



2004

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PARLIAMENT OF TASMANIA

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## PARLIAMENTARY STANDING COMMITTEE OF PUBLIC ACCOUNTS

# INQUIRY INTO THE PURCHASE OF FIBRE OPTIC CABLE

*Laid upon the Tables of both Houses of Parliament*

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*The Committee was appointed under the provisions of section 2 of the Public Accounts Committee Act 1970 (No. 54)*

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### MEMBERS OF THE COMMITTEE

#### LEGISLATIVE COUNCIL

Hon A. W. Fletcher (Chair)  
Hon I. N. Dean (from 26 May 2004)  
Hon C. L. Rattray (to 1 May 2004)  
Hon J. S. Wilkinson

#### HOUSE OF ASSEMBLY

Mr D. J. Bartlett (from 7 April 2004)  
Mr W. E. Hodgman (from 7 April 2004)  
Mr G. L. Sturges  
Ms L. T. Giddings (from 21 August 2003 to 22 March 2004)  
Mr P. C. Gutwein (from 28 August 2003 to 19 December 2003)  
Mr B. R. Best (to 21 August 2003)  
Hon. M. T. Hidding (to 28 August 2003)

By Authority: Government Printer, Tasmania

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## **1. SUMMARY OF NOTES AND FINDINGS**

### **Investigate work undertaken prior to the Fibre Optic Cable being laid**

#### **The Committee notes that:**

- The Government received advice from KPMG and Cutler & Company which both expressed similar positive opinions regarding the opportunity to rollout fibre optic cable in conjunction with the gas rollout.
- Both KPMG and Cutler & Company state that broadband capacity provided by fibre optic technology is far greater than that provided over copper wire.
- In the opinion of KPMG, Tasmania is disadvantaged in comparison to the rest of the country with regard to internet usage. Poor internet services could be retarding the use of the internet which, in turn, could be having a detrimental impact on economic development.
- In the opinion of KPMG, new telecommunications infrastructure will lead to increased price competition with Telstra and a better range of available services, as well as generating direct and indirect economic benefits to the State.
- KPMG and Cutler & Company provided advice to the Government on regulatory and project delivery issues associated with the telecommunications project.
- KPMG and Cutler & Company provided recommendations to the Government on how to proceed with the project, although they had different opinions on the most appropriate tender process.
- Gibson Quai provided the Government with estimated costs for a telecommunications network according to a number of technology options. Cutler & Company provided assistance with interpreting Gibson Quai's advice.
- The benefits to consumers from the establishment of fibre optic technology in Tasmania, as highlighted by KPMG, Cutler & Company and the Government, are likely to be incremental and dependent on the extent and pace of the rollout into homes. While there are short-term benefits arising from the construction of the FOC Backbone, the rollout of fibre optic cable into homes is likely to be a longer-term prospect (see Appendix B for further discussion on this issue).

#### **The Committee finds that:**

- KPMG, Cutler & Company and Gibson Quai appear to be suitably qualified to have provided advice to the Government to assist it with its decision to become involved in the telecommunications project.

- The advice provided by KPMG and Cutler & Company was sound and extensive and appears to have dealt with all issues which could reasonably have been foreseen at the time the advice was given.
- The modelling costs provided by Gibson Quai appear to be based on logical assumptions and detailed consideration of the infrastructure required to deliver the proposed telecommunications network.
- The lack of public submissions has resulted in there being no evidence (outside of that provided by the Government) which either support or criticise the Government's involvement in the telecommunications project. As such, the Committee is unaware of any authoritative view which might be contrary to the advice or opinions of KPMG, Cutler & Company and Gibson Quai.

### **Negotiations undertaken which led the Government to enter into a deal with Downer EDI**

#### **The Committee notes that:**

- There is no clear evidence to indicate the extent of the negotiations between the Government, Downer Engineering and DEI Tasmania Holdings prior to the signing of the Heads of Agreement, and nor is there any clear evidence to show which party initiated negotiations.

#### **The Committee finds that:**

- The issue of how negotiations took place is a relatively minor one. The important issue is that the investigative work was of sufficient scope and quality to clearly demonstrate to the Government that undertaking the telecommunications project, in conjunction with the gas project, provided a significant opportunity to the State.

#### ***Summary Finding on Term of Reference (c)***

**The Committee finds that, in relation to term of reference (c), the investigative work undertaken prior to the cable being laid was conducted satisfactorily. In the case of the negotiations undertaken which led the Government to enter into a deal with Downer EDI, the Committee finds that the lack of evidence involving the negotiations does not raise any significant issues of public concern.**

## **Explanation of the contractual conditions under which the purchase of the Fibre Optic Cable occurred**

### **The Committee notes that:**

- The Government entered into a Heads of Agreement with Downer Engineering and Jencode (later Tas21) which established the course toward the signing of the Put and Call Option Deed.
- The Put and Call Option Deed effectively put the Government into a position where it would ultimately take ownership of the FOC Backbone.
- A Multiparty Deed was signed by the parties to the Put and Call Option Deed and the Commonwealth Bank. The Multiparty Deed gave the Commonwealth Bank the right to require Tas21/Downer Connect to exercise the put option under the Put and Call Option Deed.

### **The Committee finds that:**

- The Government knowingly entered into a contract whereby it put itself into a position in which it could (and did) ultimately take ownership of the FOC Backbone.
- The Government's decision to enter into the Heads of Agreement and the Put and Call Option Deed effectively reflects a strategic policy decision by the Government to support the building of the FOC Backbone.

## **The purchase of the Fibre Optic Cable under the put option**

### **The Committee notes that:**

- The Option Period commenced upon the completion of construction of the FOC Backbone on 5 March 2003.
- The Commonwealth Bank, using its right under the Multiparty Deed, instructed Tas21/Downer Connect to exercise its put option under the Put and Call Option Deed.
- The sale of the FOC Backbone to the Government was completed on 29 May 2003. The Government also took assignment of a number of contracts upon the sale.
- The \$23.1 million of surplus funds allocated from the 2002-03 State Budget by the Government at the time of the 2003-04 Budget to the FOC purchase is consistent with the Asset Option Price in the Put and Call Option Deed (and subsequently approved amendments to that Deed) and the terms of the Transfer Deed.

**The Committee finds that:**

- The sale and transfer of the FOC Backbone to the Government appears to have been conducted in accordance with the conditions set out in the Put and Call Option Deed and Multiparty Deed.

***Summary Finding on Term of Reference (b)***

**The Committee finds that, in relation to term of reference (b), the terms of the contracts between Downer EDI and the Government which brought about the purchase of the FOC by the Government were unambiguous in relation to the obligations placed on both parties. The Committee also finds that the purchase of the FOC was conducted in accordance with the terms of the contracts.**

**The due diligence process**

**The Committee notes that:**

- AAR provided detailed and extensive advice to the Government on how to proceed with the purchase of the FOC Backbone and the associated obligations the Government assumed with the purchase.
- The Government's decision to purchase the FOC Backbone asset and not the shares in Tas21 followed the advice of AAR.
- AAR confirmed that the purchase was conducted in accordance with the terms of the Put and Call Option Deed and the Multiparty Deed.
- AAR provided detailed advice to the Government on its obligation to provide SCADA services and the associated regulatory requirements.
- AAR confirmed that the Government had assumed legal ownership of the FOC Backbone and that the FOC Backbone appeared to be fit for its intended purpose.

**The Committee finds that:**

- AAR appears suitably qualified to have provided advice and conducted the legal due diligence for the Government's purchase of the FOC Backbone.
- AAR's Legal Due Diligence Report and advice to the Government appears to address all contractual, regulatory and other legal issues that could reasonably have been foreseen in the lead up to, and at the conclusion of, the transfer of the FOC Backbone to the Government.

- The Legal Due Diligence Report should provide comfort to the Tasmanian community that there was independent scrutiny of the Government's purchase of the FOC Backbone.
- The Legal Due Diligence Report should provide comfort to the Tasmanian community that the Government was aware of the obligations it assumed upon the purchase of the FOC Backbone, and that there were unlikely to be any significant 'surprises' after the Government took ownership.

***Summary Finding on Term of Reference (a)***

**The Committee finds that, in relation to term of reference (a), the due diligence process undertaken by the Government was conducted satisfactorily.**



## 2. THE PUBLIC ACCOUNTS COMMITTEE

The *Public Accounts Committee Act 1970*<sup>1</sup> provides for the establishment of a joint committee, comprising three members from the Legislative Council and three from the House of Assembly.

The statutory function of the Committee is as follows -

The Committee must inquire into, consider and report to the Parliament on any matter referred to the Committee by either House relating to: -

- (a) the management, administration or use of public sector finances; or
- (b) the accounts of any public authority or other organisation controlled by the State or in which the State has an interest.

The Committee may inquire into, consider and report to the Parliament on: -

- (a) any matter arising in connection with public sector finances that the Committee considers appropriate; and
- (b) any matter referred to the Committee by the Auditor-General.

The current membership of the Public Accounts Committee (PAC) is: -

House of Assembly	Legislative Council
Mr D. J. Bartlett (from 7 April 2004)	Hon I. N. Dean (from 26 May 2004)
Mr W. E. Hodgman (from 7 April 2004)	Hon A.W. Fletcher (Chair)
Mr G. L. Sturges	Hon J.S. Wilkinson

The Committee has the power to summon witnesses to appear before it to give evidence and to produce documents and, except where the Committee considers that there is good and sufficient reason to take it in private, all evidence is taken by the Committee in public.

For the purpose of this inquiry the Committee received the assistance of Mr Alex Tay from the Department of Treasury and Finance and Ms Heather Thurstans, Secretary of the Committee. The Committee thanks them for their contribution.

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<sup>1</sup> The Public Accounts Committee Act 1970, No.54 of 1970 and subsequent amendments in the Public Accounts Committee Amendment Act No 89 of 1997.

### **3. THE TERMS OF REFERENCE**

On 29 May 2003, the Legislative Council referred two matters to the Public Accounts Committee.

The Committee examined both references and, due to impending legislation in the Parliament, resolved to proceed with the Inquiry into the Federal Hotels Agreement immediately. The report on the Federal Hotels Agreement was tabled in September 2003.

The other reference - the subject of this report - was to inquire into the purchase by the Government of the Fibre Optic Cable (FOC).

The Terms of Reference from the Legislative Council stated that -

In particular but without limiting its general powers the Committee was required to inquire into:

- (a) the due diligence process undertaken by the Government;
- (b) the terms of any contract between Downer EDI and the Government which has brought about the intended purchase of the fibre optic cable by the State Government; and
- (c) any investigative work undertaken prior to the cable being laid and/or negotiations undertaken which led the Government to enter into a deal with Downer EDI.

### **4. CALL FOR PUBLIC SUBMISSIONS**

Advertisements were placed in *The Examiner*, *The Mercury* and *The Advocate* newspapers on 9 August 2003 with a closing date for submissions of 1 September 2003. No submissions or enquiries were made following the advertisements appearing.

### **5. INITIAL INQUIRIES AND INVESTIGATIONS**

In August 2003, the Committee requested part-time administrative and research support from the then Treasurer, Hon Dr David Crean, MLC, in anticipation that the Committee would need assistance to examine a considerable amount of technical and detailed evidence. Mr Alex Tay from the Department of Treasury and Finance was seconded to the Committee on a part-time basis in September 2003 to assist the Committee with examination of the evidence, research and writing of this report.

On 3 September 2003, the Committee requested a briefing from the Government about:

- (a) the telecommunications industry; and
- (b) recent developments in the industry, including fibre optic technology.

The Treasurer responded indicating that a contextual briefing on the telecommunications industry would be advantageous and that accordingly he was prepared to make Dr Terry Cutler, the Government's Strategic and Industry Advisor, available to brief the Committee. The Committee met with Dr Cutler who provided the Committee with a comprehensive background briefing and answered questions on 16 October 2003.

