5. Network Management Fee

5.1 Introduction

The Final Decision is in error in disallowing the recovery by Envestra of the Network Management Fee. The Commission's Final Decision is based on an incorrect construction of the Code, an incorrect understanding of the operation of the Operating Agreement and on various matters which have been assumed by the Commission despite an absence of evidence to justify such assumptions.

As the Commission's decision to disallow recovery of the Network Management Fee is in error, Envestra has not amended its Access Arrangement to remove the Network Management Fee.

In response to the Commission's positions, Envestra notes the following points:

(a) The test under section 8.37 of the Code is that the Network Management Fee is recoverable unless it can be shown that it would not be incurred by a Service Provider acting efficiently, in accordance with accepted and good industry practice and seeking to achieve the lowest sustainable cost of delivering the Reference Service.

(b) Section 8.37 does not contemplate that there is a single manner in which a Service Provider must go about structuring its business (as seems to be assumed by the Commission, whose view is that Envestra should not use the outsourcing business model on the basis of which Envestra was established but rather should conduct its operations in-house). Clearly there may be more than one way a Service Provider might, acting efficiently, seek to achieve the lowest sustainable cost of delivering the Reference Service. Therefore if outsourcing operations is one means by which a Service Provider acting efficiently might seek to achieve the lowest sustainable cost of delivering the Reference Service, the costs attributable to that outsourcing are recoverable.

(c) The fact that outsourcing arrangements are both common and consistent with efficient and good industry practice is demonstrated by Mr Holdaway's expert witness statement.

(d) The motive for the original introduction of the Network Management Fee is irrelevant. If the Network Management Fee is one that would be incurred by an efficient Service Provider seeking to achieve the lowest sustainable cost of delivering the Reference Service it is recoverable, whatever may have been the original motive for its introduction.

(e) In any event, the Commission's analysis of the motive for the introduction of the Network Management Fee is incorrect – the reasoning is based on a number of assumptions about Boral's behaviour, with no evidence being adduced to support such assumptions. To proceed to make a determination as to Boral's motivation for introducing the Network Management Fee in the absence of evidence supporting that determination is an error.

(f) Nor is it necessary, contrary to the Commission's view, to link the Network Management Fee back to specific costs incurred by Envestra (or its contractor OEAM) for that fee to be recoverable. If the fee is a payment which would be incurred by a Service Provider acting efficiently, in accordance with good industry practice and seeking to achieve the lowest sustainable cost of delivering the Reference Service, then the fee is recoverable. Therefore if an efficient Service Provider seeking to achieve the lowest sustainable cost of delivering the Reference Service would seek to engage the services of OEAM (and pay the fee to do so) then the fee is recoverable, irrespective of how the fee is applied by OEAM.

(g) However, as previously outlined to the Commission, the fee represents reimbursement of various indirect costs. The specific nature of these indirect costs has been outlined to the Commission by both Envestra and OEAM. The Commission's view that these indirect costs are otherwise reimbursed under the Operating Agreement is in error. The Commission's decision is based upon the manner in which the Commission has construed clause 10.2 of the Operating Agreement, but the construction given by the Commission to clause 10.2 is merely a supposition, which supposition has been made despite the evidence to the contrary submitted to the Commission by Envestra and OEAM. The Commission has not sought any information from Envestra or OEAM as to how the parties construe and administer clause 10.2 and, indeed, has rejected offers to meet with OEAM and Envestra for this matter to be outlined to the Commission. The Commission has provided no reason for rejecting the evidence submitted by Envestra and OEAM on this point.

(h) No evidence has been produced by the Commission that the fee is inflated. The Commission has simply assumed that the fee must be inflated because of its view as to Boral's original motivation. That unsupported assumption has overridden the view of WorleyParsons as to the level of margins generally charged by contractors, the conclusions of the PWC Report and Mr Holdaway's expert witness statement and the benchmarking analysis conducted by Envestra and ECG.

Envestra notes that the lynchpin of the Final Decision is three assumptions made by the Commission, none of which assumptions are established by the Commission to be correct:

(a) the costs Envestra and OEAM state are comprised within the Network Management Fee are already reimbursed under clause 10.2 of the Operating Agreement;

(b) that Boral, at the time of creating Envestra, inflated the Network Management Fee or, at least, had a clear incentive to inflate that fee (which incentive was not mitigated by any countervailing factors); and

(c) that the costs of operating the distribution system were increased as a result of the creation of Envestra and implementation of the Operating Agreement.

