Critique of the AER's treatment of contractor's margins

A report for Envestra

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1. Executive summary

1. I have been asked four questions in relation to the AER Draft Decision of February 2011, "Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011 – 30 June 2016". The questions are reproduced in Section 2 of this report. I provide below a summary of the answers to each of the four questions.

2. In relation to the first question, I observe material margins being paid for contracts in workably competitive markets. This includes contracting services for asset management and businesses activities more generally in the economy. These margins are above and beyond those explained in terms of a return on physical assets. I consider that the reason for this is that firms have previously acquired valuable intangible assets which give them the ability to lower direct costs incurred and/or increase the quality of services provided. The margin observed is a return on those assets. Intangible assets are anything that allows a firm to lower costs and includes access to economies of scale/scope and business 'know how' or expertise.

3. In relation to the second question, Stage 2B of the AER's framework does not fully reflect the reasons margins are paid in workably competitive markets. This is because it does not include a return on intangible assets as a legitimate reason for paying a margin.

4. In relation to the third question, I consider that the only circumstances in which a contractor, acting rationally, would repeatedly provide services on the expectation that it only recovers its direct costs of service provision would be if it considered the contract to be an investment in acquiring know how or other intangible assets that would allow it to charge a margin in the future.

5. In relation to the last question, having regard to my understanding of Envestra's outsourcing arrangement, I consider that there is good reason to believe that APA brings valuable intangible assets to its contract with Envestra that has the effect of lowering the direct costs incurred in delivering services. Consequently, it would be reasonable to expect Envestra, acting efficiently, would pay a margin to APA that is consistent with margins observed in workably competitive markets for the supply of similar services. NERA has presented evidence to the effect that this is the case (ie, that the margin paid by Envestra is consistent with margins observed in workably competitive markets for the supply of similar services).

2. Terms of reference

6. I have been provided with the following terms of reference.

We refer to the AER Draft Decision entitled "Envestra Ltd Access arrangement proposal for the SA gas network 1 July 2011 – 30 June 2016" and dated February 2011. In particular, reference is made to section 8.6.2.1 of that decision and the conceptual framework referred to in it.

Envestra seeks your opinion, as an expert, on the following matters:

1. *please provide an explanation as to the reasons margins are paid in workably competitive markets;*
2. *whether Stage 2B of the AER's framework fully reflects the reasons margins are paid in workably competitive markets;*
3. *whether there are circumstances in which a contractor, acting rationally, would provide services on the basis it only recovers its direct costs of service provision; and*
4. *having regard to your understanding of Envestra's outsourcing arrangement, comment on whether the fee paid to APA is consistent with that which would be incurred in a workably competitive market or otherwise.*

7. I have read the Guidelines for Expert Witnesses in Proceedings of the Federal Court of Australia and confirm that I have made all inquiries that I believe are desirable and appropriate and that no matters of significance that I regard as relevant have, to my knowledge, been withheld from the Court.

3. Overview of AER decision

3.1. The issue

8. There is a legitimate concern that a regulated business may outsource some operations to a related party with the intention that:

   - the margin gets reflected in a higher regulated cost base than would have been the case without outsourcing and thereby increases prices faced by customers; and
   - the margin is received as economic profit by the related party with the outsourcing contract – where economic profits are profits above and beyond those that would be received in a competitive market.

9. As I have described in previous reports for Envestra,[1] in the presence of such incentives regulators cannot simply rely on incentive regulation to result in efficient costs. Where all contracts are with unrelated parties then incentive regulation rewards cost reductions at the regulated firm and punishes cost increases. However, if the contractor is a related party then this incentive can be undermined.

10. The Australian Energy Regulator, and other State based regulators before it, are concerned that the regulatory framework might artificially encourage outsourcing as a means of shifting profit via the mechanism described above. However, in developing a framework for assessing margins paid on outsourcing contracts, it is necessary that the framework still allow, and not penalise, outsourcing that is consistent with the National Gas Rules (NGR). In particular, consistency with rules 79(1)(a) and 91(1) would appear to require that all outsourcing contract costs, including a margin, should be paid where the outsourcing contract reflects the actions of a;

    > *"prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services."*

11. In this report I refer to the decision to outsource as 'prudent' if it is consistent with rules 79(1)(a) and 91(1). That is, 'prudent' is used as shorthand to mean the actions of a *prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services.*

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[1] CEG, *Economic Evaluation of the ESCV Draft Decision in Relation to Outsourcing Contracts* 28 October 2007 and NERA, *Outsourcing by regulated businesses Envestra*, 28 March 2007.

