The Allen Consulting Group

MEMORANDUM

To: ESCOSA

From: Jeff Balchin
Director

Date: 30 August 2006

Re: KPMG Second Statement on the Network Management Fee

A. Introduction and relevance of the matters raised by Holdaway

The purpose of this memorandum is to provide views on the Supplementary Expert Witness Statement provided by Graham Holdaway of KPMG on behalf of Envestra on the matter of the treatment of the fees payable under the Origin Energy Asset Management Contract.

At the outset, I note that the main focus of the Holdaway statement is whether or not Boral had the incentive to set a price for the services to provided by Boral Energy Asset Management (BEAM, now Origin Energy Asset Management, OEAM) at a level that is higher than the costs that would be incurred by BEAM (now OEAM).[1] I do not consider this to be a highly relevant matter for ESCOSA.

It is abundantly clear that, when the pricing formula for the services to be provided by BEAM was established, the two entities were under common ownership. Accordingly, I do not consider that it can credibly be advanced that the normal incentives for the purchasing firm to seek the lowest price for a particular service actually applied.[2] I consider that the non-arms length nature of the dealings to provide sufficient justification for ESCOSA to 'look through' the relevant contract price and inquire into whether that charges under that contract are appropriate.

I also remain of the view that was expressed in my previous memorandum that, if a contract price is to be 'looked through' (or set aside), then the only reliable measure of the cost associated with the services provided by the contractor is the cost that is actually incurred by that contractor. In this context, I refer to cost defined in the economic sense, which includes returns on capital required and compensation for risk borne. However, given the regulatory context, it should exclude any costs or risk for which Envestra is being compensated through the building block calculation by which

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1 As I explained in my previous memorandum on this matter, Boral changed its name to Origin, and so BEAM and OEAM are essentially the same entities.

2 I agree with the statement by Holdaway at paragraphs 71-72 that the concern I presented in my previous advice on this matter that Boral had an incentive to set a price for the relevant contracted services that was above cost was a theoretical concern only. The conclusion of this theoretical concern was that ESCOSA had a justification to 'look through' the contractual price, which I consider to remain justified.

are borne by OEAM (i.e. because to add those costs to the compensation for services provided by OEAM would amount to double counting).

My brief comments on the actual arguments advanced by Holdaway follow.

Was there a clear incentive for Boral to set a price for the services to be provided by BEAM at above cost?

Holdaway asserts that the strategy of inflating the contract price to above cost would only have been beneficial to Boral if two assumptions were met, namely:

- the buyers of Envestra would have to have believed that the regulator would permit an inflated contract price to be passed through ad infinitum; and
- that Boral would have to have believed that it could continue to charge the inflated contract price ad infinitum even if the regulator declared the amount excessive.

I do not consider that Holdaway has correctly stated the conditions under which Boral would have seen that it would have received a 'risk free' benefit from setting such a high price. In particular, I consider that the only condition that would be required for Boral to gain under this strategy would be for it to be able to hold Envestra to the terms of the contract irrespective of what the regulator decided. In contrast to Holdaway, I would not consider this assumption to be commercially naïve – after all, the role of contracts is to bind each party to the terms contained therein (and hence provide *ex ante* certainty) even though the positions of parties under that contract may have changed. Of course, examples do exist of parties re-negotiating contracts where they are beneficiaries of changed circumstances, but then plenty of examples also exist (and, I would posit, many more examples) of contracts that remain on foot even though changed circumstances that may benefit one party over the other.

Moreover, the examples that Holdaway provides of the likely outcomes for Origin present only polar examples in each of the cases. As relevant example, if the purchasers of Envestra thought that there was a risk (but not certainty) that the regulator would disallow Envestra's recovery of part of the payment made to Envestra, then theory would predict that the purchase price would have been reduced as a result, but not by the full amount of the disallowance. Under this scenario, while the sale price would have been depressed, Boral would still have gained.

Should part of a margin been allowed?

At the end of his statement, Holdaway notes that, even if ESCOSA considered there to be reasons for looking through the contract price, then it should have still provided some margin, rather than having disallowed the margin entirely.

I consider these statements by Holdaway to be semantic. The appropriate principle is not that a 'margin' must be added onto to some measure of the base (but not complete) costs incurred by OEAM, but rather that the cost that is attributed to the services provided by OEAM should reflect all of the costs incurred by OEAM (and include such matters as return on investments made, compensation for risk, etc, but

subject to the caveat on ‘double dipping’ made above). If all costs (widely defined) are already counted, then there is nothing left to give rise to a margin.

Indeed, I remain of the view that the most means of ensuring that all of OEAM’s costs are counted is to inquire directly into the costs that are incurred, and to avoid attempts to derive ‘benchmark’ margins. I say this because benchmarking of margins requires very careful attention to ensure that the base (or ‘included’) costs of the firms being compared are the same, otherwise the margin (which is a proxy for ‘excluded’ costs) would not be comparable. I also consider the idiosyncrasies between business means that the potential errors from benchmarking costs (including benchmarking ‘excluded costs’, i.e. margins) are likely to be high, and more so than a direct inquiry into the costs actually incurred by OEAM. I consider the inquiry that ESCOSA reported in its final decision was one of whether all of the costs incurred by OEAM were counted (subject to the caveat on double-dipping), which is the appropriate inquiry.