

State of Tasmania

**Response to Submissions
Office of the Tasmanian Energy
Regulator**

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1 Introduction

The Office of the Tasmanian Energy Regulator ('the Regulator') has provided the State of Tasmania ('the State') with the opportunity to respond to public submissions made on the State's proposed tender process. This paper sets out the State's consideration and response to the issues raised.

The Tasmania Natural Gas Project ('TNGP') proposed by Duke Energy International, and the distribution and retailing tender currently being proposed by the State, are integral to the ongoing economic development of the Tasmanian energy market. In this context, the State welcomes each of the submissions made on the process, and has attempted to provide a detailed response to each issue raised.

The State commenced its preparations for the tender process in December 2000. In structuring the opportunity for bidders, the Tasmanian Government has been concerned to offer an opportunity for investors that fairly rewards the risks involved in developing a greenfield project with the State's objectives as set out in the Tender Approval Request¹, being:

- to facilitate the development of an efficient and competitive gas supply industry;
- to maximise the coverage of reticulated gas services throughout Tasmania in an economically efficient manner;
- minimising costs to gas consumers;
- to minimise the ongoing risk for the State and consumers;
- to establish appropriate standards of safety, reliability and quality in the gas supply industry; and
- to establish a regulatory framework that maximises the long-term growth of the gas market in Tasmania while providing sufficient regulatory certainty to attract investment and maintain the financial viability of the gas supply industry.

The State has invested considerable time and effort in developing the tender process and in market testing the proposed concepts with potential bidders and industry participants. The State believes that it has achieved its aim of both attracting bidder interest and providing long-term security to consumers.

It should be noted that some components of the tender are inter-reliant in order to meet the State's objectives. The link between the franchises offered to bidders, and the risks involved in undertaking a significant capital investment in Tasmania is one example. Potential bidders have clearly linked the need for a long-term franchise with the types of risks involved in entering the Tasmanian market.

¹ Section 2.2 of the Tender Approval Request

The State remains committed to conducting a Code compliant process. The current tender structure is the outcome of significant investigation and analysis by the State. While the State retains an open mind in relation to issues raised in submissions, and has been careful not to dismiss any suggestions for process amendments, the State does not believe that any of the suggested amendments would produce a superior outcome to that already developed.

We welcome the constructive and supportive approach adopted by all parties in responding to the Regulator's Issues Paper. We trust that this Report clarifies the State's position on the issues of concern.

2 Submission by Duke Energy International

2.1 Introduction

The two areas, which are of apparent concern to Duke, are the proposed fees and terms of the Development Agreements (DAs) and the level of flexibility of the Gas Pricing Order (GPO).

Broadly, the Government has designed both the DAs and the GPO to underpin and secure the outcomes of the tender process in the interests of both the bidders and potential Tasmanian gas customers. As set out in the tender documents, the successful bidders will win rights to exclusively provide relevant gas services for all of Tasmania. In exchange, they must commit to the terms of the final DAs, which govern their obligations to establish gas distribution and retail operations in Tasmania, their rights to provide services and to the pricing principles set out in the final GPO, which accompany these services. A discussion of these documents, in the context of the issues raised by Duke, is provided below.

2.2 Development Agreements

The State notes Duke's concerns that the fees and terms set out in the DAs may impact a decision by potential bidders to participate in the tender process.

The State has carefully considered all of the terms of the DAs. The DA summaries on the Regulator's website outline the Government's intentions in this regard. A key goal in designing the process is ensuring that the draft DAs are both commercially acceptable and safeguard the Tasmanian consumer following the completion of the tender.

It is proposed that bidders will have a formal opportunity to provide comments on draft DAs during the tender process. The State will be considering carefully any suggestions made by bidders during the tender process to ensure that the project is attractive to investors while ensuring that risks to the State and Tasmanian gas consumers are adequately mitigated. Finally, bidders may submit deviations from the benchmark DAs with their bid submissions for the State to consider as part of the suite of bidder conditions, including price and coverage.

One of the conditions that the State has imposed is the payment of a franchise fee to the Government in exchange for the right to distribute and retail natural gas to the whole of Tasmania for five and six years respectively. The franchise fees will account for approximately 1.5% of the total project capital cost. The final figures, \$2.0 million for the distribution franchise and \$500,000 for the retail franchise, are one-off fees. They are designed to assist the State in recovering some of its substantial costs it will incur during the tender process. These franchise fees will be effectively built into distribution tariffs and retail margins, as developers will recover those fees paid to the State during the period of franchises or over a longer period if they choose.

The fees are considered commensurate with the opportunity being offered, and have been considered as part of the project viability assessment.

As a result of investigations into the nature of the opportunity being offered, the State is of the view that the proposed level of franchise fees is reasonable, and that the package of rights offered by the proposed DAs represents an appropriately balanced and attractive basis for bidders.

2.3 Gas Pricing Order

The GPO aims to give the distributor and retailer price certainty for specified periods.

The current draft GPO specifies a number of 'pass through' events, which allow the Distributor and/or retailer to request the Regulator to pass through an additional cost to customers. Duke has questioned whether the range of pass-through events should be broadened. Specifically Duke have raised the issue of force majeure, and requested that a pass through for force majeure events be designated within the GPO.

The decision to limit the number of events, which can give rise to a change in prices under the GPO to the existing list, was taken for several reasons, including:

- An appropriate sharing of the risk of price variations between customers and the retailer and/or distributor. It is assumed that the distributor and retailer will be better able to anticipate and manage any change in their costs and so should bear the risk of a change in those costs; and
- The prices in the GPO are subject to bid. If the distributor or retailer considers that there is risk that they are overly exposed to changes in their costs they will have the opportunity to adjust their bid price accordingly.

On the specific issue of force majeure, the State considers that this will be dealt with under the contracts between the bulk gas supplier, Duke, the distributor, the retailer and the final customer. If an event occurs which may limit the amount of gas which can be supplied, it is appropriate that contractual arrangements rectify this issue, such as the ability to terminate the contract and/or seek damages for loss, rather than prices being adjusted under the GPO.

3 Submission by Aurora/Agility Management Pty Ltd

3.1 Introduction

The State notes the comments made by Aurora Energy and Agility Management Pty Ltd (the consortium), in particular the objectives for the regulatory environment offered in Tasmania, being:

- to provide confidence to investors;
- to provide appropriate levels of risk for investors;
- to provide appropriate levels of risk for Government;
- to deliver a gas price which is competitive with other fuels; and
- to deliver gas at a price, in the initial years, which encourages rapid growth in the market and hence grows gas volumes².

The consortium, has noted concerns in three broad areas, being:

- 1) The tender process;
- 2) The Launceston Network Sale Agreement; and
- 3) The tariff regime – GPO.

The State has responded to the major concerns in detail below. Specific responses to each of the recommendations made by the consortium are addressed in Appendix A.

3.2 Tender process

3.2.1 Equity

The Consortium is concerned that the tender process ensures that all bidders are dealt with on an equitable basis. To address this concern, the State has engaged a Probity Auditor and entered into a Development Agreement with Duke Energy that covers the process of negotiations of connection and transmission agreements between Duke and bidders and involvement of the Probity Auditor in that process to ensure that all bidders are treated equally.

² Consortium submission, page 4

3.2.2 Probity

The Consortium has raised concerns that the State has provided the Probity Auditor with discretion in relation to whether it will attend meetings between bidders and relevant parties such as the State and Duke.

In line with the State Probity Guidelines, the Probity Auditor's overall responsibility is to:

- ◆ promote probity issues to the Tender Team;
- ◆ ensure the confidentiality of the process;
- ◆ oversight the tender process to ensure the process is conducted fairly and equitably to all parties;
- ◆ satisfy himself that the tender process and its conduct accords with the requirements of procedural fairness;
- ◆ ensure, as far as practicable, that the Government achieves its objective to award a gas distribution franchise and a gas retail franchise covering the State of Tasmania and to ensure that any issues of a probity nature are fully addressed and resolved on a timely basis;
- ◆ ensure that conflicts, and potential conflicts, of interest are identified and eliminated;
- ◆ ensure that participants in the tender process are accountable for their actions; and
- ◆ oversee probity relating to the appointment of advisers.

The discretion held by the Probity Auditor will be exercised within the bounds of his obligations set out above. Further information is provided as an attachment to this submission.

3.2.3 Project Agreements

The State notes the concerns raised by the consortium over the project agreements, and particularly the concerns that these documents could become 'de-facto' selection processes. This was a key concern for the State when structuring these agreements³, with these documents designed specifically to avoid such an eventuality. The concerns raised by the consortium are specifically addressed below.

³ the State did not structure the Duke Agreements. These were drafted by Duke, with the State providing comments on the nature and content of the agreements.

3.2.3.1 Participation Deed

The State notes that the Participation Deed is generally acceptable to the consortium in its current form. However, the consortium has noted concerns with two elements of the Deed, being:

- 1) Clause 2(b) which requires a bidder to acknowledge that the Tender Approval Request and the Tender Guidelines comply with all relevant laws and the Code, and clause 14 which requires a bidder to waive any right to challenge the Tender in the eventuality that the TAR or Guidelines do not comply with the Code; and
- 2) Clause 28 which restricts changes in the membership of any consortium in that the membership of the consortium may not change without the State's prior written approval.

On the first issue, the State has sought to ensure throughout the process that the tender complies with the Code. Compliance is, as noted by the consortium, determined by the Tasmanian Energy Regulator and is therefore not within the full power of either the bidders or the State. As the tender process would only proceed if the Regulator determined that the tender process met the code requirements, the State has simply sought to minimise any possible disputes by requiring bidders to accept that the Regulator's approval of the tender process is final.

On the second issue, the State welcomes involvement of institutional equity investors in the project, however any bidding consortium that wishes to introduce new equity investors has to seek the State's approval. The State has established a comprehensive qualification regime, which could be circumvented if qualified bidders were free to add or remove consortium members at will. As described in the invitation to lodge Expressions of Interest, the State will apply the same qualification criteria when considering any subsequent qualification request. This process is designed for the State to ensure financial capacity of developers and, where a consortium wishes to introduce a strategic equity partner, the State has to ensure that such consortium has both the financial capacity and the required level of experience in the gas industry.

3.2.3.2 Development Agreements

The Consortium has queried the State's intentions in relation to the Development Agreement process, and has expressed the view:

- that uncommercial terms should not be demanded of bidders by the State;
- the State should release a fully developed set of Development Agreements at the same time as the Project Brief;
- that negotiations should take place between the State and bidders, together with the State's Probity Auditor

- that a final draft of the Development Agreement should be provided to bidders not later than one month prior to bid; and
- that bidders should provide evidence of enforceable arrangements for construction.

The concerns about uncommercial terms will be addressed through the process of negotiation of the Development Agreements between bidders and the State.

