

Appendix to Access Arrangement Information:

Supplementary information regarding Multinet's outsourcing arrangements

2008 Gas Access Arrangement Review Submission to Essential Services Commission



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1 Overview and Purpose of Paper

The efficiency of any out-sourcing arrangement is best demonstrated by examining the resulting cost performance. In Multinet's case, its business model has enabled it to achieve better cost performance outcomes than those estimated by the Commission in its 2002 review of gas Access Arrangements. Furthermore, expert benchmarking reports summarised in chapter 2 of Multinet's Access Arrangement Information demonstrate that:

- Multinet's cost performance compares very favourably with its peers in Australia, New Zealand and the United States; and
- Multinet's forecast operating expenditure will ensure that customers continue to benefit from Multinet's low cost performance.

Chapter 4 of Multinet's Access Arrangement Information explains the basis of its forecast expenditure for the forthcoming Access Arrangement period. In the language of the Code, Multinet's forecast expenditure is consistent with the costs that would be incurred by a prudent service provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost.

In this Appendix Multinet provides further information to address the Commission's previously stated interest regarding contractual arrangements. In particular, in Consultation Paper No.2, the Commission explained that it intends to conduct a detailed examination of out-sourced contractual arrangements¹:

The Commission therefore intends to review:

- whether the provision of services was subject to full market testing through an open tender process
- how the costs incurred under the contract compare with the cost of similar arrangements elsewhere (ie benchmarking)
- the incentive arrangements under the contract and whether they provide incentives for cost reductions and for the reductions to ultimately be shared with customers
- the level and nature of other fees and associated payments made between the parties.

The Commission proposes to adopt a case by case approach to its evaluation of outsourcing contracts. In reviewing a contract, the Commission is likely to have regard to each of the four factors both individually, as well as their collective impact. The Commission believes it is important to review all the relevant aspects and implications of a contract. This includes the commercial expectations and motivations for the contract, as well as its workability in terms of the provision of the regulated services.

¹ Essential Services Commission, *Consultation Paper No.1*, May 2006, and *Consultation Paper No. 2*, October 2006, pp. 24 & 25.



The distributors should therefore bear the above matters in mind when providing information to satisfy the Commission that contracted costs are consistent with the Code. For example, in addition to information on incentive arrangements and fees and associated payments, the distributors may wish to provide;

- full details of the tender process undertaken, including the business case which demonstrates that outsourcing is a more efficient arrangement than internal provision of services
- data that demonstrates that the services provided under the contract are aligned with the services for which a distributor can seek cost recovery under the Code
- details of how the contract price compares with industry benchmarks or published list prices, including how the industry benchmarks have been calculated
- full details of the relationships between the parties.
- any other information which the distributor believes supports a view that the contract price is consistent with section 8.37 or 8.18 (as relevant) of the Code.

Satisfying the Commission may require the provision of information directly from the business providing the outsourced services.

Chapter 2 of Multinet's Access Arrangement Information explains the ownership and commercial arrangements that resulted from the Shearwater transaction.

An important outcome for Multinet from the Shearwater transaction is that Multinet acquires most of its operating and maintenance services from Alinta Asset Management ('AAM') through their Operating Services Agreement ('OSA'). The terms and conditions of the OSA were subject to commercial negotiation between the parties in the context that:

- AAM/Alinta as service provider had no relationship to AMP/DUET/Multinet when the OSA was negotiated; and
- In accordance with their legal obligations, each party acted in the best interests of their respective shareholders.

A further outcome of the transaction is that Multinet acquires its management and corporate services from Energy Partnership (Gas) Pty Ltd ('EPG') through which Multinet accesses the specialist skills and services of a variety of parties.

In light of the Commission's comments above, this Appendix provides further background information regarding the Shearwater transaction, in particular:

- the Shearwater transaction, and the relevant parties to that transaction;
- the resulting corporate structure and governance arrangements, including:
 - the ownership arrangements, listing all the relevant entities;
 - the names of directors and their nominating bodies, highlighting the duties of directors;



- the Board committees and their membership;
- the salient aspects of the Multinet Gas Holdings ('MGH') constitution and shareholders agreement;
- the resulting Multinet contractual agreements, and the key features of those agreements including:
 - the services provided under the various agreements;
 - the term of the agreements;
 - how prices are structured and determined over time;
 - the commercial tensions between Multinet (the buyer) and AAM (the seller) under the OSA.

The detailed information presented in this Appendix explains the sophistication of the Shearwater transaction, the resulting ownership arrangements and the contractual arrangements. Whilst a simpler set of ownership and contractual arrangements may have been desirable from a narrow regulatory perspective, commercial transactions are not focused on this objective. As described in this Appendix, the Shearwater transaction involved numerous unrelated parties, each driven by their own commercial interests, and each overseen by Independent Directors with fiduciary obligations to their shareholders.

Multinet emphasises that it is providing the information contained in this Appendix in response to the Commission's observations in its consultation paper. Notwithstanding Multinet's provision of this information, the company's view is that:

- chapter 2 of the Access Arrangement Information demonstrates that Multinet's business model has delivered efficient outcomes to date, and will continue to do so in the future;
- Multinet's cost performance is the proper basis for a consideration of whether Multinet's forecast expenditure complies with the Code's requirements;
- the contract related information sought by the Commission is simply contextual background and is not pertinent to that consideration; and
- a regulatory decision by the Commission that forces Multinet to unwind the existing contractual arrangements would be contrary to Multinet's legitimate business interests and the interests of customers.



