

AUDIT REPORT NO. 38, SALE OF BRISBANE, MELBOURNE AND PERTH AIRPORTS

Introduction

3.1 The sale of leases for Melbourne, Brisbane and Perth airports to the Australian Pacific Airports Corporation, Brisbane Airport Corporation Ltd and Australia Development Group, respectively, was completed on 1 July 1997. The sale of these leases was initiated in April 1994 and represented the first stage of the planned privatisation of the 22 Federal airports previously owned and operated by the Federal Airports Corporation (FAC).

3.2 The Office of Asset Sales and IT Outsourcing (OASITO) was responsible for the management of the sale. The OASITO engaged a range of contractors which included BZW Australia Limited as Business Adviser; the Australian Government Solicitor and Clayton Utz as Legal Advisers; and KPMG as the Investigating Accountant. The development of legislation and policy to govern the sales process was the responsibility of the Department of Transport and Regional Development (DoTRD).

3.3 The sale generated gross proceeds of \$3.31 billion, significantly in excess of book values and scoping study estimates.¹ The net sale proceeds were \$3.16 billion. The ANAO found that the sale proceeds compared favourably with

1 The major elements of the proceeds were the purchase prices of : \$1.255 billion for Melbourne, \$1.314 billion for Brisbane and \$631 million for Perth; a further payment of \$61 million from the successful bidder for Brisbane which confirms to an agreement with the Commonwealth and a total reimbursement of \$47 million for designated FAC capital expenditure at the airports since 1 July 1996.

current market values of international airport privatisation in Europe.²

3.4 The simultaneous sale of these leases was the third largest asset sale ever conducted by the Commonwealth Government and the largest ever trade sale.³

Commonwealth Sales Objectives

3.5 The Government's sales objectives were to:

- optimise sales proceeds within the context of broader sales and policy objectives;
- minimise the Commonwealth's exposure to residual risks and liabilities associated with the Phase 1 airports;
- ensure that the new airport operators have the necessary financial strength and managerial capabilities to operate and develop the Phase 1 airports over the lease term;
- ensure that the Phase 1 airports remained majority Australian owned and controlled; and
- ensure fair and equitable treatment of FAC employees, including preservation of accrued employee entitlements.⁴

Objective of ANAO Audit

3.6 The ANAO's objectives in auditing the sale of the airport leases were to:

2 After subtracting direct sale costs of \$153 million (including \$94.4 million for ex gratia payments to the State Governments in lieu of stamp duty on the airport leases) from the total gross proceeds, the net figure is \$3.16 billion. An account of the full background to the sale of the airport leases is at Chapter 1, *Audit Report No. 38, Sale of Brisbane, Melbourne and Perth Airports*.

3 Mr Ian McPhee, ANAO, Transcript, PA. 45.

4 *Audit Report No. 38*, p. 7.

- review the extent to which the Government's sales objectives were achieved;
- review the administrative efficiency of the management of the sale process; and
- assess whether the sale arrangements adequately protected the Commonwealth interests.⁵

Audit Findings

3.7 The ANAO found that the sale of the airport leases was substantially completed in 1996-97 in accordance with the government's sale timetable.⁶

3.8 The ANAO made eleven recommendations aimed at strengthening the administrative practices associated with Government trade sales. These were agreed to or agreed with qualification by the relevant agencies. However, OASITO disagreed with part (b) of Recommendation 4 which relates to capping of contracts, where applicable.⁷

3.9 In evidence to the Committee, Mr Michael Hutchinson, Chief Executive of OASITO, confirmed that there was general agreement with the ANAO's recommendations. Mr Hutchinson said, however, that OASITO is of the view that "their adoption would not have made any material difference to the substantive outcome of this transaction."⁸

3.10 Mr Hutchinson informed the Committee that many of the changes recommended by the ANAO had already been identified and implemented in the course of the recently completed phase 2 of the airports transaction. Others were adopted as that sale proceeded, and adopted as appropriate in the course of other asset sales.

3.11 Mr Hutchinson emphasised that disagreements with the ANAO's recommendations were minor. Those

5 Mr McPhee, Transcript, PA. 46 and, *Audit Report No. 38*, p. 7. See also Chapter 1

6 Mr Ian McPhee, Transcript, PA. 47.

7 *Audit Report No. 38*, p. xix.

