Outsourcing Arrangements

Directlink Joint Venture
2025-2030 Revenue Proposal

Energy Infrastructure Investments

Contents

1. Introduction

This document outlines the Management, Operations and Maintenance and Commercial Services Agreement (MOMCSA) between Energy Infrastructure Investments Pty Limited (EII) and APA. It demonstrates why the payments made for the following services satisfy the relevant provisions in chapter 6A of the National Electricity Rules (Rules):

- asset management, operating, maintenance and capital services; and
- corporate services.

EII has prepared the following information to assist the AER in assessing the MOMCSA and the attachment is structured as follows:

- Section 2 provides an overview of the MOMCSA;
- Section 3 sets out EII's understanding of the framework that the AER has developed for the purposes of assessing the consistency of outsourcing arrangements with the Rules;
- Section 4 applies the AER's framework to the MOMCSA and demonstrates the consistency of its arrangement with the operating and capital expenditure criteria; and
- Section 5 concludes that payments made under this agreement comply with the operating and capital expenditure criteria contained in s.6A.6.6(c) and 6A.6.7(c) of the Rules.

2. MOMCSA

2.1. Background

In December 2008, EII entered into an agreement with APA for the provision of asset management, operating, maintenance, capital and commercial services to the EII assets (including the Directlink interconnector). This agreement was for an initial term of seven years but has been extended on two occasions for additional 5 year periods. The terms of this agreement are set out in the Management, Operations and Maintenance and Commercial Services Agreement (MOMCSA) and a copy of the contract has been provided to the AER on a confidential basis.

The MOMCSA was entered into as part of a broader transaction, which involved the establishment of EII and the sale of nine APA owned assets (including the Directlink interconnector), to this unlisted investment vehicle. EII's shareholders include:

- MC EII Holdings Pty Ltd – 49.9%;
- Osaka Gas – 30.2%; and
- APA – 19.9%.

APA was the largest provider of asset management and operating and maintenance services in the Australian energy networks industry. Entry into the MOMCSA was therefore viewed as a means by which EII could access economies of scale, scope and other efficiencies, along with asset management and corporate services expertise, that it would not otherwise be able to obtain on a stand-alone basis.

2.2. Services provided by APA

The services that APA is required by the MOMCSA to provide EII, as owner of the Directlink interconnector, include:

- all asset management, operations, maintenance and capital services required for the safe and efficient operation of the asset, including compliance with regulatory obligations. The types of asset management, operating, maintenance and capital services that APA is required to provide under the agreement are set out in Schedule 2 of the MOMCSA; and
- all administrative, accounting and other business functions that EII is required to perform, including in compliance with legal and regulatory obligations, for each of its assets (including the Directlink interconnector). The types of commercial services that APA is required to provide under the agreement are set out in Schedule 3 of the MOMCSA.

2.3. Pricing mechanism

The payments that EII is required to make to APA for the provision of the services are:

- all of the costs and expenses that APA incurs in the provision of asset management, operations, maintenance and capital services, provided they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure. EII is also required to pay all of the costs and expenses incurred in connection with existing third party subcontracts;

- all of the expenses reasonably incurred by APA in the provision of commercial services, including the costs of hours worked by APA Group personnel. In accordance with section 10.1(b)(ii) of the agreement, the costs of hours worked are to be calculated by applying agreed hourly rates, which EII and APA must agree from time to time. As noted in this provision, it is the intention of the parties that these costs will be set on a 'cost recovery' basis and less than market rates; and
- a margin of 10% on the costs and expenses identified above.

Notable features of this pricing mechanism include:

- the cost pass-through component, which ensures that any economies of scale, scope and other efficiencies achieved by APA (or its contractors) are immediately passed through to Directlink and, in turn, are passed through to end-users;
- the requirement that costs and expenses are only passed through if they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure, which imposes some discipline on APA; and
- the margin, which is paid to access the economies of scale and scope and other efficiencies available to APA as well as APA's asset management and corporate service expertise, IT systems and business processes.