The State has indicated to bidders that it will release draft Development Agreements to qualified bidders together with the Project Brief.

As described in the Tender Guidelines, bidders will have several opportunities to comment on successive versions of the draft Development Agreements.

Final (benchmark) Development Agreements will be provided to bidders in sufficient time before close of bids to enable bidders to finalise their bid submissions. Bidders will be required to reflect any final changes to the benchmark Development Agreements as part of their bid(s), and these will be assessed by the State against the selection criteria, specifically in the context of any risk to the State and consumers. The timetable for the release of the benchmark Development Agreements is yet to be finalised and will depend on a number of factors, including the efficiency and scope of Bidder comments. However, the State considers that a timeframe of one month prior to bid date is too early and will not give bidders adequate time to undertake investigations, consider the Development Agreements and provide meaningful comments.

The attendance of the State's Probity Auditor is not required at all meetings. This is at the discretion of the Probity Auditor, who may decide to attend any and all meetings at his unfettered discretion.

The suggestion that bidders should be required to provide evidence of enforceable arrangements for construction, such as EPC contracts, is not acceptable to the State. The construction risk lies with the developer, and the State will not accept any recourse in relation to the construction cost overruns or any other construction risks. It is the responsibility of the developer to construct and commission the network in accordance with the terms of the Development Agreement with the State.

3.2.3.3 *Duke connection and transmission agreements*

The State notes the concerns raised by the consortium that the Duke Agreements might become a de-facto selection process. The State has put in place specific measures with Duke to ensure that this does not occur.

These measures are referred to in section 6.6(e) of the Tender Approval Request, which states:

Bidders will be required, by the time of lodging Bid Submissions, to have entered into a binding connection agreement and transmission agreement with Duke Energy conditional on award of the distribution and retail franchise respectively. The State will permit Bidders to negotiate connection and transmission agreements directly with Duke Energy. Duke Energy has provided the State with an undertaking that should direct negotiations occur between Bidders and Duke Energy, it will provide all Bidders with an equal opportunity to negotiate those Agreements and that information provided by each Bidder to Duke Energy in the process of such negotiations will be kept confidential from other Bidders⁴.

This undertaking reflects both the State's Development Agreement signed with Duke Energy (confidential) and the Duke Communication Protocol (also confidential) which provide for Duke's undertakings in this regard. The Probity Auditor is also able to attend these meetings to ensure that probity is maintained throughout the process.

The State considers that the arrangements established with Duke Energy provide a level of transparency into a very important part of the process, particularly in relation to transmission haulage arrangements between the Bidder and Duke Energy. The State submits that these arrangements have been structured appropriately.

The Consortium claims that the currently proposed tender process provides no process to ensure that the terms of the Duke agreements are consistent between bidders, provide equitable dealing and are commercial.

The terms of the Duke agreements cannot be 100% consistent between bidders as different bidders are likely to propose different roll-out plans for gas distribution networks and different coverage areas and therefore bidders will be seeking different transmission capacities from Duke. Equitable dealing with bidders is ensured by the terms of the State's Development Agreement with Duke and involvement of the Probity Auditor in the process of negotiations between bidders and Duke.

Commerciality of the terms of Duke agreements is something that bidders will be able to judge themselves. Bidders will have equal opportunity to negotiate commercial terms of agreements directly with Duke Energy.

3.2.4 Role of Local Government

The State notes the concerns raised by the consortium in relation to consistency in planning and approvals for Local Government bodies. This has been a major area of work for the State since the State's roadshow stage where potential bidders indicated that greater information was required on this issue.

⁴ section 6.6(e), page 22 - State's Tender Approval Request

The State is preparing an issues paper for bidders which will be contained within the Project Brief. This explains the various approvals required for both State and Local Government bodies, notes important issues that may consume time for bidders, and provides bidders with contact information for Local Government bodies. In preparing this paper, the State will contact all Local Government bodies within the Minimum Pipeline Route, and within other areas that may be investigated by bidders as part of their analysis of possible routes.

Importantly, under the Gas Act 2000 the construction or operation of a distribution system is a "Permitted Use" for the purposes of planning approvals. Advice from the Director of Environmental Management indicates that similar linear infrastructure in urban or semi-urban areas is typically assessed as a Level 1 activity, a classification which provides a 42-day maximum for consideration and approval by Councils. Local Government bodies have been extremely supportive of the gas opportunity and the State is currently undertaking discussions with Councils on or near the Minimum Pipeline Route with a view to reaching consistency of approach to management of planning approvals and with particular reference to reducing uncertainty over reinstatement and hard surface restoration.

The State will put in place a coordinated process to assist bidders and, eventually, the successful bidder to navigate the planning and approval processes.

3.2.5 State's capital cost estimates

The State notes the concerns raised by the consortium in relation to the State's capital cost estimates.

The decision by the State to assess capital costs was part of its decision to offer the opportunity to tender, which required an understanding of project feasibility.

It is important to note that the State's cost estimates are to be provided to bidders in order to raise the general level of information available in the market at the commencement of bid. Bidders are, as noted in the Tender Approval Request, required to make their own investigations and to bid a discount or a premium to the State's revenue yields.

In doing so, the State expects that its work to date will be helpful for bidders not already familiar with the Tasmanian opportunity. The estimate of \$148 million related to the Minimum Pipeline Route, as distinct from the expected reticulation area, which the State expects may be between \$150 Million and \$200 Million when complete. These numbers were prepared by the State's advisers, KPMG and GHD (Consulting Engineers).

The consortium has suggested that bidders be required to provide evidence of arrangements for construction of the network as part of bid. The bid submissions must include details of the bidder's construction plan and evidence of its capacity to deliver the project. In many cases, this would include providing details of the proposed construction arrangements. However, the State is not a principal in the project and the details of the construction arrangements are appropriately left in the hands of the bidders.

The State is also keen to ensure that the tariffs offered during the bid process are 'sustainable'. Section 8.2(b) of the Tender Guidelines set out the criteria for the State's assessment of tariff sustainability over the economic life of the proposed pipeline. The State has specified a number of situations where tariff sustainability will be material in the evaluation, for example where:

- the distribution yields do not reflect an efficient economic outcome;
- a Bid Submission departs from the Benchmark principles for the Extensions/Expansions Policy in the GPO;
- a Bid Submission departs from the 15 year GPO period;
- a Bid Submission departs from the benchmark Residual Value Fixed Principles in the GPO; or
- another aspect of the Bid Submission (such as Retail Yields) compromises the sustainability of the Reference Tariffs proposed.

The State therefore considers that the arrangement in the current tender documents is appropriate.

3.2.6 Selection criteria

The State notes the concerns raised by the consortium as to the selection criteria, particularly as they relate to the ability for bidders to structure tariffs. It should be noted that the current arrangements do provide bidders with flexibility to structure tariffs under the GPO, subject to the requirements of section 8.1 of the Code (set out in Schedule 4 of the Tender Approval Request).

3.2.7 Mandatory and conformity criteria

The State notes the concerns raised by the consortium, in particular that the Conformity Requirements and Mandatory Requirements, as set out in the Tender Approval Request, are not reasonable. This is an issue which the State has considered in detail when designing the tender process. The State also notes the table provided in the submission which set out detailed concerns for each criteria. In developing the suite of conformity and mandatory requirements, the State was careful to ensure that the requirements did not present unreasonable hurdles for bidders. Clearly, a gas infrastructure project such as this requires the State to achieve a level of certainty for several key elements of the bid submission. This is the rationale for the criteria selected.

An example of the State's intentions is the bid conformity requirement for bidders to provide evidence that they have secured, or are able to secure, sufficient 'upstream' natural gas supplies to support their bid submission. Without such information, the State would not be able to assess the risks that Tasmanian consumers and business would face gas supply shortages in peak times.

The State considers that the current suite of requirements are necessary in order to provide certainty for the State and consumers over the required term, and in testing the 'sustainability' of the tariffs offered.

3.3 Launceston Network Sale Agreement

3.3.1 Mandatory requirement

The Consortium has a view that a lower sustainable cost of delivery of gas to customers can be achieved without acquisition of the Launceston Network.

The State considers that the acquisition of the Launceston network is necessary in order to facilitate a competitive tender process and enhance tender outcomes for gas customers. In responding to the specific issues raised by the consortium, the State has considered four issues:

- Background to the Launceston network issue;
- Whether the approach of acquisition is fair for customers;
- The State's means of determining 'fair' value of the Launceston network;
- Whether the novation of the sale deed is reasonable (in particular whether the sale could have been offered as an 'option' for bidders).

Background

Origin Energy Tasmania Limited ("Origin"), a wholly owned subsidiary of Origin Energy Limited, owns a pipeline network in Launceston ("the Launceston Network"), which was used to transport town gas until 1996. The Launceston Network is not currently operational.

While the Launceston Network is no longer used for supply of town gas, it could have value to a developer of a natural gas distribution network. Experience has shown that town gas pipeline networks may provide conduits for insertion of modern natural gas networks.

During the market testing of the proposed tender process with potential bidders, the State was advised that the existence of the Launceston network could provide Origin Energy with a perceived advantage. The advantage to Origin could come from three possible areas:

- Savings in trenching/drilling costs from insertion of the network, therefore potentially lowering the tariffs that could be offered by Origin Energy to the extent that any savings are passed through to consumers;

- “Spoiling” value, in that the possibility of liability for damage to the Launceston network could restrict the ability of other bidders to lay a network; and
- “By-Pass” value, in that bidders would fear that the town gas network could be used to by-pass to large customers at the immediate cessation of the distribution franchise.

After the benefit of engineering advice, the State found that Origin Energy, or any other developer, could have the potential to utilise the infrastructure of the existing Launceston Network for insertion of natural gas distribution pipes, thus avoiding or minimising the need for trenching and/or drilling. This would potentially provide considerable capital cost savings, including:

- Savings on trenching and/or drilling costs;
- Elimination of blasting and rock sawing (where it would be otherwise required);
- Savings on reinstatement costs;
- Savings on construction management costs;
- Savings on traffic control costs;
- Minimisation of damage to parks and nature strips; and
- Reduction of possible damage to other services.

The issues of spoiling value and by-pass value were not assessed in detail by the State, as it was believed that the value of these effects could not be quantified. It was clear to the State, however, that both ‘spoiling’ and ‘by-pass’ were seen as significant issues by potential bidders in deciding whether or not to bid.

Based upon this analysis, the State considered it likely that Origin Energy would have an advantage in the gas tender, and that acquisition of the Launceston Network would be required in order to ‘level the playing field’. This was seen as essential in ensuring that potential bidders were not discouraged from investing the significant funds involved in a bid process, by their view of the risks of Origin’s network ownership.

Acquisition of the Network and Lower Tariffs

The State’s consideration of this issue balanced two countervailing points:

- That removing Origin’s advantage would deny consumers the benefit of the savings that Origin could potentially factor into its tariffs; and

- That other bidders would be less likely to participate if the Launceston network issues were not appropriately dealt with.

