

## Audit Report No. 63, 2001-2002

# Management of the DASFLEET Tied Contract

## Introduction

### Background

- 5.1 Until July 1997, a former Department of Administrative Services (DAS) business unit, DASFLEET, supplied passenger and commercial vehicles to the majority of Commonwealth bodies, with the total active fleet managed by the business unit comprising over 16 000 vehicles. The book value of the fleet was approximately \$376 million as at January 1997 and DASFLEET returned a net operating profit in its last year of Commonwealth ownership of just over \$23 million.<sup>1</sup>
- 5.2 The Government announced in the August 1996 Budget its intention to realise the Commonwealth's investment in the vehicles then owned and managed by DASFLEET. The Government indicated that this would be accomplished either by a trade sale of the whole business or by external refinancing of the vehicles. Sale and refinancing tender processes were

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<sup>1</sup> ANAO, Audit Report No. 63, 2001-2002, *Management of the DASFLEET Tied Contract*, Commonwealth of Australia, p. 27.

conducted in tandem by the then Office of Asset Sales (OAS)<sup>2</sup> and its Business Adviser (Barings)<sup>3</sup>

- 5.3 Two bids for refinancing of DASFLEET's vehicles were received on 29 April 1997 and three bids for the purchase of the DASFLEET business were received on 26 May 1997. The bids for both options were then assessed. On the basis of advice provided by Barings on 9 June 1997, the Office of Asset Sales and IT Outsourcing (OASITO) on the same day recommended to the then Minister for Finance that DASFLEET be sold rather than refinanced and asked that the Minister 'endorse our recommendation of Macquarie Bank as the party with whom we should pursue final negotiations'. The then Minister for Finance agreed to OASITO's recommendation and there were no further negotiations with the second ranked bidder after 9 June 1997.<sup>4</sup>
- 5.4 Following a number of negotiated changes to the Sale Agreement and the Tied Contract, the then Minister for Finance and the then Minister for Administrative Services announced that DASFLEET was to be sold to Macquarie Fleet. The Sale Agreement was signed on 17 July 1997 and the Tied Contract on 1 September 1997.<sup>5</sup>
- 5.5 A number of commercial disputes arose out of the 1997 sale of DASFLEET to Macquarie Bank and the operation of the five-year Tied Contract with Macquarie Fleet Leasing (Macquarie Fleet) [Macquarie Fleet Leasing is a wholly owned subsidiary of Macquarie Bank and is the entity which signed the Tied Contract]. These disputes were the subject of substantial negotiation between the Commonwealth and Macquarie Fleet and an independent arbitration process.<sup>6</sup>
- 5.6 In August 1999, the Joint Committee of Public Accounts and Audit (JCPAA) commenced a review of Audit Report No. 25 1998-99, *DASFLEET Sale*. The Committee held a public hearing on 13 August 1999 and a further hearing on 26 August 1999. The Committee was advised at the hearings that commercial disputes had arisen in relation to both the Sale Agreement and the Tied Contract and that the matters were proceeding to

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2 The Office of Asset Sales (OAS) was established in October 1996 to manage the Commonwealth Government's major asset sales and it reported directly to the Minister for Finance. In November 1997, OAS became the Office of Asset Sales and IT Outsourcing (OASITO). On July 1 2001, the agency became known as the Office of Asset Sales and Commercial Support (OASACS).

3 ANAO, Audit Report No. 63, 2001-2002, p. 9. OASITO's Business Adviser was Baring Brothers Burrows & Co., Limited.

4 ANAO, Audit Report No. 63, 2001-2002, p. 35.

5 ANAO, Audit Report No. 63, 2001-2002, pp. 35-7.

6 ANAO, Audit Report No. 63, 2001-2002, p. 10.

arbitration. In light of the evidence provided by the Department of Finance and Administration (DoFA) and the then Office of Asset Sales and IT Outsourcing (OASITO), the Committee resolved to temporarily suspend its review until the arbitration was complete.

- 5.7 Settlement of the disputes with Macquarie Fleet/Macquarie Bank occurred on 5 July 2001.<sup>7</sup>

## The ANAO audits

- 5.8 The objectives of Audit Report No. 25, 1998-1999 were to review the efficiency and effectiveness of the conduct of the sales process for DASFLEET.<sup>8</sup>
- 5.9 The objectives of Audit Report No. 63, 2001-2002 were to:
- assess the effectiveness of DoFA's management of the Commonwealth's exposure under the DASFLEET Tied Contract;
  - assess the effectiveness of DoFA's monitoring of performance of the DASFLEET Tied Contract; and
  - review the action taken by DoFA in response to Recommendation No. 6 of Audit Report No. 25, 1998-1999 that it undertake a comprehensive risk assessment of the Commonwealth's exposure under the Tied Contract.<sup>9</sup>

## ANAO findings

- 5.10 Audit Report No. 25, 1998-1999 found that:
- despite the closeness of the two highest bidders for DASFLEET, the second ranked bid was not fully evaluated;
  - despite the complexity of the transaction, coupled with the scale and nature of the financial analysis used to judge the relative merits of the bids, OASITO had not placed itself in a position to ensure that the ultimate decision maker could rely on the information about each tender contained in the evaluation report;
  - action was not taken to identify and specifically quantify the financial risks in the five year Tied Contract associated with the Commonwealth

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7 ANAO, Audit Report No. 63, 2001-2002, p. 75.

