

Office of the Tasmanian Energy Regulator

Decision and Statement of Reasons

**Request for Approval of a Tender for Natural Gas
Distribution in Tasmania**

November 2001

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Decision by the Government Prices Oversight Commission in its capacity as Local Regulator

on

Tender Approval Request from the State of Tasmania for a Natural Gas Distribution Tender in Tasmania

By letter dated 7 September 2001 the State of Tasmania (State) submitted a TAR for consideration by the *Government Prices Oversight Commission* (GPOC) in its capacity as the 'local' Regulator appointed by the *Gas Pipelines Access (Tasmania) Regulations* for the purposes of the *Gas Pipelines Access (Tasmania) Act 2000*.

I advised by letter to the State of 14 September 2001, that having reviewed the TAR and associated documentation, I was of the opinion that it was an application conforming with the requirements of section 3.22 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (Code). Pursuant to my obligations under the Code I advised interested parties, including the Code Registrar, of the receipt of a conforming TAR and invited submission relating to the tender process proposed by the State.

I have considered the submissions received, including further submission and information provided by the State. I have had regard to these in making my decision as to whether or not to approve the TAR as providing a tender process consistent with Code requirements to determine:

- reference tariffs for certain Reference Services to be provided by means of the proposed pipeline;
- other specified items which are required to be included in an Access Arrangement and which are directly relevant to the determination of the Reference Tariffs concerned (including without limitation the Revisions Submission date and Revisions Commencement Date).

I have also considered whether the State as the person submitting the TAR for my consideration, may have, or may appear to have, a conflict of interest in conducting the tender process. Having regard to the detailed mitigation measures included in the proposed tender process in respect of Aurora Energy, the role and responsibilities of the Gas Steering Committee, and the opinion of the Probity Reporter, I have concluded that at this time there are no actual or apparent conflicts which would cause me not to approve the TAR.

I have given detailed consideration to the requirements of section 3.28 of the Code, all of which must be satisfied if I am to approve the TAR. In my consideration of the sub-sections of section 3.28 I have considered, where relevant, issues arising from submissions as well as other matters which were, in my judgement, relevant to making a decision in this matter.

Taking all these matters into account as detailed in my Statement of Reasons, I have decided to approve the TAR as submitted by the State.

I am required by section 7.9 (b) (iii) of the Code to provide to the Code Registrar to place on the public register a copy of the decision and reasons for this decision.

Andrew J Reeves

A handwritten signature in black ink, appearing to read 'A J Reeves', written in a cursive style.

COMMISSIONER

Government Prices Oversight Commission

Dated 9 November 2001

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GLOSSARY

TNGP	Tasmanian Natural Gas Project
The Code	National Third Party Access Code for Natural Gas Pipelines Systems
FAR	Final Approval Request
TAR	Tender Approval Request
GPO	Gas Pricing Order
The State	State of Tasmania
DA	The Development Agreement with the State
NGPAA	Natural Gas Pipelines Access Agreement
IRR	Internal Rate of Return
NPV	Net Present Value
Tj	Terajoule
Gj	Gigajoule

EXECUTIVE SUMMARY

The Scope and the Purpose of the Paper

This Report constitutes the detailed reasons and grounds, upon which the Regulator relied, in coming to a decision on the Tender Approval Request (TAR) submitted by the State of Tasmania.

The TAR provided the detail and process for the conduct of the competitive tender the State proposes for the development of the natural gas retail and distribution markets in Tasmania.

The TAR was lodged with the Regulator in accordance with the provisions of the *National Third Party Access Code for Natural Gas Pipelines (the Code)*.¹ The Code creates a national access regime for natural gas pipeline systems and sets out the manner in which prices and conditions for pipeline services are determined.

The State has chosen to use the tender process provided for in the Code to award a distribution franchise to the tenderer who best meets the State objectives, selected according to Code criteria. By this means a successful competitive tender process will provide reference tariffs which emulate those which would be the outcome for a competitive market.

The person intending to conduct a tender must first obtain the approval of the relevant Regulator for the proposed tender process. Before granting approval, the Regulator must be satisfied, amongst other things, that the successful tenderer will be selected principally on the basis that the tender will deliver the lowest sustainable tariffs to users generally over the life of the proposed pipeline.

While the Code does not deal with the award of a retail franchise, the State has decided to approach the market with a ‘stapled’ distribution and retail franchise offering. The State advises that in its view, based on its market testing and feedback received from potential bidders, this is likely to provide the most competitive outcome for the distribution tender.

Code Responsibilities

The Regulator’s first role was to assess whether or not the TAR provides sufficient detail of the conduct of the tender such that it may then proceed to public consultation. The Regulator reviewed the TAR for conformity with these initial requirements and proceeded to public consultation, including an invitation for submissions through advertisements in Tasmania and national newspapers and direct contact with interested persons.

¹ the Code applies within Tasmania under the *Gas Pipelines Access (Tasmania) Act 2000*.

To facilitate consideration of the TAR by interested persons, the Regulator provided an Issues Paper as background to the Code process and describing the issues to be considered in the assessment of whether or not the TAR should be approved.

The following are those matters which the Regulator was required to address in making a decision on approval of the TAR and a summary of the principal issues and reasons for decision.

Conflict of Interest – Section 27 of the Code

The Regulator may, at any time, decide not to approve a TAR if of the opinion that the person who submitted the TAR may have, or may appear to have, a conflict of interest if it conducted the tender process.

A successful competitive tender process requires that the tender be determined on grounds known to all bidders and in accordance with a pre-determined evaluation and assessment methodology. To do otherwise would be likely to deter potential bidder participation in what is an expensive process. If the State had a conflict of interest and allowed this to influence the outcome of the tender, this would be inconsistent with a competitive tender.

The principal issue raised in submissions was a concern that the State, as the person conducting the tender, may have a conflict of interest as a State owned company since Aurora Energy Pty Ltd had publicly stated that it would be a bidder in a consortium with Agility Management Pty Ltd.

The State had anticipated this concern and the tender process contained a number of mitigation measures such that the State maintained the evaluation and decision making process was not exposed to a conflict of interest. Notwithstanding concern in submissions as to a possible conflict of interest, parties with a significant interest in a competitive tender outcome did support the tender and considered the mitigation measures to be effective.

Decision and Reasons - Summary

The Regulator is of the view that having regard to the mitigation measures which have been put in place in respect of the possible participation of Aurora in the bid process, the structure of the evaluation process, the role and responsibilities of the Gas Steering Committee, and the requirement that Cabinet act on the recommendation of the Gas Steering Committee, there is at this time no reason to conclude that the State has a conflict of interest in the tender process as put forward.

In forming this view, the Regulator has had regard to the submissions made by various parties and the opinion of the Probity Reporter on this matter.

The Regulator may at any time form an opinion that the State may have, or may appear to have, a conflict of interest in conducting the tender process. To assist in monitoring this matter, the Regulator will receive regular reports on the conduct of the tender process from the Probity Reporter.

Section 3.28 of the Code

Within twenty-eight days of the submissions closing date, the Regulator is obliged², having regard to all submissions, to make a decision whether or not to approve the TAR. The Regulator must decide to approve the TAR if satisfied that the requirements of section 3.28 of the Code have been met, and not approve the TAR if not satisfied thereof.

Section 3.28 (a) – a new pipeline

The Code provides at section 3.28 (a) that the proposed pipeline will be a new pipeline.

This provision reflects the fact that the setting of reference tariffs by competitive tender is a process applicable to new pipelines, not for established pipelines.

The (pipeline) subject of the tender is a new pipeline to the extent that there is no natural gas distribution pipeline in Tasmania. The only issue of concern to the Regulator in relation to this section was the mandatory requirement that the successful bidder must purchase the existing Launceston network. The Launceston network was used for the distribution of ‘town gas’. It does not cover the extent of the Launceston component of the Minimum Pipeline Route proposed by the State. The Pipeline is not in such repair that it could be used without significant further work and upgrading as a distribution pipeline for natural gas.

The Regulator is of the view that the proposed pipeline the subject of the TAR is a ‘new pipeline’ consistent with the requirements of section 3.28 (a) of the Code.

Section 3.28 (b) – public interest and reference tariff objectives

The Code at section 3.28 (b) provides that the Regulator must be satisfied that using the tender process as outlined in the TAR to determine Reference Tariffs is in the public interest and is an appropriate mechanism in the circumstances for ensuring that Reference Tariffs achieve the objectives in section 8.1.

There were several submissions which contended for an alternative approach to the tender process proposed in the TAR, the argument being that there may have been alternative approaches to the tender than those put forward in the TAR which would, in the view of the submission, better promote the public interest.

The Regulator is of the view that to adopt this interpretation is to misconstrue the process. The Code requires the selection criteria to be designed to ensure that the bidder be selected principally on the basis of the lowest sustainable tariffs to users over the life of the pipeline, consistent with the objectives of section 8.1 of the Code. It is the achievement of this objective which will promote the public interest.

The Regulator is only required to form a view as to whether the tender process proposed in the TAR satisfies the requirements of the Code. He is not obliged to

² s3.25 of the Code.

recommend or propose that the State conduct a different type of tender process, which in his view may be more effective or more Code-compliant than the TAR tender process. Accordingly it is not appropriate or necessary to consider whether alternatives to the proposed tender process, as put forward in a number of submissions, should be preferred over that proposed by the State. Any such analysis would fall outside the Regulator's responsibilities under the Code.

The Regulator has had regard to submissions and considered the clear intention in the TAR to select the successful bidder consistent with the requirements of the Code. Consideration has also been had to the risks associated with a greenfields project and the difficulties a Regulator would face in assessing such risk in the event that reference tariffs were to be set by the alternative of an access arrangement submitted for approval.

On balance, the Regulator is satisfied that using the tender process as outlined in the TAR to determine Reference Tariffs is in the public interest and is an appropriate mechanism in the circumstances for ensuring that Reference Tariffs achieve the objectives in section 8.1.

Section 3.28 (c) – the tender process will be competitive

The Code at section 3.28 (c) provides that the Regulator must be satisfied that the tender process outlined in the TAR will attract tenders of a sufficient number and character to ensure a competitive outcome.

The expected benefit of using a competitive tendering process depends on whether there is likely to be effective competition for the right to the distribution franchise.

The Regulator adopted the view that the test to be applied is whether the tender process is likely to produce bids of a number and character likely to ensure a competitive outcome. The test is not to ensure the most competitive outcome, merely that it will be a competitive outcome.

Some submissions contended for what was put forward as a 'more competitive' tender process. These submissions did not go to the duty of the Regulator in this matter.

It is not for the Regulator to put forward an alternative to the tender process outlined in the TAR. His responsibility is to either accept or reject the proposed tender process in accordance with the provisions of the Code.

The Regulator also took the view that the nature of the offering was such that a small number of tenders may be expected having regard to the capital and technical capacity required and the possible level of risk in a greenfields project. The market for this offering is time limited, highly differentiated from other such market offerings and with few if any precedents in Australia. However, a small number of bidders does not of itself suggest that the tender would not be competitive.

The introduction of non-distribution issues into the tender process, eg telecommunications and the stapled retail bid, was also considered. The Regulator was

satisfied that the proposed tender process addressed these issues such that they would not distort the selection process in a manner inconsistent with the Code.

The Regulator gave weight to the views of potential market participants and customers who, while not universally supportive of all aspects of the tender, on balance tended to support the proposal. The response of potential bidders also tended to confirm the State's contention that the design of the tender was in response to market testing. Consideration was also given to the State's commitment to providing significant information to assist potential bidders in preparation of bids. The Regulator concluded that the level of the franchise fee should not adversely affect the competitiveness of the tender.

The Regulator is satisfied that having regard to the duty of the Regulator in this matter which is confined to assessment of the proposal put forward, rather than the design of an alternative scheme, the tender as proposed is likely to attract tenders of a character and number such as to ensure a competitive outcome.

Section 3.28 (d) – exclusion of certain tenders

The Code at section 3.28 (d) provides that the Regulator must be satisfied that the proposed tender:

- *includes a statement of the Reference Tariffs the tenderer proposes and the Reference Services to which those Reference Tariffs would apply;*
- *includes an additional revenue policy;*
- *provides that the residual value of the pipeline after the expiration of the initial Reference Tariff will be based on depreciation over the Pipeline's economic life;*
- *does not limit or purport to limit the Services to which access might be sought under this Code; or*
- *otherwise includes elements inconsistent with the Code except as contemplated by section 3.34.*

These exclusion requirements of section 3.28 (d) of the Code are repeated in clause 8.2 of the TAR. The State submits that as a consequence, the proposed procedures and rules of the tender process comply with section 3.28 (d) of the Code.

If the Bid Submission otherwise contains elements which are inconsistent with the Code then the State has advised in the TAR that it will be excluded from consideration by the State. By adopting the above as mandatory criteria, the requirements of section 3.28 (d) of the Code are satisfied.

In relation to section 3.28 (d) the Regulator's more significant concern will be an assurance of the exclusion of a bid from consideration if it does not comply with the requirements of this section. As part of the Final Approval Request Code Process the

Regulator must be satisfied that the tender process has been conducted in accordance with the procedures and rules proposed in the TAR.³

The Regulator will rely on reports received from the Probity Reporter on compliance with the approved tender process to determine whether bids that did not conform with the requirements of section 3.28 (d) were excluded from consideration.

The Regulator is satisfied that the proposed tender complies with the requirements of clause 3.28 (d) of the Code.

Section 3.28 (e) – consideration of all conforming tenders

Section 3.28 (e) of the Code requires the Regulator to be satisfied that the proposed procedures and rules to be followed in conducting the proposed tender will result in no tender being excluded from consideration except where the tender fails to meet the minimum requirements of section 3.28 (d), or does not conform to other reasonable requirements, or does not meet reasonable prudential and technical requirements.

In considering whether the rules and procedures that may lead to the exclusion of a tender are reasonable, the Regulator has taken account of the following factors:

- the exclusion should on balance have the effect of improving the competitiveness or efficiency of the tender process;
- the possible exclusion will not lead to outcomes that are inconsistent with the reference tariff objectives of section 8.1; and
- the test is not whether there is, in the view of the Regulator or others, a superior way in which the Code objectives and the State’s objectives of the tender process may be achieved, but that the rule that may give rise to the exclusion is, in the circumstances, reasonable.

The State has proposed two levels of requirements for consideration of bids, the ‘mandatory’ and ‘conformity’ requirements. Those bids that do not meet the mandatory requirements described in clause 8.2 of the TAR (and those not meeting the minimum requirements of section 3.28 (d)) will not be considered.

The conformity requirements⁴ require that all bids that satisfy the requirements for ‘conforming’ bids will be considered, and ‘non-conforming’ bids may, but will not necessarily, be considered. Bidders are encouraged to lodge at least one conforming bid and, if they think it is desirable, they may lodge one or more non-conforming Bid Submissions.

The mandatory and conformity provisions gave rise to a number of submissions. The principal issues raised were:

³ s3.33 (b) of the Code.

⁴ Clause 8.3 of the TAR.

- the stapled retail and distribution bid requirement;
- the franchise fee payable on signing the Development Agreements with the State;
- the requirement to make an irrevocable offer to enter into an agreement to purchase the Launceston town gas distribution system ‘at a fair and reasonable price determined by an independent valuer’;
- the requirement to have uniform retail tariffs across the proposed service area for customers that have the same demand and load characteristics and consume less than 30 Tj per annum;
- certain conditions contained in the draft Gas Pricing Order:
 - form of price control – that bidders should have the freedom to propose their desired form of price control, rather than being constrained to adopt the revenue yield;
 - the 15 year regulatory period may be too short, it being argued that a longer period could result in lower tariffs; and
 - the State’s proposed X factor of 1% may require higher initial prices (than a lower X factor) and make it harder to encourage customers to switch to gas in the early years. It was suggested that bidders should have flexibility as to the X factor.

It is not possible to go through all these matters in detail in a summary and the reader must refer to the full reasons following this introduction. Most of these issues involve difficult matters of judgement whereby the Regulator must form a view which balances the submission of the State based on the achievement of its objectives, and supported by market testing, as against the submissions made, and ultimately the achievement of the Code objectives.

It is not the Regulator’s role to substitute his judgement as to what may be a ‘better’ means of designing the tender, rather whether the requirements are reasonable. It is an important fact that bidders are encouraged to submit at least one conforming tender, and, if they think it is desirable, they may lodge one or more non-conforming bid submissions.

An objection to this is that bidders have no certainty that their non-conforming bid will be considered. In the view of the Regulator the State does not have unfettered discretion in this matter. It should consider bids which are consistent with and promote the achievement of its stated objectives. The requirement for procedural fairness in the Probity Guidelines also suggests that all bidders should be treated fairly and consistently in this respect.

Having regard to the State’s objectives, the requirements of the Code and all the surrounding circumstances, the Regulator is satisfied that the proposed procedures and rules to be followed in conducting the proposed tender will result in no tender being excluded from consideration except where the tender fails to meet the mandatory

requirements of section 3.28 (d), or does not conform to other reasonable requirements or does not meet reasonable prudential and technical requirements.

Section 3.28 (f) – selection criteria

The Regulator must be satisfied that the selection criteria to be applied will result in the successful tender being selected principally on the basis that the tender will deliver the lowest sustainable tariffs to users generally over the economic lifetime of the pipeline and are likely to result in reference tariffs that:

- achieve the objectives of section 8.1 of the Code; and
- contain or reflect an allocation of costs between services and an allocation of costs between users which is fair and reasonable.

The principal issue raised in this regard (but not the only one) was how the legal requirement for the level of sustainable tariffs to be the principal criterion for selection should be interpreted and applied. In particular, what this implied for the appropriateness or weight to be attached to the criteria that the State has proposed in addition to price. A closely related issue was the degree of discretion that the State has proposed with respect to the weighting of the various criteria.

The evaluation methodology proposed by the State seeks to rank first the bid submission offering the lowest sustainable distribution tariffs (the first ranked Bid Submission). This ranking may be changed if in the light of the evaluation against the secondary criteria, it would be consistent with the State's objectives for the first ranked bid to be ranked below one or more other bids.

When undertaking the evaluation against the secondary criteria the Gas Steering Committee is required to ensure that the successful bid achieves the objectives set out in section 8.1 of the Code. The requirement for the successful bid to achieve the Code objectives prevails over the requirement for consistency with the State's Objectives, should a conflict arise between the two sets of requirements.

Subject to the concern raised next, this methodology, if followed, should ensure the result that the successful bid should meet the tariff objectives and hence satisfy the requirement of the principal selection criterion.

One implication of this approach, however, is that it leaves the State (in the first instance) with the requirement (potentially) to exercise a degree of judgement when assessing the relative merits of the various bidders. That said, the State has explained how it will determine a value of a number of the various criteria, which provides some insight into the weights that would expect to be assigned. For example, it has stated how it will calculate the assumed net distribution cost to users, the additional customer benefit associated with supplying additional areas, and how it will calculate the assumed net retail cost to consumers.⁵ As described above, the State has also defined a

⁵ Tender Guidelines, clauses 8.2, 8.3 and 8.4.

process and objectives that will place further limits on the exercise of its discretion. Both of these components of its proposal should alleviate, to an extent, any uncertainty.

Bidders are required to show that these proposals satisfy its requirements of sections 3.28 (f) (ii) in regard to meeting reference tariff objectives and the allocation of cost between services.

Given the range of issues that may impact upon the perceived fairness of the allocation of costs, this is considered to be appropriate. It is noted that the Regulator independently has to consider whether the allocation of costs can be considered fair and reasonable when assessing the FAR. This judgement will be made recognising the economic boundaries for the allocation of costs, and the acceptance in the Code that the allocation of costs should be subject to commercial and technical considerations.

On balance, it is considered that the State's overall approach with respect to the definition and application of the selection criteria meets the requirements of the Code.

Section 3.28 (g) – determination of items of reference tariffs

The Code at section 3.28 (g) requires that the tender documents specify which items required to be included in an Access Arrangement other than Reference Tariffs will be determined by the tender and that those items are directly relevant to the determination of Reference Tariffs.

The TAR outlines five matters that are to be determined by the competitive tendering process (which will, in part, satisfy a number of elements of the Access Arrangements) These are:

- the price control that will govern the prices for transporting gas through the distribution system (including the extent (if any) of revenue above forecasts that may be returned to customers), and pricing principles for the provision of the ancillary services;
- a list of reference services to be provided by the pipeline (which are, in broad terms, the transportation of gas and a number of services that are ancillary to the transportation of gas);
- the principles to be used to determine the value of the assets (for regulatory purposes) at the time of the first price review;
- the minimum area to be serviced by the proposed Pipeline;
- the key principles of the Extensions/Expansions Policy; and
- a Revisions Commencement Date applicable to those Reference Tariffs.

None of the submissions commented explicitly upon whether any of the matters to be determined by the tender process should be considered as outside of those permitted by section 3.28 (g), although some submissions appeared to support some of these items being determined by the process.

The Regulator has reviewed the conditions of the TAR and is satisfied that it complies with the requirements of this section of the Code. It does specify certain items required to be included in an Access Arrangement (other than Reference Tariffs) which will be determined by the tender, and that those items are directly relevant to the determination of Reference Tariffs.

Section 3.28 (h) – configuration of pipeline not limited

The Regulator is required under section 3.28 (h) of the Code to be satisfied that the tender documents will not specify the configuration of the proposed pipeline including the areas the proposed pipeline will service. Nor will it specify the dimensions of the pipeline, the level of compression or other technical specifications, unless the Regulator is satisfied that it would be appropriate to do so.

The TAR does not specify the dimensions of the proposed pipeline, the level of compression to be used in the pipeline nor do the tender documents specify any technical parameters for the proposed pipeline.

The Regulator must consider whether the specification of the Minimum Pipeline Route is a reasonable requirement and whether under section 3.28 (h) it is appropriate to disclose the areas the propose pipeline should cover. The State submits in the TAR that it is entirely appropriate for the Minimum Pipeline Route to be specified. The State contends that such disclosure will ensure that the benefits of natural gas are made available within all the major population centres of Tasmania and to most industrial centres.

As the State's proposal to specify a minimum pipeline route, and to offer incentives for a large area, were considered 'reasonable' under section 3.28 (e), these requirements are also considered 'appropriate' under section 3.28 (h).

Accordingly, it is considered that the State's proposed tender process meets the requirements of this section.

Section 3.28 (i) – other documents

Under section 3.28 (i) of the Code, the Regulator is required to ensure that any document supporting or relating to the tender process is consistent with the Code and does not purport to limit:

- the services which the Service Provider may provide or to which access may be sought under this Code;
- the configuration of the proposed Pipeline; or
- the construction or operation of other Pipelines that could deliver gas to the same gas market as the proposed Pipeline.

This section of the Code extends the Regulator's consideration of the TAR to include any documents that may establish the tender process.

The State has provided the Regulator with a number of documents. These documents are listed in schedule 3 of the TAR. To be satisfied that the requirements of section 3.28 (i) have been met, the Regulator has examined each of these documents.

The primary issue raised by this section is whether the State's proposal to award an exclusive distribution franchise may be invalidated by this section.

The other matter to be considered, apart from those against which the considerations are simply matters of fact, is whether it is Code-compliant to specify a minimum pipeline route - a matter that was considered in the context of whether it is a reasonable requirement under section 3.28 (e).

The Regulator has considered these matters, particularly with reference to the *National Gas Pipelines Access Agreement*⁶ (NGPAA), section 5 of the Access Law and section 30 of the *Gas Act 2000 (Gas Act)*. The NGPAA contemplates the existence of such exclusive franchises and, in the event of any inconsistency between the provisions of the Act and the Code, the provisions of the Act should prevail.

The Regulator considers that the requirements of section 3.28 (i) (iii) of the Code are satisfied.

Final Approval Request

The Regulator must at the conclusion of the tender selection process consider the FAR. This is a review of whether the tender was conducted in accordance with the process initially approved, and provides tariff outcomes consistent with the Code reference tariff principles.

⁶ Dated 7 November 1997 between the Commonwealth of Australia and each State and Territory of Australia.

1 BACKGROUND

1.1 The Tasmanian Natural Gas Project

Tasmania is currently the only Australian state without access to a reticulated natural gas supply. The project to introduce natural gas to Tasmania involves a number of private sector companies and Tasmanian government agencies in securing a supply of natural gas, developing the infrastructure and setting in place the regulatory framework for natural gas to be delivered to Tasmanian industry and households.

The objective of the Tasmanian State Government (the State) is to provide a choice of energy sources to consumers and encourage industrial growth within the State.

Natural gas will be used in electricity generation (initially through conversion of the Bell Bay power station owned by Hydro Tasmania) and by industry and households in substitution for other energy sources, including LPG, wood, oil, coal and electricity. The State is facilitating the project by establishing the regulatory framework and by selecting firms which will be granted the right to develop the distribution network and the right to sell gas to retail customers. These rights to a distribution franchise and to a retail franchise are to be awarded through a competitive tender process described in the Tender Approval Request (TAR).

The TAR describes the State's objectives for the Tender Process as:

- to facilitate the development of an efficient and competitive gas supply industry;
- to maximise the coverage of reticulated gas services in 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.

In 1997 the State sought expressions of interest in developing and reticulating a natural gas supply to Tasmania. As a result of this process, Duke Energy Tasmania Holdings Pty Ltd (Duke Energy) was selected as the preferred proponent for the development of a natural gas supply to Tasmanian consumers.

The results of a feasibility study conducted by Duke Energy in 1999 indicated sufficient market demand for the Tasmania Natural Gas Project (TNGP) to be

technically and economically feasible. In April 2001 Duke Energy entered into a Development Agreement with the State to bring natural gas to Tasmania.

Duke Energy's role in the TNGP involves the development of the transmission infrastructure and sale of gas to contestable customers. To extend the supply of natural gas to other industrial, commercial and smaller business customers and to residential customers, the State proposes to appoint a gas distributor and retailer and has elected to do so by the process described in the TAR.

The State is a signatory to the Australian Natural Gas Pipelines Access Agreement. It has passed legislation that gives effect to the *National Third Party Access Code for Natural Gas Pipelines Systems* (the Code)⁷ in Tasmania. The Code creates a national access regime for natural gas pipeline systems by setting out the manner in which prices and conditions for pipeline services are determined.

As an alternative to establishing reference tariffs for services in an access arrangement approved by the relevant Regulator, the Code provides that reference tariffs for a new pipeline may be set by a competitive tender process. The person conducting a tender must first obtain the approval of the relevant Regulator for the proposed tender process. Before granting approval the Regulator must be satisfied, amongst other things, that the successful tenderer will be selected principally on the basis that the tender will deliver the lowest sustainable tariffs to users generally over the life of the proposed pipeline.

The State has chosen to use the tender process provided for in the Code to award a distribution franchise to the tenderer who best meets the Code criteria including those mandatory criteria in respect of coverage and other matters which the State has included in the tender process in accordance with the Code. By this means a successful competitive tender process will provide reference tariffs which emulate those which would be the outcome of a competitive market.

While the Code does not deal with the award of a retail franchise, the State has decided to approach the market with a 'stapled' distribution and retail franchise offering. The State advises that in its view, based on its market testing and feedback received from potential bidders, this is likely to provide the most competitive outcome for the distribution tender.