On the first issue, the State noted that Origin Energy would have the advantage of offering lower distribution tariffs if it chose to pass to consumers all possible savings from insertion. This benefit would be removed if the State ‘levelled’ the playing field by requiring acquisition of the network.

On the other hand, the State was faced with concern from potential bidders that Origin held an unfair advantage in Launceston. The State also considered whether it would prove difficult for bidders to secure finance with spoil value and by-pass potential unresolved.

In balancing these tensions, the State considered its obligations in terms of the National Gas Code, in particular the requirement that the tender process be sufficiently competitive. Given the views of potential bidders, and the concern that sufficient bids would not be received, the State elected to remove the ‘advantage’ held by Origin Energy at the expense of potentially lower tariffs (to the extent that these savings may have been passed through to consumers).

Fair Value for the Network

Under the proposed process, the State and Origin Energy would be bound by the terms of an independent valuation of the Network. The purchase price would be equal to the net present value of estimated capital cost savings associated with the insertion through the existing Launceston Network.

While there remains a risk, as pointed out by Aurora/Agility, that the Launceston network has little value to the developer of a natural gas distribution network, this will be uncovered through the valuation process, ensuring that only ‘fair value’ is paid.

The State has been keen to ensure that maximum information is provided to bidders in relation to the Launceston Network. To this end, it is intended that the Launceston Network Sale Agreement (“LNSA”) will be provided to bidders with the Project Brief, containing the terms of reference for the independent valuer as well as all agreements.

In addition, the outcome of the valuation, as well as all appropriate documentation and studies, would be known to bidders before bid submissions are due. Accordingly all bidders would then be able to factor the costs of acquiring the Launceston Network, as determined by the independent valuer, into their bid submissions.

Liabilities

Under the terms of the LNSA, steps have been taken to provide an appropriate allocation of environmental and other liabilities between Origin and the acquirer of the Launceston Network. While there is a potential for transfer of certain environmental liabilities to the

acquirer of the Launceston Network, this risk is considered to be fairly limited and should be able to be adequately managed by a gas distribution network developer as part of normal operational risk management procedures.

The terms of the LNSA are confidential, but can be disclosed to qualified bidders in the tender process and have been made available to the Regulator on a confidential basis. Bidders will also be provided with relevant available information regarding the state of the Launceston Network and will be able to form their own views on the 'fair value' of the Launceston Network and any potential risk exposure.

Whether the Sale is Reasonable

It is the intention of the State to novate the LNSA to the successful Bidder for the distribution franchise. The State has therefore imposed, as a tender condition, that the successful bidder (if it is not Origin or a related body corporate) must acquire the Launceston Network under the terms of the LNSA.

Before embarking on the lengthy negotiation process with Origin Energy, the State considered whether the LNSA should take the form of an option or a sale agreement.

The possibility of acquiring an option to purchase the Launceston assets was considered in detail by the State. This option could then have been made available to the winning bidder, allowing all bidders to factor it into their bid price. Under this scenario, Origin could not have bid for the franchise with the existence of a clear alternative use value ensuring that it tendered on a level playing field with other bidders.

It was considered that an option would carry with it significant uncertainty for Origin Energy. The State recognised that Origin had made a considerable investment in the State of Tasmania through its network and therefore should be treated fairly and equitably. It was distinctly possible that Origin would not pursue an arrangement with the State unless Origin was convinced that a definite sale arrangement could be established.

Finally, the State was aware that all bidders would require the option documentation and network information during the bid process. It was considered that the State would be unlikely to conclude arrangements with Origin before the bid commenced and therefore that significant delays to the bid process would have been possible. This may have resulted in upstream risk to Duke Energy's transmission pipeline investment.

On the basis of these considerations, the State elected to structure a sale arrangement with Origin Energy in the manner set out in the Tender Approval Request.

3.3.2 Conflict of interest - Origin as vendor of the Launceston Gas Network

The consortium has raised concerns over the ownership of the Launceston Gas Network by Origin Energy, and in particular the State's proposal that the successful bidder purchase the Launceston network for 'fair value'.

The State has acknowledged early in the process that:

- any arrangement would need to be on fair and equitable terms for Origin Energy;
- continued ownership of the Launceston Network by Origin Energy could disadvantage bidders, in the eventuality that Origin Energy chose to bid for the franchise;
- this advantage stems from the ability to 'insert' natural gas pipelines and avoid the need to 'trench'. These savings can be significant depending on the nature and condition of the pipes; and
- potential bidders indicated a significant risk premium on possible by-pass through the Launceston Network to their customers after the cessation of the franchise, and therefore could choose not to enter the bid process.

The State therefore embarked on the proposed arrangements for the purchase of the Launceston Network in order to neutralise any advantage held by Origin Energy, and to provide all bidders with the opportunity to reticulate Launceston in the most equitable and efficient manner possible.

The Launceston Network Sale Agreement would effectively provide all bidders with equal access to the infrastructure of the Launceston network and provide Origin with a fair value for this asset. Sale of the Launceston network would be for the value of 'avoidable' capital costs that are likely to be realised through insertion. The valuation is to be conducted independently and both parties (the State and Origin) would be bound by the valuation.

The outcome of the valuation would be known by the time bid submissions are due. Accordingly all bidders would then be able to factor the costs of acquiring the network, as determined by the independent valuer, into their bid submissions.

3.4 Tariff regime - GPO

3.4.1 Role of the Regulator

The State notes the concerns raised by the consortium in relation to the role of the Regulator. In constructing the GPO, the State has been mindful of balancing the requirements of prices oversight with likely bidder perception of possible regulatory risk. The State believes that an appropriate balance has been achieved with the current GPO.

3.4.2 Term of the GPO – Revisions Commencement Date

The State notes the concerns raised by the consortium in relation to the Revisions Commencement Date, in particular that 15 years may be insufficient given the risks in developing a greenfield investment in Tasmania.

The term of the Revisions Commencement Date in most national Access Arrangements is five years. The State, in considering the optimal term for the GPO (and therefore the revisions commencement date) was required to form a view on the likely requirements of both bidders and consumers in the Tasmanian market.

Market testing of this concept provided Government with a range of views in relation to the risks and benefits of longer periods of price certainty. It was noted that market participants, particularly given the uncertainties in market operations, which have occurred over the last ten years, do not always welcome long periods of price certainty. Other potential bidders preferred longer periods.

In forming a view of the appropriate period, the State considered that 15 years represented a reasonable period of certainty for developers and their financiers. This period of time was also considered to offer the optimal level of security to consumers against unforeseen tariff adjustments. It is not considered necessary to allow a period longer than 15 years. The State will therefore devalue a bid that deviates from the 15-year period.

CPI-X Regime

The State notes the concerns raised by the consortium, in particular that the CPI-X framework may be inappropriate for a greenfield investment. The State has carefully considered the nature of the Tasmanian opportunity in constructing a 'volume deal' for bidders and the consequential regulatory framework. The GPO therefore sets out a model where the market operator can exceed a 'revenue requirement' by growing volume beyond the State's estimates. This can provide for significant market upside and therefore matches the risks involved in investment in a greenfield development.

The X factor is a key element of the revenue control, which governs the yield calculation, providing for a modest real decline in the yield over the term of the GPO.

The State notes that bidders will be asked to specify a yield at the commencement of the process, and therefore this yield could be lower without an X factor. It is also noted that the X factor, when specified in this way, does not necessarily imply increasing efficiency in operations over the period of the GPO. The State's decision to impose an X factor on bidders is designed to ensure that real tariffs decrease over time. Having the State form a view on X, rather than having bidders nominate values, ensures that the price control provides the level of protection for consumers consistent with the State's policy objectives. In addition, fixing the X factor provides the State with a considerably more robust evaluation framework, allowing ease of comparison between bids, and allowing the State to focus on evaluating areas of bid submissions from which it can derive greater value for consumers.

The State considers that allowing bidders the opportunity to bid an X factor unnecessarily complicates the evaluation process with little practical upside for Government or consumers.

Consistent with clause 7.6 of the Tender Guidelines, bidders are free to lodge a non-conforming bid reflecting their proposal in relation to the value of the X factor. The State reserves the right to consider different X factors in the context of risks to the State and consumers, and may in accordance with the evaluation methodology set out in the Tender Guidelines downgrade a bid that varies from the 1% benchmark provided in the Project Brief. Where a bid provides upside to consumers through other aspects, that bid will not be dismissed as non-conforming.

3.4.3 Uniform retail tariffs

The State notes the concerns raised by the consortium in relation to uniform retail tariffs, however the concerns raised seem to relate to distribution services rather than retail services.

The State has not required uniform distribution tariffs. Rather, bidders are free to nominate tariffs that meet the requirements of section 8.1 of the Code. It is considered that the winning bidder would offer network-marketing incentives as part of operations, or discounts to the tariffs set out in the GPO. The GPO provides for a series of maximum tariffs and would therefore allow such discounts to be provided where desired. The state believes that bidders will have sufficient flexibility in structuring their distribution and retail tariffs in line with regulatory requirements.

The State believes that uniform retail tariffs for small customers (those consuming less than 30 TJ p.a.) are necessary for equity reasons and are consistent with the current arrangements in relation to electricity and with gas industry arrangements in other states. As such, uniform retail tariffs are set out in the Gas Pricing Order as mandatory for the Proposed Area. The State notes that areas outside the Proposed Area may not receive uniform retail tariffs as such areas are outside the scope of the GPO. Currently, the prices oversight for these areas is set out in section 31 of the Gas Act 2000 as needing to be 'commercially reasonable'.

The State is currently seeking to amend section 31 of the Gas Act to provide for an exclusive retail franchise to be subject to licence conditions determined by the Director of Gas. These conditions must not be inconsistent with the Gas Pricing Order, which regulates prices inside the Proposed Area, or any other conditions required by the Minister under section 30(3)(d) of the Gas Act 2000. One of the conditions to be attached to the franchise retail licence will be that, where the retailer offers to sell gas to non-contestable customers outside the Proposed Area, the terms and conditions offered must be "fair and reasonable". The Director of Gas will be responsible for assessing the fairness and reasonableness of such terms and conditions, including price.

It is expected that these amendments will be in place over the coming month. The State considers that there is little potential for material cross subsidies arising from uniform retail tariffs for small customers within the Proposed Area.

3.4.4 Additional Revenue Policy

The State notes the concerns raised by the consortium in relation to the additional revenue policy and the avoidance of revenue caps. The State agrees with the consortium that a price path is a more effective means of providing incentives in a greenfield environment than a revenue cap. For this reason, the State has established the revenue yield concept, which allows for a price path approach and the avoidance of a revenue cap. This is set out in the Gas Pricing Order.

