

Jemena Gas Networks (NSW) Ltd

2015-20 Access Arrangement Information

Appendix 4.1

JGN's pipeline service delivery model

Public

30 June 2014



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GLOSSARY

AMA	Asset Management Agreement
CPI	Consumer Price Index
E&P	Evans and Peck
Envestra decision	Application by Envestra Limited (No 2) [2012] ACompT 4
FSA	Field Services Agreement
FTE	Full time equivalent employee
JAI	Jemena Assets and Investments
JAM	Jemena Asset Management Pty Ltd
JEN	Jemena Electricity Networks
JGN	Jemena Gas Networks
JIS	Jemena Infrastructure Services
KPI	Key Performance Indicator
O&M	Operating and Maintenance
Pitcher Partners	Pitcher Partners Consulting Pty Ltd
RBSM	Risk and Benefit Sharing Mechanism
RCW	Routine Capital Works
RIN	Regulatory Information Notice
SGSPAA	SGSP (Australia) Assets Pty Ltd
SPM	Service Performance Measures
Steel Contract	JAM Steel Panel Contract
TCE	Total Cost Estimates
Terms Sheet	Gas Field Services Terms Sheet
WPI	Wage Price Index

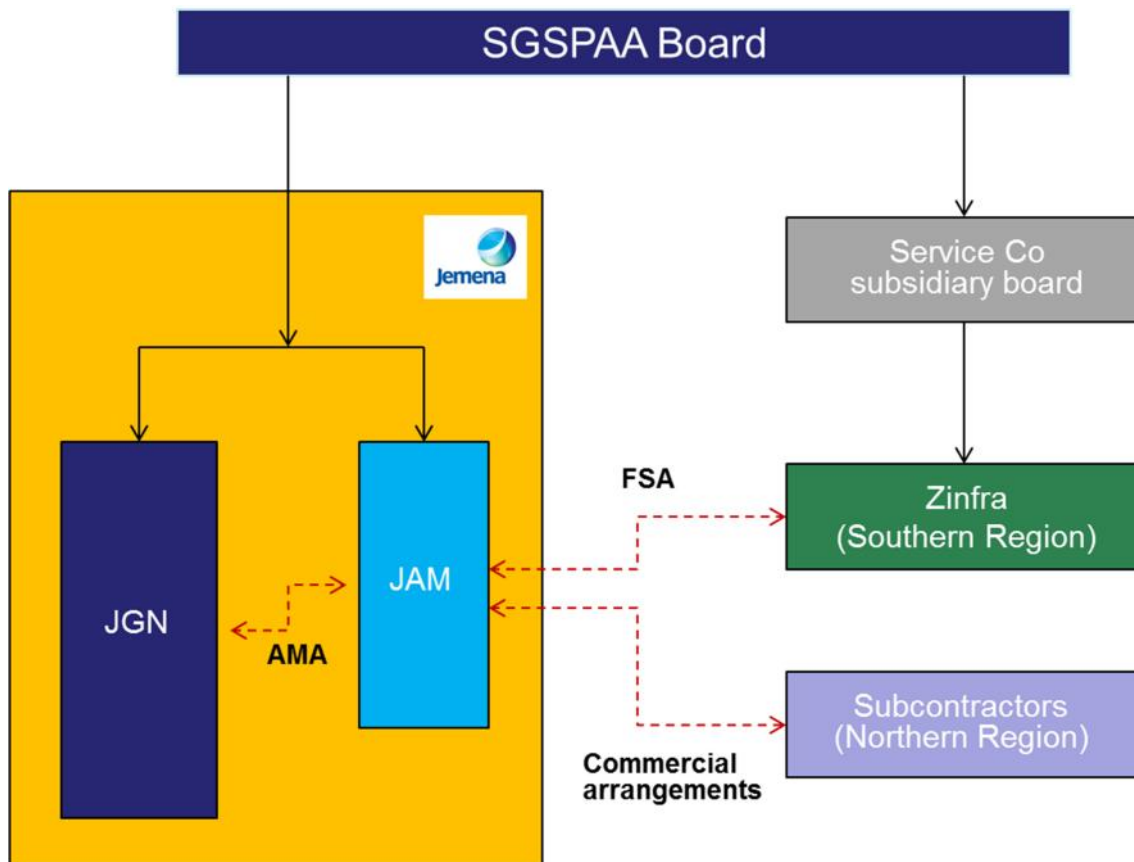
OVERVIEW

1. Jemena Asset Management Pty Ltd (**JAM**) provides asset management, network operations and maintenance services to Jemena Gas Networks (**JGN**) under the Asset Management Agreement (**AMA**)¹ directly and through subcontractors. The AMA arrangement was reviewed and accepted by the AER at the 2010 AA review as a basis for delivery of JGN's asset management services. However, the AER concluded that an allowance for the AMA margin in JGN's building block revenue was only appropriate for activities directly undertaken by JAM.
2. In 2012 Jemena, JGN's parent company, embarked on a review of all of its existing outsourcing arrangements to reconsider more broadly how it delivered services to its wholly owned assets (including JGN under the AMA). For JGN the review was driven by:
 - c-i-c
 - Jemena's strategic decision to set up a service company, Zinfra Pty Ltd and its subsidiaries (Zinfra), a wholly owned subsidiary group of SGSP (Australia) Assets Pty Ltd (**SGSPAA**), to provide competitive, contract based infrastructure services to a variety of external clients, as well as defined services to the Jemena Group pursuant to contracts with JAM.
3. On 1 July 2013, JAM's new subcontracting arrangements for delivery of JGN's field services took effect. The key elements of the new outsourcing arrangements, as they relate to JAM providing services to JGN, are:
 1. separating JGN's network into Northern and Southern regions
 2. JAM providing field services in the Northern Region through third party subcontractors and in the Southern Region via Zinfra
 3. JAM conducting an open competitive tender in the Northern Region to appoint subcontractors to carry out construction, repair and maintenance services from 1 July 2013 and to establish market-tested prices for the provision of these services
 4. JAM undertaking arms-length negotiations with Zinfra, for the provision of an equivalent scope of services in the Southern Region, with pricing to match or better the Northern Region tender outcomes for similar risk activities
 5. JAM and Zinfra entering into the JGN Field Services Agreement (**FSA**) for the Southern Region, based on the negotiations outlined in 4.
4. In addition, the AMA has been simplified since 2009 to reflect the Jemena Group's new structure. Under the new structure JAM now forms part of the Jemena Group and manages the delivery of the AMA scope of services to JGN as an in-house function (as shown in Figure OV-1). Consequently the AMA between JAM and JGN is now no longer a risk and performance sharing contract and charges under the AMA are now made at JAM's actual cost with no margins payable by JGN.²
5. The resulting outsourcing arrangements are shown in Figure OV-1.

