



Directlink Joint Venture

Attachment 10-1

Outsourcing arrangements
and margins

Effective
July 2020 to June 2025

1 Introduction

Energy Infrastructure Investments Pty Limited (EII) understands that the AER will need to satisfy itself that the payments made under the Management, Operations and Maintenance and Commercial Services Agreement (MOMCSA) for the following services satisfy the relevant provisions in chapter 6A of the National Electricity Rules (NER):

- asset management, operating, maintenance and capital services; and
- corporate services.

To assist the AER with its assessment of this issue, EII has prepared the following information on the MOMCSA and demonstrates the consistency of the payments made under this agreement with the operating and capital expenditure criteria contained in rules 6A.6.6(c) and 6A.6.7(c).

The remainder of this section is structured as follows:

- Section 2 provides an overview of the MOMCSA;
- Section 2.2 sets out EII's understanding of the framework that the AER has developed for the purposes of assessing the consistency of outsourcing arrangements with the NER; and
- Section 2.3 applies the AER's framework to the MOMCSA and demonstrates the consistency of its arrangement with the operating and capital expenditure criteria.

2 About the MOMCSA

2.1 *Background to the formation of the contract*

In December 2008 EII entered into an agreement with APA for the provision of asset management, operating, maintenance, capital and commercial services to the EII assets (including Directlink) for an initial term of seven years.¹ The terms of this agreement are set out in the Management, Operations and Maintenance and Commercial Services Agreement (MOMCSA). A copy of this contract has been provided to the AER on a confidential basis.

The MOMCSA was entered into as part of a broader transaction, which involved the establishment of EII Pty Ltd and the sale of nine APA owned assets² (including Directlink), to this unlisted investment vehicle. EII's shareholders include:

¹ The agreement also contains two five year extension options (see section 2 of the agreement).

² The nine assets owned by EII are:

- Murraylink and Directlink Interconnectors;
- Daandine and X41 power stations;

- Marubeni Corporation – 49.9%;
- Osaka Gas – 30.2%; and
- APA – 19.9%.

At the time EII was established, APA was the largest provider of asset management and operating and maintenance services in the Australian energy networks industry. Entry into the MOMCSA was therefore viewed as a means by which EII could access economies of scale, scope and other efficiencies, along with asset management and corporate services expertise, that it would not otherwise be able to obtain on a stand-alone basis.

2.1.1 Services to be provided by APA

The services that APA is required by the MOMCSA to provide EII, as owner of the Directlink assets, include:

- all asset management, operations, maintenance and capital services required for the safe and efficient operation of the asset, including compliance with regulatory obligations. The types of asset management, operating, maintenance and capital services that APA is required to provide under the agreement are set out in Schedule 2 of the MOMCSA; and
- all administrative, accounting and other business functions that EII is required to perform, including in compliance with legal and regulatory obligations, for each of its assets (including the Directlink asset). The types of commercial services that APA is required to provide under the agreement are set out in Schedule 3 of the MOMCSA.

2.1.2 Pricing mechanism

The payments that EII is required to make to APA for the provision of the aforementioned services are set out in section 10.1(e) of the Agreement. In short, EII is required to pay:

- (a) all of the costs and expenses that APA incurs in the provision of asset management, operations, maintenance and capital services, provided they have been approved in an Approved Operating Plan and Budget or an Authority for

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- Tipton West and Kogan North coal seam gas processing plants; and
 - Telfer, Bonaparte and Wickham Point gas pipelines in Western Australia.

See <http://www.apa.com.au/our-business/energy-investments.aspx>.

Expenditure;³ EII is also required to pay APA all of the costs and expenses incurred in connection with existing third party subcontracts;

- (b) all of the expenses reasonably incurred by APA in the provision of commercial services, including the costs of hours worked by APA Group personnel. In accordance with section 10.1(b)(ii) of the agreement, the costs of hours worked are to be calculated by applying agreed hourly rates, which EII and APA must agree from time to time. As noted in this provision, it is the intention of the parties that these costs will be set on a 'cost recovery' basis and less than market rates; and
- (c) a margin of 10% on the costs and expenses identified in (a) and (b).

Notable features of this pricing mechanism include:

- the cost pass-through component, which ensures that any economies of scale, scope and other efficiencies achieved by APA (or its contractors) are immediately passed through to Directlink and, in turn, are passed through to end-users;
- the requirement that costs and expenses are only passed through if they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure, which imposes some discipline on the APA; and
- the margin, which is paid to access the economies of scale and scope and other available to APA as well as APA's asset management and corporate service expertise, IT systems and business processes.

2.2 Framework Used to Assess Outsourcing Contracts

This section sets out EII's understanding of the framework that the AER has developed for the purposes of assessing whether the payments made under outsourcing arrangements satisfy the operating and/or capital expenditure criteria set out in chapter 6A of the Rules.

2.2.1 Background to the development of the framework

During the 2011-2015 Victorian electricity distribution price review process (EDPR), the AER outlined the framework it had developed for the purposes of assessing whether outsourcing arrangements satisfied the operating/capital expenditure criteria in the Rules. The AER also signalled at this time its intention to use the framework in future regulatory decisions.

In simple terms, the framework developed by the AER during the 2011-15 EDPR consisted of a two stage inquiry process that involved:

³ The two exceptions to this rule are that if the expenditure is incurred as a result of an emergency or in connection with imposts or carbon costs they can also be passed through to EII.