A revenue yield control imposes an average revenue constraint on tariffs, not on overall revenue. The State considered that a cap on revenue would not be achievable given the low volumes and revenues likely in the initial years of operation.

Under the revenue yield, the service provider has relative freedom to price services in ways which best meets the requirements of markets for those services, but the resulting revenue must not exceed the average revenue constraint – being the yield. There is therefore no revenue cap imposed on the market, rather an average price over the term of the GPO period.

The State considers that the proposed method of regulation is appropriate given the risks inherent in the market, and it provides the necessary incentives noted by the consortium.

3.4.5 Network by-pass

The State has sought to ensure that by-pass does not occur within Tasmania for the term of the franchise.

As contemplated under the Gas Act 2000 and described in clause 3.2 of the Tender Approval Request, the successful distribution bidder will enjoy an exclusive, non-renewable, five-year franchise to operate a gas distribution system in Tasmania. It is not possible to extend this period as the National Competition Policy sets the maximum term of an exclusive distribution franchise at 5 years.

3.4.6 Pass through under the GPO

As noted previously, the current draft GPO specifies a number of 'pass through' events, which allow the Distributor and/or retailer to request the Regulator to pass through an additional cost to customers. The consortium has questioned whether the range of pass-through events should be broadened to include State/Local Government taxes or charges, transmission or gas costs, and regulatory compliance costs.

The decision to limit the number of events, which can give rise to a change in prices under the GPO, to the existing list, was taken for several reasons, including:

- an appropriate sharing of the risk of price variations between customers and the retailer and/or distributor. It is assumed that the distributor and retailer will be better able to anticipate and manage any change in their costs and so should bear the risk of a change in those costs; and
- the prices in the GPO are subject to bid. If the distributor or retailer considers that there is risk that they are overly exposed to changes in their costs they will adjust their bid price accordingly.

The State considers that the pass through provisions in the GPO are appropriate.

4 Submission by Metaira Pty Ltd

4.1 Introduction

The primary issue raised by Metaira relates to the complexity of the tender process, and the assertion that it has been designed for “schemes linking load centres rather than a series of incremental small distribution schemes to which it is being applied⁵”. This assumption then frames the conclusions made by Metaira in relation to adverse outcomes on tariffs, coverage, ongoing costs and the size of the prospective bidder pool.

The State elected to follow a tender process which is compliant with sections 3.21 to 3.36 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). This was seen as favourable for a number of reasons.

Firstly, the State has enacted the National Gas Access Law as part of its own legislation. This is part of its broader commitments under National Competition Policy, and enacts the Code within the State of Tasmania. The Code provides for regulation of monopoly assets such as the proposed Tasmanian distribution system in order to provide the appropriate protections to end-users. This public consultation process, for example, is an outcome of the Code process run by the Local Regulator.

Secondly, the outcomes of a Code compliant tender, being the proposed areas and the distribution tariffs which apply within those proposed areas, are enshrined in an Access Arrangement and the Gas Pricing Order as set out in the Code. This provides bidders with, among other things, considerably greater certainty in relation to tariff levels and fixed periods than exists for unregulated pipelines. This was considered to be necessary in attracting bidders to this development opportunity.

Thirdly, the use of the Code process combined with the grant of franchises for the entire State of Tasmania allowed issues of market scale to be overcome by potential bidders. This, combined with the certainty provided by a Code process, was considered necessary in order to attract sufficient bidders for a competitive process.

Metaira have made a number of recommendations for amendment to the tender process. These recommendations are addressed in detail in Appendix B. Specific concerns raised by Metaira are addressed below.

4.2 Excessive costs to the operators, leading to higher tariffs

As noted previously, the State carefully considered the need to adopt a tender process under the National Gas Code. The final decision to follow a Code compliant process was taken on the basis that it would provide the most price certainty to bidders. This was also in

⁵ Metaira Letter to Govt 5 October 2001, page 1

accordance with the State's responsibilities under National Competition Policy. This process is more complex than a simple tender to award a franchise, however, as noted above there are considerable benefits to the State, bidders, and consumers from such a process.

To obtain these benefits, the Code process requires significant work at the 'front end'. This is necessary in order to provide the required certainty to all parties through automatic inclusion of the tariffs in the distributor's Access Arrangement under the Code. This process has required considerable work by the Government and its advisers.

The State does not consider, however, that the costs of designing the process have been excessive. The Tasmania Natural Gas Project is of strategic importance to the State. It is intended that a proportion of the costs will be recovered from the successful bidders through the imposition of Franchise Fees. As noted previously, the State is of the view that the proposed level of franchise fees are reasonable, and do not reflect an unreasonable imposition in the context of the entire investment.

The tender process is designed in such a way that it allows developers of gas distribution and retail businesses full flexibility in structuring their business ventures in Tasmania, therefore the State expects that operators will face similar ongoing costs to other investments elsewhere.

It should also be noted that the Code compliant process has provided bidders with considerably more information about the Tasmanian opportunity than would otherwise be available at this stage. The State's responsibility to seek approval of the Tender Approval Request, and the associated release of the tender details, has provided bidders with a much longer period of time in which to prepare themselves for bid. Indeed, the State has not yet released its Project Brief to bidders, which will commence the bid process, and already bidders are preparing themselves for the next stage on the basis of the available information.

4.3 Limited reticulation beyond the Minimum Pipeline Route

Metaira has expressed concern about the incentives provided to bidders to extend coverage beyond the Minimum Pipeline Route, in particular whether it would be in the franchisee's interests to explore innovative solutions for areas considered sub-economic.

Meeting the Minimum Pipeline Route is a condition of a conforming bid submission. The State therefore retains the right to exclude a bid submission if the bidder does not offer to supply at least the Minimum Pipeline Route.

The State has also made clear during the tender process that it encourages the widest economically viable rollout of gas distribution networks in Tasmania. This is reflected in section 8.3 of the Tender Guidelines, which state

The State encourages bidders to nominate Proposed Areas providing distribution network coverage over and above the coverage of the Minimum Pipeline Route. This reflects the

State's objective of providing the broadest economically feasible coverage of the gas distribution system in Tasmania⁶.

As coverage of the distribution network forms part of the selection criteria, the State therefore considers that there will be a clear interest on the part of the bidders to maximise area of coverage and extend the Proposed Area beyond the Minimum Pipeline Route.

4.4 Limited numbers of bids being received

The State has sought to provide an investment package to bidders that reflects the significant risks involved in a greenfield investment, but which also reflects the opportunity to reticulate an entire State in a franchise capacity. This has been the focus of considerable work by the State, including market testing its concepts with potential bidders and marketing of the investment opportunity. As a result, the State believes that it has succeeded in attracting sufficient interest from Tasmanian, Mainland and International bidders to operate a competitive tender as required under section 3.28(c) of the Code. The number of Expressions of Interest received by the State and credentials of interested parties have demonstrated strong bidder interest in this development opportunity.

4.5 Imposition of the State's Franchise Fees

As noted in the State's previous comments on the DEI submission, the State has imposed payment of a franchise fee to the Government in exchange for the right to distribute and retail natural gas to the whole of Tasmania for five and six years respectively. The final figures, \$2.0 million for the distribution franchise and \$500,000 for the retail franchise, are one-off fees. They are designed to assist the State in recovering some of the costs incurred during the tendering process. The fees are considered commensurate with the opportunity being offered, and have been considered as part of project viability. The cost of ongoing administration of any contracts entered into with the successful bidders will be worn by the State and will not be charged to the operators.

4.6 Exclusion of smaller entities

Metaira expressed concerns that smaller entities, such as Local Governments and Water Boards, would be prevented from participating in the tender process as such bodies would be unable to provide services on state-wide basis. Metaira notes that this will prevent such entities from covering areas that may not be covered by the initial gas distribution network determined through the tender process.

Other parties will initially be restricted from building and operating natural gas distribution networks, but only for the five-year period of the distribution franchise. The State

⁶ Tender Guidelines, section 8.3, page 25

considered that it was necessary to provide such franchise protection for the initial period of operations to provide the developer with sufficient certainty to invest in the project. The tender process, and the awarding of an exclusive distribution franchise, is expected to result in larger network coverage at a lower price than would otherwise have been the case. This position was supported by market testing and the fact that interested parties believed they would be unable to access finance to undertake the project without exclusive franchise protection. After that time, any party that obtains the necessary regulatory approvals will be able to build and operate gas distribution networks within the State.

In addition, under the provisions of the Code, the gas distributor will be required to implement an extensions and expansions policy which will provide a process for the assessment of potential extensions of the initial distribution network on a fair and reasonable basis.

The awarding of a distribution franchise to one entity was considered necessary due to the relatively small size of the Tasmanian market. In such an environment, it is necessary to extract the maximum scale economies available to ensure the construction of a distribution network at the lowest sustainable cost.

The State of Tasmania requires experienced players in the utilities industry with economies of scale, expertise and financial capacity to deliver a gas distribution network and a viable gas retail business to Tasmania. The State should not be exposing itself and gas consumers to a high risk of failure should the project be undertaken by entities that do not have the required experience and do not have sufficient financial capacity. The State has designed the tender process to incorporate bidder qualifications criteria. The bidder qualification process is intended to determine the bidders that have the required level of experience and financial capacity to develop gas distribution and retail businesses meeting the best industry standards.

4.7 Transition to contestability

The gas industry structure and regulatory system are designed in such a way to enable a smooth transition to an open competitive energy market at the end of the exclusive franchise period. For example, gas meters will be owned by gas distributors, not by gas retailers – this will allow contestable customers to switch their gas retailers once other retailers enter the Tasmanian market place at the end of the initial franchise period.

The tender process chosen by the State provides for distribution Reference Tariffs to be included in the successful bidder's Access Arrangement under the National Gas Code. An Access Arrangement sets the Reference Tariffs to be paid by any retailer intending to transport gas through a distributor's system, and is therefore necessary for preparation for retail contestability. This is consistent with the State's obligations under National Competition Policy, which require access pricing to be established.

The State does not consider that the tariffs offered to consumers will include any material cross subsidy, in accordance with the tariff requirements under section 8.1 of the National Gas Code.

4.8 Construction timetables for the Proposed Areas

Metaira has raised concerns about delays by the successful bidder to fulfil its tender obligation in constructing the network.

The State is committed to ensuring that the successful distributor reticulates 60% of its Proposed Area within the first two years, and then its entire Proposed Area within four years, as set out in the Tender Approval Request. This commitment will be enshrined in the Development Agreement between the State and the successful distributor.

However, which areas of the distribution network are to be constructed first is left to the developer to decide. Therefore the process provides for considerable flexibility in the design and construction of a gas distribution network in Tasmania. At the same time the process will achieve the desired outcomes – maximum coverage of the distribution network within the required timeframe.

