**LEGISLATIVE ASSEMBLY FOR THE AUSTRALIAN CAPITAL TERRITORY**

**STANDING COMMITTEE ON FINANCE AND PUBLIC ADMINISTRATION**
**(INCORPORATING THE PUBLIC ACCOUNTS COMMITTEE)**

# FINAL REPORT ON

# PROPOSED ACTEW/AGL PARTNERSHIP ARRANGEMENT

Finance Committee Report No 8
August 2000

**Resolution of appointment**

The Standing Committee for the Chief Minister's Portfolio was appointed by the Legislative Assembly on 28 April 1998 to examine any matter under the responsibility of the Chief Minister's portfolio. The Assembly also resolved that the committee perform the duties of a public accounts committee, specifically:

(a) to examine:
  (i) the accounts of the receipts and expenditure of the Australian Capital Territory;
  (ii) the financial affairs of authorities of the Australian Capital Territory; and
  (iii) all reports of the Auditor-General which have been laid before the Assembly;

(b) to report to the Assembly, with such comments as it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, to which the Committee is of the opinion that the attention of the Assembly should be directed; and

(c) to inquire into any question in connection with the public accounts which is referred to it by the Assembly and to report to the Assembly on that question.

On 26 November 1999, the Assembly retitled the committee as the Standing Committee on Finance and Public Administration (Incorporating the Public Accounts Committee), omitted reference to matters under the responsibility of the Chief Minister's portfolio and included reference to women's affairs, Aboriginal and Torres Strait Islander issues, asset management, gaming and racing and any other related matter.

**Terms of reference**

Inquire into and report to the Assembly on the proposed ACTEW/AGL Partnership Arrangement.[1]

**Membership of the committee**

Mr Ted Quinlan MLA, Committee Chair
Mr Trevor Kaine MLA, Deputy Committee Chair
Mr Greg Cornwell MLA

Secretary: Ms Judith Henderson
Consultant to the committee: Mr Ted Mathews

[1] Standing Committee on Finance and Public Administration, *Minutes of proceedings*, 24 March 2000.

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# 1. Introduction

## *Background*

### The ACTEW/AGL Partnership

1.1. On 9 March 2000, the Assembly enacted the *ACTEW/AGL Partnership Facilitation Act 2000,* the purpose of which is to facilitate the process and establishment of any future agreement between ACTEW and AGL to form a joint venture by way of partnerships between subsidiaries of each company for the provision of electricity and gas, and for the undertaking of certain water and sewerage operations and maintenance activities.

1.2. Under the Act, ACTEW will retain ownership of assets, rights and liabilities associated with water and sewerage operations and will contract the partnership to maintain, manage and operate these business activities. ACTEW and AGL will vest existing assets, rights and liabilities in one or more joint venture entities or the joint venture partnerships owned by them.

1.3. ACTEW will have a beneficial interest of not less than 50% in an agent company and will appoint 50% of the directors appointed to the board of such a company. ACTEW employees will be seconded to the joint venture entities and ACTEW will delegate its powers as an employer to these joint venture entities. The employees will remain employees of ACTEW.

1.4. The accounts and records of the partnership will be jointly audited by the ACT Auditor-General and an auditor appointed by AGL. The Independent Pricing and Regulatory Commission (IPARC) will make price determinations and be responsible for access and other issues normally falling within its jurisdiction.

1.5. On 9 March 2000, the Assembly also noted, and availed itself of, an offer by ACTEW and AGL jointly to provide fulsome reports on progress of the negotiations to the Assembly and to appear before relevant committees to answer questions. The Assembly further resolved that after consultation with this committee, the Treasurer appoint an Independent Probity Auditor to oversight the establishment of the proposed partnership arrangements. In this regard Mr Stephen Marks of Stephen Marks and Co Pty Ltd was subsequently appointed.

1.6. On 30 March 2000, the committee notified the Assembly that it had resolved to inquire into the proposed ACTEW/AGL Partnership Arrangement as a formal means of enabling it to report to the Assembly in due course on the outcome of its consultations with the parties and the Independent Probity Auditor.[2]

1.7. Due to the complexity of the issues and the limited time frame, the committee engaged the services of a consultant, Mr Ted Mathews, from Price Waterhouse Coopers. Mr Mathews assistance has proved to be of considerable value.

1.8. ACTEW and AGL met with the committee on a regular basis. Some of these meetings were also attended by the Independent Probity Auditor. The committee also held a number of separate meetings with the Probity Auditor as well as a series of informal discussions between committee representatives and the parties. In addition, the committee met with the Treasurer as one of the two ACTEW shareholders.