3. Framework for assessing outsourcing contracts

This section sets out EII's understanding of the framework that the AER developed for assessing whether the payments made under outsourcing arrangements satisfy the operating and/or capital expenditure criteria set out in chapter 6A of the Rules.

3.1. Background

During the 2011-2015 Victorian electricity distribution price review process (EDPR), the AER outlined the framework it had developed for the purposes of assessing whether outsourcing arrangements satisfied the operating/capital expenditure criteria in the Rules. The AER also signalled at this time its intention to use the framework in future regulatory decisions. In simple terms, the framework developed by the AER during the 2011-15 EDPR consisted of a two stage inquiry process that involved:

Stage 1 - distinguishing between those contracts entered into by a regulated service provider that could be presumed to prudent and efficient (ie, those entered into as a result of a competitive market process) and those that could not (referred to as the 'presumption threshold'). Outsourcing contracts that the AER noted could not be presumed to be efficient, unless they were subject to a competitive tender, included contracts:

- that were not entered into on an arm's length basis;
- as part of a broader transaction; and
- involving the conferral of benefit on the regulated service provider in return for it agreeing to pay an artificially inflated price

Stage 2 - undertaking a more detailed review of the contract entered into by the regulated service provider to determine whether the contract price, the contractor's directly incurred costs or some measure in between the two should be used to determine forecast operating/capital expenditure allowances. The level of review required in this stage of the AER's framework depended on whether the contract in question passed or failed the presumption threshold.

Stage 2A - passed the presumption threshold, in which case the contract price was assumed to be the starting point for setting future expenditure allowances. The AER's assessment was therefore limited to examining whether:

- the contract price related wholly to the provision of the regulated services; and
- the contract price gave rise to any double counting of risks or costs with other aspects of the regulated service provider's regulatory proposal.

Stage 2B: - failed the presumption threshold, in which case the contractor's costs were assumed to be the starting point for setting future expenditure allowances and consideration was then given to whether a margin above these costs was warranted. Those factors that the AER identified as potentially warranting the payment of a margin included[1]:

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

- any return on and of capital required to compensate the contractor for any assets it owns and uses in the provision of services;
- any allowance required by the contractor to enable it to recover a 'reasonable allocation' of its common costs; and
- any allowance required by the contractor to self-insure against asymmetric risks, to the extent it did not give rise to a double counting across other aspects of the service provider's revenue requirement.

3.2. Modified framework

In July 2011, Envestra sought leave to apply to the Australian Competition Tribunal (Tribunal) for review of a number of aspects of the AER's Final Decision for the South Australian gas network, including its decision not to allow the recovery of the margin payable under Envestra's outsourcing contract with APA (Network Management Fee).

Leave was granted by the Tribunal, and it handed down its decision in January 2012[2]. In short, the Tribunal found that while it was appropriate for the AER to 'investigate and test' the margin' paid by Envestra:

- that the balance of the evidence suggested that outsourcing is accepted industry practice
- the costs incurred by Envestra in the outsourcing agreement are consistent with industry standards; and
- the AER had erred in finding that the margin was inefficient.

EII's review of subsequent regulatory decisions in which outsourcing arrangements have been examined by the AER (the Envestra draft decision for the Victorian gas networks)[3] that the AER has revised its framework to reflect the Tribunal's findings.

Specifically, it appeared that the AER modified the scope of the enquiry to be carried out in those cases where a contract is deemed to fail the presumption threshold (Stage 2B). Rather than using the contactor's actual costs as a baseline and then considering whether any margin above these costs could be warranted, Stage 2B of the AER's framework requires consideration to be given to whether:[4]

1. the total contract cost is consistent with the operating/capital expenditure criteria. Two of the matters that the AER identified in the Envestra draft decision for the Victorian gas networks as being relevant to this consideration are:
    - the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets; [5] and
    - the operating expenditure and productivity performance of the regulated service provider vis-à-vis other regulated service providers. [6]

[2] Australian Competition Tribunal, *Application by Envestra Limited (No. 2) [2012*] ACompT 3

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

[4] Ibid, p.103.