4.9 Expansions of areas beyond the Minimum Pipeline Route and/or the Proposed Areas

Metaira raised the issue of extensions and expansions of areas outside the Minimum Pipeline Route and the issue of the uniform state tariff, and specifically:

- that the uniform state tariff would prevent constructors from recovering the costs of the system;
- that the distributor will suffer high unit costs due to a small franchise area; and
- whether customers outside the Proposed Area would not be connected regardless of the premium they would be prepared to pay.

On the first issue, the State requires uniform franchise retail tariffs for customers using less than 30TJ per annum within the Proposed Area, but provides the distributor with flexibility to set its distribution tariffs as it sees fit. The distributor will therefore be able to charge a fair rate of return on its investment in the pipeline network, as set out in the Gas Pricing Order.

The State believes that uniform retail tariffs for small customers (those consuming less than 30 TJ p.a.) are necessary for equity reasons and are consistent with the current arrangements in relation to electricity and with gas industry arrangements in other states. As such, uniform retail tariffs are set out in the Gas Pricing Order as mandatory for the Proposed Area.

The State notes that areas outside the Proposed Area may not receive uniform retail tariffs. The prices oversight for these areas is set out in section 31 of the Gas Act 2000.

On the second issue, the State has offered a franchise area for the whole of Tasmania in order to provide the maximum possible scale cost advantages to the distributor, and in order to meet requirements of potential bidders.

On the third issue, the bidders will submit a Proposed Area to be serviced and a series of tariffs to supply these areas. Customers within the Proposed Area will therefore be able to connect within four years under the terms of the Development Agreement. Customers outside the Proposed Areas are able to seek supply from their retailer under section 31 of the Gas Act 2000. The distributor will have strong commercial incentives to connect customers outside of its Proposed Area if connection of these customers is economically viable.

5 Submission by Australian Bulk Minerals

5.1 Introduction

ABM has raised several issues in its submission to the Regulator, being:

- real or perceived conflicts of interest;
- competition for distribution rights;
- the requirement for stapled bids;
- the State's requirement for uniform tariffs;
- the need for a Minimum Pipeline Route;
- the proposed selection criteria; and
- the requirements for qualification.

These issues are discussed in greater detail below. Specific recommendations made by ABM are set out in Appendix C.

5.2 Real or perceived conflicts of interest

In its submission, ABM raised concerns with the potential involvement of Aurora Energy Pty Ltd, in that such involvement would represent a conflict of interest for the State in submitting the TAR and conducting the tender process.

The State has acknowledged that such perceptions may exist and has invested considerable time into designing a tender process to overcome such concerns. The State has implemented a range of strategies to address this issue, including:

- assigning responsibility for the conduct of the tender to the Gas Steering Committee, with a selection recommendation developed without reference to Shareholder Ministers;
- providing Cabinet with the ability to either accept or reject (but not to vary) the selection recommendation from the Gas Steering Committee, with the rejection of a selection recommendation resulting in the tender process terminating;
- the appointment of a Probity Auditor to oversee the process and ensure that it is conducted in a fair and impartial manner ensuring a level playing field for all bidders;
- limiting Aurora's potential involvement such that it may participate only to the extent that it has a non-controlling interest in the distribution business;
- ensuring that the decision on whether or not to participate in the tender process is a matter for the Board of Aurora, with no directions or financial assistance provided by Government; and

- applying stringent competitive neutrality arrangements upon Aurora to ensure that it does not gain a commercial advantage by virtue of its Government ownership.

The State considers that this suite of measures adequately addresses any conflict of interest perceptions associated with Aurora's potential involvement in the gas tender process.

In its submission ABM further noted that Aurora would gain a competitive advantage through its statutory monopoly in electricity, particularly in relation to access to customers and easements. The participation limitations upon Aurora's potential involvement, combined with the market information to be provided in the Project Brief, will overcome any perceived advantages arising from information asymmetries. In addition, the arrangements for the regulation of electricity easements, associated with Aurora's electricity distribution business, are limited to electricity and are not transferable to gas.

On this basis, the State considers that any potential conflict of interest issues have been adequately dealt with in the tender process provided for within the Tender Approval Request.

5.3 Competition for distribution rights

The State notes ABM's suggestion to broaden the bidding criteria to invite separate bids to supply smaller areas within Tasmania, and to provide a separate tender for other areas similar to that adopted by the Dept of Infrastructure, Energy and Resources to grant mining licences.

As noted previously, the State has offered exclusive franchises for the whole of Tasmania, in order to provide the winning bidder with the scale economies necessary to extend coverage to the maximum extent possible. It should also be noted that areas specified under the Code process are then subject to regulation by the Local Regulator under the Code, providing certainty to consumers as to prices oversight in these areas.

Awarding franchise areas under a system similar to awarding mineral rights is unlikely to attract bidder interest, would not provide for monopoly prices oversight, and, as noted previously, would not be in accordance with the State's obligations under National Competition Policy.

5.4 Requirement for stapled bids

The State noted the concerns of ABM that stapled bids could reduce competition by precluding local entities from bidding. The State accepts that smaller operators would need to find a partner in order to bid for the franchise.

The State and its financial advisers undertook market testing of the proposed tender process during early 2001. Market testing involved consultations with a number of likely bidders on issues such as franchise conditions and tender process design.

A majority of potential bidders expressed a strong preference for stapled distribution and retail bid submissions. A clear finding was that a “mix and match” approach with the State separately selecting the best retail bid and best distribution bid is not favoured. The market testing process has demonstrated that energy industry participants have established relationships between distributors and retailers, and potential distributors would see considerable difficulties in working with a retailer selected through a separate tender process.

For this reason, the State elected to require stapled bids for distribution and retail franchises. The State also sought to assist potential bidders to find partners through inviting them to be included on lists that were circulated to other potential bidders seeking partners.

5.5 Requirement for uniform tariffs

The State notes concerns raised by ABM in relation to the requirement for uniform retail tariffs and the potential for material cross subsidisation.

The State’s comments in relation to uniform retail tariffs are set out in section 3.4.3.

5.6 Delays in the Minimum Pipeline Route

The State notes ABM’s recommendation that liquidated damages be included in the Development Agreements for delays in construction.

The State is committed to ensuring that the successful distributor reticulates 60% of its Proposed Area within the first two years, and then its entire Proposed Area within four years, as set out in the Tender Approval Request. This commitment will be enshrined in the Development Agreements between the State and the successful distributor, along with a comprehensive suite of remedies for non-compliance or delays. The precise mechanisms will be determined through discussions between the State and bidders.

5.7 Proposed selection criteria

The State noted ABM’s concerns that the Extensions and Expansions Policy should be added to the selection criteria.

As outlined in the Tender Guidelines, the extensions/expansions policy is included in the bid evaluation process. The State will be assessing any departures from the benchmark

Extensions and Expansions Policy provided by the bidders as part of the *sustainability of tariffs* as set out in section 8.2(b) of the Tender Guidelines and section 2.4 of Schedule 2 of the Tender Guidelines.

5.8 Qualification requirements

ABM suggest that local governments, Water Boards, Cable TV Providers, Fuel Distributors and other local suppliers are unlikely to be able to meet the financial capacity, gas industry experience and other requirements for a State-wide franchise in accordance with the proposed Tender Guidelines.

Indeed, the Tender Guidelines require a level of experience in the gas industry and financial capacity that local governments, Water Boards, fuel distributors and other regional businesses mentioned by ABM are not likely to be able to provide. There is a high risk of such businesses not being able to deliver a distribution network and a gas retail business. That is why the bidder qualification process is designed to ensure that bidders that will be allowed to participate in the tender process do in fact possess the required level of experience and financial capacity – this reduces risk exposure to the State and gas consumers. The State of Tasmania should not be exposing itself to risks of non-delivery of the gas distribution network that would be relatively high should businesses without appropriate experience and financial capacity be allowed to act as developers.

6 Submission by David Mitchell Tasmania (DMT)

6.1 Introduction

DMT has raised several issues in its submission to the Regulator, being:

- the proposed Contestable Retail Limit;
- retail tariffs on contestable bulk gas users;
- supply to customers remote from the Minimum Pipeline Route; and
- alternative tender arrangements.

These issues are discussed in greater detail below. Specific recommendations made by DMT are set out in Appendix D.

6.2 Proposed contestability limit

The State notes the concerns raised by DMT in relation to the contestability limit of 500TJ pa as set out in the Tender Approval Request.

The State and its financial advisers undertook market testing of the proposed tender process during early 2001. Market testing involved consultations with a number of likely bidders on issues such as franchise conditions and tender process design.

During market testing, it was confirmed to the State that franchises would be necessary in order to induce investment. Some potential bidders sought franchises of 1PJ pa or more in order to reduce the investment risk involved in entering the Tasmanian market, however other bidders were satisfied with lower franchise levels. The 500TJ contestability limit strikes a balance between the franchise requirements of potential bidders and the need to introduce a competitive market in the medium term. This has been supported by potential bidders as necessary in order for investment to proceed.

6.3 Contestable bulk gas users

DMT is concerned about contestable bulk gas users who will have to pay the retail tariff even if they take supply directly from the transmission pipeline or have made substantial customer contributions to construct their connections to the network.

Distribution tariffs for customers with loads in excess of 30TJ per annum will be distance reflective based on the most economical distance to the transmission pipeline. Distribution charges for these customers that are in close geographic proximity to the transmission pipeline will be minimal, and standard retail margins will apply. Industrial customers

located closer to transmission pipeline will not be disadvantaged, and will not be subsidising gas distribution costs for other customers.

6.4 Customers remote from the MPR

DMT raised two important issues, specifically:

- that the exclusive franchisee will be required to construct the Minimum Pipeline Route, with no requirement to construct elsewhere; and
- that the uniform state tariff would prevent constructors from recovering the costs of the system, or that prices charged will be excessive.

On the first issue, the franchised gas distributor in accordance with the terms of the Development Agreement will be required to construct the network that the distributor bids to construct. There is no requirement to extend the network beyond areas that the successful bidder has undertaken to cover with the distribution network. However, the franchise distributor will have every commercial incentive to build maximum coverage of the distribution network and to cover all areas where gas distribution can be economically viable subject to section 8.1 of the Gas Code. The limited franchise term will act as an incentive for the distribution network developer to rollout to all the areas where gas distribution is economically viable before the 5-year term of the franchise expires.

Customers outside the Proposed Areas are also free to seek supply from their retailer under section 31 of the Gas Act 2000.

On the second issue, the State requires uniform retail tariffs for the Proposed Area but provides the distributor with flexibility to set its distribution tariffs as it sees fit. The distributor will therefore be able to charge a fair rate of return on its investment in the pipeline network, as set out in the Gas Pricing Order. The Extensions and Expansions Policy is designed to ensure that distribution pricing for additional areas is undertaken on a fair and reasonable basis.

The State's comments in relation to uniform retail tariffs are set out in section 3.4.3.