While Dr Cutler's briefing provided the Committee with a general understanding of the telecommunications industry and the development of broadband technology, the Committee still did not have the necessary evidence to directly address the terms of reference.

On 3 October 2003, the Committee wrote to the Government requesting documentary evidence which was required before the Committee could progress with the Inquiry. The evidence requested included copies of contracts and any associated correspondence and supporting documentation between the Government and parties involved in the fibre optic project, with respect to the purchase and rollout of the FOC.

The Committee also requested a copy of the framework for the due diligence process, any preliminary research including feasibility studies, risk analysis, potential benefit projections and evaluation undertaken by the Government prior to the purchase of the cable.

At the time of the request, it was expected that the Committee would complete the inquiry in three to four months. However, the majority of the information was not received by the Committee until 24 June 2004. Up until this time, the Committee had made several enquiries into the circumstances of the delay in the evidence being provided. It should be noted that Hon Paul Lennon, MHA, replaced Hon Dr David Crean, MLC, as Treasurer in February 2004, and therefore the obligation to provide the requested documents and materials passed to Treasurer Lennon at this time.

Following the initial material being provided, the Committee determined that further information was required before it could satisfactorily proceed with examining term of reference (c). Consequently, the Committee requested this further information from the Government. A number of documents were subsequently provided to the Committee on 22 July 2004.

The Committee acknowledges that the parties involved in the project outside of Government were required to be consulted before sensitive commercial documents and information could be provided to the Committee. The Committee further acknowledges the difficult circumstances which led to changes in Cabinet in early 2004. While the Committee understands that these factors would have caused some delay, the Committee was frustrated by the lack of evidence to proceed with the Inquiry. The Committee considers that under normal circumstances the length of the delay would be considered excessive. Such delays impede the Committee's ability to report to Parliament the findings of its inquiries in a timely manner.

## 6. DOCUMENTS AGREED TO BE CONSIDERED COMMERCIAL-IN-CONFIDENCE

On 1 July 2004, the Committee received a request from Treasury for the documents that the Government had provided to the Committee on 24 June 2004 to be kept commercial-in-confidence. The Committee considered that there was likely to be a sound case for granting the request in relation to a number of the documents provided. However, the Committee believed that this case should be put forward and tested by the Committee before it agreed to the request. Furthermore, the Committee considered that the case for keeping some documents commercial-in-confidence was not as strong as for others, and that there appeared to be a public benefit for these documents to be made publicly available.

Consequently, the Committee requested that a representative from Treasury appear before the Committee to put the case for keeping documents commercial-in-confidence.

On 16 July 2004, Mr Robert Nicholl, Deputy Secretary of the Department of Treasury and Finance, appeared before the Committee and gave evidence. Mr Nicholl clarified the request for documents to be kept commercial-in-confidence by stating that the request did not extend to consultants reports, such as those provided to the Government from technical advisers. The focus of the request was on the commercial contracts between the parties involved in the construction, financing and handover of the FOC.

Mr Nicholl outlined the argument as to why the commercial contracts should be kept commercial-in-confidence. Mr Nicholl stated that:

*“The specific terms of the commercial contracts and the pricing and cost information that would be reflected in the contracts we would request be treated in confidence because the parties to the agreements had an expectation when they entered into those agreements that the contents of the contracts would remain confidential between the parties to the agreement. For an industry such as the telecommunications industry, which is very complex, if the Government were to reveal the contents of those contracts, it is not entirely clear to us which bits of information in those contracts, in addition to specific pricing information, would be valuable information to competitors out in the market.”<sup>2</sup>*

Mr Nicholl also argued:

*“...that if the parties to these agreements find that all of sudden commercial contracts that they have entered into come into the public domain through a process that the Government was involved in, I think it would significantly undermine the Government’s credibility to be involved in private sector related projects in the future if they didn’t think that they had the confidence that those*

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<sup>2</sup> Nicholl, Mr R., Department of Treasury and Finance, Transcript of Evidence, 16 July 2004, p.1.

*elements of their dealings with the Government that were truly confidential would remain such.*"<sup>3</sup>

The Chair of the Public Accounts Committee questioned Mr Nicholl whether the document that dealt with the due diligence process should be considered commercial-in-confidence. Mr Nicholl responded:

*"I would have to look at the due diligence report again, but to the extent that it does not inadvertently reveal anything that would have been in the contracts, that is a document that should give the community comfort that there was a process in place to scrutinise the transaction prior to it taking place."*

The Chair summarised the position put forward by Mr Nicholl that the Committee hold the contractual arrangements between private parties in confidence, but that in relation to the due diligence report, Mr Nicholl would further consider the need for the report to be kept in confidence and advise the Committee of the Government's position.

The Committee received written advice, dated 22 July 2004, advising that there did not appear to be any reason on the grounds of commercial confidentiality for the legal due diligence report to be kept private. This advice was included in the covering letter accompanying the additional information relating to term of reference (c) that the Committee had requested following the provision of the initial documents. Mr Nicholl stated in the letter that although some of the documents accompanying the letter were marked "Commercial-in-Confidence", the Committee was not being asked to consider them in private. This advice is consistent with the position Mr Nicholl took in the evidence he gave on 16 July 2004, as these documents are primarily consultants and/or technical advisors reports.

## **7. BACKGROUND**

### **7.1. Structure of the Telecommunications Industry**

The Committee understands that the structure of the telecommunications industry is complex and that different infrastructure and service delivery models operate around the world. Furthermore, due to emerging technologies, the telecommunications industry is undergoing substantial change. The Committee acknowledges that the briefing that Dr Cutler provided on 16 October 2003 provided a detailed background of the industry in Australia and overseas and of how emerging broadband technology is being delivered. Dr Cutler's briefing was provided on an informal basis to the Committee and was not taken as sworn evidence. As such, the detail of Dr Cutler's briefing is not included in this report.

For the purposes of this Inquiry, the Committee believes that it is not necessary for it to attempt to provide its own detailed account of the structure of the telecommunications industry in this report. However, one point that needs to be made clear is the difference

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<sup>3</sup> Ibid, p.2.

between telecommunications infrastructure and the delivery of telecommunications services.

In many developed countries, telecommunications infrastructure is provided by a different entity, or entities, than those that deliver telecommunications services over that infrastructure. The telecommunications service providers pay the owner(s) of the infrastructure for the right to deliver their services over that infrastructure. In Australia, however, Telstra owns the majority of the telecommunications infrastructure at all levels and provides its own services over its infrastructure. Telstra also sells capacity and access to its infrastructure to other service providers that it competes with in service delivery.

The Committee notes that there is considerable public debate over the structure of Australia's telecommunications industry and, in particular, over the effect on competition arising from Telstra's market power and position.

## **7.2. Fibre Optic Terminology**

The terms 'fibre optic' and 'optic fibre' are used interchangeably throughout the various documentary evidence provided to the Committee. Similarly, the terms 'fibre optic cable' and 'optic fibre cable' are used interchangeably. For the purposes of this report, the Committee has decided to use the terms 'fibre optic' and 'fibre optic cable' in order to be consistent with the terminology used in the terms of reference provided by the Legislative Council. However, the term 'optic fibre' and 'optic fibre cable' (or 'OFC') may appear in this report when direct quotes have been taken from documentary evidence.

When referring to the specific fibre optic cable that is now owned by the Government, the term 'Fibre Optic Cable', or 'FOC', is used. The FOC is also often referred to as the FOC Backbone.

## **7.3. The Tasmanian Natural Gas Project**

The Tasmanian Natural Gas Project (TNGP) is an essential element of the telecommunications project, as it provides the opportunity to co-locate both the gas infrastructure and broadband telecommunications infrastructure in the one trench. The consultants appointed by the Government to provide advice on the feasibility of the project highlighted the fact that the gas rollout provided a unique opportunity to simultaneously rollout fibre optic cable at a significantly reduced cost than if it were rolled out under a separate, stand-alone project (see paragraph's 9.1.1 and 9.2.1). Without this opportunity, it is highly unlikely that a fibre optic telecommunications network (outside of the Telstra network) would have been rolled out in Tasmania in the short to medium term.

Given the importance of the gas project to the telecommunications project, the Committee considers that it is useful to compare the key stages of both projects. The following timeline in paragraph 7.3.1 outlines the key events associated with the TNGP.

### 7.3.1. Key events in the TNGP<sup>4</sup>

Date	Event
April 2001	Duke Energy <sup>5</sup> and the Government signed a Development Agreement.
September 2001	The Government lodged a Tender Approval Request with the Energy Regulator to conduct a National Gas Code compliant tender for gas distribution and retail.
November 2001	The Energy Regulator approved the Tender Approval Request and the tender process commenced.
December 2001	Duke Energy received permits and approvals to commence construction of the gas pipeline. Offshore construction commenced.
January 2002	Onshore construction commenced.
September 2002	The National Gas Code tender process was terminated.
October 2002	Six companies were invited to lodge proposals in a competitive selection process for the development of a natural gas distribution network.
December 2002	The Government selected Powerco as the preferred distributor and a Memorandum of Understanding was signed. Duke Energy's gas pipeline was commissioned.
April 2003	Powerco and the Government signed the Stage 1 Development Agreement.

## 8. STRUCTURE OF THE REPORT

The Committee decided to address the terms of reference in this report in a different order to how the terms were set out in the referral from the Legislative Council (as stated above in section 3). The Committee is of the view that the logical order to report its findings is to first address term of reference (c), followed by term of reference (b) and term of reference (a). This order generally follows the chronological order in which events under the terms of reference occurred. As such, term of reference (c) is primarily addressed in sections 9 and 10, term of reference (b) is primarily addressed in sections 11 and 12 and term of reference (a) is primarily addressed in section 13.

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<sup>4</sup> The key events and dates were provided by Mr Matthew McGee, General Manager of the Natural Gas Industry Development Division in the Department of Economic Development.

<sup>5</sup> Duke Energy sold its Australian assets, including the Tasmanian Gas Pipeline (TGP), to Alinta Ltd in April 2004. Alinta Ltd acquired all the issued shares in DEI Tasmania Holdings Pty Ltd (a company incorporated by Duke Energy principally for the purpose of building the TGP) and changed DEI Tasmania Holdings' name to Alinta DTH Ltd. The Government has confirmed that its contractual obligations with DEI Tasmania Holdings, as detailed in this report, remain unchanged with the change of ownership and change of name of the company.

## **9. INVESTIGATIVE WORK UNDERTAKEN PRIOR TO THE FIBRE OPTIC CABLE BEING LAID**

The Government has provided five documents which primarily examine the opportunity provided by the TNPG to simultaneously build a fibre optic telecommunications network and the associated costs involved with this. It is not known if these five documents represent the full extent of the investigative work undertaken by the Government prior to the FOC being laid or, perhaps more importantly, before it entered into the Heads of Agreement (see paragraph 11.1) with Downer Engineering Group Pty Ltd (the head company of the engineering division of Downer EDI Ltd).

The five documents provided by the Government are summarised in this section.

### **9.1. Gas Distribution Tender: Telecomms Opportunities**

KPMG prepared a report titled *Gas Distribution Tender: Telecomms Opportunities* in March 2001 for the Tasmanian Government. KPMG has a strong presence in many countries, including Australia, and provides a number of professional services, including advisory services.

The report examines the opportunity provided by the building of the gas pipeline to simultaneously lay a fibre optic cable network, and the potential benefits to Tasmania from having the network. The report also provides a summary of broadband network development in other jurisdictions. The report identifies project issues and options, including: network configuration issues; competition issues; the timetable and coordination of tender options; telecommunications regulations; other regulations; and possible funding sources. The details of some of these are summarised below.