8 Transcript, PA. 46.

recommendations given qualified agreement and the single disagreement took into account practical considerations.⁹

3.12 In Mr Hutchinson's view, the balance of the focus on process rather than outcome in the ANAO report seemed to be inappropriate. Mr Hutchinson pointed out that reviewing process elements without adequate recognition of their materiality relative to the overall project and its outcome was cause for concern. This is so because of the effect that responses to findings of this nature may have on the proper balance between risk avoidance and risk management within a major process.

3.13 Mr Hutchinson's views were shared by Mr Daryl Quinlivan, First Assistant Secretary, Department of Transport and Regional Development (DoTRD) and Mrs Suzanne Ashmore-Smith, Assistant Commissioner and Delegate of the Development Allowance Authority, Australian Taxation Office. Both believed that the sales of the leases had produced good outcomes.¹⁰

Focus of Hearing

3.14 The hearing focussed on three key issues. These were:

- Sale Management
- Bid Assessment; and
- Sale Outcome

Sale Management

3.15 In June 1994 BZW Australia Limited was engaged as business adviser, following a competitive tendering process. The role of the business advisers was to advise on sale options and appropriate strategies to achieve the Government's sales timetable. The consultancy was for a period of 12 months, from June 1994 to June 1995 at a cost of \$1.26 million.

9 Transcript, PA. 46.

10 Transcript, PA. 46.

3.16 BZW won a further competitive tender in June 1995 to assist with marketing, due diligence, tendering and bid evaluation as well as bidder contract negotiations. With an extension, the contract to BZW ran until 3 June 1997. The contract included base fees of \$8 million and fixed fees of \$3 million payable on completion of the sales.¹¹

Management of Outsourcing

3.17 On 10 September 1997, the ANAO advised OASITO that it had detected a possible overpayment of \$79 030 to the Business Adviser. On advice of the error the Business Adviser repaid the amount on 20 October 1997. According to the ANAO's scrutiny of OASITO's financial records the Business Adviser had been paid twice for the latter half of December 1996.¹²

3.18 The Committee asked for comment about the overpayment and the reasons it took several months and an ANAO audit to discover the oversight. In reply, the Business Adviser, Mr Ari Droga, said that the basis for the billing arrangement in the contract is a monthly retainer. The December year-end monthly retainer "was rounded up to the year end inadvertently by BZW, when it should have been cut off slightly earlier, by about 13 days."¹³ Mr Droga noted that when the bill went out OASITO paid the amount under the usual programming system. The error was not detected by either BZW or OASITO.¹⁴

3.19 The Committee asked Mr Droga to confirm that the error did not comprise the payment of two bills. Mr Droga said that he disagreed with the ANAO's assessment that it was two bills and stressed that the bill "went out for the normal amount, when it should have been adjusted backwards."¹⁵ Mr Droga explained that up to the end of December 1996 all amounts were rebatable and thereafter they become non-

11 *Audit Report No. 38*, p. 21.

12 *Audit Report No. 38*, p. 26

13 Transcript, PA. 51.

14 Transcript, PA. 51.

15 Transcript, PA. 51.

rebutable. Mr Droga said that when BZW submitted the bill “an adjustment was made inappropriately”.¹⁶

3.20 The Committee asked the OASITO whether processes were in place to detect such oversights in the future. Mr Hutchinson replied that the error “should and would have been detected in the annual audit of financial statements.”¹⁷ Mr Hutchinson also said that processes existed, but on this occasion the error was in the application of the process:

*The process that we have in place requires an accountable officer to certify that the account is correct. An officer certified that it was correct. The checks he did to ensure it was correct were done incompletely. It was simply a human error in the application of the process.*¹⁸

3.21 The Committee then asked Mr Hutchinson when he believed the error should or would have been detected by OASITO. Mr Hutchinson replied that the erroneous payment should have been detected by OASITO’s financial audits at the end of the 1997 financial year when the accountants had completed their work in September 1997.