3.2. The AER framework

12. The AER sets out its 'framework' for assessing margins paid on outsourcing contracts in its 2010 Final Decision of the Victorian Electricity Distribution businesses. In that document the AER provided a detailed discussion of a variety of issues that it considered may be relevant to assessing the reasonableness of a margin paid to a related contractor. It stated that such an analysis must be carried out on a case-by-case basis:

> *"The AER considered that whether or not a margin is justified, and the magnitude of that margin where justified, requires a 'case-by-case' examination taking into account legitimate economic reasons for the exclusion of a margin."* (Page 174).

13. Ultimately, the AER arrives at a two stage framework as set out diagrammatically on page 303 of that decision. That framework involves a two stage test:

- Stage 1 'presumption threshold' for a contract to be assumed to be prudent: the threshold would not be passed if the contract was not arm's length (i.e. entered into with a related party or as part of a broader transaction) and if no competitive tender were held;
- Stage 2B: if a contract fails the presumption threshold then the AER will only allow a margin to reflect legitimate costs. The AER only nominates the following as legitimate costs:
  - a reasonable allocation of the contractor's common costs;
  - a return on and of physical assets owned by the contractor; and
  - the allowance required to compensate the contractor for any asymmetric risks that are not otherwise recovered by the regulated service provider.

14. While the AER does not explicitly state that this is an exhaustive list of all possible 'legitimate costs' in all possible circumstances, it would appear that this is the AER's belief. For example, the AER simply refers back to the Victorian decision's list of legitimate costs when considering Envestra's outsource margin.[2] The AER does not perform any analysis of whether or not Envestra's specific circumstances might require the AER to have regard to other 'legitimate costs' not on that list.

3.3. The AER's application of its framework to Envestra

15. In its application of this framework to Envestra the only examination of Envestra specific circumstances undertaken by the AER relates to whether APA is a related

[2] See page 141, footnote 54 of the SA decision.

party. The AER does not enter into any detailed discussion of the specific circumstances of Envestra's outsourcing contract but simply begins its analysis of the 'economic rationale' for the margin with the following statement.

> *"The AER questions the economic rationale behind an above-cost margin and incentive payment, and whether this is consistent with the requirements of r.91 of the NGR and the national gas objective. Such margins allow Envestra and the APA Group to withhold from consumers the benefits of the efficiencies derived from their outsourcing agreement for an indefinite time which the AER considers contradicts the intention of the regulatory framework."*[3]

16. This statement is treated as self-evident and is not arrived at via any process or reasoning or justified in any way. The AER appears to proceed on the basis that it has established this to be true in the specific circumstances of the Victorian DNSPs outsourcing contract and that the principle holds true for all related party outsourcing contracts. Moreover, the AER only applies this principle where the contract is deemed to have failed the presumption test (e.g. where the contract is with a related party and has not been subject to competitive tender).

4. Why margins are paid in workably competitive markets

17. This section sets out the answer to the first question put to me.

> *"please provide an explanation as to the reasons margins are paid in workably competitive markets."*

4.1. Prevalence of outsourcing margins in competitive markets

18. Margins on outsourcing contracts are the norm in competitive markets with firms operating at arm's length. In those markets there is no question that margins are paid in accordance with firms acting prudently and *efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services.*

19. Outsourcing of asset management and maintenance operations is commonplace in the economy and especially in asset intensive businesses. In addition to privately owned

[3] AER, draft decision for Envestra in South Australia. Page 141.

regulated businesses outsourcing certain operating and maintenance activities, outsourcing is also common in other areas. For example, the Victorian Government outsources operation of the Melbourne train and tram systems. SA Water outsources operation and maintenance of its water pipeline assets. BHPB outsources mining operations in the Pilbara to Leighton[4] etc. In order to take on such contracts businesses must expect to earn a profit margin even though they generally bring little or no physical capital to the contract.

20. Envestra has commissioned a report from NERA that estimates the average value of the margin earned by companies that specialise in outsourcing comparable services to those outsourced by Envestra[5] (and other regulated businesses). NERA estimates this margin to be around 6%.