¹ The AMA became effective 1 August 2009.

² Letter from JGN to JAM, *Amendments to the Asset Management Agreement, Commercial-in-confidence*, dated 7 June 2013 (provided as part of the AA RIN response).

Figure OV-1: JGN outsourcing arrangements



6. c-i-c

7. Since 1 July 2010 JGN and JAM have provided the AER with details of its related party arrangements through the regulatory information notice (RIN) responses. This reporting has included:

- substantial quantitative data including:
 - JGN operating and maintenance (O&M) expenditure attributable to JAM
 - JGN capital expenditure (capex) attributable to JAM broken into market expansion capex, reinforcement, renewal and replacement capex and non-system capex categories
 - JAM operating expenditure (opex) including direct costs by category and indirect costs that have been either provided internally, by a related party, via competitive tender or other unrelated parties
 - JAM capital expenditure broken into market expansion capex, reinforcement, renewal and replacement capex and non-system capex categories that have been either provided internally, by a related party, via competitive tender or other unrelated parties
 - JAM’s commercial margins
- details of all key performance indicator (KPI) outcomes and resulting margin payments up to when these ceased in March 2012

- details of amendments to the AMA
 - voluntary disclosure of related party margins earned by Zinfra since its inception.
8. In addition to the above information disclosure, senior Jemena staff met with AER staff in November 2012 and November 2013 to keep the AER informed of these service model developments. Copies of the briefing materials provided at these meetings are set out in Attachment A.

1. RATIONALE FOR CHANGES TO JAM'S SERVICE DELIVERY

9. c-i-c
10. Two factors that contributed to the subcontractors cost pressures are outlined below:
1. c-i-c
 2. A number of JAM's clients (e.g. United Energy Distribution (**UED**) and Multinet Gas Networks (**Multinet**)) decided to bring strategic asset management activities back in-house during the current AA period, which meant that JAM was no longer the largest infrastructure provider in Australia. The movement to provide these services in-house was partly in response to the approach taken by the AER in various price determinations when assessing outsourcing arrangements. Based on review of market opportunities, JAM concluded that there were no material opportunities in the prime contractor asset management space. This effectively only left construction and field services market for JAM to compete in, which in turn impacted the scale of services required by JAM from its subcontractors.
c-i-c
11. Given the change in strategic direction of JAM, Jemena decided in 2011 to set up a service company, Zinfra, a wholly owned subsidiary of SGSPAA, to provide competitive, contract based infrastructure services to a variety of external clients, as well as defined services to the Jemena Group under contracts with JAM. In effect, Zinfra absorbed the historical JAM functions for which there was still a sizable competitive market (principally construction and other field services) while the remaining JAM functions continue to be performed by JAM but as an in-sourced function within the Jemena Group (as depicted in Figure OV-1). To account for this change, JGN's AMA with JAM was de-scoped³, JGN no longer enforces the risk sharing mechanism nor does it pay JAM a commercial margin (only JAM's actual costs are recoverable from JGN under the AMA).

³ Refer section 2.3.2 of JGN's submission in response to the 2011 RIN, 16 December 2011