1.2 Legislative and Regulatory Framework

The Government's intention is to provide the successful gas retailer and distributor with a high degree of certainty over the future regulatory regime applicable to the Tasmanian gas industry. Several key regulatory instruments, both existing and proposed, will support the gas industry structure proposed by the State. These include:

⁷ the Code applies within Tasmania under the *Gas Pipelines Access (Tasmania) Act 2000*.

The Gas Act 2000

- Regulates the distribution and retailing of gas in Tasmania. It includes provisions for the appointment of the Director of Gas, the Director of Gas Safety and for the licensing of gas distributors and retailers. It is intended that Gas Regulations and Codes will be made under the Gas Act to deal with, amongst other things, applications for distribution and retail licences and the contestability arrangements for the Tasmanian retail gas market.

The Gas Pipelines Act 2000

- Regulates the construction and operation of gas pipeline facilities in Tasmania. It includes provision for the granting of gas transmission licences and for the protection of people and property through safety and operating plans.

The Gas Pipelines Access (Tasmania) Act 2000

- Adopts the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) and the National Gas Pipeline Access Law. Under the process set out in the Code, network service providers submit Access Arrangements for pipelines covered under the Code. Access Arrangements set out provisions for third party use of a covered pipeline and include such matters as reference tariffs.

As gas pipelines are in large part natural monopolies, access to pipeline services is a matter of significant interest to gas suppliers, retailers and customers.

The Code stipulates that any person, in this case the State, may conduct a tender process to establish reference tariffs, provided the person has first obtained the approval of the 'local' Regulator for the proposed tender process.

Appointment

The Regulator was appointed on 20 June 2001 by the *Gas Pipelines Access (Tasmania) Regulations 2001* as the local 'Regulator' in relation to a distribution pipeline for the purposes of the *Gas Pipeline Access (Tasmania) Act 2000*.

2 THE COMPETITIVE TENDER PROCESS

2.1 The Tender Approval Request (TAR)

The TAR is an application that was submitted by the State to the Regulator⁸ on 7 September 2001 requesting approval for the use of the tender process to determine Reference Tariffs.⁹ The TAR includes related particulars to be included in an Access Arrangement the term of which will be nominated in the successful Bid Submission.

The TAR¹⁰ nominates the location from where the proposed pipeline system will take gas, the location of gas markets and the proposed date for review of the tariff and Access Arrangements. The TAR also details the proposed bidding process to be followed by the State in conducting the tender or selection process, including the minimum requirements to be met by a Bid Submission before it will be accepted as a conforming Bid Submission. Moreover, the TAR details the selection criteria and the evaluation methodology to be applied in selecting the successful Bid Submission.

Distribution System

The successful bid for gas distribution will be awarded an exclusive, non-renewable, five-year franchise to construct and operate a natural gas distribution system in Tasmania, which will connect to the transmission system and deliver gas to customers.

The distribution franchise will give the successful bidder the exclusive right to deliver gas to all customers, other than certain industrial customers who may be supplied via either a distribution pipeline (for which the distributor will have an exclusive franchise) or a transmission pipeline. Bidders will receive the full detail of the proposed franchise with the Project Brief.

The proposed distribution pipeline will take gas from approximately 20 off-take points along the proposed Duke Energy transmission pipeline and deliver the gas within the Tasmanian gas market. In order for Duke Energy to progress its development of the project, the general location and configuration of the off-take points will be initially nominated by the State to match possible supply areas. The location of additional off-take points will be a matter for bidders to negotiate with Duke Energy.

⁸ s3.21 of the Code.

⁹ s3.28 of the Code. 'Reference Tariffs' is a term used in the Code to describe the tariffs applicable to 'Reference Services'. These are services which are expected to be required by users of the pipeline.

¹⁰ As required by s3.22 of the Code.

The Proposed Pipeline will deliver gas within the Tasmanian gas market, in the areas proposed by the successful bidder. The State has proposed in the TAR¹¹ a Minimum Pipeline Route which includes most areas within the following urban localities:

- Hobart;
- Launceston;
- Devonport;
- Ulverstone; and
- Burnie.

The State will request Bid Submissions that meet or exceed the coverage required by the Minimum Pipeline Route and that propose rollout of the network within a specified time period.

Retail Tender

The Tender Process also incorporates a tender in relation to the selection of a franchised gas retailer in Tasmania. This element of the tender does not require approval under the Code, but to ensure a streamlined and competitive tender process it has been included in the Tender Process.

In addition to selecting the successful distributor, the Tender Process will be used to select a gas retailer who will be awarded an exclusive, non-renewable, six-year franchise to retail gas to non-contestable customers in Tasmania. Under the *Gas Act*, “retailing” of gas is defined as the sale and supply of gas where the gas is conveyed by a gas distribution system.

Natural Gas Operations are expected to commence from mid 2002 at which time the State has indicated that a limited number of retail customers will be contestable. These contestable customers will be:

- five specific business premises (Comalco at Bell Bay, United Milk Tasmania at Spreyton, Norske Skog at Boyer, Starwood at Bell Bay and Australian Paper at Wesley Vale); and
- any other new and existing business premises with an actual or anticipated annual consumption greater than 500 Tj.

Customer sites will not be aggregated for contestability purposes. The State intends to maintain a 500 Tj per annum contestability threshold for the duration of the retail franchise.

It is intended that the retail gas franchise will end on 30 June 2008. This will coincide with the proposed end of Aurora Energy’s electricity retail franchise. It is intended that

¹¹ Clause 3.2 of the TAR.

new entrants will be free to seek licences to retail electricity and gas to any retail customer in Tasmania after this date. The State thereby hopes to ensure that energy contestability will be introduced in an orderly manner and that neither gas nor electricity will have a “head start” in the retail market.

Stapled Bids

The requirement that bidders lodge stapled distribution and retail bids is a mandatory requirement. The State submits that the tender design with stapled bids was sought by the majority of potential bidders with whom the proposed tender was discussed. Clause 12.6 of the TAR submits that the requirement for stapled bids is reasonable. It comments that most potential bidders were anxious about the prospect of ‘mix and match’, ie about being forced into a relationship with a distributor or retailer with whom they had no desire to be involved. The TAR suggests that if bidders were forced to accept the possibility of being matched with another bidder, then it is likely that bidders would include an additional risk premium to the proposed tariffs.

Telecommunications

The State seeks to utilise the opportunity offered by the gas distribution rollout to facilitate the simultaneous installation of broadband telecommunications infrastructure in Tasmania. The State will, in its Project Brief, invite Bidders to develop a telecommunications proposal, and to lodge a summary of this proposal concurrently with the Bid Submission. The State will not review the summaries prior to the selection of the successful bidder and accordingly the telecommunications proposals will not form part of the distribution and retail bid evaluating process.

2.2 The Role of the Regulator

Code Responsibilities

The Regulator’s key role is to determine that the tender is being conducted in accordance with the Code. The principal selection criterion is that the tender will deliver the lowest sustainable distribution tariffs over the economic life of the pipeline.

Section 3.28 of the Code sets out the matters of which the Regulator must be satisfied in order to approve a tender process. As part of a Code compliant tender, bidders may be asked to lodge their proposals with respect to reference tariffs, reference services and other matters.

The Regulator must at the conclusion of the tender selection process then consider the Final Approval Request (FAR). This is a review of whether the tender was conducted in accordance with the process initially approved, and provides tariff outcomes consistent with the Code reference tariff principles.

Regulator’s Role at the TAR Stage

The Regulator’s role in the Tender Process commenced with the receipt of the TAR. The Regulator conducted a conformity check for compliance with section 3.22 of the

Code. The issue of compliance of the TAR with the Code is examined at section 2.3 of this Paper.

Following receipt of a conforming TAR,¹² interested persons were notified by letter, and national and Tasmanian newspaper advertisements were placed. The advertisements publicised the receipt of the TAR and requested submissions in relation to the tender process. An Issues Paper was released concurrently with the advertisement and published on the Energy Regulator website at: www.energyregulator.tas.gov.au.

The Regulator may decide at any time not to approve the TAR if the State has or appears to have a conflict of interest¹³ and may reject a TAR without further consideration if of the opinion that the application has been made on trivial or vexatious grounds.

Within twenty-eight days of the submissions closing date, the Regulator is obliged¹⁴, having regard to all submissions, to make a decision whether or not to approve the TAR. The Regulator must decide to approve the TAR if satisfied that the requirements of section 3.28 of the Code have been met and not to approve the TAR if not satisfied thereof.

The requirements of section 3.28 include, but are not limited to:

- that using the tender process, as outlined in the TAR to determine Reference Tariffs, is in the public interest and is an appropriate mechanism in the circumstances for ensuring that Reference Tariffs achieve the code reference principles;
- that the number and character of tenders likely to be received would be such as to ensure a competitive outcome; and
- that the selection criteria to be applied in conducting the proposed tender will result in the successful tender being selected principally on the basis that the tender will deliver the lowest sustainable tariffs (including but not limited to reference tariffs) to users.

Regulator's Role at the bidder Evaluation Phase

Following approval of the TAR, the State will commence the bidder evaluation phase in which parties who meet the relevant qualification criteria will be qualified and invited, subject to signing a participation deed, to enter the bidding process.

¹² s3.23 of the Code.

¹³ s3.27 of the Code.

¹⁴ s3.25 of the Code.

The Regulator does not expect to be directly involved in this stage but will receive regular reports from the Probity Reporter on the conduct of the tender and evaluation process.

The Regulator may be requested to approve changes in the Tender Guidelines. In considering such a request, the Regulator will consider the materiality of any such proposed change and whether it may be desirable to seek submissions on the matter.

Regulator's Role at the FAR Stage

Upon the selection of the successful bidder, the State will submit to the Regulator a Final Approval Request. The Regulator is required to make a decision whether or not to approve the FAR.¹⁵ Before making this decision, the Regulator is entitled to request from the person submitting the FAR all the information or assistance he reasonably requires. Upon receiving the required information the Regulator must make a decision within 28 days. The Regulator must approve the FAR if satisfied that it conforms to the requirements of section 3.33 of the Code and not approve the FAR if not satisfied thereof.

The requirements of section 3.33 include:

- that the successful tender was selected in accordance with the selection criteria and rules and procedures specified in the TAR approved by the Regulator; and
- that the Reference Tariffs determined through the tender process achieve the objectives of the Code reference tariff principles.

Upon the receipt of a conforming TAR, the Regulator is required by section 3.23 of the Code to inform each person, whom he believes has a 'sufficient interest', of the receipt of the TAR. To assist in identifying persons having a 'sufficient interest' of the kind contemplated by section 3.23 of the Code, an advertisement was placed in local and national newspapers on 7 July, inviting interested persons to register that interest with the Regulator.

The Regulator has met the requirements of section 3.23 of the Code by issuing all persons on the Interested Persons Register with a copy of the principal documents submitted by the State with the TAR, accompanied by the Issues Paper, to assist them in developing their submissions. Supporting documentation submitted with the principal documents was available upon request and payment of a fee, or free from the Regulator's website.

The Code also required publication of an advertisement in a national daily newspaper describing the proposed pipeline, stating how copies of the TAR could be obtained and requesting submissions by a date no earlier than 14 days or later than 28 days after the date of the notice.¹⁶ The required advertisement, requesting submissions by

¹⁵ s3.32 of the Code.

¹⁶ s3.23 of the Code.

12 October 2001 was published in the Mercury, Examiner and Advocate newspapers on 12 September 2001 and in the Australian Financial Review on 15 September 2001.

The Regulator is required by section 3.25 to consider any submissions received within the advertised submissions period when making a decision to approve or not approve the TAR. The Regulator may (but is not obliged to) consider any submissions received after that time.

Probity of the tender process

The State has engaged a Probity Auditor to oversee the Government's tender process. The Probity Auditor operates under guidelines which seek to ensure that the tender process is Code compliant, and that the process is open, fair, not tainted by interference by any interested party, conducted in compliance with Government policies and is secure and confidential. The Probity Auditor will monitor the adherence to the probity guidelines by the Gas Steering Committee and other members of the State tender assessment and advisory team.¹⁷

The Probity Auditor for the State is also engaged by the Regulator as a Probity Reporter under a separate contract and terms of reference and is, in this role, directly accountable to the Regulator. This recognises that to do otherwise would substantially increase costs through duplication. No conflict arises between the obligations of the two roles.

The Regulator has an interest in the integrity and fairness of the tender process which, if compromised, will not deliver the best outcome for customers. If the process is not seen to be fair, bidders will be disinclined to participate, and this may mean that the process will not be competitive with the result that the best possible bid is not elicited.

Under the Code (section 3.33 (a) and (b)), the Regulator has an additional interest in the consistent and objective application of the selection criteria, without which the tender outcome would be compromised. The Regulator is required at the FAR stage to be satisfied that the successful tender was selected in accordance with the selection criteria specified in the TAR and that the tender process was conducted in accordance with the procedures and rules specified in the TAR.

The Probity Reporter will report to the Regulator at regular intervals on compliance with the tender process, conflicts of interest and the Probity guidelines and report any breaches. The Probity Reporter is responsible to ensure that conflicts, and potential conflicts, of a probity nature are identified and eliminated on a timely basis and that participants in the tender process are accountable for their actions.

A key function of the Probity Reporter's role is to provide the Regulator with the information required to make a decision at the FAR stage. The Probity Reporter will provide an opinion on key probity issues including the handling of late tenders, the

¹⁷ The Tender Team comprises the Gas Steering Committee and the Bid Assessment Team. The Bid Assessment Team includes expert consultants from KPMG and Mallesons Stephen Jacques.

processes for protecting confidential information and whether tenders were evaluated consistently and in accordance with the evaluation methodology contained in the TAR.

The staff of the Office of the Tasmanian Energy Regulator and the Regulator's advisors have also undertaken to comply with Probity Guidelines for the Tender Process. These guidelines deal with the management of confidentiality of information, conflict of interest and fair dealing, and the conduct of meetings with, and responding to questions from, tenderers.

The Regulator's responsibilities to the Code Registrar

*The Gas Pipelines Access (South Australia) Act 1997*¹⁸ makes provision for the appointment of a Code Registrar. Under the Code, the Code Registrar's primary role in relation to the tender process is to maintain a Public Register of:

- pipelines covered by the Code, along with their respective classification and Regulator;
- applications, submissions relating to such applications, and decisions relating to coverage or revocation of coverage and access arrangements; and
- all Tender Approval Requests, Final Approval Requests, and submissions received and decisions made in relation to these matters.

The Registrar provides a point of contact for the public in relation to the Code. The Regulator is required by the Code¹⁹ to provide the Registrar with a copy of the TAR and all submissions received by the Regulator relating to the Tender Process are to be placed on the Registrar's website.

The Regulator has provided to the Registrar²⁰ those parts of the TAR that have been determined not to be confidential. The Registrar has also been progressively provided with copies of submissions received in respect of the TAR.

¹⁸ s25 of the Code.

¹⁹ s7.9 of the Code.

²⁰ s7.12 of the Code.

3 REVIEW OF THE TAR

The Code sets out in section 3.22 and section 3.28 certain provisions regarding whether the TAR satisfies a certain form, conflict of interest requirements and tests relating to the likely outcome of the process. This chapter will examine the procedural requirements that must be satisfied before the Regulator can make his final decision on the TAR. In making his decision, the Regulator is required by the Code to be satisfied that the proposed tender process meets certain requirements before approving the TAR. These requirements are examined in detail in the following chapters.

3.1 TAR Conformity (Section 3.22)

The Regulator is required to make a decision upon receipt of a TAR as to whether it conforms with the requirements of section 3.22 of the Code.

The Regulator received certain documentation from the State on 7 September 2001.

The Code at section 3.22 states that a TAR must:

- (a) nominate the location or locations from where the proposed Pipeline will take gas and the location or location of the gas market to which the proposed Pipeline will deliver gas;
- (b) detail the process (including procedures and rules) proposed to be followed in conducting the tender process, including the minimum requirements which a tender must meet before it will be accepted as a conforming tender, for example, the date by which tenders must be received;
- (c) detail the selection criteria to be applied in selecting the successful tender; and
- (d) specify a possible Revisions Commencement Date or a series of possible Revisions Commencement Dates to be established for the proposed Pipeline, in relation to which tenderers are asked to submit tenders and propose Reference Tariffs.

Determination

The Regulator found that the documentation lodged by the State on 7 September 2001, and referred to in a covering letter from the Chairman of the Gas Steering Committee as being a 'revised Tender Approval Request and associated documentation', did constitute a Tender Approval Request conforming with the requirements of section 3.22 of the Code.

The 'associated documentation' is constituted by those documents being listed in the attachment to the letter as 'list of Tender Approval Request Documentation'.

3.2 Process required by the Code

Upon the receipt of a conforming TAR, the Regulator is required by section 3.23 of the Code to inform each person, whom he believes has a 'sufficient interest', of the receipt of the TAR.

In order to determine which sector of the public had a 'sufficient interest' of the kind contemplated by section 3.23 of the Code, an advertisement was placed in local and national newspapers on 7 July 2001, calling for all persons with an interest in the Tasmanian Natural Gas Tender Process to send their contact details to the Office of the Energy Regulator for inclusion in a register of interested persons. The Regulator met the requirements of section 3.23 of the Code by issuing all persons on the Interested Persons Register (as well as other persons separately identified) with a copy of the principal documents submitted by the State with the TAR. This was accompanied by an Issues Paper, to assist in developing submissions.

Submissions

Interested persons were requested in the advertisement to send submissions as electronic documents with confidential material as a separate attachment. The submissions that were not marked confidential were posted on the web and a letter of acknowledgement was sent. All issues raised that were relevant to the tender process are addressed in this Paper. Nine submissions were received in total, and these arose primarily from interested industry participants. See Appendix A for the full details of Table of Submissions.

Issues Raised

The issues raised in submissions are discussed under the relevant clauses.

4 PERCEIVED OR ACTUAL CONFLICT OF INTEREST – SECTION 3.27

4.1 Code and Background

The State of Tasmania has submitted a TAR for the conduct of a tender in relation to the selection of a franchised gas distributor in Tasmania.²¹ The proposed tender process also includes the selection of a franchised gas retailer however, this is not provided for in the Code and regard would only be had to this to the extent it impinged upon the selection process for the gas distributor.

The Regulator may at any time decide not to approve a TAR if he forms the opinion that the person who submitted the TAR may have, or may appear to have, a conflict of interest if it conducted the tender process.²²

The TAR discloses that the Gas Steering Committee will be responsible for all aspects of the tender process, including the qualification of bidders, the administration of the bidder investigation phase and the receipt and evaluation of bid submissions and recommendation of the successful bidder to the State Cabinet.

4.2 Issues Raised

Potential Conflicts Issues

The Regulator invited submissions on the adequacy of the measures proposed by the State to mitigate concerns of an actual or perceived conflict of interest arising from the possibility of Aurora Energy Pty Ltd (Aurora Energy)²³ participating in the tender process.

The State proposes to invite bidders to lodge summaries of the bidder's plans, if any, and ability to negotiate with the State suitable arrangements for the rollout of broadband telecommunications infrastructure simultaneously with the roll-out of the distribution pipeline network.

While the Regulator had identified this as a possible issue of concern, interested Parties were invited to raise other conflict issues.

²¹ The TAR was lodged by the State of Tasmania on 7 September 2001.

²² If the Regulator decides not to approve a TAR on conflict of interest grounds, another person may submit a new TAR in relation to the same proposed Pipeline.

²³ Aurora Energy Pty Ltd is a State-owned corporation.

Submissions received

The Regulator received submissions relating to the issue of perceived and actual conflict arising from the State as the person submitting the TAR from:

- Duke Energy International (Duke Energy):
 - believes it is critical that as many bidders as possible participate in the tender process. Duke Energy does not wish to see any interested bidder disqualified from bidding and supports the State’s proposed approach to mitigating possible conflicts; and
 - is of the view that the proposed arrangements in respect of Aurora Energy are adequate.
- Tasmanian Chamber of Commerce & Industry Ltd (TCCI):
 - highlighted community concerns about Aurora’s participation arising from the State having a financial interest in the event that Aurora were awarded the retail franchise and the potential for Aurora to have a possible close inside perspective of the tender process; and
 - TCCI concludes in its submission that it is satisfied the measures adopted by the State and Aurora are significant in alleviating the concerns of the community regarding possible conflicts.
- Mr Ian Martin:
 - Mr Martin raised concern that there is public speculation that Aurora Energy is the most likely successful tenderer; and
 - questions how the State intends to deal with issues of conflict of interest in relation to its dual role in conducting the tender and as sole shareholder of Aurora Energy.
- Australian Bulk Minerals (ABM):
 - raised concern that the potential involvement of Aurora Energy as a bidder would represent a conflict of interest for the State as the person submitting the TAR and conducting the tender process.
- United Energy Pty Ltd (United Energy):
 - submitted that a recent report in the Macquarie Research Equities²⁴ stated that Aurora will ‘own both the distribution assets and the retail customer base’. United Energy believes that this is in breach of the mitigating measures implemented or to be implemented by the State.
- Other issues

²⁴ Tasmanian Gas 31 August 2001.

- while potential conflicts were raised in respect of other aspects of the proposal, eg the role of Origin and the Launceston Network, there were no matters which otherwise directly related to the role of the State as the person submitting the TAR.

Conflict of interest

The Regulator has taken the view in this matter that the relevant test for conflict of interest is that a member of an administrative panel (or their advisers) should not sit on a matter, if in all the circumstances, the parties or the public, being fair minded, might entertain a reasonable apprehension or suspicion that he or she may not bring an impartial and unprejudiced mind to the resolution of the question before the panel.

Thus, the issue is not that the State may be the person submitting the tender. Rather the issue is whether the decision making process and all the surrounding circumstances lead to the conclusion that any interest the State may have in a bidder will not affect the process such that it is biased in favour of that interest.

Participation by Aurora Energy and potential conflicts

A possible bidder will be Aurora Energy, as part of a consortium. It is a wholly State-owned company with its shareholders being Ministers of the State.

Given the interests of the State in Aurora Energy, there may be an actual or potential conflict of interest whereby the State, in the form of the Gas Steering Committee, may seek to promote the interests of Aurora at the expense of procedural fairness and the interests of other bidders in the process, and ultimately to the potential detriment of customers of the natural gas distribution system.

Aurora's participation in the tender process has also raised concern in that if it is the successful bidder, it will be a significant participant in both the electricity and gas markets in Tasmania. Aurora Energy's potential participation in both the electricity and gas markets is not relevant to the Regulator's consideration of the actual or perceived conflict. It is an inter-modal competition issue.

The State has recognised the potential for an actual or perceived conflict of interest in conducting the tender process arising from its ownership of Aurora Energy.²⁵ The State has identified two available options to deal with the matter:

- (1) Prevent Aurora Energy from participating in the tender process. The State has indicated in the TAR that it does not intend to adopt this approach.
- (2) Implement procedures that effectively mitigate the possibility of any actual or perceived conflict influencing the tender process.

The TAR at clause 11.2 details several measures, which the State believes adequately address the issue.

²⁵ Clause 11.1 of the TAR.

The measures to be implemented by the State include the following:

- (a) the establishment of a Gas Steering Committee that will run the tender process and conduct the evaluation of the bid submissions. Members of the Gas Steering Committee will be specifically instructed by the State not to discuss the evaluation process or outcome with any Minister, other than communicating the Committee's recommendation of the successful bidder;
- (b) the detailed tender process itself, described in the TAR;
- (c) the engagement of an independent probity auditor to oversee and advise on all probity issues relating to the tender process;
- (d) Cabinet will make the ultimate decision on a successful bidder on the recommendation of the Gas Steering Committee;
- (e) the Shareholder Ministers of Aurora Energy²⁶ will not have any direct involvement in any bid by the company;
- (f) a letter has been written to Aurora Energy by the shareholder Ministers of the State²⁷ confirming the following:
 - a decision by Aurora as to whether or not it should participate is a matter for the Aurora Energy board;
 - the State's expectation that any bid by Aurora Energy would only be on the basis that it will not participate in the distribution of natural gas to the extent that its interest would involve it having operational or financial control; and
 - the State will not provide any funding support to Aurora in relation to participation in the tender process; and
- (g) public sector employees involved in the tender process, (including all members of the Gas Steering Committee) and advisers (including KPMG, KPMG Corporate Finance Pty Ltd and Mallesons Stephen Jacques) have been required to execute a conflict of interest declaration in a form approved by the Probity Auditor.

The State also notes that there are rigorous competitive neutrality provisions applicable to Aurora Energy, consistent with the requirements of National Competition Policy, which ensure that Aurora Energy does not derive any competitive advantage from the fact of Government ownership.

At the conclusion of the evaluation process, the Gas Steering Committee will make a recommendation to Cabinet who will then make the ultimate decision, but that decision

²⁶ The Shareholder Ministers of Aurora Energy are the Treasurer and the Minister for Infrastructure Energy and Resources.

²⁷ Copy will be made available to bidders with the Project Brief.

cannot overturn the recommendation of the Steering Committee. If for some reason Cabinet were to prefer a bidder other than that recommended by the Steering Committee, it would not be within the context of the tender process.

It is also noted that at the FAR stage of the tender process, the Regulator must be satisfied that the tender process was conducted in accordance with these procedures and rules.

Because of these measures, the State believes that it does not have, or appear to have, a conflict of interest in conducting the tender process.

4.3 Consideration of Issues Raised

Assessment of the role of Aurora Energy and conflicts

The TAR has the support of the TCCI and Duke Energy in respect of this matter. These are both well informed and resourced parties who have a direct interest (TCCI through its members) in a successful competitive tender process delivering an outcome consistent with the Code principles.

It would be contrary to the interests of Duke Energy and TCCI members if the evaluation and selection process was on any basis other than one which would deliver the lowest sustainable tariffs to users generally over the life of the proposed pipeline.

An actual conflict of interest would compromise this outcome, as would an apparent conflict which would be likely to diminish the competitive vigour of the tender process. Both TCCI and Duke Energy state that they do not wish to see any bidder excluded; TCCI specifically referring to the exclusion of Aurora Energy. Given the very direct interest of these parties the Regulator is inclined to give considerable weight to their submissions in this matter.

ABM has a similar interest to TCCI members and the Tasmanian community generally in the integrity of the tender process and the evaluation and selection being in accordance with Code principles. While ABM has raised the issue of conflicts they have not made out a specific case as to why the procedures outlined in the TAR to mitigate the risk might be inadequate.

The submission from Mr Ian Martin raises the underlying issues which the State has sought to address in the design of the TAR. It is noted that the submission from Mr Martin was received prior to the TAR becoming publicly available.

The United Energy submission does not take direct issue with the mitigation procedures put forward by the State. Rather it raises a concern that these may already have failed. If that were the case it would be a matter of serious concern to all interested parties, including the Regulator.

The State has responded to the effect 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 the retail aspects of any potential bidding consortium.

The conclusion to be drawn is that whatever may have been stated by Macquarie Research Equities,²⁸ the actual structure of any bid by the Aurora/Agility consortium is yet to be seen and will be assessed at that time for compliance with the directions of the Shareholder Ministers. The Regulator will have access to the detail if required in the FAR stage of the tender. The bidders will be provided with a copy of the confidential letter from the Shareholder Ministers to Aurora Energy with the Project Brief.