21. The AER puts forward three reasons which it regards as legitimately justifying a margin: (i) a reasonable allocation of the contractor's common costs; (ii) a return on and of physical assets owned by the contractor; and (iii) the allowance required to compensate the contractor for any asymmetric risks that are not otherwise recovered by the regulated service provider. In terms of these reasons for paying a margin, I note that in the NERA report:

- the margins are generally estimated at the company wide level - such that the 6% margin estimate is measured relative to total costs including overhead costs. Thus, this 6% margin is not explained by the need to recover overheads and/or common costs;
- the benchmark sample is composed of firms with little or no physical assets of their own – such that a return on physical assets cannot explain the 6% estimated margin; and
- the measured margins are actually earned margins measured across a large number of companies and years. This means that any inclusion of an allowance for 'asymmetric risk' in contract prices will not be reflected in average measured margins (as 'ups and downs' will tend to 'cancel out' over a large number of contracts entered into by a large number of firms).

22. It follows that something other than the AER's three 'legitimate' costs must explain the wide prevalence of margins observed in competitive markets.

4.2. Intangible assets and contract margins

23. The existence of margins, such as the average 6% margin estimated by NERA, primarily reflects the contractors' ability to provide the service at a lower cost than the

[4] http://www.leighton.com.au/about_us/projects/yandi_iron_ore_mine.html

[5] Asset management, operation, maintenance, engineering, design, project management, construction and labour services.

purchaser could achieve providing the service in-house. Margins are earned by contractors even where the contractor has made no prior investment in the acquisition of physical assets used in performing the contract services. In these circumstances, the margin represents a return to the intangible assets held by the contractor. Intangible assets refer to all the organisational assets that assist in lowering costs. These can be broken down into 'know how' and economies of scale and scope. Know how refers to everything from an effective organisational culture and management team to specific business processes and expertise (eg, inventory management and staff training processes). Law firm ST&P provides a legalistic definition of know how as:

> *"Know-how shall mean technical data, formulae, standards, technical information, specifications, processes, methods, code books, raw materials, as well as all information, knowledge, assistance, trade practices and secrets, and improvements thereto..."*[6]

24. Legalistic formulations such as this are used in the context of allowing third parties knowledge about some aspects of the firms operations which the firm is concerned may be able to be copied. Of course, know how is, in most cases, more than simply 'data' or a 'formula' capable of being written down and copied. Know how is a process of operation that relies on institutional knowledge that is costly to develop and costly to replicate.

25. Economies of scale or scope are factors that enable the contractor to lower costs by either spreading common costs across a larger number of operations or by allowing greater operational efficiencies (eg, by being able to commission lower unit prices on purchases due to larger scale of purchases).

26. The distinction between an economy of scale and scope can be thought of as the advantages of performing more of the same activity (economy of scale) and the advantage of performing multiple complementary activities (economies of scope). Depending on the strictness of the definition of what is the 'same' activity, advantages will fall into one or the other classification.

27. For example, Envestra contracts with APA to operate and maintain gas pipelines around Australia. If operating and maintaining different gas pipelines are 'the same' activity then the advantages of doing so are economies of scale. If they are different activities then the advantages are economies of scope. APA also manages other infrastructure assets such as the electricity interconnector Murraylink which operates between SA and Victoria. Any advantages associated with managing Envestra's network and Murraylink would likely fall into the category of an economy of scope.

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6 http://www.stplegal.com/service_details.php?id=8

28. The table at Appendix A lists all of the 41 assets that APA manages in addition to the Envestra assets. The Envestra assets add a further 9 assets. I would expect that the greater scale/scope of assets managed by APA to give rise to both greater economies of scale/scope and also greater incentive and opportunity for prior investment in building know how.

4.3. Why margins persist in competitive markets

29. Intangible assets are either costly to develop (eg, know how) or otherwise difficult to replicate which ensures that they are in short supply – such that margins will not be bid down to zero even in the long run and in highly competitive markets.

30. Contrary to statements by the AER[7], there is nothing inconsistent with earning a margin in perpetuity in workably competitive markets. It is costly/difficult to acquire intangible assets that allow one to lower costs. Unlike physical capital, intangible assets do not, in general, depreciate over-time. Knowledge or access to economies of scale/scope is, once obtained, not lost simply through the passage of time. As a consequence, those assets will, other things equal, earn a return in perpetuity. That is, the margin will not be competed away because it reflects a return on real investments/scarce resources – which competitors will only incur if they also expect to earn a margin.