1 — RATIONALE FOR CHANGES TO JAM'S SERVICE DELIVERY

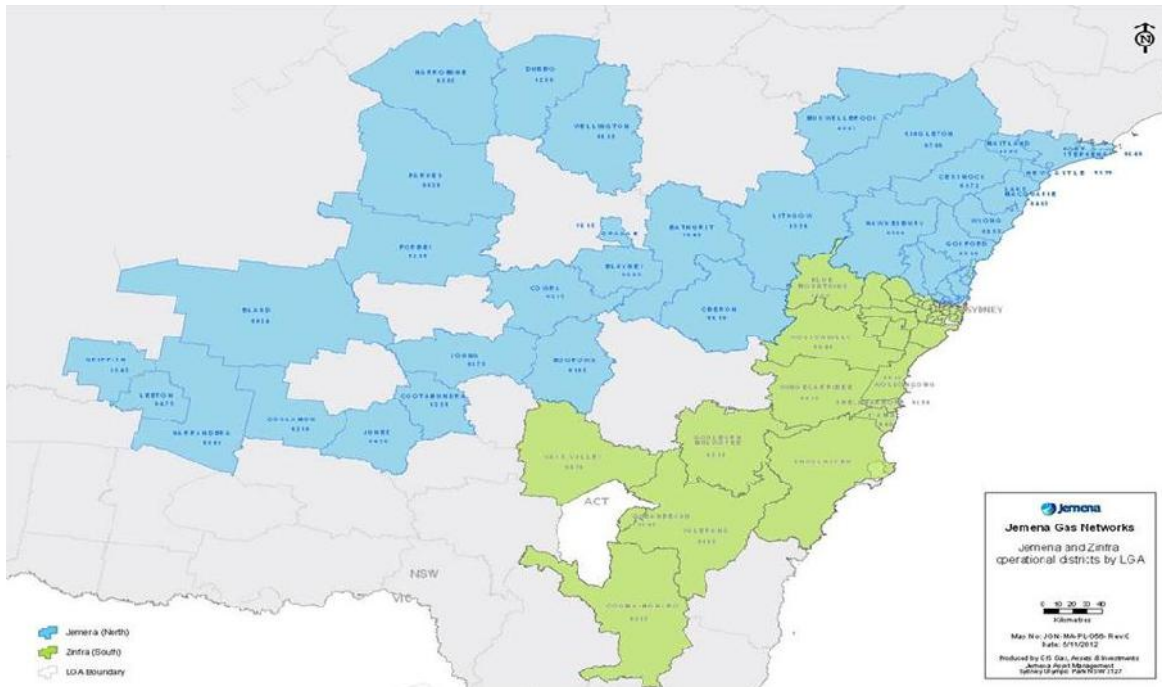
12. Jemena's reasoning⁴ in adopting the above approach was that it:
- established an asset owner/asset manager model
 - reduced the related party contracting that included a commercial margin to a smaller scope of services for which a deeper market existed for testing and benchmarking prices
 - retained critical asset management and development intellectual property with JAM
 - ensured JGN remained an informed buyer and was not beholden to a single specific contractor if a decision was made to divest the Zinfra business
 - balanced the need for JAM to retain critical field services delivery capability with the flexibility of outsourcing non-critical services, resulting in a delivery mix of approximately 33 per cent in-sourced and 67 per cent out-sourced field services.
13. Given ^{c-i-c} and the change in Jemena strategic direction, in 2012 Jemena and JAM identified the need to review JAM's existing outsourcing arrangements with a desire to:
- reassess scale and scope benefits available to JAM through its outsourcing arrangements with JGN and Jemena Electricity Networks (**JEN**)
 - align focus on asset ownership and asset management as one organisation, rather than a contractual/incentive based relationship
 - package outsourced activities into smaller more discretely scoped items that can be readily market tested.
14. Similarly, Jemena determined that the outsourcing arrangements for JEN also needed to be reviewed. As a result the Jemena Group embarked on a review of the provision of field services by JAM to JGN (and JEN) in 2012.

⁴ Refer slide 9 of the 22 November 2013 briefing

2. 2012 REVIEW OF OUTSOURCING ARRANGEMENTS

15. JGN's related party outsourcing arrangements have materially reduced the share of related party outsourced costs that attract a commercial margin. Prior to de-scoping the AMA, related party outsourced costs accounted for approximately 85 per cent of JGN's costs. Under the current approach, this has reduced to approximately 10 to 15 per cent. The following section explains this transition.
16. In 2012, the Jemena Group vision was (and still remains) to:
 - establish a world-class asset ownership and management business
 - drive required efficiency improvement and capability development
 - grow with aligned investment.
17. For its Zinfra business, Jemena's vision was for Zinfra to be a highly respected and profitable engineering, construction and maintenance service provider to the utility infrastructure sector.
18. Taking account of the Jemena Group's vision for asset ownership and management, Jemena's objectives (as they related to JGN) in the restructure of JAM's outsourcing arrangements were to:
 - establish long term, market-competitive contracts based on a clearly understood and managed risk profile between, and for, the Zinfra and Jemena businesses
 - ensure that JAM has access to robust and technically competent contractors, who are engaged using rigorous market-based processes and/or are subject to periodic benchmarking of costs
 - balance the principal considerations of performance (network performance, customer service, safety), lowest sustainable costs and regulatory recovery risk.
19. Jemena management determined that Jemena's objectives and lower overall costs could be achieved by in-sourcing high value-add activities (including asset management, first response and emergency management, and capital program management and delivery) and outsourcing a proportion of low value-adding activities.
20. As part of the review, the JGN network was split into the following regions:
 - the Northern Region covering JGN's network area north of the Sydney Harbour Bridge and Parramatta River
 - the Southern Region covering JGN's network area south of the Sydney Harbour Bridge and Parramatta River including all communities south to the Victorian border.
21. Figure 2–1 shows the regional splits.

Figure 2–1: JGN regional areas



2.1 OUTSOURCING PROCUREMENT

22. The outsourcing procurement strategy was based on:

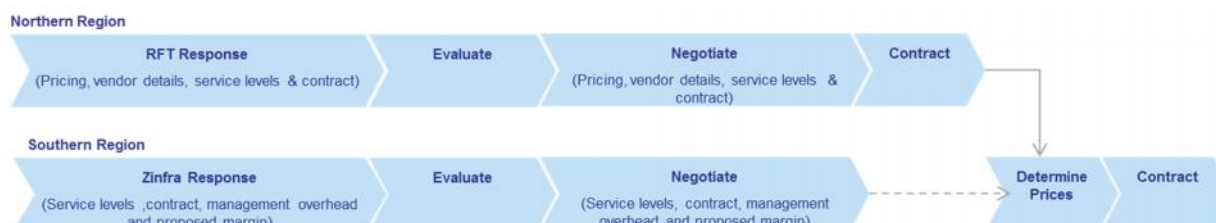
- a sound methodology and approach to deliver value for money for Jemena including the prioritisation and trade-offs of:
 - network performance (reliability)
 - customer service
 - efficiency
 - quality (safety)
- an approach for establishing Zinfra pricing
- the establishment of a commercial agreement between Jemena and other parties for provision of field services
- identification of risks and appropriate mitigation strategies related to the procurement.

