National Ports Authority

PROPOSED TARIFF METHODOLOGY—Q&A

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1. Purpose of this Document

On 21 December 2012, the Ports Regulator of South Africa ("the Regulator") published the Proposed Tariff Structure, consisting of a Tariff Methodology and a Pricing Strategy, that was drawn up by the National Ports Authority ("NPA") in accordance with Section 72(1)(a) of the National Ports Act, 2005 (Act No. 12 of 2005) ("the Act"), which requires NPA, with the approval of the Regulator, to determine tariffs for services and facilities offered by NPA and to annually publish a tariff book containing those tariffs. The Directives in terms of Section 30(3) of the Act, which were approved on the 13th July 2010 (gazetted on the 6th August 2010) and amended on 29 January 2011, require that the Regulator, when considering the proposed tariffs for NPA, must ensure that such tariffs allow NPA to:

- Recover its investment in owning, managing, controlling and administering ports and its investment in port services and facilities;
- Recover its costs in maintaining, operating, managing, controlling and administering ports and its costs in providing port services and facilities; and
- Make a profit commensurate with the risk of owning, managing, controlling and administering ports and of providing port services and facilities.

In the first week of March 2013, public hearings were held in Cape Town, Johannesburg, Port Elizabeth and Durban to present the Proposed Tariff Methodology to port users and other affected parties and gather their questions, comments, and requests for further information.

This document contains the responses by NPA to the comments and questions submitted after these public hearings with respect to the Proposed Tariff methodology. We use this opportunity to further explain our proposed Tariff Methodology and implications thereof. Answers to questions concerning the proposed Pricing Strategy can be found in a separate document.

2. Responses to Stakeholder Questions and Comments

2.1. Calculation of the Weighted Average Cost of Capital (WACC)

Question 2.1.1. Capital Asset Pricing Model (CAPM)

a. *Why has the CAPM model been used as opposed to any other pricing models? (Question by ATLAS)*

NPA Response:

The CAPM is the model used to estimate the cost of equity. Other methods which could be used to estimate the cost of equity includes: the Dividend Growth Model (DGM), the Arbitrage Pricing Theory (APT), the Fama and French Three Factor Model (FFTFM). Most large companies, their financial advisers and competition authorities and regulators generally use Capital Asset Pricing Model (CAPM) in their assessment of the cost of ordinary equity capital. NPA proposes the use of the CAPM to determine the beta.

b. *What is the defendable principle of selecting the Top 40 instead of any other comparator index to base the Beta on? (Question by ATLAS)*

NPA Response:

The Authority provides a platform for the South African market (import & export) to trade and compete globally with 98% of seaborne cargo moving through the port system. The JSE Top 40 companies are fairly active in the domestic, regional and international space and their exposures to market risk can be considered a fair reflection of global risk. For this reason the Authority is of the view that the JSE Top 40 companies are a good proxy in order to determine an appropriate asset beta.

Question 2.1.2. Beta Calculation

Does the Authority accept that the "Beta" calculation can be questioned? Have other comparators than the "JSE top 40" been considered and what are the pros' and cons' of the various alternatives? (SAAFF & SAASOA)

NPA Response:

The Beta determination is always a subjective issue, not only for the Authority and Ports Regulator but for other regulated industries as well. In its 2011/12 tariff application, the Authority used 11 port companies as comparator firms for the purposes of estimating its asset beta. In its Record of Decision on that tariff application, the Regulator commented that the Authority "did not sufficiently argue the appropriateness of the selection as proxies for the NPA". In its 2012/13 tariff application, the Authority expanded its list of comparator firms to 17 ports for the purposes of estimating its asset beta. Once again the Regulator was not convinced that the ports chosen represented an appropriate proxy for the Authority.

The nature and functioning of ports is varied and "no two ports are alike". This could possibly explain the concern raised by the Regulator in past RODs. The Authority therefore revisited its approach in terms of beta determination focusing on its operating environment and believes that the JSE Top 40 companies are a good proxy for its beta determination.