31. By way of analogy, consider the differential in the wages that an engineer can earn over the wages earned by an unskilled labourer. The engineer will earn a higher wage because the engineer has previously invested in acquiring intangible assets (skills). The wage differential between an engineer and an unskilled labourer will not be competed away over time because it is costly for an unskilled labourer to acquire the skills of an engineer. This is true even if a large number of unskilled labourers incur the cost of an engineering degree. This does not 'compete away' the margin earned by an engineer who has previously attained those skills it just increases the number of people who are more productive because they have previously invested in becoming so.

32. The same is true of firms. For example, Leighton has been in existence for over 60 years and continues to earn a margin on its outsourcing services. There is no basis in economics to assume that margins are only earned in competitive markets for a period of five years, regardless of whether the contract was subject to competitive tenders or not. I would imagine that the AER itself has many longstanding relationships with third party contractors, including legal and economic advisers, where the third party contractor continues to charge a margin on direct costs.

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7 See quote below and also second paragraph on page 142 of AER, draft decision for Envestra in South Australia.

33. In the current context, a firm that has previously invested in acquiring the institutional experience and 'know how' to perform its tasks efficiently will continue to earn a margin on its contracts in perpetuity. This margin will not be competed away because it represents a return on an asset that is costly for competitors to acquire. With this in mind the below quote from the AER is clearly misguided to the extent that the AER implies that outsource margins represent 'abnormal profits' and will eventually be competed away in a competitive market.

> *"The AER considered that, in a workably competitive market, a contractor could not in the long run charge a premium (that is, a margin) above its full economic costs and earn abnormal profits due to the efficiencies available to the contractor that are not currently available to the service provider or other contractors. This is because in a workably competitive market, it is anticipated that over time existing contractors will become more efficient or new efficient contractors will enter the market and bid away these abnormal profits. In other words, in a workably competitive market a contractor arguably could not earn abnormal profits in the long run for efficiencies it has realised in the past, it could only continue to earn abnormal profits if it were able to continually improve its efficiency relative to its competitors."*[8]

34. Whilst it may be that alternative providers will improve their relative efficiency, in a competitive market this does not occur 'by magic'. It must be recognised that (like the unskilled labourer) other providers and new entrants will incur costs in developing the same know how as the contractor (and, therefore, would expect to earn in a competitive market the same margin above future costs).

35. Moreover, the evidence from NERA indicates that even with investment in know how from new entrants, a return on the existing know how of the contractor is sustained in perpetuity. Based on the material from NERA we observe that in competitive markets, firms earn margins above current cost in perpetuity. This is likely to be because much of the know how of running businesses is generated over the years of operation and remains a cost barrier that must be replicated by any new entrant - much like the degree earned by the engineer after leaving school.

4.4. The economic importance of intangible assets in the economy

36. For many firms, if not most, the majority of their market value derives from prior investment in intangible assets (such as economies of scale, business processes, institutional knowledge, and general 'know-how'). Leonard Nakamura of the US Federal Reserve Bank has argued that annual investment in intangibles in the US is over one trillion dollars a year and that increases in this investment can explain increases in gross margins (the difference between sales and the cost of sales).

[8] Page 185, AER, Victorian DNSP final decision.

Nakamura argues that the major reason for observed increased margins is the investment in technical know-how of businesses – for example an investment in deriving cost savings from internet-based supply chains.[9]

37. Baruch Levy, also of the US Federal Reserve, has concluded that evidence on differences between book to market valuations of US companies listed in the S&P 500 index confirms:

> *"...that an amount of value equal to between one-half and two-thirds of corporate market values reflects the value of intangible assets."*[10]

38. That is, more than half of the value of these firms is derived from prior investments in technical 'know-how' and other intangible assets.

39. Firms acting rationally would only enter into the outsourcing contracts that are the subject of the NERA study (described above) if they believed that these contracts would lower their costs. Given that purchasers pay, on average, a margin of around 6% then it follows that they must expect the contractor to be able to lower costs by at least 6% relative to their own costs of providing the service in-house.