## *Interim Report*

1.9. When the committee began the inquiry it was expected that the partnership arrangement would be settled by the end of June 2000. While there was significant progress, several important issues were outstanding at that time. The committee considered it important to account to the Assembly about what had happened by the end of June 2000 and therefore the committee decided to provide an interim report, which was tabled in the Assembly on 29 June 2000.[3] That report outlined the committee's progress up to the 26 June 2000.

## *Final Report*

1.10. This, the final report covers the committee's work since the interim report was tabled. It should be read in conjunction with the interim report and other documents relating to the deal tabled by the Government.

## *Committee's Role*

1.11. The committee's involvement in the proposed ACTEW/AGL Partnership Arrangement has been to monitor developments having regard to regular reporting by the parties and the Probity Auditor. The committee has adopted a strategic approach focussing on primary outcomes and risks. This approach has been consistent with the enactment of the *ACTEW/AGL Partnership Facilitation Act 2000.*

1.12. The committee stresses that prime responsibility for scrutiny of the partnership arrangement rests with the ACTEW shareholders, the ACTEW Board and the

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[2] Legislative Assembly for the Australian Capital Territory, *Minutes of Proceedings*, 30 March 2000, p 811.
[3] Standing Committee on Finance and Public Administration, *Report No 7,* June 2000.

Independent Probity Auditor who have had the opportunity for close involvement in negotiations on a day to day basis. It has not been the committee’s function to assume any responsibility that the ACTEW shareholders have to be accountable to the Assembly about the partnership arrangement with AGL. It remains the responsibility of the shareholders, and the Probity Auditor to satisfy the Assembly that the Territory interest has been properly considered and protected in relation to crucial issues including:

- due diligence
- a fair and equitable agreement
- the legality of the agreement and regulatory issues
- staffing and employment
- energy network and retail businesses
- water and sewerage business
- valuation
- taxation issues.

### *Acknowledgment*

1.13. The committee has appreciated the willingness of ACTEW, AGL and the Probity Auditor to engage in open and frank discussion during the inquiry.

1.14. The committee is disappointed that towards the end of the inquiry the Government failed to meet its commitment to the committee to provide key documents before the deal was finalised.

# 2. Committee Assessment

2.1. As indicated in its interim report the Committee has focused at a strategic level on how well the negotiations have secured the promised benefits of the proposed merger and how effectively they have dealt with collateral risks arising from the transaction. This report finalises the Committee's assessment based on an examination of the key elements of final drafts of:

- the umbrella and retail and distribution partnership agreements which outline arrangements for the creation, operation and governance of the partnerships;
- agreements with AGL for the provision to the partnership of energy trading and gas network and retail management services;
- a service agreement with the partnership for the management of ACTEW's water and sewerage business;
- an agreement for the secondment of ACTEW staff to the joint venture to carry on the electricity distribution and retail services and to provide water and sewerage operations and management services back to ACTEW.

2.2. The Committee has also had the opportunity to consider reports by the ACTEW Board and its financial adviser Arthur Anderson Corporate Finance on the transaction, and part of the report by Mallesons Stephen Jaques on legal aspects of the transaction.

2.3. Although promised by the Government, the committee was not provided with a copy of the final Independent Valuer's report and the final report of the Probity Auditor before the deal was finalised.

## *Key Benefits*

### Energy Trading Risk Reduction

2.4. The wholesale acquisition of electricity and gas is a complex function that carries with it a number of significant risks including volume risk and price risk. Due to competitive pressures these risks are often difficult to pass through directly to customers and can thus translate into substantial financial risks and losses for energy retailers. The National Electricity Market in particular is becoming an increasingly volatile and risky environment in which to do business, while at the same time margins are being reduced by increasing retail competition.

2.5. The proposed partnership arrangements appear to shift volume and price risk for both electricity and gas onto AGL which is a major energy trader. The key partnership objective of reduced risk for ACTEW in this area thus appears to have been achieved and the probity auditor considers the contractual arrangements with AGL to be equitable to the ACT.

2.6. Because of the close relationship with AGL and the need to secure its approval to write new retail business under these arrangements, the partnership is likely to remain a niche competitor outside the ACT. But the Committee considers that this may be no bad thing.

**Employee and Shareholder Benefits**

2.7. The proposed arrangements appear to secure the employment security and enhanced opportunities promised for ACTEW employees. ACTEW is to be commended for the transparency and collaborative nature of the consultative arrangements with its employees in finalising its staff services agreement with the partnership.