#### **9.1.1. Opportunities**

In the report, KPMG stated:

*“While excavation and other civil works are occurring to lay pipes, build city gates and other parts of the gas distribution system, there is little extra cost to lay optic fibre telecommunications cables at the same time. This creates the opportunity to provide optic fibre cable direct to every property to which gas is connected.”<sup>6</sup>*

KPMG also described the capability of optic fibre:

*“At present the ‘last mile’ of telecommunications systems to end users is provided by thin copper cables, which have limited data throughput capacity. Consequently most internet users are limited to 56kb/sec modem speeds. In the last year Digital Subscriber Line (DSL) technology has become available in some areas of Australia, and this does allow higher data speeds over local loop copper*

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<sup>6</sup> *Gas Distribution Tender: Telecomms Opportunities*, KPMG, March 2001, p.5.



wires. However, with optic fibre cables the data rates attainable are greater than even for DSL, with speeds well in excess of 50Mb/sec – 1000 times the throughput available with 56k modems.”<sup>7</sup>

KPMG stated that the broadband capacity provided by fibre optic cable allows high speed data applications, such as Pay TV, video on demand, video conferencing and high speed internet, to be available to end users.

KPMG suggested that, based on internet usage statistics, Tasmania is disadvantaged in comparison to the rest of country. The capacity of local telecommunications network infrastructure or the quality of services provided by local Internet Service Providers (ISPs) were cited as two reasons why Tasmanian internet usage is below average. As such, KPMG stated:

*“A widespread broadband telecommunications network would help to overcome these problems by providing alternative local network infrastructure, to bypass any limitations of the Telstra local network, and by providing ready access to high bandwidth services for ISPs.*

*The consequences for the future development of Tasmania in the Information Age are serious. Poor internet services could be retarding the use of the internet. This will, in turn, prejudice the development of some of the leading edge industries which rely on the acquisition, processing and publication of information. Such businesses would include design houses, creative media and professional services.”*<sup>8</sup>

### **9.1.2. Benefits to Tasmania**

KPMG stated that the economic benefits to Tasmania from building a broadband telecommunications network would essentially come in three forms. Firstly, there would be increased activity associated with the construction of the network. Secondly, a significant entity would be required to run the network, which would create employment opportunities. Thirdly, the new telecommunications services would allow new businesses that require significant telecommunications infrastructure to locate in Tasmania. These include call centres and data centres. The new services would also increase the State’s investment appeal and industry development potential for both traditional businesses and ‘information age’ businesses.

KPMG also stated that a broadband customer access network would increase the range of services available to consumers, including improved Pay TV services, high speed internet access and video on demand. There would also be a potential to increase educational opportunities through improved access to on-line learning, on-line teaching and to educational resources.

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<sup>7</sup> Ibid, p.5.

<sup>8</sup> Ibid, p.6.

According to KPMG, introducing new telecommunications infrastructure would create greater competition (with Telstra), resulting in pricing benefits and a potential increase in the services and products available. KPMG stated:

*“Telecommunications networks are characterised by relatively high fixed and low variable costs. The unit costs, when the infrastructure is properly utilized (sic), are considerably lower than current retail prices would suggest. Telecommunications suppliers that have direct access to network infrastructure are in a very strong position to compete aggressively on price.*

*“Apart from the HFC system installed by Optus in metropolitan Sydney and Melbourne, there has been little competition in the local access/local call market. The proposed Tasmanian network would be the first of any significance outside of those metropolitan areas.”<sup>9</sup>*

Aside from the competition benefits, KPMG suggested there would also be increased reliability in telecommunications services, as carriers often use the infrastructure of their competitors to support the reliability of their own networks.

KPMG stated that there are two potential sources of revenue for the Government arising from the broadband network. The first source is from a direct sale of a licence or franchise to a telecommunications operator. The second source is revenue derived from the increased economic activity in the State that would arise from the opportunities the network would provide.

### **9.1.3. Precedents for Building Broadband Networks**

KPMG highlighted a number of examples from Australia and overseas (Malaysia, Canada and Sweden) where there are projects to deliver broadband capacity to businesses and households.

KPMG stated there are a number of companies building high capacity interstate fibre links. However, according to KPMG’s knowledge, none of these companies have plans to extend the network rollout to Tasmania and, as such, Tasmania faces being significantly disadvantaged in its information technology capabilities.

### **9.1.4. Project Issues and Options**

KPMG identified a number of issues and options to be addressed before proceeding with the project.

With regard to the network configuration, KPMG identified several issues that required consideration, such as the level of coverage, the rollout to properties and the major components of the infrastructure.

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<sup>9</sup> Ibid, pp.9-10.

In terms of competition issues, KPMG suggested consideration should be given to one entity operating (and perhaps owning) the FOC Backbone and a different entity operating the distribution and access network. According to KPMG, this would increase the potential for competition at the distribution level in the future. KPMG also suggested the Government should consider what level of competition should be encouraged in the future and, in particular, whether there should be competition at both the network level and the retail level. The Government would also need to consider what level of ownership (if any) it should have in the network and over the fibre optic cables.

KPMG advised that the development of a sound tender process and coordination mechanisms for both the gas and telecommunications projects would be important to help attract potential telecommunications operators. KPMG discussed the advantages and disadvantages associated with having either a combined tender process or a separate tender process to find the best gas and telecommunications operators.

KPMG discussed possible licensing arrangements and options. It also discussed the selection criteria for choosing an appropriate final bidder from the tender process.

The telecommunications issues KPMG examined involved carrier licence requirements and the universal service obligation (USO) under the *Telecommunications Act 1997* (Commonwealth) that would come with the provision of the new telecommunication services. KPMG also advised that interconnection between the new telecommunications infrastructure and existing network providers would be required to ensure services provided on one network are able to connect to similar services on another.

#### **9.1.5. Preliminary Recommendations**

Based on the issues and options KPMG identified and discussed, KPMG provided some preliminary recommendations.

With regard to the tender process, KPMG recommended:

*“A tender process should be conducted separately from the gas tender process. Agreements between and (sic) the gas and telecommunications franchisees are required to ensure that there is coordination of the rollout of the gas and telecommunications networks, with complete transfer of risk away from the State.*

*Both the gas and telecommunications tender processes should be run concurrently, with the telecommunications franchisees appointed a few weeks after appointment of the gas franchisees. The gap between the appointment of gas and telecommunications franchisees should be minimal to allow better coordination and ensure that the Local Network franchisee’s technical and other requirements are met.”<sup>10</sup>*

On the granting of franchises, KPMG recommended:

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<sup>10</sup> Ibid; p.28.

*“Where possible separate franchises should be granted to the successful bidder for the Trunk and Local Network. These franchises should be granted within the same tender process, similar to the gas tender process whereby the same process is used to appoint separately the gas retail and distribution franchisees.”<sup>11</sup>*

With regard to selecting the final bidder, KPMG recommended:

*“The final bidder for the Local Network and Trunk should be selected on the basis of its bid price, as mentioned earlier, provided that minimum requirements are met. The latter include an appropriate business model and plan, and achievement of specific quantifiable outputs based on for example the level of network coverage, the speed of network rollout, the capacity of the network and the volume of voice and data throughput.*

*The bid price should be structured in such a way that heavy penalties apply on non-achievement of targets, through a performance bond, whilst still providing the State with an upfront payment that would not be so large as to impose a tax on network end users. The bid price could therefore be split according to a pre-determined, constant percentage which would allocate the amount of upfront payment and the amount of the performance bond.”<sup>12</sup>*

With regard to how the franchise should be structured, KPMG recommended that exclusivity arrangements should be entered into with the Local Network and Trunk franchisees:

*“The Local Network franchisee should have exclusive access to the conduits for a period of say five years. After this period new entrants may obtain access to the conduits, enabling them to rollout their own optic fibre cable in competition with the franchisee...*

*The Trunk network could have an exclusive access to the trunk rights of way for a period of three to five years. This is subject to Duke’s agreement and co-operation and further work evaluating alternative rights of way. The physical location of the rights of way is yet to be determined, and could be either the railway line, the existing Duke easement or another easement in parallel with the Duke easement. In this regard the State is currently pursuing with Duke inclusion of a clause in the Development Agreement whereby Duke will grant a sub-licence to a telecommunications operator, or if it is not able to effect such a licence Duke will cooperate with such a party who would be procuring such a licence through another means”.<sup>13</sup>*

Further on the franchise structure, KPMG recommended:

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<sup>11</sup> Ibid; p.28.

<sup>12</sup> Ibid; p.28.

<sup>13</sup> Ibid; p.29.

*“Ownership of the conduits and fibre optic cable is an issue. The conduits could be owned by the State or the gas distributor. The latter might be appropriate provided the gas distributor, as part of its distribution licence and franchise agreement, has clear obligations in relation to the proper design, construction and maintenance of the conduits, including an obligation to rollout conduits wherever there is a rollout of the distribution pipe. The gas distributor would also have to be a completely separate entity to the proponent.*

*The Local Network of optic fibre and copper cables should be owned by the proponent. Such ownership would impose capital servicing fixed costs, thereby maximising the proponent’s incentive to maximise revenue. Open access to other parties should not be an issue. Prior to expiry of the Local Network franchise, as mentioned earlier there would be competition from the existing Telstra network and possibly from Aurora’s joint venture with AAPT. After expiry of the franchise, there would be competition from new entrants which would have open access to the conduits.*

*The Trunk Network’s optic fibre cables should be owned by the proponent, but this may be subject to a regulatory open access regime.”<sup>14</sup>*

#### **9.1.6. Proposed Timetable for Discussion Purposes**

KPMG presented a proposed timetable for the telecommunications project and juxtaposed this with the current gas tender timetable. The timetable was presented for discussion purposes only.

With respect to the proposed telecommunications project timetable, it begins with a target date of 30 April 2001 for the Government to approve the tender process, and ends on 3 December 2001 with the selection of the winning bidder. This coincides closely with the final date on the gas tender timetable (approval by the Regulator of the Final Approval Request on 19 November 2001), which is consistent with KPMG’s advice that the time gap between the appointment of the gas franchisee and telecommunications franchisee should be minimal.

#### **9.2. Gas and Telecommunications Infrastructure Opportunity**

The Government sought advice from Cutler & Company on how the Government might maximise the telecommunications opportunities arising from a tender for the installation of the gas distribution network. Cutler & Company is a Melbourne-based firm that provides consulting advice, counsel and practical support on the technical, regulatory and commercial aspects of the communications market.

In response to the request, Cutler & Company provided a report, titled *Gas and Telecommunications Infrastructure Opportunity*, which was dated 6 April 2001. The

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<sup>14</sup> Ibid; p.29.

report provides a high level evaluation and is not based on any detailed background material. The report examines a number of issues which are summarised below.

### **9.2.1. The Value of Telecommunications Opportunity**

Cutler & Company's analysis of the telecommunications opportunity provided by the gas project is consistent with KPMG's opinion. Cutler & Company stated:

*"Our extensive studies of the extent of, and potential for, major wireline telecommunications infrastructure investment in many other parts of regional Australia, lead us to conclude that such telecommunications infrastructure investment is highly unlikely to proceed as a stand-alone initiative except, possibly, in limited high density areas, and then only when there is strong demand in downstream digital applications markets. In other words, this opportunity presents Tasmania with an opportunity to leap frog other jurisdictions in providing 'future proof' broadband local loop infrastructure and the ability to install local loop broadband wired solutions providing a vastly more robust and long term future than the alternative wireless local loop based solutions being explored in comparable situations elsewhere in Australia."*<sup>15</sup>

Cutler & Company stated that there is an opportunity to significantly improve the competitiveness of the telecommunications industry in Tasmania. However, the opportunity would be diminished if it were linked to an incumbent telecommunications provider (Telstra).

