

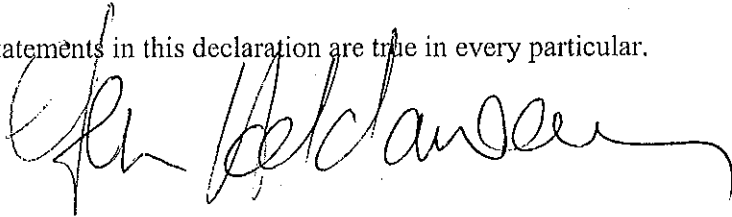
STATUTORY DECLARATION

Statutory Declarations Act 1959 (Cth)

I, GRAHAM HOLDAWAY of KPMG, 147 Collins Street Melbourne, Victoria, make the following declaration under the *Statutory Declarations Act 1959*:

1. I am the author of the Statement titled "Issues pertaining to Envestra's Contract with Origin Energy Asset Management" attached to this declaration ("**the Statement**").
2. I have made all enquiries which I believe are desirable and appropriate and believe that no matters of significance which I regard as relevant have, to my knowledge, been withheld from the Statement.
3. The Statement reflects my opinion on the topics addressed in the Statement.
4. My qualifications are set out in my curriculum vitae attached to the Statement.

I understand that a person who intentionally makes a false statement in a statutory declaration is guilty of an offence under section 11 of the *Statutory Declarations Act 1959*, and I believe that the statements in this declaration are true in every particular.



Declared at Collins Street on 6 June of 2006

Before me,

Alexandra Badham

ALEXANDRA MARIE BADHAM

SOLICITOR

LEVEL 38

530 COLLINS ST

MELBOURNE VIC 3000



Envestra Limited

Graham Holdaway Expert Witness
Statement
Issues pertaining to Envestra's Contract with
Origin Energy Asset Management
Final Report

Audit & Risk Advisory Services
June 2006

This report contains 48 pages
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1 Introduction

1.1 My details

1. Name: Graham Holdaway
2. Address: 147 Collins Street, Melbourne 3000.
3. Qualifications:
 - Bachelor of Commerce and Administration, Victoria University of Wellington (1976)
 - Diploma in Accounting, Victoria University of Wellington (1978)
 - Associate of the Institute of Chartered Accountants in Australia
 - Associate of the Society of Certified Practising Accountants
4. I have been a partner of KPMG for eighteen years. I am responsible for the policy and regulatory advisory services practice.
5. I worked on the reform and privatisation of the Victorian electricity industry, the Victorian gas industry, and the South Australian electricity industry.
6. I have also advised the Korean and Israeli governments on options for reform of their electricity industries.
7. I have advised other Australian Governments on energy policy matters.
8. I have worked for a number of Australian energy network companies on regulatory and energy policy issues.

1.2 The Terms of Reference

9. Envestra Limited ("Envestra") has engaged me to provide my opinion in respect of certain questions included in a Terms of Reference, attached as Appendix B.
10. The questions relate to the Essential Service Commission of South Australia ("ESCOSA's") draft decision on a revised Access Arrangement for the period from 1 July 2006 to 30 June 2011 submitted by Envestra for its South Australian Gas Distribution System. In particular, the questions relate to ESCOSA's determination that Envestra should not be permitted to include the network management fee ("the fee") it pays to Origin Energy Asset Management Limited ("OEAM") as part of its Non-Capital Costs.
11. Envestra has provided the following additional material on which I have relied:

- ESCOSA's Draft Decision¹;
 - The summary of the Operating and Maintenance Agreement, which Section 2.3.1 reproduces; and
 - Envestra's response to ESCOSA's draft decision on the network management fee.
12. I have read the Guidelines for Expert Witnesses and agree to be bound by it.
13. I have given this opinion based in part on the research performed by KPMG staff. I have directed and reviewed this work, and have formed my opinion from this research, and also from my personal experience. The staff members who assisted with the research are:
- Craig Mickle - Bachelor of Business, Curtin University; MBA (Honours), Middlesex University; Graduate Diploma in Applied Finance and Investment (Finsia);
 - Nara Mulquiney – Bachelor of Economics (Honours) and Master of Economics (Honours), University of Sydney; and
 - Joanna Yong – Bachelor of Commerce (Honours), University of Melbourne.
14. I have relied upon the assumptions outlined in Section 2.4.
15. It is my belief that this advice is an exhaustive and complete treatment of my opinion on the matters identified in the Terms of Reference. I have not included matters outside my experience and have expressly identified any qualifications.

¹ ESCOSA, Draft Decision: Proposed revisions to the Access Agreement for the South Australian Gas Distribution System, March 2006.

2 Background information

16. This section outlines background information relevant to my responses to the questions Envestra have asked. It relies on information that Envestra have provided to me and other publicly available information, the sources of which the footnotes indicate.

2.1 Envestra Limited

17. Envestra is a listed entity which owns about 18,800 kilometres of natural gas distribution networks and 1,110 kilometres of transmission pipeline, serving over 950,000 consumers in South Australia, Victoria, Queensland, New South Wales and the Northern Territory. More specifically, Envestra owns the following assets:
- The South Australian Gas Distribution System (the asset at issue in this Statement);
 - A gas distribution system in Eastern Melbourne and North Eastern Victoria ("Stratus Networks");
 - A gas distribution system in Northern Brisbane and the area around Rockhampton and Gladstone;
 - Two small gas distribution systems in NSW (Albury) and the Northern Territory (Alice Springs); and
 - Five gas transmission pipelines in South Australia, NSW, Queensland, Victoria and the Northern Territory, all of which are associated with the aforementioned distribution systems.
18. Envestra has assets with a book value of about \$2.4 billion and it generates its revenue by charging retailers to transport natural gas through these networks. In most cases, Jurisdictional regulators set the prices that Envestra then charge to retailers for using these assets.
19. Envestra was established and listed in 1997 when Boral Limited ("Boral"), now known as Origin Energy Limited ("Origin"), separated its upstream and downstream natural gas assets from its gas network assets, following its decision to focus on the competitive segments of the energy supply chain (consistent with the implementation of National Competition Policy).
20. Envestra's major shareholders at present are Cheung Kong Infrastructure Holdings (Malaysian) Ltd ("CKI"), which owns 134,955,100 shares and Origin which owns 134,955,000 shares. Both own approximately 17.1% of the company's issued capital. Envestra has nine directors, and both Origin and CKI have two directors each.²

² The information in Section 2.1 is drawn from Envestra's website (www.envestra.com.au).

2.2 Origin and Origin Energy Asset Management Limited

21. Origin is a listed entity which is an integrated producer and retailer of energy in Australia and New Zealand. Origin was established and listed in 1999 when Boral separated its upstream and downstream natural gas assets from its building and construction materials business. Origin has a number of lines of business:
 - Oil and gas exploration and production;
 - Electricity generation;
 - Energy retailing; and
 - Networks.
22. The networks business contains gas assets (a one-third share in the SEAgas transmission pipeline and the interest in Envestra) and an asset management business, Origin Energy Asset Management Limited ("OEAM"). OEAM is a wholly owned subsidiary of Origin.
23. For the year ended 30 June 2005, the networks business generated earnings before interest depreciation, amortisation and tax ("EBITDA") of about \$30M on revenue of about \$160M, out of a group total EBITDA of \$928M.³
24. OEAM provides asset management services to:
 - Envestra's gas distribution assets;
 - Coliban Water's assets, via a joint venture with United Utilities; and
 - Other assets including vehicle gas refuelling stations, electricity and telecommunications infrastructure (both in-house and to new clients).⁴
25. OEAM is the major contractor to Envestra and operates, maintains and extends the gas distribution networks.
26. ESCOSA have indicated that Envestra incurs costs via OEAM of about \$25M per annum under a operating and maintenance agreement.

2.3 The Operating and Maintenance Agreement

27. In respect of the Operating and Maintenance Agreement I have been advised as set out below.

³ Origin Energy, Final Results Announcement: Full-year ended 30 June 2005, 29 August 2005.

⁴ See <http://www.originenergy.com.au>

- Operating and Management Agreements have been entered into between Envestra and OEAM for Envestra's networks. These agreements set out the terms and conditions on which OEAM will operate and manage Envestra's networks.
- OEAM has been appointed exclusively to operate and manage the networks in accordance with legal and prudential standards and to provide the services and functions described below and any other services agreed between the parties. The agreements continue until terminated by breach, force majeure or by agreement between the parties.
- OEAM's obligations to Envestra include:
 - Managing the haulage of gas through each network;
 - Operating and maintaining each network;
 - Planning, designing and constructing network extensions;
 - Assisting Envestra with submissions to independent regulators;
 - Assisting Envestra in promoting the use of natural gas;
 - Preparing and settling with Envestra the budget for each financial year;
 - Providing Envestra with regular information on financial and other management issues; and
 - Reading meters and billing retailers.
- The relationship of OEAM to Envestra is that of independent contractor. Under the terms of the agreement Envestra pays to OEAM:
 - All costs and disbursements reasonably incurred or outlaid by OEAM in the performance of its obligations under the agreement
 - A management fee of 3.0 per cent of total network revenue;
 - Incentive bonuses – equal to one third of the reduction in costs from the immediately preceding financial year, after these costs have been adjusted for inflation - for real reductions in:
 - the average capital cost of connecting new consumer sites to the networks; and
 - controllable costs per gigajoule of gas; and
 - Costs and expenses incurred by OEAM consequent upon employees being made redundant.
- OEAM must develop procedures, for approval by Envestra, in relation to billing, System Use Gas, fair market rental or value for OEAM's assets used for the services provided, key design parameters for any network and public relations activities. These procedures are in place.