Stage 1: distinguishing between those contracts entered into by a regulated service provider that could be presumed to prudent and efficient (ie, those entered into as a result of a competitive market process) and those that could not (referred to as the 'presumption threshold'). Outsourcing contracts that the AER noted could not be presumed to be efficient, unless they were subject to a competitive tender, included:

- contacts that were not entered into on an arm's length basis;⁴
- contracts entered into as part of a broader transaction; and
- contracts involving the conferral of benefit on the regulated service provider in return for it agreeing to pay an artificially inflated price.

Stage 2: undertaking a more detailed review of the contract entered into by the regulated service provider to determine whether the contract price, the contractor's directly incurred costs or some measure in between the two should be used to determine forecast operating/capital expenditure allowances. The level of enquiry required by this stage of the AER's framework depended on whether the contract in question:

Stage 2A: passed the presumption threshold, in which case the *contract price* was assumed to be the starting point for setting future expenditure allowances. The AER's assessment was therefore restricted to examining whether:

- the contract price related wholly to the provision of the regulated services; and
- the contract price gave rise to any double counting of risks or costs with other aspects of the regulated service provider's regulatory proposal.

Stage 2B: failed the presumption threshold, in which case the *contractor's costs* were assumed to be the starting point for setting future expenditure allowances and consideration was then given to whether a margin above these costs was warranted. Those factors that the AER identified as potentially warranting the payment of a margin included:⁵

- any return on and of capital required to compensate the contractor for any assets it owns and uses in the provision of services;
- any allowance required by the contractor to enable it to recover a 'reasonable allocation' of its common costs; and

⁴ Under the AER's framework, parties are assumed to be 'related' if either the ownership interests in the regulated service provider and the contractor are identical or if the owner (or majority shareholder) of the regulated service provider has a *majority* interest in the contractor.

⁵ AER, *Final Decision – Victorian electricity distribution network service providers – Distribution determination 2011-2015*, October 2010, p174.

- any allowance required by the contractor to self-insure against asymmetric risks, to the extent it did not give rise to a double counting across other aspects of the service provider's revenue requirement.

EII understands that Stage 2B of this framework has recently been modified by the AER to reflect the Australian Competition Tribunal's (Tribunal) findings in *Application by Envestra Limited (No. 2)* [2012] ACompT 3 (the 'Application by Envestra'). The remainder of this section provides an overview of the Tribunal's decision and the modifications that have recently been made to the framework.

2.2.2 The Tribunal's decision

In July 2011, Envestra sought leave to apply to the Tribunal for review of a number of aspects of the AER's Final Decision for the South Australian gas network, including its decision not to allow the recovery of the margin payable under Envestra's outsourcing contract with APA (the Network Management Fee (NMF)). Leave was granted by the Tribunal in October 2011 and the Tribunal handed down its decision in January 2012.

In short, the Tribunal found that while it was appropriate for the AER to 'investigate and test' the margin⁶ paid by Envestra, the AER had erred in finding that the margin was inefficient. In doing so, the Tribunal made the following observations about the nature of the margin paid by Envestra and the benefits it derived from outsourcing the operation and maintenance of its assets to APA:

"First it is apparent, at least on the balance of probabilities, ...that it is cheaper for Envestra to pay APA to manage its networks, even taking into account the NMF. Second, it is apparent, at least on the balance of probabilities, that the costs incurred by APA in managing Envestra's networks including the NMF, are within industry standards and that APA is not earning an abnormally large margin on its operations. Third, it appears that APA may well not agree to manage Envestra's networks without the payment of the NMF."⁶

"The evidence before the AER and the Tribunal suggests that the NMF was a payment required to access the management services of APA. APA was able and willing to manage Envestra's network at a lower cost than Envestra could itself. Such a cost is clearly one that would be incurred by a prudent service provider, acting efficiently. Leaving to one side circumstances in which a service provider was in some way trying to "game" the regulatory system (and there is no suggestion that that is the case here) it is not logical to suggest that a prudent service provider should or would choose a more expensive method of exploiting its capital base. If the AER's approach were adopted, it may well lead to regulated service providers not outsourcing and, thus, increasing their operating expenditures. The AER, having disallowed the fee that provides access to outsourced management, would be hard-pressed to disallow the increased costs that would occur as a result.

⁶ Ibid, para 252.

Further, the balance of the evidence suggests that outsourcing is accepted industry practice and that the costs incurred by Envestra in the outsourcing agreement are consistent with industry standards. In those circumstances, it is inappropriate for the AER to maintain that the NMF is necessarily an inefficient cost and that it does not comply with rule 91. This implicit assumption on its part renders the decision to disallow the NMF unreasonable in all the circumstances.”⁷

“... the NMF is not a one-off cost to improve the efficiency of the management of the network. It is a fee that must be paid every year in order to have access to the efficiencies offered by APA. If the NMF is required to be paid in one year in order to access the efficiencies provided by APA, unless circumstances change, the NMF will have to be paid in the following year, and the year after, in order to ensure APA continues to manage the network. APA may well refuse to operate the network if Envestra ceased paying the fee.”⁸

“Outsourcing management of its networks to APA allows Envestra to achieve lower operating costs than it could if it managed its network in-house. There is no evidence that it would be possible for Envestra to outsource this management function for a lower cost or in the absence of the NMF.