### **9.2.2. Technical Feasibility and Implementation**

Cutler & Company advised that the laying of fibre optic cable at the same time as gas infrastructure is not technically complex or problematic. While the ongoing operation of such infrastructure is generally more complex, the Tasmanian situation has some advantages:

*"In jurisdictions where there is an installed gas distribution infrastructure there is usually a body of legislative or regulatory requirements about health, safety and access issues, which can create difficulties for ancillary or subsequent infrastructure installation. In a greenfields environment these technical and operational implications can be efficiently addressed as part of the design and planning process."*<sup>16</sup>

### **9.2.3. Tendering Options**

Like KPMG, Cutler & Company discussed whether there should be a combined or separate tender process. However, while KPMG recommended separate tenders, Cutler & Company formed the view that separate tenders were not a pre-requisite for optimising the structural options for implementation and ongoing operations.

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<sup>15</sup> *Gas and Telecommunications Infrastructure Opportunity*, Cutler & Company, 6 April 2001, p.1.

<sup>16</sup> *Ibid*; p.2.

#### **9.2.4. Structural Options**

Cutler & Company considered that there were three basic alternatives (or models) for structural arrangements around the telecommunications opportunity.

The first option (model A) identified by Cutler & Company was for a structurally integrated gas and telecommunications operation, which would require a combined tender process (presumably from a consortium). However, according to Cutler & Company, there are a number of complexities and limitations associated with this approach for both the Government and for potential tender respondents. In discussing this option, Cutler & Company commented on KPMG's recommendation for the tender process:

*“The recommended approach by KPMG for separate RFT's [tenders] for gas and telecommunications, with each successful tenderer then being required to treaty to strike a subsequent agreement, is not supported by Cutler & Company. Our initial view is that this will lead, almost certainly, to sub-optimal service delivery and economic outcomes and implementation difficulties unless the parties have a strong track record in comparable infrastructure delivery and operation. It should be noted that the KPMG proposal would necessarily produce a high level of transaction complexity and high transaction management costs.”<sup>17</sup>*

The second option (model B) identified by Cutler & Company was for the tender for the gas project to have an incremental component for the provisioning of a specified telecommunications facility to be deployed independently of the gas system.

The third option (model C) was for the Government to own the telecommunications asset for either a short-term or ongoing basis.

#### **9.2.5. Likely Proponents**

Cutler & Company stated that the parties interested in being involved in the telecommunications project would depend on the tender model. Cutler & Company was of the view that models B and C were the options most likely to attract new entrants into the Tasmanian market. Due to the separation of infrastructure ownership and service provision, model C was identified as likely to attract a range of service providers to Tasmania who would not otherwise be likely to locate in Tasmania.

Cutler & Company advised that a full assessment of the options would require indicative costings of the network elements associated with the telecommunications initiative, as well as more detailed consideration of the proposed coverage of the gas network.

### **9.3. Costing Options for a Telecommunications Distribution Network**

Cutler & Company provided a brief report, dated 19 April 2001, which identified a number of questions and issues relating to costings that it believed the Government required further advice on:

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<sup>17</sup> Ibid; p.3.

*“It is Cutler & Company’s view that a systematic study of costs for the telecommunications opportunity needs to be conducted in order to assess both the tendering options and the possible role of Government as discussed in our previous advice. This study could be undertaken in parallel with the initial Expression of Interest process for the Gas project so that decisions can be made by the time of the final RFT.”*<sup>18</sup>

Cutler & Company suggested that to obtain comprehensive and authoritative results, it would need to sub-contract a technical specialist or, alternatively, advise the Government on contracting a technical study and review the results in conjunction with the Government. Cutler & Company identified specific issues and questions involving the backbone, local area reticulation and lead-in to homes, which would need to be addressed in the study. Some indicative costings were provided by Cutler & Company in its scoping of the issues.

#### **9.4. Report on Telecommunications Network Modelling for the Tasmanian Government To Cutler & Company Pty Ltd**

Gibson Quai Pty Ltd was subcontracted by Cutler & Company to provide cost estimates for a number of potential technology models for the telecommunications network. Gibson Quai’s *Report on Telecommunications Network Modelling for the Tasmanian Government to Cutler & Company Pty Ltd* was delivered to both the Government and Cutler & Company. The copy of the report provided to the Committee is not dated, although the overview provided by Cutler & Company (see paragraph 9.5) indicates the report was finalised in June 2001.

The details of Gibson Quai’s report are discussed in paragraph 9.5, along with Cutler & Company’s comments.

#### **9.5. Telecommunications Network Costs: Overview of Gibson Quai’s Report**

The overview report was prepared in June 2001 by Cutler & Company to assist the Government to interpret Gibson Quai’s report and, in particular, understand the cost estimates provided by Gibson Quai.

Cutler & Company stated that its ‘independent technical experts’ believed that Gibson Quai’s report represented a ‘worst case’ scenario, and that the actual costs should be lower than those presented by Gibson Quai.

The key sections of Cutler & Company’s overview report are discussed below.

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<sup>18</sup> *Costing Options for a Telecommunications Distribution Network*, Cutler & Company, 19 April 2001, p.1.



### 9.5.1. Costing Assumptions

The costings in Gibson Quai's report are based on a number of assumptions. Some of the key assumptions that were highlighted by Cutler & Company include: the cost estimates being limited to that of a passive network (i.e. one that is capable of providing physical access to end users but does not include the electronic equipment to allow communications operations to be transmitted over the network infrastructure); the cost estimates being expressed in nominal dollars with no allowance made for changes in the value of currency over time (due to factors such as inflation, foreign currency movements, etc); the telecommunications infrastructure would be deployed with the gas rollout, both in terms of location and timing; and the gas route would provide access to Tasmania's 10 most populated cities and towns, which account for around 60 per cent of the State's population.

### 9.5.2. Methodology

The methodology used by Gibson Quai is based on a network model which consists of three parts or layers. The first layer is the Inter-Urban Network:

*"This layer consists of the main optical fibre trunk route extending east from Wynyard on the north west coast, through Burnie-Somerset, Ulverstone, Devonport, Georgetown, Launceston, then south through New Norfolk, Bridgewater-Gagebrook, Hobart and Kingston-Blackmans Bay. The inter-urban network extends into Edge Nodes which are the first network points within each city or town. Each Edge Node services 5 000 to 10 000 dwellings."*<sup>19</sup>

For the Inter-Urban Network, two options were provided for installing the telecommunications network. The first was *pit and pipe*, where the pipe (or conduit) is laid in trenches and the fibre is later filled in the pipes. The second was *direct buried*, where the fibre optic is directly ploughed into the trench.

The second layer is the Intra-Urban Network:

*"This consists of the network infrastructure for the local urban precincts, that is, the infrastructure from the Edge Nodes to the Access Nodes. Each Access Node services 50 dwellings"*<sup>20</sup>

For this layer Gibson Quai presented four options. The first was *blown fibre*, where pipe and microduct is laid in the gas trench and fibre optic cable is later blown into the microduct. The second option was an *underground telephone cable*, where telephone cable is installed in pipe laid in the gas trench. The third option was an *aerial telephone cable*, where telephone cable is suspended on power poles. The fourth option was *aerial cat 5 cable*, where category 5 cable is suspended on power poles.

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<sup>19</sup> *Telecommunications Network Costs: Overview of Gibson Quai's Report*, Cutler & Company, June 2001, p.4.

<sup>20</sup> *Ibid*; p.4.

The third layer is the Local Precinct Layer:

*“This consists of the ‘final leg’ in which cable is taken from an access point in the street into a dwelling.”<sup>21</sup>*

There were four options presented for this layer. The first option was *fibre to the dwelling*, where high bandwidth fibre optic cable is installed in a pipe laid in the gas trench into dwellings. The second, third and fourth options were *underground telephone cable*, *aerial telephone cable* and *aerial category 5 cable*. These are the same options as those presented for the Intra-Urban Network, except that they extend into dwellings.

### 9.5.3. Costs Summary

Cutler & Company summarised and commented on the cost estimates for the options under each of the three layers.

For the Inter-Urban Network, the lump sum costs, including project management and contractor margins were as follows:

- Pit and pipe: \$22.2 million; and
- Direct buried: \$17.2 million.

Cutler & Company commented:

*“...the Pit and Pipe option represents a 29.15% premium over the Direct Buried alternative. The Pit and Pipe option provides access points at 2 km intervals as opposed to 10 km intervals with the Direct Buried option. Moreover, this option allows additional fibre to be installed at a later date should this be necessary. However, transmission techniques now available allow very large capacities to be supported by individual fibres. It is noted in each scenario, the telecommunications infrastructure is installed in a second trench. That is, there is no assumption that the existence of the gas infrastructure provides a cost saving for the telecommunications infrastructure for the inter urban network layer.”<sup>22</sup>*

For the Intra-Urban Network, the lump sum costs, including project management and contractor margins were as follows:

- Blown fibre: \$121.5 million;
- Underground telephone cable: \$121.4 million;
- Aerial telephone cable: \$94.3 million; and
- Aerial category 5 cable: \$152.7 million.

Cutler & Company commented:

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<sup>21</sup> Ibid; p.4.

<sup>22</sup> Ibid; p.5.

*“...the above costs are the addition of four network components, i.e., access node costs, edge node costs, cluster costs and inter-edge costs. The costs of the two ‘underground’ scenarios in the above [table] lie between the two overhead options. These scenarios benefit significantly from the existence of the gas trench. The costs of these would be around 60% greater if the costs in relation to trenching were to be included.*

*It is noted that the low cost scenario, i.e., aerial telephone cable, represents a significantly restricted capacity. That is, such infrastructure would not adequately support pay TV services at present.”<sup>23</sup>*

For the Local Precinct Layer, costs are demand driven. Gibson Quai based its estimates on two scenarios where demand results in either 20 per cent or 50 per cent penetration into homes that have access to the telecommunications infrastructure (that is, those in the 10 largest cities and towns).

The estimated costs for 20 per cent penetration for each of the four options were:

- Blown fibre: \$146.7 million;
- Underground telephone cable: \$132.2 million;
- Aerial telephone cable: \$102.1 million; and
- Aerial category 5 cable: \$164.3 million.

The estimated costs for 50 per cent penetration for each of the four options were:

- Blown fibre: \$185.3 million;
- Underground telephone cable: \$148.3 million;
- Aerial telephone cable: \$113.7 million; and
- Aerial category 5 cable: \$181.8 million.

Cutler & Company commented:

*“Again the underground scenarios are the beneficiaries of significant cost savings due to the existence of the gas trench. Gibson Quai has estimated that the additional costs would be 44% higher in the case of blown fibre and 106% higher in the case of the underground telephone cable.”<sup>24</sup>*

Cutler & Company acknowledged that, at penetration levels approaching 50 per cent, blown fibre cable becomes the highest cost option. However, Cutler & Company commented that there are significant savings associated with this option due to the gas installation and, as such, this results in high capacity underground cable being in a competitive price range against the copper telephone alternatives.

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<sup>23</sup> Ibid; pp.5-6.

<sup>24</sup> Ibid: p.6.

#### 9.5.4. Implications

Cutler & Company stated it was of the view that Gibson Quai's costings were comprehensive and based on detailed modelling for a telecommunications network. It further stated that:

*"...this study provides a robust basis for considerations about the value of such an asset, and enables realistic assessments of the telecommunications opportunity, and implementation options relating to this opportunity, relative to the gas project. Independent review of the Gibson Quai calculations and assumptions gives us confidence that, in relying on these estimates for decision making, there is little likelihood of 'ugly surprises' downstream. As noted, the estimates are regarded as very conservative."*<sup>25</sup>

Cutler & Company also stated that the study provides the basis for assessing the potential market value of the asset to an operator. It could also provide the basis for analysing the potential economic contribution to the State.