23. The key elements of JGN's procurement approach were as follows:

- between 24 October 2012 and 5 December 2012 JAM conducted an open competitive tender in the Northern Region (Northern Region tender) to appoint subcontractors to carry out construction, repair and maintenance services from 1 July 2013 and to establish market-tested prices for the provision of these services. Box 1 provides further detail on the key features of this tender, which were designed to foster growth and depth in the competitive subcontractor market and encourage as many market participants to compete in the tender process as possible (i.e. regardless of their scale)

- arm's-length negotiations between JAM and Zinfra, for Zinfra to carry out an equivalent scope of services in the Southern Region, with prices to match or better the Northern Region tender outcomes (for the same scope of work)
 - JAM and Zinfra entering into the JGN FSA for the Southern Region, based on the outcomes of arms-length negotiations.
24. The JGN procurement process is shown in Figure 2–2.

Figure 2–2: JGN procurement process



25. The resulting new arrangements for the Northern and Southern Regions are discussed below.

Box 1: Design features of Northern Region tender to encourage wide participation and competition

- JGN committed to awarding the Northern Region tender to a third party (parties) only, to ensure that bidders were not concerned with losing out to a JGN related party
- JGN ran the process as an open tender, allowing any party to participate. The tender opened on 24 October 2012 and closed on 5 December 2012
- the Northern Region was broken up into four sub-regions, with bids accepted for one, some or all of the sub-regions. This ensured a wider range of bidders, encouraging both small and large suppliers to compete to provide the services.

26. Developing a two region model was also a deliberate attempt to support productive and dynamic efficiency in the way JGN's services are delivered over time, so as to support lowest sustainable costs and prudent risk management over time. Notably, this model provided for:
- resource competency and continuity risk to be managed by:
 - allowing certain experienced JAM staff to be transitioned into Zinfra to work in the Southern Region drawing on their JGN asset knowledge, while
 - allowing a broader group of new subcontractors to commence work in the Northern Region and using contractual KPIs to manage performance and monitor risk
 - lessons to be drawn from JGN's prior poor experience of large-scale outsourcing to unrelated prime contractors that was implemented across the JGN network in 1997
 - fostering competition by comparison by allowing JGN to benchmark performance the Northern Region with Zinfra's performance for the Southern Region
 - facilitating innovation and dynamic efficiency in the way operating and capital activities are delivered across the JGN network by diversifying the parties participating in these activities and monitoring performance against KPIs across these geographies over time

- current good industry practice to be followed by diversifying contractor risk (e.g. a similar two region model has been developed by UED and Multinet in the last five years).

3. NORTHERN REGION

27. The Northern Region is serviced by JAM-managed competitive tender sub-contracts. JAM is responsible for managing resource planning, supervision and quality control of outsourced work.

3.1 JAM SUBCONTRACTOR ARRANGEMENTS

28. Following a competitive tender process, JAM awarded four construction, repair, and maintenance contracts covering the Northern Region:
- two contracts were awarded to M & E Pratt Excavations Pty Limited for, respectively, the Hunter and NSW Central Coast sub-regions
 - two contracts were awarded to Linbeck Contractors Pty Limited for, respectively, Sydney Greater North and Sydney Coastal North sub-regions.

3.2 MARKET-TESTED ACTIVITIES AND RATES

29. JAM undertook the competitive tender in the Northern Region with oversight from JGN's asset management team representatives to ensure JGN was satisfied with the selection criteria for Northern Region tenderers. This also provided JGN with comfort that selecting the successful tenders was in JGN's best interests (as is required under clause 14.2 of the AMA, see later for AMA compliance).
30. To encourage competitive pricing, the competitive tender:
- was an open tender
 - included optionality on the geographic areas within the Northern Region for which a respondent could bid
 - included detailed scope description down to individual work code level
 - provided detailed information on relevant Jemena policies and procedures including an Industry Briefing Day held during the RFP period
 - was subject to an independent probity review⁵ by Pitcher Partners Consulting Pty Ltd (**Pitcher Partners**).
31. The independent probity review completed by Pitcher Partners concluded that appropriate probity principles were applied throughout the procurement process. The probity principles applied were:
- fairness and impartiality
 - use of a competitive tender process
 - consistency and transparency of process
 - security and confidentiality
 - identification and resolution of conflicts of interest.

⁵ Pitcher Partners Consulting Pty Ltd, *Jemena Ltd – Northern Region Gas Field Services, Request for Tender (RFT No.2012-0107) Probity report*, 25 March 2013.

32. In addition, Evans and Peck⁶ (**E&P**) in its review of the Southern Region unit rates (see below) concluded that Northern Region 'tender process appeared sufficiently open and competitive and recognise that the approach to probity was undertaken with appropriate measure'.⁷ E&P's report is provided in appendix 4.2 to JGN's 2015-20 AAI.
33. For these reasons the competitive tender process has resulted in the most efficient price outcomes for JGN's required services.

⁶ E&P, *JGN – Review of Pricing Methodology Report*, June 2013.

⁷ E&P, *JGN – Review of Pricing Methodology Report*, June 2013, p.10.

4. SOUTHERN REGION

34. The Southern Region is serviced by Zinfra through the JGN FSA between JAM and Zinfra. The field services undertaken by Zinfra are the same as those undertaken by contractors in the Northern Region.
35. The JGN FSA for the Southern Region comprises four key service areas:
- capital construction works on the low to medium pressure network, charged under a market-tested schedule of unit rates
 - capital construction works on the secondary network (1050 kPa), for works costed at \$0.5M or less, to be charged under a market-tested schedule of unit rates
 - opex repair and maintenance services, including secondary emergency response, charged under a market-tested schedule of unit rates
 - management services charged under a Management Services Fee and Management Fee Margin, benchmarked against JAM's cost of undertaking the same services for the Northern Region.
36. In establishing the FSA for JGN services in the Southern Region, transition risks for JGN were minimised by transferring to Zinfra highly experienced Jemena personnel and associated intellectual property.