Question 2.1.3. Debt to Equity Ratio

a. If Transnet keeps re-setting the gearing ratio of NPA to 45% and NPA repeatedly ends with 36% each year, what is the justification for using the 36% for WACC calculation? Furthermore why is 45% used by Transnet and not the 50% if that is the recommended ratio as per the Transnet's guidelines? (Question by ATLAS)

NPA Response:

The Authority, as a division of Transnet SOC Ltd, does not raise its own capital, so it is not possible to observe its optimal capital structure directly. A pragmatic solution to this problem is to assume that the Authority's historical average gearing is reflective of its capital structure. If Transnet's gearing exceeds 50%, this may trigger a breach of certain loan covenants. Therefore in order to minimise the gearing risks of such an occurrence, a buffer of 5% is maintained. Hence the 45% targeted gearing is maintained and used by Transnet.

b. What is the gearing ratio for other South African State Owned Entities? I.e. Eskom

NPA Response:

Capital structure and optimal gearing levels are business specific and the nature of SOEs are not the same. Generally risk profiles differ from one business to the other.

c. Does Transnet lend internally to NPA at a premium to what they (Transnet) borrow from the open market?

NPA Response:

Transnet does not lend internally to NPA at a premium to what is borrowed from the open market.

d. Is the decision on interest for internal loans made by Transnet SOC Ltd with or without NPA's input? Does NPA have any influence over the interest rate?

NPA Response:

The Authority does not have a treasury desk. Funding for the Authority is managed entirely by Transnet Group office.

e. Are all borrowings to NPA from Transnet SOC Ltd or does NPA going to the open market? If so what is the ratio, and difference in interest rates?

NPA Response:

As per (d) above, the Authority does not source any funding on its own accord. The Authority depends entirely on Transnet SOC Ltd treasury desk for such services.

2.2. Regulatory Asset Base (RAB)

Question 2.2.1. RAB

Was the valuation on Investment Assets based on Fair Value Model or Cost Model according to IAS 40 and why? (Question by ATLAS)

NPA Response:

Assets leased to divisions of Transnet are not considered investment property in terms of IAS 40 and have thus been considered at historic cost. Assets leased out to external parties have been accounted for in terms of IAS 40 i.e. Investment property. In terms of such accounting treatment, such assets are fairly valued in accordance with IAS 40. As part of the tariff methodology proposal for regulatory accounts, the Authority proposes that assets leased out to divisions of Transnet be fairly valued in accordance with IAS 40.

Question 2.2.2.

Was an internal or independent valuator used, and if internal - why wasn't an independent valuator used? (Question by ATLAS)

NPA Response:

For the purposes of investment property, fair value determination, Transnet Properties, (division of Transnet SOC Ltd) has undertaken the valuation based on the principles prescribed by the South African Institute of Valuers which was found to be acceptable by the independent external auditors.

Ports facilities (breakwaters, quay wall, and entrance channel) are revalued every 3 years and an indexation, prepared by ZLH Projects and Naval Architecture (Pty) Ltd, is applied annually, limited to the value of our discounted cashflow model in terms of the Transnet policy. The take on balance proposed by the Authority was valued by independent valuator, ZLH projects and Naval Architecture (Pty) Ltd. Opening balances for Tariff Application FY2010/11, was informed by the valuation undertaken, and the external auditors was satisfied with this valuation.

Question 2.2.3.

Would NPA allow cargo owners to appoint an independent valuer for comparative purposes? (Question by ATLAS)

NPA Response:

NPA is fairly comfortable that the services of an independent valuer have been used to inform the fair values of our asset base. Reliance has been placed by our external auditors, as part of the annual financial year audit on these valuations

If there is a need for further independent valuation, the Authority proposed that it must be done in conjunction with Ports Regulator’s office.

Question 2.2.4.

Does the Authority accept that there could be alternative and better ways of calculating the Regulated Asset Base? (Question by SAAFF & SAASOA)

<u>NPA Response</u>:

The Authority is of the view that there are alternatives approaches in the calculation of the Regulated Assets Base. However, the approach which has been proposed in the tariff methodology is considered to be the most appropriate method for the Authority given its mandate for the provision and maintenance of ports infrastructure in a financially sustainable manner.

Question 2.2.5.

What methodology was used in the 2008 revaluation of the Authorities assets? (Question by SAAFF & SAASOA)

<u>NPA Response</u>:

The Depreciated Optimised Replacement Cost (DORC) method was used to revalue the Authorities assets in 2008. Replacement Cost (RC) refers to the minimum that it would cost, in the normal course of business, to replace the existing asset with a technologically modern equivalent new asset with the same economic benefits.