Telecommunications

The State also seeks to utilise the opportunity offered by the gas distribution rollout to facilitate the simultaneous installation of broadband telecommunications infrastructure in Tasmania.²⁹

A perceived or actual conflict of interest may arise out of the State showing bias in favour of a bidder who is better able to facilitate the rollout of broadband telecommunications infrastructure rather than the bidder who is best able to achieve the objectives of the Code (in particular the objectives of clause 8.1). Apart from any potential conflict of interest, this would have the potential to distort the evaluation and selection process such that the achievement of the best sustainable reference tariffs was compromised.

To mitigate the possibility of this bias, clause 3.7 of the TAR states that the Project Brief³⁰, will invite bidders to develop a Telecommunications Proposal. A summary of the Telecommunications Proposal is to be lodged concurrently with the Bid Submission, but separately and independently of the Bid Submission. The

²⁸ Macquarie Research Equities, Tasmanian gas – cost versus competition, Friday 31 August 2001.

²⁹ Clause 3.7 of the TAR.

³⁰ The Project brief is to be released to qualified Bidders after they sign a Participation Deed. Refer to clause 6.6 (b) of the TAR.

Telecommunications Proposal Summaries will not be reviewed until after the successful bidder has been selected. The State will not be aware during the tender process as to whether or not a bidder has lodged a Telecommunications Proposal Summary.

The State believes that this measure will negate the possibility of any perceived or actual bias arising out of the State's want to facilitate the simultaneous installation of broadband telecommunications infrastructure.

An article appeared in the Mercury (Tasmania) newspaper on Thursday 27 September 2001, which caused concern at the State's commitment to the tender process as outlined in the TAR, especially in respect of the telecommunications roll-out. The article said:

“Although no company has confirmed it will install the cable, the Government has announced it will treat favourably any gas-reticulation tender proposal that includes optic fibre in the same trench”.

The Chair of the Gas Steering Committee has written to potential bidders who had been invited to register an Expression of Interest, clarifying that the article misrepresented the State's position. The Chair has confirmed that the selection process for the gas distribution and retailing will be conducted in accordance with the TAR.

The Regulator has made enquiry in this matter and is satisfied that there was no announcement on the record to such effect.

Conclusion

Having regard to the mitigation measures which have been put in place in respect of the possible participation of Aurora in the bid process, the structure of the evaluation process, the role and responsibilities of the Gas Steering Committee, and the requirement that Cabinet act on the recommendation of the Gas Steering Committee, there is at this time no reason to conclude that the State has a conflict of interest in the tender process as put forward.

The telecommunications process is sufficiently separated from the gas tender evaluation process to be satisfied at this time that it will not affect the decision making process outlined in the TAR.

In forming this view the Regulator has had regard to the submissions made by various parties and the opinion of the Probity Reporter in this matter.

4.4 Decision

The Regulator is satisfied at this time that the person who submitted the TAR does not have, nor does it appear to have, a conflict of interest in conducting the tender process.

The Regulator may at any time form an opinion that the State may have, or may appear to have, a conflict of interest in conducting the tender process.

To assist in monitoring this matter the Regulator will receive regular reports on the conduct of the tender process from the Probity Reporter.

5 SECTION 3.28 (A) THE PROPOSED PIPELINE WILL BE A NEW PIPELINE

5.1 Code and Background

The Code provides at section 3.28 (a) that the proposed pipeline will be a new pipeline.

This provision reflects that fact that the setting of reference tariffs by competitive tender is a process applicable to new pipelines, not for established pipelines.

A pipeline is defined in the Code as meaning ‘*a pipe, or system of pipes, or parts of a pipe, or system of pipes, for transporting natural gas, and any tanks, reservoirs, machinery or equipment directly attached to the pipe, or system of pipes*’.³¹

The new proposed Pipeline subject to the TAR will deliver gas within the Tasmanian Gas Market, in the areas proposed by the successful bidder, but including those areas designated by the State to be within the Minimum Pipeline Route³².

5.2 Issues Raised

No submissions were received by the Regulator regarding this section.

Although Tasmania has not previously had access to reticulated natural gas, there has previously been in operation a gas distribution network in Launceston (Launceston town gas distribution network), owned by Origin Energy.

It is a mandatory requirement of the Tender Process that the successful bidder enter into an agreement to purchase the Launceston town gas distribution network from Origin Energy at a fair and reasonable price to be determined by an independent valuer.

The Regulator must, in considering whether or not it is satisfied that the TAR satisfies the Code requirements, consider whether the existence of the Launceston town gas distribution network affects the classification as a ‘new pipeline’ the proposed pipeline which is the subject of the TAR.

5.3 Consideration of Issues Raised

The State in the TAR states that ‘Tasmania does not have a natural gas network and the development of a natural gas distribution network will require the installation of a new pipeline.’

³¹ *Gas Pipelines Access (South Australia) Act 1997*. Schedule 1, section 2. There are various exclusions which are not relevant in this matter.

³² Hobart, Launceston, Devonport, Burnie and Ulverstone.

While the Launceston network exists it has been largely disused for many years and has fallen into disrepair. It could not be utilised without substantial refurbishment and relining. Its main value would appear to be to allow relining for at least some of the proposed Launceston network under the tender, and the avoidance of trenching, reinstatement and other costs.

If the existing Launceston network could be regarded as a pipeline, which the Regulator doubts as it does not have the functional capacity to perform as a natural gas distribution pipeline, it is only a small part of the pipeline the subject of the tender. It is not the pipeline the subject of the tender and thus cannot be seen as altering the classification of the proposed pipeline as a “new pipeline”.

5.4 Decision

The Regulator is of the view that the proposed pipeline the subject of the TAR is a ‘new pipeline’ consistent with the requirements of section 3.28 (a) of the Code.

6 SECTION 3.28 (B) – PUBLIC INTEREST AND REFERENCE TARIFF OBJECTIVES

6.1 Code and Background

The Code at section 3.28 (b) provides that the Regulator must be satisfied that using the tender process as outlined in the Tender Approval Request to determine Reference Tariffs is in the public interest and is an appropriate mechanism in the circumstances for ensuring that Reference Tariffs achieve the objectives in section 8.1.³³

The Regulator is of the view that this section is to be read as one phrase and not segmented into a number of different tests. The issue becomes one of assessing whether or not it is in the public interest to use the Code tender process to determine the reference tariffs as against the alternative which is the Regulator approving an Access Arrangement. The public interest will be secured by the tender process delivering the lowest sustainable tariffs to users generally over the life of the proposed pipeline.³⁴

It is a necessary condition for the tender process to be consistent with the public interest that the successful tenderer will be selected principally on the basis that the tender will deliver the lowest sustainable tariffs to users generally over the life of the proposed pipeline. While the State is seeking to secure a number of objectives through this tender process, at end, these other objectives cannot override the principal selection criterion for the distribution tender.

The Regulator is only required to form a view as to whether the tender process proposed in the TAR satisfies the requirements of the Code. He is not obliged to recommend or propose that the State conduct a different type of tender process, which in his view may be more effective than that proposed in the TAR. Accordingly, it is not appropriate or necessary to consider whether alternative tender processes, such as those proposed in various submissions³⁵, should be preferred over that proposed by the State. Any such analysis would fall outside the Regulator's responsibilities under the Code.

³³ s8.1 is reproduced at section 4 of the TAR.

³⁴ This is subject to some balancing of the various objectives for reference tariff policy as provided for in s8.1 of the Code.

³⁵ Submissions from Metaira, ABM & David Mitchell.

6.2 Issues raised

Issues Raised by the Regulator

At the time of advising interested parties of the receipt of a conforming TAR, the Regulator provided an Issues Paper by way of introduction and background to the TAR and the Code processes. The Regulator also raised a number of possible issues in respect of which the submission was invited. Interested parties were invited to raise any other relevant issues for consideration. Some of the Issues included:

- As there are non-price based selection criteria, could these prejudice the bidder with the lowest sustainable tariff to the extent that the proposed process is no longer Code compliant?
- Will the ongoing regulatory regime be appropriate to ensure that the outcome of the tender process is maintained, in terms of efficiency of prices charged to customers and the winning distributor has the incentive to be efficient and promote and meet efficient growth in demand over the period?

Issues raised by Submissions

There were several submissions which contended for an alternative approach to the tender process proposed in the TAR.

David Mitchell Tasmania – this business is a substantial potential user of natural gas and has an acute interest in cost effective access to natural gas. The business is concerned that it is remote from the Minimum Pipeline Route and a single exclusive distribution franchise combined with the proposed contestability limit may operate to its detriment in obtaining access to gas at an early stage of the roll-out.

This submission suggests a number of alternatives or variations to the proposed tender process including inviting separate bids for smaller supply areas within Tasmania and to utilise a simpler regulatory scheme for the award of franchises similar to that adopted for the grant of mining licences. The submission also expressed concern about the contestability limit of 500 Tj.

The implicit suggestion is that this alternative better promotes the public interest and the achievement of the reference tariff principles of section 8.1.

Metaira Pty Ltd - 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 applied”³⁶. 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.

³⁶ Metaira submission, page 1.

Similarly to the submission by David Mitchell Tasmania, the suggestion is that the alternative put forward better promotes the public interest and the achievement of the reference tariff principles of section 8.1.

State's submission in the TAR

The State contends that the proposed tender process is in the public interest because it:

- is open and transparent;
- provides a clear criteria against which bids are evaluated;
- ensures that all bidders have an equal opportunity to lodge a Bid Submission;
- establishes a mechanism whereby the evaluation of bids is conducted in a fair and equitable manner; and
- is consistent with the underlying legislation.

The State also considers the possibility that section 3.28 (b) may require a proponent to establish that the use of the proposed tender to determine Reference Tariffs, as opposed to any other method of determining Reference Tariffs, is in the public interest. The Code contemplates two methods for determining Reference Tariffs: by Access Arrangement or by a competitive tender process. The State is of the view that the use of the competitive tender process outlined in the TAR is in the public interest when compared with the alternative approach of an Access Arrangement.

The State further contends that the proposed tender process will achieve the lowest sustainable tariffs, maximum economically feasible coverage, certainty arising from the Revisions Commencement Date and the benefits to State development, accordingly the tender process is in the public interest.³⁷

The State has submitted in the TAR that the reference tariffs will achieve the objectives of section 8.1 because they have been set in a competitive market.³⁸ The State has also asked bidders to demonstrate in their Bid Submission that the Reference Tariffs achieve the objectives of section 8.1.

6.3 Consideration of Issues Raised

The Regulator must be satisfied that the proposed tender process is an appropriate mechanism to ensure that the Reference Tariffs achieve the Reference Tariff objectives set out in section 8.1 of the Code. If satisfied of this then the proposed process will prima facie be consistent with the public interest.

The broad objectives of section 8.1 include:

³⁷ Clause 12.2 (c) of the TAR.

³⁸ Clause 12.3 of the TAR.

- the regulated tariffs will provide the distributor with the opportunity to recover its efficient costs over the expected life of the assets;
- the regulated tariffs should be efficient in their level and structure;
- the distributor should have an incentive to reduce its costs and develop the market; and
- the tariffs should replicate the outcome of a competitive market.

A tender process is assumed to deliver these outcomes, subject to meeting those other conditions of section 3.28 of the Code, eg the tender will elicit a number and quality of bids such that the process is competitive, there are no unreasonable conditions, or the selection will be on the basis that the bidder will be selected principally on the basis that it will deliver the lowest sustainable tariffs.

The issue not considered elsewhere is whether one would conclude that for some reason the use of competition for the right to distribute gas to set prices would not be likely to result in an outcome that emulates that of a competitive market. If that conclusion was reached then the proposal would not be in the public interest and the alternative approach of the Regulator approving an Access Arrangement having regard to the reference tariff principles would be preferred in meeting the public interest. This consideration will be in respect of initial reference tariffs as well as over the expected economic life of the pipeline.

Access Arrangement and a competitive tender

Unless the TAR procedure for determining a Reference Tariff is adopted, then pursuant to section 3.4 of the Code, the Access Arrangement must comply with the Reference Tariff Principles described in section 8 of the Code.

Under section 8 of the Code, the Reference Tariffs are to be set on the basis of the sales of all Services provided by the Covered Pipeline delivering (or being forecast to deliver) a certain amount of revenue (Total Revenue) over the period for which the Reference Tariffs remain in effect.

The Reference Tariff Principles specify three possible methodologies that can be used for determining the Total Revenue:

- (1) *Cost of Service*: where the Total Revenue is set to recover “costs” with those costs to be calculated on the basis of a return (Rate of Return) on the value of the assets that form the Covered Pipeline (Capital Base), depreciation on the Capital Base (Depreciation) and the operating, maintenance and other non-capital costs incurred in delivering all services;
- (2) *Internal Rate of Return (IRR)*: where the Total Revenue is set to provide an IRR for the Covered Pipeline on the basis of forecast costs and sales; and
- (3) *Net Present Value (NPV)*: where the Total Revenue is set to deliver a Net Present Value for the Covered Pipeline equal to zero, using an acceptable discount rate.

There are a number of problems with using this process in the context of this project. With a ‘greenfields’ project there are no direct comparisons nor past experience for the market to draw upon. There are significant risks associated with market penetration, costs of roll-out, load growth and the response of competitive energy sources. All these suggest a risk premium which a Regulator may be ill-placed to assess in the context of approving an Access Arrangement. It could be that the regulatory risk associated with such an approach would be a disincentive to participation in the market.

There is considerable merit in adopting a competitive tender process to assess these risks in the context of the market.

Another benefit of adopting a competitive tender process is that the pipeline will automatically be ‘covered’ under the Code.³⁹

Pricing

A potential detriment of the competitive tender process would be if there was any aspect of the tender which would directly impinge on the achievement of the section 8.1 code reference tariff principles.

The TAR makes it clear that that the principal criterion to be used in evaluating Bid Submissions is that subject to the Code, the successful tender should deliver the lowest sustainable distribution tariffs over the economic life of the distribution network.

The approach adopted under the TAR is to provide tenderers through a draft GPO with the following benchmark information:

- (1) a benchmark yield reflecting an average distribution tariff charged for all customers with annual gas consumption up to 30 Tj and then over 30 Tj;
- (2) a distribution yield escalation policy based on CPI-X; and
- (3) notional Benchmark Forecasts for these customer groups used by the State in deriving these yields.

Tenderers are then required to specify, as part of their Bid Submissions:

- (1) a discount (or a premium) to the Benchmark Yield for customers consuming up to 30 Tj and separately for customers consuming over 30 Tj per annum;
- (2) a set of distribution tariffs which would be included in the GPO in relation to Prescribed Distribution Services; and
- (3) for Excluded Distribution Services (ie those services the price of which the Regulator considers should be regulated because there is insufficient competition for those services) as described in the GPO, confirmation that the tenderer proposes to charge on a fair and reasonable basis as set out in the GPO.

³⁹ s3.22 of the Code.

Ultimately, under the TAR process the Reference Tariffs will be established within the above stated parameters, by the actual tenderers themselves. Hence reliance is being placed on the competitive nature of the tender process to itself drive prices down for the benefit of the ultimate consumers. While there is further consideration of the GPO in this paper, there is nothing in these GPO principles inconsistent with the achievement of the objectives of section 8.1 of the Code.

Section 8.1 of the Code lists six objectives as follows:

- (a) *providing the Service Provider with the opportunity to earn a revenue stream that recovers the efficient cost of delivering the Reference Service over the expected life of the assets used in delivering the service.*

By requiring bidders to tender a discount or premium on yields as a basis for determining tariffs, reliance will be placed on the competitive nature of the tender process to achieve yields that provide for the efficient recovery of costs.

As the successful distributor will be required to adjust its yields by CPI-X each year for the initial regulatory period, this should provide an ongoing incentive for the distributor to achieve efficiency improvement.

Finally, bidders are required to agree that the residual value of the distribution system after the expiration of the initial tariffs will be based on depreciation over its economic life.

- (b) *replicating the outcome of a competitive market*

On the assumption that the bid process will be competitive, and noting that there is already competition in the market from other power sources, the process should achieve this objective.

- (c) *ensuring the safe and reliable operation of the pipeline*

It is noted that tenderer's technical capacity will be one of the qualification criteria for short listing in the tender process. Additionally, bidders will be required to comply with the legislative and regulatory arrangements which will be included in prescribed safety and reliability requirements which the State has indicated will be established in line with industry practice interstate.

- (d) *not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries.*

Large customer yields will be cost reflective as under the tender process they will be based on a \$/Gj/km. These tariffs should accordingly drive the distributor's investment decisions in the trunk network which will have the flow on effect of influencing but not distorting upstream and downstream investment decisions.

For smaller customers, the adoption of a uniform tariff based on projected benchmark yields could potentially result in some distortion as the associated costs of providing services are not reflective of the actual cost. That being said, the State has specified a Minimum Pipeline Route that is based on its assessment of

the viability of gas reticulation in various areas. Further discussion of the implications for economic efficiency of specifying a minimum service area is contained in the consideration of section 3.28 (e).

(e) *efficiency in the level and structure of the Reference Tariff*

As reference tariffs will be established through the use of a competitive process, the tariffs themselves distinguish between larger and smaller customers; there will be a CPI-X yield adjustment, the requirements for an Additional Revenue Policy are aimed at ensuring that customers share a proportion of the benefits if the actual gas volume transported exceeds initial estimates, and noting that bidders will be required in their tenders to demonstrate that the cost allocation in their proposed tariff structure is fair and reasonable, this objective should be achieved.

(f) *providing an incentive to the Service provider to reduce costs and to develop the market for Reference and other Services.*

As Reference Tariffs will be based on revenue yields, these yields could be expected to provide an incentive for the Service provider to increase volumes through the network as it will retain a proportion of any additional revenue flows from the increased volumes subject to the Additional Revenue Policy.

Other issues raised in submissions

The submission from David Mitchell Tasmania has suggested that, for a number of reasons⁴⁰, the proposed exclusive State-wide distribution/retail franchise may have the effect of breaching all six of the State's objectives for the Gas Tender Process. As an alternative to the proposed tender process, David Mitchell Tasmania has proposed the model used by the State to issue exclusive mining rights and grant a series of exclusive rights to reticulate gas to areas nominated by the tenderers.

David Mitchell Tasmania has not, in its submission, addressed the issue as to whether the proposed tender process is in the public interest, although it has contended that it may not be in the public interest. Nevertheless, it appears that the tender process suggested by David Mitchell Tasmania may have a number of inherent disadvantages, such as:

- giving rise to the need for multiple tender processes for different areas covered by each franchise;
- in certain areas there may be no competition or indeed no tenderers;

⁴⁰ The reasons include the high retail contestability limit of 500Tj; the failure to require the exclusive franchisee to extend the distribution network beyond the Minimum Pipeline Network and preventing any other parties from doing so over the five year franchise period; a State-wide franchise leading to high prices and extensive regulation.

- “gaps” may arise in the distribution network if no interest is expressed in providing services to the area(s) concerned and hence no guarantee of a Minimum Pipeline Network;
- the process could lead to higher distribution tariffs (economies of scale in developing the distribution network by a single distributor/consortium may disappear);
- multiple tariffs across small regions;
- loss of economies of scale and scope associated with related activities, eg metering, maintenance, marketing and retailing;
- uncertainties in the prudential and technical standing of multiple bidders;
- the necessity for a more complex regulatory scheme;
- more risk for customers;
- more risk for the State; and
- more risk for the developer of the transmission pipeline.

Conclusion

The Regulator is satisfied that:

- The successful tender will be selected principally on the basis that the tender will deliver the lowest sustainable tariffs (including but not limited to Reference Tariffs) to users generally over the economic life of the proposed pipeline.⁴¹
- The GPO and other aspects of the proposed regulatory regime are consistent with the achievement of the objectives of section 8.1 of the Code.
- There have been no other matters raised which persuade the Regulator that determining reference tariffs using the tender process outlined in the TAR is not in the public interest.

6.4 Decision

The Regulator is satisfied that using the tender process as outlined in the TAR to determine the reference tariffs is in the public interest and is an appropriate mechanism in the circumstances for ensuring that the reference tariffs achieve the objectives of section 8.1 of the Code.

⁴¹ Note that this matter is expressly considered under s3.28 (f) (i).

7 SECTION 3.28 (C) – THE TENDER PROCESS WILL BE COMPETITIVE

7.1 Code and Background

The Code at section 3.28 (c) provides that the Regulator must be satisfied that the tender process outlined in the TAR will attract tenders of a sufficient number and character to ensure a competitive outcome.

The expected benefit of using a competitive tendering process depends on whether there is likely to be effective competition for the right to the distribution franchise.

In considering approval of the TAR, the Regulator has considered whether the measures proposed by the State are likely to deliver the necessary level of competition. The relevant market is for the franchise on offer.

The Regulator has invited public submissions on the adequacy of the measures proposed to promote competition for the distribution rights.

Applicant's Submission

The State has addressed this matter in the TAR and has made the following claims in respect of the likelihood of a competitive outcome:

- the TAR has been developed having regard to market testing that indicates there is a number of potential developers interested in participating in the tender process to develop a natural gas distribution and retail network in Tasmania;
- the tender process has been developed to address key requirements flagged by potential developers, which included a reasonable exclusive franchise period and a high degree of regulatory certainty;⁴²
- the design of the tender process and the proposed industry structure and regulatory framework was developed after extensive market research and discussion with prospective bidders;
- the State proposes national and limited international promotion of the franchise opportunity;
- bidders will be provided with a folio of information (the Project Brief) regarding the market, estimated costs of supply, and the State's view of the economics of the project. This folio should provide sufficient objective information which, while not being able to be solely relied on by the bidders, should reduce the costs and time for data acquisition by potential bidders;

⁴² Clause 12.4 of the TAR.

- actual or perceived conflicts of interest are comprehensively addressed through the design of the tender process; and
- the detailed rules and procedures have been designed to ensure that all bids are treated fairly. These rules include:
 - the documentation of the selection criteria and evaluation methodology, the adoption of detailed probity rules, and the oversight of the tender process by the Probity Auditor;
 - confirmation that Aurora is subject to the range of taxes and charges imposed on the private sector to ensure that there is no comparative financial advantage enjoyed as a result of its Government ownership; and
 - requiring interested parties to sign “no collusion” clauses in the participation Agreement.⁴³

7.2 Issues Raised

Issues raised by the Regulator

At the time of advising interested parties of the receipt of a conforming TAR, the Regulator provided an Issues Paper by way of introduction and background to the TAR and the Code processes. The Regulator also raised a number of possible issues in respect of which the submission was invited. Interested parties were invited to raise any other relevant issues for consideration. Some of the key issues raised in the Issues Paper are:

- *Market testing* - how was the market testing conducted and have the key requirements of potential developers been adequately addressed; and
- *Stapled bid* – it is a Mandatory Requirement that bidders lodge stapled distribution and retail bids. The State submits that the requirement for stapled bids was in response to requests from the majority of potential bidders approached during market testing.

The State will not consider a Bid Submission for distribution or retail alone and will not seek to “mix and match” the distribution or retail component of one Bid Submission with another Bid Submission.⁴⁴

The Regulator should consider whether the Mandatory Requirement of stapled bids will limit the number and character of tenders likely to be received.

- *Telecommunications* - the Issues Paper noted that the Regulator should consider the effect of the State’s desire to have telecommunications broadband

⁴³ s3.4 of the Issues Paper, page 25.

⁴⁴ Clause 6.3 of the Tender Guidelines.

infrastructure rolled out simultaneously with the development of the gas distribution network.

Issues arising from submissions

The Aurora/Agility consortium (Aurora/Agility) expressed concern that the successful bidder is required to enter into an agreement to buy the Launceston town gas distribution system.

It suggests that to ensure that the tariffs proposed by bidders are achievable and sustainable, all bidders should be required to provide evidence of executable/enforceable arrangements for the construction of the network. This may raise a barrier to participation and the proposal is more directed to providing a surety to the State that the bidder can deliver.

The consortium has raised a concern regarding the promotional material that has been provided to potential bidders. In particular, the consortium is concerned that the estimates of capital costs may have a significant, misleading influence on uninformed bidders. The consortium suggests that to ensure that the tariffs proposed by bidders are achievable and sustainable, all bidders should be required to provide evidence of executable/enforceable arrangements for the construction of the network.

It is also submitted that bidders should not have to meet all of the Mandatory Requirements. Further, the Consortium has argued that a potential bidder who considers a non-conforming bid as the only commercially viable option may be discouraged from bidding given the significant expense and resource commitment required and the State has no obligation to consider the bid⁴⁵.

Australian Bulk Minerals and David Mitchell Tasmania both expressed concern that the mandatory requirement that bidders construct a network along the Minimum Pipeline Route will affect the competitive outcome of the tender process because:

- (a) customers remote from the Minimum Pipeline Route are not able to make their own arrangements to access the network; and
- (b) any arrangements that were to be negotiated would be subject to cross-subsidisation.

ABM believes that a more competitive process would be to invite separate bids of supply areas nominated by the bidder, similar to the process used by the Department of Energy and Resources to grant exclusive mining rights. ABM has also submitted that the single exclusive State-wide franchise prevents local operations such as Water Boards or Local Government from bidding for areas nominated by them.

ABM asserts that contrary to promoting the objective of competition in the tender process, the proposed process in fact limits competition because few national companies would be able to meet all requirements.

⁴⁵ Public Submission by Aurora at s3.8, page 20.

ABM also submitted that the requirement for stapled bids restricts competition because it precludes local entities from bidding.

ABM is also concerned that the franchise fee of \$2.5 million is excessive and may deter bidders.

Duke Energy raised a concern that the fees and terms of the Distribution and Retail Development Agreements may have a material and adverse impact on the decision of potential bidders to participate in the tender process.

Duke Energy requests that the Regulator consider whether the fees and Development Agreements are consistent with historical industry practice in the context of greenfield gas markets.

Metaira questions whether the competitive nature of the tender process is reduced because the tender process is highly complex and inappropriate to the circumstances of this market development project.

Does the fact that the tender process excludes from bidding Tasmanian entities who do not have the resources to provide State-wide operation, such as Local Governments, Water Boards and other providers of local retail services, affect the competitiveness of the process?

Metaira suggests that bidders be allowed to sub-contract some of the mandatory requirements, particularly the provision of experience in establishing and operating an energy retail business.

TCCI has submitted it is satisfied that the defined TAR and guidelines will ensure as many companies as possible bid for the distribution and retail franchise.

TCCI has also submitted it is supportive of the stapled bid concept.

Test Energy is concerned that the dispute mechanisms provided for in section 49 of the *Gas Act* are inadequate and provide the distributor and retailer with considerable power such that they may inflict uncompetitive gas tariffs and contract conditions.

Further Test Energy has submitted that section 31 of the *Gas Act* is inadequate in ensuring that gas is supplied to customers on commercially reasonable terms under a monopoly franchise.

Test Energy also submits that the legislation does not promote competitive pricing between alternative sources of fuel.

United Energy has raised a concern that the electricity hot water tariff could be used to disadvantage gas sales, if the hot water tariff does not cover its direct and indirect costs. This is a matter for the Energy Regulator in approving electricity tariffs. It would be inappropriate for there to be significant market distortion arising from regulated electricity tariffs. Nevertheless, this is a matter of due diligence for the bidders and any effect on the competitiveness of the bids received does not arise from the bid process as provided for in the TAR.