Given the lowering of costs that results from the payment of the NMF, it should properly be classed, in the circumstances of this case, as an item of efficient operating expenditure, consistent with NGR r91.”⁹

2.2.3 Modified framework

It would appear from EII’s review of the most recent regulatory decision in which outsourcing arrangements have been examined by the AER (the Envestra draft decision for the Victorian gas networks),¹⁰ that the AER has recently revised its framework to incorporate the Tribunal’s findings. Specifically, it would appear that the AER has modified the scope of the enquiry to be carried out in those cases where a contract is deemed to fail the presumption threshold (Stage 2B). Rather than using the contactor’s actual costs as a baseline and then considering whether any margin above these costs could be warranted, Stage 2B of the AER’s framework now requires consideration to be given to whether:¹¹

1. the total contract cost is consistent with the operating/capital expenditure criteria. Two of the matters that the AER identified in the Envestra draft decision for the Victorian gas networks as being relevant to this consideration are:

⁷ Ibid, paras 261-262.

⁸ Ibid, para 264.

⁹ Ibid, paras 268-269.

¹⁰ AER, *Draft Decision – Access arrangement – Envestra Ltd 2013-17, Part 3*, September 2012.

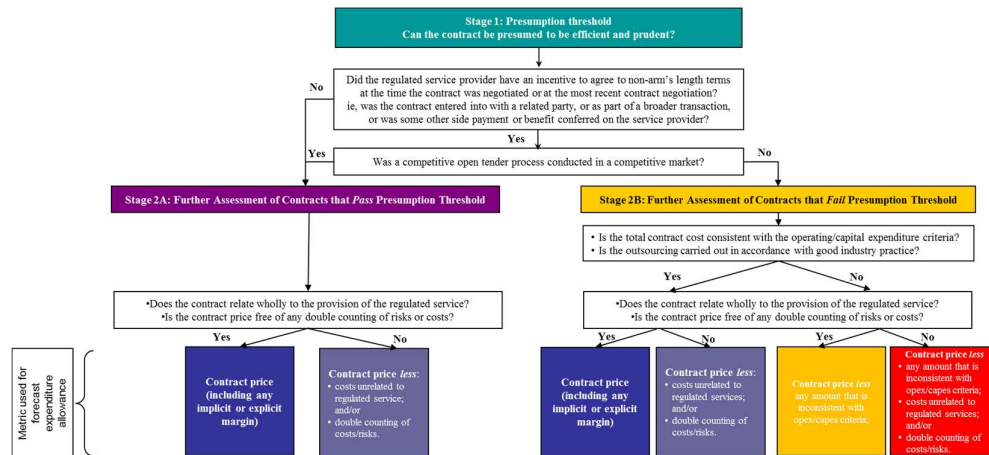
¹¹ Ibid, p.103.

- the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets;¹² and
 - the operating expenditure and productivity performance of the regulated service provider *vis-à-vis* other regulated service providers.¹³
2. the outsourcing is carried out in accordance with good industry practice;
 3. the costs within the contract relate wholly to the provision of the regulated service; and
 4. there is any double counting of costs or risks between the contract and the regulatory proposal.

2.2.4 Current framework

Figure 2.1 sets out EII's understanding of the AER's current position on the framework that it will apply when assessing outsourcing arrangements.

Figure 2.1: AER's revised framework for assessing outsourcing arrangements



Source: AER, Final Decision - Victorian electricity distribution network service providers - Distribution determination 2011-2015, p303 and
AER, Draft Decision - Access arrangement – Envestra Ltd 2013-17, September 2012

¹² Ibid, pp. 105-106.

¹³ Ibid, pp. 106-112.

2.3 *Application of the AER's Framework to Directlink*

This section addresses each of the matters identified in the AER's assessment framework as being relevant to a consideration of whether the payments made under an outsourcing contract will satisfy the operating and capital expenditure criteria set out in chapter 6A of the Rules.

2.3.1 Presumption threshold

The first stage of the AER's assessment framework requires consideration to be given to whether the regulated service provider had an incentive to pay an artificially inflated price at the time the contract was negotiated (or at its most recent renegotiation). Circumstances that the AER has previously stated could give rise to such an incentive include:

- where the parties to the contract were related at the time the contract was negotiated (or re-negotiated);
- where the contractor conferred some form of benefit on the regulated service provider in return for it agreeing to pay an artificially inflated price; or
- where the contract was entered into as part of a broader transaction.

While EII can confirm that it did not agree to pay an artificially inflated price when it entered into the MOMCSA, it understands that because the contract was entered into as part of a broader transaction (see section 2) the AER would want to conduct a more detailed examination of the contract. For the purposes of this analysis, EII has therefore assumed that the MOMCSA would be deemed by the AER to fail the presumption threshold.

Before moving on, it is worth noting that while the MOMCSA was entered into as part of a broader transaction (involving APA as both a shareholder and service provider under the MOMCSA), at the time the contract was entered into APA was the largest provider of asset management services in the energy networks industry. Entry into the MOMCSA was therefore viewed as a means by which EII could access economies of scale, scope and other efficiencies, along with asset management and corporate services expertise that it would not otherwise be able to obtain on a stand-alone basis.

Since entering into the contract, APA has maintained its position as the largest provider of asset management services in the energy networks industry. EII continues therefore to benefit from the economies of scale, scope and other efficiencies available to APA that would not otherwise be available to EII.