[5] Ibid, pp. 105-106.

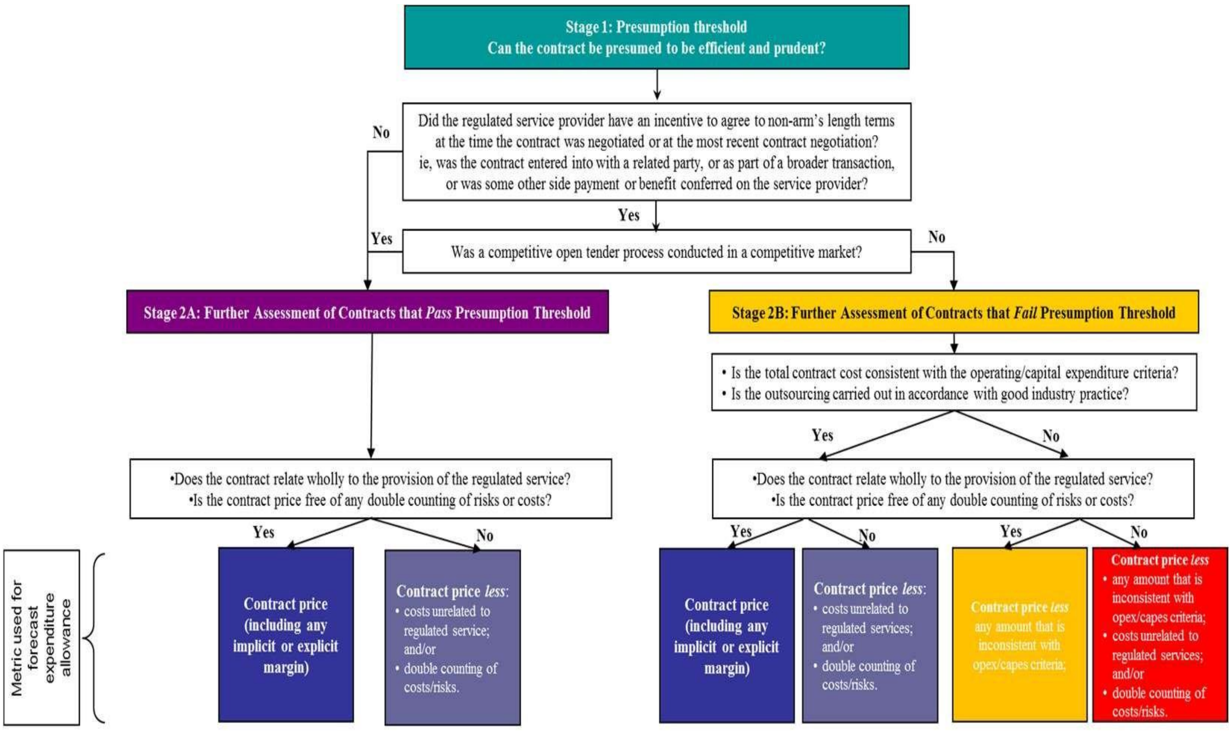
[6] Ibid, pp. 106-112.

2. the outsourcing is carried out in accordance with good industry practice;
3. the costs within the contract relate wholly to the provision of the regulated service; and
4. there is any double counting of costs or risks between the contract and the regulatory proposal.

3.3. Current framework

Figure 3-1 sets out EII's understanding of the AER's current position on the framework that it will apply when assessing outsourcing arrangements.

Figure 3-1: AER's revised framework for assessing outsourcing arrangements



Source: AER, Draft Decision - Access arrangement – Envestra Ltd 2013-17, September 2012

4. Application of the AER's framework to Directlink

This section addresses each of the matters identified in the AER's assessment framework relevant to a consideration of whether the payments made under an outsourcing contract will satisfy the operating and capital expenditure criteria set out in chapter 6A of the Rules.