8 ANAO, Audit Report No. 25, *DASFLEET Sale, 1998-1999*, Commonwealth of Australia, p. 26.

9 ANAO, Audit Report No. 63, 2001-2002, p. 32.

accepting exposure to the variations in the RBA assessment of the required risk weighting for capital adequacy purposes;

- the RBA classified leases entered into under the Tied Contract as finance leases; and
- the financial implications of the five year Tied Contract were such that the Commonwealth was exposed to a range of commercial risks including increased leasing charges to agencies and potential responsibility for the cost of terminating the contract.<sup>10</sup>

5.11 Audit Report No. 63, 2001-2002 found, *inter alia*, that:

- in the course of the arbitration process, and in light of the Arbitrator's October 2000 Interim Award, it became clear that, through the operation of the residual risk management mechanism, the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract with Macquarie Fleet;
- due to serious issues in relation to the Tied Contract and the completion statements for the Sale Agreement arising almost immediately after the commencement of the Tied Contract, DoFA was not in a position to be able to effectively monitor Macquarie Fleet's performance under the Contract, or to effectively manage the Commonwealth's exposure under the Contract;
- DoFA was engaged in strenuous negotiations with Macquarie Fleet until late May 2001 and commissioned substantial expert advice from its advisers to inform it on the legal, commercial and financial consequences of not only the proposals from Macquarie Fleet for settlement but also the alternative options in relation to the Tied Contract;
- DoFA prepared a detailed business case to support the final settlement proposal, which was submitted to the then Minister on 6 June 2001;
- DoFA actively monitored expenditure on advisers in relation to the DASFLEET disputes (DoFA advised that the total external provider costs for the management of the Tied Contract and the disputes on it and the Sale Agreement totalled more than \$9.6 million to 31 October 2001, including nearly \$7 million for professional advice. DoFA's estimate of its total staff costs for managing the disputes between August 1997 and October 2001 was \$1.5 million, but could not accurately determine the amount of staff costs related to the

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<sup>10</sup> ANAO, Audit Report No. 25, 1998-1999, pp. 11, 12-13, 47.

management of the disputes and the amount incurred for the normal contract management activities required);

- as a result of arbitration and the whole of dispute settlement completed by DoFA for the disputes with Macquarie Fleet/Macquarie Bank, the total potential exposure of the Commonwealth to possible payments to Macquarie Fleet was reduced from around \$100 million originally claimed by Macquarie Fleet to around \$50 million; and
- lessons learnt from the commercial disputes arising from the Tied Contract with Macquarie Fleet were generally implemented by DoFA in negotiating the whole of dispute settlement and the Amended Tied Contract with Lease Plan Australia.<sup>11</sup>

## The JCPAA's Review

5.12 At the public hearing on 20 September 2002, the Joint Committee of Public Accounts and Audit took evidence on the following issues:

- Commonwealth exposures; and
- Commonwealth costs.

## Commonwealth exposures

### Sale of DASFLEET

5.13 On the basis of advice provided by Barings in June 1997, OASITO recommended to the then Minister for Finance that DASFLEET be sold rather than refinanced. The Information Memorandum issued to prospective purchasers advised that offers were to assume that vehicle leasing arrangements post sale would be conducted on an operating lease basis.<sup>12</sup>

5.14 Further negotiations were held with Macquarie Bank and a sale agreement was signed between the Commonwealth and Macquarie Fleet for the sale of DASFLEET for \$407.9 million.<sup>13</sup>

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11 ANAO, Audit Report No. 63, 2001–2002, pp. 13, 15, 75, 82.

12 ANAO, Audit Report No. 63, 2001–2002, p. 35.

13 ANAO, Audit Report No. 63, 2001–2002, p. 9.

- 5.15 It has become clear that, through the operation of the residual risk management mechanism, the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract with Macquarie Fleet.<sup>14</sup>
- 5.16 The Committee drew attention to advice it had received during the 1999 public hearings from the then CEO of OASITO, Mike Hutchinson, who stated that the vehicle leases were operating leases in the accounts of the agencies, and that only part of the transaction, the head agreement, was itself a finance lease.<sup>15</sup>
- 5.17 Evidence given by Macquarie Bank to the arbitration was that it:
- ... regarded the transaction from a financial perspective as a loan and therefore if we didn't receive back all the moneys that we were advancing, part of which would be through the Reserve Account mechanism, then that would be, you know, we wouldn't be getting part of our principal back.<sup>16</sup>
- 5.18 The Committee then asked DoFA whether there was still any question in its mind as to what type of lease it had entered into under the Tied Contract.<sup>17</sup>
- 5.19 DoFA replied that it was clear with hindsight, having read all the documents, that it was a finance lease:
- ... it is clear to me, reviewing this, that we were entering into a finance lease. I understand that it is treated as a finance lease in the accounts of the Commonwealth for a whole of government approach.<sup>18</sup>
- 5.20 The Committee asked the ANAO whether it was true that the tender documents indicated that the government expected an operating lease with the accompanying understanding that the Commonwealth would be transferring risk for the operation of its vehicle fleet to the lessor rather than accepting the risk as the lessee.<sup>19</sup>
- 5.21 The ANAO agreed that this had been the stated intent.<sup>20</sup>

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14 ANAO, Audit Report No. 63, 2001–2002, p. 15.

15 *Transcript*, 20 September 2002, p. 47; *Transcript*, 13 August 1999, p. 9.

16 ANAO, Audit Report No. 63, 2001–2002, p. 15.

17 *Transcript*, 20 September 2002, p. 47.

18 Hodgson, *Transcript*, 20 September 2002, p. 47.

19 *Transcript*, 20 September 2002, p. 47.

20 Cochrane, *Transcript*, 20 September 2002, p. 47.

5.22 In response to the Committee's question as to whether it would have been clear to DoFA from the original contract and Barings' advice that the Commonwealth was entering into a finance lease, DoFA stated:

I think it is very unclear from the documents exactly what was intended or what the outcome would be.<sup>21</sup>

## Contract issues

5.23 The Committee was advised by DoFA that the lack of clarity in the DASFLEET sale was due to the level of complexity in the contract. The Committee asked whether the contract needed to be that complex.<sup>22</sup>

5.24 DoFA replied:

My personal view is no, it did not have to be that complex. I am not sure why it was set up in such a complex way. I think, trying to understand what was in the mind of various people at the time, that there was a concern that the government may have been giving away some benefits in the deal and it wanted to make sure it had an opportunity to claw back those benefits. By that I mean the increase in vehicle value over time if there was any, or the increase over the intended benchmark. In an attempt to try and cover that off, I think what was ended up being negotiated was a very complex .... Contract which was very difficult to administer and difficult to interpret.<sup>23</sup>

5.25 The Committee asked whether other existing contracts had been reviewed to ensure that the Commonwealth's interests were protected.<sup>24</sup>

5.26 DoFA advised that its internal audit function had carried out a review of all contracts entered into and any issues identified were addressed:

It was clear from very early on that [the DASFLEET sale] contract was difficult. There were differences of view as to what the contract meant. It was not a sleeper; it did not creep up on the people involved; it was clear from very early on that it was difficult to administer.<sup>25</sup>

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21 Hodgson, *Transcript*, 20 September 2002, p. 47.