5.2 Construction of the Operating Agreement

The Commission's Final Decision is based upon a particular construction that the Commission has made of clause 10.2 of the Operating Agreement. Essentially the Commission has concluded that clause 10.2 allows OEAM to pass all its costs, both direct and indirect, through to Envestra and therefore the Network Management Fee does not relate to any other costs incurred by OEAM.

However the construction the Commission has given to clause 10.2 is incorrect and therefore irrelevant. The construction applied to clause 10.2 by Envestra and OEAM is that it relates to reimbursement of direct costs. While those direct costs include overhead costs of the nature referred to in clause 10.2(d) they do not include indirect costs in the form of a return on assets and Origin Energy corporate and senior management costs. Such costs, as previously explained to the

Commission in Envestra's submission in response to the Draft Decision, letter to the Commission of 9 June 2006 and letter to the Commission of 26 June 2006, are not passed through under clause 10.2 but are recouped under the Network Management Fee. Given the parties have administered the Operating Agreement on this basis for 9 years, and agree as to the correct interpretation of its terms, it is inappropriate for the Commission to proceed to make its decision on the basis of an incorrect construction it has given to the Operating Agreement and with disregard to the evidence provided by Envestra and OEAM indicating that not all of the costs incurred in providing the services to Envestra are recovered under clause 10.2.

To repeat the matters set out in Envestra's submission in response to the Commission's Draft Decision and in its letters of 9 and 26 June 2006, the indirect costs covered by the Network Management Fee comprise:

(a) Origin Energy management time, advice on technical and corporate matters, provision of IT infrastructure, working capital and corporate governance costs; and

(b) rate of return on finance, human resources, procurement and IT Service assets used in connection with the provision of services under the Operating Agreement.

The components of these costs were specifically set out by Envestra in its letter to the Commission of 9 June 2006. As noted in the section of that letter headed "Assessing Specific Costs" the costs that comprise the Network Management Fee include:

(a) deliberations and decisions made by the Origin Energy Board on all corporate matters that impact the business (i.e. business strategy, policy sign-off and compliance);

(b) access to senior management insight and expertise within Origin Energy (which includes costs pertaining to the Office of the Managing Director and the Office of the Chief Operating Officer);

(c) development of corporate policy frameworks including financing arrangements, accounting policy, corporate governance, legal policy and IT policy;

(d) access to Origin Energy technical expertise;

(e) access to Origin Energy group infrastructure; and

(f) management of risk, including the risk of OEAM breaching the Operating Agreement, the risk of costs incurred by OEAM not being reimbursed (because Envestra determines they do not meet the criteria under the Operating Agreement for reimbursement) and reputational risk to OEAM.

Envestra also refers to the KPMG Report and letters from OEAM accompanying this submission, which further explain the operation of clauses 10.2 and 10.4 of the Operating Agreement and also confirm the reasonableness of the level of the Network Management Fee.

The Commission's decision appears to assume that it is necessary to demonstrate that the indirect costs of OEAM add up to an amount equal to the Network Management Fee. This view ignores the fact that indirect costs are, by their nature, imprecise and difficult to quantify. Furthermore the quantum of such costs will vary over time. It is therefore not realistic, nor in accordance with good industry practice, to expect to be able to establish a direct link between the Network

Management Fee and the quantum of such indirect costs.[1] The intent of the Network Management Fee was to set a fee which over time would be sufficient for OEAM to recover its indirect costs, being costs which due to the difficulty of their quantification could not readily be passed through under clause 10.2.

The above analysis also demonstrates the error in the Commission's assumption that the costs of operating and managing the Network increased by the amount of the Network Management Fee upon Envestra's creation. There was no such increase because the Network Management Fee represents costs incurred by the Origin Energy group and costs which in 1997 were incurred by the Boral group (and which costs Envestra would otherwise have to incur if it did not obtain from Origin the benefits represented by the Network Management Fee).

5.3 Risk and Financing Costs

In lines 4271 to 4288 of the Final Decision, the Commission acknowledges that risk transfer and financing costs would justify payment of a margin to OEAM. However the Commission concludes that it should not include a margin on account of OEAM's risk and financing costs in Non Capital Costs because Envestra already has an allowance for risk and financing costs built into its Total Revenue (presumably in the WACC).