2.4 *Consistency of total contract cost with the Rules*

In the most recent decision in which stage 2B of the framework has been invoked (the Envestra draft decision), the AER had regard to the following factors when

assessing whether the total costs incurred under an outsourcing contract were likely to be consistent with the operating and capital expenditure criteria.¹⁴

- the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets;¹⁵ and
- the productivity performance of the regulated service provider *vis-à-vis* other regulated service providers and a range of other partial benchmarks.¹⁶

EII accepts the approach taken by the AER in this context and has considered the extent to which it could undertake a similar analysis of margins and the relative performance of Directlink to demonstrate that the costs payable under the MOMCSA are consistent with the Rules. In short, EII is of the view that while there is some value in analysing the margin payable under the MOMCSA, the same cannot be said for the performance based analysis because the only other regulated interconnector (Murraylink) is owned by EII and is subject to the same type of outsourcing arrangement.¹⁷ EII has therefore given further consideration to how it could demonstrate that the charges it is required to pay under the MOMCSA are consistent with the Rules.

In keeping with the Tribunal's findings in *Application by Envestra*, EII is of the opinion that if it can be demonstrated that outsourcing the following services to APA allows it to achieve *lower* operating costs than it could if it managed its network in-house, then the charges payable under the MOMCSA should be viewed as being consistent with the Rules:¹⁸

- asset management, operating, maintenance and capital services; and
- corporate services

This issue is considered in further detail in the remainder of this section.

2.4.1 Asset management, operating, maintenance and corporate services charges and margin

In accordance with section 10.1(a) and 10.1(c) of the MOMCSA, EII is required to pay APA the following charges for the provision of asset management, operating, maintenance and capital services:

¹⁴ AER, Draft Decision - Access arrangement – Envestra Ltd 2013-17, Part 1, September 2012, p106.

¹⁵ *Ibid*, pp. 105-106.

¹⁶ *Ibid*, pp. 106-112.

¹⁷ As discussed below, the AER has analysed the MOMCSA in relation to Murraylink and approved the Murraylink opex costs including the amount of the margin.

¹⁸ *Application by Envestra Limited (No. 2)* [2012] ACompT 3, January 2012, paras 268-269.

- all of the costs and expenses APA incurs in the provision of these services, provided they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure;¹⁹
- all of the costs and expenses incurred in connection with existing third party subcontracts; and
- a margin on all of the costs and expenses incurred in the provision of these services, which from EII's perspective is paid to access:
 - the economies of scale, scope and other efficiencies offered by APA; and
 - APA's asset management expertise.

Over the next regulatory control period, EII expects to pay APA approximately \$13.5 million pa (inclusive of the margin) for the provision of asset management, operating, maintenance and capital services to Directlink. In the time available, it has not been possible to undertake a detailed bottom up analysis of the costs that EII would incur if it was to provide all of these services in-house and to compare these with the charges that are expected to be paid under the MOMCSA. EII's assessment of the whether these charges (which have been incorporated into Directlink's operating and capital expenditure forecasts) are consistent with the operating and capital expenditure criteria, has therefore been carried out having regard to the following questions:

1. Are the costs and expenses incurred by APA in the provision of asset management, operating, maintenance and capital services likely to be lower than what could be achieved by EII if it was to provide the services in-house?
2. Is the margin payable on these costs and expenses in line with the margins levied by other contractors providing similar services in competitive markets?

In EII's opinion, if these two questions are answered in the affirmative, then it would be reasonable for the AER to infer that the total charge (including the margin) payable for the provision of these services is lower than the in-house cost of provision and therefore *consistent* with the operating and capital expenditure criteria specified in chapter 6A of the Rules. These questions are considered, in turn, in the remainder of this section.

2.4.2 Asset management, operating, maintenance & corporate services costs

To determine whether the costs and expenses incurred by APA in the provision of these services are likely to be lower than what EII could achieve, EII has undertaken a qualitative assessment of the economies of scale, scope and other efficiencies that would be available to APA but not to EII.

As noted previously, APA is currently the largest provider of asset management services in the Australian energy networks industry, providing services to over 55

¹⁹ The two exceptions to this are that if the expenditure is incurred as a result of an emergency or in connection with imposts or carbon costs they can also be passed through to EII.

assets in various locations in eastern and Western Australia. The relative scale of APA's asset management arm and the diversity of interests (both geographically and by type of assets) are such that it would be reasonable to assume that APA can access a range of economies of scale, scope and other efficiencies that would not otherwise be available to EII. These efficiencies are likely to stem from, amongst other things:

- APA's ability to spread its fixed costs across a greater number of activities;
- the scale of APA's operation, which would enable it to obtain greater discounts when procuring materials and service contracts than would otherwise be available to EII;
- the geographic proximity of EII's assets with other assets serviced by APA, which would enable services and personnel to be shared and works to be optimised across assets; and
- the increased capacity of APA to develop specialist expertise (eg, asset management expertise and technical regulatory expertise) across a greater number of assets and locations and to utilise that expertise in the provision of its services.
- Given the ability of APA to access efficiencies and specialist expertise that would not otherwise be available to EII, the costs and expenses it incurs in the provision of asset management, operations, maintenance and capital services can be expected to be *lower* than those that would be incurred if EII were to provide the same services.