40. The ability of outsourcing firms to lower costs by the magnitude of the margin reflects past investment in developing and acquiring valuable expertise (know-how). Moreover, by providing services to multiple clients, these outsourcing companies have greater experience at providing the services in question which tends to facilitate innovation (greater opportunity for 'learning by doing').

41. Equally, by providing services to a number of clients the outsourcing party is able to gain economies of scale and scope that a single client providing in-house services could not. This might come in the form of bulk purchase discounts or more efficient use of scalable fixed investments (where this might be fixed infrastructure, management expertise, inventory management software etc).

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[9] Nakamura, L. 2001. "What Is the U.S. Gross Investment in Intangibles? (At Least) One Trillion Dollars a Year!" Federal Reserve Bank of Philadelphia Working Paper no. 01-15.

[10] Lev, B., 2003, Remarks on the Measurement, 2003, Valuation and Reporting of Intangible Assets. FRBNY Economic Policy Review, September 2003

5. The appropriateness of the AER's Stage 2B

42. This section answers the second question put to me.

> *"whether Stage 2B of the AER's framework fully reflects the reasons margins are paid in workably competitive markets."*

43. The 'legitimate' reasons for contractors charging a margin listed in the AER's Stage 2B are:

- a reasonable allocation of the contractor's common costs;
- a return on and of physical assets owned by the contractor; and
- the allowance required to compensate the contractor for any asymmetric risks that are not otherwise recovered by the regulated service provider.

44. For the reasons set out in the previous section, the factors set out in Stage 2B are an incomplete list of the reasons why margins are paid in competitive markets. Outsource providers in competitive markets also earn margins to reflect the value of the intangible assets they bring to the contract.

45. In fact, if the reasons listed by the AER were the sole reasons for earning a margin we would not observe material margins in:

- a benchmarking study of the kind performed by NERA.
  - This is because, as described in paragraph 21 above, this study effectively excludes the sources of margins relied upon by the AER by examining company wide margins over a large number of firms and years and by focussing on firms that have little in the way of physical assets; or
- a study of aggregate economy of the kind performed by Baruch Levy.
  - This is because if all margins were explained by physical assets not otherwise counted and/or risks and overhead costs not otherwise counted then, at the aggregate economy level, there would be no value to companies other than their physical capital.

46. In fact, NERA estimates a 6% margin for comparable contracts and Baruch Levy estimates one-half and two-thirds of corporate market values reflects the value of

intangible assets."[11] Further, as noted earlier, Nakamura found that investment in technical know-how is the major reason for observed increased margins.[12]

6. Circumstances where contractors accept a zero margin

47. The third question in my terms of reference asks:

> *"whether there are circumstances in which a contractor, acting rationally, would provide services on the basis it only recovers its direct costs of service provision?"*

48. The only circumstance I can envisage where an independent firm will deliberately enter into a contract that does not offer the expectation of earning a margin will be if the firm has zero intangible assets of any value and/or sees the contract as an opportunity to gain intangible assets of some sort (eg, a learning opportunity from which it can later profit in the form of charging margins to future clients). However, I can not envisage a situation where an independent firm will repeatedly and continually enter into such contracts. Of course, a firm that is a wholly owned member of a group of companies might provide services at no margin but that would simply be a matter of that group's accounting policies rather than implying that the activities could be undertaken independently for no margin.

49. A firm that continually fails to earn a margin is, in effect, a firm that fails to learn. In a competitive capital market such a firm would either disappear, or, more likely, be taken over by a firm able to use its resources (eg, staff and physical assets) more productively. That is, market forces will drive firms with valuable know how to take over and use the resources of such a firm to earn a margin themselves. For this reason I would not expect to observe any firm repeatedly contracting for a zero margin.

6.1. Circumstances where outsourcers refuse to pay a margin

50. The conclusion that no firm would repeatedly contract and earn a zero margin does not imply that it is always rational or prudent to pay a margin to an outsource firm. It would

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[11] Lev, B., 2003, Remarks on the Measurement, 2003, Valuation and Reporting of Intangible Assets. FRBNY Economic Policy Review, September 2003

[12] Nakamura, L. 2001. "What Is the U.S. Gross Investment in Intangibles? (At Least) One Trillion Dollars a Year!" Federal Reserve Bank of Philadelphia Working Paper no. 01-15.

not be prudent for a business to pay a margin to a third party if the business had access to the same intangible assets as the potential contractor.