- Envestra must provide OEAM with access to pipelines and networks and relevant information, and a description of information needed for OEAM's reporting purposes.
 - Envestra has certain veto rights in respect of the engagement of OEAM's general manager.
 - Envestra negotiates third party Access Arrangements with the assistance of OEAM.
 - There is provision for benchmarking of OEAM's costs where they exceed those allowed by a Regulator under a third party Access Arrangement.
28. Envestra and OEAM entered into these agreements when the transaction establishing Envestra occurred (ie. in 1997), or when Envestra subsequently acquired new infrastructure assets.

2.4 Points of clarification

29. The Terms of Reference and my responses to the questions it contains both use certain terms. I provide my view of what these terms mean below, to assist in understanding my Statement.
- **Asset owners:** refers to the party or parties that bear the risks and benefits of ownership of the physical assets of a business. There may be multiple parties in an asset ownership consortium for asset intensive businesses, and there may be various subsidiaries within an asset owner.
 - **Asset management:** refers to the function of operating and maintaining the assets of a business. The term "asset manager" or "contractor" refers to the party that performs this function.
 - **Asset intensive:** refers to industries (or businesses which operate within them) that have a relatively high proportion of asset related costs compared to operating costs. Asset intensive industries include the following industries: Upstream oil and gas; Convention centres; Ports; Power stations; Listed property trusts; Mining and mineral production; Airports; Toll roads; Railroads; Water; and Energy network businesses.
 - **Direct costs:** generally refers to costs that are caused by the production of a particular product or service and may therefore be directly attributed to, or readily identified with, a particular product, service or contract (for example, raw materials used to produce a good). Direct costs are also often referred to as variable costs because typically the quantum of the cost varies with the quantity of output.
 - **Indirect costs:** generally refers to the costs of doing business that are not directly related to a particular product, service or contract (or all non-direct costs). Such costs cannot be readily attributed to, or are not readily identified with the production of a unit of product, service or contract (for example, the cost of a Chief Executive).

- **Margin:** generally refers to the difference between the revenue and costs of a business. Margins can be expressed at a number of levels of a business's Income Statement. A reference to 'margin' in this statement should be interpreted as the difference between revenues and the direct costs of production of a business.

There is a considerable degree of judgement applied in determining what direct or indirect costs are for different purposes and estimating some margins is therefore subject to the same uncertainties.

- **Outsourcing:** refers to when a firm elects to purchase a good or service that previously was made or provided in-house. It involves sourcing and using a supplier that provides the completed good or service rather than buying the components required to produce the good or service in-house. It differs from limited forms of contracting out in the sense that it requires the supplier to focus more on outcomes rather than just activities.

More generally, it refers to a business trend over the last couple of decades toward greater use of outsourcing to provide key business outputs. This trend would appear to be associated with the development of a more sophisticated and competitive economy, with greater levels of specialisation.

- **Regulated industry:** refers to an industry which is subject to direct price regulation by a body similar to ESCOSA. It excludes industries that are price monitored (such as airports and ports). Regulated asset intensive industries include most energy networks, water and rail infrastructure assets.

3 Responses to the questions that I have been asked

3.1 Question 1

Why, from an economic perspective, might asset owners generally enter into arrangements to outsource management, operation and maintenance of their assets and what are the advantages of doing so?

30. Asset owners enter into arrangements to outsource management, operation and maintenance of their assets because they expect it to be more effective and efficient to do so. The advantages that outsourcing can provide underpins these expectations.
31. The potential advantages of outsourcing management, operation and maintenance services include:
 - Enabling the asset owner to focus more on its core competency (i.e. asset ownership and funding);
 - Access to the contractor's greater expertise, focus and experience in providing the services in question;
 - Cost savings from access to the asset manager's ability to benefit from economies of scale (size of operations) and scope (for example, efficiencies due to providing a number of different services);
 - Quicker transfer of new asset management skills and experience into the business by virtue of a contractor's wider exposure to market developments;
 - More effective allocation and transfer of operational risk; and
 - Greater capital market efficiency due to more attractive risk allocation.
32. Economics often expresses the outsourcing question in terms of the 'make' or 'buy' decision. In other words, what are the relative costs and benefits of 'making' versus 'buying' certain goods or services in particular situations. For example, you might be less adept at making something than third parties however you need to weigh this against the transaction costs and risks of contracting with a third party.
33. In many instances the potential advantages of outsourcing will outweigh the transaction costs and risks of outsourcing, whereas in others they will not. It is likely that the advantages and disadvantages of outsourcing will often be different for different companies for the same goods or services. It is also likely that these advantages and disadvantages will vary over time as the business concerned and the market in question evolve. The trend toward greater outsourcing across many sectors of the economy over the last couple of decades, which has been driven by the market's need to find new ways of generating further efficiency improvements, reflects this evolution.

34. As a general rule, however, the more important the activities are in terms of the strategic nature of the work they involve and the risks they entail, the less likely they are to be outsourced.
35. For example, cleaning services for office blocks are typically outsourced. It is typically more efficient for a cleaning specialist to provide cleaning services to a number of buildings, rather than the building operator to hire and manage cleaning staff directly. These specialised cleaning businesses may have greater purchasing power or skills in negotiating with cleaning staff, providing cost efficiencies. In this case it is fairly easy to devise a contract and monitor performance.
36. By contrast, outsourcing a firm's strategic planning function is much less common because it tends to be of fundamental importance to the business, is likely to require the use of specific skills and knowledge that the firm has, and the risks of getting it wrong are substantial and difficult to allocate effectively to a third party.
37. The benefits of outsourcing often stem from the benefits of specialisation. There are often economic benefits in terms of cost efficiencies from parties specialising in providing particular services.
38. Contractors will often have a greater focus on providing the services in question which can lead both to more effective and efficient operation. In other words, contractors will often select more effective means of achieving a certain outcome and execute those means more efficiently. For example, a specialised provider might be able to utilise capital equipment that the "in-house" service provider might either be unable to justify acquiring and/or not skilled enough to utilise properly.
39. There would appear to be a couple of specific issues driving the outsourcing that Envestra has engaged in.
40. First, infrastructure businesses typically engage in a significant amount of outsourcing or contracting out.
41. The arrangements that Envestra has entered into effectively aggregate the outsourcing function and hand the risk and responsibilities for managing these contracts/ors to a third party. One of the drivers for this form of outsourcing is presumably the counterparties (ie. OEAM's) superior technical and procurement expertise. Outsourcing might also be a more efficient way to acquire the necessary skills, particularly when a business owns relatively few assets or assets which are geographically dispersed.
42. Second, independent of any benefits that a firm and a contractor might share from an outsourcing arrangement, such arrangements might also lead to capital market efficiencies. This might arise through the creation of business models that are more attractive to the capital market due to the supply and demand for certain types of investments. In other words, it is not just the firm and the service provider that dictate the relative merits of the 'make' or 'buy' option. The capital markets will also implicitly express a view.

43. AGL's originally proposed demerger illustrates the benefits that can arise in terms of market efficiency, while the outcome (ie. the proposed assumption of the infrastructure assets by Alinta) highlights the benefits of outsourcing in particular.
44. Facilitating the originally proposed demerger required an independent expert's report confirming that the demerger is in shareholders' interests. The AGL Board's expert endorsed the demerger as in shareholders' interests:
- notwithstanding the costs, disadvantages and risks (associated with it);
- ...and despite the fact that:
- there would be no change in the underlying economic interests of shareholders.⁵

It stated there is:

...the possibility of a higher aggregate sharemarket valuation of the two companies compared to AGL alone because of the way in which the market tends to apply different valuation metrics to the different businesses. Following the demerger, each business will be rated by the market on the basis of its particular risk/return profile...⁶

It also noted that the substantial increase in AGL's share price since it announced the demerger endorsed this view.

45. Meanwhile, the proposed demerger resulted in the emergence of an alternative bidder, Alinta, and an agreed demerger proposal has won the endorsement of both Boards.
46. Alinta was prepared to pay more for the infrastructure assets than AGL thought they were worth partly because it had an alternative model for supplying services to those assets; indeed, this was a key difference between the two competing demerger proposals. In its original merger proposal, Alinta highlights the "differences from AGL Demerger Proposal". It then states:

Consistent with the asset allocation principles proposed, we believe the following assets fit better within the Energy Company: Agility...⁷

Agility is AGL's asset manager which it houses with the infrastructure assets and was proposing to continue to do so with its demerger. By contrast, Alinta's Bidder's Statement says:

The Alinta strategy is centred on separating the asset ownership from asset management (including assets wholly or partially owned by Alinta). Alinta (or a subsidiary of Alinta) has operating service agreements over the infrastructure assets in which it holds an ownership interest...Under the operating services agreements Alinta provides a comprehensive suite of services to manage both the business and assets.⁸

⁵ Grant Samuel, Demerger Proposal, 13 February 2006, page 1.