22 *Transcript*, 20 September 2002, p. 48.

23 Hodgson, *Transcript*, 20 September 2002, p. 48.

24 *Transcript*, 20 September 2002, p. 55.

25 Hodgson, *Transcript*, 20 September 2002, p. 55.

- 5.27 The Committee noted that the tender information provided to the Commonwealth in relation to the DASFLEET sale was very limited and asked the ANAO whether there had been transparency.<sup>26</sup>
- 5.28 The ANAO replied:
- [The ANAO] could not understand [the tender documents], and we tried for months to work out what the standard Commodore or Ford vehicle price was that was being bid. ....
- We could not relate material from the tender into the contract in respect of what was being charged.<sup>27</sup>
- 5.29 The Committee drew attention to its contract management inquiry<sup>28</sup> where it took evidence that one organisation had for some years established a procedure with its construction contracts where tenderers were required to produce to the purchaser their full costing sheets within 24 hours of the close of tenders. The Committee asked DoFA whether it had ever considered implementing full disclosure by tenderers.<sup>29</sup>
- 5.30 In response, DoFA stated that its standard practice was to ask for a detailed breakdown of the costs so that tender costs, expected completion times and personnel requirements formed part of the tender.
- 5.31 The Committee suggested to DoFA that it consider the benefits of requiring fuller disclosure for tenders.

## Risk weighting

- 5.32 The DASFLEET Tied Contract specifically required the Commonwealth to bear the risk associated with any decision of the prudential regulator (initially the RBA) to assess a different capital adequacy requirement for the DASFLEET transaction to the 10 per cent requirement assumed by Macquarie Fleet in its bid for DASFLEET. This was not a requirement of any of the other bidders for DASFLEET.<sup>30</sup>
- 5.33 At the time, the RBA's capital adequacy guidelines allowed assets of a bank, which represented government risk, to be risk weighted at 10 per cent for capital adequacy purposes. A loan to a corporate was risk rated at 100 per cent. In early September 1997, Macquarie Bank advised OASITO

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26 *Transcript*, 20 September 2002, pp. 51-2.

27 Cronin, *Transcript*, 20 September 2002, p. 62.

28 JCPAA, Report 379, *Contract Management in the Australian Public Service*, October 2000, Commonwealth of Australia.

29 *Transcript*, 20 September 2002, p. 61.

30 ANAO, Audit Report No. 63, 2001-2002, p. 16.



that the RBA had indicated that it would treat the transaction as being weighted not a 10 per cent but rather at 100 per cent.<sup>31</sup>

- 5.34 During negotiation with Macquarie Fleet in June 1997, the risk that the RBA would determine a capital adequacy requirement for the DASFLEET transaction different to that assumed by Macquarie Fleet in its offer was transferred to the Commonwealth. This issue was not specifically mentioned in the main body of the brief to the then Minister for Finance on 30 June 1997 which recommended that he agree to the sale of DASFLEET to Macquarie Fleet and enter into the Tied Contract with Macquarie Fleet. However, Barings' advice which was attached to the brief, noted this as a risk event.<sup>32</sup>
- 5.35 At no time did OASITO seek advice from the RBA as to its view of the commercial risk associated with the transaction and how it was likely to assess the transaction for capital adequacy purposes.<sup>33</sup>
- 5.36 OASITO told the ANAO that it had a risk management strategy designed to secure for the Commonwealth the benefits of an expected 10 per cent RBA weighting, while affording Macquarie protection against an adverse outcome that was assessed as unlikely:

The capacity of the Commonwealth to negotiate or effectively cancel the transaction in the event that a 10 per cent weighting did not apply was designed to manage the relevant regulatory risk. That is the way any other purchaser of services would need to deal with regulatory uncertainty. OASITO did not seek to place the Commonwealth in a more advantageous position because the RBA happens to be a Commonwealth agency.<sup>34</sup>

- 5.37 On 15 October 1997 OASITO advised the then Minister for Finance that:

The Commonwealth is contractually obliged to pay higher lease charges to compensate for the cost to Macquarie of holding a higher level of deposits for capital adequacy purposes, unless an alternative can be agreed to maintain the 10 per cent risk weighting.<sup>35</sup>

- 5.38 The margin increase (from 0.45 per cent per annum to 1.95 per cent per annum) suggested by Macquarie would have increased average lease rates

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31 ANAO, Audit Report No. 63, 2001–2002, p. 37.

32 ANAO, Audit Report No. 63, 2001–2002, pp. 37-8.

33 *Transcript*, 20 September 2002, p. 58.