2.4.3 Margin on asset management, operating, maintenance and capital services

To determine whether the margin payable under the MOMCSA for the provision of asset management, operating, maintenance and capital services is in line with the margins earned by other contractors, EII has compared it with the arrangements that exist in publicly information on margins.²⁰

- An Evans & Peck report for APA in relation to Agility with returns between 8.5 and 12%
- The 3% margin on revenue that Envestra is required to pay for the provision of operating and maintenance services.
- The K Lowe report for Australian Gas Networks of EBIT returns from 5.3% to 7.3%

The results of this analysis indicate that the level of margin that APA earns changes directly in relation to expenditure and so when it is converted to other methodologies it is volatile.

²⁰ All of these reports were provided to the AER as part of the Murraylink responses to questions, in particular response to AER information request 10.

The APA margin of 10% is entirely consistent with the Evans & Peck report of margins between 8.5% and 12%.

In order to undertake this comparison, it has been necessary to convert the 10% margin on expenditure to an equivalent margin on Directlink's revenue (Envestra) and EBIT for APA (AGN). The calculations are for the set out in Table 2-1.

Table 2-1: MOMCSA margin on asset management, operating, maintenance and capital services expenditure as a % of revenue

| | Formula | Historic | | | | | | | | | | Regulatory Control Period | | | | | |
|---------------------------------------|--------------|----------|-------|-------|-------|-------|-------|-------|-------|-------|-------|---------------------------|-------|-------|-------|-------|-------|
| | | FY 10 | FY 11 | FY 12 | FY 13 | FY 14 | FY 15 | FY 16 | FY 17 | FY 18 | FY 19 | FY 20 | FY 21 | FY 22 | FY 23 | FY 24 | FY 25 |
| Margin on expenditure (\$ m, nominal) | A | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 | 0.7 | 0.7 | 0.7 | 1.3 | 1.3 | 1.2 | 1.6 | 1.3 | 1.2 | 1.4 | 1.0 |
| Directlink Revenue (\$ m, nominal) | B | 12.4 | 12.9 | 12.9 | 13.1 | 13.1 | 13.3 | 13.2 | 13.5 | 14.3 | 14.6 | 15.9 | 17.0 | 18.5 | 19.8 | 21.1 | 12.4 |
| MOMCSA Margin as % of Revenue | C=A÷B | 2% | 2% | 2% | 2% | 3% | 5% | 5% | 5% | 10% | 9% | 8% | 10% | 8% | 6% | 7% | 5% |

As the analysis in this table reveals, the margin payable under the MOMCSA varies across time largely as a result of the variable capital expenditure across time.

The margin under the MOMCSA estimated to account for:

- 2-3% of the revenue earned by Directlink over the period FY 10 – FY13;
- 5-10% of Directlink's proposed revenue requirement between FY 14 and FY 21 as capital expenditure on fire suppression and the control system is undertaken;
- Before declining throughout the forecast regulatory control reflecting the smoothing of capital expenditure to finish at 5%. The expectation would be that this would decline as capital expenditure falls in future years.

The margin payable under the MOMCSA for the provision of asset management, operating, maintenance and capital services should therefore be viewed by the AER as being consistent with the operating and capital expenditure criteria.

The K Lowe report looked at the profitability of the contracts expressed as EBIT as a percent of revenue. This report found over the period of 2010 to 2014 the range of EBIT returns from the agreements in the analysis was 5.3% to 7.3%. With an average of 6.3%.

The table below sets out

Table 2-2: EBIT as a percent of Revenue

| | Historic | | | | | | Transmission Determination Period | | | | |
|------------------------------------------------|----------|-------|-------|-------|-------|-------|-----------------------------------|-------|-------|-------|-------|
| | FY 15 | FY 16 | FY 17 | FY 18 | FY 19 | FY 20 | FY 21 | FY 22 | FY 23 | FY 24 | FY 25 |
| EBIT (\$ m, nominal) | -0.1 | -0.3 | -0.2 | -0.7 | -0.6 | -0.6 | -0.8 | -0.5 | -0.3 | -0.4 | -0.1 |
| APA (\$ m, nominal) | 7.5 | 7.0 | 7.3 | 13.8 | 13.0 | 12.6 | 16.9 | 13.5 | 12.5 | 14.2 | 10.5 |
| MOMCSA EBIT as % of Revenue | -1.6% | -4.0% | -2.5% | -5.2% | -4.9% | -4.4% | -4.9% | -3.5% | -2.6% | -3.0% | -0.9% |

Under this analysis the contract is generating negative returns for APA. This is a demonstration of the difficulties of comparing across different methods of determining margins.

2.4.4 Conclusion on the total charge payable for asset management, operating, maintenance & capital services

It follows from the preceding analysis that:

- the costs incurred by APA in the provision of asset management, operations, maintenance, capital and corporate services are *lower* than those that could reasonably be expected to be achieved if EII were to provide the services in-house; and
- the margin payable to APA for the provision of asset management, operating, maintenance and capital services is substantially *below* the 3% margin on revenue that the Tribunal and the AER have previously found to be in line with the margins earned by other contractors and therefore consistent with good industry practice.

Given these findings, it is reasonable to infer that the total charge payable to APA for the provision of asset management, operating, maintenance and capital services is *lower* than the costs that EII would incur if it was to provide the services in-house. Directlink's operating and capital expenditure forecasts, which are based on the charges that it expects to pay under the MOMCSA over the next regulatory control period, should therefore be deemed to satisfy the operating and capital expenditure criteria set out in chapter 6A of the Rules.

