Murraylink Transmission Company

Attachment 11

Outsourcing arrangements and margins

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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 Murraylink) 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 previously 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 assets (including Murraylink), to this unlisted investment vehicle. EII's shareholders include:

- Marubeni Corporation – 49.9%;

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

- 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 Murraylink 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 Murraylink 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 Expenditure;[2] 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

2 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.

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 Murraylink 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:

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;[3]
- 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:[4]

- 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
- 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.

3 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.

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

EII understands that Stage 2B of this framework has 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 margin' 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."[5]
>
> "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.
>
> 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"[6]

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5 Ibid, para 252.

6 Ibid, paras 261-262.

"… 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."[7]

"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."[8]

2.2.3 Modified framework

It would appear from EII's review of the way in which outsourcing arrangements have been examined by the AER (the Envestra draft decision for the Victorian gas networks),[9] that the AER has 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:[10]

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:
   - the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets; [11] and
   - the operating expenditure and productivity performance of the regulated service provider *vis-à-vis* other regulated service providers. [12]
2. the outsourcing is carried out in accordance with good industry practice;

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7 Ibid, para 264.

8 Ibid, paras 268-269.

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

10 Ibid, p.103.

11 Ibid, pp. 105-106.

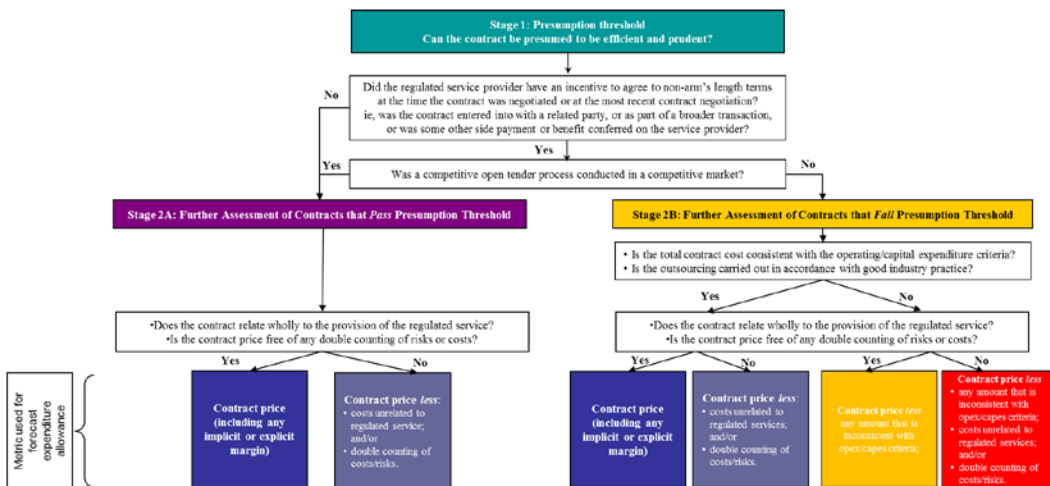
12 Ibid, pp. 106-112.

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

2.3 Application of the AER's Framework to Murraylink

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 a 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.[13]

- the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets; [14] and
- the productivity performance of the regulated service provider *vis-à-vis* other regulated service providers and a range of other partial benchmarks.[15]

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 Murraylink to demonstrate that the costs payable under the MOMCSA

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

14 Ibid, pp. 105-106.

15 Ibid, pp. 106-112.

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 (Directlink) is owned by EII and is subject to the same type of outsourcing arrangement.[16] 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:[17]

- 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:

- 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;[18]
- 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 $8.1 million pa (inclusive of the margin) for the provision of asset management, operating, maintenance and capital services to Murraylink. In the time available, it has

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[16] As discussed below, the AER has analysed the MOMCSA in relation to both Murraylink and Directlink, and approved the amount of the margin in both cases.

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

[18] 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.

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 Murraylink'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 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 3% margin on revenue that Envestra is required to pay for the provision of operating and maintenance services. The margin payable under Envestra's operating and maintenance agreement, has been selected as the reference point for this analysis, because it has been found by both the Tribunal[19] and the AER[20] to be in line with the margins earned by other contractors and therefore consistent with good industry practice.

In order to undertake this comparison, it has been necessary to convert the 10% margin on expenditure to an equivalent margin on Murraylink's revenue. These calculations are set out in Table 2.1.