Variations on the theme of Replacement Cost occur when cognisance is taken of optimisation and depreciation. Optimisation is the process of determining the value of an asset(s) that is equivalent to the market value of the asset(s) of a business in a competitive market. That is, what another party might pay in an arm's length transaction for the assets of a business. It also requires that the optimised set of assets deliver the required levels of service most efficiently, given the constraints applicable to the site and the business. It takes account of overdesign, overcapacity and redundant assets. Taking account of depreciation to reflect the shorter remaining life of the existing assets, we calculate depreciated replacement cost (DRC) and account of optimisation leads to depreciated optimised replacement cost (DORC).

2.3. Operating Costs

Question 2.3.1.

Are operating costs calculated using current, historic or projected figures? Are there any other conditions considered i.e. large investment costs? (Question by ATLAS)

<u>NPA Response</u>:

Allowed operational costs in any given tariff period are to be based on a best forecast of costs for the tariff period under review, supplied by the Authority. Allowed costs may include all costs legitimately incurred in the pursuit of the regulated business.

Question 2.3.2.

Are there any measures in place to ensure operating cost efficiency? If so can you provide further information? (Question by ATLAS)

NPA Response:

Forecast costs for the Authority are determined through a rigorous budgeting process which commences in October each year and is ultimately defended to the Transnet Board of Directors in February the following year. The Authority is of the view that these forecast costs, adjusted for updated information available just prior to the tariff application being made on 1 August each year, be used for tariff determination purposes. Cost increases in excess of inflation will certainly be described fully in the tariff application for the Ports Regulator's consideration. The Authority is further guided by the Port Directive 22(3) (b) which requires that all operating costs, expenses and revenue incurred or generated from a port service or port facility, as well as the value of the capital stock related to such services or facilities are to be declared in the application.

Question 2.3.3.

Have external service providers been consulted to improve efficiencies? (Question by ATLAS)

NPA Response:

By virtue of the rigorous process described above, the Authority has not engaged any service provider to determine the operating cost efficiency in terms of the projected budget.

2.4. Excessive Tariff Increase Margin Credit (ETIMC)

Question 2.4.1.

What are the conditions and rules under which the ETIMC will be utilised? (Question by ATLAS)

NPA Response:

The Authority is of understanding that the ETIMC is a mechanism introduced in the Record of Decision (ROD) FY12/13 by Ports Regulator to offset against future large but justified, tariff increases resulting from the capital expenditure spikes. The Ports Regulator through the road shows on the proposed tariff methodology has invited suggestions (from stakeholders) in writing on the conditions and rules to utilise the ETIMC.

Question 2.4.2.

Can NPA provide their investment expenditure plan that would impact the ETIMC? (Question by ATLAS)

NPA Response:

The Authority has commenced the process of sharing its investment plan in 2012 and plan to continue to update and provide feedback hereon on an annual basis through the Ports Consultative Committee (PCC).

Question 2.4.3.

On the R900million ETIMC, it was indicated that this would be used as a shock absorber to reduce massive increases in future. Shipping lines are currently encountering grave economic difficulties and current increases are already shocking. Given that this is the view of port users the ETIMC should be used sooner rather than later to keep the Port as competitive as possible. The stated use of this to prevent tariff increase to pay for the new dug out Port is not acceptable and should be struck out of the document presented. At the presentation it was mentioned that how the dig out port should be paid for is not considered. Does NPA consider that current Port users should also absorb part the cost of the new mooted new dug out Port? Or would that cause major economic difficulty? (Question by SAASOA)

NPA Response:

The Authority is of understanding that the ETIMC is a mechanism introduced in the Record of Decision (ROD) FY12/13 by Ports Regulator to offset against future large but justified, tariff increases resulting from the capital expenditure spikes. The Ports Regulator through the road shows on the proposed tariff methodology invited suggestions in writing on the conditions and rules to utilise ETIMC. In terms of the proposed tariff methodology, it is envisaged that the current port users will contribute to the funding of future capital investment in order to ensure continued provision of port infrastructure on a timeous basis to support economic trade flow growth.

2.5. Financing Factor

Question 2.5.1.

We do not understand why an additional financing factor is needed, please provide further info? (Question by ATLAS)

NPA Response:

Financing factor has been included for the Authority to borrow money from the port users to finance port activities should the allowable revenue (i.e. Revenue Requirement model) determined by Ports Regulator be insufficient to meet the Authority’s debt obligations projected.