34 ANAO, Audit Report No. 25, 1998-1999, p. 50.

35 ANAO, Audit Report No. 63, 2001–2002, p. 39.

and resulted in additional costs over the Contract's life of some \$25 million.<sup>36</sup>

- 5.39 In February 1998, OASITO (on behalf of the Commonwealth) and Macquarie Bank made a joint submission to the RBA on the issue of the appropriate capital risk weighting for capital adequacy purposes that should apply to the DASFLEET Tied Contract transaction. The joint submission noted that a finance lease, where the lessor has recourse to the lessee for the full lease receivable, was risk weighted at 10 per cent for government lessees.
- 5.40 The parties argued that in their opinion 'the Tied Contract leasing arrangement is, in substance, a finance lease which should be risk weighted at 10 per cent'. The joint submission set out the details of the parties' case for why Macquarie Bank (and Macquarie Fleet) had full recourse to the Commonwealth for the entire lease receivable.<sup>37</sup>
- 5.41 The RBA agreed in June 1998 that a 10 per cent risk weighting would apply to individual leases entered into under the Tied Contract with Macquarie Fleet and which were due to expire before the Tied Contract matured. However, for vehicle leases that were to expire beyond that date, the RBA considered that a 100 per cent risk weighting would apply. Accordingly, the Commonwealth remained exposed to an increase in Macquarie Fleet's margin for those vehicle leases due to expire after 31 August 2002.<sup>38</sup>
- 5.42 It was the Committee's opinion that a reasonable person would accept that a risk rating of 10 per cent would tend to indicate with whom the risk lay, and expressed surprise that the risk rating seemed not to have alerted the Commonwealth to the nature of the contract into which it was entering.<sup>39</sup>
- 5.43 DoFA commented in response it considered that the mistake was that the Commonwealth took the risk of that variation without really understanding the potential for that variation to move so dramatically.<sup>40</sup>
- 5.44 The Committee asked DoFA why neither OASITO nor Barings had bothered to approach the RBA to get its views on the likely risk weighting to be assigned to the contract before advice was sent to the then Minister.<sup>41</sup>

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36 ANAO, Audit Report No. 63, 2001–2002, p. 38.

37 ANAO, Audit Report No. 63, 2001–2002, p. 40.

38 ANAO, Audit Report No. 63, 2001–2002, p. 16.

39 *Transcript*, 20 September 2002, p. 49.

40 Hodgson, *Transcript*, 20 September 2002, p. 50.

41 *Transcript*, 20 September 2002, p. 58.

5.45 In reply, DoFA stated that it would have looked at the rules and regulations surrounding capital adequacy requirements and applied them. If there were any questions flowing from that, DoFA advised that it would have approached the RBA for its views.<sup>42</sup>

5.46 The ANAO commented that Macquarie Bank's bid offered a margin rate one-fifth of that offered by the second ranked tenderer, Lease Plan, which had to relate to how the transaction was treated on its books:

If Macquarie did not have it on their books then they did not have to claim much of a margin in terms of their capital adequacy. If Lease Plan were carrying it on its books, which it expected to, it had to fully fund that. That is the heart of the problem, and it goes right through to the selection: did [the Commonwealth] actually select the best candidate in terms of a risk return trade-off ...? That process of not knowing what the RBA was doing and not knowing the deal then set in train all the other events.<sup>43</sup>

5.47 The Committee advised DoFA that OASITO had told the ANAO that it did not accept that it stood in a reporting line between advisers and the Minister and did not evaluate Barings' advice before it was passed to the Minister. The Committee sought DoFA's comments on OASITO's position, and asked whether DoFA accepted that it had a role in advising the Minister on broad issues such as the sale of an asset.<sup>44</sup>

5.48 DoFA replied that it certainly had a role in advising the Minister on such issues:

Certainly the Department of Finance and Administration has always adopted a policy of standing between advice given and the minister and of advising the minister independently if that is appropriate.<sup>45</sup>

5.49 In response to the Committee's question as to why OASITO had a different view, the ANAO stated:

... our report merely records the fact that OASITO had a much different view of their approach, which surprised us to some extent, because we thought that OASITO should have taken a bit

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42 Pahlow, *Transcript*, 20 September 2002, p. 58.

43 Cronin, *Transcript*, 20 September 2002, p. 59.

44 *Transcript*, 20 September 2002, p. 46.

45 Hodgson, *Transcript*, 20 September 2002, p. 46.

more interest in the advice it was receiving from its advisers before passing it on to the minister.<sup>46</sup>

## Value for money

- 5.50 The bids for DASFLEET were assessed by Barings on the basis of a Relative Whole of Government (RWOG) approach which took into account, amongst other things, the initial lump sum offer price and the future vehicle lease and fleet management rates. The future vehicle lease rates are primarily determined by the estimated residual values of the vehicles and the cost of funds; the latter comprises the benchmark leasing rate and a lender's margin.<sup>47</sup>
- 5.51 In assessing the bids, Barings used a 6.2 per cent benchmark cost of funds to which was added the bidders' various margins. By far the largest component of the cost of funds arises from the benchmark rate as opposed to the lenders' margin rate.<sup>48</sup>
- 5.52 The aim of a RWOG analysis was to ensure that the sale outcome generated the most favourable net present value (NPV) return to the Commonwealth. The Macquarie Bank bid was considered by Barings to generate the highest NPV to the Commonwealth based on all inputs to the RWOG analysis. The Macquarie Bank bid had the largest up front payment and the lowest cost of funds for the vehicles leased but it had a higher fleet management rate than that proposed by the second ranked bidder (Lease Plan).<sup>49</sup>
- 5.53 Barings advised that Macquarie Bank's bid provided for an estimated overall financial outcome of a net present value (NPV) over 6 years of \$116 million, \$6 million better than the bid from Lease Plan.<sup>50</sup>
- 5.54 Barings advised the ANAO that 'the Commonwealth and its advisers had more than sufficient grounds on which to make the decision to continue negotiations with the winning bidder'.<sup>51</sup>
- 5.55 The ANAO pointed out in its earlier audit report that there were risks for the Commonwealth in accepting a qualified or conditional bid too early:

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46 Cochrane, *Transcript*, 20 September 2002, pp. 46-7.

