Sale of Brisbane, Melbourne and Perth Airports

Australian National Audit Office

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24 March 1998

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit of the *Sale of Brisbane, Melbourne and Perth Airports*, in accordance with the Authority contained in the *Auditor-General Act 1997*. I present this report and the accompanying brochure to the Parliament. The report is titled *Sale of Brisbane, Melbourne and Perth Airports*.

Yours sincerely

P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

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Audit Team

Brian Boyd
Barbara Cass
Alison Cerritelli
Anna Walsh
Fran Holbert
Colin Cronin

Abbreviations/Glossary

ABC	Airport Building Controller
ACCC	Australian Competition and Consumer Commission
AEO	Airport Environment Officer
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
ASG	Airports Sales Group
ASTF	Airports Sales Task Force
ATO	Australian Taxation Office
AVO	Australian Valuation Office
BZW	BZW Australia Limited
CERA	Capital Expenditure Reimbursement Amount
DAA	Development Allowance Authority
DAB	Development Allowance Bond
DoFA	Department of Finance and Administration
DoTRD	Department of Transport and Regional Development
FAC	Federal Airports Corporation
GBE	Government Business Enterprise
IBC	Infrastructure Bond Certificate
IM	Information Memoranda
OAS	Office of Asset Sales
OASITO	Office of Asset Sales and IT Outsourcing

Part One

Summary and Recommendations

Summary

Background

1. On 1 July 1997, 50 year leases, with an option of a further 49 years, were granted over Melbourne, Brisbane and Perth airports to the Australian Pacific Airports Corporation, Brisbane Airport Corporation Ltd and Airstralia Development Group respectively. The sale of these leases is the first stage of the planned privatisation of the 22 Federal airports previously owned and operated by the Federal Airports Corporation (FAC). A further 15 airports are planned to be sold by 30 June 1998, leaving only the Sydney basin airports under the stewardship of the FAC.

2. The sale of the three airports represented the culmination of the first phase of a sales process initiated in April 1994. Following consideration of the recommendations of a scoping study into the viability of the sale of the FAC's network and a study of post-sale regulatory requirements, the then Government announced in April 1995 its decision to sell the FAC airports in two phases. Bills to establish the post-sale regulatory framework and to facilitate the sale of leases of the airports were introduced into the Parliament in September 1995 but had not been passed by the time of the March 1996 Federal Election. Following the election, the Government decided to continue with the sale of leases on Melbourne, Brisbane and Perth airports with the aim of completing these sales (Phase 1) prior to 30 June 1997.

3. Overall responsibility for the management and completion of the sale was initially assigned to the Airports Sales Task Force (ASTF) within the then Department of Finance. In October 1996, the ASTF was replaced by the Office of Asset Sales.[1] The ASTF, and later OASITO, was assisted by a range of contractors notably, a business adviser, legal advisers and an investigating accountant.

4. The Department of Transport and Regional Development (DoTRD) played an important role in the sale, being primarily responsible for the development of legislation and regulations, the airport leases,

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[1] The OAS was established within the Finance portfolio to manage the Commonwealth Government's major asset sales with its Chief Executive Officer reporting directly to the Minister for Finance. In late 1997, the OAS was renamed the Office of Asset Sales and IT Outsourcing (OASITO) following the Government's decision to expand its responsibilities to include the outsourcing of the provision of information technology services to Commonwealth agencies. In this report the OAS will be referred to by its current name or by its acronym OASITO.

development of a paper on the pricing policy to be applied by the Australian Competition and Consumer Commission (ACCC) post-sale; and review of bids from a transport policy perspective. DoTRD is also responsible for ongoing administration of the sale documentation including the airport leases.