2 The Shearwater Transaction

2.1 Overview and milestones

The Shearwater transaction ('Shearwater') involved an ownership reorganisation of United Energy Limited, Multinet and AlintaGas Networks. The following table outlines the key milestones of the Shearwater transaction.

The table outlines the key milestones, as publicly reported, of the transaction albeit primarily from the perspective of United Energy Limited ('UEL'). This is because the delisting of UEL was the critical milestone that allowed the transaction to proceed, and with UEL a publicly listed entity, and Multinet not, the public announcements on which the chronology is based is UEL focussed. After delisting, UEL changed its name to United Energy Distribution ('UED').

Key participants in the transaction were:

- AMP Henderson ('AMPH') now called AMP Capital Investors ('AMPCI'), a specialist investment manager with over \$105 billion in funds under management. It is a wholly owned subsidiary of AMP a leading Australian wealth management company. Prior to Shearwater, AMPH managed funds held indirect ownership interests in UEL and Multinet. During the Shearwater transaction, AMPH represented the interest of the funds it managed at that time as well as the interests of the new fund it created through the transaction – DUET. The AMPH interests also held pre-emptive rights over Aquila's indirect ownership in UEL and Multinet.
- Aquila Inc. a publicly listed US utility, previously known as Utilicorp United. Prior to Shearwater, Aquila held indirect ownership interests in UEL, Multinet and Alinta. Aquila's indirect ownership of UEL and Multinet was through holding companies jointly owned with AMPH. Aquila had contracts whereby it provided management services to UEL and indirectly to Multinet.
- Alinta Limited, which is a Western Australian based publicly listed utility. In 2003, prior to Shearwater, Alinta did not hold interests in any other Shearwater participants other than AlintaGas Networks.²
- United Energy Limited, which in 2003, prior to Shearwater, was a Victorian based publicly listed utility. UEL's public shareholders, via the company's independent directors, were key participants in the Shearwater transaction, being the recipients of the offer from AMPH/Alinta to buy their shares in UEL.³
- Diversified Energy Utilities Trust ('DUET') was established in 2003 by AMPH as a part of the Shearwater transaction. Today it is a listed infrastructure fund

² Prior to the transaction Alinta was known as AlintaGas, but changed its name as part of the transaction.

³ This was executed via the Power Partnership Pty Limited.



comprising three stapled DUET entities and their associated responsible entities, managed jointly by AMP Capital Investors and Macquarie Bank. DUET listed in August 2004 with the assets it acquired in the Shearwater transaction.⁴

Table 2.1: The Shearwater Transaction

Date	Key milestones
1995-2000	<p>In 1995 the Victorian Government created United Energy via a trade sale of a stapled electricity distribution and retail business. United Energy was then acquired by the Power Partnership. In 1998 the Power Partnership listed its subsidiary United Energy Ltd (UEL) with 43 per cent of the company sold to the public. In 2000 UEL became a stand alone electricity distribution business after selling its stapled retail arm, Pulse Energy.</p> <p>Multinet was created when the Government-owned Gas and Fuel Corporation was corporatised in the 1990s. Multinet was subsequently privatised in 1999 when a consortium of AMPH and Aquila purchased the business.</p>
21 May 2002	<p>Aquila launches "Project BBB+/Baa1", in response to deteriorating market conditions and its performance in the wake of the collapse of Enron. This project included an objective to sell \$500 million of non-core, non-strategic assets in an effort to improve its credit rating.⁵ By June 2002, Aquila had announced plans to sell \$1 billion in non-strategic assets by year-end.⁶ At that time AMPH interests held pre-emptive rights over Aquila's indirect ownership in UEL and Multinet.</p>
17 Dec 2002	<p>UEL announces that AlintaGas Limited (ALN) and UEL are reviewing strategic opportunities in relation to ALN acquiring Aquila's 34 per cent indirect interest in UEL.</p>
27 Feb 2003	<p>UEL confirms it is continuing its negotiations with AlintaGas, AMPH and Aquila Inc., regarding Aquila's Australian assets.</p>
20 March 2003	<p>UEL announces that in response to speculation contained in The Australian Financial Review, UEL wishes to make the following comments...</p> <p>The Independent Directors of UEL are involved in these negotiations, which are incomplete. No agreement has been reached;</p> <p>The Independent Directors will not agree to any proposal unless they consider it to be in the best interests of UEL shareholders; and</p> <p>UEL has retained Deloitte Corporate Finance to provide an Independent Expert's Opinion in the event that a formal agreement is reached.</p>
23 April 2003	<p>UEL publishes 'Open Briefing: Directors on \$3.15 Offer'</p>

⁴ For simplicity, in some parts of this paper (ie. in summarising the substance of the outcomes) we refer to the current name of the entities that undertook the relevant transactions.

⁵ Aquila News Release, *Aquila Focused on Improving Credit Rating, Launches Project BBB+/Baa1*, 21 May 2002.

⁶ Aquila News Release, *Aquila Announces Strategic and Financial Repositioning*, 17 May 2002.