47 ANAO, Audit Report No. 25, 1998-1999, p. 35-6.

48 ANAO, Audit Report No. 25, 1998-1999, p. 36.

49 ANAO, Audit Report No. 25, 1998-1999, p. 36.

50 ANAO, Audit Report No. 25, 1998-1999, pp. 40-1.

51 ANAO, Audit Report No. 25, 1998-1999, p. 41.

The preferred bidder may seek, during these negotiations, to reduce the margin by which they won the bid through reducing their effective price by modifying the risk allocation between themselves and the Commonwealth.<sup>52</sup>

5.56 During the hearing, the Committee asked the ANAO about the alternative bidder to Macquarie Bank.<sup>53</sup>

5.57 The ANAO replied:

Lease Plan were actually offering a genuine operating lease. That explains the large difference in the funding margin [of its bid]. If you take that out, Lease Plan had significantly cheaper components in terms of the vehicle operations.<sup>54</sup>

5.58 When the Committee asked the ANAO whether the Commonwealth would have been better off under the Lease Plan arrangements, the ANAO pointed out that the Amended Tied Contract was now with Lease Plan.<sup>55</sup>

Following the settlement of the disputes and the novation of the Tied Contract to Lease Plan Australia, Macquarie Fleet no longer has any involvement in the provision of fleet leasing services under the Tied Contract.<sup>56</sup>

5.59 In response to further Committee questioning on whether the Commonwealth had received value for money from the DASFLEET sale, DoFA stated that it had not undertaken that analysis:

My understanding from reading previous transcripts of evidence is that Mr Hutchinson [the former CEO] from OASITO estimated [the profit] to be \$88 million ... in present value terms. We have not done the analysis but my gut feeling is that we have not eaten into \$878 million in terms of amounts either received from or paid to Macquarie Bank.

We estimate settlement and all amounts paid – adjustments to sale proceeds, both disputed and non-disputed – to be less than \$50 million.<sup>57</sup>

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52 ANAO, Audit Report No. 25, 1998-1999, p. 42.

53 *Transcript*, 20 September 2002, p. 51.

54 Cochrane, *Transcript*, 20 September 2002, p. 51.

55 Cronin, *Transcript*, 20 September 2002, p. 51.

56 ANAO, Audit Report No. 63, 2001-2002, p. 77.

57 Pahlow, *Transcript*, 20 September 2002, pp. 52-3.

- 5.60 The Committee sought to confirm with DoFA that it considered the Commonwealth to be some \$38 million better off as a result of the DASFLEET sale.<sup>58</sup>
- 5.61 DoFA responded that, on the basis of the information provided by OASITO, \$38 million was the approximate benefit to the Commonwealth.<sup>59</sup>
- 5.62 The Committee noted that DASFLEET's net operating profit in the last year of Commonwealth ownership was some \$23 million. The Committee. inquired whether OASITO, in its calculations that the benefit to the Commonwealth from the disposal of DASFLEET was an estimated \$88 million in present value terms, took into account the net operating profit of DASFLEET over the term of the contract.<sup>60</sup>
- 5.63 DoFA took the question on notice and later advised that the scoping study estimates took into account projected DASFLEET levels of annual profit or loss.<sup>61</sup>

## Committee comment

- 5.64 The Commonwealth considered that in disposing of DASFLEET it had engaged in a trade sale of the DASFLEET business together with a five year Tied Contract for the provision of vehicles leasing and fleet management services to Commonwealth Public Account (CPA) agencies. The alternative of externally refinancing the fleet had been specifically explored and rejected.<sup>62</sup>
- 5.65 It became clear during the arbitration process that, contrary to the Commonwealth's view, Macquarie Bank had bid for DASFLEET on the basis that some \$15 million of the total price tendered was for the purchase of the business and the remaining \$392.9 million related to the sale and leaseback of the vehicle fleet.<sup>63</sup>
- 5.66 This resulted in Macquarie Bank's providing external refinancing of the Commonwealth's fleet at an interest rate approximately 67 basis points higher than that at which the Commonwealth could have funded the fleet itself (equivalent to the 5-week Treasury note rate). The ANAO estimated

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58 *Transcript*, 20 September 2002, p. 53.

59 Pahlow, *Transcript*, 20 September 2002, p. 53.

60 *Transcript*, 20 September 2002, pp. 53-4.

61 DoFA, Submission No. 8, p. 4.

62 ANAO, Audit Report No. 63, 2001-2002, p. 15.

63 ANAO, Audit Report No. 63, 2001-2002, p. 15.

the difference between the Commonwealth's funding the refinancing of the vehicle fleet itself compared to refinancing it through the Tied Contract with Macquarie Fleet was around \$6.9 million over the total life of the Tied Contract.<sup>64</sup>

- 5.67 The Committee considers that the government's objective was to sell the DASFLEET business as well as the risk of that business. The Commonwealth's perception early in the sale was that the majority of the risk was being borne by Macquarie Fleet.
- 5.68 The different mechanisms for sharing risk offered by the bidders were reflected in their differing margins over the benchmark leasing rate cost of funds. The margin rate offered by Macquarie Bank in its May 1997 binding offer was one-fifth of that offered by the next highest bidder, Lease Plan, in the first year of the transaction. In the case of the Macquarie Bank bid for DASFLEET, there was a direct linkage between the interest rate payable by the Commonwealth, as customer, on the leasing of the fleet and the regulatory risk weight determined by the RBA for the transactions.<sup>65</sup>
- 5.69 A short time after the sale, to avoid a change in the RBA's risk weighting from 10 per cent to 100 per cent and the consequent additional cost impact to the Commonwealth of some \$25 million, the Commonwealth and Macquarie Bank together put a submission to the RBA, and it was agreed that the transaction represented, at a whole of government level, a finance lease.
- 5.70 It is clear to the Committee from evidence uncovered by the audit that Macquarie Bank viewed the arrangement from the beginning as a risk free investment. In short, Macquarie Bank had a very good understanding of the contract and the Commonwealth did not.
- 5.71 When the arbitrator looked at the commercial disputes in relation to the Tied Contract, one of the elements he took into account was the fact that the RBA, the Commonwealth and Macquarie Bank were in agreement that the arrangement was a finance lease and that the risk was with the Commonwealth. The arbitrator considered that this fact supported the arguments that Macquarie Bank was making about the purchase price of the vehicles et cetera. This led to an interim decision by the arbitrator which was not the outcome that the Commonwealth had been seeking from the arbitration process.