Cutler & Company reiterated its view that Gibson Quai's report confirmed the one-off opportunity the gas project provided to Tasmania:

*"The Gibson Quai report provides costing data for both narrowband and broadband reticulation. This shows that the cost differential in a greenfields situation is marginal, while the output capability differential is huge. This has important implications for demand estimates and potential rates of return for the asset."*<sup>26</sup>

#### 9.5.5. Next Steps

Cutler & Company recommended that the next stage in the project should involve a study reviewing and positioning the project within the context of the Tasmanian telecommunications sector, and an economic analysis of the project in terms of the asset's value under possible operating and ownership models and in terms of the social and economic benefits to the State.

### 9.6. Notes and Findings

**The Committee notes that:**

- **The Government received advice from KPMG and Cutler & Company which both expressed similar positive opinions regarding the opportunity to rollout fibre optic cable in conjunction with the gas rollout.**
- **Both KPMG and Cutler & Company state that broadband capacity provided by fibre optic technology is far greater than that provided over copper wire.**

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<sup>25</sup> Ibid; p.8.

<sup>26</sup> Ibid; p.8.

- In the opinion of KPMG, Tasmania is disadvantaged in comparison to the rest of the country with regard to internet usage. Poor internet services could be retarding the use of the internet which, in turn, could be having a detrimental impact on economic development.
- In the opinion of KPMG, new telecommunications infrastructure will lead to increased price competition with Telstra and a better range of available services, as well as generating direct and indirect economic benefits to the State.
- KPMG and Cutler & Company provided advice to the Government on regulatory and project delivery issues associated with the telecommunications project.
- KPMG and Cutler & Company provided recommendations to the Government on how to proceed with the project, although they had different opinions on the most appropriate tender process.
- Gibson Quai provided the Government with estimated costs for a telecommunications network according to a number of technology options. Cutler & Company provided assistance with interpreting Gibson Quai's advice.
- The benefits to consumers from the establishment of fibre optic technology in Tasmania, as highlighted by KPMG, Cutler & Company and the Government, are likely to be incremental and dependent on the extent and pace of the rollout into homes. While there are short-term benefits arising from the construction of the FOC Backbone, the rollout of fibre optic cable into homes is likely to be a longer-term prospect (see Appendix B for further discussion on this issue).

**The Committee finds that:**

- KPMG, Cutler & Company and Gibson Quai appear to be suitably qualified to have provided advice to the Government to assist it with its decision to become involved in the telecommunications project.
- The advice provided by KPMG and Cutler & Company was sound and extensive and appears to have dealt with all issues which could reasonably have been foreseen at the time the advice was given.
- The modelling costs provided by Gibson Quai appear to be based on logical assumptions and detailed consideration of the infrastructure required to deliver the proposed telecommunications network.
- The lack of public submissions has resulted in there being no evidence (outside of that provided by the Government) which either support or criticise the Government's involvement in the telecommunications project. As such, the Committee is unaware of any authoritative view which might be contrary to the advice or opinions of KPMG, Cutler & Company and Gibson Quai.

## **10. NEGOTIATIONS UNDERTAKEN WHICH LED THE GOVERNMENT TO ENTER INTO A DEAL WITH DOWNER EDI**

The documents discussed in section 9 demonstrate the extent of the evidence provided to the Committee in relation to the investigative work the Government undertook prior to signing a Heads of Agreement with Downer Engineering. However, there was no evidence presented to the Committee which demonstrated the extent of the negotiations between the Government and Downer Engineering prior to the signing of a Heads of Agreement.

It is logical to assume that there must have been some discussions and negotiations between the Government and Downer Engineering prior to them arriving at a position where they agreed to enter into the Heads of Agreement. Without testimony from either of the parties involved or further documentary evidence, it is not possible to know how extensive the negotiations were and which party or parties instigated negotiations.

The question therefore remains as to what stage the Government became involved, and whether its involvement was initiated by Downer Engineering or by its own accord. There are a number of possible scenarios, with one being that Downer Engineering approached the Government to become involved. This is a possible scenario given that the Heads of Agreement established the path toward the signing of the Put and Call Option Deed, which effectively gave Downer Engineering options whereby ownership of the FOC Backbone could be transferred to the Government (see paragraphs 11.1 and 11.2).

Another possible scenario is that the Government, after identifying the opportunity to build the FOC Backbone with the gas pipeline, initiated discussions and negotiations with DEI Tasmania Holdings and Downer Engineering. However, it is not clear how Downer Engineering would have been selected to enter into such discussions and negotiations.

While these scenarios are just two of a number of possible scenarios, the Committee reiterates that there is no evidence which indicates how the negotiations actually took place. The only clue that is provided comes from KPMG's *Gas Distribution Tender: Telcomms Opportunities* report. As stated in paragraph 9.1.5, at the time of KPMG's report in March 2001, the Government was negotiating with DEI Tasmania Holdings to include in the TNGP Development Agreement (which was subsequently signed in April 2001) a clause where DEI Tasmania Holdings would grant a sub-licence to a telecommunications operator or, alternatively, it would cooperate with such a party who would procure a licence. However, it is not clear whether the Government's negotiations with DEI Tasmania Holdings at this time were influenced by any discussions or negotiations with Downer Engineering, as it is not clear whether Downer Engineering was involved at this stage.

The Committee considers that the issue of how negotiations took place is a relatively minor one. The important issue in the Committee's view is that the investigative work

was of sufficient scope and quality to clearly demonstrate to the Government that undertaking the telecommunications project, in conjunction with the gas project, provided a significant opportunity to the State. As indicated in section 9, the Committee considers that the investigative work undertaken was satisfactory and the Government received proper advice that, in the opinion of the consultants, the opportunity provided by the project was a good one.

## **10.1. Notes and Findings**

**The Committee notes that:**

- **There is no clear evidence to indicate the extent of the negotiations between the Government, Downer Engineering and DEI Tasmania Holdings prior to the signing of the Heads of Agreement, and nor is there any clear evidence to show which party initiated negotiations.**

**The Committee finds that:**

- **The issue of how negotiations took place is a relatively minor one. The important issue is that the investigative work was of sufficient scope and quality to clearly demonstrate to the Government that undertaking the telecommunications project, in conjunction with the gas project, provided a significant opportunity to the State.**

### ***Summary Finding on Term of Reference (c)***

**The Committee finds that, in relation to term of reference (c), the investigative work undertaken prior to the cable being laid was conducted satisfactorily. In the case of the negotiations undertaken which led the Government to enter into a deal with Downer EDI, the Committee finds that the lack of evidence involving the negotiations does not raise any significant issues of public concern.**

## **11. EXPLANATION OF THE CONTRACTUAL CONDITIONS UNDER WHICH THE PURCHASE OF THE FIBRE OPTIC CABLE OCCURRED**

The Government entered into a number of contracts with Downer Engineering (or its subsidiaries) which set the conditions under which the Government purchased the FOC. Those contracts or agreements are summarised in this section. As discussed in section 6, the Committee has agreed to a request that many of the details of these contracts and agreements remain commercial-in-confidence to protect the commercial interests of the parties involved. As such, these details cannot be discussed in this report.

### **11.1. Tasmanian Telco Project Heads of Agreement**

The Government signed a Heads of Agreement with Downer Engineering and Jencode Pty Ltd (a wholly owned subsidiary of Downer Engineering) on 21 September 2001. It was Downer Engineering's intention to use Jencode as the vehicle to own the FOC. Jencode was later renamed Tas21 Pty Ltd.

It was established in the Heads of Agreement that Downer Engineering had identified an opportunity to co-locate a fibre optic cable in DEI Tasmania Holdings' proposed gas pipeline trenches. Downer Engineering's intention was to also distribute telecommunications services to retail, residential and commercial customers in Tasmania, in conjunction with the gas distribution network (once the Government had awarded a franchise to distribute gas to domestic and commercial premises).

It was also established in the Heads of Agreement that the parties wished to provide for options whereby the Government might purchase either the FOC Backbone from Jencode, or all of the shares in Jencode (which would give the Government ownership of the FOC Backbone).

To this end, the Heads of Agreement included a draft put and call option deed, which the Government, Downer Engineering and Jencode committed to work toward signing. However, the Heads of Agreement was not binding on any of the parties.

### **11.2. Put and Call Option Deed**

The Government, Downer Connect Pty Ltd (another wholly owned subsidiary of Downer Engineering) and Tas21 Pty Ltd signed the Put and Call Option Deed on 21 November 2001. While the Deed states that Downer Connect is the legal and beneficial owner of all the shares in Tas21, both companies are wholly owned by the parent company, Downer Engineering. A Deed of Parent Company Guarantee was also signed on 21 November 2001 by Downer Engineering that provided a guarantee to the Government for the performance of its entities obligations under the Put and Call Option Deed.

While Tas21 was the designated vehicle in which ownership of the FOC Backbone would be held, Downer Connect was the company that Tas21 later contracted to design, construct and install the FOC Backbone. Tas21 also later contracted Downer Connect to provide operation, repair and maintenance works.

The Committee has accepted that the terms of the Put and Call Option Deed are commercial-in-confidence, and therefore the details cannot be publicly reported. However, the Committee noted that the Deed set out specific circumstances where Tas21 or Downer could elect to exercise a put option to sell the FOC Backbone to the Government, or alternatively sell all the shares in Tas21 to the Government. Similarly, under the Deed, in specific circumstances the Government could also elect to exercise its call option to purchase the FOC Backbone, or alternatively all of the shares in Tas21.



The Put and Call Option Deed also set out the Asset Option Price to be paid by the Government should either the put or call option be exercised.

### **11.3. The Amending Deed**

The Amending Deed amended the Put and Call Option Deed and was executed on 25 March 2002 by the parties to the Put and Call Option Deed. The amendment related to a variation to the Asset Option Price contained in the Put and Call Option Deed.

Prior to the execution of the Amending Deed, Downer Engineering signed a Deed Poll on 22 February 2002 which acknowledged that the Deed of Parent Company Guarantee would remain in full force and effect upon the signing of the Amending Deed.

### **11.4. The Multiparty Deed**

On 14 June 2002, Tas21, Downer Connect, the Government and the Commonwealth Bank of Australia signed the Tasmanian Fibre Optic Cable Network Project – Multiparty Deed. Three days earlier Downer Connect and Tas21 had established a financial facility with the Commonwealth Bank to fund the construction of the FOC Backbone.

The Multiparty Deed established that under certain conditions, the Commonwealth Bank could require Tas21/Downer Connect to exercise its put option under the Put and Call Option Deed. If the Commonwealth Bank required the exercise of the put option, the conditions that needed to exist for Tas21/Downer Connect to exercise the put option under the Put and Call Option Deed would not be required to be fulfilled. However, the procedures for the transfer and sale of the FOC Backbone would remain under the Put and Call Option Deed.

Downer Engineering signed a Deed Poll on 13 June 2002 which acknowledged that the Deed of Parent Company Guarantee would remain in full force and effect upon the signing of the Multiparty Deed.

### **11.5. Notes and Findings**

**The Committee notes that:**

- **The Government entered into a Heads of Agreement with Downer Engineering and Jencode (later Tas21) which established the course toward the signing of the Put and Call Option Deed.**
- **The Put and Call Option Deed effectively put the Government into a position where it could ultimately take ownership of the FOC Backbone.**
- **A Multiparty Deed was signed by the parties to the Put and Call Option Deed and the Commonwealth Bank. The Multiparty Deed gave the Commonwealth Bank the right to require Tas21/Downer Connect to exercise the put option under the Put and Call Option Deed.**

**The Committee finds that:**

- **The Government knowingly entered into a contract whereby it put itself into a position in which it could be (and was) ultimately called upon to take ownership of the FOC Backbone.**
- **The Government's decision to enter into the Heads of Agreement and the Put and Call Option Deed effectively reflects a strategic policy decision by the Government to support the building of the FOC Backbone.**

## **12. THE PURCHASE OF THE FIBRE OPTIC CABLE UNDER THE PUT OPTION**

The following section discusses the procedures under which the Government purchased the FOC Backbone from Tas21.

