



Envestra Limited

**Graham Holdaway: Supplementary
Expert Witness Statement
Issues pertaining to Envestra's Contract
with Origin Energy Asset Management**

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1 Introduction

1.1 My details

1. My details are included in my initial witness statement.¹

1.2 The Terms of Reference

2. Envestra Limited (“Envestra”) has engaged me to provide my opinion on certain conclusions drawn by the Essential Services Commission of South Australia (“ESCOSA”) in its Final 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.²
3. In particular, Envestra has asked me to provide my opinion on the conclusions ESCOSA draw in respect of the Network Management Fee (“NMF” or “the fee”) and Boral’s incentives when the fee was set.
4. I have read the Guidelines for Expert Witnesses and agree to be bound by it.
5. 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.
6. This statement should be read in conjunction with my initial witness statement.

¹ Graham Holdaway, Expert Witness Statement: Issues pertaining to Envestra’s contract with Origin Energy Asset Management, May 2006.

² ESCOSA, Final Decision: Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System, June 2006.

2 ESCOSA's conclusions and reasoning on the NMF

7. ESCOSA disallows the NFM in its Final Decision. In this respect, its Final Decision is consistent with its Draft Decision. The reasoning in the Final Decision is, however, different to the reasoning in the Draft Decision (see, for example, paragraphs 75-78).

8. ESCOSA now argues that there was a 'strong financial incentive' for Boral to inflate the NMF when it negotiated the Operating Agreement with Envestra. Its Final Decision states:

The Commission considers that there would have been a strong financial incentive for Boral Ltd, as the owner of Envestra and OEAM at the time the Operating Agreement was created, to inflate the price above the cost of providing the contracted services. At the time, the form of the current economic regulatory regime for gas pipelines was well advanced, and indeed, was described in some detail in the prospectus for Envestra, including that regulation would most likely be based upon a recovery of costs and a return on an objectively determined asset value (DORC was described as the most likely valuation method). In this environment, when deciding upon the price that Envestra should pay BEAM for the services, the choice of strategies would have been to:

- Strategy 1: Set a price that just recovered BEAM's costs (including compensation for financing costs and risk), and so allocate a larger share of the profit that existed at the time to Envestra – in which case, any excess profit that existed in Envestra's charges would be expected to be removed at a future price review and passed on to customers (and so reduce the value of the business); or
- Strategy 2: Set a price that recovered a margin over BEAM's costs (including compensation for financing costs and risk), and so allocate a larger share of the profit that existed at the time to BEAM – in which case, if the regulator just passed through all of Envestra's costs to customers (including the margin to BEAM), the pre-existing profit level would be maintained even after the introduction of cost-based regulation. Moreover, even if the regulator rejected the margin component, then Boral Ltd would have been in the same position as if it had embarked on Strategy 1.

Clearly, Strategy 2 is superior for the owner. Moreover, the same incentives would continue to apply even if either business were subsequently sold (in which case, while Envestra may be sold at a lower price than otherwise, BEAM would be sold at a higher price, and the sum of the proceeds would be expected to exceed that obtained under Strategy 1).³

9. ESCOSA also refers to advice from two consultants which support its key conclusion.⁴

10. In short, ESCOSA argues that Boral had an incentive to inflate the NMF because, if it did so, it could have been better off but there was no way it could have been worse off.

³ ESCOSA, op. cit., June, 2006, page 136.

⁴ Allen Consulting Group, Memorandum to ESCOSA: Management fee in the Envestra-OEAM Operating Agreement, 28 June 2006, and Pacific Economics Group, Non-Capital Costs in the Access Arrangements for Envestra: Report to ESCOSA, June 2006.