5. Expressions of interest were invited by 10 October 1996. After shortlisting (Stage 1), nine consortia submitted offers by 30 January 1997 (Stage 2). Following evaluation of Stage 2 offers, OASITO and the Business Adviser concluded that no clear winner had emerged for any of the airports. They recommended a further round of bids to improve offers in terms of conditionality and conformity with the tender requirements so as to enable the Commonwealth to be in a position to select winners. Six consortia were allowed the opportunity to present revised bids (Stage 3) by 10 April 1997.

6. The three successful consortia were announced on 7 May 1997 following the signing of Sale Agreements for the airports and payment of deposits totalling $325 million. The balance due of $2 923 million was paid on 1 July 1997 upon signing of the leases. A further payment of $61 million from the successful bidder for Brisbane was received on 16 February 1998 pursuant to an agreement between the bidder and the Commonwealth.

Commonwealth sale objectives

7. The Government's sale 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;
- ensure the lessees have the necessary financial strength and managerial capabilities to operate and develop the airports over the lease term;
- ensure majority Australian ownership and control of the airports; and
- ensure fair and equitable treatment of FAC employees, including preservation of accrued entitlements.

8. The Government also nominated ongoing privatisation objectives concerning diversity of ownership; access to the airports for air service operators; quality of service; pricing policy; and economic development.

Audit approach

9. The ANAO objectives in auditing the sale were to assess the extent to which the Government's sale objectives were achieved; review the efficiency of the management of the sale process; assess whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing Commonwealth risk; and identify principles of sound administrative practice to facilitate improved arrangements for future trade sales, particularly the later phases of airport sales.

10. The audit criteria addressed whether the Government's sale objectives were achieved; the management of the sale process including sale planning and preparation, sale coordination, contracting processes and contract management; and the bidding process. The audit also examined measures taken by DoTRD and OASITO and its advisers in pursuit of the ongoing privatisation objectives.

Audit conclusions

1. The sale was substantially completed by OASITO in 1996-97 in accordance with the Government's timetable. The Sale Agreements were signed on 7 May 1997 with settlement occurring on 1 July 1997.

Sale objectives

2. In terms of the sale objectives, the ANAO found the following:

- *Optimising sale proceeds objective:* Gross proceeds from the sale of the Phase 1 airports were $3.31 billion.[2] The gross proceeds were significantly in excess of book values, the Business Adviser's 1995 scoping study estimates of minimum likely proceeds and estimated Budget receipts. They also compare favourably with current market values of previous privatisations of major European airports. 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 total gross proceeds, net sale proceeds are estimated to be $3.16 billion. The direct costs of the sale,

[2] Gross proceeds comprised a total of $3.2 billion in purchase prices, a further payment of $61 million from the successful bidder for Brisbane pursuant to an agreement with the Commonwealth, $47 million in reimbursed designated FAC capital expenditure, interest of $2.7 million on the initial deposit paid to the Commonwealth by the purchasers, and a total of $1 million for cost recovery of marketing materials and the initial payments from the purchasers for the Airport Building Controllers and Airport Environment Officers.

excluding indirect costs of $688 million from the assumption of FAC debt, were 4.6 per cent of gross proceeds.

The bid accepted for Perth of $631 million offered the highest purchase and highest net price. The bid accepted for Brisbane of $1.314 billion was the highest net price offer after the highest indicative proposal was considered to be non-compliant with major aspects of the Request for Proposals and after factoring in a contingent further payment by the successful bidder. The bid accepted for Melbourne of $1.255 billion was the highest net price offer after the highest offer price was adjusted for the estimated taxation revenue effects of infrastructure bonds.

- *Minimise exposure to residual risks and liabilities objective:* OASITO and DoTRD effectively minimised the Commonwealth's residual risks and liabilities. The Sale Agreements included effective measures to minimise the Commonwealth's exposure to residual risks and liabilities including limited warranties and a nominal cap on the Commonwealth's liability.

  At the request of DoTRD, the OASITO's' legal advisers prepared an administrator's version of the lease to assist in managing the Commonwealth's ongoing risks under the leases. DoTRD has not yet developed a comprehensive framework or procedures to discharge its obligations concerning monitoring and enforcing lessee's compliance with the airport leases. The ANAO considers the timely development of an appropriate framework and procedures important to manage the Commonwealth's ongoing risks under the leases.