4.1. Presumption threshold

The first stage of the AER's assessment framework requires consideration to be given to whether the regulated service provider had an incentive to pay an artificially inflated price at the time the contract was negotiated (or at its most recent renegotiation). Circumstances that the AER has previously stated could give rise to such an incentive include:

- where the parties to the contract were related at the time the contract was negotiated (or re-negotiated);
- where the contractor conferred some form of benefit on the regulated service provider in return for it agreeing to pay an artificially inflated price; or
- where the contract was entered into as part of a broader transaction.

While EII can confirm that it did not agree to pay an artificially inflated price when it entered the MOMCSA, it understands that because the contract was entered into as part of a broader transaction (see section 2) the AER would want to conduct a more detailed examination of the contract. For the purposes of this analysis, EII has therefore assumed that the MOMCSA would be deemed by the AER to fail the presumption threshold.

It is worth noting that while the MOMCSA was entered into as part of a broader transaction (involving APA as both a shareholder and service provider under the MOMCSA), at the time the contract was entered into APA was the largest provider of asset management services in the energy networks industry. Entry into the MOMCSA was therefore viewed as a means by which EII could access economies of scale, scope and other efficiencies, along with asset management and corporate services expertise that it would not otherwise be able to obtain on a stand-alone basis.

Since entering into the contract, APA has maintained its position as the largest provider of asset management services in the energy networks industry. EII continues therefore to benefit from the economies of scale, scope and other efficiencies available to APA that would not otherwise be available to EII.

4.2. Consistency of total contract cost with the Rules

In the most recent decision in which stage 2B of the framework has been invoked (the Envestra draft decision), the AER had regard to the following factors when assessing whether the total costs incurred under an outsourcing contract were likely to be consistent with the operating and capital expenditure criteria.[7]

[7] AER, *Draft Decision - Access arrangement – Envestra Ltd 2013-17*, Part 1, September 2012, p106.

- the comparability of the margin paid by the regulated service provider with those earned by contractors providing similar services in competitive markets; [8] and
- the productivity performance of the regulated service provider vis-à-vis other regulated service providers and a range of other partial benchmarks.[9]

EII accepts the approach taken by the AER in this context and has considered a similar analysis of margins and the relative performance of Directlink to demonstrate that the costs payable under the MOMCSA are consistent with the Rules. In short, EII is of the view that while there is some value in analysing the margin payable under the MOMCSA, the same cannot be said for the performance based analysis because the only other regulated interconnector (Murraylink) is owned by EII and is subject to the same type of outsourcing arrangement.[10]

EII believes that if it can be demonstrated that outsourcing the services to APA allows it to achieve lower operating costs than it could if it managed its network inhouse, then the charges payable under the MOMCSA should be viewed as being consistent with the Rules:[11]

This issue is considered in further detail in the remainder of this section.

4.2.1. Contract charges and margin

In accordance with section 10.1(a) and 10.1(c) of the MOMCSA, EII is required to pay APA the following charges for the provision of asset management, operating, maintenance and capital services:

- all of the costs and expenses APA incurs in the provision of these services, provided they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure;
- all of the costs and expenses incurred in connection with existing third party subcontracts; and
- a margin on all of the costs and expenses incurred in the provision of these services, which from EII's perspective is paid to access:
    - the economies of scale, scope and other efficiencies offered by APA; and
    - APA's asset management expertise.

Over the next regulatory control period, EII expects to pay APA approximately $13.2 million pa (inclusive of the margin) for the provision of asset management, operating, maintenance and capital services to Directlink.

EII's assessment of the whether these charges (which have been incorporated into Directlink's operating and capital expenditure forecasts) are consistent with the operating and capital expenditure criteria, has been carried out having regard to the following questions:

[8] Ibid, pp. 105-106.