Date	Key milestones
24 June 2003	<p>UEL announces the publication of the Scheme of Arrangement Information Memorandum outlining the details of the transaction. In the covering letter it states:</p> <p>After considering the advantages and disadvantages of, and other relevant matters regarding the proposed Scheme, we concluded that the Scheme is in the best interests of UEL shareholders. The advantages, disadvantages and other relevant considerations regarding the Scheme are outlined in the Scheme Booklet.</p> <p>It also notes that for the proposal to proceed, the Scheme must be supported by at least 50 per cent of the number of shareholders who vote on the proposal and 75 per cent of the votes cast.</p>
10 July 2003	<p>UEL holds an Extraordinary General Meeting to decide the future ownership of the company. Independent Director, John Clark, states:</p> <p>Let me start by addressing one question that many of you may have – how did we get here? Well, it's certainly not because we, the UEL board, sought to privatise – or sell – the company. We did not initiate the process leading to us being here today. The process started because: one, Aquila – a corporation based in the United States – last year indicated that it wished to sell all of its Australian assets..., And two because Alinta and AMP Henderson put an acceptable proposal to Aquila to buy all of its Australian assets..., Having received the offer we were obliged to give it due consideration.⁷</p>
10 July 2003	<p>UEL announces that the motion regarding the Scheme of Arrangement was carried on a poll by a majority of 78.10 per cent of shares voted and 80.86 per cent of the shareholders who voted.</p>
15 July 2003	<p>UEL announces that the Supreme Court of Victoria has given its approval to the Scheme of Arrangement.</p>

Prior to the Shearwater transaction AMPH owned 51.77 per cent of Multinet and Aquila owned 48.23 per cent of Multinet. Interests associated with DUET now own 79.9 per cent of Multinet and Alinta own 20.1 per cent. In essence, therefore, this part of the transaction involved Aquila's interest in Multinet transferring to Alinta. Interests associated with AMPH were and remain the dominant shareholder. The transaction, which included the acquisition of Multinet, UED and AGN, involved a total investment by the parties of almost \$1.5 billion.

2.2 Execution of the Transaction

The Shearwater transaction involved payments between the relevant parties, all of which were fully disclosed at the time in accordance with each party's legal obligations.

The table below sets out the major transactions associated with the Shearwater project, which were executed in June and July of 2003. The table shows how the ownership of the key entities changed. Like many transactions of this nature there were a number of intermediate steps in some of the transactions, some of which involved other subsidiaries within the key ownership groups. These intermediate steps and entities have not been included in the table as they do not add to

⁷ United Energy, *Extraordinary General Meeting*, 10 July 2003.

understanding the substance of the overall transaction. Multinet can provide further information on these intermediate steps on request.

Table 2.2 – The Components of the Shearwater Transaction

Party./ Assets etc.	Sellers	Buyers
UEL (UED)	<p>The sellers were:</p> <ul style="list-style-type: none"> • Aquila (the exiting major shareholder – 34 per cent interest) • the public investors in the listed entity UEL (42.95 per cent) • other investors associated with AMPH converted their investments into investments in DUET (23.05 per cent) <p>All sellers received \$3.15 per share of UEL</p>	<p>The buyers were</p> <ul style="list-style-type: none"> • DUET (66 per cent) and • Alinta (34 per cent) <p>DUET comprised:</p> <ul style="list-style-type: none"> • some of the investors who had previously invested in UEL and Multinet through AMPH • new private equity investors arranged by AMPH <p>All buyers invested in the new vehicle (UEDH) on identical terms.</p>
United Energy non-distribution assets	<p>United Energy sold its non distribution assets comprising interests in:</p> <ul style="list-style-type: none"> • National Power Services Pty Ltd • Uecomm Limited • the WAGH group. 	<p>Alinta acquired United Energy's non distribution assets for \$210 million</p>
Multinet	<p>The sellers were:</p> <ul style="list-style-type: none"> • Aquila (48.23 per cent) • AEF2, a trust managed by AMPH (51.77 per cent of Multinet) <p>Some of the investors associated with AEF2 converted their investments into investments in DUET, others took a direct interest in MGH while others sold their interests.</p>	<p>The buyers were</p> <ul style="list-style-type: none"> • DUET (74.9 per cent), • Alinta (20.1 per cent) and • some direct investors (via AEF2 - 4.99 per cent) <p>DUET comprised:</p> <ul style="list-style-type: none"> • some of the investors who had previously invested in UEL and Multinet through AMPH • new private equity investors arranged by AMPH <p>The AEF2 investors sold their investments or converted to DUET units a short time later.</p> <p>All buyers invested in a new vehicle (MGH).</p>
Alinta	<p>Aquila sold their 22.5 per cent (indirect) shareholding in Alinta, to Alinta.</p>	<p>Alinta</p>
AlintaGas Networks	<p>Alinta sold 25.9 per cent of AlintaGas networks</p>	<p>DUET purchased a 25.9 per cent stake in AlintaGas networks through a new investment vehicle, Alinta Network Holdings Pty Ltd.</p>



2.2.1 Service Transactions

AMPH, as a financial investor, did not have the capability to operate and maintain the Multinet network. As a consequence, when considering its participation in the transaction arising from the sale by Aquila of its Australian assets, AMPH sought on behalf of its clients the participation of a party willing to take both an equity interest and be the operator of the network.⁸ It was important that the operator hold equity to align the interests of that party with AMPH and ensure that there was an appropriate incentive to balance the drive for cost efficiency with maintaining the integrity of the network.

The resulting OSA to operate the network was negotiated between representatives of AMPH and of Alinta. The negotiation took place within the commercial and competitive tensions of the transaction as a whole. The parties were unrelated, each driven by their own commercial interests, and each overseen by independent directors with fiduciary obligations to their shareholders.

The presumption that a competitive tender will always result in efficient prices is incorrect except in limited circumstances. Such circumstances did not apply to the type of services supplied to Multinet. Once the presumption is relaxed, it is valid for the contractee to enter in bilateral negotiations with a potential supplier and this is more likely to produce efficient outcomes than competitive tender in these circumstances.

It important that buyers act as informed purchasers and have an understanding of the likely costs of supply. AMPH negotiated with AAM the operating fees Multinet would pay taking into account its judgement on the existing efficiency of the business, and the other businesses that it already owned (and which were operated by Aquila). This resulted in it agreeing to operating fee levels in line with the typical pre-acquisition operating expenditure levels.