3 My opinion of ESCOSA's conclusion and reasoning

11. I do not agree that Boral had a clear incentive to inflate the NMF (ie. use Strategy 2) because there is no way it could be worse off than if the fee was not so inflated (ie. Strategy 1).
12. I disagree with ESCOSA's conclusion because it relies on two false assumptions. The assumptions are that:
 - The market would have to accept that a regulator would allow Envestra to recover in perpetuity the costs of an inflated NMF; and, if this was not the case,
 - There was no risk of a removal or reduction in the allowed NMF affecting Boral.
13. The analysis set out in Section 3.1 illustrates this. More importantly, the available evidence suggests that neither of these assumptions is correct for the facts of this case. Moreover, in my view, they are commercially naïve in the implicit assumptions made about how capital markets actually behave.
14. Section 3.2.1 presents the evidence in respect of whether the market accepted that a regulator would allow Envestra to recover in perpetuity an inflated NMF. In short, the evidence shows that there was significant uncertainty regarding the application of the regulatory regime, but investors were well aware of the risk that a regulator might disallow, at some later date, costs sought by Envestra that were inflated or otherwise inefficient.
15. By contrast, ESCOSA provides no evidence to support its view that investors accepted that a regulator would allow inflated costs in perpetuity. More importantly, it provides no evidence that the NFM is in fact inflated. In addition, ESCOSA provides no evidence to support the implied allegation that Boral had purposes other than those disclosed in the documentation supporting the sale of Envestra or produced around that time, which I referred in my initial witness statement (see paragraphs 96, and 135-137).
16. Section 3.2.2 presents the evidence in respect of whether there was no risk that removal or reduction of the NMF would affect Boral. In my view, it would have been commercially naïve for Boral to assume that the reduction or removal of the NFM would have no implications for it.
17. By contrast, ESCOSA provides no evidence to support its assumption that there was no risk that, if a regulator removed or reduced the NMF at a later date, it would affect Boral.
18. The conclusions I drew on Boral's incentives in my initial witness statement (see paragraphs 124-132) therefore remain valid. My key conclusion was that Boral did not have an incentive to inflate the NMF. This is because if the NMF was set at an "inflated" level, Boral would have risked:
 - Making an immediate capital loss by selling a less profitable Envestra;
 - Lowering its ongoing revenues, if a regulator later removed or reduced the NMF;

- Damaging its commercial reputation – along with those of its managers, directors and advisers; and
- Damaging its relationship with Envestra and therefore its ability to execute its growth strategy.

In these circumstances, were Boral to have followed the course posited by ESCOSA, it is likely it would have destroyed shareholder value.

3.1 The errors in ESCOSA’s reasoning

19. I have a number of issues with ESCOSA’s reasoning. Some of these issues do not, however, affect its key conclusion on Boral’s incentives, although they do serve to confuse its position (eg. the relevance of ownership changes and the assumption of pre-existing “excess” profits). Section 3.3 addresses these other issues.
20. ESCOSA’s argument appears to be that Boral had what might be termed a free option. It could either:
 - Strategy 1: Charge a “market” NMF; or
 - Strategy 2: Charge an “inflated” NMF and see what the regulator did. If it:
 - (a) Allowed the NMF – there would be no impact on Envestra’s profitability compared with Strategy 1, but Boral would receive the inflated NMF; or
 - (b) Disallowed the NMF – Envestra would be less profitable but Boral would be no worse off than it would have been under Strategy 1.

Hence, Strategy 2 is preferred on ESCOSA’s analysis.

21. ESCOSA does not explain how it arrives at the outcome for Boral of strategy 2(b), although the presumption appears to be that Boral would still get a market NMF.
22. Table 1 below identifies ESCOSA’s two strategies, the regulatory assumptions it appears to use and the resulting value impacts. It also identifies the assumptions which appear to form the basis of ESCOSA’s conclusions about value impacts.

Table 1: ESCOSA’s strategies and their assumed value implications

<i>Strategy</i>	<i>Assumed regulator response in setting Envestra’s prices</i>	<i>ESCOSA’s assumed value implications for Envestra at sale</i>	<i>ESCOSA’s assumed value implications for Boral</i>	<i>Implicit assumption</i>
1. Market NMF	Allows full recovery of the market NMF	No impact - as the market NMF is a cost pass through	Envestra sold for “market” price Boral gets market NMF	Assumes regulator allows a market NMF
2. Inflated NMF	(a) Allows full recovery of inflated NMF in all future price reviews	No impact - as the inflated NMF is a cost pass through	Envestra sold for “market” price (equal to the above). Boral gets inflated NMF in perpetuity. Boral maximises wealth	Assumes regulator allows an inflated NMF in perpetuity. Also assumes the market is 100% certain that regulator will allow recovery of inflated NMF in perpetuity
	(b) Disallows inflated NMF at next price review	As for 2(a) above	As for 2(a) above Boral gets inflated NMF in perpetuity, (or market NMF if parties review it). Boral no worse off than under Strategy 1	As for 2(a) above Assumes Boral’s NMF unaffected by regulatory decision, if assumption above on regulatory treatment does not hold.