⁶ Ibid., page 4

⁷ See <http://www.alinta.net.au/investor/newsRoom/newsReleases/2006/030306.pdf>, page 16

⁸ Alinta, Bidder's Statement: The Australian Gas Light Company, 18 April 2006, page 33. Alinta's justification for its model goes beyond how the capital markets might perceive it.

It also demonstrates that this model provides the key source of cost savings.⁹

47. Capital markets would currently appear to have a high demand for infrastructure investments. This can be anecdotally observed by the number of recent market offerings (eg. DUET, Alinta Infrastructure Holdings, SP AusNet). Envestra was, as far as I am aware, the first of these investments to become available in the Australian energy network sector.
48. It appears that Australia's relatively high proportion of managed funds, the relative dearth of alternative investments (eg. the limited size of the Government bond market) and historically low global interest rates have all played a part in this process. For example, Australia has more money in managed funds per person than any other developed country, and 25% higher than the second ranked country (the United States).¹⁰ Australia's government bond market is so small that in 2002 the Government held an inquiry into whether it was necessary to maintain that market.¹¹
49. In addition to the significant amount of capital required to acquire these assets, it is also necessary for these new assets owners to manage these assets. Whilst these investors will have the funds to invest, they are unlikely to have the necessary operational skills. Under such circumstances, they may choose to find an equity partner with such skills or alternatively outsource these services.
50. By shifting more of the operational risk to third parties (by outsourcing it) these assets may be more attractive to the market, in the sense that investment in the asset becomes attractive to a wider pool of potential investors.

⁹ Alinta, Bidder's Statement: The Australian Gas Light Company, 18 April 2006, page 47-48, 101.

¹⁰ Sydney Morning Herald, 'Aussies biggest investors in funds', 24 January 2006, page 23 (business).

¹¹ Skeffington, Business Review Weekly, 'Australia's illiquid bond market has its supporters, but others want it abolished', 18 July 2002, page 38.

3.2 Question 2

Are outsourcing-type arrangements common? If there are arrangements similar to the arrangement between Envestra and OEAM of which you are aware, please provide examples.

51. Outsourcing is common, and can range from minor contracting out of specific activities such as cleaning or information technology support, to more "strategic" outsourcing of management, operation and maintenance of the assets.¹²
52. Strategic outsourcing arrangements are also common in a number of asset intensive industries and there are numerous examples of similar arrangements to those between Envestra and OEAM. Indeed, AT Kearney argues that to date utilities are behind other industries in this respect.¹³
53. To assess the prevalence of outsourcing arrangements similar to those that exist between Envestra and OEAM, I have drawn on a desktop study¹⁴ undertaken by my staff on outsourcing arrangements in asset intensive industries.
54. The industries covered in the desktop study were:
 - Upstream oil and gas;
 - Convention centres;
 - Ports;
 - Power stations;
 - Listed property trusts;
 - Mining and mineral production;
 - Airports;
 - Toll roads;
 - Railroads;
 - Water; and
 - Energy network businesses.
55. Appendix C contains a list of all the projects covered in the study.

¹² AT Kearney, 'Complex services and strategic outsourcing unite', *Electric Perspectives*, March/April 2006, page 73-75.

¹³ Ibid.

¹⁴ Collected from publicly available sources including company websites, annual reports and reports by the relevant regulators. We have focussed on privately owned asset intensive businesses but the sample contains a few examples of publicly owned businesses where outsourcing has occurred. It does not include instances where the public sector has considered and rejected outsourcing. However, it is worth noting that the 'purchaser-provider' model is widespread in the public sector and is designed to create similar disciplines and efficiencies.

56. The following table sets out the number of businesses in each industry sector where outsourcing arrangements similar to the arrangements between Envestra and OEAM, were found.

Table 1: Summary of desktop study

Industry	Economic Regulation	Number assessed	In-house operation	Operation outsourced
Upstream oil and gas	No	26	3	23
Convention centres	No	7	2	5
Ports (private)	Mixed	5	2	3
Power stations	No	11	7	4
Listed property trusts	No	8	7	1
Mining and mineral production	No	16	8	8
Airports	Mixed	11	6	5
Toll roads	No	8	5	3
Rail roads	Yes	14	10	4
Water	Yes	3	0	3
Energy networks	Mixed	11	5	6
Total		120	55	65

57. As can be seen from the table outsourcing of asset management is very common in asset intensive industries. The majority of the sample considered outsourced this function. In every industry considered there is at least one example of the outsourcing of asset management. Outsourcing is particularly common in the upstream oil and gas, convention centres and water and energy networks.
58. In the majority of circumstances where asset management is outsourced (ie. 52 out of the 65 examples identified, or about 80%), the asset manager has some equity interest in the assets it manages.
59. Outsourcing asset management does not appear to be unique to regulated industries. It can be observed in unregulated industries such as upstream oil and gas, mining and minerals production and power stations (for example, Hazelwood and Gladstone), as well as in regulated industries such as rail, water and some energy networks.
60. Some notable examples of similar arrangements to those between Envestra and OEAM, identified in the study are summarised in the table below.

Table 2: Some examples of outsourced operations

Industry	Economic Regulation	Asset name	Asset manager	Details on asset manager
Airports	No	Melbourne	BAA	Part owner of the airport.
Energy networks	Mixed	APT	Agility	Owned by AGL who is a part owner of pipelines.
Energy networks	No	Alinta Infrastructure Holdings	ANS	ANS is owned by Alinta, who is part owner of AIH.
Energy networks	Yes	AGL Actew	Agility	Owned by AGL who is a part owner of the network.
Energy networks	Yes	DUET	ANS	Owned by Alinta, who is part owner of DUET.
Upstream gas and oil	No	Gippsland Basin	Esso	Esso is a subsidiary of ExxonMobil who is a part owner of the field.
Upstream gas and oil	No	Carnarvon Basin	Apache	Part owner of the field.
Power stations	No	Hazelwood	International Power Hazelwood	Owned by International Power who is a part owner of the power station.
Power stations	No	Gladstone	NRG	Minority owner of the power station.
Ports	Price monitoring	Flinders Ports	AdEgis	Owned by two minority holders in the consortium that owns the ports.
Ports	Price monitoring	Geelong Port	Toll	Part owner
Mining	No	Mount Newman	Mount Newman Mining Co	Subsidiary of a part owner, BHP Billiton Iron Ore
Mining	No	Mount Goldsworthy	Goldsworthy Mining Ltd Iron Ore	Subsidiary of a part owner, BHP Billiton
Mining	No	Portland Aluminium smelter	Portland Smelter services	Subsidiary of Alcoa who is a part owner of smelter
Mining	No	Boyne Island Aluminium smelter	Comalco	Part owner of smelter
Roads	No	M7	Transurban	Part owner Transurban (not completed yet)

3.3 Question 3

In the case of Envestra, do you consider it advantageous from an economic perspective that it does not perform operational and management tasks "in house"?

61. I have seen no evidence which suggests that it would be advantageous (ie. more effective and efficient) for Envestra to perform in-house the operational and management tasks associated with running a gas distribution business.
62. Moreover, I think it is unlikely that it would be advantageous for Envestra to perform in-house all or even most of the operational and management tasks associated with running a gas distribution business.
63. I base this view on the degree to which all asset intensive business outsource and the strength of this trend in recent times. There are a number of large businesses active in this sector including Abigroup, Tenix, Temp and United Group. In other words, asset intensive businesses that do not outsource operational and management tasks in the same manner as Envestra (ie. to one major contractor) still typically outsource a substantial proportion of their operational and management tasks. Moreover, I understand that OEAM subcontracts a significant proportion of its work for Envestra to other contractors, and utilises its technical and procurement expertise to do this.
64. It would seem reasonable to conclude therefore that Envestra would find it advantageous not to perform all or even most of the operational and management tasks associated with running a gas distribution business. This is because other contractors could almost certainly provide some or most of these services in a more effective and efficient manner.
65. A more relevant point of distinction may be whether it is advantageous for Envestra to outsource to a third party in the way it has (ie. to one major contractor) rather than perform all these functions in-house.
66. Envestra have provided some evidence which appears to support the notion that outsourcing in the way it has to OEAM is advantageous to Envestra. This evidence includes the views of PWC.¹⁵ I have not been asked to review this evidence and do not make any comments about it.

¹⁵ Envestra's response to ESCOSA's draft decision on the network management fee makes reference to a PWC study which assesses Envestra's 'stand-alone' costs if it managed the assets in-house.