AMPH had an incentive to ensure that the prices of the services provided by AAM were as low as is feasible, subject to it maintaining the service performance of the assets and accepting a suitable level of performance risk. There was no parent/subsidiary relationship between AMPH and AAM and there is no parent/subsidiary relationship between DUET and AAM, rather DUET is the majority holder (79.9 per cent) of the equity in MGH. If AAM were charging prices such that it was earning "excess" profits then it could only mean that the minority owner (Alinta) was making profit in which the majority owner (DUET) could also potentially share but is not. The majority owner could not allow this situation to arise when renegotiating the service agreements and meet its fiduciary obligations.

2.3 Transactions involving Alinta Ltd

It is clear from sections 2.1 and 2.2 above that the Shearwater transaction involved four principal parties, each with their own commercial objectives. Multinet notes,

⁸ References to AMPH in this report refer to AMPH and its clients. As indicated above, AMPH subsequently became known as AMPCI, which then created DUET.



however, that the Commission's focus relates to the transactions and commercial arrangements involving Multinet and Alinta. This section explains the transactions and associated payments between AMPH on behalf of its clients (as majority owner of Multinet) and Alinta.

The Shearwater transaction resulted in the following key financial transactions between the parties:

- Alinta subscribed for \$122 million of securities in UEDH giving it an indirect 34 per cent interest in United Energy Distribution;
- Alinta subscribed for \$42.9 million of securities in MGH giving it an indirect 20.1 per cent interest in Multinet;
- AMPH subscribed for \$44 million of securities in Alinta Network Holdings Pty Ltd giving it an indirect 25.9 per cent interest in AlintaGas Networks; and
- Alinta paid UEL \$210 million for 100 per cent ownership of United Energy Limited's non-distribution assets⁹
- Alinta paid AMPH and associated entities a total of \$19.1 million to ensure that the transaction went ahead and that they secured the service contracts. Of these payments the majority went to the account of AMPH investors in Multinet and to AMPH in relation to underwriting costs.

Alinta explained the flow of funds that would result from the Shearwater transaction as shown in Table 2.3 below.¹⁰

⁹ Because the prospectuses were being prepared at slightly different times during the ongoing transaction, some of the relevant details are slightly different (e.g. in terms of precise ownership shares to be acquired and consideration). These variations may have occurred because of these timing differences and due to adjustments in, for example, expected net debts and working capital at execution.

¹⁰ AlintaGas, *ASX Announcement: The Aquila Opportunity*, 23 April 2003, p. 11.

Table 2.3: Alinta Shearwater transaction: Flow of funds

Assets Acquired & Direct Fees Paid by Alinta		(\$M)
Buyback and cancel Aquila's Alinta shares		153.4
Multinet (19.9 per cent) ¹¹		46.8
UED (34 per cent)		122.7
UEL Non Distribution Assets		210.0
Payments for ANS contracts		19.1
ANS restructuring costs & leave liability (after tax)		27.5
Super Equity - Multinet (maximum payment)		11.0
Fees and Charges Directly Payable (approximately)		19.0
Total		609.5
Assets Sold & Funds Raised		
Alinta Networks Selldown (25 per cent) - after tax		30.8
RePS issue to fund buyback		160.0
Sale of UEL Non Distribution Assets		210.0
Total		400.8
Net Investment		208.7

The relevant Alinta Prospectus noted the potential requirement to contribute further equity (the 'super-equity' referred to in the above table). It stated in relation to the costs of acquiring the ANS management contracts:¹²

"In addition, Alinta has agreed to subscribe for up to 11,000,000 Class B Ordinary Shares at \$1.00 per share (Class B Shares) if the return to all ordinary shareholders does not exceed 11.75% per annum for the first three years.

The Class B Shares carry no voting rights and are not redeemable. They grant priority in the event of winding-up."

This equity would also receive a greater proportion of distributions if returns exceed a benchmark yield (set at 13 per cent per annum).

¹¹ The shareholding acquired by Alinta was variously reported as 19.9 per cent and 20.1 per cent. This difference occurred as Duet and the AMPCI finalised their shareholdings following the resolution of working capital adjustments.

¹² Alinta Limited, *Prospectus for the issue of 1,250,000 Reset Preference Shares at \$100 each to raise \$125,000,000*, 13 June 2003, p. 57.



The DUET Prospectus also explained the potential for Alinta to invest in additional (super) equity:¹³

“For three years, at each anniversary of completion of the Multinet acquisition, if the total dividends paid or determined to be payable to MGH do not reach 11.75% of the total equity of MGH contributed by Alinta and AMP Capital-managed interests, then Alinta must subscribe for additional (super) equity in MGH in an amount equal to the shortfall up to a maximum amount of \$5 million per annum and \$11 million in three year period, which sum is to be distributed to ordinary shareholders of MGH pro-rata to their equity.”

A dividend on (super) equity is only payable where the Equity Return to holders of Ordinary Shares for the relevant Period is greater than the Required Equity Return.

The DUET Prospectus went on to note:

“For the year ending 30 June 2004, DUET has calculated that Alinta is required to subscribe for \$5 million of (super) equity under this arrangement. Alinta has been notified of this, and has questioned the extent of the payment it is required to make. The parties have agreed to settle the quantum of Alinta's liability through determination by an independent auditor, and are in the process of appointing such a party.”

This was the only additional investment in relation to the need to invest in super equity, as these are the only Class B Shares on issue.¹⁴

With regard to the subscriptions that Alinta made during the Shearwater transaction it is important to note that Alinta paid the same price for its equity as any other party.