[9] Ibid, pp. 106-112.

[10] The AER analysed the MOMCSA in relation to Murraylink and approved the opex costs and the margin.

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

- Are the costs and expenses incurred by APA in the provision of asset management, operating, maintenance and capital services likely to be lower than what could be achieved by EII if it was to provide the services in-house?
- Is the margin payable on these costs and expenses in line with the margins levied by other contractors providing similar services in competitive markets?

In EII's opinion, if these two questions are answered in the affirmative, then it would be reasonable for the AER to infer that the total charge (including the margin) payable for the provision of these services is lower than the in-house cost of provision and therefore consistent with the operating and capital expenditure criteria specified in chapter 6A of the Rules.

These questions are considered, in turn, in the remainder of this section.

4.2.2. Contract costs

To determine whether the costs and expenses incurred by APA in the provision of these services are likely to be lower than what EII could achieve, EII has undertaken a qualitative assessment of the economies of scale, scope and other efficiencies that would be available to APA but not to EII.

As noted previously, APA is currently the largest provider of asset management services in the Australian energy networks industry, providing services to over 55 assets in various locations in eastern and Western Australia. The relative scale of APA's asset management arm and the diversity of interests (both geographically and by type of assets) are such that it would be reasonable to assume that APA can access a range of economies of scale, scope and other efficiencies that would not otherwise be available to EII. These efficiencies stem from, amongst other things:

- APA's ability to spread its fixed costs across a greater number of activities;
- the scale of APA's operation, which would enable it to obtain greater discounts when procuring materials and service contracts than would otherwise be available to EII;
- the geographic proximity of EII's assets with other assets serviced by APA, which would enable services and personnel to be shared and works to be optimised across assets; and
- the increased capacity of APA to develop specialist expertise (eg, asset management expertise and technical regulatory expertise) across a greater number of assets and locations and to utilise that expertise in the provision of its services.

Given the ability of APA to access efficiencies and specialist expertise that would not otherwise be available to EII, the costs and expenses it incurs in the provision of asset management, operations, maintenance and capital services can be expected to be lower than those that would be incurred if EII were to provide the same services.

4.2.3. Contract Margin

To determine whether the margin payable under the MOMCSA for the provision of asset management, operating, maintenance and capital services is in line with the margins earned by other contractors, EII has compared it with the 3% margin on revenue that Envestra is required to pay for the provision of operating and maintenance services.

The margin payable under Envestra's operating and maintenance agreement, has been selected as the reference point for this analysis, because it has been found by both the Tribunal[12] and the AER[13] to be in line with the margins earned by other contractors and therefore consistent with good industry practice.

In order to undertake this comparison, it has been necessary to convert the 10 per cent margin on expenditure to an equivalent margin on Directlink's revenue. The calculations are set out in Table 4-1.

Table 4-1: MOMCSA margin as a % of nominal revenue

	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30	Ave.
Margin ($m)	0.6	0.7	1.2	1.1	1.0	1.9	1.1	1.1	1.1	1.5	1.4
Revenue ($m)	14.8	14.5	15.5	16.1	16.6	23.7	28.0	26.9	27.2	29.1	27.0
Margin (%)	4.1%	4.8%	7.8%	6.8%	6.0%	8.2%	4.0%	4.1%	4.1%	5.2%	5.0%

As the analysis in this table reveals, the margin payable under the MOMCSA varies considerably over time with the margin in any individual year largely dependent on the capital expenditure that is required.

However, the average margin payable under the MOMCSA over the last 10 years is aligned with the 3% margin on revenue that the AER have previously found to be consistent with industry practice for these types of services.

The average percentage has fallen in the forecast regulated period due to the nature of the contract being expressed as a percentage of expenditure but this analysis being conducted as a percentage of revenue.

4.2.4. Conclusion on total contract charge

The margin payable under the MOMCSA for the provision of asset management, operating, maintenance and capital services should be viewed as being consistent with the operating and capital expenditure criteria.