This analysis is in error. The allowance for risk and financing costs in the WACC only provides compensation to equity holders for market/systematic risk and to debt capital providers for the costs of debt finance (i.e. no compensation for business specific risk). When the WACC is applied to the regulatory asset base, being the distribution system owned by Envestra, the resulting building block revenue amount compensates debt and equity providers for their respective allocations of capital to the business. It does not provide an allowance for the specific risk[2] and financing costs in respect of the assets employed by OEAM. The Commission's determination excludes any allowance in respect of specific risk and financing costs for such assets in Total Revenue. If outsourcing assists Envestra to achieve lower sustainable costs, then these risk and financing costs of the outsourced entity are legitimate costs, associated with outsourcing, that should be recoverable from consumers.

The clear error in the Commission's reasoning is apparent when the conclusion is taken to its logical conclusion, being that in respect of each subcontractor engaged by Envestra, from OEAM to Envestra's cleaners, the Commission should remove that component of the margin attributable to risk because it is already allowed for in Total Revenue.

5.4 Motive of Boral Limited

The Commission has proceeded on the basis that Boral Limited, at the time of the disaggregation and divestment of Envestra, had an incentive to inflate the Network Management Fee. The Commission therefore concludes that the Network Management Fee must be inflated and therefore is irrecoverable.

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[1] This is noted in the letter from OEAM to the Commission of 26 June 2006 and is the reason why OEAM does not calculate the costs included in the Network Management Fee.

[2] These risks include risk of incurring liability to Envestra under the Operating Agreement, risk of incurring liability to third parties in the course of performing services under the Operating Agreement, risk of Envestra refusing to reimburse specific costs incurred by OEAM and reputational risk (which risk is potentially greater for OEAM than for Envestra given the OEAM business operates in multiple, competitive markets).

Envestra notes that even if the Commission were correct (which it is not) in claiming that the Network Management Fee is inflated above market levels, that would not mean that the entire fee is irrecoverable. It would only mean that such part of the fee above market levels (and which therefore did not meet the section 8.37 criteria) should be disallowed. The Commission has clearly acknowledged in the Final Decision that margins paid to contractors are a recoverable cost – see its analysis under the heading "Inconsistency with Electricity Distribution Price Determination" and lines 4607 to 4609.

No evidence is produced to support the Commission's assumption Boral Limited had an incentive to inflate the Network Management Fee. The Commission simply proceeds on the basis this is the most likely scenario. The Commission's analysis ignores:

(a) that Boral Limited was selling Envestra and therefore also had an incentive not to impose costs upon Envestra that would reduce its value. A Network Management Fee above market levels would be such a cost. Similarly Boral had an incentive not to impose an outsourcing arrangement upon Envestra if it would have been cheaper for Envestra to undertake functions in-house, because the outsourcing arrangement would also have lowered the value of Envestra;

(b) the analysis set out in section 3.10 of Mr Holdaway's expert witness statement, which expands upon paragraph (a) above;

(c) the fact that neither the prospectus for Envestra (which was approved by the directors) nor accompanying expert reports expressed any concern as to the level of the Network Management Fee nor the structure of the OEAM/Envestra relationship; and

(d) the fact that the Commission's analysis implicitly assumes that the directors of Envestra, despite their statutory duties, agreed to a Network Management Fee above market levels.

Envestra also refers to Mr Holdaway's supplementary expert witness statement, which further demonstrates the flaws in the Commission's reasoning and that there is no basis for the Commission's conclusion that Boral Limited inflated the Network Management Fee. Envestra also notes the attached letter from Karen Moses, Chief Operating Officer for Origin Energy Limited outlining the basis on which the Network Management Fee was negotiated in 1997.

As the Commission's determination as to Boral Limited's motives is based entirely on supposition, it is not, as a matter of law, a permitted basis upon which the Commission may reach its determination in respect of the Network Management Fee. In making a decision based on an unsubstantiated supposition, the Commission has committed an egregious error.

The Commission also proceeds on the basis that there can have been no motivation or commercial logic to the introduction of the structure underpinning the Operating Agreement, other than to increase the Boral group's profit. That is, Envestra was established as a small-scale entity with operation and maintenance of its networks conducted for it by OEAM so as to enable Boral Limited to reap the benefit of the Network Management Fee. As well as ignoring the matters noted above, the Commission ignores the fact that there may have been substantial benefits to Envestra arising from the economies of scale, scope and the expertise of OEAM, whose activities extend beyond the operation of Envestra's distribution networks and ignores the other benefits of outsourcing outlined in Mr Holdaway's statement. The Commission also ignores the potential for the Operating Agreement to facilitate long term productivity gains, including the gains due to Envestra's monitoring of the performance of its independent contractor.