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64 ANAO, Audit Report No. 63, 2001-2002, pp. 15-16.

65 ANAO, Audit Report No. 25, 1998-1999, p. 50.

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- 5.72 The Committee considers that OASITO should have ensured that the RBA was approached prior to the DASFLEET sale for formal confirmation of how the RBA would treat the transaction for risk weighting purposes.
- 5.73 Macquarie Bank's bid of May 1997 for DASFLEET indicated that its lower transaction funding rate was based on the RBA assessing the transaction for capital adequacy purposes at the rate of 10 per cent. OASITO chose the Macquarie Bank tender and the low interest rate, but failed to realise that the lower risk weighting indicated that the risk would remain with the Commonwealth.
- 5.74 When the capital adequacy ratio was assessed by the RBA at 100 per cent if the risk was to lie with Macquarie Bank, the Commonwealth had to convince the RBA that it bore all the risk to ensure that its lower transaction funding rate remained intact. To have done otherwise would have resulted in the Commonwealth paying Macquarie Bank some \$25 million in higher lease charges.
- 5.75 The Committee cannot understand how an assessment of a capital adequacy requirement of 10 per cent did not alert OASITO as to where the risk of the transaction would lie.
- 5.76 The two highest bidders for DASFLEET were close in financial terms having regard both to the up front lump sum offered and the ongoing charges proposed. Macquarie Fleet Leasing intended to sub-contract fleet management to a company (Serco) which had no fleet management experience. The second ranked bidder, Lease Plan, was Australia's largest fleet management company. Despite this, no further negotiations were held with the second ranked bidder after mid June 1997.<sup>66</sup>
- 5.77 The Committee agrees with the ANAO that in evaluating bids in such a competitive process, negotiations should be continued until one bid is identified as clearly presenting a superior outcome in terms of the overall risk and return. In the Committee's view, if this process had been carried out, the Commonwealth would have stood a much improved chance of receiving value for money from the DASFLEET sale.
- 5.78 The Committee notes that at several points, advice from Barings came to OASITO and was forwarded on the same day to the then Minister with a recommendation for action.
- 5.79 The Committee considers that there was effectively no capacity in that circumstance to review the advice before making a recommendation to the Minister.
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66 ANAO, Audit Report No. 25, 1998-1999, p. 42.



- 5.80 The role of the Public Service in such a process is to act as a means of value adding. Business advisers provide advice, and if public servants are involved, it is their role to evaluate that advice and to check that the decision maker has an appropriate basis on which to make an informed decision and take a recommended course of action.
- 5.81 The Committee finds it unacceptable that OASITO did not evaluate Barings' advice and that OASITO did not accept that it stood in a reporting line between advisers and its Minister.

## Commonwealth costs

- 5.82 As a result of the arbitration process and the Interim Award, the total potential exposure of the Commonwealth to possible payments to Macquarie Fleet was reduced from around \$100 million originally claimed by Macquarie Fleet to around \$50 million. Various attempts at negotiating a resolution of the DASFLEET matter had occurred over the course of the disputes, most significantly between June 2000 and the 26 October 2000 handing down of the Interim Award. However, when a settlement could not be secured prior to the Arbitrator's decision on the Interim Award, both parties withdrew all settlement offers. Negotiations were recommenced between the parties in early November 2000.<sup>67</sup>
- 5.83 On 3 February 2001, the then Minister approved the 'whole of dispute' settlement framework approach subject to substantial improvements being obtained in the settlement offer from Macquarie Fleet and DoFA obtaining comprehensive legal advice to underpin any view that a commercially sound settlement had been arrived at. The ANAO stated that DoFA had been engaged in strenuous negotiations with Macquarie Fleet until late May 2001. Offers and counter-offers were exchanged between the parties. At the same time, DoFA commissioned substantial expert advice from its advisers to inform it on the legal, commercial and financial consequences of not only the proposals from Macquarie Fleet for settlement but also the alternative options of termination of the Tied Contract or continuation of the continuation of arbitration, litigation and performance of the Tied Contract by Macquarie Fleet.<sup>68</sup>
- 5.84 Macquarie Fleet's letter of commercial intent of 23 May 2001 led to the negotiation of a final settlement agreement. DoFA prepared a detailed

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67 ANAO, Audit Report No. 63, 2001–2002, p. 75.

68 ANAO, Audit Report No. 63, 2001–2002, p. 75.

business case to support the final settlement proposal, which was submitted to the then Minister on 6 June 2001. The business case outlined the dispute, activities aimed at resolving the dispute and the proposed settlement. All material supporting documents were attached, including drafts of the detailed sign-offs to be provided by DoFA's advisers, including the Department's Probity Adviser. On 29 June 2001, the then Minister approved the settlement basis and signed an instrument authorising a senior DoFA officer to approve and exercise the settlement documentation.<sup>69</sup>

- 5.85 Following the settlement of the disputes and the novation of the Tied Contract to Lease Plan Australia, Macquarie Fleet no longer had any involvement in the provision of fleet leasing services under the Tied Contract. The Commonwealth has assumed the full residual risk on the vehicles currently on lease as at the date of settlement. New leases entered into under the Amended Tied Contract are operating leases and the Commonwealth bears no residual risk on these vehicles.<sup>70</sup>
- 5.86 As part of the settlement principles, the Commonwealth paid Macquarie Fleet \$15.7 million and Macquarie Fleet paid the Commonwealth \$8 million, resulting in a net payment by the Commonwealth to Macquarie Fleet of \$7.7 million.<sup>71</sup>
- 5.87 The complex commercial disputes that arose in connection with the DASFLEET transaction resulted in substantial additional costs to the Commonwealth. Costs were incurred in the attempt to monitor and manage the Tied Contract, in the attempts to resolve the commercial disputes, and by both DoFA and the Office of Asset Sales and Commercial Support (OASACS) for legal and commercial advisers and other experts in relation to the Tied Contract and Sale Agreement disputes.<sup>72</sup>
- 5.88 In July 1999, management of the two disputes was combined under DoFA's administration. From July 1999, OASACS met half the costs incurred by DoFA in the management of the disputes.<sup>73</sup>
- 5.89 The ANAO stated in its report that DoFA had actively monitored expenditure on advisers in relation to the DASFLEET disputes but had advised that it was unable to determine accurately the amount of the costs that related to the management of the disputes and the amounts incurred

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69 ANAO, Audit Report No. 63, 2001–2002, p. 75.