2.8. ACTEW has also reiterated its expectation that the partnership will allow the delivery of synergies that are greater than those being achieved by ACTEW or AGL alone. To this end the retail and distribution partnership agreements both require the preparation of annual four year business plans which among other things "contain a description of the synergies between the partnership gas and electricity businesses, which the Central Management Committee will seek to achieve for the partnership during the period to which the business plan relates".

2.9. Arthur Anderson Corporate Finance project annual joint venture savings from best practice measures and synergies increasing from $1.2 million in 2001/02 to $8.2 million in 2003/04 with a resultant increase in ACTEW equity value of $67 million.

**Public Interest Protection**

2.10. ACTEW has reiterated that it and its wholly owned subsidiaries will continue to be subject to the full range of controls applicable under the *Territory Owned Corporations Act 1990* including for approval of borrowings, preparation of statements of corporate intent and appointment of directors. All other relevant legislation (including FOI, ADJR, Ombudsman, Annual Report, Audit) will also continue to apply to ACTEW and its subsidiaries and be extended to the joint venture as joint and several compliance obligations. Customer and community interests are to be protected by the regulation of partnership activities through the licences to be issued to the joint venture under the proposed Utilities Act.

## *Collateral Risks*

### Joint and Several Liability

2.11. ACTEW has advised that the partnership form for the joint venture has been chosen for a variety of tax, commercial and regulatory reasons. From ACTEW's and the ACT's perspective, this structure preserves tax payments to the ACT under the tax equivalents regime.

2.12. However, in general, partners are jointly and severally liable for all liabilities incurred in respect of the partnership business. There is thus a risk of a partner becoming liable to a third party on account of a liability incurred by the other partner without authority or consent.

2.13. ACTEW has advised that the proposed arrangements address this risk by:

- each partner indemnifying the other against these liabilities;
- guarantee of those liabilities by each partner's parent (ACTEW and AGL).

2.14. Under this arrangement, each ACTEW partner (and indirectly, ACTEW) thus bears a credit risk in relation to the AGL partner and AGL parent company. The incurrence of a material liability or failure to pay under the partner indemnity or the parent company guarantee would be a basis for dissolving the joint venture. ACTEW considers the credit risk on AGL to be low (reporting AGL's credit rating at A+) and the commercial risk of an unauthorised liability incurred by AGL also to be low.

2.15. The decision (see discussion below) that the joint venture will not borrow but be fully equity funded reduces ACTEW's exposure in this area.

2.16. The probity auditor has assessed these proposed arrangements as being equitable to the ACT.

### Related Party Transactions

2.17. The proposed arrangements entail the partnership entering into sole source contractual arrangements with AGL for energy trading (electricity and gas) and gas retail and network services. While aimed at helping to secure the energy trading risk reduction and business synergies promised for the partnership, these arrangements could expose ACTEW to the risk of unfair transfer pricing by AGL unless action is taken to mitigate this risk.

2.18. ACTEW has advised of a variety of provisions in the proposed arrangements to mitigate this risk including:

- “most favoured customer” requirements;
- provision for independent audit of AGL prices;
- provision for accessing alternative sources of supply if AGL does not deliver;
- responsibility on decisions on the enforcement of a remedy or exercise of a right under partnership contracts with AGL being ceded to ACTEW management committee members acting alone (and a corresponding right for AGL management committee members for partnership contracts with ACTEW).

2.19. The probity auditor has assessed these arrangements as being equitable to the ACT. Mallesons Stephen Jaques have commented:

> *As Directors will appreciate, once the joint venture relationship is formed, the practical utility of contractual rights may be limited. In a joint venture, it would be a major step to terminate a related party service agreement or even to acquire a competitor’s services, because of the impact of that on the joint venture relationship.*
>
> *Overall, on balance, we are now satisfied, as a legal matter, that the provisions dealing with related party transactions, together with other rights under the agreements confer on ACTEW legal rights adequate to protect what we are instructed are the joint venture’s key interests, should commercial avenues fail.*

**Constraints on Dissolution of the Partnership**

2.20. The Committee accepts that in developing its position on the dissolution provisions in the partnership agreements ACTEW has had to balance the need to provide a secure and sustainable basis for future business operations and investment, and the need for flexibility to cater for unforeseen developments in a volatile and rapidly changing industry.