The Commission's decision also ignores the expert reports referred to in Mr Holdaway's statement. In SBC Warburg Dillon Read's August 1997 report in respect of Envestra they state:

> "*Although we believe outsourcing the O&M functions is beneficial to Envestra because the company will gain access to the expertise of Boral, the O&M agreement has not been subject to an open tender and does not contain competitive review clauses. We believe that the level of management fees and bonuses however are reasonable for the level of services undertaken by BEAM*."

5.5 PWC Report

The Commission has dismissed the PWC Report on the basis that:

(a) the benchmarking in that report is imprecise and therefore it is difficult to place substantial weight on it; and

(b) the question answered in the report, whether a stand-alone South Australian distribution entity would operate at a higher cost than Envestra's outsourced arrangements, is irrelevant because if Envestra did not engage OEAM Envestra would not operate as a stand-alone South Australian entity. Rather Envestra would manage in-house its networks in Victoria, Queensland and South Australia.

In respect of the Commission's comments on benchmarking, Envestra notes the comments in PWC's supplementary expert statement which accompanies this report. As noted in that supplementary report, the PWC benchmarking data is used extensively by private sector businesses (including entities operating in the energy market) to assess their performance. Given this, the Commission's dismissal of the benchmarking data as of no value is in error and ignores the manner in which competitive firms use benchmarking data to assess their performance.

In respect of the Commission's comments concerning the analysis of a stand-alone South Australian entity, the Commission ignores the fact that the test in section 8.37 is that only those costs which would not be incurred by a prudent Service Provider operating the South Australian network should be disallowed. That is the reference is to an objective, hypothetical Service Provider operating only the South Australian network and not a Service Provider which also happens to own networks in Victoria and Queensland.

If such a Service Provider can be shown to lower the stand-alone cost of operating the South Australian network by outsourcing to an entity such as OEAM, and the Network Management Fee is a cost required to be incurred to achieve such lower costs, then the Network Management Fee is recoverable under section 8.37. The PWC report demonstrates that this is the case (that is the cost of operating the South Australian network is lowered by outsourcing).

Furthermore, PWC then take the costs estimated for the hypothetical Service Provider, and compare them with available benchmarks for a sample of firms. The analysis demonstrates that the estimated costs of the hypothetical Service Provider compare well with the benchmarks. On the basis of this analysis, PWC conclude that the estimated costs are reasonable and prudent.

The point the Commission may be making is that there are some economies of scale and scope that may be achieved through operating multiple networks across Australia that have not been taken into account by PWC. In developing the cost estimates, engineering assumptions were made by PWC around the structure of the organization that would be required. While different minds could propose different structures for the hypothetical Service Provider, the fact that the costs estimated by PWC are consistent with industry benchmarks, that incorporate economies of size, implies that overall the costs are prudent. Therefore the PWC analysis takes into account economies of scale impacts and the conclusion that costs are reduced by outsourcing remains valid. This point is further developed in the supplementary PWC report. Envestra also notes that in that in the supplementary report, PWC has performed further analysis comparing Envestra's position against that of an entity operating three networks. That further analysis also demonstrates that Envestra achieves cost savings through its engagement of OEAM and confirms the conclusions in PWC's first report.

The analysis in the PWC report is therefore correct and the Commission's criticisms of it are not sustainable.

5.6 Benchmarking

The Commission states that it has not relied on benchmarking to arrive at its decision in relation to the Network Management Fee (p.133). The rationale offered for rejecting benchmarking is PEG's conclusion that the studies Envestra has provided are:

> "*problematic with respect to the data chosen, the definition of non-capital costs that excludes network marketing expenditures, the benchmarking techniques employed, the selected operating condition variables and the standards used to evaluate efficiency*".

It is well accepted that in many markets benchmarking is often the best source of information on the relative performance of the firm. PEG state that "Benchmarking evidence could in principle demonstrate that the costs of outsourced services to related parties are efficient (p.3)". Furthermore, the Commission has relied on benchmarking in its determination on the Gas Standing Price Contract (2005) reinforcing the validity of the method for determining efficient costs.

The critical factor influencing the Commission's decision to reject use of benchmarking appears to be criticisms made by PEG of Envestra's approach to benchmarking. Two broad sets of issues are raised by PEG:

(a) Should marketing expenditure be included in the benchmarking?

(b) Is the benchmarking model and data sufficiently rigorous so as to produce reliable results?