4.1 FSA ARRANGEMENTS

37. The FSA between JAM and Zinfra took effect on 1 July 2013. The FSA enables JAM to procure management services from Zinfra that:
- allow flexibility to adjust contractor management costs as an appropriate and considered response to work volume fluctuations
 - create an on-going ability for JAM and JGN to benchmark JAM's subcontractor management performance and costs against an external provider of equivalent services.
38. Under the terms of FSA, _____ c-i-c _____, Zinfra is required to:
- provide construction work, and repair and maintenance services in the Southern Region of JGN's network, either in its own capacity or through sub-contracting arrangements
 - manage⁸ and support the delivery and completion of the opex and capex work program in the Southern Region.
39. JAM recovers from JGN the costs of Zinfra's services under the AMA on a cost pass through basis. Payments made by JAM to Zinfra under the FSA are:

⁸ The management services Zinfra is required to perform under the FSA include: program management; scoping, estimating and scheduling; procurement and logistics; contract management; subcontractor management; quality management; risk management; environmental management; health and safety management; reporting, record keeping and record management; emergency response management and incident investigations; and any other management services required to complete the contract work.

- c-i-c
-

40. c-i-c

4.2 MARKET-TESTED ACTIVITIES AND UNIT RATES

4.2.1 UNIT RATES

41. The unit rates included in the FSA were benchmarked against those unit rates received from third parties through the open competitive tender run in respect of the Northern Region for the same services under the same or very similar terms and conditions. In effect, the use of these benchmarks enabled JGN to leverage off the competition that occurred in the Northern Region to set prices in the Southern Region.
42. JAM undertook benchmarking of Zinfra's Southern Region rates against market-tested Northern Region rates by matching North and South network areas (sub-regions) according to key service delivery risks⁹ (so that the sub-regions were compared on a like-for-like basis) as shown in Table 4–1.

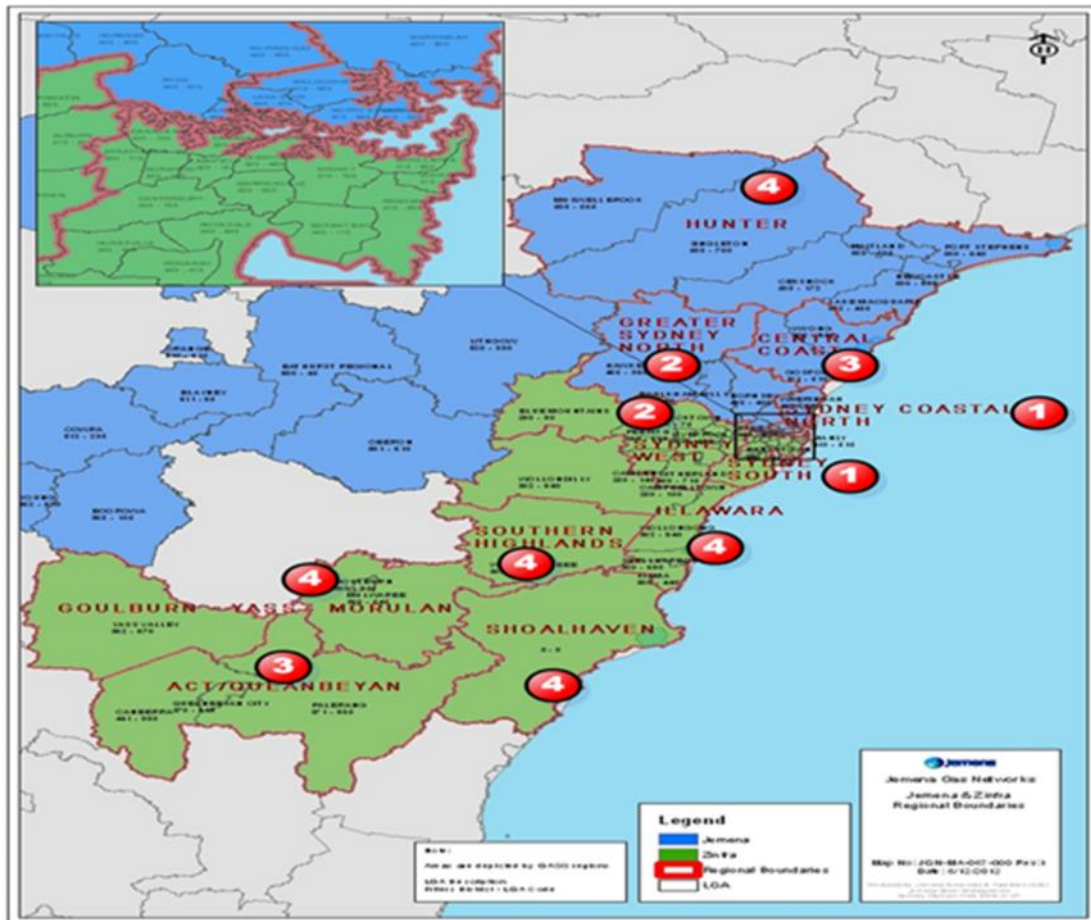
Table 4–1: Grouped sub-regions

	Northern Sub-regions	Southern Sub-regions
Group 1	Sydney Coastal North	Sydney South
Group 2	Sydney North	Sydney West
Group 3	Central Coast	ACT, Queanbeyan
Group 4	Hunter	Illawarra, Southern Highlands, Goulburn, Marulan, Yass and Shoalhaven

43. The matching of the sub-regions is shown in Figure 4–1.

⁹ Service delivery risks considered in the sub-regions included operating pressures, mains type, population density, traffic, region/length size, locating main and services, footpaths, rock, service lengths and one-way feeds. Jemena's detailed risk ratings analysis is set out in Jemena, Regional Matching Analysis Version 5.0 (Draft), dated 15 May 2013, prepared by Liz Welsh (see Attachment 6).