3.4 Question 4

Why, from an economic perspective, would contractors generally charge a margin in addition to recovering direct costs incurred in providing services to asset owners and what might a contractor, in charging a margin, seek to obtain or recover from the asset owner?

67. In addition to recovering direct costs, contractors seek to charge a margin to provide for the recovery of an appropriate share of the indirect costs of providing their services, and to provide an adequate return to financiers and investors who supply the capital that is employed in providing the relevant services.
68. If businesses do not charge prices that allow them to recover their indirect costs and provide the return required by their financiers and investors, they would not be charging enough to remain in business over the medium and long term.
69. Indirect costs are incurred to pay for a range of business functions including but not limited to management time and expertise, finance and administration, and human resources. Even though such costs cannot be directly assigned to a particular product or service, they are legitimate and necessary costs of operating a business. A contractor would normally charge a price that reflects an appropriate contribution towards its indirect costs to each of its contracts.
70. It is necessary to provide an adequate return to financiers and investors who supply the capital that is employed by the business because capital is a necessary factor of production and like any other factor, it has a cost. Financiers require a return in the form of interest on the funds they supply, and investors require a return that compensates them for the risks of their investment. Since the cost of capital employed cannot normally be directly attributed to a particular product or service, it could be regarded as a type of indirect cost.
71. A contractor's rationale for charging prices that are sufficient to cover their direct costs plus a margin to cover their indirect costs and cost of capital is, in principle, no different to the cost model employed by ESCOSA to establish the required revenue for Envestra. This model is often referred to as the "building block" model. In both cases, the contractor and ESCOSA are attempting to ensure that the contractor and Envestra respectively recover the total cost of providing their respective services.
72. Under the building block model, Envestra's revenue is set at a level that allows it to recover the efficient direct and indirect costs of its regulated network operations (i.e. maintenance costs and corporate overheads), as well as a required return on debt and equity capital employed.
73. As I understand it, the Epic decision identified the importance of allowing gas access prices to recover more than just a narrow economic definition of what might constitute efficient cost (ie. marginal or incremental costs only).¹⁶

¹⁶ *Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231.

It was noted, however, (Hilmer p269) that where the conditions for workable competition are absent, firms may be able to charge prices above the efficient level for periods "beyond those justified by past investments and risk taken", it being a primary goal of competition policy to increase competitive pressures in such situations. It appears to be inherent in this that in a workably competitive market past investments and risks taken may provide some justification for prices above the efficient level.¹⁷

The Court concluded that the notion of efficient costs did not necessarily preclude the consideration of past investment costs (ie. it therefore is not necessarily limited to a forward-looking exercise of estimating marginal or incremental costs).

¹⁷ Ibid, paragraph 144.

3.5 Question 5

In paying a margin, can an asset owner be said to be purchasing something? If so, what might the margin pay for?

74. When an asset owner purchases operating and maintenance services from a contractor, it pays a price which should, over the medium and long term, reflect the efficient direct costs incurred by the contractor, plus a margin which reflects the contractor's efficient indirect costs and required return on capital.
75. The margin therefore pays for legitimate commercial costs incurred by the contractor in providing the services to the asset owner. The characteristics of the costs reflected in the margin is that they are not directly incremental to the service provided under the contract and must therefore be allocated to the relevant contract.
76. The types of commercial costs that the asset owner is likely to be paying for in paying the margin would include:
- A contribution towards the overheads of the service provider. As mentioned earlier, these include but are not limited to IT costs, finance and administration costs, legal and contract management costs, the costs of the chief executive's office and the costs of running a head office. It is quite possible that the contractor may itself choose to acquire some of these costs from a third party rather than set up the functions in-house (a legal department is a common example). This might be the case where the contractor is a subsidiary of a larger group of entities;
 - A contribution towards the costs associated with acquiring and maintaining tangible assets that the contractor must have in place to properly provide operating and maintenance services to all its customers, such as depots and equipment; and
 - A contribution towards the costs associated with intangible assets that the contractor has or can effectively access, such as technical knowledge and specialist asset management skills.
77. Prices are typically set prior to costs being incurred. The prices a contractor seeks to achieve will reflect the margin it hopes to achieve. However, there is a risk associated with agreeing to provide outputs at a certain price in advance. The risk is that the cost of providing those services is higher than expected. This means that often actual margins will not meet expected margins, as businesses can suffer from an inability to foresee all the reasons why costs might increase and attempt to price with this in mind.
78. An asset owner is also likely to be paying for the costs associated with the performance risks that have been effectively transferred to the contractor through the outsourcing arrangement, and which must therefore be managed by it. This type of risk transfer in service contracts is common in outsourcing arrangements and can be reflected in various ways including by way of penalty and indemnity clauses dealing with non-performance to agreed standards, or by way of non-approval of costs incurred above certain levels.

3.6 Question 6

Could an asset owner retain a contractor without paying a margin?

79. As noted earlier, a business that does not charge prices that are sufficient to recover a margin is most unlikely to be able to remain in business over the medium and long term.
80. There may be times at which a contractor is prepared to discount the price of its services by not charging an asset owner a margin. This is a pricing decision that the contractor would have to make having regard to a range of considerations, including but not limited to the size of the contract, the specific terms and conditions of the contract and the number of other contracts that the contractor already has in place. However, it is unlikely that such an arrangement could be sustained over the long term, or be extended to all customers. It depends, in effect, on the existence of opportunities to charge higher margins on other contracts – such that the average margin covers that necessary for business sustainability.

3.7 Question 7

OEAM instructs us that the network management fee covers a number of indirect costs and benefits to Envestra which are not able to be recovered through reimbursement by Envestra of actual costs incurred in providing the services (see attached list). Please comment on these factors in light of your response to questions 4 and 5 above.

81. It is my understanding that the fee that Envestra pays to OEAM allows for the recovery of OEAM's expected indirect costs of meeting its obligations to Envestra under the contract. Without the fee, OEAM would only recover the direct costs of providing its services to Envestra.
82. Envestra has instructed me that OEAM's indirect costs relate to a range of services which it procures from the Origin group and a charge for recovery of working capital by the Origin group. These include:
- Input and managerial insights from senior management of Origin (including the Board) on a wide range of corporate matters including business development, commercial advice, taxation advice, legal advice, and strategic advice;
 - The return on the infrastructure used by Origin Energy Services for functions (essentially back-office or support functions) such as:
 - Finance – accounts processing, management accounting and the preparation of statutory reports;
 - Human resources – payroll, the development and management of human resource, health, safety and environmental policy and staff training on such policy; and
 - Procurement – purchasing of major infrastructure, contract negotiation and facilities management.
 - Assistance with corporate governance, risk management and internal audit activities.¹⁸
83. If OEAM did not purchase these services from the Origin group, it would incur the costs associated with employing the systems, people and other resources required to operate these functions in-house. Either way, OEAM would still expect to recover these costs under its contract with Envestra.
84. The types of services that OEAM is acquiring from other parts of the Origin group are services that are essential to the proper operation of a business. Without these functions, OEAM would not be able to perform properly its obligations under its contract with Envestra. By way of example, OEAM will not be able to meet its obligations under the

¹⁸ This material is drawn from Envestra's response to ESCOSA's Draft Decision on the network management fee (see page 11).

contract if it does not have in place the payroll management systems and procedures necessary to ensure that the staff who are involved in operating and maintaining Envestra's network are paid on time and at the right rates, and the finance systems in place to ensure that there are sufficient funds available as required to remit payments to staff and disburse payroll-related taxes to the appropriate authorities.

85. I do not consider it unusual that OEAM acquires the types of services listed at paragraph 82 from other entities within the Origin group. It is common for many groups to centralise the management of certain functions – particularly, back-office or corporate support type functions – and to share these services amongst the companies or business units in the group. Providing shared services in this way is typically more cost effective than having the same activities duplicated by each business unit. It also enables the business units to focus on their performance rather than on internal processes. Hence the motivation for shared services is very similar to that which underpins outsourcing.
86. The potential benefit to Envestra of OEAM acquiring the services listed in paragraph 82 from other parts of the Origin group rather than obtaining it in-house is access to greater cost savings. This may be case, for example, if OEAM is able to minimise the indirect costs that it charges to Envestra by acquiring these services at a lower cost from the Origin group because of the economies of scale and scope that the Origin group can achieve.
87. The indirect costs which OEAM indicates it recovers via the fee are consistent with my understanding of the indirect costs that are likely to be represented in a margin, as noted in my responses to questions 4 and 5. The benefits that potentially accrue to Envestra as a result of OEAM acquiring the services represented by its indirect costs from other parts of the Origin group are also consistent with my understanding of why companies outsource to specialised contractors.

3.8 Question 8

OEAM is 100% owned by Origin Energy which also has a minority shareholding (17.1%) in Envestra. In what way(s), if at all, would this affect the relationship between Envestra and OEAM given the terms of the Agreement. Are there any risks associated with this relationship which could result in inefficiency in performing the services under the Agreement?