23. When I examine ESCOSA’s analysis it produces four possible outcomes for Boral under 2(b) depending on whether its two assumptions hold. Table 2 illustrates these outcomes relative to Strategy 1.

Table 2: Possible outcomes under Strategy 2(b) and the value implications for Boral

<i>Strategy 2(b)</i>	<i>Outcomes on regulator's assumptions</i>	<i>Sale price of Envestra</i>	<i>Boral's NMF</i>	<i>Impact on Boral</i>
Inflated NMF disallowed	Both assumptions hold	Unaffected	Unaffected	Better off – sale price the same and Boral gets inflated fee.
As above	Regulator's assumption on sale price holds, but Boral affected by disallowance of NMF	Unaffected	Affected	Indifferent – sale price the same but fees reduced to market.
As above	Regulator's assumption on sale price fails, but Boral unaffected by disallowance of NMF	Affected	Unaffected	Indifferent - loss on sale value recouped through inflated fee.
As above	Both assumptions fail	Affected	Affected	<i>Worse off - loses on sale value and on fees.</i>

24. Table 2 shows that ESCOSA's conclusion that Strategy 2 would be Boral's preferred option because it could not possibly be worse off than under Strategy 1 does not hold.

25. For ESCOSA's view to prevail two commercially naïve assumptions would have to hold:

- The market would have to accept that a regulator would allow Envestra to recover indefinitely the costs of an inflated NMF; **and**, if this was not the case,
- There was no risk of a removal or reduction in the allowed NMF affecting Boral.

If the market believed there was no risk that a regulator would remove or reduce the inflated NMF, Envestra would likely have sold for a market price. So even if the regulator later reduced the NMF, Boral could be no worse off.

If, however, the market believed that there was a risk of the regulator removing or reducing the inflated NMF, Envestra would likely have sold for less relative to Strategy 1 (ESCOSA appears to concede later in its analysis that this is a possibility – "Envestra may be sold at a lower price than otherwise"⁵).

Boral may still have been indifferent to this outcome, if it was certain it would continue to get the inflated NMF in perpetuity regardless. If, however, a reduction in the NMF had implications for Boral's fees, then it could be worse off.

26. Accordingly, a possible outcome for Boral under Strategy 2(b) is that:

⁵ ESCOSA, op. cit., June 2006, page 136.

- The proceeds of the Envestra sale are lower than that which would be achieved under Strategy 1; and
- Envestra forces Boral to accept lower fees at a later date (eg. after a regulator removes or reduces the NFM).

Under this scenario, Boral is worse off than it would be had it employed Strategy 1.

27. Having re-established that Boral could be worse off by setting the NMF at an inflated level, the key issue is whether this outcome represented a realistic, foreseeable commercial risk for Boral.

3.2 The basis for ESCOSA's assumptions

28. Below I outline the evidence for the two key assumptions that ESCOSA make:

- The market's expectations regarding the recovery of an inflated NMF; and
- The risk of a reduction in the allowed NMF affecting Boral.

3.2.1 The market's expectations on recovering an inflated NMF

29. The basis of ESCOSA's assumption that the market (and Boral) concluded that the regulator would accept an inflated NMF in perpetuity is that the economic regulatory regime was "well advanced" at the time Boral negotiated the NMF with Envestra.⁶

30. I am not sure what ESCOSA means by 'well advanced', but the evidence I have examined and my own experience does not support the suggestion that the regulatory regime would have encouraged the market (and Boral) to form such a definitive view.