3.22 The Committee reminded Mr Hutchinson that the ANAO audit had disclosed the error in September 1997 and asked him to elaborate further on this issue. Mr Hutchinson said that he recalled that the error:

*was disclosed to us while our financial accountants were preparing the financial accounts. Whether they had got to it and missed it, or whether they had not yet got to it, is impossible to tell.*¹⁹

3.23 Mr Hutchinson made the further point that accountants work on a “concept of materiality and sampling”. Under these circumstances, a transaction might escape the sampling or the materiality test.²⁰

3.24 In commenting on Mr Hutchinson’s understanding of events, Mr McPhee agreed that it would have been unlikely

16 Transcript, PA. 51.

17 Transcript, PA. 51.

18 Transcript, PA. 51.

19 Transcript, PA. 52.

20 Transcript, PA. 52.

for the error to have been picked up in a sample because of its materiality. Mr McPhee said, however, that it is the agency's responsibility to ensure that its own processes are operating properly and that it should not rely on auditors who come after the event to detect errors.²¹

3.25 The Committee suggested to Mr Hutchinson that, despite the relatively small amount involved, the issue was, nevertheless, significant. In the view of the Committee, this particular oversight highlighted a weakness in the internal processes which, if not corrected, would result in the recurrence of a similar situation sometime in the future.

3.26 Mr Hutchinson replied by informing the Committee that in the intervening period the *Financial Management and Accountability Act 1997* had been introduced with changes to the arrangements governing the financial administration of agencies. The processes now in place by OASITO under the Act confirm the importance of the proper checking of accounts. Mr Hutchinson reiterated that he was not prepared to claim that OASITO processes "are flawless", but he believed that with the diligent application of current processes and controls, future errors of this type should be prevented and detected.²²

3.27 The Committee sought a further comment from the Business Adviser, noting that that the size of his organisation should have prevented such an irregularity from taking place.

3.28 Mr Droga replied by first defending the administrative processes of OASITO. He said that in his experience, the processes were rigorous and the agency was extremely thorough in conducting its various checks. He believed this particular incident to be an anomaly and related to the method of billing in place during that time.

3.29 Mr Droga stressed that BZW's processes were also thorough. He informed the Committee that BZW had been a Government adviser for over four years and in his experience, this was the first irregularity of this nature that has occurred.²³

21 Transcript, PA. 52.

22 Transcript, PA. 53.

23 Transcript, PA. 53.

Contracting Process

3.30 The Committee considered the issue of financial risk associated with the management of contracts. The Committee noted comments in the ANAO audit report that the Business Advisor bore no effective financial risks associated with the contracts it was managing, and which it had arranged, in addition to those which had been previously arranged by OASITO.

3.31 The contracts included those associated with the appointment of an Investigating Accountant; establishment and management of buyer data rooms; and design, typesetting and printing of tender documentation. The Committee further noted that these outsourced contracts involved cost overruns with the final total cost ranging from almost 1.5 times to more than 3.5 times the initial estimate.²⁴ The Committee asked for elaboration and comment on these issues.

3.32 Mr Hutchinson advised the Committee that OASITO had discussed these matters thoroughly with the ANAO during the course of the audit. Mr Hutchinson said that the two major contracts the ANAO identified were a small proportion of the \$30 million total sale costs. Mr Hutchinson explained that the major outsourced contracts described in the audit finding actually applied to the major logistics supplier contracts and not the major outsource contracts. The amount of money involved is \$2 million or \$3 million, rather than the \$30 million or \$31 million which was spent on the sale.

3.33 Mr Hutchinson further explained that two contracts were involved. The first was the printing contract which gave rise to the figure of 3.5 times the initial estimate. Mr Hutchinson said that it was OASITO's view that this was "a little misleading because the original contract quoted a figure of about \$250 000 for printing plus unspecified typesetting costs."²⁵

Printing Contract

3.34 According to the ANAO report, the Business Adviser invited five printers to submit quotes for printing of 400-500

24 *Audit Report No. 38*, p. 27.

25 Transcript, PA. 54.

copies of the Invitation to Register Expressions of Interest and 200-300 copies of each of the Information Memoranda, the Request for Proposals, Tender Procedures Memorandum and Presentation Boxes. Based on fee rates quoted, the Business Adviser estimated design, typesetting and printing would cost approximately \$250 000.

3.35 After work had commenced, the Business Adviser provided the printer with a proposed contract, including the Commonwealth standard indemnity clauses and standard confidentiality agreements used in the sale. The printer would not agree to the clauses contained in the proposed contract. The Business Adviser decided to change printers and approached the firm ranked second following the initial tender. Although confidentiality deeds were signed no contract was signed.