2.4 Efficient outcomes for Multinet

The following factors establish that all payments made during the Shearwater transaction, including those for Alinta's service contracts, have delivered arrangements that have, in turn, delivered efficient outcomes for Multinet.

- The total costs incurred by Multinet, which included those associated with AAM's OSA, benchmark extremely well when compared to Multinet's peers.
- Multinet's actual total operating costs have been reduced at an average annual rate of approximately 4 per cent in real terms since 1998, and have been consistently lower than the corresponding expenditure benchmarks set by previous regulatory decisions.
- Multinet has sought to minimise its OSA costs by contesting claims by AAM for scope changes and cost increases.

¹³ DUET, *Supplementary Product Disclosure Statement for the Initial Public Offering*, 15 July 2004, p. 173.

¹⁴ ASIC Company Extract – Current, Mutinet Group Holdings Pty Limited, 8 March 2003, p. 4.



- In the absence of Alinta entering into the agreements to secure the service contracts, the Shearwater transaction might not have proceeded. Multinet would therefore have been deprived of the opportunity to enter into the current efficient contract with AAM and consumers would have been deprived of the efficiencies that flowed.

2.5 Conclusion

This section has explained the key milestones and features of the Shearwater transaction. It is clear that the transaction involved four principal parties (AMPH, Aquila, Alinta, and the UEL public shareholders), each with their own commercial objectives and legal obligations, including in relation to information disclosure. The Shearwater transaction was conducted in a competitive market between unrelated parties. The commercial and competitive tensions between the parties resulted in arrangements that were reasonable and efficient.

In considering the regulatory aspects of the Shearwater transaction it is important to recognise that:

- Alinta did not pay more for its equity than other party;
- all payments made during the transaction were a part of the whole package and without them the resulting business arrangements, which have delivered superior and efficient outcomes, are unlikely to have been achieved;
- DUET had no obligation to select Alinta as an equity partner and service provider. DUET did so because Alinta was a party able to meet its objectives;
- DUET and Alinta were not related parties at the time of the transaction;
- DUET's majority shareholding meant that it had very strong incentives to obtain out-sourced services at the lowest sustainable cost; and
- Although the Commission may have found it easier to deal with a simpler structure and a formal, standalone competitive tender for the provision of asset management services, the Commission should accept and recognise that sophisticated commercial transactions do not undermine the legitimacy, the commercial incentives and the strong efficiency drivers of the contractual arrangements and the resulting commercial realities.



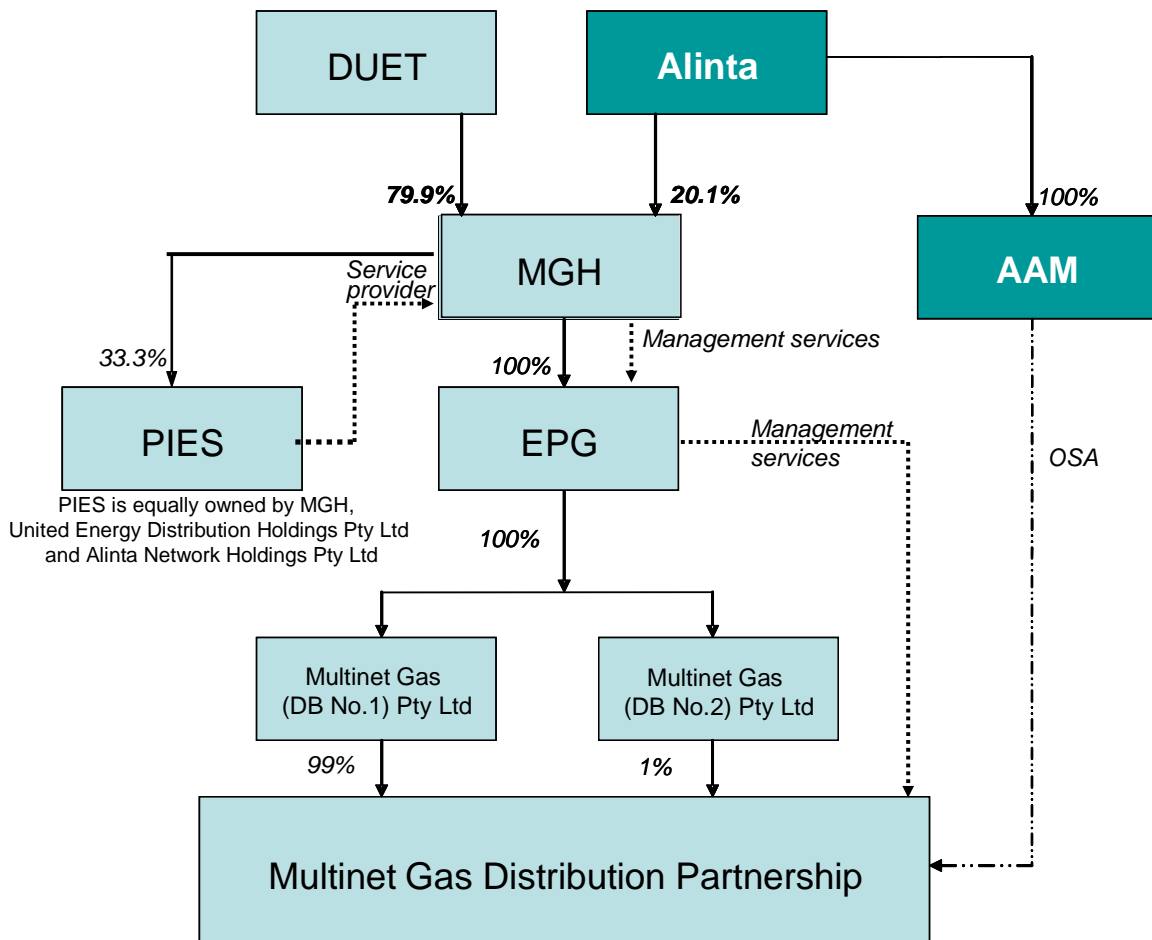
3 Corporate structure and governance

This section summarises the corporate structure and governance arrangements that resulted from the Shearwater transaction.