31. At the time Boral negotiated the Operating Agreement with Envestra, the National Third Party Access Code for Natural Gas Pipelines ("Gas Code") had been written, but was in draft and considerable doubt still existed about what outcomes would be achieved by regulated businesses under it. As noted in paragraph 138 of my initial witness statement, the ACCC had not made any gas transmission decisions prior to 1998. The infancy of the Gas Code, and the consequent lack of precedent on its application and that of economic regulation generally, meant that it would have been extremely difficult for the market to have been certain how regulators would apply the Gas Code.

32. A broker's report from April 1998 summarises the uncertainty around regulation that existed at the time.⁷ Its states:

Setting the regulatory regime for Envestra's networks will remove an element of risk from the stock. This should lower the risk premium at which the stock is trading.

⁶ ESCOSA, op cit, June 2006, page 136.

⁷ SBC Warburg Dillon Read, Envestra: TU increases Boral's Allgas bid by 4% to \$19.50, SA Regulator Appointed-Buy, 2 April 1998, page 15.

It goes on to state:

Determination of regulatory returns allowed is dependent on:

- appointment of the South Australian regulator – similar to IPART in NSW and Office of Regulatory General in Victoria;
- passage of the National Gas Pipelines Access Bill in Federal Parliament;
- the new regulator’s tariff determination.

It then provides an update of the situation in regard to each of these variables. For example, the recent appointment of the regulator, Graham Scott; the forthcoming Senate debate on the Bill; and the likely timetable for the Access Arrangement review including any potential for slippage in the timetable.

33. Subsequent events (ie. numerous appeals and a review of the Gas Code) have borne this regulatory uncertainty out. Some of the appeals have gone to fundamental attributes of the Code such as the Epic Decision⁸ and the GasNet decision⁹. The Epic Decision highlighted the importance of the standard of competition against which regulators should assess Access Arrangements. The GasNet decision revealed the existence of the “propose-respond” model that the provisions of the Gas Code required, but which regulators had failed, to that point, to apply. The Productivity Commission has also highlighted the degree of regulatory uncertainty in the application of the Gas Code when identifying the problems with the current regime. It attributes this regulatory uncertainty to the “virtually unlimited discretion” the Gas Code provides, which the “wide range of objectives given to regulators” exacerbates.¹⁰

34. Indeed in the initial period after the finalisation of the Gas Code, there is evidence to indicate that the market attached considerable uncertainty in relation to regulation and its impact on regulated businesses:

Regulatory Environment - THE ONE REAL RISK, in the longer term principles of the Code and nature of the regulatory formula provide certainty (sic). Currently we are in the new, untried and more risky early stage of implementation. Consistent regulatory determinations will give greater confidence.¹¹

35. In my view, these examples indicate that there was a substantial degree of uncertainty on the application of economic regulation at the time Boral entered into the Operating Agreement both generally and in relation to the NMF in particular.

36. ESCOSA’s consultants, Allen Consulting Group, highlights the level of uncertainty that existed in relation to making assumptions about how outsourcing arrangements would be treated in future, by illustrating the present uncertainties:

The Commission should be aware that it has only been recently that Australian regulators have considered closely the implications for utility regulation of the recent trend by utilities to outsource the majority of the utility operations to an independent party (i.e. rather than

⁸ *Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231.

⁹ Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6.

¹⁰ Productivity Commission, Review of the Gas Access Regime: Inquiry Report No. 31, June 2004, pages xxix-xxx.

¹¹ Macquarie Equities Limited, Envestra – A regulated business ... a few secrets, May 1999, page 9.

performing the activities in house). It is reasonable to expect that significant additional debate will occur over the matters discussed in this memorandum before a settled position is reached.¹²

37. ESCOSA also claim that regulation “would most likely be based on a cost recovery approach”. This is inconsistent with:

- What the Code says;
- What the Envestra Prospectus and the Independent Expert actually say (ie. that the focus is on the recovery of efficient costs)¹³; and
- How ESCOSA is applying it.