3.36 According to the audit report, the Business Adviser disputed the invoice presented by the printer after completion of the work. However, in the absence of a contract, no agreed performance standards existed which would have allowed an assessment to be made of the printer's performance and costs. In the event, OASITO and the Business Adviser negotiated a payment of \$880 000. Including payments to the first printer for the initial phase of the task, the total cost of designing typesetting and printing tender documentation was \$912 000²⁶ plus an amount of \$61 000 for marketing materials.²⁷

3.37 As the findings in the audit report state, the lack of written contracts for the design, typesetting and printing of the tender documentation led to the overall printing costs increasing to \$900 000. This figure was more than 3.5 times the initial estimate.²⁸

3.38 The Committee expressed its concern about the contractual arrangements relating to the printing of sales documentation and asked OASITO to provide details.

3.39 Mr Hutchinson informed the Committee that there was general dissatisfaction with the services of the first printer, compounded by that printer's refusal to enter into a

26 *Audit Report No. 38*, pp.30-32.

27 *Audit Report No. 38*, Exhibit 4.1, p. 59.

28 *Audit Report No. 38*, p. 31.

contract. As a result, there had been no option but to cancel the initial arrangements with that printer. The subsequent printer was more reliable and time and quality deadlines were met. The cost of the second printer was \$293 000 plus agreed rates for typesetting.

3.40 Mr Hutchinson observed that no fixed price was attached to the typesetting. In the end it was the typesetting component of the contract which increased the cost above the \$275 000. OASITO finally paid \$970 000 for printing in total.²⁹

3.41 The Committee sought clarification that typesetting alone cost approximately \$600 000. Mr Hutchinson replied that the settlement price for typesetting was approximately \$600 000 against a final bill of \$1 million which the second printer had submitted.

3.42 Mr Hutchinson confirmed the audit finding that a dispute arose with the printers and that negotiations took place before a final figure was agreed to. Mr Hutchinson explained that the printer was required to rework the typesetting, which proved to be a complex matter as a result of moving from word process format to typeset format earlier than necessary.

3.43 Significant rewrites were done in typeset at high cost rather than in word processing at a lower cost. Mr Hutchinson noted that the wide-ranging changes to the documentation were demanded by the Federal Airports Corporation. This was an added complication which not only threatened the firm deadline in the sale process but led to a further increase in the printing price.

3.44 Added to all these problems was the lack of available quality printing. Mr Hutchinson observed that it was very difficult "if not impossible" to find printers able to produce quality work and the quantity required within the required time scale. Mr Hutchinson added:

For that reason, we ended up without signed contracts for that sort of work. These people were just not prepared to waive their rights against the Commonwealth in respect of indemnities and the like.³⁰

29 Transcript, PA. 54.

30 Transcript, PA. 55.

3.45 The Committee reminded Mr Hutchinson that a serious problem had occurred in the contracting process in that two printing contracts were entered into with two separate printers without either being signed.

3.46 Mr Hutchinson replied that it is not unusual in the commercial sector to commission work of the scale indicated without a signed contract. Mr Hutchinson stressed that it had always been the intention of OASITO to impose a contract on the printers, but they failed because the printers would not accept the standard form presented to them.³¹

Investigating Accountant

3.47 The ANAO audit found that a small number of contracts arranged by OASITO were not competitively tendered. Amongst these was one for superannuation advice totalling \$130 000 about which the Committee sought further elaboration.

3.48 Mr Brian Boyd, ANAO, advised that the contract in question related to an increase to an existing KPMG contract. Mr Boyd explained that KPMG was hired initially to provide an investigating accountancy service. Initially, the contract was expected to cost \$1.02 million which later increased to \$1.45 million. In addition to the investigating accountant services, KPMG provided the data room. The firm was asked later to provide superannuation advice without a tender and without a contract being executed. That advice was provided at a cost of \$130 000.³²

3.49 Mr Hutchinson, OASITO, added that the issue of extending the scope of work for advisers already engaged was important. Mr Hutchinson said in their view it is not a requirement of the Commonwealth purchasing guidelines, nor is it cost effective, to retender every additional piece of work which becomes necessary during the course of the sale. Mr Hutchinson emphasised that:

If we have an adviser in place who has already been selected by competitive tender, if the work is a small addition to their work, if their sole source quote for that work or their rates for

31 Transcript, PA. 55.

32 Transcript, PA. 56.

*doing that work appear to us to be competitive at the time, it is just not worth putting the industry through a competitive selection exercise.*³³