Figure 4–1: Match sub-regions



44. JGN's analysis¹⁰ of the unit rate variations of the sub-regions within groups 1, 2 and 3 indicated that the current contractor prices match within ± 10 per cent for the sub-regions within each of the individual groups.
45. Within Group 4 the contractor prices between the Hunter, Shoalhaven, Goulburn, Marulan and Yass also fall within the ± 10 per cent range. However, the Illawarra and Southern Highlands' rates were greater than the current Hunter rates by between 33 per cent and 40 per cent. JAM believes that the significant discrepancy between the rates was due to the historical rates of Illawarra and Southern Highlands not representing the true market costs, and/or that the existing rates had been distorted by significant cross-subsidies.
46. In relation to Zinfra's unit rates for mains works, service connections and repairs and maintenance, E&P concluded¹¹ that the:
- *'...regional matching analysis is well considered and based on the quantitative and qualitative review we accept that the regional matching methodology for the transfer of rates and prices is reasonable.'*
 - *'We acknowledge that the tender process in the North Region was sufficiently open and competitive and recognise the approach to probity was undertaken with appropriate measure.'*

¹⁰ Jemena, *Regional Matching Analysis Version 5.0 (Draft)*, 15 May 2013.

¹¹ E&P, *JGN – Review of Pricing Methodology Report*, June 2013, p. 3.

- *'It has been evidenced in the Regional Matching and the North Region RFT process that the rates obtained through the tender in our opinion form a reasonable basis for the pricing submission provided to Zinfra.'*
- *'It has been evidenced in the Jemena documentation that the data from the preferred tenderers in the North RFT has been incorporated appropriately for the mains works, service connections and repairs and maintenance.'*

47. E&P noted that in some instances the Zinfra rates were marginally below the preferred tender rates.¹²

4.2.2 CONTRACT EXCLUSIONS AND VARIATIONS

48. c-i-c

49. c-i-c

50. c-i-c

51. c-i-c

52. c-i-c

¹² E&P, JGN – Review of Pricing Methodology Report, June 2013, p.11.

¹³ c-i-c

¹⁴ E&P, JGN – Review of Pricing Methodology Report, June 2013, p.3.

c-i-c

4.2.4 STEEL CONTRACT ARRANGEMENTS

53. Construction works on JGN's secondary network are currently undertaken by three service providers (including Zinfra) under the JAM Steel Panel Contract (**Steel Contract**). The Steel Contract was established through a competitive tender.
54. Under the JGN FSA, secondary network construction in the Southern Region will be exclusive to Zinfra up to a threshold construction cost of \$0.5M.¹⁷ Services for projects expected to cost more than \$0.5M will be procured competitively. The secondary network construction unit rates in the JGN FSA are the same as the rates in the Steel Contract for the same scope of work.

¹⁵ E&P, *JGN – Review of Pricing Methodology Report*, June 2013, p.17.

¹⁶ E&P excluded the Zinfra margin from its analysis on the basis that there was no direct comparable with the Jemena structure in the Northern Region.

¹⁷ The Steel Contract will remain in place for works in the Northern Region and for works over A\$0.5M in the Southern Region. Zinfra will remain as a counter-party to the Steel Contract.

5. ASSET MANAGEMENT AGREEMENT (AMA)

55. JGN's relationship with JAM is governed by the AMA under which JAM provides asset management, network operations and maintenance services to JGN on a cost pass through basis. The cost pass through element of this agreement ensures that JGN benefits directly from cost savings JAM achieves through its subcontracting arrangements. The AMA commenced in August 2009 following an RFP and extensive bilateral negotiations that took place in 2008 and 2009 and which were subject to probity audit.

5.1 ORIGINAL AMA

56. When established in 2009 the AMA enabled JGN to access significant economies of scale and scope because JAM was Australia's largest provider of energy asset management services at that time. JAM provided services to JGN directly and indirectly through subcontractors.
57. Under the AMA:
- the service scope and KPIs for network services were clearly set out (it should be noted that non-asset management services are provided to JGN by Jemena Ltd at cost)
 - JAM was subject to service and cost performance incentive arrangements (gain/pain arrangements)
 - JAM was entitled to a commercial margin.¹⁸
58. The AER reviewed and accepted the AMA arrangement at the 2010 AA as a basis for delivery of asset management services on the JGN network but concluded it would only provide an allowance for the AMA commercial margin in the building block revenue for activities undertaken by JAM.
59. In subsequent decisions, underpinned by a Tribunal decision (Application by Envestra Limited (No 2) [2012] ACompT 4, **Envestra decision**), the AER did not limit allowed reasonable commercial margins to just activities directly undertaken by the related party. In the Envestra decision, the Tribunal found that whether a margin is recoverable primarily depends on whether the total cost (including any margins) incurred by the relevant network operator in outsourcing services was lower than insourcing the services. The Tribunal decision made no mention of any distinction between margins paid on internal or external costs. In fact, the APA margin paid by Envestra was calculated as a percentage of Envestra's revenues, not APA's costs.

5.1.1 ORIGINAL AMA SCOPE

60. The AMA provides for JAM to deliver asset management services, operating and maintenance services, and capital program delivery. Table 5–1 describes key aspects of the original AMA services.