The preceding analysis shows that:

- the costs incurred by APA in the provision of asset management, operations, maintenance, capital and corporate services are lower than those that could reasonably be expected to be achieved if EII were to provide the services in-house; and
- the margin payable to APA for the provision of asset management, operating, maintenance and capital services is consistent with the 3% margin on revenue

[12] *Application by Envestra Limited (No. 2)* [2012] ACompT 3, January 2012, para 252.
[13] AER, Draft Decision - Access arrangement – Envestra Ltd 2013-17, Part 1, September 2012, p112.

that the AER have previously found to be in line with the margins earned by other contractors and therefore consistent with good industry practice.

Given these findings, it is reasonable to infer that the total charge payable to APA for the provision of asset management, operating, maintenance and capital services is lower than the costs that EII would incur if it was to provide the services in-house.

Directlink's operating and capital expenditure forecasts, which are based on the charges that it expects to pay under the MOMCSA over the next regulatory control period, should therefore be deemed to satisfy the operating and capital expenditure criteria set out in chapter 6A of the Rules.

4.3. Commercial services charges

In addition to providing asset management, operating, maintenance and capital services, APA is required under the MOMCSA to carry out all administrative, accounting and other business functions for all of the EII businesses, including Directlink. In return for the provision of these services, EII is required to pay:

- all of the expenses reasonably incurred by APA in the provision of these commercial services;
- the costs of hours worked by APA Group personnel in the provision of these services, which are to be calculated by applying agreed hourly rates. The hourly rates are to be agreed by EII and APA from time to time with the intention being that they will be set on the basis of 'cost recovery' and less than market rates[14]; and
- a margin on the costs and expenses incurred by APA in the provision of these services, which from EII's perspective is paid to access:
  - the economies of scale, scope and other efficiencies offered by APA;
  - APA's corporate services expertise; and
  - APA's IT systems and business processes.

Over the current regulatory control period, EII is estimated to pay APA approximately $0.6m million pa (inclusive of the margin) for the provision of corporate services to Directlink. This is forecast to remain largely unchanged for the next regulatory period. To test whether these charges (included in Directlink's operating expenditure forecasts) are likely to satisfy the operating expenditure criteria, they have been compared with both:

- an estimate of the corporate overheads that APA would attribute to Directlink if it still had a 100% interest in the asset; and
- an estimate of the costs that Directlink would incur if it was to provide the services in-house.

4.3.1. APA Charges assuming 100% interest in Directlink

If APA still had a 100% interest in the Directlink asset, then it would seek to attribute a share of its corporate overheads to this asset. The corporate overheads that it would seek to recover from Directlink would depend on:

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

- the overall level of corporate costs incurred by APA in the performance of the following functions:
  - Chief Executive Officer function;
  - Company Secretary function;
  - Corporate Finance function;
  - Corporate Commercial function;
  - Human Resources function;
  - IT and Transformation function;
  - Legal and Regulatory function; and
  - Projects and Other; and
- the method used to allocate corporate overheads across all of APA's assets.

In its submission to the AER on the proposed revisions to the Roma to Brisbane Pipeline (RBP) access arrangement, APA set out in detail:[15]

- the market and commercial based incentives for keeping corporate overheads as low as possible and the rigorous budgeting and Board approval process that is in place to ensure that these costs are prudently incurred; and
- the method used to assign corporate overheads across all its operating businesses, which has been approved by the AER in a number of instances. In simple terms the allocation method involves:
  - attributing any costs that are directly attributable to a particular asset to that asset;
  - allocating costs among the different assets where there is a causal allocator to do so; and
  - allocating any remaining costs by revenue (excluding any costs considered 'corporate development' such as investigating acquisitions).