3.50 Mr Hutchinson further advised the Committee that customarily, OASITO would have some documentation in place, such as an exchange of letters, which would make the point that as the selected adviser, it would be incumbent on them to provide extra work and advice. Mr Hutchinson made the further point that frequently during the course of the sale process, advice is needed urgently and it is commissioned orally, and must subsequently be paid for. Mr Hutchinson acknowledged that such procedures may be criticised by the ANAO, but that would not necessarily lead OASITO to change their methods in such instances.³⁴

Legal Adviser

3.51 The Australian Government Solicitor (AGS) was awarded a contract as Legal Adviser to advise on Commonwealth related interests. The AGS contract was renegotiated and extended during the course of the sale to take into account changes in requirements. The final AGS contract was capped at \$300 000 per month, a figure significantly less than the average monthly payments of \$500 000 under the previous contract which ran until December 1996. The audit report notes that the new contract demonstrated value for money for the Commonwealth, particularly as the services required of AGS were similar to those required under the initial contract.

3.52 The Committee questioned OASITO about its agreement with AGS for the provision of legal services for a capped fee of \$4.85 million. Mr Simon Lewis replied on behalf of OASITO that because AGS and OASITO were Commonwealth agencies, an agreement between them, in the form of a Memorandum of Understanding, was in place.³⁵

3.53 Mr Lewis also noted that OASITO found copies of the document signed by one party only, but believed that a

33 Transcript, PA. 56.

34 Transcript, PA. 56.

35 Transcript, PA. 57.

document which has both signatures was available somewhere on OASITO files, although he has not been able to locate it. Mr Lewis says he understands that the AGS' file also holds the document which has only one signature on it, but stressed that both parties negotiated and agreed to the same terms.³⁶

3.54 The Committee asked the ANAO whether it was normal for one party only to sign a Memorandum of Understanding. Mr Brian Boyd said it was not usual to have one party only sign the document.³⁷

3.55 The Committee noted that in addition to the AGS, the private legal firm of Clayton Utz was contracted to provide a legal service. Clayton Utz was required to participate in bidder negotiation, restructuring the FAC, the preparation of tender and sale documentation and to contribute to the setting of sale strategies and policies. During the final six months of sale (from January to June 1997), the Clayton Utz contract was not fully capped. Payments during that period averaged \$250 000 per month. This figure was significantly in excess of average monthly payments during 1996 under a previously negotiated contract averaging \$150 000 per month.³⁸

3.56 The Committee asked Mr Hutchinson to explain why the Clayton Utz contract was not fully capped, and why the payments for the final contract were significantly in excess of those for the initial contract.

3.57 Mr Hutchinson advised the Committee that the nature of legal advice required by OASITO would not have given rise to an acceptable tenderer prepared to accept a price cap. Added to this, during the time Clayton Utz was selected as legal adviser the scope of the work was not clearly defined. Clayton Utz, and other parties tendering for the work, tendered on a time and materials basis, rather than on a fee cap basis. Clayton Utz was paid under those arrangements.³⁹

3.58 The Committee also queried Mr Hutchinson about overlap of work between the Australian Government Solicitor and Clayton Utz. Mr Hutchinson observed that the work was

36 Transcript, PA. 57.

37 Transcript, PA. 57.

38 *Audit Report No. 38*, p. 22.

39 Transcript, PA. 48.

complementary. However, complementary work “usually involves some overlap”, but generally the roles of the AGS and Clayton Utz were separate.⁴⁰

3.59 Mr Simon Lewis, OASITO, acknowledged that while overlaps were minimal, they nevertheless occurred and proved useful to OASITO. As a result, OASITO was able to gain a different perspective between the AGS because of its acknowledged expertise in such matters as Commonwealth legislation and administrative practices and Clayton Utz with their commercial expertise.

3.60 Mr Lewis confirmed that the fee arrangements with AGS were fixed but the agreement with Clayton Utz was not. Mr Lewis further observed that OASITO recognised the risk of the non-capped fee arrangements and began to closely monitor Clayton Utz’s expenditure during the non-capped period, approximating to the final six months of the sale process.

3.61 The monitoring process required Clayton Utz to provide, on a monthly basis, forecasts of expenditure across each of the main work streams for which they were responsible. These were vetted at the commencement of each month by OASITO and queried on occasions at mid-monthly intervals. The end of month bills were carefully checked against Clayton Utz forecasts and a reconciliation made. On some occasions, OASITO changed the nature of the work being performed by Clayton Utz to ensure the correct balance was achieved between the AGS and Clayton Utz and the overall expenditure pattern acceptable to OASITO.