Table 2.1: MOMCSA margin on asset management, operating, maintenance and capital services expenditure as a % of revenue

FY	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28
Margin	0.31	0.36	0.36	0.47	0.44	0.46	1.77	1.32	0.99	0.91	0.61	0.63	0.71	1.06	0.75	0.59	0.59
Revenue	14.02	14.25	13.30	13.48	13.57	13.52	13.41	14.32	15.13	15.44	17.14	18.34	13.33	14.07	14.85	15.67	16.54
Margin as a percent of Revenue	2.2%	2.5%	2.7%	3.5%	3.3%	3.4%	13.2%	9.2%	6.5%	5.9%	3.6%	3.4%	5.4%	7.5%	5.0%	3.7%	3.6%

As the analysis in this table reveals, the margin payable under the MOMCSA is consistent with the 3% margin on revenue that the Tribunal and the AER have previously found to be consistent with industry practice for these types of services.

Given that MOMCSA is not constructed in revenue terms any analysis would be expected to demonstrate that the amount of margin varies in any individual year or

[19] *Application by Envestra Limited (No. 2)* [2012] ACompT 3, January 2012, para 252.

[20] AER, Draft Decision - Access arrangement – Envestra Ltd 2013-17, Part 1, September 2012, p112.

with regard to any individual project but it is the level over time that should be considered against peer contracts.

Reflected on in this context a margin equivalent to 4.6% of Murraylink's proposed revenue requirement ($ nominal) over the entire contract period until the end of the next regulatory control period is consistent with those operating of previously operating in competitive market circumstances.

This average percentage would be expected to fall again going forward after the end of the forecast revenue control period. This is due to the nature of the contract being expressed as a percentage of expenditure but this analysis being conducted as a percent of revenue.

2.4.4 Industry standard margins on asset management, operating, maintenance and capital services

In 2003 APT as it was then engaged Evans & Peck to undertake study of margins on contracts for service. The report was undertaken at the time when APT contracted with Agility for construction, operation and maintenance services.

The report found that an average margin of 9.5 percent for firms that were providing construction operating and maintenance services as well as design and centralised management services.[21]

Acknowledging this report was written in 2003, it does support a margin of 10 percent as consistent with the analysis conducted at that time.

A report provided by AGN as part of its 2016/17 to 2020/21 access arrangement proposal indicated that a 3% of revenue margin remained at the lower end of the range.[22]

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

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.

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 consistent with the 3% margin on revenue that

[21] Evans7 & Peck, Agility Industry Standards

[22] K Lowe Consulting, Benchmark Study of Contractor Profit Margins (2005-2014),June 2015,p3

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. Murraylink'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 Murraylink. 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;[23] 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 approximately $0.6m million pa (inclusive of the margin) for the provision of corporate services to Murraylink. To determine whether these charges (which have been included in Murraylink'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 Murraylink if it still had a100% interest in the asset; and
- an estimate of the costs that Murraylink would incur if it was to provide the services in-house.

[23] See section 10.1(b)(ii) of the MOMCSA.

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

If APA still had a 100% interest in the Murraylink 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 Murraylink 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;
  - 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:[24]

- 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.

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

In this case, the corporate overheads that were proposed by APA and approved by the AER, represented 6.7% of RBP's revenue.[25]

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 Murraylink if it still had a 100% interest in the asset, then it would result in a corporate overheads charge of $1.00 - $1.20 million pa. As the information in Table 2.2 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 $0.77-$1.08 million pa) that EII and users of the Murraylink asset have derived from the MOMCSA.

Table 2.2: Corporate service charges in regulatory control period vs estimate of charges that would be recovered if asset owned by APA

	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26	FY27	FY28
A: Corporate Service Charges included in Murraylink's Revenue Proposal	0.44	0.53	0.60	0.60	0.62	0.62	0.62	0.62	0.62	0.62
B: Indicative estimate of charges that would be levied if APA had 100% ownership interest (6.7% of smoothed revenue requirement)	0.96	1.02	1.04	1.15	1.23	0.90	0.95	1.00	1.05	1.11
C: Difference (A – B)	-0.52	-0.48	-0.44	-0.55	-0.61	-0.28	-0.33	-0.38	-0.44	-0.49

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

EII addressed these same issues in the context of the Directlink 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 Directlink is equally relevant to Murraylink.