¹⁸ Prior to 1 July 2012 a margin was payable by JGN to JAM under the AMA.

Table 5–1: Original AMA services

Key aspect	Description
Service integration	<ul style="list-style-type: none"> • coordinating of service delivery
Asset management	<ul style="list-style-type: none"> • managing the technical policy framework • developing asset management plans • managing the capital program • documenting procedures and quality management systems • managing and monitoring technical compliance • undertaking capacity planning and system design • managing meter assets • investigating and managing incidents • monitoring and assessing network performance • maintaining asset records and controlling document • managing UAG
Market and billing services	<ul style="list-style-type: none"> • managing market transactions • managing complaints • addressing revenue protection and theft • reading meters and managing data • managing emergency load • providing a support desk function for stakeholders
Capital works	<ul style="list-style-type: none"> • conducting design and cost estimation • managing construction
Network operations and maintenance	<ul style="list-style-type: none"> • managing consumer service • conducting network maintenance • coordinating emergency response • providing network operating and control services • managing asset relocations required by third parties • maintaining land and property
Other technical services	<ul style="list-style-type: none"> • managing and operating an accredited appliance and material testing laboratory • managing NGV contracts and equipment • analysing and testing plastic pipe and fitting failure
Information systems	<ul style="list-style-type: none"> • maintaining the JGN's IT systems for compliance with its policies and management plans • managing IT projects delivery program

61. JGN sought a prudent mix of in-house functions and outsourced activities. The delineation between these activities reflects JGN's selective retention of commercial and governance functions, while adopting outsourcing for activities where contracted asset managers can achieve economies of scale and scope that are not available to JGN on a stand-alone basis.
62. By entering the AMA, JGN was able to maximise productive efficiency via economies of scope and scale, and incentive structures. At the time, JAM was largest energy network asset manager in Australia and therefore was

5 — ASSET MANAGEMENT AGREEMENT (AMA)

able to achieve economies of scale and scope. JGN benefited from these economies through its AMA governance and pricing structure.

5.1.2 INCENTIVE ARRANGEMENTS IN THE ORIGINAL AMA

63. c-i-c

64. c-i-c

c-i-c

65. c-i-c

5.1.3 ORIGINAL AMA MARGIN

66. c-i-c

67. c-i-c

68. c-i-c

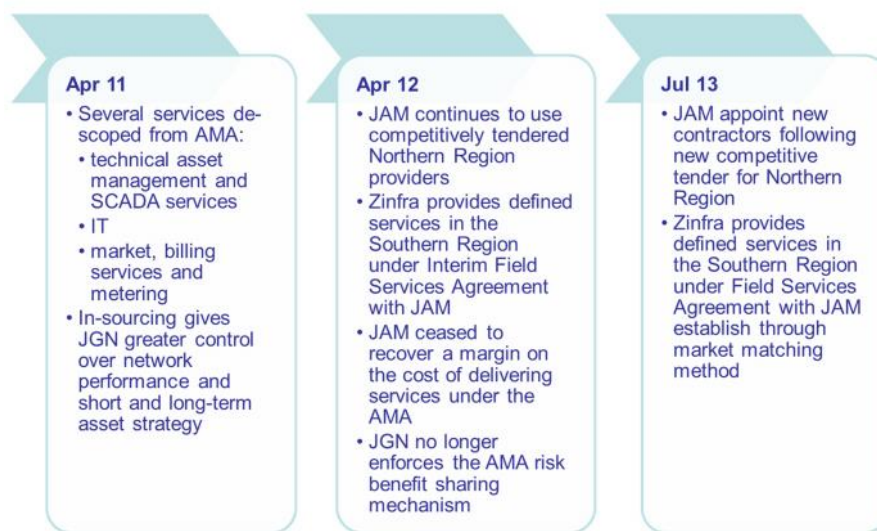
69. c-i-c

5 — ASSET MANAGEMENT AGREEMENT (AMA)

5.2 EVOLUTION AND APPLICATION OF THE AMA

70. The AMA continues to be the umbrella arrangement between JGN and JAM for JGN's outsourced services. The AMA is the basis upon which JAM recovers costs from JGN for the provision of field services either directly or through subcontracting arrangements. However, since the 2010 AA review the AMA has been simplified to reflect the Jemena Group's new structure, removal of risk elements of the AMA and de-scoping certain activities out of JAM and into JGN consistent with the new outsourcing arrangements discussed above.
71. The AER has been informed of these changes through the annual RIN responses, with JGN also providing in-person briefings to the AER on 28 November 2012 and 22 November 2013.
72. Figure 5–2 shows the transition from the previous AMA arrangements to the new arrangements covering the Northern and Southern Regions as presented on 22 November 2013.

Figure 5–2: Outsourcing transition



73. The following sections set out the changes that were made to the AMA between 2009 and 2014, and what commercial outcomes were achieved within the AMA risk and incentive framework over that time.

5.2.1 2010-2011¹⁹

5.2.1.1 Changes made to the AMA

74. In November 2010, resulting from business restructuring, Jemena created Jemena Assets and Investments (**JAI**) as a business unit responsible for the group assets companies (the Asset Owners, including JGN) and Jemena Infrastructure Services (**JIS**) as a separate business unit to provide field services contracting principally through JAM.
75. This separation came into effect on 1 April 2011 and moved Jemena's asset management function into JAI to consolidate the Asset Owner's focus on managing network performance and to allow JIS to focus on providing network and construction services to Jemena Asset Owners and third party infrastructure owners. As part of

¹⁹ Jemena Asset Management Submission in response to 2011 RIN, Commercial-in-confidence, 16 December 2011.

this separation, JGN and JAM amended the AMA to reflect the new functional arrangements which took effect from 1 April 2011.