2.5 *Commercial services charges*

In addition to providing asset management, operating, maintenance and capital services, the APA is required under the MOMCSA to carry out all administrative, accounting and other business functions for all of the EII businesses, including Directlink. In return for the provision of these services, EII is required to pay:

- all of the expenses reasonably incurred by APA in the provision of these commercial services;
- the costs of hours worked by APA Group personnel in the provision of these services, which are to be calculated by applying agreed hourly rates. The hourly rates are to be agreed by EII and APA from time to time with the intention being that they will be set on the basis of 'cost recovery' and less than market rates;²¹ and
- a margin on the costs and expenses incurred by APA in the provision of these services, which from EII's perspective is paid to access:
 - the economies of scale, scope and other efficiencies offered by APA;
 - APA's corporate services expertise; and
 - APA's IT systems and business processes.

Over the next regulatory control period, EII expects to pay APA EII approximately \$0.5m million pa (inclusive of the margin) for the provision of corporate services to Directlink. To determine whether these charges (which have been included in Directlink's operating expenditure forecasts) are likely to satisfy the operating expenditure criteria, they have been compared with both:

- an estimate of the corporate overheads that APA would attribute to Directlink if it still had a 100% interest in the asset; and
- an estimate of the costs that Directlink would incur if it was to provide the services in-house.

2.5.1 Charges that APA would levy if it had a 100% interest in Directlink

If APA still had a 100% interest in the Directlink asset, then it would seek to attribute a share of its corporate overheads to this asset. The corporate overheads that it would seek to recover from Directlink would depend on:

- the overall level of corporate costs incurred by APA in the performance of the following functions:
 - Chief Executive Officer function;
 - Company Secretary function;
 - Corporate Finance function;

²¹ See section 10.1(b)(ii) of the MOMCSA.

- Corporate Commercial function;
 - Human Resources function;
 - IT and Transformation function;
 - Legal and Regulatory function; and
 - Projects and Other.
- the method used to allocate corporate overheads across all of APA's assets.

In its submission to the AER on the proposed revisions to the Roma to Brisbane Pipeline (RBP) access arrangement, APA set out in detail:²²

- the market and commercial based incentives that it had to keep corporate overheads as low as possible and the rigorous budgeting and Board approval process that had been put in place to ensure that these costs are prudently incurred; and
- the method that it uses to assign corporate overheads across all of its operating businesses, which has been approved by the AER in a number of instances. In simple terms the allocation method involves:
 - attributing any costs that are directly attributable to a particular asset to that asset;
 - allocating costs among the different assets where there is a causal allocator by which to do so; and
 - allocating any remaining costs (excluding any costs that could be considered 'corporate development', eg, costs associated with investigations for new acquisitions) by revenue.

The reasonableness of this allocation is then tested by comparing it to an allocation based entirely on revenue.

In this case, the corporate overheads that were proposed by APA and approved by the AER, represented 8.8% of RBP's revenue.²³

If the same ratio of corporate overheads to revenue that was allowed in the AER's RBP final decision was used to determine the corporate overheads that APA would attribute to Directlink if it still had a 100% interest in the asset, then it would result in a corporate overheads charge of \$1.39 - \$1.86 million pa over the forecast transmission determination period. As the information in Table 2-3 reveals, this is more than double the corporate services charge that EII expects to pay over the next regulatory control period. This difference is significant and clearly demonstrates the benefits (ie, savings of \$0.48-\$0.52 million pa) that EII and users of the Directlink asset have derived from the MOMCSA.

²² APA, Roma to Brisbane Pipeline Access Arrangement Submission, October 2011, pp. 87-96.

²³ In 2012-13 the corporate costs approved by the AER were \$3.6 m while the approved revenue was \$46.2 million. See AER, *Access arrangement final decision – Roma to Brisbane Pipeline 2012-13 to 2016-17*, August 2012, tables 1.1 and 6.1.

Table 2-3: Corporate service charges in regulatory control period vs estimate of charges that would be recovered if asset owned by APA

| (\$m, nominal) | Historic | | | | | | Regulatory Control Period | | | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------|----------|-------|-------|-------|-------|-------|---------------------------|-------|-------|-------|-------|-------|
| | FY 14 | FY 15 | FY 16 | FY 17 | FY 18 | FY 19 | FY 20 | FY 21 | FY 22 | FY 23 | FY 24 | FY 25 |
| A: Corporate Service Charges included in Directlink's Revenue Proposal | 0.37 | 0.40 | 0.36 | 0.40 | 0.42 | 0.46 | 0.47 | 0.48 | 0.50 | 0.51 | 0.53 | 0.54 |
| B: Indicative estimate of charges that would be levied if APA had 100% ownership interest (8.8% of unsmoothed revenue requirement) | 1.15 | 1.15 | 1.17 | 1.16 | 1.19 | 1.25 | 1.29 | 1.39 | 1.49 | 1.62 | 1.74 | 1.86 |
| C: Difference (A – B) | 0.78 | 0.75 | 0.82 | 0.76 | 0.77 | 0.80 | 0.82 | 0.91 | 0.99 | 1.11 | 0.78 | 0.75 |

2.5.2 Costs that Directlink would incur were it to provide the services in-house

EII addressed these same issues in the context of the Murraylink revenue proposal. Considering the similarities in the nature of the asset and the corporate structure and MOMCSA arrangements, EII considers that the analysis applied to Murraylink is equally relevant to Directlink.