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 was lodged as Appendix A to the last Murraylink revenue proposal.

[25] For 2016/17 the corporate costs approved by the AER were $3.8 m while the approved revenue was $55.4 million. See AER, *Access arrangement final decision – Roma to Brisbane Pipeline 2012-13 to 2016-17*, August 2012, tables 1.1 and 6.1.

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

($000, 2012)	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 Murraylink 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 11 years' CPI,[26] resulting in an estimated $2.0m. This is more than three times what Murraylink expects to pay under the MOMCSA over the next regulatory control period ($2.0 million pa vs $0.6 million pa). 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 Murraylink to provide the services in-house. The difference also highlights the benefits (ie, savings in the order of $1.4 million pa) that EII and users of the Murraylink 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 Murraylink was still owned by APA or if Murraylink was to provide the services in-house. This element of the MOMCSA (which has been incorporated into Murraylink'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 Murraylink would be likely to incur under the following counterfactuals:

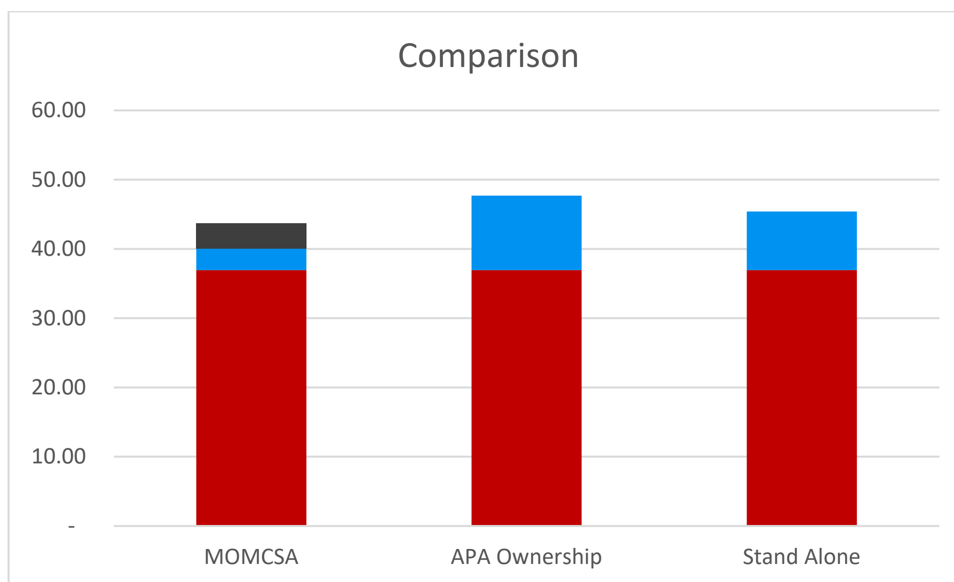
- APA holds a 100% ownership interest in Murraylink; and
- Murraylink undertakes the services in-house.

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.

[26] CPI Sep 2016 (110.4) / CPI Sep 2012 (102.2) = 1.0802.

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.

Figure 2.2: Average costs payable over the Murraylink regulatory control period under the MOMCSA vs APA ownership and stand alone counterfactuals



As the comparison in this figure demonstrates, *even if it is assumed that EII could access the same efficiencies and expertise available to APA*, the overall charge payable under the MOMCSA (including the margin) would still be **$0.3-$0.7 million pa lower** than what it would cost to operate Murraylink under the alternative counterfactuals.

On the basis of this analysis it is clear that outsourcing to APA has allowed Murraylink to achieve lower operating costs than it would if it managed its network in-house or if APA still had a 100% interest in the asset. Consistent with the Tribunal's findings in *Application by Envestra*,[27] the charges payable under the MOMCSA (which have formed the basis for Murraylink's operating and capital expenditure forecasts 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.

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

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'.[28][29]

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 Murraylink 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:

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

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

- Do the costs incurred under the contract relate solely to the provision of the regulated service? and
- 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, Murraylink'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 Murraylink asset; and
- the allowance that has been made for the contract costs in Murraylink's operating and capital expenditure forecasts does not give rise to any double counting across other elements of Murraylink'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 contact (the MOMCSA). This contract has been provided to the AER in both the recent Murraylink and Directlink cases.

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

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