The reasonableness of this allocation is then tested by comparing it to an allocation based entirely on revenue. In this case, the corporate overheads that were proposed by APA and approved by the AER, represented 6.9% of RBP's revenue.[16]

If the same ratio of corporate overheads to revenue that was allowed in the AER's RBP final decision was used to determine the corporate overheads that APA would attribute to Directlink if it still had a 100% interest in the asset, then it would result in average corporate overheads of $1.85 million pa over the forecast transmission determination period.

As the information shown in Table 4-2 reveals, this is more than double the corporate services charge allocation that EII expects to pay over the next regulatory control period

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

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

for Directlink. This difference is significant and clearly demonstrates the benefits that EII and users of the Directlink asset have derived from the MOMCSA.

Table 4-2: Corporate services charge, actual vs charge if 100% APA asset ($m, nominal)

	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30	Total
Directlink actual charge	0.57	0.57	0.60	0.64	0.66	0.68	0.70	0.72	0.74	0.76	3.61
Estimate with APA at 100%	1.01	1.00	1.06	1.10	1.14	1.63	1.92	1.84	1.86	2.00	9.25
Difference	0.44	0.43	0.46	0.46	0.48	0.94	1.21	1.12	1.12	1.24	5.63

4.3.2. In-house cost of the Commercial Services

EII addressed these same issues in the context of the Murraylink revenue proposal. Considering the similarities in the nature of the asset and the corporate structure and MOMCSA arrangements, EII considers that the analysis applied to Murraylink is equally relevant to Directlink.

To get an understanding of the costs that Murraylink would be likely to incur if it was to undertake the corporate services currently provided under the MOMCSA in-house, EII engaged KPMG to:

- identify the types of functions that Murraylink would need to perform; and
- estimate the costs incurred if each of these functions was performed in-house.

KPMG's findings are contained in a report entitled, *Murraylink - Corporate Cost Benchmarks*[17]. The analysis indicated that it would cost Murraylink approximately $1.63m per annum to undertake the corporate service functions in-house in 2012. Escalating by CPI would result in an average estimated cost of $12.7m over the next regulatory period.

This is more than $9.5m greater than what Directlink expects to pay under the MOMCSA over the next regulatory control period. This difference is significant and clearly demonstrates that outsourcing the corporate service functions to APA has resulted in substantially lower costs than would be incurred were Directlink to provide the services in-house. The difference also highlights the benefits that EII and users of the Directlink interconnector have derived from the MOMCSA

In EII's view, this clearly demonstrates that the charges payable for the provision of corporate services under the MOMCSA (including the margin) are substantially lower than what would be incurred if Directlink was owned by APA or if Directlink was to provide the services in-house.

This element of the MOMCSA (which has been incorporated into Directlink's operating expenditure forecasts), should therefore be deemed by the AER to satisfy the operating expenditure criteria in chapter 6A of the Rules.