Competition

Before turning to the analysis of the issues raised it is appropriate to outline the approach the Regulator has taken to competition in this matter.

The test to be applied is whether the tender process is likely to produce the number and character of tenders likely to ensure a competitive outcome. The test is not to ensure the most competitive outcome, merely that it will be a competitive outcome. It is not for the Regulator to put forward an alternative to the tender process outlined in the TAR. His responsibility is to either accept or reject the proposed tender process in accordance with the provisions of the Code.

In considering the issues, the Regulator must place considerable weight on the views of the market. This is an investment opportunity which the market is uniquely placed to consider as compared with any other commentator. There is very little precedent for a franchise offering of this nature in Australia and the detail of the possible costs and risks of network development are best assessed by a business already engaged in this activity.

The State maintains that it has conducted extensive market testing and the tender process outlined in the TAR has regard to the wishes of the market as well as the State's objectives in conducting the tender. It has chosen to offer the stapled exclusive franchise for distribution and retail having regard to these matters. The Regulator will reasonably and appropriately have regard to the fact that no potential bidder has raised any doubts as to the market testing or the appropriateness of the underlying structure of a stapled bid for the distribution and retail franchise.

The nature of the market and the offering is such that one would not expect to receive a large number of bids. The range of potential bidders with the financial, human and technical expertise will be limited, but the tender must be likely to produce bids of a number and character as is likely to ensure a competitive outcome.

The essential element is whether the tender raises such barriers to participation as might exclude potential bidders. In the alternative, where there are acknowledged barriers to entry, does the tender process seek to reduce these in a manner which will facilitate bidder participation.

These barriers could include:

- cost of information acquisition;
- non-gas related requirements, eg telecommunications;
- failure to recognise the functional levels of the market such that the bidder was required to undertake functions additional to its principal business, eg a distributor being required to undertake retailing;
- costs imposed – the bidder is taxed or otherwise has costs imposed upon it which are unrecoverable or which, if recoverable, reduce the attractiveness of the offer by reducing the potential margin or revenue stream;

- regulatory uncertainty;
- conflicts of interest in the persons offering the franchise;
- a franchise, either in terms of time, customer class, capital requirements for roll-out inconsistent with reasonable load projections, or otherwise; which introduces an unreasonably high level of risk; and
- other unreasonable conditions – unreasonable in this context will mean such conditions as are likely to reduce the competitiveness of bidding for the offering. Thus, a condition may have a marginal effect on competitiveness but will not of itself be excluded as it may reflect a policy preference in the design of the bid for a balancing of those elements of section 8.1 of the Code.⁴⁶

It could be possible that the offering is of such a marginal nature that it would never have attracted competitive bids because of high costs, low potential margins or it is below minimum efficient scale and is faced by an efficient competitor in the energy sector. While the Aurora/Agility submission hints at such a possibility, this suggestion is outweighed by the fact that it states that it is likely to be a bidder.

The Regulator is not required to consider whether or not the design of the offering is the best available, rather whether the offering is such that it is likely to elicit bids of a character and number such as is likely to provide a competitive outcome. The actual outcome will be assessed at the FAR stage against the matters provided for in section 8 of the Code.

7.3 Consideration of issues raised

In relation to market testing, the Regulator raised the issue of market testing, how it was conducted and whether the key requirements of potential developers have been adequately addressed?

The Regulator has been provided with certain information in confidence as to the market testing conducted by the State. Nevertheless, the real test of whether or not the tender has been designed in such a way as to be acceptable to the market will be discovered through submissions received from potential bidders or their advisers and ultimately through the bids received.

It is the Regulator's assessment of the submissions received that potential bidders do not take issue with the general approach and design of the tender as proposed. They do raise some issues of detail and some issues of significance, but they tend to be in isolation rather than undermining the general design of the tender.

Various parties, eg ABM, Metaira and David Mitchell Tasmania would prefer a quite different competitive model based around a much more fragmented offering with

⁴⁶ The Code provides that the Regulator may determine the manner in which any conflicts in these objectives can best be reconciled. In doing so the Regulator would have regard, inter alia, to the objectives of the State in conducting the tender.

different parameters in respect of contestability limits and other aspects of the tender. These do not go to the matter of whether or not this offering of itself is likely to attract a number and character of bids such as would ensure a competitive outcome. That another model may attract more bidders for smaller franchises is not the point.

There is nothing in the submissions from any party such as would lead the Regulator to conclude that the proposed tender has not been designed having regard to the needs of the market. This is likely to reflect the extensive market testing claimed for it by the State.

This is not to say that it meets the needs of the market in every particular. It is in the nature of such things that different potential bidders will have different needs and preferences. Nevertheless, on balance there seems to be general acceptance from potential bidders of the offering.

Stapled bid – it is a Mandatory Requirement that bidders lodge stapled distribution and retail bids. The State submits that the requirement for stapled bids was in response to requests from the majority of potential bidders approached during market testing.

The State will not consider a Bid Submission for distribution or retail alone and will not seek to “mix and match” the distribution or retail component of one Bid Submission with another Bid Submission.⁴⁷

For the reasons outlined previously in respect of market testing, the reasonable conclusion is that the stapled bid approach is consistent with the needs of the market, as asserted by the State.

The Regulator should guard against the possibility that the silence of parties who may have preferred to bid for either the retail or distribution franchise is taken as endorsement. Nevertheless, there does appear to be a reasonable opportunity for such a party to participate in the bid process through seeking a partner in some form or another.

The principal concern of the Regulator in respect of a stapled bid would be that non-distribution considerations may distort the evaluation process such that the clear objective of the Code, that the successful tenderer will be selected principally on the basis that the tender will deliver the lowest sustainable tariffs to users generally over the life of the proposed pipeline, was compromised. The Regulator has satisfied himself that the design of the tender process is such that this objective will be met. This is subject to ongoing probity review and the FAR process.

Telecommunications – the role of telecommunications in the tender process has been considered in respect of potential conflicts of interest. The conclusion reached was that the structure of the tender was such that telecommunications would not influence the evaluation and recommendation of the Gas Steering Committee.

⁴⁷ Clause 6.3 of the Tender Guidelines.

A bidder with an established telecommunications business or relationship may be well placed to factor this into its bid in terms of the yields it proposes or otherwise. This is part of the ordinary competitive process where each party will make out its business case based on its own strengths and weaknesses. The requirement to purchase the Launceston network could marginally affect the efficiencies of a combined telecommunications/gas network roll-out for a bidder as the benefit of the Launceston network is in large part the potential to avoid trenching and its associated costs. Trenching will on the face of it be a necessary aspect of the telecommunications roll-out. Nevertheless, the Regulator does not have such information as would allow him to conclude that this would be significant in terms of the competitiveness of the tender process.

The Aurora/Agility consortium raised a number of issues which need to be specifically addressed:

- It is concerned that the successful bidder is required to enter into an agreement to buy the Launceston town gas distribution system. This is a mandatory requirement as is considered in the discussion on section 3.28 (e) ; and
- It suggests that to ensure that the tariffs proposed by bidders are achievable and sustainable, all bidders should be required to provide evidence of executable/enforceable arrangements for the construction of the network.

This may raise a barrier to participation, it is more directed to providing a surety to the State that the bidder can deliver.

The consortium has raised a concern regarding the promotional material that has been provided to potential bidders. In particular, the consortium is concerned that the estimates of capital costs may have a significant, misleading influence on uninformed bidders.

- The consortium suggests that to ensure that the tariffs proposed by bidders are achievable and sustainable, all bidders should be required to provide evidence of executable/enforceable arrangements for the construction of the network.
- It would be inappropriate to make this a mandatory requirement of the tender as it would presume the very extensive preliminary work that the consortium asserts that it has undertaken. Rather this would appear to be appropriately addressed through the assessment of the bidder's financial and technical resources and the negotiation of the Development Agreements between the bidders and the State.
- It is also submitted that bidders should not have to meet all of the Mandatory Requirements. Further, the Consortium has argued that a potential bidder who considers a non-conforming bid as the only commercially viable option may be discouraged from bidding given the significant expense and resource commitment required and the State has no obligation to consider the bid⁴⁸.

⁴⁸ Aurora/Agility submission at s3.8, page 20.

- The Tender Guidelines encourage bidders to lodge at least one conforming Bid Submission and if they think it is desirable, they may lodge one or more non-conforming Bid Submissions⁴⁹. Any non-conforming Bid Submission may be excluded or considered by the State at the State's discretion⁵⁰. Nevertheless the State does not have entirely unfettered discretion. It has stated the objectives it wishes to meet through the tender process and to arbitrarily disregard these in respect of one bidder while applying them in respect of another would not meet the standard of procedural fairness which it has established in its Probity Guideline.

Franchise fees – both ABM and Duke Energy have expressed concern that the franchise fee of \$2.5 million is excessive and may deter bidders.

The State has responded to these concerns in the following terms:

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 the 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 Development Agreements represents an appropriately balanced and attractive basis for bidders.

In the absence of a submission as to why the fee structured in this matter is inappropriate, the Regulator accepts the position of the State in this matter.

Metaira has raised a number of issues which merit specific consideration.

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 applied”⁵¹. This assumption then frames the conclusions made by Metaira in relation to adverse

⁴⁹ Clause 7 of the Tender Guidelines.

⁵⁰ Clause 5.4 (b) of the Tender Guidelines.

⁵¹ Metaira Submission, page 1.

outcomes on tariffs, coverage, ongoing costs and the size of the prospective bidder pool.

For the tender process, in any form to proceed, there needs to be an established legal and regulatory framework, and ideally one with which potential bidders have some familiarity. The State has 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 has a number of benefits:

- 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. As an example, the public consultation process, of which this report is a part, is an outcome of the Code process.
- 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 GPO 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 degree of certainty will enhance bidder confidence and increase the likelihood of bidder participation.
- The use of the Code process combined with the grant of franchises for the entire State of Tasmania allows issues of market scale to be overcome by potential bidders. This, combined with the certainty provided by a Code process, may increase the likelihood of attracting sufficient bidders for a competitive process.

Metaira raises various other issues:

- excessive costs to the operators, leading to higher tariffs;
- limited reticulation beyond the Minimum Pipeline Route;
- limited numbers of bids being received;
- imposition of the State's Franchise Fees;
- exclusion of smaller entities;
- transition to contestability;
- construction timetables for the Proposed Areas; and
- expansions of areas beyond the Minimum Pipeline Route and/or the Proposed areas.

Generally speaking these matters go to tender design and a preference for another model. To the extent that they go to the likelihood or otherwise of the proposed tender

attracting bids of a character and number to ensure a competitive outcome, these matters have been addressed.

As previously noted, the test to be applied is whether the tender process is likely to produce bids of a number and character of tenders likely to ensure a competitive outcome. The test is not to ensure the most competitive outcome, merely that it will be a competitive outcome. It is not for the Regulator to put forward an alternative to the tender process outlined in the TAR. His responsibility is to either accept or reject the proposed tender process in accordance with the provisions of the Code.

It is certainly the case that where the matters raised do not go to the likelihood of a competitive outcome in terms of the tender process (although this may be distinct from the final market outcome), eg expansions beyond the Minimum Pipeline Route, the Regulator has no role in such matters in the context of this assessment. To the extent that the issues raised may reflect an opportunity, the bidder may include them in the proposal.

Conclusion

Having regard to the duty of the Regulator in this matter which is confined to assessment of the proposal put forward, not the design of an alternative scheme, the conclusion to be drawn is that the tender as proposed is likely to attract tenders of a character and number such as to ensure a competitive outcome.

7.4 Decision

The Regulator is satisfied that the TAR as submitted complies with the requirements of section 3.28 (c) of the Code.

8 SECTION 3.28 (D) – EXCLUSION OF CERTAIN TENDERS

8.1 Code and Background

Section 3.28 (d) of the Code provides that the Regulator must be satisfied that the proposed procedures and rules to be followed in conducting the proposed tender will result in a tender being excluded from consideration if it:

- (1) does not include a statement of the Reference Tariffs the tenderer proposes and the Reference Services to which those Reference Tariffs would apply;*
- (2) does not include a policy on whether the additional revenue which would result if the volume of gas actually transported by the proposed Pipeline exceeds a certain volume will either be retained by the Service Provider or returned in whole or in part to Users in the form of lower charges or some other form (an Additional Revenue Policy);*
- (3) does not provide that the residual value of the proposed Pipeline after the expiration of the initial Reference Tariff will be based on depreciation over the Pipeline's economic life;*
- (4) limits or purports to limit the Services to which access might be sought under this Code; or*
- (5) otherwise includes elements inconsistent with this Code except as contemplated by section 3.34.*

This provision prescribes a set of minimum conditions which a tender must meet for inclusion in the tender process. If it does not meet these standards then the bid will be excluded from consideration. In essence these are the minimum conditions which are necessary for the achievement of the objectives of section 8.1 of the Code.

8.2 Issues Raised

The Regulator raised the following matters for consideration:

Do the processes and procedures of the proposed tender process adequately allow for the exclusion from consideration of bids that do not comply with the requirements of section 3.28 (d) of the Code.

State submission

The exclusion requirements of section 3.28 (d) of the Code are repeated in clause 8.2 of the TAR. The State therefore submits that as a consequence, the proposed procedures and rules of the tender process comply with section 3.28 (d) of the Code.

8.3 Consideration of Issues Raised

The TAR indicates that the following will be mandatory selection criteria:

Each Bid Submission must contain:

- the Bidder's bona fide estimate of the opening distribution Reference Tariffs and retail tariffs that correspond to its proposed yields;
- confirmation of the Distribution Reference Services to which the Distribution Reference Tariffs apply;
- a demonstration that the cost allocation in the proposed distribution tariff structure is fair and reasonable;
- a demonstration that its proposed Reference Tariffs achieve the objectives set out in section 8.1 of the Code;
- uniform retail tariffs for each customer class (by volume) below 30 Tj (see section 3.28 (d) (I) of the Code);
- an Additional Revenue Policy setting out the extent to which additional revenue resulting from higher than expected gas volumes will be shared with users (see section 3.28 (d) (ii) of the Code);
- acknowledgement by the Bidder that the residual value of the distribution system after the expiration of the initial tariffs will be based on depreciation over the system's economic life. Benchmark residual values are set out in the GPO. However, bidders may propose an alternative suite of residual value principles consistent with the above acknowledgement (see section 3.28 (d) (iii) of the Code; and
- confirmation from the Bidder that it will not limit the services to which access might be sought under the Code (see section 3.28 (d) (iv) of the Code).

If the Bid Submission otherwise contains elements which are inconsistent with the Code then the State has advised in the TAR that it will be excluded from consideration by the State. Monitoring of this process by the Regulator and the Probity Reporter will be important when it comes to the Regulator's assessment of compliance by the State with the application of this and the abovementioned criteria.

By adopting the above as mandatory criteria the requirements of section 3.28 (d) of the Code are satisfied.

Conclusion

In relation to section 3.28 (d), the Regulator's more significant concern will be an assurance of the exclusion of a bid from consideration if it does not comply with the requirements of this section. As part of the FAR process the Regulator must be

satisfied that the tender process has been conducted in accordance with the procedures and rules proposed in the TAR.⁵²

The Regulator will rely on reports received from the Probity Reporter on compliance with the approved tender process to determine whether bids that did not conform with the requirements of section 3.28 (d) were excluded from consideration.

8.4 Decision

The Regulator is satisfied that the TAR complies with the requirements of clause 3.28 (d) of the Code.

⁵² s3.33 (b) of the Code

9 SECTION 3.28 (E) – ARE EXCLUSIONS REASONABLE?

9.1 Code and Background

Section 3.28 (e) of the Code requires the Regulator to be satisfied that the proposed procedures and rules to be followed in conducting the proposed tender will result in no tender being excluded from consideration except where the tender fails to meet the minimum requirements of section 3.28 (d), or does not conform to other reasonable requirements, (with request for Tenders) or does not meet reasonable prudential and technical requirements.

In considering whether the rules and procedures that may lead to the exclusion of a tender are reasonable, the Regulator has taken account of the following factors:

- that the exclusion should on balance have the effect of improving the competitiveness or efficiency of the tender process;
- that the possible exclusion will not lead to outcomes that are inconsistent with the reference tariff objectives of section 8.1; and
- that the test is not whether there is in the view of the Regulator or others a superior way in which the Code objectives and the State's objectives of the tender process may be achieved, but that the rule that may give rise to the exclusion is, in the circumstances, reasonable.

The requirements of section 3.28 (d) have previously been discussed. To ensure that the State's policy objectives⁵³ are met, the State has imposed additional requirements to those specified in section 3.28(d).

The State has proposed two levels of requirements for consideration of bids, the 'mandatory' and 'conformity' requirements. Those bids that do not meet the mandatory requirements described in clause 8.2 of the TAR (and those which do not meet the minimum requirements of section 3.28 (d)) will not be considered.

The conformity requirements⁵⁴ require that all bids that satisfy the requirements for 'conforming' bids will be considered, and 'non-conforming' bids may, but will not necessarily, be considered. Bidders are encouraged to lodge at least one conforming bid and, if they think it is desirable, they may lodge one or more non-conforming Bid Submissions.

⁵³ Clause 2.2 of the TAR.

⁵⁴ Clause 8.3 of the TAR.

The Regulator is required to consider whether the proposed tender rules are such that no tender would be excluded from consideration unless it does not ‘conform to other reasonable requirements’. These include, in the terms of the TAR, both the mandatory requirements and other conformity requirements. Additional mandatory requirements require the successful bidder to:

- submit a tender for both the distribution and retail franchise, but with separate entities as bid vehicles for the distribution and retail component of the Bid;
- pay a franchise fee;
- make an irrevocable offer to purchase the Launceston town gas distribution system;
- introduce uniform retail tariffs within the proposed supply area; and
- enter into certain agreements to undertake the development (eg the Duke connection and transmission agreements and that it have a gas supply agreement).

The State has also designed conformity requirements⁵⁵ including:

- acceptance of a defined regulatory regime (the GPO);
- a coverage in excess of the minimum pipeline route; and
- evidence of ability to undertake the project (including funding).

It is noted that an implication of a number of the conformity and mandatory requirements, and of the process adopted by the State, is that one retail and one distribution franchise will be issued for all of Tasmania, rather than multiple franchises.

The proposals in relation to the more important of these mandatory or conformity requirements are discussed in turn.

Stapled Retail/Distribution Bids

A significant mandatory requirement is that bidders lodge stapled bids for the distribution and retail franchise. The State will not consider Bid Submissions for distribution or retail alone and will not seek to “mix and match” the distribution or retail component of one Bid Submission with another.

The State contends that the tender design requiring stapled bids was sought by the majority of potential bidders with whom the proposed tender was discussed. The State has disclosed that some potential bidders were concerned about the possibility of mixing and matching. The TAR suggests that if bidders were forced to accept the possibility of being matched with another bidder, then it is likely that bidders would include an additional risk premium in the proposed tariffs.

⁵⁵ Clause 2.2 of the TAR.

The State submits in clause 12.6 of the TAR that the requirement of stapled bids is reasonable. The State has not however considered in the TAR the alternative industry structure whereby there is no retail franchise or a reduced retail franchise or a longer retail franchise. Market design is a relevant consideration for the Regulator since the selection of an inappropriate design may result in a less competitive outcome if prospective bidders choose not to participate, or participate but seek higher prices because of additional risk.

No submissions raised this matter, though reasons for the approach taken by the State have been discussed with the State's representatives and advisers. The Regulator has been advised that because of the 'volume deal' being proposed, in that the returns to the distributor are directly dependent on the volumes of gas sold through the network, there is a preference by bidders for a relationship with a franchised retailer. The Regulator accepts this view and recognises that, given the rate of take-up expected in a greenfields environment as illustrated by the State's demand forecast, prospective distributors would not wish to take the risk of a lack of interest or lack of incentive for aggressive retail activity. The reasons for the preference of prospective distributors for a stapled bid approach are similar to their preference for a franchise retailer rather than for retail competition.

Franchise Fees

A bidder must also agree to pay a distribution franchise fee⁵⁶ and retail franchise fee⁵⁷ upon signing the Development Agreements with the State. These fees have been proposed to recover part of the State's costs of running the competitive tender.

Launceston Network

A further Mandatory Requirement is that as part of each Bid Submission, a bidder is required to make an irrevocable offer to enter into an agreement to purchase the Launceston town gas distribution system 'at a fair and reasonable price determined by an independent valuer'. This mandatory requirement is intended to put other bidders on a more even footing with Origin Energy, which currently owns the Launceston town gas distribution system.⁵⁸

Uniform Retail Tariffs

It is a mandatory requirement that there be uniform retail tariffs across the bidder's proposed service area for customers that have the same demand and load characteristic and consume less than 30 Tj per annum.

⁵⁶ Of \$2.0m.

⁵⁷ Of \$0.5m.

⁵⁸ Origin owns the rights to a gas distribution network in parts of Launceston. The network has been decommissioned, but has the potential to be refurbished for the reticulation of natural gas.

(GPO - the Future Regulatory Regime)

The State has proposed prescribing many of the elements of the regulatory regime that is to apply to the successful retailer and distributor in a GPO.⁵⁹ The GPO will set out the detail of the regulatory control over distribution prices to be charged by the successful bidder until its prices are reviewed at a future date. It will also detail the regulatory control over the final retail prices that the successful bidder may charge for the duration of the retail franchise⁶⁰.

For the gas distributor, the State has proposed to use a ‘revenue yield’ form of control. The main features of this control are:

- It regulates the average revenue (expressed in \$ per Gj or \$ per Gj per km) that the distributor is permitted to earn from its sale of transportation services. That is, if gas volumes carried by the distributor are greater than those set out in the State’s forecasts, the distributor will be permitted to earn additional revenue, equal to the yield multiplied by the additional sales. (The extent to which revenues arising from additional sales are retained by the distributor or shared with customers is the subject of the Additional Revenue Policy which Bidders are invited to propose). The GPO proposes that there will be no sharing of the risks that volumes are less than forecast in any year. The GPO will contain a separate yield for large and small customers. The starting value for the allowed average revenue (or yield) will be determined by the winning distributor’s bid. This starting value will then be varied over time to take account of inflation (CPI) and a trend factor (X), both of which will be specified in the proposed GPO.
- The distributor has flexibility over the design of the specific tariff structure for each customer. That is, subject to the additional restrictions referred to below, the distributor will have the freedom, for example, to decide upon the relative size of any fixed and variable elements of the distribution tariff, provided that the constraint on its average revenue is complied with. The distributor will also be permitted to rebalance charges between customer groups over time – although, under the particular form of the control that has been proposed, rebalancing between the large and small customer classes will be precluded.
- The State has said that it intends to implement side-constraints to limit the rate of change of prices to protect customers from any sudden and significant change in charges.⁶¹ The proposed tender documents will also require bidders to disclose the tariffs proposed to apply initially, and to demonstrate that these tariffs can be

⁵⁹ It is proposed that a benchmark GPO would be provided to bidders, which will contain the algorithms, provisions and principles, with the final GPO incorporating the outcomes of the tender process (where bids are sought, or where the relevant provision of the GPO is not a mandatory requirement and a non-conforming bid is accepted). The features of the GPO are described in clause 6.4 (d) of the TAR.

⁶⁰ Intended to be six years.

⁶¹ Clause 6.6 of the TAR.

considered to imply a fair and reasonable sharing of the costs of the distribution system between end-users.⁶²

The regulatory regime that applies to retail (that is, delivered) prices is similar.

The average revenue that the retailer is permitted to earn from sales of gas to non-contestable customers will be regulated, the major component of which will be determined from the winning retailer's bid.⁶³ One of the inputs for the winning retailer is transportation on the distribution system, which it will purchase from the distributor at the regulated distribution prices (discussed above). However, its price would also be expected to reflect its other inputs, which include the purchase of natural gas, transportation on the gas transmission system, and its retailing activities.

The retailer will also have flexibility over the design of its specific tariff structures, subject to meeting the constraint on its average revenue from the sale of gas. As with the distribution charges, there will be side-constraints that limit the rate of change of any price. In addition, the retailer will be required to offer a uniform tariff schedule to small customers⁶⁴ within the Proposed Area to customers of the same class.

Importantly, the form of control over prices that has been proposed – the revenue yield price control – in effect is a mandatory requirement for the tenders, implying that alternative proposals could not be considered. However, related principles – like the X factor that the State has proposed to specify for the distributor – are conformity requirements only, and so alternative proposals can be submitted (albeit as a non-conforming tender and without the assurance that they will be considered).

The proposed GPO also includes (as conformity requirements) procedural provisions dealing with the administration of the price control, the requirement for uniform retail prices (discussed above), and provisions that permit the regulated prices to be changed to reflect the net cost implications for the distributor and retailer of certain well-defined events. These events include changes to certain types of taxes, as well as the implications of the introduction of full retail contestability (for the distributor).

In addition, the GPO includes benchmark principles for the determination of the residual value at the end of the initial regulatory period, principles governing the charges for certain ancillary monopoly services, and principles governing the pricing of extensions and expansions to the network beyond the proposed area. However, bidders are free to make proposals on these matters, and the State has not expressed an

⁶² Clause 8.2(e) of the TAR.

⁶³ The 'retail yield' that the retailers will propose as part of their bids will cover the non-distribution components of the service. However, the retailer will then be permitted to set tariffs that recover an amount of money to be determined by its retail yield, plus the charges it pays for transporting gas across the distribution system.

⁶⁴ Clause 8.82(e) of the TAR. Small customers are to be defined as customers taking less than 30 Tj of gas per annum.

intention to treat any proposals on these matters more favourably than others, and so they are not interpreted as restricting bidders.⁶⁵

In contrast, while proposals are sought from Bidders on the terms of the initial regulatory period, the Government has expressed a strong desire for bidders to accept a period of 15 years before or without a review of tariffs, prior to the first review of tariffs. That is, while bidders are free to propose shorter or longer regulatory periods and still be treated as ‘conforming’ (and therefore assured of being considered), it is proposed that a shorter or longer period will be considered as generating greater risk to customers, which would be taken into account when ranking the bids. Accordingly, for the purpose of the assessment, the State’s desire for a 15 year regulatory period is considered below.

9.2 Issues Raised

Issues Raised in submissions

The comments received in submissions on these matters, and the Regulator’s response to the less complex matters, are summarised below.

Fees and Charges

The Duke Energy submission has requested that the Regulator consider the proposed franchise fees and the Development Agreements and their consistency with industry practice in the context of greenfield gas markets. In contrast, the Aurora/Agility consortium has noted that, as the fee is to be applied across all bidders, it is reasonable (but should not be changed over the bidding process).⁶⁶

(Implicit) Requirement for a Single Distribution Franchise

A number of submissions expressed concern about the State’s proposal to select one retailer and one distributor (as a stapled pair) for the whole of Tasmania. It was argued that it would be more appropriate to issue a number of smaller franchises, as this would permit smaller (and local) organisations, such as local government entities and water boards, to bid. It was also noted that having multiple franchisees would require differential tariffs, which in turn would provide more efficient price signals, and would also alleviate any concerns about a lack of incentive to serve higher cost areas.⁶⁷

In response, the State commented that the award of a single franchise for all of Tasmania was appropriate given the small size of the market, and the scale economies

⁶⁵ It has been proposed that allowances be made (when ranking bidders) to take account of the implications of the bidder’s proposals on these matters for the sustainability of the distribution yields that are proposed. However, such an adjustment would have the effect merely of ensuring the comparison of the distribution yields (as adjusted) implied that ‘like was being compared with like’.