On the first issue, Envestra initially chose to exclude marketing from the benchmarking analysis on the grounds that marketing expenditure was influenced by regulatory decisions on the quantum of Non Capital Costs that were available for marketing activities. PEG argued that because marketing affects penetration rates and overall efficiency etc, it should be included in the benchmarking study. For the reasons set out below, Envestra maintains that Envestra's position is correct.

While Envestra agrees that it would be appropriate to include marketing in the analysis if one was determining the total factor productivity of the enterprise, that is not the task here. The task is to determine if Non Capital Costs are efficient and prudent. Envestra provided separate detailed analyses to the Commission on each marketing program that demonstrated they were NPV positive. The results of these analyses were accepted by ECG and the Commission as demonstrating that the marketing programs were prudent. Thus there is no need to look further at the prudence of marketing expenditure. There is a need to determine if the Non Capital Costs, excluding marketing, are prudent. The benchmarking analysis provided by Envestra has the additional benefit of addressing this matter by comparing the costs Envestra incurs in operating and maintaining its network with those of its peers. It demonstrated that the costs were prudent, and represents the only data the Commission has to make such a comparison.

In respect of the second point, Envestra does not dispute that benchmarking is an imprecise process and that various criticisms may be made of the different means through which benchmarking may be undertaken. However, acknowledging these limitations, the fact remains that all benchmarking undertaken in this review process suggests that Envestra's costs are prudent and efficient and no evidence has been produced to the contrary. Further the criticisms in the PEG report of the Benchmark Economics report do not affect the validity of the conclusions in that report - in this respect Envestra refers to the attached supplementary report from Benchmark Economics.

Envestra notes that it has previously engaged PEG to undertake a benchmarking study of its Victorian business. That study, which was undertaken using the approach advocated by PEG in its report to the Commission and which included in cost data the Network Management Fee, concluded that Envestra's actual Non Capital costs were 34% below its predicted value. This difference was statistically significant and resulted in PEG concluding that Envestra was a superior performer with respect to its use of O&M inputs.

Envestra uses a consistent cost allocation methodology that is uniformly applied across all its businesses (ie Queensland, South Australia and Victoria). That is, the fact that PEG has determined that Envestra's Victorian distribution network operates in a prudent and efficient manner provides further support for the fact Envestra's South Australia network operates in the same manner (given the two networks are operated in a similar way). PEG's study is consistent with the benchmarking studies performed in respect of the South Australian network.

In summary:

(a) the Worley Parsons report, Benchmark Economics Report and PWC report all conclude, based on benchmarking studies, that Envestra's costs (including the Network Management Fee) are efficient and prudent;

(b) ECG in its work for the Commission concluded that Envestra's Non Capital Costs are generally prudent and efficient;

(c) the PEG report benchmarking Envestra's Victorian costs demonstrates that Envestra's approach to managing its networks is prudent and efficient;

(d) the QCA in its decision on Envestra's Queensland Access Arrangement in 2006 concluded that Envestra's Non Capital Costs (including the Network Management Fee) for Queensland were generally prudent and efficient.

That is, all empirical evidence sourced for the purposes of the current review supports the position that Envestra's Non Capital Costs (including the Network Management Fee) are prudent and efficient. In contrast there is no empirical evidence supporting the Commission's position, but rather a series of assumptions for which assumptions no substantive evidence has been produced.

5.7 Additional Matters

(a) In respect of the Commission’s statement on page 141 of the Final Decision that “*The Commission is perplexed by Envestra’s suggestion that the removal of the network management fee from the Non Capital Cost forecasts will mean that Envestra will not be able to absorb the fee and will be required to undertake its operations in-house. This suggestion appears inconsistent with Envestra’s argument that it would be more expensive to shift operations in-house relative to outsourcing*”, this statement is either a misunderstanding or misinterpretation of Envestra’s submission. Envestra has no intention of moving operations in-house and increasing its costs. What Envestra is stating is that the result of the Commission’s determination is that it would be more logical for Envestra to move its operations in-house and incur higher costs (on the assumption those higher costs, now being classified as direct Envestra costs, would be recoverable) than continue to lower its costs by employing OEAM given that the Commission refuses to allow recovery of a cost necessarily incurred to engage OEAM.

(b) In respect of the memorandum of the Commission’s consultant, the Allen Consulting Group, Envestra notes the following points:

(i) In their discussion of the statement: “*The network management fee makes up for certain excluded costs*” Allens states: “*This would justify an upward adjustment to the measured costs to take account of those excluded costs..We also note that the appropriate adjustment for any excluded costs is to add those costs to the cost allowance, rather than to add the network management fee*.”

