Application. In particular, the ESC states:

To promote an appropriate level of engagement and support compliance demonstration, we consider the port licence holder should consult on and publish a tariff rebalancing strategy prior to submitting an application to the Commission. This would set out how it plans to rebalance prescribed service tariffs over the short and medium term. The Commission would expect that a final (post-consultation) version of the tariff rebalancing strategy would then be submitted as supporting information with any tariff rebalancing application.

PoM is committed to undertaking meaningful and comprehensive engagement with Port Users and other stakeholders. PoM undertook a range of consultation and engagement activities for the purpose of preparing its 2017-18 TCS. This engagement built on PoM's existing consultation processes, having regard for the requirements of the Pricing Order, and was conducted via the following engagement pathways⁴⁷:

- Targeted - face to face industry forums
- Blended - business as usual and ongoing discussions with stakeholders
- General - general communication

PoM recognises that, while there is a clear regulatory imperative for it to engage with Port Users and other stakeholders under the Pricing Order, best practice engagement should be an integral and ongoing part of its business. Port Users' and other stakeholders' views are important to PoM and PoM is committed to fostering genuine and transparent dialogue to understand what Port Users and other stakeholders expect from it and taking action to address their concerns. PoM recognises that its engagement and consultation expertise will evolve over time and is committed to working with the ESC to ensure continuous improvement in its engagement practices and activities.

PoM queries whether there is a need, at this early stage of the regulatory regime, for the ESC to develop a "sufficient supporting information" determination in relation to stakeholder consultation on tariff rebalancing. The Pricing Order already requires PoM to consult with Port Users and demonstrate how any proposed tariff rebalancing satisfies the pricing principles contained in the Pricing Order should PoM make a Rebalancing Application. PoM would welcome further discussion with the ESC on this matter and as noted above, is committed to working collaboratively with the ESC in relation to stakeholder engagement.

5. What forecast and historical service performance information should PoM provide to demonstrate that its capex complies with the relevant Pricing Order requirements?

The Consultation Paper suggests that forecast and actual service performance data will be the minimum information requirement for PoM to demonstrate compliance with the capex efficiency and prudence tests. In particular, the ESC states that:

We cannot assess compliance with the Pricing Order efficiency and prudence tests without knowing:

- *the forecast service levels those expenditure forecasts are intended to deliver*
- *the actual service levels that actual expenditure did deliver.*

⁴⁷ The engagement activities and customer feedback is contained in Appendix E "Port User Consultation Process and Summary" of PoM's 2017-18 TCS.

PoM is not clear what service performance information the ESC is specifically referring to. PoM queries whether the ESC is referring to section 55(1)(a) of the PMA, replicated below:

.... the Commission has power to—

(a) develop, issue and review standards and conditions of service and supply in respect of prescribed services;

In its Overview Paper⁴⁸ the ESC confirms that the:

- ESC has not exercised its power under section 55(1)(a).
- ESC Minister has not requested it to develop standards and conditions of service and supply.

Under the Port Concession Deed (PCD) PoM also has requirements to document and detail how it will achieve service levels for Core Port Infrastructure and maintain and repair assets. The Victorian Government is responsible for overseeing these obligations.

PoM would welcome a discussion with the ESC to better understand what service performance information it is referring to.

Notwithstanding this clarification, PoM considers that any assessment of the prudence and efficiency of capex is best undertaken by applying well accepted capex assessment techniques including expenditure governance, asset management processes, engineering review and trend analysis. This is discussed in response to question 6 below.

The Consultation Paper states that⁴⁹:

In other regulatory regimes, the tests for prudence and efficiency of capital expenditure generally require the regulator to be satisfied that the expenditure would be incurred (or would have been incurred) by a prudent service provider acting efficiently, having regard to applicable service standards, regulatory obligations and expected levels of demand.

Service level performance is used in other well established regulatory frameworks such as electricity, however it is not used to assess the prudence and efficiency of capex. Service performance outcomes are used to ensure that any capex savings in an ex-ante incentive framework are driven by efficiency savings and are not at the expense of service quality. In ex-ante incentive frameworks, capex is set at the beginning of the regulatory control period and businesses receive reward or penalty payments for outperforming or underperforming the benchmark capex. The service performance scheme counterbalances this incentive by rewarding or penalising any outperformance or underperformance against the established services levels.