88. To assess the potential impact of Origin's ownership interest in Envestra on the relationship between OEAM and Envestra and OEAM's efficiency in performing the services under the contract, it is important to understand, in all the circumstances, what impacts Origin's shareholding might have.
89. First, the size of Origin's shareholding in Envestra does not provide it with control over Envestra. Due to the absence of control, OEAM and Envestra are not 'related parties' as I understand that phrase to mean under the Corporations Law and under accounting standards (in relation to consolidation matters). For the same reason, Origin and Envestra are not related parties.
90. Second, whilst Origin does not have control Envestra, it is one of the largest shareholders in Envestra in terms of the size of its interest. However, it is only one of the largest shareholders in Envestra because it shares this position with CKI which has an equivalent shareholding interest in Envestra. This interest gives each party two of the nine directors on Envestra's Board.
91. It is possible that the size of Origin's ownership interest in Envestra is large enough for Origin to exert some influence over decisions that Envestra makes in relation to the provision of services to OEAM.
92. It is possible that Origin could use this influence in ways that are either detrimental or conducive to the efficiency of the arrangements.
93. For example, it is possible that through its ownership in Envestra, Origin (or Boral as it was then known) had the ability to influence Envestra's choice of contractor for operating and maintenance services. It is also possible that Origin would have the ability to influence the continuity of Envestra's contract with OEAM, for instance, by making it more difficult for Envestra to exit the arrangements with OEAM. However, the ability of Origin to act in ways that are not conducive to the efficiency of the arrangements is likely to be constrained by the factors outlined below.
94. There are likely to be countervailing benefits as a result of Origin having a direct ownership interest in Envestra. This means it has some 'skin in the game' of asset ownership which assists in aligning its interests with those of Envestra. For example, this should encourage Origin not to take an overly short term view in regard to maintaining the quality of the assets, even though it can benefit from reduced operating costs.
95. Managing the tension between the potential costs and benefits of the ownership arrangements is something that the capital markets would expect the management and board of Envestra to do. The market's expectation is likely to be that good corporate

governance and systems of internal control should operate to balance these matters. In my experience, capital markets can be harsh in their judgements when their expectations are disappointed. Moreover, in my experience, capital markets are usually reasonably accurate in their assessment of such matters over the medium and long term.

96. In the Origin Envestra situation there is nothing I am aware of that indicates that Origin has used that influence in a way that undermines the efficiency of the services provided under the contract. The outsourcing arrangement between Envestra and OEAM has been in place since 1997 (at which time the agreement was with Boral Energy Asset Management ("BEAM")) and based on my review of various stockbroker reports on Envestra since its listing on the ASX, I am not aware that it is regarded as being uncommercial or non-arm's length from the perspective of the market. Indeed, it has been noted by one stockbroker that:

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.¹⁹

97. In addition, I consider that Origin's ability to exercise any such influence over Envestra in practice is likely to be mitigated by the existence of CKI's equivalent interest in Envestra. This is particularly the case given that CKI itself is a major infrastructure asset owner and manager (and owns ETSA Utilities). Indeed, in my view, CKI's shareholding in Envestra, plus its potential to compete with OEAM is likely to provide Origin with the commercial incentive to ensure that the services supplied by OEAM to Envestra are efficiently priced.
98. The long-standing contractual relationship that exists between Envestra and OEAM should not be presumed to exist solely because of any undue influence that may be exerted by Origin. In my view, there could be a range of good commercial reasons why this relationship has endured or is commercially preferable to Envestra:
- First, as I have noted in my response to Question 9, it is possible that at the time the contract between Envestra and OEAM was first established, there were no other parties other than OEAM that were capable of performing the same services.
 - Second, the types of services that Envestra has outsourced requires specialised and complex skills and resources. Under such circumstances, it is not surprising that once an asset owner has found a competent and responsive contractor, there is a strong incentive to retain that contractor on an ongoing basis. This might explain why the relationship between Envestra and OEAM has endured over time. In my view, as long as the contract contains terms and conditions which create an environment of continuous improvement, provide for cost reviews and for termination for non-performance, the risks associated with potential inefficiency can be managed.
 - Third, the outsourcing of network operations and management entails a high degree of information sharing between the asset owner and the asset manager. Often, much

¹⁹ SBC Warburg Dillon Read, August 1997, Envestra Initial Public Offering – Buy, page 19.

of this information is commercially sensitive. Therefore, once a trusted asset manager has been found, the asset owner may be more inclined to keep the same asset manager rather than employ a new asset manager and therefore risk revealing commercially sensitive information to another party.

- Fourth, the types of services that Envestra has outsourced are important to the growth, performance and sustainability of its network. Under such circumstances, there are significant benefits in ensuring that the incentives of the asset manager to perform to required standards are aligned as much as possible with those of the asset owner. An asset manager with an equity interest in the asset owner has a direct economic incentive to perform for the benefit of the asset owner because any under-performance will affect the value of its own economic interest. In effect, the asset manager is bearing some of the risks associated with asset ownership.

99. In summary, whilst there may be risks associated with OEAM providing services to Envestra given the relationship of both entities with Origin, I consider that such risks may be mitigated by:

- CKI's ownership interest in Envestra; and
- The benefits of Envestra obtaining such services from OEAM.

3.9 Question 9

Question 9: Do you consider that there were/are entities other than OEAM capable of performing the services provided under the Agreement:

- (a) at present;
- (b) at the time the Agreement was entered into?

- 100. I am aware that there are entities other than OEAM that can provide the services provided to Envestra under the Agreement at the present time. One of these is CKI. Others include Agility, Alinta Network Services and Tenix.
- 101. I am not aware of whether there were any entities other than OEAM that may have been capable of providing the same services to Envestra at the time the Agreement was entered into. Outsourcing of network operations and management in the manner that Envestra has achieved it is more prevalent today in the energy sector than it was at the time the Agreement was entered into. However, at the time other choices still existed (ie. in-house service provision or more traditional outsourcing of particular tasks).
- 102. Even if there were other entities other than OEAM that may have been capable of providing the same services to Envestra at the time the Agreement was entered into, as I have noted in my responses to Questions 8 and 10, there are sound commercial reasons why Envestra might still have preferred an arrangement with OEAM and would continue with that arrangement.

3.10 Question 10

If you consider that there are additional matters which are relevant to Envestra's decision to have OEAM manage and operate its gas distribution network, please discuss these in your report.

103. There are some additional matters which are relevant to Envestra's decision to have OEAM manage and operate its SA gas distribution network, given ESCOSA's view in its Draft Decision on whether it ought to allow the margin OEAM currently earns in providing those services.
104. These matters relate to ESCOSA's rationale for disallowing the OEAM margin. In particular, ESCOSA's:
- Findings in respect of the efficiency of Envestra's costs appear to contradict its rationale for disallowing the fee; and
 - Concern about whether the arrangements between the parties are arm's length and market tested appears to misunderstand both Boral's incentives when it established Envestra and the ways market testing often occurs in asset intensive industries.

My understanding of ESCOSA's position

105. ESCOSA proposes to disallow the margin apparently due to concerns about whether the contract between the parties was market tested and made at arm's length. It states:

To the extent that the 3 percent management fee represents a profit margin, the Commission's view is that inclusion of the fee will not reflect the "lowest sustainable cost" for providing the Reference Service, particularly since the contract has not ever been market tested and is not made at arms length.²⁰

106. This implies that ESCOSA is concerned about the profit margins earned by all contractors, but is particularly concerned about those earned in the circumstances it identifies. ESCOSA, however, does not define what it means by the terms 'market tested' and 'arm's length'.
107. In my view, market testing refers to commercial arrangements which have been subject to the disciplines of a competitive market. Arm's length refers to arrangements made between parties which have competing as well as any common interests. Common interests of the sort that might imply a non-arm's length arrangement typically derive from factors which may give a party control of another party, as might arise where an entity is a subsidiary of another party.
108. I see no reason why an economic regulator should be concerned about:

²⁰ ESCOSA, Draft Decision: Proposed revisions to the Access Agreement for the South Australian Gas Distribution System, March 2006, page 153.

- Arm's length and market tested outsourcing arrangements; or
 - Market tested but not arm's length transactions.
109. Equally, I can also see no reason why an economic regulator should be concerned about arm's length transactions which are not market tested, provided it has implemented regulation which provides the regulated business with an incentive to improve its efficiency by profiting from doing so.
110. Given ESCOSA's concern in respect of margins appears to focus on the OEAM contract, it might share the view that only arrangements that are neither arm's length nor market tested should be of concern, but have a different view on what arrangements meet these criterion.
111. I can see why an economic regulator might have a *prima facie* reason for concern about arrangements that might appear both not to be arm's length and market tested. In these circumstances, an economic regulator might be concerned about whether a contract is efficient and thus consistent with providing the services at the lowest sustainable cost. However, while these circumstances might be necessary to draw such conclusions, they are not in my view sufficient.
112. There are three main reasons for this:
- A margin may still be appropriate, even though a contract is neither arm's length nor market tested;
 - It is necessary to examine the incentives of the parties to form a view about whether they are likely to act at arm's length; and
 - Market testing occurs in a variety of ways.