This statement confuses the costs incurred by OEAM and the costs incurred by the Service Provider. The test in section 8.37 of the Code is what are the costs incurred by Envestra, not what are the costs of its contractor. The Network Management Fee is a cost incurred by Envestra and that is the cost recoverable under section 8.37.

(ii) No legal or other support is provided for Allens’ discussion on page 4 of their memorandum as to “technical efficiency.” This discussion is simply Allens’ view as to what should be the regulatory environment. No apparent attempt is made by Allens to interpret section 8.37 and conduct their assessment against the criteria in the Code.

(iii) Allens also appear to assume, for example in their suggestion on page 20 of their memorandum that the Operating Agreement should be assessed against the assumption Envestra is still owned by Origin[3], that the Code contemplates that there never will be a change in the corporate or ownership structure of a

[3] Rather than against the reality that Envestra is an ASX listed company, in which Origin is a minority shareholder.

regulated entity. There is no support for such an assumption in the Code and the assumption is completely at odds with the Code's objective of replicating competitive markets. It is inconceivable that the Code should contemplate that the appropriateness of Envestra's costs be assessed on the hypothetical assumption that Envestra was still part of the same corporate group as 9 years previously, which corporate group was disaggregated prior to the Code even having been finalized let alone enacted. The test in section 8.37 is whether a cost would be incurred by Envestra, in its capacity solely as operator of the South Australian network, given the circumstances faced by Envestra in 2006. What occurred in 1997 is irrelevant to this issue. What is relevant, amongst other things, is that by engaging OEAM Envestra reduces its costs as compared to the alternative of conducting its operations in-house. It is Envestra's costs that the Commission should be considering, not those of OEAM or Boral.

(c) Envestra notes the Commission's comment on page 145 of the Final Decision that "the question of how regulators treat outsourcing arrangements that are established between related parties is an important regulatory issue." Envestra notes that those other regulators who have examined the Operating Agreement, being the Victorian ESC, SAIPAR and the Queensland Competition Authority, have all allowed recovery of the Network Management Fee. Envestra is therefore unsure what comfort the Commission is seeking to draw from the decisions of other regulators. The Commission's statement that if it allows recovery of the Network Management Fee other entities may be encouraged to outsource at an inflated cost to a related party ignores the fact that each outsourcing arrangement will be examined by the relevant Regulator having regard to the particular characteristics of that outsourcing arrangement to assess whether the arrangement meets the requirements of section 8.37. Further, it is not the role of the Commission under the Code to make determinations as to how Service Providers are required to structure themselves – the Commission's role is to assess whether Non Capital Costs satisfy the requirements of section 8.37.

(d) The Commission's analysis also ignores the fact that the effect of its decision may be to discourage outsourcing (because the Commission will not allow recovery of costs inherent in outsourcing) despite the fact that such outsourcing may reduce costs to consumers and the fact that outsourcing is an accepted and common business structure.

(e) The Commission's analysis of section 2.46(b) is superficial. Essentially the Commission has dismissed that section as having no weight. The decision in *Re Michael: Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor* that the balancing of the factors in section 2.24 is a matter for the Regulator does not mean that the Regulator can simply make an arbitrary election as to how it balances those factors. The Regulator must have some reasoned basis for doing so. The Commission's analysis of section 2.46(b) contains no such reasoning.

(f) On page 149 of the Final Decision the Commission states that even if Envestra outsourced to a different contractor and had to pay that contractor a margin, "*this does not imply that such a margin should be included as part of prudent and efficient cost of operating Envestra's South Australian network. Rather, the fact that such a margin would need to be paid would add weight to the Commission's concern that the decision to create Envestra as a stand alone entity without the capacity to operate its business* *was not a prudent and efficient decision*."[4] Effectively, therefore, the Commission is stating that it will not allow recovery of costs inherent in outsourcing arrangements, despite the fact those arrangements are demonstrated, by Mr Holdaway's expert witness statement, to be an efficient and effective means of managing business operations in both regulated and unregulated industries. In effect, the Commission is stating that the Code does not allow recovery of costs inherent in a model which is now customarily accepted as efficient and good industry practice. Having regard to the objectives of the Code as outlined in Section 8.1 of the Code (that is to replicate efficient market practice), the Commission's interpretation of the Code is clearly wrong.

[4] Presumably then the Commission is also stating if a tender were conducted for a replacement contractor and even if every tenderer charged a margin, that margin would be irrecoverable.