51. Put simply, if a business could achieve the same level of direct costs internally as could the contractor then it would be imprudent to outsource and pay the contractor's direct costs plus a margin. It would be more efficient and lower cost to simply incur those direct costs internally and avoid the cost of the margin.

52. However, a business will only be able to match a contractor's direct costs internally if the business has access to the same value of intangible assets (economies of scale/scope and know how) as the contractor. Only where the contractor brings greater value of intangible assets (ie, can lower direct costs relative to internal provision) will the payment of a margin be prudent.

53. This is essentially the test adopted by the ESCV and, subsequently the Victorian Appeal Panel. Both the ESCV and the Appeal Panel accepted that if a contract was entered into with the reasonable expectation of lowering overall costs then any margin paid on that contract is recoverable. In its Draft Decision the ESCV stated:

> *"Where the Commission can be satisfied that the costs incurred under an outsourcing contract are lower than those costs that would be likely to be incurred by the distributor in undertaking those activities, then the payments made under those contracts are likely to meet the specific requirements in relation to the approval of operating and capital expenditure under the Code and be consistent with other Code objectives as well." (Page 40.)*

54. This was affirmed in the Final Decision where the ESCV stated:

> *"The Commission indicated, however, that in looking at the actual costs incurred by the contractor in undertaking the contracted activities, the Commission is not adopting the position that only the contractor's actual costs form a reasonable basis for the benchmark of prudent and efficient costs. The Commission accepted that it is a prudent and efficient outcome for the contractor to incur lower costs relative to providing the service in-house and that the full amount of payments under an outsourcing arrangement would represent an efficient level of expenditure if the total amount of payments do not exceed the amount that would have been incurred by the distributor undertaking the activity itself."*

55. Application of the principles underpinning the ESCV/Victorian Appeal Panel's decisions would lead to the conclusion that if the payment of a margin in perpetuity would lower overall costs in perpetuity then the margin would be recoverable in perpetuity. By contrast, the AER framework would treat it as imprudent and not recoverable after the lapse of five years or so.

6.2. Application under specific circumstances of Victorian DNSPs and Envestra

56. The above discussion points to a special situation where the application of Stage 2B as described by the AER will be appropriate. Specifically, where the value of intangible assets brought to the contract is no greater than the value of intangible assets available to the outsourcing business then the factors listed in Stage 2B are sufficient to describe legitimate reasons to pay a margin. That is, the omission of the intangible assets as a legitimate reason to pay a contractor a margin is reasonable if it has already been established that the contractor brings no greater value of intangible assets to the contract than the regulated business already had access to without the contract.

57. That is, the Stage 2B assessment is sufficient where the regulated business could reasonably have accessed, at zero cost, the economies of scale/scope and other intangible assets of the outsource provider. In that context, the regulated business could expect to achieve the same direct costs as the outsource provider without contracting with that provider. It would therefore be imprudent to pay a margin on top of this to the provider.

58. In the context of the Victorian electricity decision the AER put forward plausible reasons why this was the case – at least for the CKI group of companies (Citipower and Powercor). In particular, the AER made two important observations in support of its position. The first was based on a view that, but for artificial 'corporate structuring', the DNSPs had direct access to the economies of scale and scope achieved through their combined O&M operations. In the Victorian final decision the AER states:

> *"Importantly, under this approach, somewhat artificial corporate distinctions where a division of a service provider (for example, its field services team) is turned into a separate but wholly owned company, does not affect the regulatory treatment of merger synergies."*[13]

59. Second, the AER observes that while it is common for contractors in competitive markets to command margins based on the prior costly acquisition of intangible 'know how' this was not relevant in the specific circumstances of the Victorian DNSPs. This was because the Victorian DNSPs had merely pooled their existing staff and resources into a single entity. Any 'know how' embodied in the new entity was, by definition, already available to the DNSPs without that entity. Moreover, the AER argued that the costs of acquisition of this 'know-how' was likely to have been already paid for by customers of the DNSPs in past regulatory decisions.