Margins and the nature of the relationship between parties

113. ESCOSA's findings support the view that a margin may still be appropriate, even though a contract is neither arm's length nor market tested.
114. In principle, I see no necessary connection between the nature of a relationship between an asset owner and a contractor and whether the latter might earn a margin. Whether a contractor might earn a margin in any particular circumstances is an empirical question.
115. For example, Envestra's operating costs are likely to include three "types" of costs: costs it incurs itself; costs it incurs via third party contractors other than OEAM; and costs it incurs via OEAM.
116. For costs Envestra incurs directly, it is likely to earn a margin via the return on assets utilised in providing those services (as ESCOSA allows).

117. For costs incurred via third parties other than OEAM, to the extent that these parties are operating efficiently (and Envestra is able to recover the efficient costs of buying these services), they are likely to earn a commercial margin.
118. For OEAM's costs, the same principle ought to apply. In other words, subject to the same efficiency constraints as above, OEAM should be able to earn a commercial margin. Otherwise, ESCOSA would penalise OEAM merely because it is owned by Origin, who also owns shares in Envestra.
119. In other words, if Envestra's costs are efficient then ESCOSA need not be concerned about whether third parties including OEAM are likely to earn a margin or not. Inevitably, at any point in time some are likely to be earning margin on this customer which is either above or below a commercially sustainable level.
120. ESCOSA's draft decision suggests that its consultants concluded that Envestra's Non-Capital costs (inclusive of the fee) be accepted as Code compliant and as efficient (with one minor exception). Moreover, ESCOSA appears to concede that these costs might be efficient, but then also appears to draw a distinction between efficient costs and lowest sustainable costs.²¹
121. Even if it is assumed ESCOSA has a basis for concern about the margin OEAM is earning in particular, the question of what an appropriate margin might be is an empirical one, which benchmarking can address.
122. The equivalent issue arises regularly in respect of taxation law and international transfer pricing in particular. It is also worth noting that under taxation law there are well-established principles to address the enormous variety of transactions that occur within major multinationals (ie. where arrangements might be neither arm's length nor market tested), to ensure that companies do not shift profits to lower taxation countries. In these circumstances, taxation authorities typically either establish a reference price for the service provided or, failing that, require the seller to charge a commercial margin. These reference prices or margins are typically determined by benchmarking.
123. The Australian Taxation Office's TR 94/14 describes the available methodologies.²² Further details on how the ATO applies its transfer pricing rules are located in TR 97/20, TR 98/11 and TR 99/01. These rules are broadly consistent with the OECD's guidelines which are widely applied across OECD countries, as these tax rulings make clear.

Arm's length transactions and incentives

124. To establish whether parties are likely to act at arm's length it is necessary to examine their incentives. Analysing the incentives of the parties at the time Envestra and OEAM (or BEAM as it was then known) entered this arrangement strongly suggests that ESCOSA's concerns are misplaced.

²¹ ESCOSA, Draft Decision: Proposed revisions to the Access Agreement for the South Australian Gas Distribution System, March 2006, pages 151, 153-154.

²² See paragraph 86 and paragraphs 346-390.

125. ESCOSA's primary concern appears to be that the parties might have deliberately agreed to terms that were inefficient and artificially increase Envestra's costs (ie. the network management fee it pays to OEAM is too generous). It is possible that when Boral listed Envestra it deliberately sought to set the fee above a commercial or efficient level; in other words, to engage in some form of "transfer pricing" which would shift profits and value to Boral's, at the expense of Envestra's, shareholders.
126. There is, however, a sound commercial reason why Boral would not have found this in its interests. This is simply because overstating the fee would more likely have destroyed rather than created value for Boral. At best, it is likely to have been a zero sum game.
127. A party seeking to create value along the lines ESCOSA imply typically would seek to capitalise the benefits of charging above market prices and try to pass the risk of those prices being unsustainable to a third party.
128. This is what a property developer might seek to do. In other words, lease a new property at rents that are above market if possible (eg. perhaps by leasing it to a subsidiary or more commonly having rent free periods in return for higher 'face value' rents), sell the property on the basis of those higher rents (i.e. capitalise the rents into the sale price), and pass the risks that those rents will not be sustainable to a third party (ie. when rents are reviewed). To the extent that a property developer is successful in this exercise it will have capitalised the profits but shifted the risk of lower cash flows flowing from that asset over time to the third party.
129. The listing of Envestra by Boral creates the opposite situation and incentive.
130. If Boral were charging above market rates for the fee it would have produced a less profitable Envestra than otherwise would have been the case. In other words, Envestra would likely have sold for less money (ie. Boral would have capitalised the losses associated with charging above market rates).
131. In addition, Boral would have exposed itself to the risk that those fees are unsustainable. In other words, in the event that the margin is removed because it is "inefficient" (as is currently threatened), it seems likely that Envestra will seek to have the contract renegotiated because otherwise it will be harmed financially (ie. by incurring costs under a contract it cannot recover from its customers). Indeed, I understand that the Agreement provides for such an eventuality (ie. by allowing Envestra to benchmark costs in the event that the costs exceed those allowed by a regulator under a third party Access Arrangement, as Section 2.3 identifies).
132. In other words, Boral would have capitalised the losses and exposed itself to the risk that its cash flows would fall at a later time. It is implausible that a rational seller of an asset would deliberately seek to lower the price at which it sells the asset and then also subject itself to the risk that the cash flows it generates from that asset would reduce in future.
133. In addition, Boral would probably have taken into account its growth strategy and its need to maintain a longer term relationship with Envestra to execute that strategy.

134. If Boral were actively trying to achieve the objective implied by ESCOSA, it would more likely have done the opposite of what ESCOSA suggests. In other words, it would have set the fee at an unsustainably low level to create a more profitable Envestra, which would likely have enabled it to sell for a higher price. It would also have inserted a clause to have the fee reset to market at a later date. This would have allowed it to capitalise the benefits of a more profitable Envestra and shift the risk that these benefits were unsustainable to Envestra's shareholders.
135. The available evidence would appear to support the proposition that the fees were set at market levels.
- First, the fees were disclosed in the Envestra's 1997 Prospectus²³ and the expert's reports that it contains make no mention of the unreasonableness of the fees.²⁴
 - Second, Boral's 1997 Annual Report notes the transaction and the value drivers for it. In discussing its key strategies for the year, Boral stated:

Another initiative was undertaken towards the end of the financial year when Boral announced the public sale of its gas distribution networks in South Australia and Queensland into a company called Envestra Limited, for a total consideration of \$889 million.

The transaction was value enhancing for Boral in three ways. Firstly, these infrastructure assets have more value in an appropriately geared independent vehicle than within Boral. Secondly, Boral, together with Envestra, is in an enhanced position to acquire additional downstream energy assets and thirdly, Boral's gearing ratio on completion of the transaction in August 1997, declined significantly to 25%.²⁵
136. Boral's 1997 Annual Report makes no mention of any value enhancing effects associated with the fee that its new contract would generate. This may well be because Boral and the range of expert advisers involved in the transaction saw that using artificially high fees to enhance its value would be, at best, a zero sum game and more likely would destroy value.
137. Boral's explanation about of the benefits of the transaction is consistent with setting the fees at market levels and its incentive to partner with Envestra in future infrastructure acquisitions.
138. It is also worth noting that the transaction occurred in August 1997, which was early in the development of economic regulation. At this time there was relatively little guidance in the form of precedents on how regulators might implement economic regulation. For example, the National Third Party Access Code for Natural Gas Pipeline Systems is dated November 1997 and according to the ACCC's website it made no gas transmission decisions were made prior to 1998.²⁶ At the time of the transaction, the expert regulatory report prepared by PWC indicates that prices for Envestra's SA gas distribution system

²³ http://www.envestra.com.au/files/pdf/EnvPros97_chpt8.pdf

²⁴ http://www.envestra.com.au/files/pdf/EnvPros97_chpt9.pdf

²⁵ Boral Limited, Annual Report 1997, page 7.

²⁶ <http://www.aer.gov.au/content/item.phtml?itemId=678639&nodeId=file426469e79a739&fn=Status%20of%20access%20arrangements%20for%20natural%20gas%20transmission%20pipelines.pdf>

were still set by the SA Government.²⁷ This would have increased the risk associated with any attempt to 'game' the regulator by attempting to second-guess how regulators might respond nearly a decade later.