The regulatory regime under the Pricing Order:

- is not an ex-ante incentive regime
- does not provide for the ESC to approve PoM's capex at the start of the period
- only provides for the ESC to assess whether PoM's capex is prudent and efficient in the five yearly reviews (but not approve its capex).

The ESC also recognises this and states that⁵⁰:

- *assessing capital expenditure assessment after it has been incurred can adversely affect investment incentives if the prospects of recovery are uncertain*

PoM agrees with the ESC's views. PoM would welcome a discussion with the ESC to understand how this shortcoming could be addressed to provide PoM with greater investment transparency and certainty and thereby promote investor confidence and commercial decisions. This is essential to promote the objectives of the PMA with respect to the long-term interests of Port Users and Victorian consumers.

⁴⁸ ESC Overview Paper, March 2017 p. 12

⁴⁹ ESC, Consultation Paper, p. 35 (underlying added for emphasis)

⁵⁰ ESC, Consultation Paper, p. 35

6. What capex assessment tools and information requirements, outlined in the Consultation Paper, are suitable for assessing whether PoM's capex is prudent and efficient under the Pricing Order?

The Consultation Paper foreshadows that the ESC will issue a technical paper for assessing the efficiency and prudence of PoM's capex. In particular, the Consultation Paper states⁵¹:

...we will consider preparing a technical paper on this aspect of compliance [whether capex is prudent and efficient], and developing requirements for our information determination.

As discussed in section 4 above, PoM considers "other regulatory instruments" (including "technical papers") appear to be beyond what constitutes "sufficient supporting information" and are therefore beyond the ESC's role under the Pricing Order.

In addition, PoM wishes to make the following two comments:

(i) PoM is best positioned to identify what assessment methods are most appropriate

PoM agrees with the ESC that in order to promote stakeholder confidence, PoM should explain the prudence and efficiency of its capex using well accepted assessment methods. As outlined in the Consultation Paper, there are a wide range of assessment techniques that can be employed to assess whether capex is prudent and efficient, many of which are well established and regularly applied by businesses and regulators. These include:

- robust governance framework including procurement processes
- forecasting methodology
- best practice asset management processes (including International Organisation for Standardisation (ISO) 55000 Asset Management certification)
- justification for any departures from trends
- explanation of difference in actual compared to forecast
- engineering assessments

Given the diversity in the nature, key drivers and value of its individual capex categories (which can differ significantly over time), PoM considers that (i) it is best positioned and (ii) it would be more efficient for it to identify what assessment methods are most appropriate for each capex category.

(ii) Benchmarking

PoM does not support the use of top-down economic benchmarking as a technique for assessing the prudence and efficiency of its capex. Benchmarking is not likely to be suitable because:

- it requires robust and consistent data sets (across Ports and across time)
- it does not account for the factors driving different costs - no two ports are the same – i.e. significant differences in commodity trade, age of infrastructure, growth requirements and environmental and other external conditions such as weather
- data is collected and reported differently across ports due to differences in cost allocation approaches, capitalisation policies, service provision and service level obligations for core assets⁵²; and
- the significant additional cost required to collect data could outweigh the benefits.

⁵¹ ESC Consultation Paper, p. 35

⁵² Service level obligations are generally contained in confidential documents

7. To what extent does PoM expect to (i) receive capital contributions from non-public sector entities and (ii) incur asset disposals? Should these be excluded from the RAB in accordance with the normal regulatory practice?

(i) Asset Disposals

PoM does not expect any material asset disposals over the foreseeable future.

(ii) Capital Contributions

It is common for Port Users to fund unloading equipment located on PoM wharves, including for example conveyors, hoppers and pipelines. These assets are owned and used by specific Port Users and are typically able to be removed⁵³.

It is not common for Port Users to fund Core Port Infrastructure because (i) it is typically very expensive and therefore unaffordable and (ii) port infrastructure needs to be accessible to any access seeker (i.e. common infrastructure). Investment in Core Port Infrastructure is therefore best undertaken by the port manager.

In the rare circumstances that a Port User was to contribute to Core Port Infrastructure, then the asset (or the portion of the asset funded by the Port User) would either be excluded from PoM's Regulatory Asset Base (RAB) (or cost base) or included at zero value⁵⁴.