3.62 Mr Lewis also advised that OASITO had in place a funding limit of \$1.8 million for Clayton Utz for the entire period of the engagement. This arrangement ensured that costs would not exceed that capped sum and control over the funds approval process. Mr Lewis disputed the comments made by Mr McPhee in relation to the audit findings⁴¹ that the sale did not include performance monitoring arrangements of contracts which are not on a fixed basis. He noted that the processes put in place in relation to the Clayton Utz contract were a case in point.⁴²

40 Transcript, PA. 48.

41 Transcript, PA. 47.

42 Transcript PA. 49

3.63 The Committee sought an assurance from OASITO that future legal contracts for Phase 2 and Phase 3 sales would be capped. Mr Lewis informed the Committee that the AGS agreement for the Phase 2 sales was a fixed price contract for the 15 transactions. However, with respect to Phase 3 “the jury is out at the present time.”⁴³

3.64 Mr Hutchinson made the further point that Clayton Utz had previously accepted work on capped fee arrangement for the sale of the Commonwealth Bank, Phase 3. Clayton Utz considered that the commercial outcomes of this arrangement had not been advantageous. Against that background, it was very difficult for OASITO to enter into a capped fee arrangement with that firm.⁴⁴

3.65 The Committee asked OASITO to discuss the difference in remuneration arrangements between AGS and Clayton Utz. Mr Lewis replied that in the case of the AGS the fixed fee arrangement did not allow for any reduction to a standard rate or alignment of fees to hours worked. Clayton Utz, however, worked on a fee for service basis.⁴⁵

Bid Assessment

3.66 The ANAO audit found that the sale objectives were addressed during the bid evaluation process by predetermined criteria and a structured approach to ranking. The sale tender evaluation methodology did not specify weightings or priorities for each assessment criterion which set out their relative importance for evaluation purposes.⁴⁶

3.67 In evidence, Mr McPhee, ANAO, observed that the new airport operators were considered to be financially viable and to have the managerial capabilities to operate and develop the airports over the lease term. Mr McPhee also indicated that audit findings demonstrated that the bids were highly geared but were assessed appropriately.⁴⁷

43 Transcript, PA. 49.

44 Transcript, PA. 49.

45 Transcript, PA. 50.

46 *Audit Report No. 38*, p. 37.

47 Transcript, PA. 47.

3.68 However, the ANAO also found that some bidders did not address all of the issues raised by the specialist consultants⁴⁸ but that no comment of this was made in the Business Adviser's evaluation report of the Stage 3 assessment.⁴⁹

3.69 In reply to questions from the Committee relating to the bidding process, the Business Adviser, Mr Droga indicated that the issues about which the specialist consultants were required to comment were wide ranging. Essentially, it was the considered view of BZW and members of the government sales team that the report prepared by the specialist consultants flagged material issues which were relevant to the decision making process. Mr Droga acknowledged that the report did not cover all issues and stressed that that was not the intention of the report.⁵⁰

3.70 The Committee questioned whether bidders understood the extent to which they were legally bound to ensure that legislations, particularly those relating to environmental matters, would continue to be complied with for the entire life of the leases.

3.71 Mr Hutchinson observed that all the obligations of the bidders are documented in formal agreements between the bidders and the Commonwealth by way of sale contracts which are legally enforceable. Mr Hutchinson further noted that the relevant documents were filed and recorded with the Attorney-General's Department and lodged with the DoTRD, the responsible agency for post-sale monitoring and enforcement.⁵¹

3.72 Mr Daryl Quinlivan, DoTRD, added that environmental matters are subject to a legal regime under the Airports Act. In addition a comprehensive management regime is outlined in that Act together with relevant regulations.⁵²

48 These specialist consultants were contracted to assess the suitability of bidders against a range of issues relating to the bidding process. For further elaboration see *Audit Report No. 38*, p. 34.

49 *Audit Report No. 38*, p. 35.

50 Transcript PA. 58.

51 Transcript, PA. 58.

52 Transcript, PA. 59.

Market Risk

3.73 The Committee sought comment on an audit report finding that the decision to conduct a further round of bids involved risks for the Commonwealth. According to the audit report, by conducting Stage 3 bids, bidders were given an opportunity to revise or even withdraw their bids.⁵³

3.74 Mr Hutchinson acknowledged that if bidders were allowed to revise their bids, that would have been to the disadvantage of the Commonwealth. Mr Hutchinson observed that when the bids were assessed at Stage 2, a clear leader had not become apparent. Uncertainty on a range of material matters was also apparent which led to the opening of a further bidding round.