6.5 Alternative tender arrangements

The State notes DMT's suggestion to broaden the bidding criteria to invite separate bids to supply smaller areas within Tasmania, and to provide a separate tender for other areas similar to that adopted by the Department of Infrastructure, Energy and Resources to grant mining licences.

The State has offered exclusive franchises for the whole of Tasmania, in order to provide the winning bidder with the scale economies necessary to extend coverage to the maximum possible extent. It should also be noted that areas specified under the Code process are then subject to regulation by the Local Regulator under the Code, providing certainty to consumers as to prices oversight in these areas.

Awarding franchise areas under a system similar to awarding mineral rights is unlikely to attract bidder interest, would not provide for monopoly prices oversight, and, as noted previously, would not be in accordance with the State's obligations under the National Competition Policy.

7 Submission by Mr Ian Martin

7.1 Introduction

Mr Martin raised several important issues:

- speculation that Aurora is the most likely successful tenderer;
- how the State intends to deal with issues of conflict in relation to its dual role in conducting the tender and as sole shareholder of Aurora Energy; and
- the timetable for resolving the tender process.

7.2 Aurora's participation in the Gas Tender Process

The State has acknowledged that perceptions of conflict of interest may exist and has invested considerable time into designing a tender process to overcome such concerns. The State has implemented a range of strategies to address these perceptions, including:

- assigning responsibility for the conduct of the tender to the Gas Steering Committee, with a selection recommendation developed without reference to Ministers;
- providing Cabinet with the ability to either accept or reject the selection recommendation from the Gas Steering Committee, with the rejection of a selection recommendation resulting in the tender process terminating;
- the appointment of a Probity Auditor to oversee the process and ensure that it is conducted in a fair and impartial manner ensuring an equal playing field for all bidders;
- ensuring that the decision on whether or not to participate in the tender process is a matter for the Board of Aurora, with no directions or financial assistance provided by Government; and
- application of stringent competitive neutrality arrangements upon Aurora to ensure that it does not gain a commercial advantage by virtue of its Government ownership.

In addition, the Shareholder Ministers wrote to Aurora outlining a number of expectations in relation to Aurora's potential involvement in the Gas Tender Process. While some of these expectations related to shareholder issues such as debt, returns and risk, a number of expectations were placed upon Aurora to address conflict of interest perceptions. These latter expectations included the following:

- that Aurora will not participate in the distribution of natural gas to the extent that its interest would involve it having operational or financial control over such a business;
- that Aurora's exposure to risk through participation in the distribution of natural gas is consistent with a minority share of ownership and control; and

- that such participation will have governance and operational separation from Aurora's electricity interests during the franchise period to ensure a fully competitive market between electricity and gas.

The State considers that this suite of measures adequately addresses any conflict of interest or preferential treatment perceptions associated with Aurora's potential involvement in the gas tender process.

7.3 Timetable for resolving the Tender Process

In his submission, Mr Martin raised concerns in relation to the finalisation of arrangements in relation to the gas tender process, noting that Duke Energy has already commenced the preliminary stages of its project.

The timetable associated with the gas tender process is outlined in Schedule 1 of the TAR. This timetable is designed to achieve the commencement of the construction and operations of the gas distribution network at around the same time that Duke is expected to commence operations, ie mid 2002.

The TAR, represents the first formal step of the tender process, which has involved considerable work for the Government "up front". It has taken considerable time to finalise the arrangements that support the processes provided for in the TAR. However, provided that the TAR is approved, it is expected that the tender process will proceed in line with the timelines outlined in Schedule 1 of the TAR.

8 Submission by the Tasmanian Chamber of Commerce and Industry

8.1 Introduction

The Tasmanian Chamber of Commerce and Industry (TCCI) supports:

- the proposed conflict of interest policy and procedures as set out in the Tender Approval Request and the Tender Guidelines;
- the considerable effort directed towards promoting competition for the tender;
- the concept of stapled bids in order to reduce bidder risk premia; and
- the Minimum Pipeline Route concept as a means of maximising coverage across Tasmania.

TCCI raised one issue of concern, being the issue of retail tariff uniformity. This is addressed below.

8.2 Uniform retail tariffs

The State notes TCCI's concerns in relation to the principle of uniform retail tariffs for customers using less than 30TJ per annum, in particular the possible existence of material cross subsidisation.

The State's comments in relation to uniform retail tariffs are set out in section 3.4.3.

9 Submission by TEST Energy

9.1 Introduction

TEST Energy (TEST) raised three primary issues, being:

- that a distributor/retailer will impose a price premium on industrial customers;
- that the disputes mechanism outlined in section 49 of the Tasmanian Gas Act 2000 is inadequate; and
- that section 31 of the Gas Act is inadequate.

These issues are considered in detail below.

9.2 Pricing for franchise customers

TEST has noted a concern that pricing to customers above and below the 30TJ pa limits will be conducted in some other manner than cost reflection.

The State has been careful to structure a regime for consumer protection in the Gas Pricing Order, and in requesting tariff information from bidders under the tender process. As a consequence, the State believes that it has largely mitigated any possibility of cross subsidisation and directed bidders towards structuring efficient tariffs.

As noted previously, the State has established a revenue yield concept, which allows for a price path approach across the two customer categories – those using under 30TJ pa and those using above 30TJ. This is set out in the Gas Pricing Order.

The revenue yield for large customers is based on consumption and distance from the transmission pipeline. The inclusion of a distance component for large customers locks in a large measure of cost reflectivity for these customers and will act to discourage inefficient bypass when the distribution franchise is removed.

Under the revenue yield, the service provider has relative freedom to price services in ways which best meet the requirements of markets for those services, but the resulting revenue must not exceed the average revenue constraint – being the yield. Under a revenue yield control, cross subsidisation between the two customer classes is significantly minimised.

Additionally, the Tender Guidelines require distribution bidders to demonstrate that the proposed tariffs comply with the objectives of section 8.1 of the Gas Code. Failure to provide such information, or to structure tariffs in an efficient manner, may result in the Regulator not approving the Final Approval Request.

The distributor and retailer are also restricted from movements in tariffs in any given year, in order to avoid the possibility of significantly increasing one tariff, and decreasing another

tariff for customers within one class of yield. This 'Y' factor is provided in the formula schedule to the GPO.

The State believes that it has carefully minimised the extent of possible monopoly price exploitation, while providing bidders with sufficient 'upside' to balance the risks involved in investing in a greenfield energy project.

9.3 Disputes mechanism

TEST considers that the dispute mechanisms in section 49 of the Gas Act 2000 are inadequate. This issue does not relate to the Tender Approval Request, but to the regulatory regime and energy policy generally. In any event, the State is considering possible alternative dispute resolution mechanisms, which might apply in the regulated gas industry.

9.4 Section 31 of the Gas Act – Obligation to Supply

TEST consider that section 31 of the Gas Act 2000 is inadequate in ensuring that gas is supplied to customers on commercially reasonable terms. The State's comments in relation to uniform retail tariffs and section 31 of the Gas Act 2000 are set out in section 3.4.3.

10 Submission by United Energy

10.1 Introduction

The concerns raised by United Energy (United) relate largely to the potential involvement of Aurora Energy in the gas tender process. The particular concerns and comments made by United include:

- the nature and extent of Aurora's participation in any potential bidding consortium;
- the nature of competitive neutrality arrangements; and
- independence and competitiveness of electricity tariffs.

These issues are discussed in greater detail below.

10.2 Nature and extent of Aurora's potential participation

As noted by United, the Shareholder Ministers have written to Aurora Energy and advised that any participation by Aurora in the gas tender process is a commercial matter for the Aurora Board, but that Aurora should not participate to the extent that it will have financial or operational control over the gas distribution business.

United has noted that this requirement appears to conflict with comments made by Macquarie Research⁷ that Aurora will "own both the distribution assets and retail customer base".

It should be noted that the letter from the Shareholder Ministers outlined a number of expectations in relation to Aurora's potential involvement in the Gas Tender Process. While some of these expectations related to shareholder issues such as debt, returns and risk, a number of expectations were placed upon Aurora to address conflict of interest perceptions. These latter expectations included the following:

- that Aurora will not participate in the distribution of natural gas to the extent that its interest would involve it having operational or financial control over such a business;
- that Aurora's exposure to risk through participation in the distribution of natural gas is consistent with a minority share of ownership and control; and
- that such participation will have governance and operational separation from Aurora's electricity interests during the franchise period to ensure a fully competitive market between electricity and gas.

The detailed structure of any potential bid by Aurora is confidential to Aurora. However, it should be noted that no restrictions have been placed on Aurora's participation in relation to

⁷ Source: Macquarie Research Equities, Tasmanian gas – cost versus competition, Friday 31st August 2001.

the retail aspects of any potential bidding consortium. This position was taken on the basis that such an arrangement would not impact on the tender process, or competition between electricity and gas, as the driving force behind the retail gas market will be the desire for the distributor to achieve sufficient volumes to cover what is expected to be a significant investment in the construction of the distribution network.

In relation to the issue of the ownership of the distribution assets, it is considered that the statement by Macquarie Research that Aurora will “own the distribution assets” is only true to the extent that:

- Aurora will not be able to exert operational or financial control over the distribution business of any potential bidding consortium in which it participates; and
- Aurora’s exposure to risk through such participation in the distribution of natural gas is consistent with a minority share of ownership and control.

United has requested that this issue be clarified with bidders. A copy of the confidential letter from the Shareholder Ministers to Aurora will be released to qualified bidders with the Project Brief.

10.3 Nature of competitive neutrality arrangements

United have asserted that Aurora’s potential involvement in the tender process may provide a conflict of interest if the Government elects to manipulate the competitive neutrality framework to Aurora’s advantage.

In this regard, the Government has clearly stated that it will not provide assistance to Aurora in relation to its participation in the gas tender process. Further the accountability and openness built into the competitive neutrality framework in place would effectively prevent the manipulation of this framework to the benefit of Aurora.

The competitive neutrality framework for Aurora is built upon well-defined statutory requirements, including:

- operations being required to conform with Corporations Law;
- payment of income tax equivalents to Government;
- payment of guarantee fees to offset any interest benefit; and
- being liable for other State, Commonwealth and Local Government taxes, rates, duties and other imposts as if it were a private company.

These arrangements will apply regardless of the structure and financing issues associated with the potential involvement of Aurora in the gas tender process.

10.4 Independence and competitiveness of electricity prices

United presented two issues in its submission in relation to electricity tariffs.

United expressed concern that a conflict of interest issue would exist if the Government was able to manipulate electricity prices to the benefit of Aurora Energy, regardless of whether Aurora participated in the gas tender process or not.

Secondly, United suggested that the Government should ensure that electricity prices are cost reflective to ensure that such tariffs are not artificially set to be anti-competitive with expected gas prices.