Where a Port User requires infrastructure predominately for its own use (i.e. a dedicated asset) or requires a different standard of service, this can be facilitated by PoM building the infrastructure on behalf of the Port User who in turn would fund the cost of the investment via contracted revenue. This contracted revenue would form part of the Aggregate Revenue Requirement but would not be subject to the Tariff Adjustment Limit (TAL) constraint.

8. What other characteristics, considerations or trade-offs should be taken into account when selecting an appropriate sample of benchmarking comparators for the Port of Melbourne, for the purposes of calculating the return on capital?

In its Consultation Paper, the ESC foreshadows issuing a technical paper for the rate of return⁵⁵.

As discussed in section 0, PoM considers "other regulatory instruments" (including "technical papers") appear to be beyond what constitutes "sufficient supporting information" determinations and are therefore beyond the ESC's role under the Pricing Order.

As discussed in sections 3 to 5, PoM considers that:

- seeking to define terms in the Pricing Order, like "benchmark efficient entity providing services with a similar degree of risk" (i.e. potential comparator entities) is inconsistent with the Victorian Government's intent that the new regulatory regime is a compliance monitoring regime
- the high-level drafting of the Pricing Order is intended to afford PoM the discretion to interpret, and demonstrate compliance with the Pricing Order in the first instance. PoM's interpretation will be guided by the objectives of the PMA and ESC Act and in accordance with the natural meaning of the words in the Pricing Order. PoM notes that should the Victorian Government have wanted a narrower meaning of "benchmark efficient entity providing services with a similar degree of risk" then the Pricing Order would have been drafted to specify the narrower meaning.

As noted above, PoM submitted its first TCS to the ESC on 31 May 2017. This set out PoM's current view on the appropriate sample of benchmarking comparators for the purposes of calculating the return on capital, after having due regard to a range of well accepted approaches. As discussed:

- PoM has not yet received any questions or clarifications on its TCS from the ESC

⁵³ PoM may inherit the equipment (and other improvements made by Port User) on the land at the end of the Port User's lease. This does not impact tariffs for Prescribed Services

⁵⁴ For the avoidance of doubt, only the portion of the asset funded by the Port User would be excluded from the cost base

⁵⁵ ESC Consultation Paper, p. 42

- PoM welcomes ongoing and regular dialogue with the ESC in order to be able to respond to the ESC's views and expectations as they develop over time including as they relate to benchmarking comparators.

9. Are there any reasons why the Pricing Order terminology 'well accepted' is not to be interpreted as the common methods used by Australian regulators to set the cost of capital? Well accepted approaches would be (i) the Sharpe-Lintner capital asset pricing model to estimate the prevailing return on equity and (ii) the trailing average method to estimate the cost of debt

PoM's interpretation of the Pricing Order terminology "one or a combination of well accepted approaches" to calculate debt and equity for its 2017-18 TCS was guided by the objectives of the PMA and the ESC Act. These objectives require that the cost of capital promotes efficient use of, and investment in, the provision of Prescribed Services in the long-term interests of Port Users and Victorian consumers. PoM considers that the meaning of "one or a combination of well-accepted approaches" includes not only the approaches accepted by regulators (both Australian and international), but also those approaches adopted by the financial and academic communities. Importantly, the deliberate drafting of "one or a combination" clearly provides PoM the flexibility to have regard to a number of different approaches rather than be limited to a single approach (i.e. Sharpe-Linter) or methodology (i.e. trailing average method). If it was the intent of the Victorian Government to specify and limit PoM's method of calculating its cost of capital, then it would have done so through the drafting of the Pricing Order.

While the approach of regulators can provide important considerations for the meaning of "well accepted", it only provides a subset of possible approaches that may be considered "well accepted". Therefore, PoM considers it essential to also include:

- consideration of approaches used in a workably competitive market. These are also important because the efficiencies referred to in the objectives of the PMA and the ESC Act are intended to reflect the out-workings of a workably competitive market
- models used by financial practitioners and in academia – regulators have adopted models developed in academia and also adopted models used by financial practitioners, acknowledging that each model has its own merits and flaws (with respect to a range of factors including but not limited to the underlying theory, ease of application and reliance on historical / accurate data and empirical fit). Financial practitioners have also adopted and adapted models developed in academia. To this end, PoM considered that it would be inappropriate not to consider these approaches when regulators are permitted to and clearly do so.

PoM considers that a failure to consider these broader models in interpreting "well accepted" may result in a failure to achieve the efficiencies referred to in the objectives of the regulatory regime.