⁶⁶ Aurora/Agility, submission page 31.

⁶⁷ Metaira, pages 2-3; ABM, submission page 4.

believed to exist in the construction and operation of a distribution network. It also noted that it is in the interests of potential Tasmanian gas customers for it to attract experienced players with financial capacity, amongst other things, to reduce the risk that the project may not be delivered.⁶⁸

Stapled Bids

ABM commented that the requirement for stapled bids (and a State-wide service area) may restrict local entities from bidding, and hence reduce competition.⁶⁹ In contrast, TCCI noted that it is 'highly supportive of the "stapled-bid" methodology/concept', agreeing with the State that the alternative of potentially forcing two parties to enter into commercial relations may result in a risk premium being added to the tariff.⁷⁰

The State's response to the previous issue also addressed ABM's comment on this issue, namely that it is in the interests of potential Tasmanian gas customers for it to attract experienced players with financial capacity, amongst other things, to reduce the risk that the project may not be delivered.

Uniform Retail Tariffs

Aurora/Agility expressed a concern as to whether the proposed Duke Energy transmission tariffs were likely to be consistent with the State's proposals for uniform retail tariffs.

Duke Energy has indicated in its submission to the Regulator⁷¹ that it is committed to using non-discriminatory tariffs and that all like customers seeking access to like services will face the same tariff, irrespective of location. That is, the Duke Energy pricing regime will not impact on the uniform retail tariff structure to be proposed by retailers in their Bid Submissions.

A number of submissions have expressed the concern that the requirement for uniform retail tariffs is likely to lead to cross-subsidisation between customers, to delays in connecting the 'subsidised' areas and possibly an aversion for the winning bidder to connect areas outside of its proposed service area.⁷² TCCI also commented that 'serious consideration must be given to whether uniform retail tariffs between locations are appropriate', and it expressed a particular concern at the potential for cross subsidies between customer classes.⁷³ It was also commented that uniform retail tariffs

⁶⁸ State submission, page 23.

⁶⁹ ABM, submission page 5.

⁷⁰ TCCI, submission page 3.

⁷¹ Dated 28 September 2001.

⁷² ABM, submission page 5; Metaira, submission page 2.

⁷³ TCCI, pages 3-4.

will cause difficulties and give new competitors an unfair advantage when retail contestability commences.

Gas Pricing Order – Future Regulatory Regime for Distribution

Aurora/Agility made a number of comments on and raised a number of concerns with the proposed GPO. These included the following:⁷⁴

Form of price control – that bidders should have the freedom to propose their desired form of price control, rather than being constrained to adopt the revenue yield. They commented that the GPO imposes a de facto revenue cap which was inappropriate, and commented that a ‘price path’ (which is interpreted to be individual price caps on each tariff component) is more appropriate.

Regulatory Period – the 15 year period is too short, and drew attention to a number of practical issues. It also drew a parallel with concessions for toll roads where far longer periods are the norm, and for transmission pipelines, where periods longer than 15 years have been used. It argued that, with a longer period, it could offer lower tariffs.

X factor – it argued that the State’s proposed X factor of 1% was inappropriate as, amongst other things, it would require higher initial prices (than a lower X factor) and make it harder to encourage customers to switch to gas in the early years. It considered that bidders should be provided with flexibility as to the X factor.

Regulatory discretion – the Regulator’s discretion under the GPO should be minimised.

Prudent discounts – it was argued that there should be flexibility for ‘prudent discounts’ to be offered to customers to encourage conversion to gas.

Pass-through events – it was argued that the scope of the pass-through events should be broadened to include State and local government taxes and charges, to expand the scope of the pass-through where there has been a change to the law, to permit a pass-through of changes in transmission and gas costs (for the retailer), and to permit a pass-through for regulatory compliance costs.

Duke Energy also expressed concern⁷⁵ that the 15 year period proposed by the State combined with the narrow scope for changing the Reference Tariffs during this period, limits the flexibility of the distributor and Regulator to deal with unforeseen events. It commented that the pass-through clause should be broadened to permit the Regulator to deal with unforeseen events (such as force majeure).

The State has responded to all of these criticisms, which may be summarised as follows:

⁷⁴ Aurora/Agility, submission pages 21-26.

⁷⁵ Page 2 of Duke Energy submission.

Form of price control – the control is not a revenue cap, but is a ‘volume deal’ that can provide for significant upside and match the risks associated with investment in a greenfield development.

Regulatory Period – a 15 year period is far longer than the norm for gas distribution systems (of 5 years). Its market testing revealed a range of views regarding the appropriate term, noting that participants do not always welcome long periods of price certainty given the uncertainties in market operation. 15 years was considered a reasonable period of certainty for financiers and developers.

X factor – setting an X factor was argued to provide a more robust evaluation framework. It also noted that 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.

Regulatory discretion – the State considers that the balance between having effective prices oversight and risk have been balanced appropriately in determining the Regulator’s discretion under the GPO.

Prudent discounts – the GPO sets maximum tariffs, and so discounts are permitted.

Pass-through events – the events reflect a view on who is best able to anticipate and manage the risks, and it noted that the prices are subject to bid (and so any perceived risk can be reflected in the bid prices). Regarding Duke’s comment about force majeure, it was noted that contractual arrangements would be likely to deal with such matters.

Aurora/Agility also commented that the benchmark principles for the calculation of the residual value do not adequately take account of the difference between forecast and actual expenditure.⁷⁶

Project agreements - Aurora/Agility raised a concern regarding the requirement on bidders to negotiate key project agreements with the State and other parties. The consortium has submitted that the negotiation of these agreements may potentially become a de facto selection process.

The Regulator acknowledges the concern raised in the submission and notes that the State has advised that the Probity Auditor is to attend such negotiations between bidders and the State and bidders and Duke that are necessary for him to meet his responsibilities under the Probity Guidelines. The Guidelines provide that the Gas Tender Process must meet five primary probity objectives, which include that the process is fair, unbiased and impartial and satisfies the requirements of section 3.28 of the Code and that conflicts of interest are identified and eliminated⁷⁷. In the circumstances the Regulator is of the view that the probity process, including the presence of the Probity Auditor at such negotiations, and such protocols that Duke

⁷⁶ Aurora/Agility, submission page 31.

⁷⁷ s4 of the Probity Guidelines.

Energy may agree with the Probity Auditor and the State, should alleviate any concern that negotiation of these agreements may potentially become a de facto selection process.

Participation Deed - The Consortium has raised two key issues regarding the mandatory requirement of bidders to enter the Participation Deed:

- The Consortium disagrees with the requirement that the bidder acknowledge that the TAR and Tender Guidelines comply with all relevant laws and the Code and waive any right to challenge the Tender or the Tender Guidelines in the event that they are found not to comply with the Code.
- The Consortium has raised a concern with the requirement that the State must give prior written approval to any change to the membership of a consortium. The Consortium submits that the qualification that approval or non-approval is in the absolute discretion of the State is unreasonable.

In relation to the first issue, the Regulator notes that the Participation Deed requires bidders to acknowledge that the TAR and Tender Guidelines comply with all relevant laws and the Code⁷⁸. Further the Participation Deed requires the bidder to waive, as against the State and the Regulator, any right to challenge the tender process or its outcome, on the basis that the TAR or the Tender Guidelines does not comply with the Code⁷⁹.

As a consequence of the TAR approval process, potential bidders have the opportunity to review and comment on the TAR and Tender Guidelines, including any non-compliance issues. Further, potential bidders will be able to consider the Regulator's decision on the TAR prior to accepting an invitation by the State to participate in the Gas Tender Process. In the circumstances, potential bidders should be in a position to form a view in relation to the acknowledgment in the Participation Deed at the time they are required to sign the Deed. Further, the Regulator acknowledges that the State has sought to minimise any possible disputes by requiring bidders to accept that the Regulator's approval of the tender process is final⁸⁰.

In relation to the second issue, the Regulator notes that under the Participation Deed, a bidder which is a consortium must not change its members without the State's prior written approval, which approval may or may not be given in the State's absolute discretion⁸¹. The Regulator notes the Consortium's concern that the restrictions have the potential to hinder the competitiveness of the Gas Tender Process.⁸² The Regulator

⁷⁸ Clause 2(b).

⁷⁹ Clause 14.

⁸⁰ s3.2.3.1 (at page 7) of the State's submission.

⁸¹ Clause 28.2.

⁸² s3.2.1 (at page 13) of their submission.

also notes that the Consortium currently intends introducing institutional investors as equity participants in the Consortium at the time of lodging a bid⁸³.

In its response, the State has advised the Regulator that it welcomes the 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 referred to its "comprehensive qualification regime" which is designed for the State to ensure the financial capacity of developers and, where a consortium wishes to introduce a strategic equity partner, that the State has to ensure that such new party has both the financial capacity and the required level of experience in the gas industry⁸⁴.

The Regulator understands the "comprehensive qualification regime" referred to in the State's response is that referred to in the TAR⁸⁵ and the Invitation to Register an Expression of Interest⁸⁶. The Regulator also understands the necessity for a process to be in place to ensure that consortia do not change their members without the State's prior approval and the State should be able to withhold its approval in appropriate circumstances. The Regulator expects that the State, when exercising its discretion as to whether or not to provide its approval to a request by a consortium to change its members, will act consistently with its objectives for the Gas Tender Process, which include facilitating the development of an efficient and competitive gas supply industry and minimising costs to gas consumers⁸⁷. Thus the State's discretion is bound by these objectives.

In the circumstances, the Regulator does not consider that the requirements in the Participation Deed are unreasonable.

The Development Agreement (DA) with the State - the Consortium has submitted that it would like the terms of the DA to be resolved at an early stage, so as to allow potential bidders the opportunity to assess and finalise their bids in a manner which is uniform with the DA. It has further submitted that a final version of the DA issued for bidding purposes, should be issued not later than one month prior to the Bid Date and no changes should be made after that date.

In its response, the State has advised the Regulator that it will release draft Development Agreements to qualified bidders together with the Project Brief⁸⁸. According to the TAR each bidder will be provided with a copy of the Project Brief following execution of the Participation Deed⁸⁹.

⁸³ s3.2.1 (at page 13) of their submission.

⁸⁴ s3.2.3.1, State's submission, page 7.

⁸⁵ TAR, s6.3.

⁸⁶ Invitation to register expression of interest, s2.3.

⁸⁷ Clause 2.2 of the TAR and clause 1.2 of the Tender Guidelines.

⁸⁸ s3.2.3.2 (at page 7) of the State's submission.

⁸⁹ Clause 6.6(b) of the TAR.

The Tender Guidelines provide that any revision to the DA will be circulated to all bidders⁹⁰. The State has further advised that final (benchmark) Development Agreements will be provided to bidders in sufficient time before bids close to enable bidders to finalise their Bid Submissions⁹¹. The State has noted however that a timeframe of one month prior to the bid date is too early and will not give bidders adequate time to undertake investigations and provide meaningful comments.

In the circumstances the Regulator is satisfied with the State's assurances concerning the release of the DA to bidders. Whilst the Regulator recognises the need for bidders to gain access to a final DA at the earliest possible date in order to allow for the completion of financing arrangements, it is not practical to require the State to issue the final DA no later than one month prior to the Bid Date.

Duke Connection and Transmission Agreements - the Consortium is concerned that the tender process does not ensure that the terms of the Connection Agreement and Transmission Agreement are consistent between bidders and are "commercial".

Section 6.6 (e) of the TAR notes that Duke Energy has provided the State with an undertaking that should direct negotiations occur between bidders and Duke Energy in connection with the Connection and Transmission Agreements that Duke Energy 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 bidders. In addition the Regulator has recommended to the State that the Probity Auditor be present at negotiations between the bidders and Duke Energy.

The Regulator acknowledges that the nature of each bidder's proposed bid may lead to different requirements to be addressed in their respective agreements with Duke Energy. The State has noted in its response that the terms of the Duke Energy 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 Energy⁹².

Whether the agreement reached between each bidder and Duke Energy represents a "commercial" outcome will be a matter for those parties. The Regulator expects that the Probity Auditor will monitor negotiations to ensure that Duke Energy provides all bidders with an equal opportunity to negotiate the agreements and hence each bidder should be in a position to achieve a "commercial" outcome in such negotiations.

Negotiated Outcomes - Duke Energy encourages the Regulator to allow minor variations to the TAR as a result of a number of elements of the TAR being subject to negotiations between the State and bidders.

⁹⁰ Clause 4.2 of the Tender Guidelines.

⁹¹ s3.2.3.2 (at page 7) of the State's submission.

⁹² s3.2.3.3 (at page 9) of the State's submission.

Section 3.33 of the Code provides that the Regulator must not approve the FAR if he is not satisfied that certain matters have been satisfied, including that the tender process was conducted in accordance with the procedures and rules specified in the TAR approved by the Regulator. The TAR includes the documents referred to in schedule 3 of the TAR, which includes the tender guidelines. Clause 1.10 of the Tender Guidelines provides that the Tender Guidelines may, with the approval of the Regulator, be amended at any time by the State. Accordingly if the State proposes any amendments to the TAR, such proposed amendment will be considered by the Regulator. It should be noted however that once the TAR is approved, the Regulator has no ability under the Code to agree to amend any aspect of the TAR which if amended would change or otherwise affect the arrangements approved under the TAR. The Regulator may however be prepared to accept advice, in writing, provided by the State, which clarifies (in accordance with the TAR) the way in which the State proposes to conduct the Gas Tender Process. For example, such advice may seek to resolve an ambiguity in the TAR or provide an explanation as to how a discretion, referred to in the TAR, will be exercised by the State.

9.3 Consideration of Issues Raised

This section deals with the more complex issues raised in submissions in addition to matters not addressed by respondents but which must be considered by the Regulator.

Requirement for a Single Distribution Franchise

This is an requirement implicit in the TAR. As discussed earlier, a number of submissions commented that it may be more efficient if a number of tendering processes were conducted for smaller areas. Amongst other things, it was considered that this would be a lower cost option, preclude cross-subsidies between areas, and permit a greater role for local organisations that would not have the financial capability to serve the whole of the State. In response, the State commented that offering a single retail franchise and distribution franchise would permit economies of scale to be reaped, and that attracting well qualified businesses was essential for minimising the risk to Tasmanian customers.

The State's arguments in support of a single franchise for distribution (and retail) are considered sound. First, there are considered to be economies of scale in gas distribution, and even with one franchise for the whole of Tasmania, the distributor will be small (in terms of customer numbers) compared to mainland distributors.⁹³ Secondly, with respect to the cost of the process, while any single tender for a small area may cost less to run, it is less obvious that the sum total of the tender processes would be less costly, nor that the overall effectiveness of those processes would be comparable. Thirdly, having smaller entities without gas experience awarded contracts to supply would impose greater risk on gas customers.

⁹³ It is noted that, in Victoria, three distribution businesses were formed prior to privatisation (originally named Westar, Multinet and Stratus). However, at the time of privatisation, these businesses had 412 000, 587 000 and 419 000 customers respectively, whereas the Tasmanian distributor may supply 100 000.

A particular concern in the submissions, however, was to ensure that synergies with existing local entities (such as water boards) be realised where possible. It is noted that, to the extent there may be benefits in any services being provided by local suppliers, there is no barrier to the bidders contracting out such services on commercial terms. In addition, it would be expected that the competition generated by the tender process would result in some or all of the value of any expected synergies being reflected in lower bid prices.

Accordingly it is considered that the implicit requirement for a single distribution franchise is reasonable.

Acceptance of the Tender Guidelines

Clause 6.1 of the Tender Guidelines requires each Bid Submission to contain an acknowledgement by the bidder that it accepts the Tender Guidelines and that its directors, employees and consultants have not breached the Tender Guidelines. To seek acknowledgements from bidders and others connected with the bidder, in the form proposed in the Tender Guidelines is not unusual in a competitive tender process and hence could be categorised as a reasonable tender requirement.

An obligation to enter into binding Development Agreements with the State, as noted in the Tender Guidelines (clause 6.2), in order to ensure certainty and enforceable rights with respect to the development of the gas distribution and retail businesses, each Bidder must agree to enter into binding DA's with the State. Further, the Guidelines note that the DA's need not be identical to the DA's proposed by the State, however they must be legally certain and capable of acceptance by the State. In a tender process of this nature, the State's requirement for certainty as to the commitments agreed with the successful bidder and rights which are enforceable against that bidder appears to be reasonable. In the absence of such commitments the State would be unable to be certain that the objectives of the Gas Tender Process which are contingent upon the cooperation of the successful bidder could be achieved.

Stapled Retail/Distribution Bids

Each Bid Submission must include a tender for the distribution franchise and a tender for the retail franchise (clause 6.3): in the TAR the State has submitted that this is a reasonable requirement. The State has also submitted that on the basis of its market testing most potential bidders were anxious about having the distribution or retail component of their bids "cherry picked" and being forced into a long relationship with a distributor or retailer with whom they had no desire to be involved. Further the State submitted that in the absence of stapled bids there is:

- "a real risk" a number of potential bidders might not be prepared to bid; and
- if bidders were forced to accept a "match" with other another bidder then it is likely that bidders would build in a risk premium to the proposed tariffs.

The State has submitted in the TAR that the competitive outcomes of the tender process will be maximised by requiring stapled bids.

It appears that the market testing relied on by the State was limited, in relation to both the number of parties approached and the areas of industry that such parties represented. Since the issue of the TAR, it is understood that approaches have been made to the State by potential distributors and potential retailers who have expressed interest in participating in the Gas Tender Process and do not have a matching party with whom to bid. The Regulator has been advised that the State agreed to provide a matching service for any parties (retailers without a distributor and vice versa) seeking the service. As discussed above, ABM opposed the requirement for State-wide franchises on the basis that it would preclude most local entities from bidding. This was related to its view that running a number of tenders for smaller areas would have been more appropriate, a point which has already been addressed above. In contrast, TCCI supported the proposal for stapled bids, and the requirement was noted (but not opposed) by Aurora/Agility.

Each Bid Submission must provide that separate legal entities are used as bid vehicles for the distribution and retail components of Bid Submissions (clause 6.4)- as noted in the Tender Guidelines under the ring fencing rules in chapter 4 of the Code, the entity which provides gas distribution services will be prohibited from engaging in the retailing of gas. Thus the requirement that there be separate distribution and retail bids is a technical requirement necessary for compliance with the Code. Further, the requirement for stapled bids, as discussed here and elsewhere in this Report, is considered in the circumstances to be reasonable.

Franchise Fees

As noted above, the successful bidder must agree to pay to the State a distribution franchise fee of \$2.0m and a retail franchise fee of \$0.5m, which are intended to reflect a portion of the State's costs in conducting the Gas Tender Process (clause 6.9). Duke Energy has asked that the Regulator consider whether such fees are consistent with practice elsewhere. Whereas Aurora/Agility has commented that it does not oppose the application of such a fee given that it will apply to all parties (but has requested that the fee not be changed during the bidding process).

Regarding the Duke Energy concern, it is considered that there are no real precedents (in Australia at least) for the competitive tendering process being undertaken by the State against which these fees can be benchmarked. While the tendering processes under the Code (or processes similar to the Code process) have been used to set regulated charges for gas infrastructure previously, these either have been for more straightforward projects (point-to-point transmission pipelines) or small systems (such as the Mildura system in Victoria), when compared to the Tasmanian gas distribution project.

It is noted that as the fee would be charged equally to all proponents, it is likely to just result in higher tariffs than otherwise would have been the case. In turn, this would imply that the ultimate beneficiaries of the gas project – the future consumers – would contribute a share of the cost of running the tendering process, which is not considered unreasonable. It may be unreasonable if the fee was so large that it made a profitable project unprofitable, but given the size of the fee (about 1 per cent of expected cost of the distribution and retail components of the project) and Aurora/Agility's comments,

this is considered unlikely. Accordingly, the imposition of the proposed fees is considered reasonable.

Regarding Aurora/Agility's concern that the fee not be changed during the bidding process, it is noted that the magnitude of the fees are written into the TAR, and so cannot be changed (without jeopardising the Regulator's approval of the FAR).

Not Limit Services

Each Bid Submission must, in relation to distribution services, contain confirmation that the bidder agrees that it will not limit the services to which access might be sought under the Code (clause 6.11).

This requirement addresses the exclusion in section 3.28 (d) (iv) of the Code and hence is compliant with the Code.

Inconsistency with Code

If a Bid Submission includes elements inconsistent with the Code, the Bid Submission will be excluded from consideration by the State (clause 6.12).

This exclusion, which is qualified, seeks to pick up the requirement in section 3.28 (d) (v) of the Code, which requires that tender rules provide that a tender be excluded from consideration if it includes elements inconsistent with the Code. The State's qualifications would allow Bid Submissions that :

- Propose Reference Tariffs different from those that would otherwise be determined under the Code. This is a reference to those provisions of the Code under which Reference Tariffs can be determined other than through a competitive tender process.
- Specifies items to be included in an access arrangement which are to be determined by the Gas Tender Process. This is a reference to those provisions of the Code under which access arrangements are to be determined by a means other than through a competitive tender process.

As the matters referred to in the State's exclusions are to be addressed under the Gas Tender Process in accordance with the Code, the qualifications to the exclusions are reasonable.

Connection Agreement

Each bidder must lodge with its Bid Submission a copy, executed by both parties, of the Duke Connection Agreement provided by the State or an alternative connection agreement with Duke Energy which is conditional on the distribution franchise being awarded to the Bidder (clause 6.13).

As it will be necessary for the successful bidder to connect its distribution pipeline network to the Duke Energy natural gas pipelines it appears reasonable to require each bidder to have reached agreement with Duke Energy at the time their Bid Submissions

are lodged with the State. The State expects each bidder to have entered into a form of connection agreement with Duke Energy, which need not be the Duke Connection Agreement provided by the State. Bidders appear to have essentially two options. First, accept and sign up to the Duke Connection Agreement provided by the State, which according to the Tender Guidelines has been approved by Duke Energy. In so doing and on the assumption that Duke Energy also executes the Agreement, the bidder will have satisfied this mandatory requirement. Secondly, negotiate the Duke Connection Agreement provided by the State or another connection agreement with Duke Energy. Such course may not lead to a concluded agreement. The State's requirement is capable of being satisfied by bidders (on the assumption that Duke Energy honours its commitment to the State to execute the Duke Connection Agreement) and appears to be reasonable.

Transmission Agreement

Each bidder must lodge with its Bid Submission a copy, executed by both parties of the Duke Transmission Agreement provided by the State or an alternative transmission agreement with Duke Energy which is conditional on the retail franchise being awarded to the bidder (clause 6.14):

The same comments noted above apply in relation to the Duke Connection Agreement. Further, given the proposed requirement in the Gas Tender Process for stapled bids it is reasonable to expect that the State would require bidders to enter into a binding commitment with Duke Energy for the transmission of gas.

As the State has reserved the right to exclude non-conforming Bid Submissions it is necessary to consider each of the conformity requirements in the Tender Guidelines.

Schedule 2

Bid Submissions must contain the information and confirmations set out in schedule 2 of the Tender Guidelines (clause 7.1):

Schedule 2 sets out the form of the Bid Submission, in three sections, namely:

- the Offer;
- the Bidder Proposal (principally addressing the mandatory requirements); and
- capacity to perform (including details of the bidder's technical and financial capacity to develop, finance and operate the distribution pipeline and retail business and bidder probity checks).

In their submission, Aurora/Agility recommended that as well as evidence of firm financing, bidders should be required to provide evidence of executable/enforceable arrangements for the construction of the network to demonstrate that the capital cost on which the distribution tariffs are based is achievable and to demonstrate the capability to ensure delivery without further recourse to the State⁹⁴. In response, the State has

⁹⁴ s 3.6 of the submission to the Regulator.

noted that bid submissions must include details of the bidder's construction plan and evidence of its capacity to deliver, which the State contends would in many cases include providing details of the proposed construction arrangements⁹⁵. The State has further noted that it is not a principal in the project and the details of the construction are appropriately left in the hands of the bidders.

The Regulator is satisfied with the arrangements proposed by the State in addressing this issue in the TAR⁹⁶, including in particular the commitments required to be made in the Development Agreement. He does not consider it necessary for the State to require bidders to provide evidence of executable/enforceable arrangements for the construction of the network.

On the assumption that each of the mandatory, conformity and other requirements referred to in Schedule 2 satisfy the Code requirements, the requirement to provide the information and confirmations in the form at Schedule 2 is a reasonable prudential requirement for a tender process of this nature.

Each bid submission must demonstrate the bidder's ability to fund the construction and ongoing operation of the distribution network and a gas retail business (clause 7.2). The evidence required of funding, either fully committed funding or a funding proposal is a reasonable prudential requirement for a tender process of this nature.

Each Bid Submission should include evidence that the bidder has secured, or is able to secure, an upstream supply of gas sufficient to meet the Benchmark Forecast volumes for retail consumption of gas for the period of the proposed retail franchise (clause 7.3). This is considered to be a reasonable requirement to provide the State and customers with the assurance that the retailer will be able to meet its obligations as a franchise retailer.

Each Bid Submission should involve a rollout of the gas distribution system which meets certain requirements in the Distribution Development Agreement (clause 7.5). No submissions were received on this point. Thus the Regulator concludes that the rate of roll-out is achievable without imposition of undue additional capital cost, and is reasonable.

Each Bid Submission should be expressed as an irrevocable offer to the State open for a period of not less than 90 days after the date on which the Bid Submission is lodged (clause 7.7). The requirement in a tender process of this nature for bidders to make irrevocable offers which are capable of acceptance for a period of or in excess of 90 days is a reasonable prudential requirement.

⁹⁵ s 3.2.5 (at page 10) of the State's submission to the Regulator.

⁹⁶ Including the obligation to provide information on the bidder's development and construction program, including key milestones and dates for their achievement, as provided for in clause 2.7 of Schedule 2 of the Tender Guidelines.

Purchase of the Launceston Network

As discussed above, each bidder is required to make an irrevocable offer to enter into the Launceston Network Sale Agreement to purchase the Launceston town gas distribution system (clause 6.15).

The Aurora/Agility consortium expressed concern about the implications of the mandatory acquisition of the Launceston Network and the State response has included a more detailed description of the basis for the proposed valuation of the network-information which was not previously available for consideration by interested parties.

The State has stated that, under the Agreement, the purchase price will be calculated as the net present value of estimated capital savings associated with insertion through the existing Launceston Network.⁹⁷ Under the proposed process that has been negotiated with Origin Energy, the State and Origin will be bound by the terms of an independent valuation of the network. This valuation will be known prior to the end of the bidding period. The State response acknowledges that there remains a risk that the Launceston network has little value to the developer of a natural gas distribution network, but states that this will be uncovered through the valuation process, ‘ensuring that only “fair value” is paid’.