3.75 Mr Hutchinson indicated that it was not unusual in a trade sale of this nature for bidders not to put forward their best bids until they were assured the best opportunity had been presented to them. Because the best bids had not been presented, the decision was made to advise on a further round of bidding.⁵⁴

3.76 Mr Lewis added that there is also the question of "clean bids". OASITO asked bidders for clean bids at the Stage 2 round. However, although the bids appeared attractive, conditionality varied across the bids which made it difficult to make recommendations to Ministers at that stage.

3.77 Mr Lewis further observed that their strategy to proceed with a further bidding round has had the effect of alerting prospective bidders that OASITO would continue the bidding process until a desired outcome had been achieved. This has been evident in the Phase 2 of airport lease sales.⁵⁵

3.78 Mr Droga also noted that the decision which was taken at the time was believed to be the most appropriate to manage risk through competitive pressure. Mr Droga believed that the outcome and the process were very sound and, while not intended, increased the total proceeds by 5 per cent (\$160 million).⁵⁶

53 *Audit Report No. 38*, p. 41.

54 Transcript, PA. 60.

55 Transcript, PA. 60

56 Transcript, PA. 61.

Gearing Levels

3.79 The audit report stated that the Business Adviser had recognised that bidders could propose highly leveraged financing structures to propose higher sale prices, or implement post-sale refinancing plans to substitute debt for equity. Both these cases indicated highly leveraged financing structures which could impair the financial stability of the airport and the lessee's ability to finance future development.

3.80 The Committee sought elaboration about possible risks to the Commonwealth on the level of debt carried by a bidder. Mr Hutchinson replied that the assessment which was made related to the financial stability of the bidder. Mr Hutchinson acknowledged that the question between the OASITO and the ANAO related to whether subordinated debt, essentially money injected by the equity owners for the purpose of financial stability, should be treated in the same way as third party debt, that is money borrowed from a bank, or whether it should be treated as equity.

3.81 Mr Hutchinson acknowledged that the ANAO's position, as to an accounting classification, to treat subordinated debt as debt is correct. However, for the purpose of assessing financial stability of the equity holder, also a debt holder, debt and equity could essentially be treated "as being intermingled", which is customary in a corporate finance sense as opposed to an accounting opinion.⁵⁷

3.82 Mr Cronin commented that the ANAO treated the subordinated debt as debt for a number of reasons. Firstly, DoTRD treated the bidders' subordinated debt as debt for the purposes of determining whether bidders met the requirements of the foreign ownership provisions of the Airports Act. If DoTRD had treated subordinated debt as equity, the winning bidder for Perth Airport would have been non-compliant with these provisions.

3.83 Secondly, on economic substance grounds, the subordinated debt involved in these transactions did not generally possess the characteristics associated with equity - that is; they did not have a variable coupon rate; were not subordinated to all other claims; and were not perpetual. Thirdly, ANAO noted that OASITO's Business Adviser treated bidders' subordinated debt as debt during the evaluation of

57 Transcript, PA. 61.

tenders when evaluating the cash flow projections of the bidders.

3.84 Mr Cronin further commented that the reasons ANAO considered that bidders' financial strength is significant are that financial strength was a Government sale objective and a criterion against which the tenders were assessed. The ongoing financial strength of the successful bidders also had implications for the Commonwealth because of the contractual obligations which it assumed under the airport leases and associated tripartite agreements.

3.85 Under these agreements, should an operator fail, the Commonwealth may be obliged to step in and operate the airport. The financial strength of the operators also may have implications for the contractual development commitments they have made. In any transaction of this kind, the Commonwealth's reputation and residual risk position may also be affected if the financial strength of the successful bidders is not sufficiently strong.⁵⁸

3.86 In a further comment from Mr Hutchinson, he indicated that on this issue the OASITO is unable to agree with the ANAO's assessment. He said that reference to the definition of equity in the Airports Act is not relevant and does not relate to financial stability. Mr Hutchinson argued that the definition in the Act relates to the ownership regulation of the airport for foreign ownership purposes and is therefore an entirely separate matter⁵⁹

3.87 Mr Droga added that, in line with the views of the ANAO, the main aim of the sales team was to make an assessment of financial strength. Making an assessment on the application of subordinated debt under relevant legislation and the tripartite agreement was not the issue.