  Tripartite deeds vary the terms of the leases to provide the lessees' financiers with step-in and cure rights should a termination event occur under the lease. Amendment of the tripartite deeds to require the Commonwealth to compensate financiers for lease termination was not DoTRD's preferred position and imposes an additional ongoing obligation on the Commonwealth to redistribute the proceeds of any resale and re-grant of the airport lease. However, DoTRD's advice to the ANAO is that this amendment was necessary in order to preserve the policy intent of the lease.

- *Financial strength and managerial capability objective:* Each of the new airport operators was assessed by OASITO and its Business Adviser to have the necessary financial strength and managerial capabilities to operate and develop the airports over the lease term. This assessment included a detailed review of the financial structures of all bids including a comparative assessment of bidders' financial

projections against the financial model initially developed by the Business Adviser during the scoping study and refined for bid evaluation purposes. The financial analysis in the bid evaluation reports did not include comparisons to objective benchmarks of financial strength.

In the bid evaluation process, subordinated debt was treated as equity. The ANAO considers that, given its characteristics, subordinated debt should be treated as debt for the purposes of determining bidders' financial strength. On this basis, bids were highly geared with the successful bidders' debt to equity ratios ranging from 79:21 to 93:7.

- *Majority Australian ownership and control objective:* DoTRD advised the ANAO that bid assessment appropriately and fully addressed the foreign ownership and control requirements of the *Airports Act 1996.* The ANAO was also advised by DoTRD that each of the lessees complied fully with these requirements at the time the leases were granted. Post-sale ongoing compliance is to be addressed through the Act's requirement that lessees provide a statutory declaration at 12 monthly intervals affirming their compliance.
- *Fair and equitable treatment of FAC employees objective:* OASITO effectively addressed the fair and equitable treatment of FAC employees at the sale airports including preservation of their accrued entitlements. Employee terms and conditions have been preserved for a minimum 12 month period following completion of the sales.

Post-sale airport management

1. The Sale Agreement required a contractual commitment from bidders to a specific amount of capital expenditure on aeronautical infrastructure development for the initial ten years of the lease. The lease includes a covenant on the part of the lessee to develop the airport site at its own expense consistent with a major international airport throughout the term of the lease. However, DoTRD has not yet developed comprehensive administrative procedures to monitor the ongoing development of the Phase 1 airports. This includes comprehensive and direct indicators of whether the airports are being developed in accordance with the requirements of the leases and monitoring development expenditure the lessees have committed themselves to over the initial ten years of their lease.

2. A price cap on charges for aeronautical services has been imposed at the leased airports for a five year period using a Consumer Price Index (CPI) minus X formula, where the X value reflects the productivity improvements expected in the delivery of aeronautical services. Prices

cannot increase on average by more than the cap in any one year which has been set at CPI - 4.0 per cent for Melbourne Airport, CPI - 4.5 per cent for Brisbane Airport and CPI - 5.5 per cent for Perth Airport. The ACCC is responsible for monitoring these charges and will review the price cap arrangements after four years to determine future arrangements.

3. After discussions with State Governments, DoTRD concluded that they would not be in a position to assume responsibility for control of on-airport activities and, in a short period of time, DoTRD developed a regulatory regime for the control of on-airport activities including liquor, commercial trading, vehicle movements, gambling and smoking. In addition, DoTRD has developed and is implementing a regulatory regime for planning and environmental management at the leased Federal airports.

4. The decision to require the new operators to provide funding for the Airport Building Controller and Airport Environment Officer positions at the airports was not notified to bidders until after Stage 3 bids had closed and three days before the preferred bidders were announced. The ANAO considers that the introduction of these additional cost burdens for bidders after the closing date for the submission of binding bids resulted in inadequate disclosure to bidders of the cost sharing arrangements to apply.