Electricity prices in Tasmania are independently regulated by the Tasmanian Energy Regulator, under the provisions of the *Electricity Supply Act 1995*. Under the provisions of that Act, the Energy Regulator determines electricity prices in consultation with the electricity businesses and customers as well as in conjunction with detailed financial and economic analysis.

The Government does not have the ability to manipulate electricity prices.

Further the Energy Regulator is obliged, amongst other things, to take into account cost reflectiveness and economic efficiency when determining electricity tariffs.

In this environment, the Government does not believe that there are any significant issues in relation to the independence and competitiveness of electricity prices.

A Recommendations by Aurora/Agility Management Pty Ltd for amendment to the Tender Process

A.1 Tender Process

A.1.1 The Probity Auditor be present at all negotiations

It is envisaged that there will be no meetings between bidders and Origin Energy, as all the terms of the acquisition of the Launceston Network will be covered in the Launceston Network Sale Agreement. In relation to meetings between Duke and the bidders, the State's Probity Auditor has considered carefully the need to attend each meeting, and has elected to retain the flexibility to attend all meetings if necessary. The State/Duke Development Agreement and Communication Protocol outline a carefully constructed probity process, which balances the need for ongoing probity throughout the process with the practicalities of negotiations. The State wishes to provide bidders with the ability to construct their bid documents unimpeded, subject to probity. The State therefore believes that the current arrangements are sufficient to achieve the desired outcomes.

A.1.2 The Participation Deed be amended

The consortium has noted concerns with two elements of the Deed, being:

- clause 2(b) which requires a bidder to acknowledge that the Tender Approval Request and the Tender Guidelines comply with all relevant laws and the Code, and clause 14 which requires a bidder to waive any right to challenge the Tender in the eventuality that the TAR or Guidelines do not comply with the Code; and
- clause 28 which restricts changes in the membership of any consortium in that the membership of the consortium may not change without the State's prior written approval.

On the first issue, the State has sought to ensure throughout the process that the tender complies with the Code. Compliance is, as noted by the consortium, determined by the Tasmanian Energy Regulator and is therefore not within the full power of either the bidders or the State. As the tender process would only proceed if the Regulator determined that the tender process met the Code requirements, the State has sought to minimise any possible disputes by requiring bidders to accept that the Regulator's approval of the tender process is final.

On the second issue, the State welcomes involvement of institutional equity investors in the project, however any bidding consortium that wishes to introduce new equity investors has to seek the State's approval. The State has established a comprehensive qualification regime, which could be circumvented if qualified bidders were free to add or remove

consortium members at will. As described in the invitation to lodge Expressions of Interest, the State will consider any subsequent qualification request, where a previously qualified bidder changes structure, on the same qualification criteria. This process is designed for the State to ensure financial capacity of developers and, where a consortium wishes to introduce a strategic equity partner, the State has to ensure that such consortium has both the financial capacity and the required level of experience in the gas industry.

A.1.3 That uncommercial and unfinancable terms should not be demanded of bidders by the State

The concerns about uncommercial terms will be addressed through the process of negotiation of the Development Agreements between bidders and the State.

A.1.4 The State should provide complete Development Agreements with the Project Brief

The State has indicated to bidders that it will release a draft Development Agreement to qualified bidders together with the Project Brief. As described in the Tender Guidelines, bidders will have several opportunities to comment on successive versions of the draft Development Agreements.

A.1.5 The State should not propose changes to the Development Agreements later than one month before bids are due

Final (benchmark) Development Agreements will be provided to bidders in sufficient time before the close of bids to enable bidders to finalise their bid submissions. Bidders will be required to reflect any final changes to the benchmark Development Agreements as part of their bid(s), and these will be assessed by the State against the selection criteria, specifically in the context of any 'risk to the State and consumers'. The timetable for the release of the benchmark Development Agreements is yet to be finalised and will depend on a number of factors, including the efficiency and scope of Bidder comments. However, the State considers that a timeframe of one month prior to bid date is too early and will not give bidders adequate time to undertake investigations, consider the Development Agreements and provide meaningful comments.

A.1.6 Bidders should provide evidence of enforceable arrangements for constructions

The suggestion that bidders should be required to provide evidence of enforceable arrangements for construction, such as EPC contracts, is not acceptable to the State. The construction risk lies with the developer, and the State will not accept any recourse in relation to the construction cost overruns or any other construction risks. It is the responsibility of the developer to construct and commission the network in accordance with the terms of the Development Agreement with the State.

A.1.7 Duke should not propose changes to the agreements later than one month before bids are due

This is a matter between Duke Energy and the bidders.

A.1.8 The State should provide complete Duke Agreements with the Project Brief

The State will provide draft agreements to the bidders with the Project Brief. The State has elected to allow further negotiation of these agreements with Duke on the basis that the bidders would be best placed to structure these arrangements with Duke directly. This was an issue confirmed by potential bidders during market testing.

A.1.9 Bidders should be required to provide evidence of contracts to construct the network, with bid submissions

The consortium has suggested that bidders be required to provide evidence of arrangements for construction of the network as part of bid. The bid submissions must include details of the bidder's construction plan and evidence of its capacity to deliver the project. In many cases, this would include providing details of the proposed head contractor. However, the State is not a principal in the project and the details of the construction arrangements are appropriately left in the hands of bidders.

The State therefore considers that the arrangement in the current tender documents is appropriate.

A.1.10 Evaluation of tariffs based on NPV analysis to enable different CPI and GPO terms

The State believes that a purely quantitative assessment of bids would not be appropriate, and has therefore elected to evaluate tariffs in the manner set out in the Tender Approval Request and Tender Guidelines.

The term of the Revisions Commencement Date in most national Access Arrangements is five years. The State, in considering the optimal term for the GPO (and therefore the Revisions Commencement Date) was required to form a view on the likely requirements of both bidders and consumers in the Tasmanian market.

In forming a view of the appropriate period, the State considered that 15 years represented a reasonable period of certainty for developers and their financiers. This period of time was also considered to offer the optimal level of security to consumers against unforeseen tariff adjustments. It is not considered necessary to allow a period longer than 15 years. The State will therefore downgrade a bid that deviates from the 15-year period.

The X factor is a key element of the revenue control, which governs the yield calculation, providing for a real decline in the yield over the term of the GPO. The State notes that bidders will be asked to specify a yield at the commencement of the process, and therefore this yield could be lower without an X factor.

Having the State form a view on X, rather than having bidders nominate values, ensures that the price control provides the level of protection for consumers consistent with the State's policy objectives. Fixing the X factor also provides the State with a considerably more robust evaluation framework, allowing ease of comparison between bids.

A.1.11 The mandatory requirements should allow bidders to deviate from the GPO

In constructing the GPO, the State has been mindful of balancing the requirements of prices oversight with bidder's perception of possible regulatory risk. The State believes that an appropriate balance has been achieved with the current GPO.

A.1.12 The State should consider all bids, whether conforming or non-conforming, in the evaluation process

In developing the suite of conformity and mandatory requirements, the State was careful to ensure that the requirements did not present unreasonable hurdles for bidders. Clearly, a gas infrastructure project such as this requires the State to achieve a level of certainty of several key elements of the bid submission. This is the rationale for the criteria selected.

Under the Tender Guidelines, the State may consider non-conforming bid submissions at its discretion. This is a standard tender mechanism and, provided (as in this case), the conformity requirements are reasonable, each bidder is, by meeting the requirements, able to ensure that its bid submission will be considered.

An example of the State's intentions is the requirement for bidders to demonstrate evidence⁸ that they have secured, or are able to secure, sufficient 'upstream' natural gas supplies to support their bid submission. Without such information, the State would not be able to assess the risks that Tasmanian consumers and business would face supply shortages in peak times.

The State considers that the current suite of requirements are necessary in order to provide certainty for the State and consumers over the required term, and in testing the 'sustainability' of the tariffs offered.

⁸ this is required for conforming bids

A.1.13 A uniform approach to planning should be implemented

The State is preparing an issues paper for bidders which will be contained within the Project Brief. This explains the various approvals required for both State and Local Government bodies, notes important issues that may consume time for bidders, and provides bidders with contact information for Local Government bodies. In preparing this paper, the State will contact all Local Government bodies within the Minimum Pipeline Route, and within other areas that may be investigated by bidders as part of their analysis of possible routes.

Importantly, under the Gas Act 2000 the construction or operation of a distribution system is a "Permitted Use" for the purposes of planning approvals. Advice from the Director of Environmental Management indicates that similar linear infrastructure in urban or semi-urban areas is typically assessed as a Level 1 activity, a classification which provides a 42-day maximum for consideration and approval by Councils. Local Government bodies have been extremely supportive of the gas opportunity and the State is currently undertaking discussions with Councils on or near the Minimum Pipeline Route with a view to reaching consistency of approach to management of planning approvals and with particular reference to reducing uncertainty over reinstatement and hard surface restoration.

The State will put in place a coordinated process to assist bidders and, eventually, the successful bidder to navigate the planning and approval processes.

A.1.14 That the State not impute any value from telecommunications

In accordance with the Tender Guidelines, bidders' proposals in relation the rollout of telecommunications infrastructure will not be incorporated in the evaluations process. The State has therefore made it clear to bidders that it will not impute any value from telecommunications proposals in assessing gas bids.

A.2 Launceston Network Sale Agreement

A.2.1 Launceston Network Sale Agreement not be mandatory

See section 3.3.1

A.3 Tariff Regime

A.3.1 Bidders should have flexibility to nominate the Revisions Commencement Date

The term of the Revisions Commencement Date in most national Access Arrangements is five years. The State, in considering the optimal term for the GPO (and therefore the Revisions Commencement Date) was required to form a view on the likely requirements of both bidders and consumers in the Tasmanian market.

Market testing of this concept provided Government with a range of views in relation to the risks and benefits of longer periods of price certainty. It was noted that market participants, particularly given the uncertainties in market operations, which have occurred over the last ten years, do not always welcome long periods of price certainty. Other potential bidders preferred longer periods.

In forming a view of the appropriate period, the State considered that 15 years represented a reasonable period of certainty for developers and their financiers. This period of time was also considered to offer the optimal level of security to consumers against unforeseen tariff adjustments.

While it should be noted that the State does not restrict bidders from nominating different periods, it is not considered necessary to allow a period longer than 15 years and the State will therefore discount a bid that deviates from the 15 year period.

A.3.2 Regulatory discretion should be minimal and require justification

In constructing the GPO, the State has been mindful of balancing the requirements of prices oversight with bidder's perception of possible regulatory risk. The State believes that an appropriate balance has been achieved with the current GPO.

A.3.3 Bidders should have flexibility in proposing X factors

See Section 3.4.2

A.3.4 Retail tariffs should be flexible

The State has not required uniform distribution tariffs. Rather, bidders are free to nominate tariffs, which meet the requirements of section 8.1 of the Code. It is considered that the winning bidder would offer network-marketing incentives as part of operations, or discounts to the tariffs set out in the GPO. The GPO provides for a series of maximum tariffs and would therefore allow such discounts to be provided where required.