The State has proposed that the requirement to purchase the Launceston network is designed amongst other things to ‘level the playing field’. The Regulator is not persuaded that imposing requirements on bidders merely to ‘level the playing field’ is reasonable. In particular, it needs to be borne in mind that one of the objectives of a competitive tender process is to ‘discover’ the comparative advantage of each tender, as reflected in each bid, and capture some of that advantage for customers through the best submission of the winning bid.

However, for this objective of the tender process to be achieved, there needs to be effective competition for the right to distribute gas. The State has argued that were Origin to retain control over the Launceston Network, Origin would have had such a comparative advantage that other potential bidders would be less likely to participate in the process, which would affect materially the degree of competition. The State has indicated that this view is supported by its discussions with potential tenderers. The precise sources of Origin Energy’s comparative advantage that the State has identified included the following:⁹⁸

- Origin would retain a significant cost advantage in relation to serving Launceston;
- Origin would be able to restrict the ability of others to lay a network in Launceston through the rights that it continues to hold in its network (for

⁹⁷ An implication on this valuation methodology (if applied perfectly) is that customers would pay the same price, had the Launceston Network not existed.

⁹⁸ State of Tasmania, response to Submissions, pages 12-13.

example, the potential for other developers to be liable for damaging its network and the "potential spoiling" effect this could create); and

- the fear that there would be a ready-made competitor to any distributor other than Origin (or a consortium including Origin) after the expiration of its franchise (which may lead other bidders to submit a higher charge). This of course depends upon the actual condition of the network and the ability of origin to capture market share once the exclusive franchise period has expired;

The first factor – that Origin would be seen to retain a significant cost advantage, such that other bidders may not be inclined to participate, is considered to be the most important reason.

Against this, there are countervailing factors, which are that:

it may be less likely that some of the ‘value’ or comparative advantage associated with the existence of the Launceston network would be passed on to customers;

- the winning distributor may absorb some of the operational risks associated with the network and require higher prices as a result, resulting in higher tariffs to customers than otherwise;
- the winning distributor may include a premium to compensate for liabilities that may transfer with the network. The State has responded that steps have been taken to provide an ‘appropriate allocation of environmental and other liabilities’. It comments that ‘while there may be the 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 adequately managed by a gas distribution network developer as part of normal operational risk management procedures.’
- the winning distributor may include a premium to guard against the valuer underestimating the actual refurbishment cost, resulting in higher tariffs to customers than otherwise;
- to the extent that the winning distributor may have laid telecommunications infrastructure in new trenches, and may have recovered some of the trenching costs from its telecommunications business (which is not possible if the Launceston Network is used) then, again, higher tariffs to customers than otherwise would result; and
- prospective bidders may consider the risks associated with acquisition of the network to be such that they chose not to participate.

Accordingly, the Regulator needs to weigh up – on the one hand, the likely implications for tariffs of the potentially greater competition through increased participation of bidders as a result of the purchase of the Network- and on the other, the potential for (a) higher tariffs because bids include a premium for uncertainty and transfer of liability or (b) the risk that potential bidders may not be prepared to accept the ‘unquantifiable risks referred to by Aurora/Agility, and choose not to participate in the tender.

In considering this balance, the Regulator must put considerable weight on the views of the State's advisers who have considered this balance. They have held discussions with prospective bidders, and have better information than the Regulator who must rely solely on his analysis and the perspective of one of the prospective bidders. In the light of the strong views of the State and its advisers about the desirability of the Agreement and about the reasonableness of the arrangements contemplated by the Agreement, the Regulator is satisfied that the proposal for novation of the Launceston Network Sale Agreement is reasonable. However, the Regulator considers that the State should reduce the risk for bidders (and hence the premium which may be reflected in bids and ultimately paid by consumers) by ensuring that the valuation is based on a sound assessment of the condition of the network and its suitability for refurbishment. This risk may be managed by, amongst other measures, providing prospective bidders with a reasonable opportunity to review the technical data and tests that support the valuation and making provision for prospective bidders to advise the State of their views on the need for further information to enhance their appreciation of the condition and risks associated with the network, in time for this to be passed on to the valuer.

Aurora/Agility proposed that it would be preferable that the successful bidder have an option rather than an obligation to purchase the network. In response to this proposal, the State submitted that it carefully considered the 'option' alternative, whereby the option could have been made available to the winning bidder, allowing all bidders to factor it into their bid price. It rejected this course of action on the grounds that:

- 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; and
- there would be a risk that the arrangements with Origin could not be concluded before the bid commenced, thus risking delay to the bid process.

Thus it appears that the State rejected this possibility on practical grounds. Again, the Regulator must put considerable weight on the views of those who have been conducting the negotiations with Origin as to the practicalities of negotiating an option. The effect of an option as against a mandatory purchase is that bidders would not have to factor a risk premium into their bids to guard against the prospect of being obliged to pay more for the network than its (in their opinion) true worth. As discussed above, the Regulator considers that the State should take all reasonable steps to reduce the uncertainty by providing in a timely manner quality information to prospective bidders and to consider the views of bidders in regard to the acquisition of additional information. Subject to these concerns, the Regulator considers that the mandatory requirement for novation of the Launceston network Sale Agreement is a reasonable requirement.

Uniform Retail Prices

As noted above, the State has proposed that there be uniform prices for 'like customers' across the bidder's proposed service area, where those customers consume less than 30 Tj per annum. As the Regulator's role under the Code is limited to the process that is used to determine tariffs for the distribution component of the service, the State's

proposals with respect to the regulation of prices is relevant only to the extent that this impacts upon the efficiency of the distribution activities (and tariffs).

A number of concerns were raised with the State's proposal for uniform retail tariffs (and which would impact upon the efficiency of the distribution component), which were:

- a concern about the effect of uniform retail tariffs on the incentive to serve areas outside of the distributor's proposed service area;
- a concern about the ability to offer discounts to attract new customers; and
- a concern about there being cross-subsidies between customers.

These issues are addressed in turn.

Incentives To Serve New Areas

A number of submissions commented that the imposition of a uniform price across the system for customers with the same load and demand characteristics may reduce the incentive for areas beyond the proposed service area to be reticulated.

It is noted that, under the Code, the distributor can level a charge that is in addition to the standard charge (referred to as a surcharge) for supply to a new area if the project is not economically feasible at the existing tariffs.⁹⁹ This principle has also been incorporated into the benchmark extensions and expansions policy in the GPO, although bidders are free to bid variations to this (albeit, not variations that are inconsistent with the Code). The implication of these principles is that the regulatory regime would not preclude the distributor from recovering from customers outside the proposed service area the additional costs of serving that area, and so would have an incentive to extend supply where it was efficient to do so.¹⁰⁰

Clearly, this incentive would be stifled were the existing uniform retail price to apply to these customers (and so preclude the surcharge from being passed through to final customers). That is, while the distributor could levy the surcharge on the retailer, the retailer would not be able to pass this on – with the expected result that the project would not proceed, and efficient investment may be stifled.

However, under the draft GPO, it is clear that the uniform retail prices apply only to the customers in the distributor's proposed minimum service area.¹⁰¹ For areas outside of this, the State has noted that it is seeking to amend the *Gas Act 2000* to permit conditions to be attached to a franchise retail licence. One of these conditions will be

⁹⁹ The test of economic feasibility is set out in section 8.16(b)(i), and the ability to levy a surcharge is set out in s8.25.

¹⁰⁰ That is, the distributor would need to take account of whether, at the price required, it could compete with other energy sources in that area.

¹⁰¹ GPO, Schedule 1, Part C.

to require the terms and conditions of supply (including price) by the retailer outside of the proposed area to be 'fair and reasonable' (with the Director of Gas responsible for assessing the fairness and reasonableness of terms). It would be expected that it would be fair and reasonable for the price to include any surcharges calculated in a manner consistent with the Code and relevant extensions and expansions policy.¹⁰²

Accordingly, the proposal for uniform retail prices within the proposed service areas would not appear to affect the distributor's incentive to extend its system to serve additional new areas.

Discounting

One of the submissions expressed a concern that the State's requirement for uniform retail prices would prevent 'prudent discounts' from being offered to customers to increase the rate of switching to natural gas. It is noted that while the requirement for uniform prices applies to retail prices, it is highly relevant to the operations of the distributor. This is because any discount offered by the distributor would need to be passed-through by the retailer to have any effect. In addition, discounts normally would be expected to be at the instigation of the distributor and, to the extent that a discount implied the loss of retail revenue (compared to that permitted under the price control), this loss would be expected to be borne wholly or predominately by the distributor.¹⁰³

It is noted that there are two forms of discounts. First where a discount is offered to a customer or group of customers, and the shortfall in revenue (against the published price) is not recovered by the retailer/distributor, and secondly, where the loss in revenue from one customer or group of customers is redistributed to the other customers (and the retailer/distributor receives all of the revenue permitted by the price control).

Regarding the first of these forms of discounts, prices will be governed by the GPO and maximum prices, but there is nothing that prevents the retailer from discounting below those prices.¹⁰⁴ Under the proposed form of price control, it may be in the interests of the retailer/distributor to offer a discount if it is necessary to bring on a customer or customers that otherwise would not switch to gas, or who otherwise would switch at a some time in the future. This is because, while (on the face of it) a discount appears to imply that revenue is lost, the additional volume will increase the 'allowed revenue' under the 'revenue yield' price control. To explain:

¹⁰² State of Tasmania, Response to submissions, page 18.

¹⁰³ The regulatory arrangements concerning retail prices are focussed on here, as it is the retail prices that are relevant for the period until the end of the six year retail franchise. However, the discussion of the price control arrangements apply equally to the distribution control, which will be relevant after contestability. It would be anticipated that the retailer and distributor would have an agreement covering network marketing activities during the period of the retail franchise that allocated losses of retail revenue from discounts (compared to that permitted by the price control) between the entities.

¹⁰⁴ In particular, the requirement for uniform prices applies only to the maximum prices.

The extra net revenue (in \$/Gj) where a new customer is induced to switch at the discount rate (and otherwise would not have switched) is equal to the yield (in \$/Gj), minus the discount offered against the standard tariff (in \$/Gj).

Thus, if the cost of connecting the relevant customer was low, a sizable discount could be offered before it would not be in the retailer/distributor's commercial interests.

Moreover, to the extent that such discounting was expected to be necessary, the apparent loss of revenue would be expected to be factored into the bid submitted into the tender process. Accordingly, the incremental revenue from such discounting would be expected to result in lower average prices.

Regarding the second form of discounting (that where the entity is able to recover the lost revenue from other customers), it should be noted that, under the form of price control, revenue is only 'lost' where a customer is charged less than the published price (tariff). However, if a special charge (tariff) is introduced for a particular type of customer, then there is no discount, and hence no loss of revenue (against that permitted by the price control).

Whether the retailer/distributor could introduce such charges during the period of the retail franchise is constrained, to a large extent, by the requirement proposed by the State for uniform retail prices across the proposed area for small customers with the same technical (load and demand) characteristics. To the extent that this requirement precluded special or transitional charges from being introduced, the second form of discounting would be precluded. Bidders should take account of (and judge for themselves) the implications of the requirement for uniform retail prices. However, to the extent that there are fewer constraints on distribution prices, once retail contestability is introduced the distributor would face fewer constraints to offering this form of discount.¹⁰⁵

As a result, it is considered that the proposed GPO provides ample ability for discounts to be offered where required to stimulate market growth.

Cross-Subsidies

A cross-subsidy is said to result if one group of customers is expected to pay less than the additional (or incremental) cost of serving them, which implies that the remaining customers would pay more than it would cost to supply them on a stand-alone basis (that is, with the subsidised customers removed). Where a uniform tariff is required, but the cost of serving different areas varies significantly (for gas, factors like customer density, soil and surface conditions and existence of natural barriers (like rivers) are important), it would be expected that a degree of cross-subsidy between those areas would exist.

As discussed below, the information that has been provided by the State suggests that it is expected that some of the areas that have been included in the minimum pipeline

¹⁰⁵ There would still be some constraints, however. In particular, all published prices would be subject to the rebalancing controls in the GPO, which would limit the ability to provide short term 'discounts'.

route would expect to pay less than the incremental cost of serving them (and so be in receipt of a subsidy).

It should be noted, however, that any such cross-subsidy is more likely to exist between areas in relation to small customers (that is, who consume less than 30 Tj per annum).

It is expected that the combination of no requirement to charge uniform prices for large customers, the form of the price control proposed, and the ability for these customers to by-pass the distributor after the expiration of the five-year exclusive franchise will limit the ability either for large customers to subsidise small customers, or for geographic cross-subsidies in relation to these large customers to exist.

Economists generally advocate the principle that the price charged for a service should recover at least the additional cost of providing the service to the customer and group of customers. This is because, faced with such a price signal, the customer (or customers in a particular area) will only choose the relevant service if it is the least cost means of providing their service requirement.¹⁰⁶ Applied to the supply of natural gas, if the price that was charged for its use in a particular area recovers at least the cost of providing the service, then customers would only choose gas if it is a cheaper means of providing their energy requirements than through alternatives (eg electricity). Where customers are subsidised (or subsidise others), this price signal to the customer disappears – and the customer could switch to gas (or remain on electricity) even though the converse may be the lower cost option.¹⁰⁷

This is an important matter, because if gas displaces other energy sources (such as electricity) where gas is a lower cost alternative, then the total cost of supplying Tasmania's energy needs will fall, and average prices will fall. In contrast, if gas is connected and displaces the other energy sources where gas is a higher cost energy source, then the total cost of meeting Tasmania's energy needs will rise, and average prices will rise.¹⁰⁸

¹⁰⁶ It is assumed here that the price of the alternative service reflects the forward-looking cost of continuing to provide that service.

¹⁰⁷ The focus of the analysis in this section is on whether gas is likely to be supplied to areas where it is inefficient to do so (as a result of a subsidy being provided), rather than on whether gas is unlikely to be provided to an area where it would be efficient to do so (as a result of those customers paying far higher than the incremental cost of providing the service). It is considered that bidders would not make proposals that included so many high-cost areas that it could not compete with alternative energy sources as this would threaten the economics of the whole project.

¹⁰⁸ While the discussion refers to differences in the cost of energy sources, it is also appropriate to take account of the level of service that a customer may derive from the different sources. For example, even if the cost of supplying a customer's heating requirements through gas may be higher than the cost of meeting these needs with wood, the customer is likely to receive service-related benefits from gas (for example, by avoiding the need to fetch wood from the shed in the middle of winter in the pouring rain), and may have chosen to switch to gas even chosen even if the price were higher. When assessing the efficiency of gas versus other energy sources, it is appropriate to take account of the perceived value of these service related benefits.

However, when assessing the impact on efficiency, it is appropriate to ask whether any cross-subsidies between areas are sufficiently material such that even though gas may not be the lowest-cost energy source, those customers choose to connect to gas as a result of the receipt of the subsidy. It is likely to be the case that a reasonable degree of cross-subsidisation between areas may be possible before inefficient investment decisions were induced. In addition, it was noted in the Issues Paper that some degree of averaging and imprecision is inherent (and even efficient) in the design of tariffs, given the administrative costs associated with more complex tariffs, and technological constraints (such as those imposed by the information on usage that can be metered), and it is recognised elsewhere in the Code that commercial and technical considerations may temper the application of strict efficiency criteria to tariff design and cost allocation.¹⁰⁹ It was also noted in the Issues Paper that it is not possible to determine the prospective cost of alternative energy supply with precision.

With regard to the proposed competitive tendering process, whether inefficient areas may be included in a bidder's proposed service area will depend upon the minimum service area that has been proposed by the State, and the incentives that are built into the evaluation of tenders for a greater area to be proposed.¹¹⁰ The first of these matters is discussed below, and the second is addressed in section 5.6 of this statement (which assesses the proposed selection criteria against the requirements of section 3.28 (f) of the Code). Taking account of the factors noted above, and on the basis of the information provided, it was concluded in this section that it is considered that both the proposed minimum service area and incentives for proposing a larger area are unlikely to result in proposals to serve inefficient areas. Accordingly, regardless of the degree of cross-subsidisation implied in prices, distortions to investment are unlikely to be induced.

The State has also noted that it considers uniform retail tariffs within the proposed area to be an important equity concern, and is consistent with tariff policy in other states. It is noted that distribution charges would be expected to mirror (to some extent) retail prices, and that the Regulator needs to consider whether the selected distributor's proposed tariffs imply a fair and reasonable allocation of costs.¹¹¹ The State's views on the requirements for equity of final tariffs may be relevant to the assessment of whether the allocation of costs implied by distribution charges is fair and reasonable.

¹⁰⁹ For example, s8.38 of the Code, which deals with the design of Reference Tariffs (and, by implication, the allocation of costs).

¹¹⁰ If the State had not imposed a requirement on the area to be served, nor offered any incentive to serve more areas, then there could not have been any cross-subsidies between areas. Bidders would have selected the area that would have resulted in the lowest yield, which would imply adding areas while the customers (at the uniform yield) pay the additional cost of serving them, but not to add areas beyond that. However, the requirement to propose a minimum service area and the incentive offered to serve greater areas will imply that the bids are likely to lie above the lowest yield.

¹¹¹ This required by s3.33 (c)(ii) of the Code. This matter is also discussed in s5.6 of this statement.

Prescribed Minimum Pipeline Route

The State has proposed that bidders offer to serve a minimum area, and will treat bids that do not propose serving the full area as non-conforming. This implies that bidders could propose a smaller area, but would risk not being considered.

One of its arguments in support of proposing a minimum area is that it will assist considerably in the comparison of bids, and because the proposal for a minimum area will assist bidders to frame their bids. These arguments are accepted as implying that it is reasonable to specify a minimum service area. However, the more difficult question is whether or not the area that is proposed to be specified is reasonable. In assessing whether the area is reasonable, one of the criteria that should be satisfied is that the required service area not be expected to result in tariffs that are inconsistent with the objectives in section 8.1 of the Code. The relevant objective is that investment in gas pipelines not be distorted.¹¹²

As discussed above (under cross subsidies), it was noted that investment in pipeline systems in an area can be considered to be efficient (or not distorted) if the supply of consumers' energy needs in that area through gas is a lower cost (adjusted for service) option than alternatives. Hence, this requires a comparison of the incremental cost of serving an area through gas with the cost of continuing to meet those energy needs through other fuel sources (such as electricity). As noted earlier, this is an important matter, because if gas displaces the other energy sources where gas is higher cost, then the total cost of meeting Tasmania's energy needs will rise, and average prices will rise.

The State has explained its proposed approach for determining its proposed minimum service area to the Regulator. In effect this involved:

- breaking up all of the potential service area into a number of 'assessment areas' (about 40 in all across Tasmania were used), where those 'assessment areas' were determined by geographical considerations (eg roads and rivers) and population density considerations;
- determining the most efficient pipeline network for serving each of those 'assessment areas', and estimating its cost through forecasting capital and non-capital expenditure requirements over the 15 year period;
- forecasting demand associated with the two yields (ie G_j for customers smaller than 30 T_j per annum, and G_j x km for large customers) over the 15 year period; and
- calculating the yields that equate the discounted revenue from selling gas distribution services, with the discounted cost of providing those services (which could be undertaken for different groups of 'assessment areas' ranked from the lowest average cost to the highest average cost.

¹¹² Code, s8.1 (d).

In selecting the minimum pipeline route, the State had regard to a number of factors, including the desire to make the project as attractive as possible to a developer (which would lean in favour of a smaller area and lower average price, subject to the interests of a developer in the scale of the project). However, it is noted that the change in the yield from one set of ‘assessment areas’ to another would reflect the extent to which the incremental cost associated with that set of areas exceeds the incremental revenue (calculated at the yield). If an assumption is made about the cost of continuing to serve that area with alternative fuels,¹¹³ then this information can be used to test whether the incremental cost associated with serving that new area is likely to be lower or greater than the cost of continuing to serve that area with an alternative energy source.¹¹⁴ The Regulator notes that the costs (on a \$ per GJ basis) are relatively consistent across each of the areas included in the minimum service area, though the cost variations within the nominated minimum service area may be material. Since the average cost must be less than the cost of supply by alternative fuels and since there appears to be a reasonable uniformity of costs within the minimum service area, the analysis undertaken by the State suggests that it would be unlikely that, for any of the ‘assessment areas’ included in the minimum pipeline route, the incremental cost of serving that area with gas would exceed the cost of continuing to serve the area with alternative energy sources.

It is noted that the State’s analysis adopted a number of assumptions and approximations. However, this is considered inevitable in an analysis of this type. It is accepted that, on the basis of the analysis presented by the State, and taking account of the inherent imprecision in analyses of this type, there are no strong grounds for considering that the State’s proposed service areas would result in significant areas being included where gas was not expected to be the lowest cost energy source.

Matters pertaining to the Gas Pricing Order

Form of Price Control

In the Issues Paper, the relative merits of the forms of price controls that were considered potentially most appropriate for Tasmania – the revenue yield (as proposed) and the tariff basket, were discussed at some length. The latter places a control on the weighted average of all tariffs, rather than the average revenue. Advantages and disadvantages with both forms of control were identified.

Aurora/Agility has suggested that the price control proposed is, in effect, a revenue cap, which would not provide the incentive for a distributor to seek to expand the Tasmanian gas market. It also criticised the prescription of the revenue yield control, and suggested instead that bidders should be free to propose whatever form of control they like, and suggested that a regime based upon individual price caps would be more

¹¹³ As discussed in s5.6 of this statement, the State assumed that the cost savings (over alternative energy sources) from connecting to gas to be about \$820 per household (in NPV terms).

¹¹⁴ It is noted that adjustments also need to be made to ensure that the costs of delivered energy sources are compared.

appropriate (which implies that a different CPI-X escalation applies to individual tariff components, and rebalancing of rates is precluded).

Turning to the first of Aurora/Agility's comments, it is incorrect to say that the control may amount to a revenue cap, as it is a revenue yield, and so additional throughput is rewarded (which is not a characteristic of a revenue cap). It may be that this was considered to be the implication of an Additional Revenue Policy under which a significant share of any revenue above forecast would be refunded to customers. However, it is noted that the form of Additional Revenue Policy is at the discretion of bidders (and it is stated explicitly that a policy of nil sharing is permitted).

Turning to the second of Aurora/Agility's comments, it is noted that the State has defended its proposal to specify the form of control on two grounds which are:

- it wishes to see in place an efficient regulatory regime, which may not naturally be produced from a bidding process; and
- having all bidders accept a common form of control (and associated implementation principles) reduces significantly the difficulties of comparing bidders.

Both of these arguments are considered to be sound, accordingly, it is agreed that it is reasonable to specify a form of control.

Regarding the precise form of control, while Aurora/Agility has suggested that individual price caps may provide superior incentives to a revenue yield, it has not provided any further analysis or intuition as to why this may be the case. Moreover, it is noted that the lack of opportunity for rebalancing that is implied by individual price caps is typically considered to expose utilities to unnecessary risk through not being able to respond to changed market conditions. Accordingly, Aurora/Agility's suggested control is not considered to be appropriate.

It is considered that the choice between the State's proposal of a revenue yield and tariff basket is finely balanced in the context of a new system that is likely to be subject to a significant degree of cost and demand uncertainty in the early years (which implies that the additional flexibility provided by the revenue yield is more important, and the superior efficiency properties of the tariff basket are less arguable). Accordingly, the Regulator has no basis upon which to draw a strong conclusion that the revenue yield is inappropriate, and so this requirement is accepted as reasonable.

Length Of The Regulatory Period

As noted above, the State has expressed a preference for the initial regulatory period to be 15 years, noting that both a shorter and longer period will be treated as imposing additional risk. In addition, the Regulator (in effect) needs to approve an initial regulatory period longer than 15 years.¹¹⁵ In response to this requirement, bidders are required to provide material to demonstrate why the extended date is appropriate on the

¹¹⁵ Code, s3.33 (d).

basis of the proposed tariffs, if a longer period is proposed. In effect, two matters must be considered when assessing whether the State's proposal is reasonable: whether the proposal to favour a particular period is appropriate, and secondly, whether 15 years is appropriate.

Aurora/Agility has argued that bidders should be permitted full flexibility to propose whatever period they choose. In addition, this consortium has argued that a longer period than 15 years is appropriate, with its supporting arguments including that:

- the period minimises the risk associated with regulatory re-sets; and
- longer periods of tariff certainty are the norm for some other infrastructure projects (including concessions for toll roads and for transmission pipelines where tariffs have been set by a competitive process).

The arguments in support of favouring a particular term for the initial regulatory period are the same as those offered by the State for the other elements of the regulatory framework that it has offered, namely that this assists considerably with the comparison of bidders (particularly in the context of the State's proposal not to undertake a purely quantitative analysis – this matter is discussed further in section 5.6). It has also argued that it is appropriate for important components of the regulatory arrangements to be determined for the bidders, particularly where the most efficient arrangements may not be delivered by the tender process. These arguments are accepted as implying that it is reasonable to favour a particular regulatory period.

Turning to the length of the regulatory period, it was noted in the Issues Paper that there are a number of trade-offs associated with the determination of this term. First, a longer period will provide stronger incentives to promote market growth and minimise cost, and also permit a greater share of the upside to be borne (which can offset the downside-risk associated with project failure). It also reduces the risk associated with the outcomes of a regulatory price review (as this is pushed off further into the future). Opposing this, however, a longer period will expose the developer to greater market risk as tariffs could not be re-set on the basis of cost or demand until the time of the price review. In addition, a longer period also exposes the customer and the developer to greater risk associated with the effectiveness (and outcomes) of the original tender process.

It is noted that developers' views on the appropriate regulatory period are likely to vary significantly, depending upon their own appetites for risk, and perceptions of the magnitudes of the different forms of risk, and the State has confirmed that a range of views on the period were expressed during its market testing. It is also noted that there is likely to be a significant degree of uncertainty associated with the cost associated with constructing the Tasmanian gas distribution network (as Agility/Aurora has emphasised in other parts of its submissions) which should distinguish the Tasmanian gas tender process from the case of toll roads and transmission pipelines.

In addition, while the fact that a tender process (using competition to determine prices) implies that there is less risk to customers from 'regulatory gaming' (which should imply less concern with having a regulatory period longer than the norm of five years), the tender process is not guaranteed to be free from gaming opportunities. Hence, very

long regulatory periods may expose customers to substantial risk associated with the initial regulatory settings.

It is also noted that the State has only stated that proposals that depart from the 15 year regulatory period will be accorded more risk. It is open for Aurora/Agility to put in a bid with its desired period (as one of its bids), and to demonstrate the benefits to customers from a longer period.

On balance, it is considered that the State's proposal to favour proposals with a 15 year regulatory period (with shorter or longer periods being treated as implying greater risk) is reasonable.

X-Factor

The State has proposed setting the X factor in the CPI-X formula at 1%, implying that tariffs will fall in real terms by 1% per annum over the term of the initial regulatory period. Bids with a different X factor will be treated as non-conforming.

The arguments in support of favouring a particular X factor are the same as those offered by the State for the other elements of the regulatory framework that it has offered, namely that this assists considerably with the comparison of bidders. It has also argued that it is appropriate for important components of the regulatory arrangements to be determined for the bidders, particularly where the most efficient arrangements may not be delivered by the tender process. These arguments are accepted as implying that it is reasonable that a particular X factor is favoured.