To get an understanding of the costs that Murraylink would be likely to incur if it was to undertake the corporate services currently provided under the MOMCSA in-house, EII engaged KPMG to:

- identify the types of functions that Murraylink would need to perform; and
- develop an estimate of the costs that Murraylink would incur if each of these functions was carried out in-house.

KPMG's findings are contained in a report entitled, *Murraylink - Corporate Cost Benchmarks*, which can be found in Appendix A.

In order to estimate the costs that Murraylink would be likely to incur if it was to provide the corporate services currently provided by APA, KPMG has had regard to benchmark costs for the following types of functions:

- Board of directors;
- Office of the Chief Executive;
- Finance;
- Information and Communication Technology;
- Regulation and Strategy; and
- Contracts Management.

KPMG has also had regard to a number of other matters when deriving its estimates of the efficient costs that Murraylink would be likely to incur, including:

- government regulations and requirements;
- Commonwealth and ASX corporate regulatory requirements;
- the governance arrangements that would be required to support a stand-alone publicly listed company; and
- the magnitude of the revenue generated by Murraylink, the number of customers serviced, the annual operating and maintenance expenditure and the size of Murraylink's capital base.

The results of KPMG's analysis are summarised in the table below.

Table 2-4: KPMG's estimate of the corporate costs that Murraylink would incur if it was to provide these services in-house

| (\$000, nominal) | Low | Medium | High |
|-----------------------------------------|----------------|--------|-------|
| Board of Directors | \$151 | \$249 | \$385 |
| Chief Executive Officer/General Manager | \$397 | \$495 | \$593 |
| Finance | \$153 | \$208 | \$280 |
| ICT | \$403 | \$403 | \$403 |
| Economic Regulation | \$165 | \$191 | \$208 |
| Contracts Management | \$70 | \$85 | \$100 |
| Total | \$1,631 | | |

Source: KPMG, *Murraylink - Corporate Cost Benchmarks*, October 2012, Table 4.1.

As the analysis in this table indicates, were Directlink to undertake the corporate service functions in-house, it would cost approximately \$1.63 million pa. having been undertaken in 2012, this result should be escalated by CPI.

Table 2-5: Comparison of Stand alone with APA provision

| (\$m, nominal) | Forecast | | | | | Total |
|---------------------------------------------------------------------|----------|---------|---------|---------|---------|-------|
| | 2020/21 | 2021/22 | 2022/23 | 2023/24 | 2024/25 | |
| Corporate Service Charges included in Directlink's Revenue Proposal | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 2.6 |
| KPMG estimate of stand-alone corporate costs | 1.9 | 2.0 | 2.0 | 2.1 | 2.1 | 10.1 |
| Difference | 1.4 | 1.5 | 1.5 | 1.5 | 1.6 | 7.5 |

This difference is significant and clearly demonstrates that outsourcing the corporate service functions to APA has resulted in substantially lower costs than would be incurred were Directlink to provide the services in-house. The difference also

highlights the benefits (ie, savings in the order of \$1.5 million pa) that EII and users of the Directlink asset have derived from the MOMCSA.

2.5.3 Conclusion on corporate services charge

In EII's view, the analysis set out above clearly demonstrates that the charges payable for the provision of corporate services under the MOMCSA (including the margin) are substantially lower than what would be incurred if Directlink was still owned by APA or if Directlink was to provide the services in-house. This element of the MOMCSA (which has been incorporated into Directlink's operating expenditure forecasts), should therefore be deemed by the AER to satisfy the operating expenditure criteria in chapter 6A of the Rules.

2.6 *Overall contract cost*

To get some insight into whether the overall charge payable under the MOMCSA is likely to be lower than the cost of providing the services in-house, EII has prepared the following figure, which compares the average charge that it expects to pay over the regulatory control period with the costs that Directlink would be likely to incur under the following counterfactuals:

- APA holds a 100% ownership interest in Directlink; and
- Directlink undertakes the services in-house.

Before examining this figure, it is worth reiterating that in the time available it has not been possible to undertake a detailed bottom up analysis of the costs that EII would incur if it was to provide the asset management, operating, maintenance and capital services in-house. While EII is of the opinion that the costs and expenses APA incurs in the provision of these services (including the margin) would be substantially lower than what it would incur, it has, for the purposes of this analysis, made the simplifying assumption that it would be able to access the same efficiencies and expertise available to APA.

It has therefore been assumed in the stand-alone counterfactual, that EII would incur the *same* costs and expenses as APA (excluding the margin) if it was to carry out these services. The costs and expenses incurred in the provision of asset management, operating, maintenance and capital services are therefore assumed to be the same across all the counterfactuals. It is important to note that this is a simplifying assumption only and that in EII's opinion if it were to provide the services in-house the costs would be substantially higher than those incurred under the MOMCSA.

2.7 *Outsourcing consistent with good industry practice*

In its draft decision on Envestra's access arrangement proposal for the Victorian gas networks, the AER noted that 'industry practice is to outsource the operation of networks to take advantage of economies of scope and scale available to asset management companies'.²⁴²⁵

EII concurs with the AER on this issue and notes that it has acted in accordance with good industry practice by:

- outsourcing the operation of Directlink to a much larger asset management company to take advantage of the efficiencies available to APA that would not otherwise be available to EII; and
- entering into a contract that exhibits many of the characteristics that one would expect to observe in an arm's length contract, such as:
 - a pricing structure that is designed to ensure that:
 - any efficiencies derived by APA are immediately passed through to EII; and
 - EII and end-users are afforded some protection against inefficiencies on the part of APA. This protection is provided by the limitation of costs and expenses that can be passed through to EII to those that have been approved through either the Approved Operating Plan and Budget or an Authority for Expenditure.
 - an appropriate allocation of responsibilities between EII and APA, with EII retaining strategic control over its assets and responsibility for approving the Operating Plan and Budget and any Authority for Expenditure;
 - a transparent budget and reporting process; and
 - the ability of EII to engage other contractors at the end of the initial term (second term or third term) of the contract if APA does not exercise its right to match the price proposed by the other contractor.