Market testing

139. ESCOSA does not elaborate on what it considers to be market tested arrangements.
140. I have outlined my view on what constitutes market testing.
141. ESCOSA's implicit view would appear to suggest that a significant proportion of economic activity particularly in asset intensive industries is not market tested. I find this implication most unlikely.
142. I have, for example, observed many cases where contracts between asset owners and managers are established without the use of a competitive tender.
143. There are many reasons why competitive tendering is often not used to identify an asset manager and to negotiate an operating services agreement. These include:
- Cost and complexity of tendering;
 - Time to complete a tender;
 - Price and quality of service must be considered jointly. The lowest price tender is not necessarily the best option. Reputation and trust are also important;
 - Confidentiality, particularly during a bid process; and
 - Insufficient depth in the market to provide asset management services.
144. Bilateral negotiation is often used to set prices and terms for these sorts of contracts in preference to competitive tendering. However, this does not mean that the prices and terms have not been market tested.
145. There are a number of techniques that can be used in bilateral negotiations to establish a competitive price for services including benchmarking, financial modelling and analysis, and scrutinising accounting and other information of the asset manager.
146. In addition to the fact that these techniques are used, and as I have indicated above, there are strong commercial pressures in negotiations between asset owners and asset managers to ensure that the costs of asset management are optimised. These pressures derive from the need for those parties whose economic interest in the management activity is less than in the ownership activity to optimise their returns and vice versa.

²⁷ http://www.envestra.com.au/files/pdf/EnvPros97_chpt8.pdf, page 102.



147. I have not observed many examples of the use of competitive tendering in the provision of asset management services. In most of the industries I have studied I have not been able to establish that competitive tendering for asset management is often used. The fact that it is not commonly discussed is probably an indication of how rare it is.

Access pricing in regulated monopoly industries.

Appointments

Graham is a member of the Panel of Experts established under South Australia's Electricity Act.

Graham is a member of the Essential Services Commission Appeal Panel Pool in Victoria.

Specific Experience - examples

Victoria

- *Department of Industry Innovation and Regional Development, Victoria*
Graham led a team that assisted the Victorian Government with the design and implementation of the Natural Gas Extension Program – which involved Government support for expansion of the gas distribution network to regional towns.
- *Department of Industry Innovation and Regional Development and Department of Infrastructure, Victoria*
Graham leads a team assisting the Victorian Government in its consideration of a major energy intensive investment.
- *Energy Projects Division of Department of Treasury and Finance, Victoria*
Graham applied his financial analysis and regulatory skills to significantly contribute to the reform process for the gas industry in Victoria. Graham led a team with responsibility for:
 - financial modelling and analysis of the industry;
 - transmission, distribution and retail pricing analysis; and
 - economic regulatory aspects of the project.Graham played substantial role in the development of Access Undertakings for three distribution companies and one transmission company.
- *Electricity Supply Industry Reform Unit of Victorian Government*
KPMG was one of the lead advisors to the Victorian Government on ESI reform throughout the reform process. Graham was a key member of the team and had direct responsibility for:
 - financial modelling and analysis of the industry;
 - transmission, distribution and retail pricing analysis; and
 - economic regulatory aspects of the assignment.
- *Office of the Regulator-General, Victoria*
Graham led a KPMG team that provided financial and economic advice to the ORG during the period its establishment.

- *Gippsland Water*
Graham led a team that undertook a strategic analysis of the options facing this regional water/sewerage authority. A key part of the project was the development of a cost of supply model which provided a fifteen year forecast of the economic cost of Gippsland Water products.
- *Melbourne Water*
Graham acted as a mediator between Melbourne Water and South East Water in relation to a dispute involving prices for monopoly like services.
- *National Generators Forum*
Graham provided expert opinion on behalf of the National Generators Forum on the method by which NEMMCO set Participant Fees. He subsequently participated in an expert witness's conference at the direction of the appeal authority.
- *Victorian infrastructure businesses*
Graham has worked for many of the electricity and gas network owners on matters relating to access pricing. He has provided due diligence advice to parties considering the acquisition of Victorian electricity and gas assets.

South Australia

- *Electricity Reform and Sale Unit, South Australian Government*
Graham has led a group of KPMG specialists that provided ERSU with advice on economic regulation of transmission, distribution and retail prices, and the financial modelling to support price setting.
- *ElectraNet Ltd*
Graham has provided advice on regulatory strategy
- *ETSA Utilities Ltd*
Graham has provided advice on regulatory strategy.

Western Australia

- *Epic Energy Ltd*
Graham led a team that assisting Epic to prepare an Access Arrangement for the Dampier to Bunbury natural gas transmission pipeline in Western Australia and subsequently to challenge the Regulator's decision.
- *AlintaGas*
Graham led a small team which established an Access Arrangement under the National Gas Code for AlintaGas. The Access Arrangement established terms and conditions for third party use of AlintaGas' distribution system and set prices for system use.
- *Western Power Networks*
Graham has provided advice on regulatory strategy.

New South Wales

- *Independent Pricing and Regulatory Tribunal of NSW*
Graham led a team that assisted IPART to review the Access Arrangement submitted by AGL Gas Networks Ltd.

Queensland

- *Epic Energy Ltd*
Graham led a small team to assist Epic with a cost of service analysis and pricing for Epic's South West Queensland pipeline.
- *Powerlink Queensland Ltd*
Graham has provided advice on regulatory strategy.

Northern Territory

- *NT Power Ltd*
Graham led a team assisting NT Power to obtain access to the electricity transmission and distribution systems owned by the Northern Territory's Power and Water Authority. He participated in negotiations with the Northern Territory Government on behalf of NT Power. He provided expert testimony for NT Power's litigation against PAWA and the Northern Territory Government.

Tasmania

- *Department of State Development*
Graham led a team that assisted the Government of Tasmania to attract a gas distributor using the tender provisions of the National Gas Code.

Experience prior to KPMG

Before joining KPMG Graham held financial management positions with:

- AMP Society (1973 – 78);
- Goodman Fielder Ltd (1980 – 82); and
- ACI International Ltd (1982 – 84).

B Terms of Reference



4 May 2006

Mr Craig Mickle
KPMG
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Sydney NSW 1213

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Adelaide, South Australia 5000
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Dear Craig,

You will be aware that Envestra Ltd has submitted a revised Access Arrangement for the period 2006 – 2010 to the Essential Services Commission of South Australia ("the Commission"). The Commission has issued a draft decision in relation to the revised Access Arrangement. The Commission has requested responses to the draft decision by this Friday 5 May 2006. The draft decision includes a determination that Envestra should not be permitted to include the network management fee it pays to Origin Energy Asset Management ("OEAM") in its non-capital costs.

Envestra requests that you provide it with a written report setting out your opinion in relation to its arrangement with OEAM, in particular, please set out your opinion in response to the following specific questions:

1. Why, from an economic perspective, might asset owners generally enter into arrangements to outsource management, operation and maintenance of their assets and what are the advantages of doing so?
2. Are outsourcing-type arrangements common? If there are arrangements similar to the arrangement between Envestra and OEAM of which you are aware, please provide examples.
3. In the case of Envestra, do you consider it advantageous from an economic perspective that it does not perform operational and management tasks "in-house".
4. Why, from an economic perspective, would contractors generally charge a margin in addition to recovering direct costs incurred in providing services to asset owners and what might a contractor, in charging a margin, seek to obtain or recover from the asset owner?
5. In paying a margin, can an asset owner be said to be purchasing something? If so, what might the margin pay for?
6. Could an asset owner retain a contractor without paying a margin?

7. OEAM instructs us that the network management fee covers a number of indirect costs and benefits to Envestra which are not able to be recovered through reimbursement by Envestra of actual costs incurred in providing the services (see attached list). Please comment on these factors in light of your response to questions 4. and 5. above.
8. OEAM is 100% owned by Origin Energy which also has a minority shareholding (17.5%) in Envestra. In what way(s), if at all, would this affect the relationship between Envestra and OEAM given the terms of the Agreement. Are there any risks associated with this relationship which could result in inefficiency in performing the services under the Agreement?
9. Do you consider that there were/are entities other than OEAM capable of performing the services provided under the Agreement:
- (a) at present;
- (b) at the time that the Agreement was entered into?
10. If you consider that there are additional matters which are relevant to Envestra's decision to have OEAM manage and operate its gas distribution network, please discuss these in your report.

In your report, please give your opinion about the relationships between asset owners and contractors generally, but also discuss the particular arrangement between Envestra and OEAM.

Please provide your opinion having regard to:

- The nature and characteristics of asset intensive businesses, whether they be in the energy industry or any other industry, regulated or unregulated;
- The different types of arrangements used by assets owners to manage large assets; and
- Any other matter you consider relevant.

Please note your report may be provided to the Commission in support of Envestra's submissions in response to the draft decision.

Envestra asks that in preparing your report you familiarise yourself with and follow the guidelines for experts set out in South Australian Supreme Court Practice Direction 46A (attached). We will ask you in due course, as we have done with all experts engaged in this matter, to make a statutory declaration in support of your report, to the effect that you have made all enquiries which you believe are desirable and appropriate and that no matters of significance, to your knowledge, have been withheld from the report. This is to ensure your report carries maximum weight and probative value and will be suitable to rely upon in any subsequent appeal.

We would appreciate obtaining at least your preliminary views in relation to the questions outlined in this letter by Thursday 4 May 2006. We appreciate that you may not be in a position to provide a final written report before Friday 5 May when Envestra is required to lodge its submissions and supporting evidence with the Commission.