Question 2.5.2.

At what interest rate is this financing, at a Premium or Discount to what Transnet could achieve through the open market? (Question by ATLAS)

NPA Response:

Financing factor will attract an interest rate equal to the WACC determined by the Ports Regulator for the period of the financing. There is a high likelihood that such financing will differ from the open market.

2.6. Proposed multi-year tariff process

Question 2.6.1.

Is it the intention to request increases at a set rate per annum for a particular number of years similar to that recently granted to ESKOM by the National Energy Regulator? (Question by SAAFF)

NPA Response:

The Authorities proposes a multi-year tariff similar to Eskom as it would provide port users with tariff adjustment certainty by having a defined tariff adjustment for a set period of time.

Question 2.6.2.

If such request is granted how any surpluses or deficit in revenue generated be adjusted? (Question by SAAFF)

NPA Response:

The Authority's tariff methodology proposed that the Ports Regulator should conduct a review of the methodology to ensure that the contents still reflect the regulatory circumstances existing at the time of the application. The Authority recognizes that special circumstances may arise that may necessitate changes to be effected, perhaps sooner than the formal review cycle convenient to Ports Regulator's time frame.

To ensure compliance, the Authority proposes that a Regulatory Monitoring Account (RMA) be created separately to deal with surplus or deficit in revenue during the allowed multi-year tariff process. This will require the Authority to report on a regular basis to the Ports Regulator on its operations (i.e. CAPEX, OPEX, RAB etc.) to determine the deviations in revenue granted. The RMA will be measured as a percentage of total allowed revenue. Thresholds would be agreed upon and if the allowed revenue is within the thresholds, then there will be no immediate pass-through adjustment but the RCA balance will be adjusted after the multi-year cycle. If the allowed revenue is above the agreed thresholds, the multi-year cycle may be re-opened with stakeholder consultation to review the Authority's tariffs.

Question 2.6.3.

Does the Authority intend to keep stakeholders informed of its capital expenditure programme? (Question by SAAFF)

NPA Response:

The stakeholders would be updated and be informed about the Authorities Capex programme through the respective Ports Consultative Committee (PCC).

2.7. Cash reserves and cash flow

Question 2.7.1.

Does NPA define separate "regulated cash reserves and other liquid assets" similar to its "Regulated asset base"? Does NPA keep separate accounts for such a "regulated cash reserves and other liquid assets"? Please provide NPA's current balance of such "regulated cash reserves and other liquid assets" and interest received thereon. Please provide NPA's "regulated cash flow forecast or planning" for the coming five years. If no "regulated cash reserves and other liquid assets" are not being kept separately please advise the same information as per NPA's financial statements. In this case please also advise why "regulated cash etc." is not kept separately. Please advise if interest income is offset against the cost of capital. Please provide NPA's "regulated liabilities". Please advise what happens with NPA's surplus cash. Is it being returned to Transnet or to the shareholder? (Question by SAASOA)

NPA Response:

Cash generated by the Authority is a function of revenue allowed in terms of the proposed tariff methodology, offset by operating cost, capital expenditure, taxation and recapitalisation of the Authority by Transnet Group. The Authority's daily working capital movement are accounted for in the Authority's bank account, which is swept to Transnet Group account every evening. This sweeping by Transnet Group is accounted for by the Authority on its balance sheet through a ''current account''. This current account is further used as a mechanism for loan funding that the Authority may require to meets its CAPEX requirement as well as recapitalisation of the division in line with the Transnet Group Policy, on an annual basis. The balance of the current account at each reporting period is considered in determining the gearing ratio when calculating the Weighted Average Cost of Capital to be applied in the tariff methodology. The Authority does not hold any other liquid asset, whilst any balance of cash at financial year end in its bank account is fairly minimal.

3. Abbreviations and Definitions

"WACC"	Weighted Average Cost of Capital
"CAPM"	Capital Asset Pricing Model
"MRP"	Market Risk Premium
"MDS"	Market Demand Strategy
"SARB"	South African Reserve Bank
"DMS"	Dimson, Marsh and Staunton
"ETIMC"	Excessive Tariff Increase Margin Credit
"Authority"	means National Ports Authority, a division of Transnet.
"Act"	means the National Ports Act No. 12 of 2005