3.1 Overview of ownership arrangements

Diagram 1 below summarises the parties relevant to Multinet's overall ownership and commercial structure.

Diagram 3-1: Summary of the Commercial Structure within which Multinet's Operates



The above structure does not show the following companies:



- Amistel Pty Ltd, Multinet Gas (IE) Pty Ltd and Energy Retail Holdings Pty Ltd that are dormant subsidiaries of EPG; and
- Utilities Southern Cross Pty Ltd, UtiliCorp Australia (Gas) Holdings Pty Ltd, UtiliCorp Australia (Gas) Finance Pty Ltd, Energy Partnership (Holdings) Pty Ltd and Energy Partnership Pty Ltd that are subsidiaries of MGH and are part of the debt financing structure of the group.

Multinet Gas (DB No. 1) Pty Ltd and Multinet Gas (DB No. 2) Pty Ltd¹⁵ are partners in the Multinet Gas Distribution Partnership ("Multinet") and a gas distribution licence has been issued to Multinet Gas (DB No. 1) Pty Ltd and Multinet Gas (DB No. 2) Pty Ltd trading as 'The Multinet Partnership'. Multinet carries out the gas distribution function in accordance with all legal and regulatory requirements. These entities are beneficially owned by DUET (79.9 per cent) and Alinta (20.1 per cent). DUET and Alinta are independent entities with no cross shareholdings.

3.2 Boards and Directors for each entity in the Commercial Structure

This section briefly summarises the role of each entity and the composition of each entity's Board.

MGH is the holding company for the Multinet group. MGH owns 100 per cent of EPG. It provides the general management for the Multinet Partnership, EPG and other members of the Multinet group. It acquires some of those services from PIES and the ultimate shareholders of Multinet.

EPG is a company which facilitates the ownership of Multinet. It is responsible for the management of Multinet's licensed gas distribution business and provides associated corporate services.

The directors of MGH, EPG, Multinet Gas (DB No. 1) Pty Ltd and Multinet Gas (DB No. 2) Pty Ltd are:

- Peter Scott Lowe (Independent);
- Peter John Barry (DUET);
- David James Bartholomew (DUET); and
- Ian Stewart Devenish (Alinta).

Bruce Kendle Berry and Shaun Reardon are alternate directors for DUET and Alinta, respectively.

DUET has a majority on the boards of the companies that comprise the Multinet group. It should be noted that Section 2.4 of the Shareholders' Agreement states

¹⁵ The Victorian Government established these two companies in 1999 to facilitate the privatisation process.



that the directors of MGH who are nominated by Alinta are unable to vote on issues relating to the Multinet's contract with AAM.

DUET owns 79.9 per cent of Multinet via the same level of shareholding in Multinet Group Holdings Pty Ltd. DUET's directors are nominated by Macquarie Bank and AMPCI respectively and are:

- Philip Garling (AMPCI)
- John Roberts (Macquarie Bank);
- Emma Stein (Independent);
- Duncan Sutherland (Independent);
- The Hon. Michael Lee (Independent);
- Eric Goodwin (Independent);
- Doug Halley (Independent);
- Ronald Finlay (Independent);
- Stephen Mentzines (Macquarie Bank, Alternate for John Roberts); and
- Gregory Roder (AMPCI, Alternate for Philip Garling)

Pacific Indian Energy Services Pty Ltd ("PIES") is a provider of certain services to EPG. PIES is owned equally by MGH, United Energy Distribution Holdings Pty Ltd and Alinta Network Holdings Pty Ltd.¹⁶ Its directors are:

- Peter Scott Lowe (Chair, Independent);
- Ian Stewart Devenish (Alinta); and
- Henry Gregory Roder (AMPCI)

Alinta Ltd ("Alinta") is a listed energy company that owns 20.1 per cent of Multinet. Its directors are:

- John Howard Akehurst (Chair, Independent);
- John Michael Wilkins (Independent);
- Fiona Elizabeth Harris (Independent); and
- Tina Renna McMekan (Independent).

¹⁶ PIES is majority owned by DUET by virtue of its ownership shares in the three assets (ie. 79.9% of Multinet, 66% of UED and 25.9% of Alinta Gas Networks). Each asset has a indirect one third interest in PIES.



Alinta Asset Management Pty Ltd ('AAM')—formerly Alinta Network Services ('ANS')—is a provider of energy network operational services. It is 100 per cent owned by Alinta. Its directors are all nominated by Alinta and are:

- Peter Magarray (Alinta);
- Ian Damien Wells (Alinta); and
- Yasmin Broughton (Alinta).

3.3 The Audit and Risk Committee

The Multinet Group has established an Audit and Risk Committee to focus on the audit and risk aspects of the business. The composition of the Committee is as follows:

- Peter Scott Lowe (Chair, Independent);
- Bruce Kendle Berry (DUET); and
- Ian Stewart Devenish (Alinta).

3.4 Corporations Law and the duties of directors

It is worth noting that Section 181 of the Corporations Law imposes a statutory duty on directors and other officers to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose. This means that Directors owe a fiduciary duty to act in good faith in the best interests of the company. Attachment A describes those responsibilities in more detail.