### **12.1. The Completion Date**

Under the terms of the Put and Call Option Deed (and the Multiparty Deed), construction of the FOC Backbone was required to be completed before either the put or call option could be exercised. On 5 March 2003, Gibson Quai, which had been appointed as the independent certifier, issued a Certificate of Completion. This certified that the FOC Backbone had been completed and tests had revealed that it met all the required technical standards and was fit for its intended purposes. Under the terms of the Put and Call Option Deed, the Option Period under which the put or call option could be exercised commenced on the completion date.

### **12.2. Exercise of the Put Option**

Under the Multiparty Deed, if the Commonwealth Bank decided it wished to require Tas21/Downer Connect to exercise its put option under the Put and Call Option Deed, the Commonwealth Bank was required to issue an Exercise Notice to the selling party during the Exercise Period. The Exercise Period was the period commencing 45 days prior to and ending 10 business days before 30 May 2003.

However, before an Exercise Notice could be issued, the Bank was required to issue a Notice of Intention to Tas21, Downer Connect and the Government any time after the Option Period commenced but not earlier than 10 business days before the start of the Exercise Period and, where practical, at least 10 business days before giving an Exercise Notice. In circumstances where the Bank considered that it was not practical to give the Notice of Intention at least 10 business days before giving an Exercise Notice, it was required to give the Notice at least one business day before.

The Bank gave a Notice of Intention to Tas21, Downer Connect and the Government on 1 May 2003 and gave an Exercise Notice on 15 May 2003 and, as such, satisfied the requirements set out in the Multiparty Deed and the Put and Call Option Deed.

The sale and transfer of the FOC Backbone to the Government then took place under the execution of a Transfer Deed on the specified effective date, which was 29 May 2003. The Transfer Deed indicates that the sum paid by the Government for the FOC Backbone was the Asset Option Price, which was set by the Put and Call Option Deed (and subsequently approved amendments to this Deed). The Government announced at the time of the 2003-04 State Budget the allocation of \$23.1 million in surplus funds from the previous Budget to the purchase of the FOC. This amount is consistent with the Asset Option Price and the terms of the Transfer Deed.

### **12.3. Assignment of Other Contracts**

The Government took assignment of a number of contracts under the Transfer Deed under which the Government took ownership of the FOC Backbone. These contracts are summarised below.

#### **12.3.1. Project Agreement (Co-location and Access) Deed**

The Project Agreement (Co-location and Access) Deed (referred to as the Access Deed) was signed by Tas21 and DEI Tasmania Holdings on 14 December 2001. Under the Access Deed, DEI Tasmania Holdings effectively granted Tas21 the right to install and operate a FOC Network in co-location with DEI Tasmania Holdings' gas pipeline.

The Access Deed specifically sets out the obligations and processes each party was required to observe and carry out with regard to the construction and operation of the fibre optic and gas assets. It also sets out the financial obligations Tas21 owed to DEI Tasmania Holdings for the right to co-locate the FOC Backbone in the gas pipeline trenches.

The parties agreed that if Tas21/Downer Connect or the Tasmanian Government wished to exercise their respective options under the Put and Call Option Deed, Tas21 may assign its interests in the Access Deed to the Government. This assignment took place under the Transfer Deed.

#### **12.3.2. Design and Construct Contract**

This contract is the formal instrument of agreement between Tas21 and Downer Connect in which Tas21 contracted Downer Connect to design, construct and install the FOC Backbone. The contract was executed on 7 June 2002.

#### **12.3.3. Operations and Maintenance Agreement for Repair and Maintenance of a Fibre Optic Cable Backbone in Tasmania**

As well as contracting Downer Connect to design, construct and install the FOC Backbone, Tas21 also signed an agreement with Downer Connect for Downer Connect to perform certain operations, repair and maintenance works. This agreement was signed on 2 May 2003. Downer Connect subcontracted a number of these works to Aurora Energy Pty Ltd and the Hydro-Electric Corporation.

#### **12.3.4. Third Party Agreements**

The Government also took assignment of two third-party agreements, namely a Pole Access Agreement between Tas21 and Aurora Energy, dated 18 July 2002, and a Licence Agreement between the Central Coast Council and Tas21, dated 7 November 2002. Details of these agreements were not provided to the Committee. However, it is the Committee's opinion that these agreements are not material to the Inquiry.

The Government also agreed to take assignment of any other contract or arrangement between Tas21 or Downer Connect and landowners in relation to the installation of the FOC Backbone on landowners land. Details of specific contracts or arrangements with landowners were not provided to the Committee.

#### **12.4. Notes and Findings**

**The Committee notes that:**

- **The Option Period commenced upon the completion of construction of the FOC Backbone on 5 March 2003.**
- **The Commonwealth Bank, using its right under the Multiparty Deed, instructed Tas21/Downer Connect to exercise its put option under the Put and Call Option Deed.**
- **The sale of the FOC Backbone to the Government was completed on 29 May 2003. The Government also took assignment of a number of operations, maintenance and access contracts upon the sale.**
- **The \$23.1 million of surplus funds allocated from the 2002-03 State Budget by the Government at the time of the 2003-04 Budget to the FOC purchase is consistent with the Asset Option Price in the Put and Call Option Deed (and subsequently approved amendments to that Deed) and the terms of the Transfer Deed.**

**The Committee finds that:**

- **The sale and transfer of the FOC Backbone to the Government appears to have been conducted in accordance with the conditions set out in the Put and Call Option Deed and Multiparty Deed.**

#### ***Summary Finding on Term of Reference (b)***

**The Committee finds that, in relation to term of reference (b), the terms of the contracts between Downer EDI and the Government which brought about the purchase of the FOC by the Government were unambiguous in relation to the obligations placed on both parties. The Committee also finds that the purchase of the FOC was conducted in accordance with the terms of the contracts.**

### **13. THE DUE DILIGENCE PROCESS**

The Government engaged national legal firm, Allens Arthur Robinson (AAR) to provide advice on how to proceed with the purchase of the FOC Backbone, as well as advice on the Government's legal, regulatory and other obligations it assumed upon the purchase. The advice was given in the lead up to and shortly after the purchase took place. Advice was given in regular correspondence in the lead up to the purchase. After the purchase, AAR provided a Legal Due Diligence Report which summarised some of the earlier advice as well as providing further information on the Government's obligations.

The following summarises the key advice provided by AAR in its Legal Due Diligence Report.

#### **13.1. The Purchase Procedures for the FOC Backbone Under the Multiparty Deed**

In the Legal Due Diligence Report, AAR summarised the advice it provided to the Government on how to proceed with the purchase, prior to the purchase taking place...

AAR advised the Government that it could have avoided the put option being exercised under the Multiparty Deed by exercising its call option under the Put and Call Option Deed. However, exercising the call option would have required the Government to consult with Tas21/Downer Connect to identify the most 'mutually beneficial' choice between purchasing only the FOC Backbone asset or purchasing the shares in Tas21. AAR pointed out that with the exercise of the put option, the Government had the right to elect whether to purchase the shares in Tas21 or only the FOC Backbone, without having to consult with Tas21/Downer Connect. AAR therefore recommended against the Government exercising the call option under the Put and Call Option Deed.

AAR recommended that the Government purchase the FOC Backbone and not the shares in Tas21. AAR considered that purchasing the FOC Backbone asset was optimal for taxation reasons and allowed a cleaner break from the business of Tas21. By purchasing the asset, the Government only took on the liabilities it agreed to assume upon the transfer and avoided any contingent or actual liabilities of Tas21.

AAR also recommended that when Tas21/Downer Connect did exercise the put option, the Government should use a wholly owned company (that is, a Corporations Act company as opposed to a statutory corporation) to acquire the asset. AAR's view was that certain depreciation benefits might be reduced if the ownership was taken directly by the Government and not through a wholly owned company.

The Government's purchase of the FOC Backbone followed the advice given by AAR in all instances, with the exception that it did not use a wholly owned company as the vehicle for the purchase. The Government did not exercise the call option and allowed the put option to be exercised through the Multiparty Deed (as discussed in paragraph 12.2). If the Government had decided to purchase the shares in Tas21, it was required to notify the Commonwealth Bank of this decision within 10 business days of receiving the Notice of Intention from the Commonwealth Bank. The Government elected not to notify the Bank of its intentions and, under the terms of the Multiparty Deed, the Government was deemed to have elected to purchase the FOC Backbone asset only.

The Government's decision not to use a wholly owned company to purchase the FOC Backbone, as recommended by AAR, was due to 'timing and other impediments' to transferring the asset which the Government considered outweighed any tax and accounting benefits of using a wholly owned company.

### **13.2. Telecommunications Regulatory Issues**

The assignment of the Access Deed to the Government upon the purchase of the FOC Backbone resulted in the Government being obliged to provide Supervisory Control and Data Acquisition (SCADA) services to DEI Tasmania Holdings. The SCADA system enables remote surveillance of the gas pipeline and control by DEI Tasmania Holdings' operational staff located in Queensland. The SCADA system is considered essential for the safe and efficient operation of the gas pipeline.

The SCADA system is classified as a telecommunications link and therefore its operation is subject to the *Telecommunications Act 1997* (Commonwealth). AAR advised the Government that it would require either a carrier licence, a nominated carrier declaration, or an exemption from the carrier licensing provisions in the Telecommunications Act to operate the SCADA system. AAR noted that the Government had considered this issue in association with its election to purchase the FOC Backbone asset instead of the shares in Tas21. The Government's decision also took into account the fact that Tas21 held an existing carrier licence, which the Government would have gained the benefit of had it purchased the shares in Tas21.

AAR recommended that the Government either seek a carrier licence or an exemption from the carrier licensing provisions in the Telecommunications Act. AAR noted that the Government considered these options having regard to the proposed timeline for further development of the FOC, the time constraints for completing the FOC Backbone acquisition and the extent of its potential liabilities for carrier licence fees and the universal obligation levy. Based on these factors, the Government decided to apply for an exemption on 16 May 2003.

At the date of AAR's report, the application for the exemption was yet to be processed and therefore had yet to be granted. AAR advised that the Government was providing unlicensed telecommunications carriage services in breach of the Telecommunications Act, to which fines of up to \$10 million may apply. However, AAR's opinion was that the likely exposure was not a material issue as the application for the exemption was in progress and the Government could immediately apply for a carrier licence in the event that its application for the exemption was unsuccessful.

The evidence provided to the Committee does not indicate whether the application for the exemption was eventually successful or whether the Government had to apply for a carrier licence. However, the Committee does not believe this is material to its Inquiry and is satisfied appropriate advice was provided and acted upon by the Government in relation to the telecommunications regulatory issues.

### **13.3. Ownership of the FOC Backbone**

AAR advised the Government that it had the benefit of a number of warranties relating to the ownership of the FOC Backbone.

With regard to any liabilities associated with the FOC Backbone, AAR advised that:

*"Under the Option Deed, Tas21 warrants that upon the transfer of the Assets, the Government shall assume the OFC free of all pre-existing liabilities other than those contained in the agreements relating to the OFC and transferred to the Government on completion."*<sup>27</sup>

This warranty was repeated by both Tas21 and Downer Connect in the Transfer Deed. Tas21 and Downer Connect also provided an indemnity to the Government under the Transfer Deed in relation to losses and liabilities connected with the various FOC agreements prior to the transfer on 29 May 2003.