[13] AER, Victorian electricity final decision, 2010, Page 186

"Importantly, the AER noted that the ESCV's opex and capex allowances for the Victorian DNSPs in the current regulatory control period were based on the historical opex and capex of the DNSPs and their related parties. Accordingly, to the extent that a service provider currently possesses 'know-how', this know-how has most likely already been funded by customers."[14]

60. A similar analysis of the specific circumstances surrounding Envestra's outsourcing to APA was never undertaken. Had it been undertaken, the AER would have found that unlike the Victorian DNSPs, Envestra was outsourcing to a separate legal and economic entity in which it had no economic interest. Moreover, the economies of scale and scope enjoyed by APA go beyond those realisable by simply combining Envestra's networks – with APA having responsibility for operating and maintaining a significant number of gas pipeline assets above and beyond Envestra's assets (see Appendix A). The maintenance operations of APA could not be construed as an artificial corporate structure aimed at Envestra placing economies of scale available to it internally into a third party.

61. Put simply, the special conditions that were relied on in the AER decision in relation to Victorian DNSPs simply do not exist in the context of Envestra's outsourcing arrangement. In Envestra's specific circumstances a clear presumption should exist that it is efficient for Envestra to access the intangible assets of APA – including access to economies of scale and scope.

6.3. The AER's 'Catch 22' approach to regulation

62. The AER draft decision acknowledges and accepts the evidence that Envestra has presented that outsourcing to APA lowers costs (inclusive of the margin paid) substantially relative to in-house provision.

63. However, instead of allowing the full cost of the contract as efficient on this basis, the AER argues that, based on the information provided by Envestra, it would be imprudent for Envestra to cease outsourcing to APA and to bring those services 'in-house'. That is, the AER suggests that were Envestra to cease outsourcing to APA and incur higher direct costs then the AER would likely interpret the NGR as not allowing these higher costs to be recovered.[15]

64. In this context, Envestra is caught in a 'Catch 22' paradigm. If it continues to access APA's economies of scale and other intangible assets it will be punished via the non-allowance of the contract margin paid to APA for precisely that access. If it instead

[14] AER, Victorian electricity final decision, 2010, Page 181

[15] See last two full paragraphs on page 143 of the AER, draft decision for Envestra in South Australia.

decides not to access those intangible assets and, instead, incurs higher costs, it will be punished via the non-allowance of costs in excess of those costs APA can achieve.

65. Put simply, the AER's position is that either:

- Envestra should be treated 'as if' it can achieve the same direct costs as APA. This is not a reasonable position for the AER to take in the specific circumstances that Envestra finds itself in. Unlike the Victorian DNSPs, there is no basis for assuming that Envestra could achieve that outcome without relying on APA – a separate legal and economic entity from Envestra; or
- APA should give Envestra access to its valuable intangible assets for free (ie, APA has no legitimate right to earn a return on its intangible assets).

66. Unlike in the case of the Victorian DNSPs, the AER does not have a rationale for dismissing as irrelevant the evidence provided by Envestra as to the economies of scale and scope accessed through its contract with APA. In fact, to act 'as if' Envestra could costlessly access these economies would be inconsistent with statements in the Victorian electricity final decision that:

> *"Were a service provider to actually be a 'standalone' network and not connected to a corporate group that owned and operated multiple networks, the AER considered it should not be penalised through setting its expenditure allowances below its costs (that is, at a level that would be incurred by a multi-network business). However, should that service provider (or the corporate group the service provider is in) acquire other networks, the AER considered those merger synergies should be retained for a period of time by the service provider but eventually passed through to consumers."*[16]

7. Reasonableness of the margin paid by Envestra

67. On the basis of the logic and facts set out above, I am now able to answer the fourth question put to me.

> *"having regard to your understanding of Envestra's outsourcing arrangement, comment on whether the fee paid to APA is consistent with that which would be incurred in a workably competitive market or otherwise."*

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16 AER, Victorian electricity final decision, 2010, Page 184

68. I consider that APA brings substantially greater intangible assets to the contract than Envestra would have access to without relying on APA. I therefore would expect that Envestra would pay a margin to APA that was consistent with the margins paid on similar contracts. I note that NERA estimates Envestra is paying a margin to APA of around 6%, which is consistent with the range for margins found in competitive markets as estimated in the benchmarking study of NERA.

8. Conclusion

69. In summary, there are legitimate reasons as to why firms in competitive markets are able to earn margins that go beyond those considered by the AER. In particular, intangible assets such as the expertise accumulated over many years in an industry are an important factor in explaining the returns of firms in many industries. Rather than dismissing all margins not explained in terms of a return on physical capital, the AER should have regard to the reasonableness of margins based on benchmarks to firms in competitive markets.