70 ANAO, Audit Report No. 63, 2001–2002, pp. 77–8.

71 ANAO, Audit Report No. 63, 2001–2002, p. 72.

72 ANAO, Audit Report No. 63, 2001–2002, p. 81.

73 ANAO, Audit Report No. 63, 2001–2002, p. 81.

for the normal contract management activities required. DoFA advised that this was due to the overwhelming effect of the disputes on the management of the Tied Contract.<sup>74</sup>

- 5.90 The Committee asked DoFA about the possibility of quantifying the total cost of the DASFLEET sale exercise, including the additional costs incurred by the disputes.<sup>75</sup>
- 5.91 DoFA responded that to cost the whole exercise would itself incur a further large cost. However, DoFA indicated to the Committee that it had an estimate of the hours spent on the disputes and in-house costs.<sup>76</sup>
- 5.92 DoFA later confirmed in a submission to the Committee that its records did not differentiate between contract administration and dispute administration. DoFA's estimate of its staff salary cost between August 1997 and October 2001 for staff engaged in the management of the Tied Contract and the handling of the DASFLEET dispute was \$1.5 million.
- 5.93 DoFA noted that it had assumed that the total costs of the dispute process should reasonably include the costs of DoFA staff associated with the management of the DASFLEET dispute and the costs associated with DoFA's retention of external expertise. DoFA estimated these costs to be \$11.2 million.<sup>77</sup>
- 5.94 The ANAO report noted that OASACS' staff costs for the period September 1997 to October 2001 were estimated by DoFA to be \$0.72 million.<sup>78</sup>
- 5.95 The Committee asked DoFA why the resolution of the disputes with Macquarie Fleet took so much longer to achieve than either DoFA or OASITO officials forecast when they appeared before the Committee in August 1999.<sup>79</sup>
- 5.96 In response, DoFA stated that the unfavourable interim ruling 'meant that we did not want to just accept that and pay that money; we wanted to pursue it further. So [resolution of the disputes] took longer than would have been the case. When we got into the issues ... they were more complex, the views on either side were more entrenched than was

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74 ANAO, Audit Report No. 63, 2001–2002, p. 82-3.

75 *Transcript*, 20 September 2002, p. 63.

76 *Transcript*, 20 September 2002, p. 63.

77 DoFA, Submission No. 8, pp. 5-6.

78 ANAO, Audit Report No. 63, 2001–2002, p. 83.

79 *Transcript*, 20 September 2002, p. 64.

originally thought and there was more interrelationship between the issues'.<sup>80</sup>

## Barings' advice

5.97 The Committee asked DoFA whether it had looked at the written advice on the sale of DASFLEET provided by Barings at the time.<sup>81</sup>

5.98 DoFA replied:

The simple answer to your question is no. When I took responsibility for this area it was for the management of the current contract that the Commonwealth had entered into. Although at that stage we were heavily in dispute, I [apprised] myself of what most of the issues in the dispute were rather than going back to see what advice had been given at the time. Quite extensive work has been done by various teams that have looked at what the intent was at the time, what was agreed and what was thought to be agreed.<sup>82</sup>

5.99 The Committee advised that it was trying to obtain an appraisal of the quality of Barings' advice in view of the circumstances and asked the ANAO to comment.<sup>83</sup>

5.100 The ANAO noted that it had not audited the advice given by Barings but stressed that procedures had to be improved to ensure that better work from consultants was obtained.<sup>84</sup>

5.101 The ANAO noted that a distinguishing feature of the sale was that there was no tender evaluation committee, which was a common feature of activities where tenders are being sought:

As a standard rule, [the ANAO] supports this concept of having this evaluation, because you would have had people in from the then Department of Administrative Services who had a lot of experience in running and managing the fleet, you would have had people in from the then Office of Asset Sales and you would have had advisers, and together you would go through the tender in a systematic way and work out whether in fact the Commonwealth got advice. [OASITO] did not have a tender

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80 Hodgson, *Transcript*, 20 September 2002, p. 64.

81 *Transcript*, 20 September 2002, p. 54.

82 Hodgson, *Transcript*, 20 September 2002, p. 54.

83 *Transcript*, 20 September 2002, p. 54.

84 Cochrane, *Transcript*, 20 September 2002, p. 54.

evaluation committee in place for [the DASFLEET sale] so the information went ... straight from the adviser through to the minister.<sup>85</sup>

5.102 The Committee asked DoFA what contractual arrangements with advisers it now had, what terms and conditions were imposed and whether the advisers were indemnified.<sup>86</sup>

5.103 DoFA replied that it did not indemnify advisers for bad advice:

If [advisers] give us bad advice, we have the right to pursue them for the consequences of that bad advice. ....

That is contractual. That is the way we approach the contracting of our advisers.<sup>87</sup>

5.104 In response to the Committee's question on how many advisers had been pursued for bad advice, DoFA stated:

I am not aware of any but that does not mean to say they have not been. ....

I was not involved in Barings.