Tas21 provided a warranty under the Put and Call Option Deed that it was the legal and beneficial owner of the FOC and the spare parts (otherwise known as the Prime Cost Spares). This warranty was provided again by Tas21 and Downer Connect in the Transfer Deed. AAR stated that this was beneficial to the Government:

*"As Tas21 had sold its main asset, it is important that the Government now have this warranty from Downer. It is our understanding that Downer has a number of other business activities and there are no plans for it to enter into insolvency administration."*<sup>28</sup>

AAR also provided advice on the transfer of the FOC to Tas21 under the Design and Construct Contract. While there was no explicit transfer of ownership under the contract, the nature of the contract was that Tas21 had contracted Downer Connect to build the

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<sup>27</sup> *Legal Due Diligence Report*, Allens Arthur Robinson, June 2003, p.8.

<sup>28</sup> *Ibid*; p.8.

FOC for its benefit. AAR did not raise any concern that Tas21 may not have taken ownership of the FOC after the completion of its construction and installation.

AAR also examined the transfer of title to Downer Connect under a number of sub-contracts that Downer Connect entered into to install the FOC. AAR noted that the Government had elected not to take assignments of the individual sub-contracts for the installation of the FOC.

#### **13.4. The Fitness for Purpose of the FOC Backbone**

AAR advised the Government that it can take some comfort from Gibson Quai's statement in its Certificate of Completion that the FOC is capable of being used for its intended purposes and had no outstanding omissions or defects. However, AAR also advised that the Government might not be able to rely on the Certificate. Despite this, AAR was of the opinion that if the FOC was found to be wrongly certified as being free of defects and fit for its purpose, the Government could have recourse against Gibson Quai for negligence.

In addition to Gibson Quai's certification, project engineer firm Sinclair Knight Merz Pty Ltd was required to issue certificates under Tas21/Downer Connect's financial facility agreement with the Commonwealth Bank. These certificates had to state that at particular points in the construction, the FOC was being completed in accordance with the Design and Construct Contract and the specifications under the Put and Call Option Deed and Multiparty Deed.

AAR noted that Sinclair had raised an issue relating to defective works:

*"In letters between DEI, Downer and Nacap [Nacap Australia Pty Ltd - one of three companies subcontracted by Downer Connect to install the FOC] dated 25 July 2002, 30 July 2002 and 15 August 2002, there is discussion of a dispute that arose in relation to defective backfill discovered by Sinclair for which Downer sought rectification from Nacap. We understand from the letter also provided by Tas21 from Linda Hornsey, Secretary of the Department of Premier and Cabinet to Tas21 dated 21 August 2002 regarding this issue that the Government is aware of the allegations but has elected to rely on undertakings from Downer that the conduits have been installed to the standard of the Specification and are fit for purpose."*<sup>29</sup>

In relation to warranties given under the Design and Construct Contract, AAR noted that the Government obtained from Tas21 upon the purchase of the FOC the benefit of the manufacturers and suppliers warranties in relation to the FOC. As such, Downer Connect bears full liability and responsibility for the design and construction of the FOC.

With the assignment of the Design and Construct Contract to the Government, the Government gained the right to direct Downer Connect to rectify any omission or defect

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<sup>29</sup> Ibid; p.11.



in the work Downer Connect was contractually responsible, provided that the Government (or Tas21 previously) gave the direction within the Defects Liability Period (which is defined as 365 days commencing from the completion of the Design and Construct Contract).

AAR noted that Downer Connect had warranted under the Design and Construct Contract that its work under the contract would be fit for its intended purpose and constructed in accordance with the relevant specifications.

In relation to the Government's Operations and Maintenance (O&M) Agreement with Downer Connect, AAR recommended that:

*"The Government should consider how to ensure that appropriate Work Orders are issued to Downer under the O&M Agreement so that the Government's obligations under the Access Deed in relation to the SCADA link are met and the OFC is properly maintained. As a first step, the monitoring requirements under the O&M Agreement should be discussed with Downer to assess what role the Government will have."*<sup>30</sup>

AAR also stated that it was advised by Downer Connect that the Prime Cost Spares referred to in the Put and Call Option Deed are items that are listed and annexed to the Transfer Deed. Downer Connect wrote to Aurora Energy informing it that the Prime Cost Spares which Aurora had stored were now owned by the Government, and that it should continue to store the spares on behalf of the Government.

### **13.5. SCADA Arrangements**

AAR advised that the Government was obliged to provide DEI Tasmania Holdings with a SCADA link in all areas where the FOC is co-located with the natural gas pipeline for a period of 15 years after the completion of the network. This period can be extended for a further 15 years, or for three further periods of five years each, subject to DEI Tasmania Holdings approval.

AAR noted that DEI Tasmania Holdings may require additional SCADA sites to be connected and the Government must comply with such a request. In this case, the Government can charge for its reasonable costs of providing these additional services.

The use of the FOC to provide telecommunications services is linked to its use for the SCADA system. Under the Access Deed, a single fibre pair in the FOC is used as the SCADA link to connect the SCADA sites. The same single fibre pair is to be used by the Government to also carry other telecommunications services.

AAR stated that:

*"The Government does not have the ability to provide the SCADA link on its own account and will outsource the operation and maintenance of the SCADA link*

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<sup>30</sup> Ibid; p.13.

*(and the FOC more generally) to Downer upon the assignment of the O&M Agreement...*

*We note that DEI is not charged for the SCADA link. However, there is consideration from DEI in the form of co-location access rights.”<sup>31</sup>*

With regard to insurance requirements, AAR noted that under the Access Deed, the Government and DEI Tasmania Holdings are required to maintain industrial special risk and public liability insurance in relation to the FOC Backbone and the natural gas pipeline. AAR recommended that the Government’s existing insurance policy should be reviewed to ensure it meets this requirement.

### **13.6. Liabilities**

AAR discussed a number of liabilities, or potential liabilities, associated with the various contracts involving the FOC Backbone.

With regard to the Option Deed, AAR stated that:

*“Under the Option Deed, Tas21 was to be liable for all ‘pre-existing liabilities’ associated with the OFC Backbone, excluding contractual liabilities. Accordingly, under the Option Deed, the Government was to assume all the debts, obligations and liabilities under the contracts to be transferred to the Government, notwithstanding that such liabilities accrued prior to the transfer date. The Transfer Deed, however, contains an indemnity in relation to contractual liabilities incurred by Tas21 prior to 29 May 2003 (the Effective Date).”<sup>32</sup>*

In relation to the Design and Construct Contract, AAR noted that Tas21 had written to Crown Law stating there were no payments to be made after 29 May 2003. However, the Government did assume liabilities under the O&M Agreement. Under the Agreement, Tas21 agreed to pay Downer Connect’s reasonable costs incurred in the performance of its obligations. Tas21 advised Crown Law that it had paid Downer Connect the sum of \$197 199 for the period of 12 July 2002 to 11 July 2003 inclusive. Tas21 also advised Crown Law that no further costs were due to be paid by Tas21 relating to the rollout of the FOC.

With the assignment of the O&M Agreement to the Government, AAR noted that the total estimated cost for each of the second and subsequent years of the O&M Agreement that the Government would have to pay was \$318 042. The increase in costs after the first year was attributed to the addition of a technician together with a vehicle, equipment and associated costs, and a profit margin of 10 per cent on these additional costs. A 3 per cent escalation factor was also added to the second year estimate.

In relation to the Access Deed, AAR stated that:

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<sup>31</sup> Ibid; p.14.

<sup>32</sup> Ibid; p.15.

*“Under the Access Deed, Tas21 states that it owns and bears all responsibility for the materials which make up the OFC and the Conduit Works. Tas21 is also liable for all risks and obligations in relation to the parts of the OFC that are co-located with the TGP. Upon assignment of the Access Deed, the Government will assume these obligations and representations on behalf of Tas21.”*<sup>33</sup>

### **13.7. Parent Company Guarantee**

The Deed Polls signed by Downer Engineering on 22 February 2002 and 12 June 2002 stated that the Parent Company Guarantee it gave with the execution of the Put and Call Option Deed remained in force despite the amendment to the Put and Call Option Deed and the execution of the Multiparty Deed. However, AAR noted that Downer Engineering refused to extend this guarantee to the performance of Tas21/Downer Connect under the Transfer Deed. Despite this, AAR advised that the Parent Company Guarantee still provides comfort to the Government, as many of Tas21/Downer Connect’s obligations in relation to the transactions under the Transfer Deed are contained in the Put and Call Option Deed.

### **13.8. Encumbrances**

AAR noted that there were two charges registered in favour of the Commonwealth Bank - one over Tas21’s assets and undertakings and the other over Downer Connect’s present and future right, title and interest in the Put and Call Option Deed.

AAR noted that Crown Law had filed documents with the Australian Securities and Investments Commission (ASIC) to release the charges. AAR advised that it had reviewed the draft versions of the release documents and confirmed that they would be sufficient to remove the encumbrances.

### **13.9. Land Access**

AAR noted that under the *Telecommunications Act 1997* (Commonwealth), carriers have a right to install low-impact facilities such as underground conduit and cable. This right allows a carrier to access private land and install any facility which is designated as a low impact facility under the *Telecommunications (Low-Impact Facilities) Determination 1997* (Commonwealth), provided that written notice of the work is provided to affected landowners and occupiers and the work is conducted in accordance with the *Telecommunications Code of Practice 1997* (Commonwealth).

AAR advised that it had not reviewed the work plans for the FOC and therefore could not verify which components of the FOC were low impact installations. However, the land access documents it had reviewed generally indicated that Tas21 had appropriately exercised its statutory land access rights.

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<sup>33</sup> Ibid; p.16.

AAR noted that where the FOC does not fall within the definition of a low-impact facility (ie where the FOC is overground), the usual rules of property would had to have been followed by Tas21. AAR advised that this is mostly of concern with regard to entry onto private land and the negotiation of appropriate access rights through license agreements or easements. AAR stated that:

*“Insufficient information had been provided to confirm if Tas21 negotiated such access rights in all instances. Practically, this could prove to be a problem for the Government in the future if access rights were required to be negotiated, however, we understand that the number of instances where the cable was not a low-impact facility and was required to be laid on private land are few and this is unlikely to be a high risk.”<sup>34</sup>*

There are some instances where the FOC was installed along or above bridges or on aerial poles. AAR reviewed a number of consents to install the FOC that were given by various government authorities. While AAR was of the opinion that the consents appear to be sufficient, it could not determine if all appropriate consents had been obtained.

Work that was not designated to be low-impact facilities required approval under State planning laws. AAR advised that it had examined the permits and approvals which were provided. AAR noted that all planning permits granted by local councils under the *Land Use Planning and Approvals Act 1993* are granted for the use or development of land and are not personal. Therefore, these permits were not required to be transferred to the Government. However, the Government is required to comply with the conditions of the planning permits.

AAR noted that various approvals had been granted by the Department of Infrastructure, Energy and Resources (DIER) under the *Roads and Jetties Act 1935*. The Act requires a person to obtain consent from the Minister prior to carrying out works within the State road reservations. AAR advised that the approvals were granted to Tas21 to carry out works on the State’s highways, subject to conditions in the permit.

AAR advised that the Roads and Jetties Act and the permit do not make it clear whether the permit should be transferred to the Government upon the change in ownership. AAR recommended that a transfer of the permit to the Government should be sought from DIER to avoid the ambiguity and to ensure that the Government can meet its ongoing obligations with respect to being able to enter onto roads and perform maintenance works on the FOC. AAR noted, however, that because the Government was effectively dealing with itself in this regard, consents to the transfer of any necessary permits were unlikely to be withheld by DIER.

With regard to access to land to perform operations and maintenance, detailed procedures and costs are set out in the Joint Management Plan between DEI Tasmania Holdings and Tas21, the O&M Agreement and the O&M subcontracts. AAR noted that the Government considered whether there was sufficient value in continuing with the existing

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<sup>34</sup> Ibid; p.18.

arrangements between Downer Connect, Hydro and Aurora. The Government decided to take an assignment of the O&M Agreement under the Transfer Deed and to continue with the existing arrangements. On this decision, AAR noted that Downer does add value by overseeing compliance with the procedures under the various O&M agreements and contracts. However, AAR also noted that there was not sufficient time for the Government to have conducted a new tender process for the appointment of contractors to perform the work undertaken by Aurora and Hydro. AAR advised this issue could be considered at a later date.