[17] KPMG, *Murraylink - Corporate Cost Benchmarks*, October 2012, Table 4.1

4.4. Overall contract cost

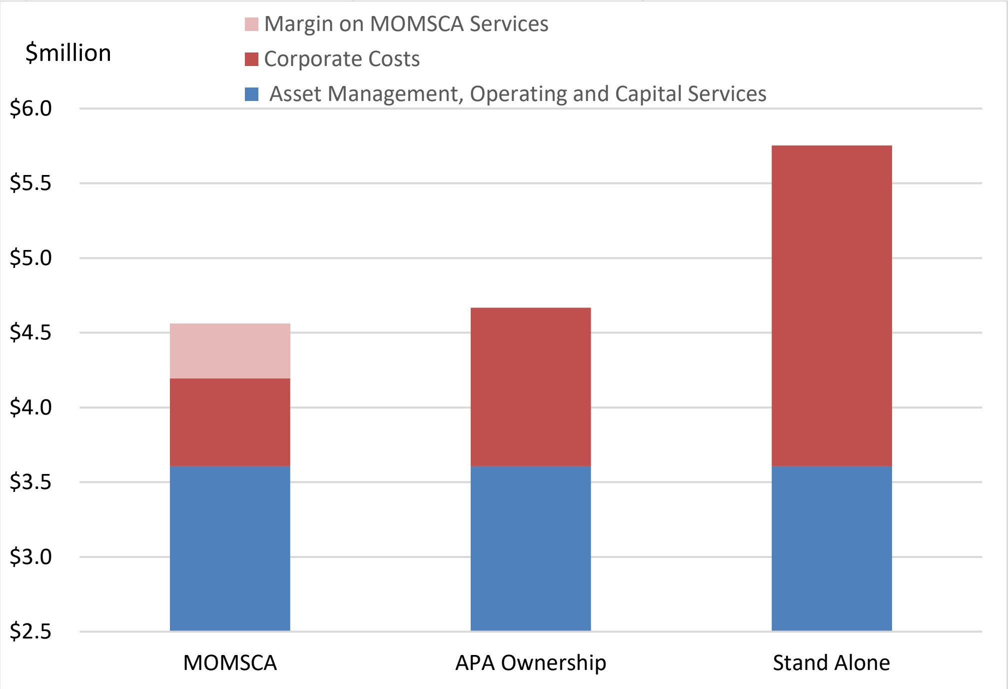
Figure 4-1 highlights that the overall charge payable under the MOMCSA is lower than the cost of providing the services through alternative methods. It compares the average charges that were paid over the current regulatory control period with the costs that Directlink would be likely to incur under the following counterfactuals:

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

It is assumed in the stand-alone counterfactual that EII would incur the same costs and expenses as APA (excluding the margin) if it was to carry out these services. The costs and expenses incurred in the provision of asset management, operating, maintenance and capital services are therefore assumed to be the same across all scenarios.

It is important to note that this is a simplifying assumption and in EII's opinion the costs would be substantially higher if it were to provide the services in-house rather than those incurred under the MOMCSA.

Figure 4-1: : MOMSCA Average cost vs APA ownership & stand-alone



As the comparison in the above figure shows, even if it is assumed that EII could access the same efficiencies and expertise available to APA, the overall charge payable under the MOMCSA (including the margin) would still be $0.2-$1.2 million pa lower than what it would cost to operate Directlink under alternative structures.

Using this analysis, it is clear that outsourcing to APA has allowed Directlink to achieve a lower operating cost than it would have if it managed its network in-house or if APA had a 100% interest in the asset.

5. Conclusion

It follows from the analysis set out above, that the costs payable under the MOMCSA, including the margin, are lower than what EII would incur if it was to provide the services in-house and are therefore consistent with the operating and capital expenditure criteria set out in chapter 6A of the Rules.

EII believes that outsourcing the operation of Directlink to a much larger asset management company has allowed it to take advantage of the efficiencies available to APA that would not otherwise be available to EII. The contract has also provided:

- a pricing structure that ensures that: any efficiencies derived by APA are immediately passed through while EII and its end-users are afforded some protection against inefficiencies on the part of APA. This protection is provided by the limitation of costs and expenses that can be passed through to EII to those that have been approved through either the Approved Operating Plan and Budget or an Authority for Expenditure;
- an appropriate allocation of responsibilities between EII and APA, with EII retaining strategic control over its assets and responsibility for approving the Operating Plan and Budget and any Authority for Expenditure;
- a transparent budget and reporting process; and
- the ability of EII to engage other contractors at the end of each contract term (second term or third term) if APA does not exercise its right to match the price proposed by the other contractor.

Both the Directlink and Murraylink interconnectors are subject to the same operating contact (the MOMCSA) so this contract has been provided to the AER in Murraylink's recent Revenue Determination for the 2023-28 regulatory period and has been provided again with this revenue proposal .

The AER has analysed the MOMCSA in considerable detail in previous Murraylink and Directlink regulatory determination processes and accepted the margins charged under the contract. As such, EII believe that consistent with its previous decisions, the AER should find that the margins payable by Directlink are reasonably reflective of the efficient cost.