2.21. ACTEW advises that after considering more flexible arrangements it has determined that the balance of advantages lies with a restrictive approach to partnership dissolution. The proposed arrangements thus limit the circumstances triggering dissolution essentially to insolvency events, material breach or funding difficulties with the offending partner facing financial penalties and loss of control of partnership affairs. ACTEW's flexibility in reducing its economic exposure to the joint venture would also be limited by restrictions on changes in control of the ACTEW partners or their partnership interests.

2.22. However it remains open for either partner to seek to renegotiate the agreements with the other partner where it wishes to change course and ACTEW considers that on balance this would be the best option for dealing with such eventualities.

2.23. The Committee notes that the probity auditor accepts this approach as being equitable to the ACT and has no reason for disputing this assessment (but see discussion below on valuation implications).

**Valuation Control Premium**

2.24. The Committee understands that in conducting an independent valuation review KPMG has raised the issue of inclusion of a 'control premium' being incorporated in the valuation of contributed assets and the resultant equalisation payment from AGL to ACTEW. Market experience suggests that a potential premium averaging approximately 20 percent can be achieved in trade sales of 100 percent of a business.

2.25. ACTEW has responded that:

- the joint venture is a 50/50 partnership and that it is thus not appropriate to include a control premium based on a 100 percent trade sale option;
- ACTEW and the ACT Government will benefit from the partnership best practice and synergies benefits outlined above;
- the dissolution mechanisms prescribe that no control premium would be payable on ACTEW assets if it exited the partnership and thus these would be retained by the ACT in any future Assembly decision to sell 100 percent of ACTEW.

2.26. However the Committee notes advice by Mallesons Stephen Jaques that:

> *the Board should note that the dissolution provisions may well result in a loss of value compared to the investment in the joint venture. This is because the dissolution provisions provide limited options to ACTEW and AGL. They provide that ACTEW and AGL may only take back their respective initial contributions (as varied over time) at a*

*value determined in accordance with the initial valuation principles. That is, without having regard to synergy benefits that might have been achieved over time. In addition, because of its larger initial contribution, ACTEW may need to make a reverse equalisation payment to AGL on dissolution.*

*We also note that it may be practically difficult to implement the dissolution provisions. The risk of this potential difficulty will likely increase over time as the electricity and gas businesses become more seamlessly integrated in the joint venture.*

2.27. It would appear to the Committee that establishment of the joint venture would make it difficult for the ACT Government to ever realise a full control premium in any future sale by competitive auction of 100 percent of ACTEW assets because of the prior need to negotiate financial dissolution settlement arrangements satisfactorily to AGL. Any residual control premium achieved in these circumstances would also be reduced by the costs of dislocation in unwinding the partnership.

2.28. However the Committee accepts that these constraints may be a necessary cost of achieving the promised partnership benefits.

**Valuation Adjustments for Post Partnership IPARC Decisions**

2.29. ACTEW has advised that the valuation of asset contributions by each of the parties will be critically affected by IPARC price path decisions. While ACTEW has an IPARC price determination in place for its electricity network assets, a corresponding determination for AGL gas assets may not be available until after the target completion date for the joint venture.

2.30. Accordingly the parties have agreed to an arithmetic adjustment to the equalisation payment once the IPARC Final Determination has been made. This adjustment is to be based on the difference between the initial capital base proposed by AGL for its assets and that included in the IPART Final Determination.

2.31. ACTEW further advises that the parties considered an adjustment formula based on a combination of changes to other variables in the final IPARC Determination (for example rate of return where the 7.75 percent rate used in IPARC's Draft Determination has apparently been applied in the base case evaluation) but agreed to the initial capital base adjustment mechanism primarily on the basis of its simplicity and workability. ACTEW considers the risk of a change in other variables having a material value impact to be low. A similar approach is proposed to any reopening of IPARC gas or electricity price path decisions within 24 months of partnership establishment.

2.32. The probity auditor was closely involved in the development of this approach and considers it equitable to the ACT.

**Capital Structure**

2.33. At the time of the Committee's interim report it was envisaged that decisions on the future capital structure and any resultant followings would be for the Partnership Board to consider in consultation with ACTEW, AGL and the ACT Government.