The State's argument in support of its proposed X factor is (essentially) that it considers that this structure of price control provides the level of price protection for customers consistent with the State's policy objectives. This argument does not appear to have substantial economic merit, given that the X factor does not affect the incentive to make efficiency gains (this comes about by setting prices independent of cost for a period). In contrast, Aurora/Agility's comment that having an X factor of 1% implies higher initial prices, which may affect the rate of customer switching (and hence the economics of the project) does have merit.¹¹⁶

In response, the State has provided further advice as to how it will take account of bids that submit a bid with a non-conforming X factor.

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

¹¹⁶ The impact of an X= 1% on prices may not be immaterial – it has been estimated that this would result in prices to small customers being about 8 per cent higher in the first year than they would be were X = 0.

Project Brief. Where a bid provides upside to consumers through other aspects, that bid will not be dismissed as non-conforming.¹¹⁷

The Regulator considers that this commitment should provide bidders with a degree of confidence that a non-conforming bid with an X factor that differed from 1% would be considered to the extent that it would permit material benefits to customers (which is the implication of Aurora/Agility's comments).¹¹⁸ On the basis of this commitment, the Regulator is prepared to accept an X factor of 1% as a conformity requirement.

GPO – Other matters

As summarised above, there are two forms of 'requirements' that are imposed by the tender process in relation to the elements of the future regulatory regime (to be given effect through the GPO). These are:

- requirements to make proposals on certain principles (with the effect that these principles will be determined through the tender process), but where bidders have flexibility as to the principles proposed; and
- requirements to accept the principles that are defined in the benchmark GPO, with a bid being considered as either non-conforming or ineligible for consideration if it fails to accept the principles.

The areas where proposals are required (but no constraints are imposed) are:

- the proposed yields (distribution and retail) and a bona fide estimate of the first year tariffs;
- key principles for the extensions and expansions policy;
- principles for the determination of the residual value of the assets at the end of the first regulatory period (which is also the opening regulatory asset base at the start of the second regulatory period), which must include confirmation that the bidder agrees that the residual value of the distribution system will be based on depreciation over the distribution system's economic life; and
- an 'additional revenue policy'.

All of these items are included in the criteria that will be taken into account to select the 'winner', and have been accepted as appropriate criteria (this matter is discussed in section 5.6 which addresses the requirements of section 3.28 (f) of the Code). In addition, it has also been concluded that all of these matters are 'directly relevant to the determination of Reference Tariffs', and so are matters that are permitted to be determined by the tender process (this matter is discussed in section 5.7 which discusses the requirements of section 3.28 (g)), and the requirement for depreciation to be based upon the system's economic life is required by section 3.28 (d) (iii).

¹¹⁷ The State, response to submissions, page 17.

¹¹⁸ It would be expected that such a bid would be submitted with a conforming bid.

Accordingly, the requirement that proposals be submitted on these matters is considered reasonable.

It is noted above that Aurora/Agility expressed a concern with the benchmark principles for calculating the residual value of the pipeline that have been included in the draft GPO. Under those principles, the assumed return of capital to investors (ie regulatory depreciation) over the initial regulatory period would be determined (in \$ terms, but adjusted for inflation), rather than being determined according to financial accounting conventions (ie by applying assumed depreciation rates to different classes of actual expenditure).

In response to Aurora/Agility's concern, it is noted again that bidders have the freedom to bid different principles to those that have been proposed. It is noted, however, that there are a number of reasons to consider that the State's proposal is superior to that of Aurora/Agility, including that:

- it provides more certainty to investors as the assumed return of capital is pre-determined;
- it is far easier to administer – if the assumed return of capital was calculated according to financial accounting conventions, the Regulator would need to impose detailed regulatory accounting guidelines and requirements to preclude 'gaming'; and
- it imposes less market risk (not more) than the alternative on investors.

Two other concerns were raised with the regulatory regime implied by the GPO, which were that the Regulator should have minimum levels of discretion under the regime, and that the scope of the pass-through clauses should be expanded.

Turning to the first of these, it is noted that the Regulator's discretion under the GPO already will be very constrained. The yields that are set as part of the tender process are determined and unchangeable for the initial regulatory period (which also will be set), and the algorithms that translate the yields into a control over prices have also been prescribed, and the application of the formulae themselves leave little room for discretion. One area where some discretion is accorded is in the administration of the pass-through clauses. However, even there, the Regulator is bound by a number of principles that are likely to provide significant guidance for the answer to any pass-through application.¹¹⁹

Another place where the GPO currently provides the Regulator with some discretion is in relation to the price for excluded services, where the benchmark principle is that such charges be 'fair and reasonable'. However, those principles are one of the matters upon which bidders may submit alternative principles without being considered non-conforming. Accordingly, if any bidder has a concern about the level of the

¹¹⁹ In particular, the requirement for the pass-through to keep the entity 'economically neutral' (GPO, clause 5.5 (b)) is likely to be capable of being objectively ascertainable in many cases.

Regulator's discretion, that can be remedied through their bid. Accordingly, it is considered that the draft GPO already meets the concern.

Turning to the scope of pass-through clauses, it is noted that, where the events are clearly beyond the control of the distributor or retailer, the determination of the appropriate pass-through clause involves a trade off. That trade-off is between a desire (possibly) to not subject the distributor to excessive risk associated with events it cannot control, on the one hand, and to minimise administrative costs (and, potentially, regulatory risk) on the other.

While the proposed pass-through clauses do not cover the 'world of events' that would be outside of the control of the retailer and distributor, the Regulator has no reason to believe the State's proposals are inappropriate. In particular, it is noted that if bidders consider that the clauses expose them to greater risk, this will be factored into bid prices. The fact that the retailer and distributor face greater risk would imply that the customers face less risk, and so need not be any worse off. Regarding Aurora/Agility's proposal that reasonable regulatory compliance costs be a pass-through, it is noted that this would be (at least partly) within the control of the winning retailer and distributor, and so permitting a pass-through would be inappropriate. Thus the Regulator concludes that the pass-through provisions of the GPO constitute a reasonable requirement.

9.4 Decision

The Regulator considers that the proposed rules and procedures to be followed in conducting the tender will result in no tender being excluded from consideration except in the circumstances outlined in paragraph 3.28 (d) or if the tender does not conform to other reasonable requirements in the request for tenders, or does not meet reasonable prudential and technical requirements.

10 SECTION 3.28 (F) – SELECTION CRITERIA

10.1 Code and Background

Section 3.28 (f) deals with the criteria the State will apply to rank the various bidders and ultimately to determine the successful bidder. The design and application of the selection criterion will be an important determinant of whether the competition that is generated by the tender process is harnessed effectively to generate the maximum benefit for Tasmanian industry and consumers.

The selection criteria applied during the tender process must satisfy two requirements. Section 3.28 (f) (i) and (ii) will be dealt with separately.

Under section 3.28 (f) (i) of the Code, the Regulator is required to ensure that the selection criteria to be applied in conducting the tender

‘will result in the successful tender being selected principally on the basis that the tender will deliver the lowest sustainable tariffs (including but not limited to the Reference Tariffs) to Users generally over the economic life of the proposed pipeline’

Secondary criteria may also be employed provided that they are not inconsistent with the objectives for regulated charges.

An issue that requires some consideration is whether the word “principally” prohibits selection criteria being applied such that the tender does not deliver the lowest sustainable tariff. As noted above, the State proposes to include a number of selection criteria in addition to the price criterion. Section 3.28 (f) (i) also requires the sustainability of the distribution tariffs proposed by each bidder to be a separate matter for evaluation. The Code requires the price criterion to take account of the prices expected to prevail over the economic life of the pipeline and related to this, the sustainability of prices.

Section 3.28 (f) (ii) requires the Regulator to ensure that the selection criteria are likely to result in Reference Tariffs that meet the criteria specified in section 3.33 (c) of the Code, which include achieving the Reference Tariff objectives outlined in section 8.1 of the Code; and contain or reflect an allocation of the costs between the Users that is fair and reasonable.

The interpretation of the objectives set out in section 8.1 of the Code were discussed above. With respect to the fairness and reasonableness of the allocation of costs between Users, it is noted that while the User would typically be a retailer, the implications of any tariff for the allocation of costs amongst the ultimate consumers is relevant to the assessment of the fairness and reasonableness of that allocation.

Turning to the State's proposal, the key features of the selection criteria that have been proposed are as follows:

- *Price criterion* – bidders will be required to bid a discount (or premium) to the benchmark 'yields' specified in the Project Brief for the two classes of customers.¹²⁰ These yields will then be used to estimate the total cost of distribution that is implied by each bid, using the State's demand and other forecasts. Adjustments may then be made to take account of the sustainability of the proposed prices (discussed further below). Bidders will be ranked from lowest distribution cost to highest.
- *Distribution network coverage* – the State proposes calculating a net benefit (or loss) to customers where bidders offer a larger (or smaller) service area, and to take account of this customer benefit or loss when ranking the bidders. The value of the benefit or loss will be based upon the State's estimate of the average savings associated with supplying energy needs through gas (compared to other fuels, like electricity).¹²¹
- *Retail price offerings* – bidders will be required to submit a retail yield for the two classes of customers, as well as a time-path for this price over the six-year period of the retail franchise. The total retail gas cost to customers that is implied by the different bids will be taken into account in the evaluation of bidders.
- *Risk to the State and to consumers* – these include but are not necessarily limited to any departures from the draft Development Agreements proposed by the State, or other conformity requirements, the Revisions Commencement Date (ie the term before the tariffs are reviewed), and the bidder's proposal on funding the development of the natural gas distribution and retail businesses.
- *Additional Revenue Policy* – which is the proposal as to whether any of the benefit from sales in excess of those forecast will be shared with customers.

The factors that the State has noted that may bear on a bid being considered less sustainable than other bids (when applying the price criterion) include:¹²²

- the relationship between the yield that has been bid and estimates of efficient cost;
- any changes proposed from the benchmark extensions/expansions policy;
- any changes proposed from the benchmark 15 year initial regulatory period;

¹²⁰ As discussed above, the term 'yields' refers to the allowed average (or per unit) revenue that the winning distributor will be permitted to recover from a particular class of customers.

¹²¹ Note that bidders that offer a lower service area will be treated as non-conforming.

¹²² Tender Guidelines, clause 8.2 (b).

- any changes proposed from the benchmark principles for determining the regulatory value of the distribution network at the first price review; or
- the relationship between retail yields and estimates of efficient cost.

As an example of where an adjustment for sustainability may be appropriate, the State has proposed evaluating the total cost of distribution to customers that is implied by each bid on the assumption that those prices remain in effect for the first 15 years (which corresponds with the State's proposed Review Commencement Date). Where a bidder proposes a different initial regulatory period, the State will make an adjustment to the rank of that bidder (if necessary) to take account of the sustainability of the bid price.

With respect to the weighting of these criteria, the State has proposed not prescribing weights, but rather permitting judgement to be exercised, subject to specified objectives and a defined process. That is:

- Section 8.8 (c) of the Tender Guidelines provides that the Gas Steering Committee will evaluate the Relevant Bid Submissions on the basis of the principal selection criterion, and rank the Bid Submissions in order of merit. The Gas Steering Committee is then required to:
 - evaluate and rank, in order of merit, each Bid Submission on the basis of the additional (secondary) criteria; and
 - evaluate each Bid Submission against the requirements of section 3.33 (c) of the Code (section 8.8 (d) of the Tender Guidelines).
- On completion of the above process, the Gas Steering Committee is required to undertake an overall evaluation of the Bid Submissions (section 8.8 (f) of the Tender Guidelines). In this evaluation the Gas Steering Committee is required to:
 - apply distribution tariffs as the principal selection criteria;
 - only re-rank a Bid Submission downwards (as compared to its initial ranking against the principal selection criteria, namely the lowest sustainable distribution tariffs) if the Committee considers that, in the light of the evaluation against the secondary criteria, it would be consistent with the State's Objectives for this Bid Submission to be ranked below one or more other Bid Submissions; and
 - in evaluating Bid Submissions against the secondary criteria ensure that the selection of the successful Bid Submission achieves the objectives set out in section 8.1 of the Code and in the event of any conflict, this requirement prevails over the requirement in the above dash point, which requires consistency with the State's Objectives.

The State's objectives referred to above include facilitating the development of an efficient and competitive gas supply industry, maximising the coverage of reticulated

gas services in Tasmania in an economically efficient manner and minimising costs to gas customers.¹²³ The State has argued that the difficulty of foreseeing perfectly how bidders will respond to the selection criteria justifies the reservation of a degree of discretion as to how the different criteria should be weighted.

With respect to the requirement for price to be the principal criterion, the State has noted that “principally” is not defined in the Code. The State has relied on the ordinary principles of statutory interpretation to conclude that principally would be determined by a qualitative analysis of a particular item or factor. Further, the State has argued that in undertaking a qualitative analysis, a quantitative component is helpful, but not determinative.¹²⁴

The State contends that by using the word “principally” as opposed to “solely” or “only”, the drafters of the Code intended that other criteria other than the “lowest sustainable tariff” be taken into account in evaluating the tenders. The State submits that the better view is that section 3.28 (f) (i) provides that:

- distribution tariffs should be the single most important criterion to be used in evaluating tenders;
- the selection criteria may involve one or more qualitative items and, as a result, it is unlikely that a pure dollar value analysis can be undertaken; and
- in appropriate cases, a tender that includes higher distribution tariffs might be favoured over a competing tender with lower distribution tariffs if the first tender was materially favourable on other criteria.

Consistent with this, as described above, the Evaluation Methodology (described in the Tender Guidelines) provides for an initial ranking of bids based solely on the distribution yield, additional criteria then considered, but with the final ranking made such that the selection of the successful Bid Submission achieves the objectives set out in section 8.1 of the Code (with those objectives prevailing in any conflict).

Regarding the requirement for the tariffs to achieve the objectives of section 8.1, the State has submitted that the selection criteria, together with the competition generated by the tender process, will naturally result in the objectives of section 8.1 being achieved. The State will also require bidders to demonstrate that their proposals would meet section 8.1 of the Code,¹²⁵ and will exclude bids that are not considered to meet with these objectives.¹²⁶ Regarding the tariffs to reflect a fair and reasonable allocation of costs, the State will require the bidders to demonstrate that their bids meet this

¹²³ Tender Guidelines, clause 1.2.

¹²⁴ Clause 12.7 (b) of the TAR.

¹²⁵ TAR, clause 8.2 (e).

¹²⁶ TAR, clause 8.4 (d).

requirement,¹²⁷ and will exclude bids that are not considered to contain such an allocation.¹²⁸

10.2 Issues Raised

A number of issues associated with the selection criteria were identified for public comment in the Issues Paper.

An overarching issue that was raised was how the legal requirement for the level of sustainable tariffs to be the principal criterion for selection should be interpreted and applied, and in particular, what this implied for the appropriateness or weight to be attached to the criteria that the State has proposed in addition to price. A closely related issue is whether the degree of discretion that the State has proposed with respect to the weighting of the various criteria is appropriate.

Regarding the price criterion, an issue that was raised was whether the State's proposed interpretation of price was reasonable. It was noted that the concept of the price charged by a utility is not straightforward, given that utilities generally have a scale of rates (including fixed (standing) components, potentially components dependent upon maximum demand, throughput, distinctions on the basis of size and season etc). The methodology proposed by the State would have the effect of selecting the distributor that offered the lowest average charge (in \$ per Gj) for large and small customers, with the two groups weighted according to the revenue expected from each (calculated using the State's demand forecasts).

Regarding the non-price criteria employed, an issue to be considered is whether the consideration of each of those factors is appropriate. Amongst other things, this requires a view to be taken as to whether regard to these factors would lead to tariffs that are inconsistent with the factors in section 8.1 of the Code. Two issues to be considered are the State's proposal to ascribe a greater value to a bid that includes a service area that is greater than the required minimum area, and its proposal to take account of the proposed retail yields (noting that the role of the tender process is to determine tariffs for the distribution component only).

The Regulator is also required to consider more broadly whether the tender process is likely to lead to tariffs that meet the requirements of section 8.1. While the actual tariffs that are bid could be assessed against section 8.1 (as has been proposed), a more powerful mechanism for achieving these objectives is to ensure that the selection criteria (and other components of the tender process) are designed such that bidders have an incentive to bid such tariffs.

Lastly, it will need to be considered whether the proposed approach for ensuring that tariffs are consistent with a fair and reasonable allocation of costs is appropriate.

¹²⁷ TAR, clause 8.4 (e).

¹²⁸ TAR, clause 8.4 (d).

Submissions

A number of the submissions expressed broad support for the selection criteria proposed by the State.¹²⁹ ABM believes that the selection criteria based principally on the basis of the lowest sustainable tariff is admirable.

ABM has submitted that the Extensions/Expansions policy should be added to the additional criteria for consideration if the franchise is not limited to the Minimum Pipeline Route, otherwise an exclusive franchisee will be able to dictate excessive terms to any new customer away from the Minimum Pipeline Route.

The Aurora/Agility consortium made a number of specific comments about the selection criteria, which included the following:

Sustainability – that the criteria should focus on ensuring that bids were commercially sustainable, which is interpreted as implying that a primary concern should be that the bid prices are sufficiently high for the project to be commercial.¹³⁰

Telecommunications – that the Regulator should not ascribe any value to telecommunications.¹³¹

Retail – it is inconsistent with the Code for account to be taken of the retail proposals.¹³²

Excluded services – it is inappropriate for the Regulator to impute any value from excluded service charges.¹³³

In addition, Aurora/Agility commented that the standard NPV methodology should be used to rank bids, and that all of the assumptions adopted should be disclosed.¹³⁴ On a matter that is related to the selection criteria, Aurora/Agility argued that the exclusive franchise to the distribution business should extend for the whole initial regulatory period (which the State has expressed a preference to be 15 years) for the area that is covered by the minimum pipeline route.¹³⁵

The Aurora/Agility Consortium also expressed concern that the negotiations in relation to project agreements may become a de facto selection criteria.

¹²⁹ ABM; submission page 5, Duke Energy, submission

¹³⁰ Aurora/Agility, submission page 19.

¹³¹ Aurora/Agility, submission page 16.

¹³² Aurora/Agility, submission page 19.

¹³³ Aurora/Agility, submission page 21.

¹³⁴ Aurora/Agility, submission page 19.

¹³⁵ Aurora/Agility, submission page 25.

Duke Energy has submitted that it is supportive of the approach outlined by the State and believes that the proposed approach should result in reference tariffs and reference tariff policies achieving the objectives of section 8.1, though Duke Energy does have concerns in regard to some aspects of the package.

10.3 Consideration of Issues Raised

Overall approach

The Regulator must form a view as to whether the method that the State has proposed for considering the additional or secondary criteria is consistent with meeting the tariff objectives and consistent with the legal requirement for the level of ‘sustainable tariffs’ to be the principal criterion for selection.

The evaluation methodology proposed by the State seeks to rank first the Bid Submission offering the lowest sustainable distribution tariffs (the first ranked Bid Submission). However, this ranking may be changed if in the light of the evaluation against the secondary criteria, it would be consistent with the State’s Objectives for the first ranked Bid Submission to be ranked below one or more other Bid Submissions. When undertaking the evaluation against the secondary criteria, the Gas Steering Committee is required to ensure that the successful Bid Submission achieves the objectives set out in section 8.1 of the Code. The requirement for the successful Bid Submission to achieve the Code objectives prevails over the requirement for consistency with the State’s Objectives, should a conflict arise between the two sets of requirements.

The implication of the State’s proposed selection criteria is that the rank of the various bidders against the price criterion is evaluated first, and changes are only then made to the extent that it would be consistent with the State’s objectives. In addition, the evaluation against the secondary criteria ultimately rests on a determination of whether the successful Bid Submission achieves the objectives set out in section 8.1 of the Code. Subject to the concern raised next, this methodology, if followed, should ensure the result that the successful Bid Submission should meet the tariff objectives and satisfy the requirement of the principal selection criterion.

One implication of this approach, however, is that it leaves the State (in the first instance) with the requirement (potentially) to exercise a degree of judgement when assessing the relative merits of the various bidders. In turn, this implies that the Regulator would also have to exercise a degree of judgement when it receives the FAR for assessment.

There is the potential with such an approach that the added degree of uncertainty associated with the application of the criteria by the State, and the uncertainty associated with the Regulator’s assessment at the FAR stage, may reduce the preparedness of bidders to enter the process. Similarly, the uncertainty with respect to the weight to be attached to some of the non-price criteria may reduce the clarity of the incentives for bidders to submit bids that are consistent with the relevant Code objectives (some of these incentives are discussed below). Consistent with this theme, one of the public submissions expressed the view that it would be appropriate for all

assumptions to be adopted in the evaluation (including, presumably, the detailed method) to be disclosed prior to bidding.

In response, the State has argued that the flexibility sought is necessary to avoid creating unforeseen potentially perverse incentives for bidders. In particular, the State has commented that:

In establishing the regulatory structure and determining the evaluation criteria, the State has sought to minimise any potential gaming opportunities. It has formed the view that the scope for any such gaming opportunities is likely to be limited and the benefits of the flexibility and incentives built into this evaluation methodology are likely to exceed the detriment associated with any gaming risks.¹³⁶

One of the reasons for the State's concern about potential 'gaming' concerns is because it has proposed providing all of its financial and market assumptions (such as the cost of capital and demand forecasts) to bidders in order to assist bidders to evaluate the merits of the project. If the bidders' assumptions or forecasts are materially different to those adopted by the State, there is a higher potential for gaming of the evaluation process through the structure of the bid.

That said, the State has explained how it will determine the value of a number of the various criteria, which provides some insight into the weights that would expect to be assigned. For example, it has stated how it will calculate the assumed net distribution cost to users, the additional customer benefit associated with supplying additional areas, and how it will calculate the assumed net retail cost to consumers.¹³⁷ As described above, the State has also defined a process and objectives that will place further limits on the exercise of its discretion. Both of these components of its proposal should alleviate, to an extent, any uncertainty.

On balance, it is considered that the State's overall approach with respect to the definition and application of the selection criteria meet the requirements of the Code.¹³⁸

¹³⁶ Tender Approval Request, clause 8.4.

¹³⁷ Tender Guidelines, clauses 8.2, 8.3 and 8.4.

¹³⁸ It is noted that one of the mechanisms that put a limit on the potential *gaming* possibilities is the fact that the exclusive franchise for the distributor will only last for five years, and the form of price control in the GPO will not permit costs to be allocated between the different 'yield' baskets (ie small and large customers) once the initial yields have been determined. The combination of these two factors places a limit on the ability for the distributor to propose an artificially high yield for large customers, and low yield for small customers (which could be its incentive in certain circumstances). Were this incentive to exist, it would also provide an (unintended) incentive to bid yields that would imply a cross subsidy from large to small customers (and breach the Code objectives). It is for this reason (amongst others) that Aurora/Agility's suggestion that the winner should be granted an exclusive franchise for all customers for the term of the GPO (noted above) is considered inappropriate.

Price Criterion

As noted above, the Regulator needs to assess whether the definition of price implied by the criteria is appropriate, and whether the prices to be compared represent sustainable prices.

With respect to the first of these matters, none of the submissions commented explicitly on the proposed definition of price that has been adopted, which is a weighted average of all prices. The approach proposed takes account of all transportation prices, and would appear to reflect a reasonable weighting of the different prices. Accordingly, the proposed approach is considered appropriate.

Regarding the sustainability of prices, Aurora/Agility has made two comments, which are that a focus of the assessment should be to ensure that the tariffs proposed are commercially sustainable, and it is inappropriate to ascribe value to excluded distribution services.

Turning to the first of these issues, it is considered inappropriate for the selection criteria to require an explicit assessment of whether the bids that bidders may submit are commercially sustainable. Rather, individual bidders are in the best position to form a view as to what is commercially sustainable, and on related matters, such as the cost of building the network, future demand for gas, and the cost of financing the project.

It is noted however, that if the winning bidder was not held to deliver according to its bid then providing this level of 'freedom' to bidders may expose Tasmanian consumers to risk (as a developer could subsequently walk away if it discovered that its bid was imprudent), which in turn could lead to perverse bidding behaviour. It is considered that the appropriate response to such a concern is to ensure that the proposed Development Agreement is sufficiently robust to hold the successful bidder to its commitments.

Related to this, it is noted that Aurora/Agility has commented that the capital expenditure forecasts that have been produced by the State's advisers understate the likely expenditure requirements. When providing potential bidders with its forecasts (and other relevant information), it is understood that the State will explain the process undertaken to derive the forecasts, which will make known the level of precision attached to that information. Bidders can decide for themselves the extent of investigation necessary to submit a tender, and related to this, the extent to which they place weight upon the information provided by the State. The risk to Tasmanian consumers (and the integrity of the bidding process) would be secured by ensuring that the Development Agreement is sufficiently robust to hold bidders to their commitments.

Turning to excluded distribution services, it is noted that the expected prices for excluded services may impact upon the price charged for transporting gas. Accordingly, if there are material differences in the proposed principles for excluded services, it is appropriate for an adjustment to be made to ensure that the prices are comparable.

Non-Price Criteria

It was noted above that an issue to be considered is whether regard to the non-price factors would lead to tariffs that are inconsistent with the factors in section 8.1 of the Code. The more important of the non-price criteria are the proposals to take account of the retail yield, and to assign a ‘net customer benefit’ for a service area that is greater than the minimum pipeline route.

Regarding the retail yield, it is noted that the cost of gas to consumers will comprise the sum of the cost of the processed gas, the cost of transportation along Duke’s transmission system, the distribution cost, and the cost associated with the retail function. Accordingly, the well-being of customers will be maximised if the criteria results in the minimisation of the sum of the components that make up the delivered price. As the State has proposed (and the Regulator has accepted) the requirement for stapled retailer/distributor bids, issuing an exclusive franchise for the retail business for a six year period and using the tender to also set retail prices, it is necessary to take account of the proposed retail prices in the tender evaluation to minimise the cost of gas to end-users.

As noted above, Aurora/Agility has commented that taking account of the retail proposals when determining the ranking of bidders when using the competitive tendering process is inconsistent with the Code.

With respect to the legal requirements of the Code, the Regulator has received advice that it is not inconsistent with the Code to have regard to the retail proposals, provided this does not lead to the distribution tariffs being inconsistent with the objectives in section 8.1. The Regulator considers that failing to take account of the retail proposals may lead to the tariff objectives not being met. This is because, if retail prices are ignored, the strategy for bidders would be to submit a high retail component, and a lower (and exactly offsetting) distribution yield. Such distribution tariffs would be unlikely to meet the requirements of section 8.1.¹³⁹

Turning to the second of these criteria, the issue to be considered is whether the State’s proposal to ascribe a customer benefit to bids that contain a service area that is greater than the minimum pipeline route is likely to be consistent with the Code’s objectives for tariffs, the relevant one being whether it is likely to distort (ie promote inefficient) investment.¹⁴⁰ As discussed, in regard to section 3.28 (e), one of the criteria by which investment in pipelines in a service area is considered to be efficient is that the costs associated with meeting energy demands in that area with gas are lower than the cost of continuing to meet those needs through alternative fuel sources. As has been noted earlier, the State has proposed that there be uniform retail prices across the minimum

¹³⁹ An alternative strategy would have been to use the competitive process to set distribution prices only, and for a Regulator to determine the price that is charged in respect of the non-distribution components. The State’s proposal has the advantage of competition – rather than a Regulator – to determine the retail component.