The State's comments in relation to uniform retail tariffs are set out in section 3.4.3.

A.3.5 The evaluation of tariffs proposed by bidders should be based on the net present value analysis

The evaluation of the distribution and retail costs to the industry will be based on the net present value analysis as described in the Tender Guidelines.

A.3.6 The evaluation process should cater for comparison of different tariff structures.

The evaluation is based on distribution and retail yields and total distribution and retail costs to the industry. Bidders have flexibility to structure their tariffs in accordance with the relevant provisions of distribution and retail Codes and the evaluation process does cater for comparison of different tariff structures.

A.3.7 By-pass should not be allowed within the MPR for the term of the GPO

As contemplated under the Gas Act 2000 and described in clause 3.2 of the Tender Approval Request, the successful distribution bidder will enjoy an exclusive, non-renewable, five-year franchise to operate a gas distribution system in Tasmania. It is not possible to extend this period as the National Competition Policy sets the maximum term of an exclusive distribution franchise at 5 years.

A.3.8 Pass through of State and Local Government charges be incorporated within the GPO

The decision to limit the number of events, which can give rise to a change in prices under the GPO, to the existing list, was taken for several reasons, including:

- An appropriate sharing of the risk of price variations between customers and the retailer and/or distributor. It is assumed that the distributor and retailer will be better able to anticipate and manage any change in their costs and so should bear the risk of a change in those costs; and
- The prices in the GPO are subject to bid. If the distributor or retailer considers that there is risk that they are overly exposed to changes in their costs they will adjust their bid price accordingly.

The State considers that the pass through provisions in the GPO are appropriate.

B Recommendations by Metaira Pty Ltd for amendment to the Tender Process

B.1 Remove the requirement for the Minimum Pipeline Route (MPR) and replace with bids for specific areas on an exclusive basis

There are two separate issues inherent in this recommendation. These are:

- The removal of the MPR; and
- The viability of areas when priced on an exclusive basis.

On the first issue, the State has selected the MPR based on financial and engineering assessments undertaken by its consultants. The MPR reflects a reasonable commitment to supply gas to all viable areas, but leaves to bidders the decision on whether to reticulate other areas which may be less viable. Bidders are strongly encouraged to exceed the MPR.

Secondly, the State does not consider that coverage would be maximised by the suggested approach. This is because it is unlikely that small areas, when priced on an exclusive basis, would have sufficient demand to justify the required investment. This is an issue of scale cost recovery, and reflects the fact that bidders will need to spread the costs of billing systems and other overheads across as wide a customer base as possible.

The State has therefore provided an exclusive franchise in order to allow the successful bidder to centralise their business functions, and therefore devote their costs to expanding coverage to as many areas as possible.

B.2 Allow differential tariffs in different areas

The State is unclear whether Metaira is referring to allowing different distribution tariffs or different retail tariffs across areas. It is therefore worth restating the provisions of the Tender Guidelines in this regard, which are:

- That distribution tariffs be set at the discretion of the bidders, but such that the tariffs reflect the objectives of section 8.1 of the Code; and
- That retail tariffs for similar users, using under 30TJ per annum, in the Proposed Area be similar.

On the former issue, the objectives of Section 8.1 of the Code include, among other things, that the tariffs replicate the outcomes of a competitive market and that there is efficiency in the level and structure of tariffs. These provisions are designed to ensure that the Regulator is satisfied as to the absence of material cross subsidisation. The distribution component is expected to account for between 40-50% of the final delivered cost of gas to customers.

The State's comments in relation to uniform retail tariffs are set out in section 3.4.3.

B.3 Allow ongoing bids to be submitted for areas not taken up in initial rounds

As noted previously, the State has offered exclusive franchises for the whole of Tasmania, in order to provide the winning bidder with the scale economies necessary to extend coverage to the maximum possible extent. It should also be noted that areas specified under the Code process are then subject to regulation by the Local Regulator under the Code, providing certainty to consumers as to prices oversight in these areas. Awarding franchise areas under a system similar to awarding mineral rights is unlikely to attract bidder interest, would not provide for monopoly prices oversight, and, as noted previously, would not be in accordance with the State's obligations under National Competition Policy.

B.4 Allow bidders to Sub-Contract Mandatory Bid Requirements

The Tender Approval Request sets out a series of mandatory requirements in relation to the distribution and retail bids. These mandatory requirements do not currently affect the right or the ability of the winning bidder to sub-contract responsibilities in construction or asset operation.

B.5 Modify the qualification criteria to reflect the limited creditworthiness required to reticulate small areas

The State has sought to ensure that only qualified bidders are eligible to compete for the distribution and retail franchises. The Qualification criteria are set out in section 6.3 of the Tender Approval Request and require, among other things, that the bidder have experience in development, operation, and ability to finance, an energy business. The State considers that these criteria are appropriate, given the State's need to appoint a distributor and retailer, which can deliver on the promises made to the State and consumers during the bid stage.

C Recommendations by Australian Bulk Minerals for amendment to the Tender Process

C.1 Allow customers remote from the MPR to make their own supply arrangements

Bidders must provide the State with a Proposed Area which meets or exceeds the Minimum Pipeline Route in order to be a 'conforming' bid submission. Customers outside the MPR, and within the Proposed Area, will therefore be supplied under the terms of the Gas Pricing Order.

For customers outside the Proposed Area, the State has structured section 31 of the Gas Act to provide an obligation to supply for retailers to customers throughout Tasmania, on reasonable terms and conditions. If a connection of a particular customer or a particular area is economically viable, the franchised distributor has every commercial incentive to connect that customer without delays. The State believes that these provisions are sufficient to see all viable customers connected within a reasonable time frame.

C.2 Reduce the retail contestability limit from 500TJ pa to 50TJ pa

The State and its financial advisers undertook market testing of the proposed tender process during early 2001. Market testing involved consultations with a number of likely bidders on issues such as franchise conditions and tender process design.

During market testing, it was confirmed to the State that franchises would be necessary in order to induce investment. Some potential bidders sought franchises of 1PJ pa or more in order to reduce the investment risk involved in entering the Tasmanian market, however other bidders were satisfied with lower franchise levels. The 500TJ contestability limit strikes a balance between the franchise requirements of potential bidders and the need to introduce a competitive market in the medium term. This has been supported by potential bidders as necessary in order for investment to proceed.

C.3 Clarify approvals / licences processes

Refer section A.1.13.

C.4 Impose liquidated damages for construction delays

The State is committed to ensuring that the successful distributor reticulates 60% of its Proposed Area within the first two years, and then its entire Proposed Area within four years, as set out in the Tender Approval Request. This commitment will be enshrined in the Development Agreements between the State and the successful distributor, along with a

comprehensive suite of remedies for non-compliance or delays. The State has not yet committed to liquidated damages provisions or any other specific remedy.

C.5 Allow bids for specific areas on an exclusive basis

As noted previously, the State has selected the MPR based on financial and engineering assessments undertaken by its consultants. The MPR reflects a reasonable commitment to supply gas to all viable areas, but leaves to bidders the decision on whether to reticulate other areas that may be less viable. Bidders are encouraged to exceed the MPR.

The State does not consider that coverage would be maximised by the suggested approach. This is because it is unlikely that small areas, when priced on an exclusive basis, would have sufficient demand to justify the required investment. This is an issue of scale cost recovery, and reflects the fact that bidders will need to spread the costs of billing systems and other overheads across as wide a customer base as possible. Also, in the case of multiple local franchises, the State of Tasmania and its gas consumers would be exposed to a considerably higher risk of default by small developers of local distribution networks.

The State has therefore provided an exclusive franchise in order to allow the successful bidder to centralise their business functions, and therefore devote their costs to expanding coverage to as many areas as possible.

C.6 Include Extensions and Expansions Policy within the Evaluation Methodology

The State will be assessing any departures from the benchmark Extensions and Expansions Policy provided by the bidders as part of the *sustainability of tariffs* as set out in section 8.2(b) of the Tender Guidelines and section 2.4 of Schedule 2 of the Tender Guidelines.

C.7 Remove the franchise fee

The State has imposed payment of a franchise fee in exchange for the right to distribute and retail natural gas to the whole of Tasmania for five and six years respectively. The final figures, \$2.0 million for the distribution franchise and \$500,000 for the retail franchise, are once-off fees. The franchise fee will equal approximately 1.5% of the overall project capital expenditure, which is not going to have a material impact on distribution or retail tariffs or the economic viability of the proposed development. They are designed to assist the State in recovering some of the substantial costs incurred during the tendering process. The fees are considered commensurate with the opportunity being offered, and have been considered as part of project viability.

As a result of investigations into the nature of the opportunity being offered the State is of the view that the proposed level of franchise fees is reasonable, and that the package of rights

offered by the proposed DAs represents an appropriately balanced and attractive basis for bidders.

D Recommendations by David Mitchell Tasmania for amendment to the Tender Process

D.1 Reduce the contestability level

Refer section C.2.

D.2 Use the Mineral Rights Process to award franchises for smaller areas

The State has offered exclusive franchises for the whole of Tasmania, in order to provide the winning bidder with the scale economies necessary to extend coverage to the maximum possible extent. It should also be noted that areas specified under the Code process are then subject to regulation by the Local Regulator under the Code, providing certainty to consumers as to prices oversight in these areas. Awarding franchise areas under a system similar to awarding mineral rights is unlikely to attract bidder interest, would not provide for monopoly prices oversight, and, as noted previously, would not be in accordance with the State's obligations under National Competition Policy.

E Recommendations by TEST Energy for amendment to the Tender Process

E.1 That the Director of Gas have the capacity to determine retail gas prices

The State has set out a regime for tariff calculation in the GPO. This provides the Director of Gas, as Pricing Regulator, with some flexibility in relation to Pass-Through and revenue control functions. The State believes that the current mechanisms in place under the GPO, and the tender process, are sufficient to minimise the extent of monopolistic pricing behaviour.

E.2 That market based principles be imposed for the 30TJ pa – 500TJ pa Customers

The GPO sets out the regime for prices oversight for all franchise customers. Controls currently in place include:

- Two revenue yields to ensure that cross subsidisation is minimised and that large customers that may attract better gas and haulage prices have these reflected in the yield;
- “Y” factors which restrict movements in individual tariffs within a period;
- ‘X’ factors which allow for real rates of decrease in tariffs over the term of the franchise.

In addition, the State’s intention to set GPO prices as an outcome of the bid process provides the benefits of multiple bidders and competitive forces to set lowest sustainable tariffs.

The State believes that the tariffs, as set through tender, will ‘replicate the outcomes of a competitive market’ and that therefore no amendment is necessary.

E.3 That the contestability limit of 500TJ be reduced

Refer section C.2