38. Based on my review of various stockbroker reports on Envestra around and subsequent to the time of its listing on the ASX, the evidence indicates that the market was aware of the potential for not recovering inefficient costs. Indeed, one stockbroker noted that:

Under the Draft Code, access fees are intended to reflect ‘recoverable costs’ of the network [cost reflectivity] including:

- a rate of return on assets [likely to be determined through the Capital Asset Pricing Model and a weighted cost of capital]
- depreciation of assets [to reflect economic life of assets]
- operating, maintenance and other non-capital costs [expended by an ‘efficient’ operator]¹⁴

This same stockbroker also noted the following in relation to investment risks on Envestra:

Operational Risk	To ensure Envestra can achieve cost reflectivity and pass on costs to network users, it must operate efficiently. Boral is an efficient operator and Boral’s ongoing influence through the Board and O&M agreement reduces this risk. ¹⁵
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39. ESCOSA’s presumption that investors (and Boral) would have expected a regulator to allow the recovery of an inflated NMF in perpetuity, would appear to assume that:

- The capital markets were inefficient in valuing Envestra; and/or
- Multiple parties will make naïve commercial judgements.

40. I consider that the market was aware of the risks that economic regulation posed to the recovery of inefficient costs by regulated businesses and that those risks were material. Indeed, of the four possible outcomes identified in Table 2, in my view, the last option (where Boral is worse off), would be the default market assumption - if the NFM was inflated.

¹² Allen Consulting Group, op cit., page 8.

¹³ Envestra Prospectus 1997, pages 29, 58-59, 103-104, 106-107.

¹⁴ SBC Warburg Dillon Read, Envestra Initial Public Offering – Buy, August 1997, page 14.

¹⁵ SBC Warburg Dillon Read, op cit., August 1997, page 37.

41. I also note that ESCOSA appears to provide no evidence to the contrary in relation to whether the NFM was inflated; it merely asserts that Boral had an incentive to do so (see paragraphs 70-74).

3.2.2 The risk of a reduction in the NMF affecting Boral

42. ESCOSA does not explicitly recognise that its conclusion that Boral could not be worse off by charging an inflated NMF is dependent on it assuming that Boral would be unaffected by its removal or reduction. As a result, it is not possible to assess the basis for its assumption.
43. I am aware of instances where the market has formed a view that it no longer considers the level of prices or fees paid in certain circumstances to be suitable, and has either forced a reduction in them and/or found ways to impose costs on the beneficiary (eg. by impacting on their performance).
44. This has occurred, for example, in the superannuation¹⁶ and property sectors in recent times, with a number of list property vehicles internalising management as a result of strong pressure from institutional investors. There has also, for example, been considerable debate about the fees that Macquarie Bank has been charging, or has been proposing to charge, in a variety of instances recently. I note that this has appeared to have had implications for its share market performance and its ability to execute transactions and raise capital.¹⁷
45. I am not aware of such pressure being exerted on Envestra and Origin Energy, but I expect that it would have been in the event that the market had formed the view the NFM was inflated.
46. In my experience, the capital markets are usually reasonably accurate in their assessment of such matters over the medium to long term.
47. It would therefore have been commercially naïve for Boral to assume that the reduction or removal of the NFM would have no implications for it.
48. At a minimum removal of the fee, would likely:
- Cause significant disruption to the relationship between the parties, as Envestra would probably redouble its efforts to ensure it is not paying “inflated” fees (which it can no longer recover from customers) to a third party. In my view, the capital markets would likely put it under considerable pressure to do so.
 - Undermine both parties’ growth strategy (ie. acquiring new infrastructure assets and adopting the same business model for them). OEAM is unlikely to be interested in managing other assets on behalf of Envestra, if it is unable to make a margin from doing so.

¹⁶ Australian Financial Review, Wider choice does not necessarily translate into lower fees, 22 December 2005

¹⁷ Australian Financial Review, A wild week on the wild side by Macquarie Bank, 13 May 2006.

49. Quite possibly, the relationship between the parties would become unmanageable and ultimately break down (eg. causing disputation about the agreement).
50. As noted paragraph 90 and 97 of my initial witness statement, CKI has a similar shareholding interest in Envestra as Origin, and CKI itself is a major infrastructure asset owner and manager. Evidence that I have reviewed indicates that CKI acquired its initial shareholding interest in Envestra in July 1999. Given its shareholding interest and potential to compete with OEAM, it is unlikely that CKI would have invested or supported the continued payment of the NMF (along with the increase in the NMF from 2.5% to 3.0% of revenue in 2001) to its fellow shareholder if it was in fact inflated.
51. It is difficult to see how Boral could have formed the view in these circumstances that it would be completely immune from a regulator removing or reducing the NMF.