¹⁴⁰ ‘Not distorting investment in Pipeline transportation systems’ is one of the objectives for Reference Tariffs in the Code: s8.1(d). A ‘distortion’ is a factor that induces an inefficient outcome.

pipeline route regardless of cost differentials, and so one of the normal signals for efficient investment would be absent.¹⁴¹

The State's proposal assumes that the average customer-benefit from being supplied with gas is about \$820 per household, which it has stated has been calculated on the basis of an estimate of the avoided cost of substitutes for the same service (in NPV terms over the life of a customer connection). Assuming this reward reflects accurately the customer benefit from gas, the out workings of such a reward (to a first approximation) are as follows:

- Where the cost of serving an additional area is greater than the customer benefit (ie the project was inefficient), then the rise in the net distribution cost that would be calculated for that bidder would exceed the 'customer benefit' computed by the State – and the bidder's relative ranking may fall. Under this scenario, the bidder would logically choose not to propose the area. Hence, the bidder would have an incentive not to propose supplying an area that was inefficient to serve.
- Where the cost of serving an additional area is lower than the customer benefit (ie the project was efficient), then the rise in the net distribution cost that would be calculated for that bidder would be less than the 'customer benefit' computed by the State – and the bidder's relative ranking may rise. Hence, the bidder would logically choose to propose the area, and that area would be efficient to serve.

Accordingly, assuming the reward is set at a level that properly reflects the comparative cost of service by alternatives, it is considered that the State's proposed approach would be likely to provide an incentive for gas to be supplied to areas only where it is efficient to do so. Regarding the size of the reward, the Regulator considers that it is not inappropriate, noting the difficulties of calculating the costs of alternative energy supply with any precision. Accordingly, the Regulator is satisfied that the State's proposal to take account of the customer benefit associated with serving additional areas is likely to generate tariffs (and investment underpinning those tariffs) that are consistent with the Code's tariff objectives.

Lastly, Aurora/Agility has commented that, like the State, the Regulator should ascribe value to telecommunications proposals. It is noted that the TAR states clearly that telecommunications proposals cannot be considered.¹⁴² Accordingly, the Regulator would be precluded from having regard to any telecommunications proposals (if such proposals are known at that stage) in assessing the FAR.

¹⁴¹ This 'signal' is that prices reflect cost. Relating this to gas, if prices reflected cost, then customers (in choosing the lowest *price*) naturally choose gas only where it was a lower cost energy source than alternatives. In turn, as gas would only be supplied in areas where there was sufficient demand, it necessarily would only be supplied in areas where it was lowest cost. As noted in s5.5, however, the absence of this signal does not necessarily imply that inefficient investment will proceed.

¹⁴² TAR, clause 3.7.

Achieves the Section 8.1 objectives

The Regulator is required to form a view as to whether the selection criteria are likely to result in tariffs that meet the objectives for prices set out in section 8.1 of the Code. It was also noted that the most efficient means of ensuring that these objectives are met is to ensure that the tender process provides the incentive to submit bids that meet these objectives.

The more relevant of these objectives include that tariffs:

- reflect efficient cost (8.1(a));
- do not distort investment in pipelines or upstream or downstream industries (8.1(d)); and
- are efficient in level and structure (8.1(e)).¹⁴³

Turning to the first of these: bidders would want the regulated prices to be as high as possible, however as price is the principal criterion for selection, the threat of losing to another bidder would place a discipline on the price that each bidder would bid. With effective competition, the prices that are bid would be expected to be close to efficient cost, and satisfy this requirement.

The primary factors that would influence whether the investment in the pipeline was efficient are the principles that were used to determine that area and the benefit assigned for serving a larger area. The first of these issues was discussed in section 5.5, and the latter in this section, and it was concluded that the State's proposal would meet this requirement.

With respect to whether tariffs will be efficient in level and structure, the fact that the tariffs for all of the services combined are expected to reflect efficient cost also implies that the tariffs (taken as a whole) are expected to be efficient. Turning to the individual tariffs, the normal test for the tariff for a particular service to be considered efficient is for that tariff to lie between the bounds provided by the incremental (or avoidable) cost, and standalone cost.

The selection criteria adopted in the tender process would not be expected to impact directly upon the structuring of individual tariffs. However, one case where a distributor could have had an incentive to bid yields that would result in large customers potentially being cross-subsidised has been discussed above. It was concluded that the form of price control adopted, and ability for large customers to bypass the system after five years, would imply that such cross-subsidisation would be unlikely.

¹⁴³ Another objective is that tariffs replicate the outcomes of a competitive market. However, the implications of this for tariffs is addressed, to a large extent, by the other objectives.

Delivers a Fair and Reasonable Allocation of Costs

While the requirements for the allocation of costs implied by a tariff structure to be considered economically efficient are reasonably well-defined (albeit, typically only providing a range for tariffs rather than a particular value), the requirements for an allocation of costs also to be considered to be fair and reasonable are inherently more subjective.

The State has proposed that bidders demonstrate that their proposals for tariffs (in particular, the opening tariffs) can be considered to imply a fair and reasonable allocation of costs, and to exclude a bid from consideration where the allocation was not considered to meet this criterion.¹⁴⁴

Given the range of issues that may impact upon the perceived fairness of the allocation of costs, this is considered to be appropriate. It is noted that the Regulator independently has to consider whether the allocation of costs can be considered fair and reasonable when assessing the FAR. This judgement will be made recognising the economic boundaries for the allocation of costs, and the acceptance in the Code that the allocation of costs should be subject to commercial and technical considerations.

10.4 Decision

The Regulator is satisfied that the selection criteria to be applied in conducting the proposed tender:

- (i) will result in the successful tender being selected principally on the basis that the tender will deliver the lowest sustainable tariffs (including but not limited to Reference Tariffs) to Users generally over the economic life of the proposed Pipeline; and
- (ii) are likely to result in Reference Tariffs that meet the criteria specified in section 3.33 (c).

¹⁴⁴ It should be noted that, while the distributor will be able to rebalance charges over time – which is an implicit change to the allocation of costs – the rate at which the allocation can be changed is constrained by the rebalancing control.

11 SECTION 3.28(G) – DETERMINATION OF ITEMS OF REFERENCE TARIFFS

11.1 Code and Background

Section 3.28 (g) requires that the tender documents specify which items required to be included in an Access Arrangement other than Reference Tariffs will be determined by the tender and that those items are directly relevant to the determination of Reference Tariffs.

This section, in effect, imposes two conditions, which are that:

- where the items required in the distributor's Access Arrangement other than reference tariffs are to be determined by the tender process, those items must be identified in the tender documentation;¹⁴⁵ and
- only items that are directly relevant to the determination of reference tariffs may be determined by the tender process.

An Access Arrangement is a statement of the policies and basic terms and conditions that are to apply to third party access to a Covered Pipeline.¹⁴⁶ Access Arrangements must, as a minimum, include the following elements:

- services policy – which is, amongst other things, a description of the services to be offered by the distributor;
- one or more reference tariffs – which is (a) benchmark tariff (or tariffs) for a defined service (or services);
- terms and conditions – governing the supply of the services;
- a capacity management, trading and queuing policy – which describe, amongst other things, the extent to which users of the pipeline have rights to trade in reserved capacity, the terms of that trade and the processes under which rights to use capacity are allocated where there is a shortage of capacity;
- extensions and expansions policy – which describes, amongst other things, how new investment in the facility will be regulated and priced; and

¹⁴⁵ Includes the TAR, Tender Guidelines and the documents referred to in schedule 3 of the TAR.

¹⁴⁶ Covered Pipeline is defined in the Code as meaning subject to sections 2.3 and 2.4 of the Code, the whole or a particular part of a Pipeline which is subject to the Code. Pursuant to s1.21 of the Code, a Pipeline becomes covered from the time a Regulator makes a decision under s3.32 of the Code approving the outcome of the competitive tender process.

- revisions submission/commencement date – which fixes the date at which the next formal review of the Access Arrangement will commence, and the revised tariffs will take effect.

For the elements of the Access Arrangement that have not been determined by the tender process, the successful distributor will be required to submit its proposals to the Regulator, which will then be assessed under section 2 of the Code. Amongst other things, section 2 requires the Regulator to undertake public consultation prior to making a decision, and to apply specified principles in its assessment of the proposals.

The TAR and Tender Guidelines outline five matters that are to be determined by the competitive tendering process (which will, in part, satisfy a number of elements of the Access Arrangements) which are:

- the price control that will govern the prices for transporting gas through the distribution system (including the extent (if any) of revenue above forecasts that may be returned to customers), and pricing principles for the provision of ancillary services;
- a list of reference services to be provided by the pipeline (which are, in broad terms, the transportation of gas and a number of services that are ancillary to the transportation of gas);
- the principles to be used to determine the value of the assets (for regulatory purposes) at the time of the first price review;
- the minimum area to be serviced by the proposed Pipeline;
- the key principles of the Extensions/Expansions Policy; and
- a Revisions Commencement Date applicable to those reference Tariffs.

On a number of these matters, the State has proposed placing limits on the bidders as to the principles that they may (or be required to), accept. Whether these proposed limitations are reasonable has been considered in the assessment of the requirements of section 3.28 (e), and is not repeated here.

11.2 Issues Raised

The Regulator did not raise any specific issues in the Issues Paper in relation to matters to be determined by the tender process relating to section 3.28 (g) of the Code.

None of the public submissions commented explicitly upon whether any of the matters to be determined by the tender process should be considered as outside of those permitted by section 3.28 (g), although some submissions¹⁴⁷ appear to support that

¹⁴⁷ For example, Aurora/Agility appeared to support the tender process determining the length of the regulatory period (pages 22-23), the extensions/expansions policy (page 30) and the residual value (page 31), although it disagreed with some of the constraints on these items that have been proposed (Aurora and Agility, submission, 12 October 2001).

some of these items should be determined by the process. These matters, raised by the Aurora/Agility consortium, are discussed in the context of section 3.28 (e), and include:

- *Revisions Commencement Date:* The Consortium is of the view that it is appropriate, given the level of gas volume being taken by the developer, the long construction period and the long period to achieving gas volumes upon which the network is viable, that a period longer than 15 years should be set for the Revisions Commencement Date.
- *Distribution Yields:* The Consortium has submitted that the proposed tariff yield based on CPI-X regime with X=1% is inappropriate for a greenfield development. It is the Consortium's view that the full CPI escalation may be more appropriate and should be allowed as a conforming bid.
- *Network Bypass:* The Consortium has recommended that Bypass should not be allowed within the regions covered by the Minimum Pipeline Route.

11.3 Consideration of Issues Raised

Regarding the first of the requirements, it is noted that the items required in an Access Arrangement that are to be determined by the Access Arrangement have been set out in the TAR and related documentation. Accordingly, it would appear that this part of the section has been complied with.

One means of assessing whether the items to be determined by the tender process (other than reference tariffs) are 'directly related to the determination of reference tariffs' is to ask whether a change to each item would normally result in a change to the reference tariff that would be determined. For the purpose of this analysis, it is assumed that a change to the average cost of providing the distribution services would lead to a change to the tariff that would be determined.

Where tariffs are set through the regulatory approach (that is, where the distributor proposes tariffs and these are assessed by the Regulator against section 8 of the Code), the link between average cost and price is explicit, as the Code requires that tariffs be set to provide a stream of revenue that equates with benchmark costs.

Where tariffs are set through a competitive tender process, the link between average cost and price is less clear, given that proponents are free to use whatever bidding strategies they like (subject to the tender rules). However, effective competition in the bidding process should place a discipline on bidders to put in bids that just deliver a normal (commercial, risk adjusted) return. In this situation, a change to average cost would be expected to lead to a change to the tariff that is bid.

Turning to each of those items in turn:

- *List of reference services* – different services normally have different prices, and so a change to the list of services would imply a change to the prices. Accordingly, this item can be considered 'directly relevant' to tariffs.

- *Principles to determine the regulatory value of the assets at the first review* – the difference between the capital expenditure undertaken over the regulatory period and the regulatory value (or residual value) at the end of the period reflects the assumption about the amount of the invested capital that is returned to investors (under the regulated charges) over that period. Alternatively, the difference in the regulatory value and capital expenditure can be interpreted as the reduction in the value of the asset (for regulatory purposes) over the period, which is equivalent to economic depreciation. If the regulatory value at the end of the first regulatory period were lower, then more capital needs to be returned to investors over that period (or economic depreciation is higher), which in turn requires higher prices over that initial period. Likewise, if the residual value at the end of the period were lower, then prices over the first period could also be lower. Accordingly, this item can be considered ‘directly relevant’ to tariffs.
- *Minimum area to be served by the pipeline* – the average cost of building the various sections of the network will differ with such factors as soil conditions (eg sand or rock), surface conditions (eg open fields or concrete footpaths), customer density and distance from the transmission pipeline. Accordingly, a change to the area that is served would be expected to lead to a change to the average cost associated with providing the services, in turn, changing the price that would be determined. Accordingly, this item can be considered ‘directly relevant’ to tariffs.
- *Key principles in the extensions and expansions policy* – these principles determine, in effect, the principles by which tariffs will be determined for areas outside of those included in the minimum pipeline route. These principles, in turn, will determine the extent to which those new customers would make a contribution towards the assets that serve the minimum pipeline area, which in turn would affect the revenue required from customers within the minimum pipeline route (and hence their tariffs). Accordingly, this item can be considered ‘directly relevant’ to the determination of Reference Tariffs.
- *Revisions commencement date* – the revisions commencement date determines the period over which the tariffs that are determined by the tender process will remain in effect, prior to being reviewed by the Regulator (the regulatory period). The regulatory period will affect the extent to which the distributor will bear the risk associated with the cost of constructing the distribution network and demand for its services, as well as any uncertainty that may exist with respect to the regulatory review of tariffs. These sources of risk may impact upon the tariff that would be determined. In addition, depending upon how the residual value for the assets is determined at the first price review, the length of the regulatory period may affect the amount of capital that is returned to investors over a particular period, which would affect tariffs for the reasons discussed under dot-point 2 above. Accordingly, this item can be considered ‘directly relevant’ to tariffs.

11.4 Decision

The Regulator is satisfied that the tender documents specify which items required to be included in an Access Arrangement other than Reference Tariffs will be determined by

the tender and that those items are directly relevant to the determination of Reference Tariffs.

12 SECTION 3.28(H) – CONFIGURATION OF PIPELINE NOT LIMITED

12.1 Code and Background

The Regulator is required under section 3.28 (h) of the Code to be satisfied that the tender documents will not specify the configuration of the proposed pipeline, including the areas the proposed pipeline will service, or specify the dimensions of the pipeline, the level of compression or other technical specifications, unless the Regulator is satisfied that it would be appropriate to do so.

The TAR proposes that the bidders will be provided with a Project Brief, which, amongst other things, will provide a description of the required Minimum Pipeline Route being in effect most areas within the urban centres of Hobart, Launceston, Devonport, Ulverstone and Burnie. The Tender Guidelines explain that each Bid Submission should involve a rollout of the gas distribution system, which covers at least 100 per cent of the Minimum Pipeline Route for it to be a conforming tender, and therefore assured of consideration.

The Tender Guidelines also indicate that bidders will be rewarded in the tender evaluation process through a premium for the provision of network coverage beyond the Minimum Pipeline Route. The converse will also apply. The tender evaluation process therefore provides an incentive to bidders to exceed the coverage requirements of the specified minimum Pipeline Route.

The Regulator must consider whether the specification of the Minimum Pipeline Route is a reasonable requirement and whether under section 3.28 (h) it is appropriate to disclose the areas the proposed pipeline should cover. The State submits in the TAR that it is entirely appropriate for the Minimum Pipeline Route to be specified. The State contends that such disclosure will ensure that the benefits of natural gas are made available within all the major population centres of Tasmania and to most industrial centres.

The TAR does not specify the dimensions of the proposed pipeline, the level of compression to be used in the pipeline nor do the tender documents specify any technical parameters for the proposed pipeline.

12.2 Issues Raised

The issues associated with the specification of the Minimum Pipeline Route have already been discussed in section 5.5 (which assessed the State's proposal against the requirements of section 3.28 (e) of the Code). The issues associated with the incentives proposed for bidders to propose a service area in excess of the Minimum Pipeline Route were discussed in section 5.6 of this statement (which assessed the State's proposal against the requirements of section 3.28 (e) of the Code).

No further issues were raised in the Issues Paper, nor in submissions.

12.3 Consideration of Issues Raised

As the State's proposal to specify a minimum pipeline route, and to offer incentives for a large area, were considered 'reasonable' under section 3.28 (e), these requirements are also considered 'appropriate' under section 3.28 (h).

None of the other requirements of the tender process appear to place technical restrictions on the configuration of the pipeline.

12.4 Decision

The Regulator is satisfied of compliance of the TAR with the requirements of section 3.28 (h).

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13 SECTION 3.28(I) – OTHER DOCUMENTS

13.1 Code and Background

Under section 3.28 (i) of the Code, the Regulator is required to ensure that any document supporting or relating to the tender process is consistent with the Code and does not purport to limit the services which the Service Provider may provide or to which access may be sought under this Code, the configuration of the proposed Pipeline nor the construction or operation of other Pipelines that could deliver gas to the same gas market as the proposed Pipeline.

This section of the Code extends the Regulator's consideration of the TAR to include any documents that may establish the tender process.

The State has provided the Regulator with a number of documents. These documents are listed in schedule 3 of the TAR. To be satisfied that the requirements of section 3.28 (i) have been met, the Regulator has examined each of these documents.

The State has submitted in clause 12.11 of the TAR, that nothing in the TAR or in the documents listed in schedule 3 of the TAR breaches section 3.28 (i).

Section 8 of the TAR excludes a Bid Submission from consideration if it limits or purports to limit the Services to which access might be sought under the Code, therefore preventing the Service Provider from limiting the Services provided or to which access may be sought under the Code.

Section 3.28 (i) (ii) reiterates section 3.28 (h) by again stating that the configuration of the proposed Pipeline should not be limited. As in relation to section 3.28 (h), the State contends that it is appropriate to specify a Minimum Pipeline Route, to ensure real competition in the energy markets and optimising the social and economic benefits for the State from the gas project.

Section 3.28 (i) (iii) restricts any documents relevant to the tender process from limiting the construction or operation of other Pipelines that could deliver gas to the same gas market as the proposed Pipeline.

It is intended by the State that the proposed Pipeline will be a distribution pipeline to which the successful bidder will have an exclusive franchise for a period of 5 years, effectively creating a monopoly situation. Section 3.28 (i) (iii) may on some interpretations invalidate the State's proposal to grant an exclusive distribution franchise as it limits the construction and operation of other distribution pipelines in Tasmania.

The State submits that this section does not prevent it from granting an exclusive distribution franchise, based on a consideration of section 7.1 of the NGPAA¹⁴⁸, section 5 of the Access Law and section 30 of the *Gas Act*. The NGPAA contemplates the existence of such exclusive franchises and, in the event of any inconsistency between the provisions of the Act and the Code, the provisions of the Act should prevail.

Section 7.1 of the NGPAA provides that:

“Each party will, no later than the time its Access Legislation commences, take all reasonable measures to repeal, amend or modify any other Legislation which is inconsistent with, or would alter the effect or scope or operation of, the Access legislation (including the access code) or this agreement (other than legislation in relation to transitional arrangements and derogations permitted under clause 12 or franchising and licensing arrangements permitted under clauses 13 and 14).”

Section 30 of the *Gas Act* provides that if the Minister determines that a gas entity should have an exclusive franchise to operate a distribution system within a certain area, the Director of Gas has various obligations in respect to the licence, including that the licence confers an exclusive franchise.

The State contends that in the event of inconsistencies, section 7 of the NGPAA requires that other State legislation be in accordance with the Access Law¹⁴⁹ but that franchising rules are an exception. The Code is subject to both the Access Law and State legislation. Section 5 of the Access Law provides that “a provision of the Code that is inconsistent with a provision of this Law (other than the Code) or of an Act of the legislature is of no effect to the extent the inconsistency”. The cascading order of priority is as follows:

- Access Law (subject to exceptions in NGPAA, clause 7.1);
- other state legislation (provided it is not inconsistent with the Access Law and the NGPAA); and
- the Code.

The State concludes that in accordance with section 5 of the Access Law, section 30 of the *Gas Act* relating to the conferral of an exclusive franchise will prevail over section 3.28 (i) (iii) of the Code to the extent of the inconsistency, thereby not preventing the State from granting an exclusive distribution franchise under section 30 of the *Gas Act*.

¹⁴⁸ Dated 7 November 1997 between the Commonwealth of Australia and each State and Territory of Australia.

¹⁴⁹ *South Australian Gas Pipeline Access Act*.

13.2 Issues Raised

The primary issue raised by this section is whether the State's proposal to award an exclusive distribution franchise may be invalidated by this section. Apart from those against which the considerations are simply matters of fact, the other matter to be considered is whether it is Code-compliant to specify a minimum pipeline route- a matter that was considered in the context of whether it is a reasonable requirement under section 3.28 (e).

13.3 Consideration of Issues Raised

In response to section 3.28 (i) (i) of the Code, the State has submitted that the documents do not purport to limit the Services which the Service Provider may provide or to which access may be sought under the Code. One of the mandatory requirements in the Tender Guidelines (clause 6.11) provides that each Bid Submission must contain, with respect to the distribution services, confirmation that the bidder agrees that it will not limit the services to which access might be sought under the Code. The Guidelines further provide that if a Bid Submission limits or purports to limit the services to which access might be sought under the Code, then the Bid Submission will be excluded from further consideration. The Regulator accepts that the requirement in the Guidelines satisfies section 3.28 (i) (i).

In response to section 3.28 (i) (ii) of the Code the State has submitted that the documents do not purport to limit the configuration of the proposed Pipeline including the areas the Proposed Pipeline will service, pipeline dimensions, level of compression and other technical specifications. The State has submitted that this issue is addressed in clause 12.10 of the TAR. The section requires that there be no such limitation unless the Regulator is satisfied it is appropriate. The TAR documents may be interpreted to limit the minimum pipeline area, and the question of whether the minimum service area is a reasonable requirement has been considered in the discussion of section 3.28 (e). The TAR invites bidders to submit a larger area, and to also submit an extension and expansions policy. The Regulator is satisfied that the requirements of section 3.28 (i) (ii) are satisfied.

Finally, in response to section 3.28(i) (iii) of the Code the State has submitted that the documents do not purport to limit the construction or operation of other Pipelines which could deliver gas to the same gas market as the proposed Pipeline. The issue arising from this section is whether the Code invalidates the State's proposal to award an exclusive distribution franchise.

The State's submission in regard to the exclusive franchise appears to be based on the following:

- the NGPAA, to which the State is a party, provides that all parties enact pipeline access legislation identical to the Access Law (clause 5). The State was obliged to take steps to repeal, amend or modify any other legislation inconsistent with the operation of the access legislation or the NGPAA, other than franchising and licensing arrangements permitted under clauses 13 and 14 of the NGPAA

(clause 7). The NGPAA contemplates the existence of exclusive franchises that meet certain criteria (Annex E, clause 3);

- the *Gas Pipelines Access (Tasmania) Act 2000* provides that the Gas Pipelines Access Law applies as a law of Tasmania. The Gas Pipelines Access Law means Schedule 1 to the *Gas Pipelines Access (South Australia) Act 1997*, being the Access Law and the Code;
- Section 5 of the Access Law provides that a provision of the Code that is inconsistent with a provision of the Access Law (other than the Code) or of an Act of the legislature is of no effect to the extent of inconsistency;
- when interpreting section 5 of the Access Law, the Access Law is to be read subject to the NGPAA;
- Section 30 of the *Gas Act* provides that if the Minister determines that a gas entity should have an exclusive franchise to operate a distribution system within a certain area, the Director of Gas has various obligations in respect to the licence, including that the licence confers an exclusive franchise;
- Section 30 of the *Gas Act* may be inconsistent with section 3.28 (i) (iii) of the Code which limits the construction or operation of other Pipelines which could deliver gas to the same gas market as the proposed Pipeline;
- in accordance with section 5 of the Access Law, section 30 of the *Gas Act* will prevail over section 3.28 (i) (iii) of the Code to the extent of any inconsistency; and
- accordingly section 3.28 (i) (iii) does not prevent the State from granting an exclusive distribution franchise over section 30 of the *Gas Act*.

The Franchising Principles in the NGPAA provide that no exclusive franchises should be granted for the provision of natural gas pipeline services in a geographic area or through a specific facility except for a prospective natural gas pipeline service which meets the following criteria (Annex E, clause 3):

- an integrated pipeline network requiring systematic development over a significant period in order to achieve the lowest expected long term cost;
- a strong likelihood that in the absence of an exclusive franchise the pipeline network will not be developed in line with the lowest expected long term cost;
- the pipeline service operator is selected through a competitive public tender process, prospective users are consulted in determining the conditions of the franchise and any other conditions that are considered necessary to protect the public interest are met; and
- the exclusive franchise is limited to a period of not more than 5 years and is non-renewable.

The State has not addressed in the TAR whether the Gas Tender Process meets the criteria in the NGPAA for an exclusive franchise. It appears however, based on the information provided by the State, that the Gas Tender Process meets each of the above criteria. In particular:

- it is an integrated pipeline network requiring systematic development over a period of time with the aim of achieving the lowest expected long term cost;
- based on the market information provided by the State, there was a strong likelihood that in the absence of an exclusive franchise the pipeline network will not be developed in line with the lowest expected long term cost;
- the pipeline service operator is to be selected through a competitive public tender process and through both the public consultation process contemplated for the development of Codes and Licences and the Gas Tender Process prospective users are consulted in determining the conditions of the franchise and any other conditions that are considered necessary to protect the public interest; and
- the exclusive franchise is limited to a period of not more than 5 years and is non-renewable.

Finally, it should be noted that the requirement in section 3.28 (i) (iii) of the Code is also addressed in the licensing principles in the NGPAA (Annex F, clause 2). The NGPAA provides that licensing should not be used to restrict the construction or operation of pipelines that could deliver gas to the same gas market as the licensed pipeline. This principle was intended to stand with the exclusive franchising arrangements contemplated in Annex E.

13.4 Decision

In the circumstances the Regulator considers that the requirements of section 3.28 (i) (iii) of the Code are satisfied.

APPENDIX A: TABLE OF SUBMISSIONS

Date of Receipt	Interested Person	Confidential Material (the register notes whether any additional confidential material was provided with the submission)
28/09/2001	Duke Energy International	No
07/10/2001	Metaira Pty Ltd	No
10/10/2001	Tasmanian Chamber of Commerce and Industry Ltd	No
08/07/2001	Ian Martin	No
11/10/2001	David Mitchell Tasmania	No
12/10/2001	Australian Bulk Minerals	No
12/10/2001	Aurora Energy Pty Ltd & Agility Management Pty Ltd	Yes
12/10/2001	United Energy Ltd	No
12/10/2001	Test Energy Limited	No
08/11/2001	Department of State Development	No