76. The activities de-scoped from the AMA at that point—and thereby no longer attracting a commercial margin—were reported in JGN’s 2010-11 RIN response. These were:

- technical asset management and SCADA services
- IT
- market, billing services and metering.

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²⁰ See clause 21 of Schedule 5 (Fees) of the AMA.

²¹ See clause 18 of Schedule 5 (Fees) of the AMA.

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5.2.2 2011-12²²

5.2.2.1 Changes made to AMA

87. In August 2011 the SPI (Australia) Assets Pty Ltd Board approved a restructure of the Jemena Group's assets business to in-source specialist services within its assets and establish a separate services business to provide field service activities that can be market tested. This resulted in:
- an Assets business (Jemena) focusing on the ownership and management of the Jemena assets
 - a Services business (Zinfra) operating independently in the construction, operation and maintenance services market, including providing services to the Jemena Assets business and also competing for business from third party customers.
88. Under the new structure, JGN and JAM are both part of the Jemena Assets business. JAM holds key supply and services contracts (including, from 1 April 2012, with Zinfra), which it relies on to deliver some of the AMA services to JGN.
89. In light of JAM being brought in house, the parties to the AMA agreed that, although the AMA would remain in place, effective from 1 April 2012:
- JAM ceased to recover a margin on the cost of delivering the services to JGN under the AMA and is only entitled to recover its actual costs
 - JGN no longer enforces the risk benefit sharing mechanism under the AMA.²³
90. The restructure also required various structural and organisational changes within Jemena. Those changes included the following:
- effective 1 April 2012, JGN, JAM and Zinfra entered into an agreement termed the Gas Field Services Terms Sheet (**Terms Sheet**) under which certain services that JAM provides to JGN in the Southern Region of the JGN network either directly or through sub-contractors, were provided by Zinfra as JAM's prime contractor. The terms of this agreement are described in greater detail in sections 1.6 and 1.7 of JAM's 2012 RIN Submission. A copy of the Terms Sheet has also been provided as part of that RIN submission. The Terms Sheet (which was ultimately converted into a long-form agreement) expired on 1 July 2013.

²² Jemena Asset Management Submission in response to 2012 regulatory information notice, Commercial-in-confidence, 15 November 2011

²³ Letter from JGN to JAM, *Amendments to the Asset Management Agreement, Commercial-in-confidence*, dated 7 June 2013 (provided as part of the AA RIN response).

- It was envisaged that pre-existing agreements between JAM and its sub-contractors would be novated from JAM to Zinfra insofar as they related to providing services within the scope of Zinfra’s engagement in the Southern Region of the JGN Network. However, despite the Terms Sheet commencing on 1 April 2012, the novation of these agreements did not occur during the regulatory year. Instead, all sub-contractors remained contracted directly to JAM, and Zinfra had access to those contractors, at cost, to perform its functions under the Terms Sheet.

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5.2.3 2012-13²⁶

5.2.3.1 Changes made to AMA

96. No changes have been made to the AMA effective after 30 June 2012.

²⁴ See clause 19 of Schedule 5 (Fees) of the AMA.

²⁵ See clause 20 of Schedule 5 (Fees) of the AMA.

²⁶ Jemena Asset Management 2013 Annual Regulatory Information Notice submission in respect of services provided to Jemena Gas Networks (NSW) Ltd, Commercial-in-confidence, 15 November 2013

5.2.4 2013-2014

5.2.4.1 Changes made to the AMA

97. From 1 July 2013, the Northern Region and Southern Region subcontracting arrangements detailed in sections 3 and 4 have been in force. While these arrangements did not result in any direct changes to the AMA, they affected the costs flowing through the AMA from JAM to JGN.
98. On 18 December 2013, the term of the AMA was extended so that it now expires on 31 December 2018. The initial term of the AMA was due to expire on 31 December 2013.

5.2.4.2 Compliance with AMA arrangements

99. The new outsourcing arrangements have to comply with the obligations set out in the AMA, which are summarised below. c-i-c

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100. As noted above the provision of field services in the Northern Region was the subject of a competitive tender. The unit rates for the Southern Region were benchmarked against those received from third parties though the competitive tender run in respect of the Northern Region for the same services under the same or very similar terms and conditions.
101. The JGN board considered its compliance with the above AMA contractual requirements when reviewing the outcomes of the regional subcontracting process at the time of entering into the corresponding subcontracting agreements, and noted JAM's compliance with these provisions.²⁷

5.2.4.3 Commercial outcomes achieved

102. While JGN will report the commercial outcomes achieved in the upcoming annual RIN response for the 2013-2014 regulatory year, section 6 outlines the outcomes of the new regional subcontracting arrangements as they are expected to affect JGN in that year.

²⁷ JGN board meeting, Paper 5, JGN Field Services Procurement, 4 June 2014 (provided as part of the AA RIN response).

6. NORTHERN AND SOUTHERN REGION OUTCOMES

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105. JGN is confident that these rates will remain consistent with lowest sustainable costs into the future because:

- the Southern Region FSA requires the unit rates to be subject to benchmarking after five years, which will ensure this safeguard applies over the term of the FSA
- the Northern subcontractor rates will be tested through competitive market tenders when the current contracts expire.

106. The new outsourcing arrangements for the Northern and Southern Regions were noted by the JGN board in June 2014. In doing so the JGN board satisfied itself that JAM had met the requirements of the AMA and that JGN was benefiting from commercially reasonable outcomes that were consistent with achieving the lowest sustainable cost of operations for JGN.

²⁸ Weighted average of the top 10 unit rates by total cost impact (when applied to respective volumes).

Attachment A

JGN briefing materials to the AER

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