3.88 Mr Droga stressed that the direction taken in determining financial strength was not limited to assessing a ratio of debt to equity. The key consideration was to determine the ability of the organisation to remain financial into the future. Irrespective of the methodology used to make that

58 Transcript, PA. 61, 62.

59 Transcript, PA. 62.

assessment, the end result should be to reveal financial strength.⁶⁰

Sale Outcome

Airport Leases

3.89 In the post-sale process, the DoTRD is responsible for administering the airport leases, enforcing any Commonwealth rights and ensuring the obligations of the Commonwealth and the lessee are performed. To this end, the ANAO recommended that DoTRD should develop a comprehensive framework or procedures in order to allow it to monitor and enforce lessee's compliance with the airport leases. The DoTRD gave qualified agreement to this recommendation.⁶¹

3.90 The Committee asked DoTRD to discuss its reasons for agreeing to the ANAO's recommendation with qualification. Mr Michael Mrdak, Assistant Secretary, Airports, DoTRD, observed that the Department considered that it was performing its monitoring obligations relating to all the relevant provisions of the leases appropriately.

3.91 Mr Mrdak added that the Department recognised the ANAO's findings and had established a comprehensive framework to allow it to discharge its obligations. Mr Mrdak emphasised that while a system has now been developed within DoTRD to monitor development commitments and compliance with a range of other issues, it was the view at the time of the ANAO's report that the Department was meeting its obligations.⁶²

3.92 In commenting on DoTRD's response, Mr Cronin indicated that the ANAO welcomed the establishment of a comprehensive framework by the Department. It was the view

60 Transcript, PA. 63.

61 *Audit Report No. 38*, pp. 62-64.

62 Transcript, PA. 63.

of the ANAO during the course of the audit that this was a deficient area, because of the long periods of these leases.⁶³

C o n c l u s i o n s

3.93 The Committee welcomed this ANAO audit into the largest ever Commonwealth Government trade sale. In welcoming this major audit, the Committee is pleased with the audit findings that the sale proceeds compare favourably with current market values of previously privatised international airports in Europe.

3.94 The Committee acknowledges the importance of the report in providing an assessment of a Government trade sale of such magnitude and in highlighting areas of weakness in the sales process which could result in risks to the Commonwealth.

3.95 The Committee supports the general direction taken by the ANAO audit, and endorses the recommendations it has made to ensure that, in future, Government sales processes are followed and improvements are made in the management of the sale.

3.96 The Committee is pleased by comments made by OASITO that many of the changes recommended in the report have already been identified and implemented in the course of the recently completed Phase 2 sales. The Committee also notes that disagreements with the ANAO's recommendations were minor.

3.97 The Committee is sympathetic to OASITO's view that those recommendations which were given qualified agreement and the single disagreement took into account practical considerations. However, the Committee believes that it is of paramount importance to ensure the protection of public expenditure and to minimise risks to the Commonwealth. This is particularly important if an airport operator fails and the Commonwealth is obliged to resume the right to operate the airports.

3.98 Of concern also to the Committee were the weaknesses in the contracting process noted by the ANAO.

63 Transcript, PA. 63.

These related to lapses in the contracting process which resulted in some contracts not being signed and others being filed without the signature of all of the parties on the document.

3.99 The Committee is unable to accept the justifications for these very serious oversights and endorses the ANAO's recommendation that a formal, written contract, including indemnities and confidentiality provisions should be drafted and signed prior to any work commencing.

3.100 Further, the Committee is unconvinced by the argument that external timetables impose tight deadlines which prevent a Commonwealth agency from following set procedures and processes designed to lessen any risk to the Commonwealth.

3.101 The Committee appreciates the views expressed by OASITO that, in terms of the overall cost of the sale (approximately \$31 million), the contracts of the major logistics supplier involved is a sum of between \$2 million to \$3 million. However, the Committee believes that it is incumbent on OASITO to ensure that any expenditure involving Government funds in any of its sales should be appropriately managed to ensure that costs are contained within agreed-to limits.

3.102 The Committee urges OASITO to implement the ANAO's recommendations and looks forward to identifying improvements in the sale management process in the Phase 2 ANAO audit.