3.2.3 The risk of Boral being worse off

52. My analysis of the basis of ESCOSA's assumptions above demonstrates that the risk of Boral being worse off by having the NMF set at an inflated level was material.
53. There was no basis for the market to expect (or for Boral to assume) that the regulator would allow an inflated NMF in perpetuity.
54. In these circumstances, by having the NMF set at an inflated level, Boral would have effectively crystallised a certain upfront loss relative to the sale price that would have been achieved under Strategy 1. It is unrealistic, in the absence of any countervailing evidence, to assert that Boral would have adopted this strategy:
 - In view of the uncertainty with respect to the regulator's treatment of an inflated NMF; and
 - Given the risk that the regulator's response could impact on Boral's fees and its business strategy.
55. I consider that it is unrealistic to assert that Boral would consider this trade-off to be acceptable since Boral had no guarantee that it would be able to recover the relative loss of value from the sale of Envestra through the inflated NMF. As with the investors in Envestra, there was no basis for Boral to assume that the regulator would allow Envestra to recover the inflated NMF in its prices in perpetuity. There was also no basis for Boral to assume that it would have been able to continue charging Envestra an inflated NMF in perpetuity.
56. Ironically, ESCOSA's decision to remove the NMF potentially produces a worse outcome than that described in paragraphs 22-23 for Boral (ie. Boral sells Envestra for less than it could have and then potentially makes no margin on supplying it under the Operating Agreement, thus losing the revenue stream that might have recouped the loss in sale value).

3.3 Other issues with ESCOSA's analysis

57. I disagree with a number of the other assumptions in ESCOSA's analysis. The most important of these are described below and relate to:

- The implications of the ownership changes;
- ESCOSA's additional assumption about "excess" profits;
- ESCOSA's lack of evidence to support its assertions; and
- ESCOSA's acceptance of a margin.

3.3.1 The implications of ownership changes

58. ESCOSA also argue that any ownership changes that might have happened subsequent to the setting of an inflated NMF would have had no impact on Boral's incentives. The implication appears to be that what matters is total value. In this respect, ESCOSA appears to rely on the work of two advisers, who both argue that common ownership provides an incentive to maximise the profits of the corporation as a whole.¹⁸

59. I would agree that what matters is total value and that common ownership (if that means common control) creates an incentive for entities to maximise the profits of the corporation as a whole.

60. The critical question is what defined total value for Boral at the time it sold Envestra and entered in the Operating Agreement. I have defined this in some detail in section 3.1.

61. Section 3.1 shows that the only way Boral could maximise its wealth, given the commonly accepted intention to create and sell Envestra, is by:

- Maximising the sale proceeds of Envestra; and
- Ensure it is in a position to maximise the revenues (and any profits) it derives from the NMF and the contract over time.

This is because these are the only two sources of revenue available to it as a result of the establishment of Envestra and the creation of the Operating Agreement.

62. This describes the total value in dollars that Boral could gain (excluding its ongoing minority ownership interest).

63. Value is, however, not just a function dollars, it is also a function of risk. The analysis demonstrates the differing risks associated with these two revenue streams by virtue of Boral capitalising its interest in Envestra in the first revenue stream, but having ongoing uncertainty in regard to the second revenue stream. The different risk profiles of these

¹⁸ Allen Consulting Group, op cit., page 9 ; and Pacific Economics Group, op cit., page 8.

revenue streams would have informed Boral's commercial judgement about how it could maximise its total value.