3.5 Conclusion

This section has described the ownership structure and governance arrangements that resulted from the Shearwater transaction. It is important to note that appropriate governance arrangements are in place to ensure that each entity has a Board structure that is consistent with the Directors satisfying their fiduciary duties to their shareholders under the Corporations Act and common law. Specifically, Multinet's Board of Directors has a composition that enables it to act in the interests of its shareholders, of which DUET is the majority shareholder.

In examining the implications of the ownership structure and the composition of the various Boards, it is helpful to note the following facts:

- Alinta is not in a position to control Multinet;
- The Directors of Multinet appointed by Alinta are not able to vote on the service agreements;



- DUET is not in a position to control AAM or Alinta, as the DUET Initial Public Offering makes clear;¹⁷
- There are no cross shareholdings between DUET and Alinta; and
- Commercial tensions exist between the parties, noting that Multinet's interests are best served by obtaining outsourced services at the lowest sustainable cost.

In summary, these arrangements ensure that Multinet's is able to acquire services at efficient levels of service and cost, in accordance with the requirements of the Access Code.

¹⁷ DUET, *Supplementary Product Disclosure Statement for the Initial Public Offering of DUET*, 2003, p. 84.



4 Contractual arrangements

As a part of the Shearwater transaction, Multinet entered into a number of contractual arrangements to facilitate the efficient management and operation of Multinet. This section provides details of these contractual arrangements.

4.1 Contract for the provision of management services between Multinet and EPG

Multinet acquires management and corporate services from EPG. EPG in turn acquires some of these services from MGH, PIES (through MGH) and its ultimate shareholders (i.e. AMPCI, Macquarie Bank and Alinta) – under agreements with those parties.

4.1.1 Services provided by EPG to Multinet

EPG is the focal point for the management of Multinet's gas distribution business. EPG's responsibilities include but are not limited to:

- general management and corporate governance;
- financial management, accounting and reporting;
- corporate strategy and planning;
- corporate relations and stakeholder management;
- risk and quality management;
- treasury management;
- regulatory management;
- overseeing customer and back-office management;
- overseeing operations, network planning and investment decision making;
- insurance management (but not the direct cost of insurance premiums);
- contract management, including the operations contract between Multinet and AAM; and
- company secretarial.

4.1.2 Contract price

The Multinet and EPG agreement provides for:

- initial prices for 4.5 years with those prices set by reference to efficient, independent benchmarks;
- prices for future Access Arrangement periods to be set by reference to benchmarks; and



- a CPI-X increase during the contract periods, with X an efficiency factor agreed between the parties (but no less than the X factor set for Multinet's tariffs in the partnership's prevailing Access Arrangement). The X factor for the initial period was agreed at 1 per cent.

4.2 Contract for the provision of asset management services between Multinet and AAM

Multinet acquires most of its operating and maintenance and capital expenditure service requirements from AAM in accordance with the OSA.

4.2.1 Overview of OSA

The OSA outlines:

- the nature of the services AAM provides (Schedule 1) and the requirements in relation to the standards at which those services need to be provided (Section 6 and Schedules 3-5);
- fees for services (Schedules 2 and 7);
- issues relating to the appointment of service providers and the renegotiation of fees at the first and any subsequent renewals of the contract term (Part 4 Section 5); and
- dispute processes (Part 4 Section 5) and non-compliance (e.g. Part 7).

4.2.2 Services provided by AAM to Multinet

The services provided by AAM to Multinet in accordance with the OSA are:

- regulatory services (particularly regulatory compliance);
- network management;
- construction management;
- network customer services;
- network planning and engineering services; and
- network operation, incident management and supervisory control services.

The services explicitly not provided by AAM include:

- approval of and final submissions to the Commission in relation to the Access Arrangement, revisions to the Access Arrangement and other requirements under the Access Code;
- regulatory strategy including strategy for network pricing and tariff reassignment;
- claims by customers of third parties at the Commencement Date;



- general management and operation of Multinet including the board of Multinet; and
- press releases and publications of Multinet.

4.2.3 Contract price

As noted above, schedule 2 of the OSA sets out the fees that Multinet pays to AAM. The fees are:

- The Opex Fee;
- The Fixed Capex Fee;
- The Variable Capex Fee; and
- The Emergency Fee (for costs in responding in an emergency).

The OSA in respect of operating and maintenance costs operates as a fixed price contract, with an annual CPI-X adjustment.

The capital expenditure fees are set in accordance with a CAPEX Pricing Procedure that Multinet and AAM has formalised.

The DUET IPO document stressed the fixed nature of the agreement in respect of operating costs and the implications for risk allocation:

“Prior to the acquisition of the Asset Companies, each operating business incurred both fixed and variable costs associated with managing, operating and maintaining their assets. Following the acquisitions on 23 July 2003, ANS now performs most of these functions for the Asset Companies under each of the Operating Services Agreements described in Section 13.1.6. The fees payable for those services are in line with typical pre-acquisition operating expenditure levels, however they are largely fixed and DUET therefore effectively transfers certain operational risks and rewards to ANS.”¹⁸

4.2.4 Term and renegotiation of the contract

The contract has an initial term of five years to 30 June 2008. The contract allows for a further term of five years with further five year extensions (on a competitive basis). Attachment B describes the terms under which that price renegotiation occurs, including the factors that must be taken into account and the scope for independent arbitration in the event that the parties cannot agree to those terms.