AAR noted that the Government has the right under the Access Deed to carry out works within the TGP corridor. AAR states that arguably this right also extends to the Government's contractors, as DEI Tasmania Holdings is required under the Access Deed to allow sufficient access to allow the Government to maintain and update the SCADA equipment.

With regard to maintenance of the FOC where it is located outside the TGP corridor, AAR advised that a carrier licence would allow the holder of the licence to conduct maintenance of the FOC wherever it is located. However, during the period when the Government did not hold a carrier licence, it would either have to enter into licence agreements or make requests to landowners for access to undertake maintenance. Alternatively, AAR advised the Government could engage a licensed carrier to undertake or authorise maintenance activities.

### **13.10. The Assignment of FOC Backbone Agreements**

Tas21/Downer Connect were required to obtain third party consents to the assignment of the contracts detailed in paragraph 12.3.4. AAR advised that there was a risk that the counterparties to these contracts may demand a payment for the consent to transfer the contracts. AAR further advised that if Tas21/Downer Connect had not obtained consents, they could be in breach of the relevant agreements, which in turn would give the counterparties a right to terminate. AAR recommended that Tas21/Downer Connect be contacted on 12 June 2003 if proof of assignment of the relevant agreements had not been provided.

### **13.11. Notes and Findings**

**The Committee notes that:**

- **AAR provided detailed and extensive advice to the Government on how to proceed with the purchase of the FOC Backbone and the associated obligations the Government assumed with the purchase.**
- **The Government's decision to purchase the FOC Backbone asset and not the shares in Tas21 followed the advice of AAR.**
- **AAR confirmed that the purchase was conducted in accordance with the terms of the Put and Call Option Deed and the Multiparty Deed.**

- AAR provided detailed advice to the Government on its obligation to provide SCADA services and the associated regulatory requirements.
- AAR confirmed that the Government had assumed legal ownership of the FOC Backbone and that the FOC Backbone appeared to be fit for its intended purpose.

The Committee finds that:

- AAR appears suitably qualified to have provided advice and conducted the legal due diligence for the Government's purchase of the FOC Backbone.
- AAR's Legal Due Diligence Report and advice to the Government appears to address all contractual, regulatory and other legal issues that could reasonably have been foreseen in the lead up to, and at the conclusion of, the transfer of the FOC Backbone to the Government.
- The Legal Due Diligence Report should provide comfort to the Tasmanian community that there was independent scrutiny of the Government's purchase of the FOC Backbone.
- The Legal Due Diligence Report should provide comfort to the Tasmanian community that the Government was aware of the obligations it assumed upon the purchase of the FOC Backbone, and that there were unlikely to be any significant 'surprises' after the Government took ownership.

*Summary Finding on Term of Reference (a)*

The Committee finds that, in relation to term of reference (a), the due diligence process undertaken by the Government was conducted satisfactorily.

Parliament House  
Hobart  
11 October 2004

A. W. Fletcher MLC  
CHAIRMAN

## **APPENDIX A**

### **REPORT TO DPAC ON PROJECT TELCO ISSUES**

Gibson Quai prepared a report for the Department of Premier and Cabinet (DPAC) in July 2002 which provided advice on a proposal made by Downer Engineering and Tas21 to provide fixed voice telephone services (Centrex services) to the Tasmanian Government. The proposal was for these services to replace, at least partially, if not fully, the existing Centrex services provided to State Government departments and associated bodies.

Gibson Quai provided technical and commercial advice on issues that it believed were raised by the proposal and by the information provided by Downer Engineering and Tas21 in support of the proposal. This advice includes Gibson Quai's opinion on a number of issues which may be commercially sensitive. As such, the Committee decided that the details of the report should be kept commercial-in-confidence.

The Committee notes, however, that the report provides evidence that the Government considered at least one proposal, and that Tas21 and Downer Engineering had at least one plan, for the commercial use of the FOC Backbone prior to the Government taking ownership of the asset. It is not clear whether the proposal progressed further after the advice to the Government was provided by Gibson Quai, but it is clear that at some point the proposal was either rejected by the Government or withdrawn by Tas21 and Downer Engineering.

## **APPENDIX B**

### **DISCUSSION AT THE COMMITTEE MEETING OF 12 AUGUST 2004**

At the Committee meeting of 12 August 2004, the Committee spoke generally about fibre optic technology and its potential impact in Tasmania in the short-term and long-term.

The Committee noted that competition exists on a number of infrastructure levels in the telecommunications industry. As such, the final retail price for telecommunications services paid by households and businesses partly reflects the pricing of the various infrastructure levels used to deliver the services.

In the case of the FOC Backbone, the Government expects it to deliver competition and pricing benefits to consumers even over the short-term when the delivery of services will still need to rely on Telstra infrastructure beyond the Backbone infrastructure level. This is because telecommunications service providers will have the choice of delivering their services over either the FOC Backbone or Telstra's backbone infrastructure. This should create price competition at this infrastructure level, which should then be reflected in the final retail price. Price competition should occur irrespective of whether service providers provide services over infrastructure levels which are solely owned and operated by Telstra, or over a FOC Backbone owned and operated by the Government and/or another entity which is connected to other infrastructure levels owned by Telstra.

The rollout of further infrastructure levels connected to the FOC Backbone to compete directly with Telstra's infrastructure is likely to be a medium to long-term prospect, and will be dependent on the gas rollout and demand for broadband services by households and businesses. As such, the benefits of having fibre optic connection to the home are unlikely to be realised in the short-term, with the delivery of broadband services via the FOC Backbone having to rely on Telstra's copper wires into homes for some time. Greater competition and range of services are likely to be available in the medium to long-term assuming that infrastructure beyond the FOC Backbone level is constructed.



## APPENDIX C

### ACRONYMS

AAR	Allens Arthur Robinson
ASIC	Australian Securities and Investments Commission
DIER	Department of Infrastructure, Energy and Resources
DPAC	Department of Premier and Cabinet
DSL	Digital Subscriber Line
FOC	Fibre Optic Cable
ISP	Internet Service Providers
O&M	Operations and Maintenance
OFC	Optic Fibre Cable
PAC	Public Accounts Committee
SCADA System	Supervisory Control and Data Acquisition System
TGP	Tasmanian Gas Pipeline
TNGP	Tasmanian Natural Gas Project
USO	Universal Service Obligation

## APPENDIX D

### LIST OF DOCUMENTS TAKEN INTO EVIDENCE

Document	Name and Date Received	
<i>Legal Due Diligence Report</i> , June 2003	Allens Arthur Robinson 24 June 2004	1
<i>Tasmanian Telco Project Heads of Agreement (Put and Call Options Deed)</i> , 21 September 2001 <b>Received in confidence</b>	Downer Engineering Group Pty Ltd, Jencode Pty Ltd and the Crown in the Right of the State of Tasmania 24 June 2004	2
<i>Put and Call Option Deed for Optic Fibre Cable Backbone in Tasmania</i> , 21 November 2001 <b>Received in confidence</b>	Downer Connect Pty Ltd, Tas21 Pty Ltd and the Crown in the Right of the State of Tasmania 24 June 2004	3
<i>Deed of Parent Company Guarantee for Optic Fibre Cable Backbone in Tasmania</i> , 21 November 2001 <b>Received in confidence</b>	Downer Engineering Group Pty Ltd and the Crown in the Right of the State of Tasmania 24 June 2004	4
<i>Deed Poll (for Optic Fibre Cable Backbone in Tasmania)</i> , 22 February 2002 <b>Received in confidence</b>	Downer Engineering Group Pty Ltd 24 June 2004	5
Letter from Tas21 Pty Ltd, 4 March 2002 <b>Received in confidence</b>	Brian Eslick, Project Director, Tas21 Pty Ltd 24 June 2004	6
<i>Amending Deed to Amend the Put and Call Options Deed</i> , 25 March 2002 <b>Received in confidence</b>	Downer Connect Pty Ltd, Tas21 Pty Ltd and the Crown in the Right of the State of Tasmania 24 June 2004	7
<i>Design and Construct Contract</i> , 7 June 2002 <b>Received in confidence</b>	Downer Connect Pty Ltd and Tas21 Pty Ltd 24 June 2004	8
<i>Deed Poll (for Optic Fibre Cable Backbone in Tasmania)</i> , 13 June 2002 <b>Received in confidence</b>	Downer Engineering Group Pty Ltd 24 June 2004	9

<p><i>Tasmanian Fibre Optic Cable Network Project – Multiparty Deed</i>, 14 June 2002</p> <p><b>Received in confidence</b></p>	<p>Commonwealth Bank of Australia, Downer Connect Pty Ltd, Tas21 Pty Ltd and the Crown in the Right of the State of Tasmania</p> <p>24 June 2004</p>	10
<p><i>Operational Plan Fibre Optic Cable Network – Tasmanian Gas Pipeline</i>, not dated. The document includes a certified copy of the <i>Tasmanian Gas Pipeline Telecommunications Infrastructure Project Agreement. Co-location and Access Deed</i>, 14 December 2001.</p> <p><b>Received in confidence</b></p>	<p>DEI Tasmania Holdings Pty Ltd and Tas21 Pty Ltd</p> <p>24 June 2004</p>	11
<p><i>Operations &amp; Maintenance Subcontract Agreement between Downer Connect Pty Ltd and Hydro-Electric Corporation for Repair &amp; Maintenance of a Fibre Optic Cable Backbone in Tasmania</i>, 8 May 2003</p> <p><b>Received in confidence</b></p>	<p>Downer Connect Pty Ltd and Hydro-Electric Corporation</p> <p>24 June 2004</p>	12
<p><i>Operations &amp; Maintenance Subcontract Agreement between Downer Connect Pty Ltd and Aurora Energy Pty Ltd for Repair &amp; Maintenance of a Fibre Optic Cable Backbone in Tasmania</i>, 16 April 2003</p> <p><b>Received in confidence</b></p>	<p>Downer Connect Pty Ltd and Aurora Energy Pty Ltd</p> <p>24 June 2004</p>	13
<p><i>Operations and Maintenance Agreement for Repair &amp; Maintenance of a Fibre Optic Cable Backbone in Tasmania</i>, 2 May 2003</p> <p><b>Received in confidence</b></p>	<p>Tas21 Pty Ltd and Downer Connect Pty Ltd</p> <p>24 June 2004</p>	14
<p><i>Transfer Deed</i>, 29 May 2003</p> <p><b>Received in confidence</b></p>	<p>Downer Connect Pty Ltd, Tas21 Pty Ltd and the Crown in the Right of the State of Tasmania</p> <p>24 June 2004</p>	15

<i>Report on Telecommunications Network Modelling for the Tasmanian Government to Cutler &amp; Company Pty Ltd, June 2001</i>	Gibson Quai Pty Ltd 24 June 2004	16
<i>Report to Department of Premier and Cabinet on Project Telco Issues, July 2002</i> <b>Received in confidence</b>	Gibson Quai Pty Ltd 24 June 2004	17
<i>Gas Distribution Tender Telecomms Opportunities, March 2001</i>	KPMG 22 July 2004	18
<i>Gas and Telecommunications Infrastructure Opportunity, 6 April 2001</i>	Cutler & Company 22 July 2004	19
<i>Costing Options for a Telecommunications Distribution Network, 19 April 2001</i>	Cutler & Company 22 July 2004	20
<i>Telecommunications Network Costs. Overview of Gibson Quai's Report, June 2001</i>	Cutler & Company 22 July 2004.	21.