2.34. ACTEW has now advised that because of "negative pledge" commitments under AGL Corporate's debt financing arrangements it has been agreed that:

> *... the Joint Venture cannot borrow within the Partnership, however there is no restriction on borrowing at the partner level against each partner's interest in the Joint Venture.*
>
> *It would now be up to the ACTEW partner (in consultation with the ACT Government) and the AGL partner to separately determine whether any debt is introduced at the partner level and if so whether that debt is internal or external and what security is offered. Also, the partners would not be restricted from granting security against its Joint Venture interest to external lenders, subject to the Partnership Board's approval.*
>
> *The new arrangement has the following advantages:*
>
> - *Borrowing at the partner level would be on a several basis, whereas borrowing within the Joint Venture would have been on a joint and several basis. Therefore, ACTEW's (and indirectly the ACT Government's) potential exposure is less under the new arrangement.*
> - *The new arrangement gives the ACT Government the opportunity to gear the ACTEW partner with ACT Government debt, an option that was unlikely to have been acceptable to AGL under the previous proposal.*
> - *Under the new arrangement, AGL has undertaken to pay the equalisation payment on the completion date. Under the previous proposal, ACTEW had agreed to allow AGL to pay the equalisation payment within a defined timeframe after the completion date (supported by a promissory note and parent company guarantee).*

- *As a non-recourse debt is no longer an option, the AGL Section 51AD tax ruling falls away as a condition precedent to completion. Therefore, completion is likely to occur earlier than previously envisaged.*[4]

*It is intended that the ACTEW partners will, prior to capitalisation of the partnerships, grant equitable charges in favour of ACTEW over the assets to be contributed to the partnerships …to ensure that the interests of ACTEW are not disadvantaged as a result of the AGL arrangements with its financiers.*[5]

2.35. These arrangements appear to provide an overall better outcome for ACTEW. The Committee anticipates advice to the Assembly in due course from the ACT Government on its future plans for ACTEW's capital structure and borrowings and any resultant further capital repayments it may decide to pursue from ACTEW.

## Future ACTEW Responsibilities and Resourcing

2.36. While ACTEW's current operational responsibilities will be transferred to the joint venture, it will retain important continuing and contingent management and strategic responsibilities including:

- it will continue to own the water and sewerage business and be accountable for oversight of a 50 percent investment in the joint venture;

- it will be responsible for ensuring that ACT interests are protected under the water and sewerage managing contractor alliance agreement and the negotiation of a utilities service agreement (of up to 20 years duration with the joint venture to commence during the next ICRC regulatory reset) which will transfer more of the risks to the joint venture (with a corresponding profit margin);

- it will retain the ACTEW northern service centre (Mitchell) property and Fyshwick property and hold ACTEW's investment in Transact;

- it will hold ACTEW's existing debt and pay interest on this debt and dividends and tax equivalent payments to the ACT Government.

2.37. These responsibilities will be demanding and while it will be important for the partnership to have operational autonomy it will not be enough for ACTEW to be left as a silent partner or passive investor.

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[4] ACTEW/AGL report to the Committee on the proposed partnership, dated August 2000.
[5] ibid

2.38. As noted by Mallesons Stephen Jaques, ACTEW appointees to the Partnership Board will wear two hats. First as Directors of ACTEW and its partnership subsidiaries they will act as company directors subject to the corporation's law and general law in relation to Director's duties. Secondly as members of the Partnership Board they will be obliged by the Partnership Agreements to act in the best interests of the joint venture.

2.39. In the latter capacity, ACTEW board members will be served by the partnership Chief Executive and supporting staff. But it will be important to ensure that they along with other ACTEW Directors are as well served in meeting their ACTEW Company Director responsibilities. These responsibilities will include rigorous monitoring of related party transactions with AGL and in extremis taking action against AGL if it does not meet its responsibilities. In the hopefully unlikely event of partnership dissolution, ACTEW Board Members will need support in managing exit arrangements.

2.40. More immediately ACTEW will need to protect its interests in the development of the water and sewerage arrangements where it remains as licence holder in a highly sensitive consumer and environmental protection climate.

2.41. Current proposals are for an ACTEW with a staff of five or less located with, and extensively supported by, the joint venture. These proposals need to be assessed against ACTEW's continuing responsibilities and the resources which AGL, serviced from outside the partnership, will be able to bring to bear in protecting its interests.

# 3. Conclusion

3.1. Based on the documents received in time for consideration, the Committee considers that ACTEW and its advisors have acquitted themselves professionally and effectively in partnership negotiations and to have achieved an overall outcome which is equitable to the ACT.

3.2. Assuming that the final reports of the Probity Auditor and the Independent Valuer are favourable, the challenge now passes to the ACT Government to ensure that it establishes governance working arrangements which protect ACT interests in what will hopefully be a flourishing business.

Ted Quinlan MLA
Chair
29 August 2000