The renegotiation in 2013 allows for a fully competitive tender process. It also provides AAM with a right to match the preferred tender. If AAM is unwilling to match the preferred tender, the new service provider would be required to invest in at least 10 per cent of Multinet to align the interests of the contractor with the interests of

¹⁸ DUET, *Supplementary Product Disclosure Statement for the Initial Public Offering*; 15 July 2004, p. 94.



Multinet. In the absence of this ownership interest, a contractor may be inclined to place undue emphasis on reducing costs in the short term, without having sufficient regard to the longer term impact on cost and service performance.

It should be noted that Multinet's negotiating position is strengthened considerably by:

- the significant investment that AAM has made in developing its capability to provide asset management services to Multinet, and its subsequent inability to easily walk away; and
- the commercial arbitration protections offered under the OSA if Multinet and AAM are unable to agree a price.

4.2.5 Operation of the contracts

It has been clearly recognised that a company such as Multinet cannot relieve itself of its licence obligations and legal and commercial responsibilities by outsourcing. Multinet has taken steps to ensure that it has the appropriate systems and processes in place to give its directors and shareholders confidence that obligations are being met. At the highest level, this comfort must be obtained in one of two ways:

- either Multinet carrying out the function itself; or
- Multinet adopting processes to ensure that its obligations are being appropriately discharged through contractual arrangements.

Oversight mechanisms that Multinet has put in place include:

- an extensive risk management process governed by Multinet's Audit and Risk Management Committee; and
- an extensive internal audit process governed by the Multinet Audit and Risk Management Committee;

For each calendar year, AAM develops a series of management plans to cover each of the activities of the business. These management plans generally cover a rolling 5 year period and are developed in consultation with Multinet. The management plans generally cover:

- Asset Management plan;
- IT plan;
- OH&S;
- Environmental;
- Regulatory; and
- Customer Service and Revenue Collection.



An extensive set of KPIs has been established (broader than those encompassed in the OSA) to monitor and report on performance against the management plans.

For reasons of maximising efficiency, AAM is generally the 'first port of call' to address Multinet's resource requirements. In many cases, however, Multinet engages other external contract expertise to ensure that Multinet's obligations are satisfied fully, and to maximise Multinet's commercial position.

4.2.6 Management of the capital plan

All capital projects require the preparation of a business case, consistent with long standing Multinet practice and policy. AAM is responsible for the development of these business cases in consultation with Multinet.

For operational purposes, a set of delegations of authority has been established similar to those that would exist in most companies/distribution businesses. These arrangements allow for the approval of business cases below a certain level to be delegated to AAM staff, whilst approval of business cases above that level being the responsibility of Multinet staff. The delegation to AAM staff in no way diminishes AAM's responsibility to act in the interest of the asset owner.

All business cases are recorded by AAM and passed to Multinet for review and audit regardless of the value. These business cases are retained as a permanent record of AAM's adherence to the principles established between Multinet and itself. The periodic review of business cases prepared by AAM provides Multinet's board with assurances that capital is being invested prudently by Multinet on behalf of its shareholders.

Substantial time and effort has been invested in the development of practice and procedures for the management of capital budgets. Multinet has developed robust practices and procedures, to a greater extent than may have been initially envisaged in the OSA. Multinet's focus on developing appropriate practices and procedures recognises that commercial tensions exist between Multinet and AAM.

4.3 Conclusion

The contractual arrangements resulting from the Shearwater transaction provides for a healthy commercial tension between AAM and Multinet, resulting in on-going downward pressure on Multinet's future costs.

In renegotiating the contract terms for the provision of asset management services in the forthcoming Access Arrangement Period, Multinet's strong incentive is to drive the price to the lowest sustainable level. This commercial pressure is consistent with the reference tariff principles set out in the Access Code and is also consistent with the commercial pressure that any distributor has when dealing with its contractors. In this regard it should be noted that DUET, as the 79.1 per cent publicly listed owner of Multinet has a strong interest in Multinet paying the lowest sustainable price for operational services.



As noted in chapter 2 of its Access Arrangement Information dated 30 March 2007, Multinet has provided supporting benchmarking reports and other analysis, which demonstrates that:

- Multinet's business model has already delivered, and will continue to generate considerable efficiency benefits; and
- those benefits will flow to customers from 1 January 2008 under Multinet's proposed Access Arrangement for the forthcoming period.

Therefore, whilst the information contained in this Appendix is intended to address the issues raised by the Commission in its earlier consultation papers, the information presented in the Access Arrangement Information demonstrates that Multinet's forecast expenditure for the Third Access Arrangement Period satisfies the Code requirements.



Attachment A: Corporations Law and the Duties of Directors

Section 181 of the Corporations Law imposes a statutory duty on directors and other officers to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose. This means that Directors owe a fiduciary duty to act in good faith in the best interests of the company.

Director's Fiduciary Duties:

Directors are considered to stand in a fiduciary relationship (being a position of trust and power over another) with their company, and are therefore subject to the following duties flowing from that relationship:

- (a) to act bona fide and in the company's best interests;
- (b) not to fetter their discretion;
- (c) to exercise their powers for their proper purposes;
- (d) to avoid conflicts of interest;
- (e) to disclose any relevant interests in a contract, to the company; and
- (f) to maintain confidentiality of company information, and not disclose it or use it for their own benefit.

Duty to Act Honestly and in the Best Interests of the Company:

At common law directors of a company must do what they honestly and reasonably believe to be in the best interests of the company. In addition to the common law duty to act honestly in the company's best interests, section 232 (2) of the Corporations Law requires that "an officer of the corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office". Breach of this duty may result in civil and/or criminal liability, penalties, payments of compensation, and prohibition from management of a corporation.