64. Again, ESCOSA's assumptions are commercially naïve.

3.3.2 ESCOSA's additional assumption about "excess" profits

65. Both of ESCOSA's strategies introduce an additional assumption that "excess" profits may have existed that the parties could share, although it does not clearly explain what it means by this term.
66. The presence or absence of this assumption would not appear to alter its key conclusion on Boral's incentives, but the inference appears to be that the presence of "excess" profits may have facilitated its ability to act on these incentives.
67. It is worth noting, however, that:
- ESCOSA provides no evidence to support its assertion of excess profits generally or in relation to the opex allowance in particular. On the contrary, there would appear to be some evidence of under-recovery of efficient costs in the Independent Expert's report that formed part of the Envestra sale documents.¹⁹ There would also appear to be little evidence of "excess" profits within opex in SAIPAR's 2001 decision for Envestra;²⁰ and
 - Absent these excess profits it is not obvious how Boral could set the NMF to "allocate a larger share of the profit that existed at the time to BEAM", without requiring that Envestra shareholders would get less than the return presumably expected by them.
68. The absence of "excess" profits would, however, have made the strategy ESCOSA believes Boral undertook (ie. inflating the NMF) more risky. This is because, to execute this strategy successfully, it would have required:
- The regulator allowing a price increase at the next price review to account for the new inflated NMF (ie. Envestra would have been less profitable immediately); and
 - Envestra accepting that its opex costs increase merely by virtue of its disaggregation from Boral.
69. Allen Consulting note that entering into the arrangements (to the extent that the NMF includes a margin) is likely to have had the
- ...immediate effect of raising Envestra's recorded expenditure.²¹

¹⁹ Envestra Prospectus 1997, pages 108-109.

²⁰ SAIPAR, Final Decision for Envestra's South Australian Natural gas Distribution System, December 2001.

²¹ Allen Consulting Group, op cit., page 15.

In other words, Envestra's costs would have increased immediately, but its revenues would have remained unchanged, at least until it could convince the regulator to increase its prices at the next review to recover an "inflated" fee.

3.3.3 ESCOSA's lack of evidence to support its assertions

70. ESCOSA has not presented any evidence to support the basis of the assumptions which underpin its reasoning and thus conclusion.
71. Even if ESCOSA could provide evidence to support its assertion that Boral had an incentive to charge an inflated NMF, it does not necessarily follow that Boral acted on that incentive.
72. One of ESCOSA's advisers even noted the incentive that Boral is alleged to have is a theoretical concern:

It should be emphasised that PEG has no evidence that either company has in fact behaved in this way, but it remains a theoretical concern.²²
73. To demonstrate that Boral had acted on the incentive, ESCOSA would need to provide evidence that the NMF charged by Boral is above a "market" NMF. However, it has failed to provide any evidence of what a market or efficient NMF would be. If the NMF is inflated, it would not seem too difficult a task to demonstrate this by reference to relevant market benchmarks.
74. In my initial witness statement, I presented in paragraphs 96 and 135-138 a summary of the evidence I was able to identify and review on whether the NMF was inflated. That evidence suggests that the NMF was not inflated.

3.3.4 ESCOSA's acceptance of a margin

75. ESCOSA's Final Decision appears to be inconsistent with the analysis in the decision. This is because it removes the margin despite forming a conclusion that it is "inflated." ESCOSA therefore conflates two separate issues: whether a margin is appropriate and, if so, its magnitude.²³
76. ESCOSA's definition of Strategy 1 suggests that there is a reasonable margin that BEAM could be charging Envestra:

...a price that just recovered BEAM's costs (including compensation for financing costs and risk).

It now also appears to accept that the margin could be set at a reasonable level and that it is "normal" for a contractor to get a margin.²⁴ In the Draft Decision, by contrast, it

²² Pacific Economics Group, op cit., page 11.

²³ ESCOSA, op cit., June 2006, page 137, lines 4163-4167.

²⁴ ESCOSA, op cit., June 2006, page 149, Lines 4607-4608.

appeared to argue that any margin was inconsistent with the lowest sustainable costs of providing the services.

77. One of ESCOSA's advisers, Allen Consulting Group, holds a similar view:

An outcome of a competitive market that is in long run equilibrium is that revenue should recover cost, with cost including a return on investments made (including investments in building a brand or other intangible assets), a return on other financing costs and compensation for risks incurred.²⁵

78. On this basis, one would expect ESCOSA to allow an 'efficient' NMF, but not disallow the NMF entirely.

²⁵ Allen Consulting Group, op cit., page 16.