2.8 *Other relevant matters*

The final questions that the AER's assessment framework requires consideration to be given to are set out below:

- Do the costs incurred under the contract relate solely to the provision of the regulated service? and

²⁴ AER, *Draft Decision - Access arrangement – Envestra Ltd 2013-17, Part 1*, September 2012, p101.

²⁵ A similar point was made by the Tribunal in *Application by Envestra Limited (No. 2)* [2012], see para 262.

- Do the payments made under the contract give rise to any double counting of costs across other aspects of the regulated service provider's revenue requirement?

EII has considered both of these questions and can confirm the following:

- while the MOMCSA provides for the provision of services to all of EII's assets, Directlink's operating and capital expenditure forecasts only include those costs that are expected to be incurred as a result of the provision of services by APA to the Directlink asset; and
- the allowance that has been made for the contract costs in Directlink's operating and capital expenditure forecasts does not give rise to any double counting across other elements of Directlink's regulatory proposal.

2.9 Conclusion

It follows from the analysis set out above, that the costs payable under the MOMCSA, including the margin, are lower than what EII would incur if it was to provide the services in-house and are therefore consistent with the operating and capital expenditure criteria set out in chapter 6A of the Rules.

2.10 AER assessment of MOMCSA

Both the Directlink and Murraylink interconnectors are subject to the same operating contract (the MOMCSA). This contract has been provided to the AER in the recent Murraylink case and has been provided again in the context of this proceeding.

The AER analysed the MOMCSA in considerable detail in the Murraylink price review process, and accepted the margins charged under that contract.

In reaching that conclusion, the AER found:²⁶

For these reasons, the AER used a benchmarking approach to assess Murraylink's opex forecast margin with margins earned by comparable services providers. Murraylink did not provide any benchmarking of its margin costs so the AER has considered the industry benchmarking report by NERA¹⁸⁶ which was used in the AER's recent draft decision for Envestra.¹⁸⁷ NERA used the earnings before interest and tax (EBIT) margin metric as a standardised measure to assist with comparisons between different businesses.¹⁸⁸ The EBIT metric measured the difference between revenue and operating expenses and so provided a measure of the funds available to a contractor to pay taxes and a return on physical and intangible assets.¹⁸⁹ The EBIT margin standardises this profit measure for the scale of operations by measuring the funds available for these purposes on a 'per unit of revenue' basis.¹⁹⁰ The AER used Murraylink's margin as a ratio of its maximum allowable revenue (MAR) as a comparator.

However, the AER has previously expressed concerns with NERA's benchmarking analysis.¹⁹¹ Specifically, business contracts use margins for different purposes including

²⁶ AER, *Draft decision Murraylink Transmission determination 2013–14 to 2022–23*, November 2012, s3.4.4.

recovery of overheads and returns on assets. Given the variances between terms and price structures of individual contracts, the AER considers EBIT margins may not be compared on a like-for-like basis. The large volatility in the range of margins observed in NERA's sample is an indication that the margins included in the sample may be for different purposes.

Even so, while the NERA benchmarking report does have some limitations, the AER found that Murraylink's margin—about 4.9 per cent of MAR—sits within NERA's 95 per cent confidence interval for all the benchmark comparisons and was also in the most frequently observed category. This suggests that Murraylink's margin is not an 'outlier' and is within a reasonable range of comparable margins. On this basis, the AER accepts that Murraylink's margin paid to APA to operate Murraylink's assets may be reasonably reflective of the efficient cost.

¹⁸⁶ NERA Economic Consulting, *The market risk premium: A report for CitiPower, Jemena, Powercor, SP AusNet and United Energy*, February 2012 (NERA, MRP for the Vic electricity DNSPs, February 2012).

¹⁸⁷ Envestra (Victoria) access arrangement 2013–17, p.105.

¹⁸⁸ NERA Economic Consulting, *The market risk premium: A report for CitiPower, Jemena, Powercor, SP AusNet and United Energy*, February 2012 (NERA, MRP for the Vic electricity DNSPs, February 2012).

¹⁸⁹ The EBIT margin may also incorporate the allowance paid to the contractor to align its interests with those of the asset owner.

¹⁹⁰ NERA also noted that in this context while many companies report EBIT there are many other companies that simply report all sources of revenue and costs while others separately report earnings before interest tax depreciation and amortisation (EBITDA) and depreciation and amortisation (DA). In these circumstances the EBIT measure has been calculated using the information contained in the annual reports. For example, where EBITDA has been reported EBIT.

¹⁹¹ Envestra (Victoria) access arrangement 2013–17, p.106.

As the operating framework and contractual arrangement apply equally to Directlink as to Murraylink, Directlink submits that, consistent with its decision on Murraylink, the AER should find that the margins payable by Directlink are reasonably reflective of the efficient cost.