I have been very happy with the quality of advice that I have received in the time that I have been responsible for [DASFLEET sale issues].<sup>88</sup>

5.105 The Committee asked DoFA whether DoFA, on behalf of the Commonwealth, had ever sought to recover any moneys from Barings.<sup>89</sup>

5.106 DoFA replied that it had not done so, but that there had been a 'serious look at whether we could sue Barings for bad advice':

There was legal advice sought as to whether that was a course of action which would be productive. The advice we received said it would be difficult to succeed in such a case. The main reason it would be difficult to succeed was that it would be difficult to identify exactly the loss incurred by the Commonwealth as a result of the bad advice and, therefore, difficult to assess what you would actually sue them for and how the court could assess what

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85 Cronin, *Transcript*, 20 September 2002, p. 55.

86 *Transcript*, 20 September 2002, p. 57.

87 Hodgson, *Transcript*, 20 September 2002, p. 57.

88 Hodgson, *Transcript*, 20 September 2002, p. 57.

89 *Transcript*, 20 September 2002, p. 59.

damage had been done to the Commonwealth as a result of bad advice.<sup>90</sup>

- 5.107 DoFA claimed that it would be difficult within a whole-of-dispute settlement to clearly say, 'this bit of it relates to any settlement of the issue related specifically to any questionable advice by Barings'.<sup>91</sup>
- 5.108 The ANAO stated that if the question arose of losses on the sale, had it been undertaken one way as against the other, it did not think that it would be possible to determine an actual dollar loss. However, the ANAO stated that it had not sought advice on the question of whether loss recovery should have been pursued in this case.<sup>92</sup>
- 5.109 After the public hearing, the Committee wrote to DoFA requesting that DoFA supply a copy of the legal advice on which it had relied and a copy of the request for advice and any associated briefing material prepared to assist in briefing counsel.
- 5.110 DoFA declined to supply the legal advice but provided a summary paragraph which it included in its reply:

In conclusion there are a number of difficulties or potential obstacles which may arise in seeking to establish in court the loss suffered by the Commonwealth, and the cause of that loss, in any action for breach of contract or negligence arising out of the Purchase Price of Vehicles issues. The nature and scope of the factual inquiry that the Commonwealth would need to undertake, the expense involved in obtaining the necessary evidence (both expert and lay), and the uncertainty that those investigations would ultimately establish loss, suggest that, the costs of those investigations may exceed the likely benefit to be gained by their pursuit. Although the Commonwealth would likely incur less expense in attempting to establish loss based on the known quantity of costs paid by the Commonwealth, for the legal and expert advice received in relation to the DASFLEET dispute, the Commonwealth will face similar difficulties in attempting to prove causation to those described above (i.e. that those costs were incurred by reason of the breach of contract, or negligence, of the Commonwealth's former advisers).<sup>93</sup>

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90 Hodgson, *Transcript*, 20 September 2002, p. 59.

91 Hodgson, *Transcript*, 20 September 2002, p. 60.

92 Cochrane, *Transcript*, 20 September 2002, pp. 60, 64.

93 DoFA, Submission No. 8, p. 7.

- 5.111 DoFA advised the Committee that its request for a legal opinion was made orally to its legal advisers, Phillips Fox Lawyers, and that no departmental briefing, discussion paper or letter was provided to assist in briefing counsel.<sup>94</sup>

### Committee comment

- 5.112 It is quite clear to the Committee that in the case of the DASFLEET sale, OASITO did not understand the contract. With hindsight, it is easy to say that it should have, but it did not. As a result, the Commonwealth had a poorly constructed and complex contract and a total misunderstanding of the nature of the arrangement it was entering into.
- 5.113 The Commonwealth's understanding of the DASFLEET sale contract appears to have emerged over several years. The ANAO told the Committee that DoFA has worked hard to try to effect some remedy for the Commonwealth but was left in a very difficult position. In the end, DoFA's efforts in the settlement process reduced the Commonwealth's potential exposure by a very significant amount.
- 5.114 It is clear that there have been substantial costs to the Commonwealth in connection with the DASFLEET transaction which were not envisaged at the start of the sale process. The Commonwealth paid \$7.7 million to Macquarie Fleet as part of the final settlement, external provider costs and DoFA staff costs for the management of the Tied Contract and DASFLEET Dispute totalled \$11.1 million and OASACS' staff costs were \$0.72 million.
- 5.115 At the hearing the Committee requested advice from DoFA regarding the cost of the dispute process. While DoFA was able to provide an estimate of costs, the Committee notes that DoFA's records do not differentiate between contract administration costs and dispute costs.
- 5.116 The Committee is of the view that effective record keeping and administrative practices would allow for that differentiation to be made. The Committee considers that in this regard DoFA's practices and procedures were inadequate.

### Recommendation 7

- 5.117 **The Committee recommends that the Department of Finance and Administration improve its record management practices with regard to**

94 DoFA, Submission No. 8, p. 7.

### **dispute resolution activities.**

- 5.118 Given the complexity of the leasing arrangements and the potential for significant risk to Commonwealth revenue, the Committee considers it undesirable that DoFA's request for a legal opinion was made orally. The Committee considers that in future DoFA's requests for legal opinions should be written requests to enable the context of legal advice to be properly ascertained when decisions are reviewed.

### **Recommendation 8**

- 5.119 **The Committee recommends that in future the Department of Finance and Administration's requests for legal opinions are written requests.**

### **Summary**

- 5.120 The Committee is concerned about the following aspects of the DASFLEET transaction:
- that OASITO did not evaluate Barings' advice before passing it to the Minister;
  - that OASITO did not accept that it stood in a reporting line between advisers and its Minister;
  - that OASITO did not adequately pursue negotiations with the second ranked bidder;
  - that OASITO failed to realise that a capital adequacy requirement of 10 per cent indicated that the risk of the transaction would lie with the Commonwealth;
  - that the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract, when this was not the original intention of the sale;
  - that the Commonwealth ended up with a finance lease when its expressed intention was to have an operating lease;
  - that the Commonwealth did not understand the nature of the contract which it was entering into;



- that the Commonwealth incurred substantial costs in connection with the DASFLEET sale that were not envisaged at the start of the sale process.

Bob Charles MP  
Chairman  
12 December 2002