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Envestra Limited
Graham Holdaway: Expert Witness Statement
Audit & Risk Advisory Services
May 2006

ATTACHMENT TO GUYON STANFORD

However, we intend to advise the Commission that a report has been sought and that it will be submitted as soon as practically possible.

If you have any questions, require additional information or further clarification of the questions outlined above, please contact me on 08 8418 1125.

Yours sincerely,

Andrew Staniford
Commercial Manager

Encs

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C Outsourcing in asset intensive industries

Upstream petroleum and gas

- 1 Gippsland Basin – Halibut, Marlin, Kingfish, Cobia, Mackerel, Tuna, Barracouta, Snapper, Bream, Flounder, Fortescue and West Kingfish fields
- 2 Gippsland Basin – Kipper field
- 3 Gippsland Basin – Patricia-Baleen field
- 4 Otway Basin – Minerva field venture
- 5 North West Shelf venture (LNG, domestic gas, condensate, crude oil and LPG)
- 6 Timor Gap – Laminaria oil field
- 7 Timor Gap – Corallina oil field
- 8 Timor Gap – Bayu-Undan Liquids
- 9 Timor Gap – Elang-Kakatua field
- 10 Timor Gap – Jabiru-Challis field
- 11 Carnarvon Basin – Barrow Island
- 12 Carnarvon Basin – East Spar field
- 13 Carnarvon Basin – Legendre oil field
- 14 Carnarvon Basin – Mutineer-Exeter field
- 15 Carnarvon Basin – Stag field
- 16 Carnarvon Basin – Thevenard Island oil processing facility
- 17 Carnarvon Basin – Enfield oil field
- 18 Carnarvon Basin – Stybarrow oil field
- 19 Browse Basin (various fields)
- 20 Cooper Basin – South Australia
- 21 Cooper Basin – Queensland
- 22 Amadeus Basin – Mereenie field

- 23 Amadeus Basin – Palm Valley field
- 24 Surat Basin – Moonie field
- 25 Surat Basin – Scotia coal seam gas field
- 26 Port Bonython processing plant

Convention centres

- 27 Brisbane Convention & Exhibition Centre
- 28 Sydney Convention & Exhibition Centre
- 29 Melbourne Exhibition & Convention Centre
- 30 Cairns Convention Centre
- 31 Adelaide Convention Centre
- 32 Perth Convention and Exhibition Centre
- 33 Gold Coast Convention and Exhibition Centre

Ports

- 34 Western Port (Hastings Port)
- 35 Geelong Port
- 36 Portland Port
- 37 Flinders Ports (Ports of Adelaide, Port Lincoln, Port Pirie, Port Giles, Klein Point, Thevenard & Wallaroo)
- 38 Dalrymple Bay Coal Terminal

Power stations

- 39 Ecogen Power – Newport and Jeeralang power stations
- 40 Loy Yang A power station and coal mine
- 41 Loy Yang B power station
- 42 Hazelwood power station and coal mine
- 43 Valley Power

- 44 Yallourn power station
- 45 Pelican Point, Port Lincoln, Mintaro, Dry Creek, Snuggery power stations
- 46 Redbank power Station
- 47 Kwinana power station
- 48 Townsville and Collinsville power stations
- 49 Gladstone power station

General property trusts

- 50 DB Reef Trust
- 51 Macquarie DDR Trust
- 52 Macquarie Goodman Group (MGQ)
- 53 Macquarie Office Trust
- 54 Mirvac Group
- 55 Stockland Corporation
- 56 Westfield Group
- 57 General Property Trust

Mining

- 58 Hamerlsey Iron Pty Ltd (Brockman, Mount Tom Price, Paraburdoo, Channar, Marandoo, Yandicoogina and Eastern Range mines)
- 59 Robe River Iron Associates (Mesa J and West Angelas mines)
- 60 Mount Newman Joint Venture (mining at Mt Whaleback, Orebodies 29, 23 & 25, the Newman to Nelson Point railway & Nelson Point facility)
- 61 Mount Goldsworthy Mining Associates Joint Venture (mining at Nimingarra, Yarrie & Area C, Goldsworthy to Port Hedland railway & port operations at Finucane Island)
- 62 Yandi Joint Venture (mining at Yandi mine)
- 63 POSMAC Joint Venture
- 64 Boyne Island aluminium smelter

- 65 Bell Bay aluminium smelter
- 66 Point Henry aluminium smelter
- 67 Portland aluminium smelter
- 68 Tomago aluminium joint venture
- 69 Kurri Kurri aluminium smelter
- 70 Queensland Alumina refinery
- 71 Worsley alumina refinery and Mount Saddleback bauxite mine
- 72 Kwinana, Pinjarra and Wagerup alumina refineries
- 73 Gove alumina refinery and bauxite mine

Airports

- 74 Brisbane Airport
- 75 Sydney Airport
- 76 Melbourne Airport
- 77 Launceston Airport
- 78 Perth Airport
- 79 Hobart Airport
- 80 Alice Springs Airport
- 81 Tennant Creek Airport
- 82 Darwin Airport
- 83 Adelaide Airport
- 84 Gold Coast, Mount Isa and Townsville airports

Toll roads

- 85 M1 (Eastern Distributor), NSW
- 86 M2 (Hills Motorway), NSW

- 87 M4, NSW
- 88 M5, NSW
- 89 M7, NSW
- 90 CityLink, Victoria
- 91 Queensland Motorways Corporation
- 92 Tunnel Holdings Pty Ltd (Sydney Harbour Tunnel)

Rail

- 93 Mt Newman Railway Line
- 94 Goldsworthy Railway Line
- 95 Hamersley Iron & Robe River Railway Networks
- 96 Track from Kalgoorlie (WA) to Broken Hill (NSW) and Wolsley (SA)
- 97 Interstate gauge rail network in Victoria
- 98 NSW interstate and Hunter Valley rail corridors
- 99 Metropolitan freight lines to Sydney ports
- 100 Remaining NSW network
- 101 Queensland Rail network
- 102 Western Australian metropolitan Passenger Rail network
- 103 Western Australian Freight Rail Network
- 104 Alice Springs – Darwin
- 105 NSW metropolitan Rail Network
- 106 Victorian Rail Freight Network

Water

- 107 United Water International Pty Ltd/SA Water
- 108 Coliban Water

- 87 M4, NSW
- 88 M5, NSW
- 89 M7, NSW
- 90 CityLink, Victoria
- 91 Queensland Motorways Corporation
- 92 Tunnel Holdings Pty Ltd (Sydney Harbour Tunnel)

Rail

- 93 Mt Newman Railway Line
- 94 Goldsworthy Railway Line
- 95 Hamersley Iron & Robe River Railway Networks
- 96 Track from Kalgoorlie (WA) to Broken Hill (NSW) and Wolseley (SA)
- 97 Interstate gauge rail network in Victoria
- 98 NSW interstate and Hunter Valley rail corridors
- 99 Metropolitan freight lines to Sydney ports
- 100 Remaining NSW network
- 101 Queensland Rail network
- 102 Western Australian metropolitan Passenger Rail network
- 103 Western Australian Freight Rail Network
- 104 Alice Springs – Darwin
- 105 NSW metropolitan Rail Network
- 106 Victorian Rail Freight Network

Water

- 107 United Water International Pty Ltd/SA Water
- 108 Coliban Water

109 Yarra Valley Water

Energy networks²⁸

110 ActewAGL²⁹

111 AGL³⁰ (assets include):

- New South Wales gas distribution network (AGL Gas Networks)
- AGLE

112 Alinta Infrastructure Holdings (assets include):

- Eastern gas pipeline
- Tasmanian gas pipeline
- Queensland gas pipeline

113 Australian Pipelines Trust (assets include):

- Amadeus gas trust
- Carpentaria gas pipeline
- Goldfields Gas Pipeline
- Moomba-Sydney gas transmission pipeline
- Roma to Brisbane gas transmission pipeline

114 CKI (assets include):

- South Australian electricity distribution (ETSA Utilities)
- Powercor Victorian electricity distribution
- CitiPower Victorian electricity distribution

115 DUET (assets include):

²⁸ Because there are numerous individual energy assets and the adoption of outsourcing is largely dependent on the asset owner, we have aggregated energy assets by owner.

²⁹ Gas, electricity and water

³⁰ AGL currently has an integrated model. However AGL is subject to an agreed merger with Alinta. Alinta plans to outsource the operation of the network assets.

- Multinet gas distribution network (Victoria)
- UED electricity distribution network (Victoria)
- Dampier to Bunbury gas pipeline

116 ElectraNet (South Australian electricity transmission)

117 Envestra (assets include):

- Stratus gas distribution network (Victoria)
- South Australian gas distribution network
- Queensland gas distribution network

~~118 Epic (assets include):~~

- Dampier to Port Headland
- South West Queensland pipeline
- Moomba to Adelaide pipeline
- South East South Australian pipelines

119 GasNet (assets include)

- Victorian gas network system
- Western Australian pipeline

120 SP AusNet (assets include):

- Westar gas distribution network (Victoria)
- TXU electricity distribution (Victoria)
- Victorian electricity transmission