Appendix A. APA economies of scale and scope

Table A.1: Assets serviced by APA

State/ Territory		Asset name	Asset Ownership
Gas Pipeline Assets			
NSW and ACT	T	Moomba to Sydney Pipeline (MSP)	APA
		Interconnect	APA
		Central West Pipeline (CWP)	APA
		Central Ranges Pipeline	APA
		Central Ranges Network	APA
Vic	T	Principal Transmission System (PTS)	APA
SA	T	SEA Gas Pipeline	Joint venture between APA (33.3%), International Power (33.3%), REST Superannuation Fund (33.3%)
		SESA Pipeline	APA
Qld	T	Roma to Brisbane (RBP)	APA
		Carpentaria Gas Pipeline (CGP)	APA
	D	Allgas Energy Distribution System	APA
WA	T	Goldfields Gas Pipeline	APA 88.2% BBP 11.8%
		Midwest Gas Pipeline	APA 50%, Horizon 50%
		Kalgoorlie to Kambalda Lateral	APA
		Telfer Gas Pipeline	Energy Infrastructure Investments, APA 19.9% interest
		Parmelia Gas Pipeline	APA
		Cape Lambert, Dampier, Paraburdoo and YMP Gas Pipeline	Pilbara Iron
		Nifty Consumer Gas Pipelineee	Birla Nifty Pty Ltd
		Plutonic Gas Lateral	Barrick Gold
		Maitland Gas Lateral	EDL Group Operations Pty Ltd
		Onslow Gas Pipeline	Horizon Power
		Burrup Fertilizer	Apache Energy Pty Ltd
		Cawse Gas Lateral	Norilsk Nickel Cawse Pty Ltd
		Cosmos Gas Lateral	Xstrata Nickel Australasia Operations Pty Ltd
		Jundee Gas Lateral	Newmont Yandal Operations Pty Ltd
		Leonora Gas Lateral	Energy Generation
		Wiluna Gold Gas Lateral	APA
		Thundebrox Gas Lateral	Norilsk Nickel Wildara NL
		Jaguar Lateral	Jabiru Metals Ltd
		Magellan Gas Lateral	Redback Pipelines Pty Ltd
		Cockburn Cement Delivery Station (Dongara Pipeline)	Origin Energy Pipelines Pty Ltd
		Woodada Receipt Facilities	Arc Energy Ltd
NT	T	Amadeus Basin to Darwin Pipeline (ABDP)	APA 96%, and remainder PAWA and Centrecorp Aboriginal Investment Corporation Pty Ltd

State/ Territory		Asset name	Asset Ownership
		Bonaparte Gas Pipeline	Energy Infrastructure Investments, APA 19.9% interest
		Wickham Point Pipeline	Energy Infrastructure Investments, APA 19.9% interest
	⌂	Darwin Distribution System	APA 96%, and remainder PAWA and Centrecorp Aboriginal Investment Corporation Pty Ltd
Other Assets			
Moomba to Sydney Ethane Pipeline			Ethane Pipeline Income Fund, APA 6.1% interest
Muarraylink and Directink electricity interconnectors			Energy Infrastructure Investments, APA 19.9% interest
Daandine and X41 power stations			Energy Infrastructure Investments, APA 19.9% interest
Tipton West and Kogan North coal seam methane processing plants			Energy Infrastructure Investments, APA 19.9% interest
Reticulated LPG System in Queensland, Northern NSW, SA and NT			Origin Energy LPG Ltd

Source: Letter from John Ferguson (APA) to Craig de Laine (Envestra), dated 24 June 2010.

Contact with us

We request that you contact us or Envestra Limited by telephone in the first instance to discuss any requests for the provision of data or your preliminary conclusions. All enquiries to Envestra Limited should be made to Craig de Laine.

Please sign a counterpart of this letter and forward it to Envestra Limited to confirm your acceptance of the engagement by Envestra.

Yours faithfully

Johnson Winter & Slattery

Enclosed: Federal Court of Australia Practice Note CM 7, "Expert Witnesses in Proceedings in the Federal Court of Australia"

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Signed and acknowledged by Dr Tom Hird

Date 22/3/2011