Contracting processes

1. Asset sales are invariably complex, resource intensive activities undertaken within tight timeframes. OASITO relied heavily on its major advisers and other consultants to undertake the sale. More than 30 contracts were let by OASITO and its major advisers over the three year period of the sale. Sound administrative principles and policies for Commonwealth procurement include the achievement of value for money and open and effective competition. However, during the sale process sound contracting practices were not consistently adopted to implement these principles and policies.

2. For a variety of reasons a small number of contracts were not competitively tendered; contracts were not finalised and signed in a few instances; and a number of contracts let during the sale did not include performance monitoring arrangements such as reports on progress, resources used and costs incurred.

3. Contracts for the design, typesetting and printing of the tender documentation and establishment and management of buyer data rooms were not let sufficiently early to allow appropriate planning and

reasonable time to complete the task. These contracts were arranged during the period when OASITO staffing levels were being reduced and particular tasks were being outsourced from OASITO to the Business Adviser. There were no written contracts for the design, typesetting and printing of the tender documentation, a task which cost in total over $900 000, more than 3.5 times the initial estimate.

Tendering process

4. A further round of bids was undertaken to maximise competitive pressures and as a means of managing risks to the Commonwealth. This included the Business Adviser identifying and assessing the risk that movements in interest rates could adversely impact on offer prices. The strategy of providing bidders with draft sale documentation, which was broadly non-negotiable, assisted OASITO to optimise its negotiating position in relation to the allocation of risk to the Commonwealth.

5. Sale objectives were addressed during the bid evaluation process by predetermined assessment criteria and a structured approach to ranking against individual criteria. OASITO and the Business Adviser did not specify in the sale tender evaluation methodology, at any time during the tender process, priorities or weightings for each assessment criterion which set out their relative importance for evaluation purposes. Sound administrative practice suggests that the relative importance attaching to each criterion should be included in the tender evaluation methodology to be employed. OASITO advised the ANAO that it considers such an approach would not have been appropriate in the circumstances of this sale, given that the evaluation criteria were not conducive to mechanical trade-offs. Instead, Ministers needed to be given the opportunity to make important relative judgements regarding bid information in the light of thorough briefings on the bids.

6. The ANAO has been advised that bid evaluation examined and assessed the tax effects of all bids on a consistent and non-discriminatory basis to identify whether they involved substantive tax revenue costs. OASITO and its advisers concluded that, with the exception of infrastructure bonds, there were no issues that needed to be taken into account in a comparative price evaluation.

7. The Business Adviser developed a methodology to assess the impact of infrastructure bonds on overall Commonwealth revenue. The process undertaken by OASITO and the Business Adviser in seeking the views of Commonwealth agencies on their methodology was appropriate. The methodology adopted was developed by the Business Adviser and endorsed by the Department of the Treasury, the department with policy

responsibility, but was different from the one developed jointly by the Department of the Treasury, the Development Allowance Authority[3] and the Australian Taxation Office and which had been provided to the Treasurer on 28 January 1997. The ANAO notes that it would be accepted practice for OASITO to rely on Department of the Treasury advice on this aspect of the sale given its functional responsibilities. The adoption of the methodology developed by the Business Adviser and endorsed by the Department of the Treasury led to a different bidder ranking for Melbourne Airport in relation to the price criterion.

Administrative practices

8. The ANAO considers that for future airport trade sales administrative procedures could be strengthened in the following areas:

- *Bidder facilitation*: Documents needed for bidder due diligence should be available in a manner which does not exacerbate the costs and time pressures incurred by bidders.
- *Tender documentation:* Although security procedures were in place during the bid evaluation process, improvements can be made to procedures for the receipt, opening, registering, handling and filing of offer documents.
- *Sale documentation:* The leases will be in operation for up to 99 years; the tripartite deeds could be operative for up to twenty years and the Sale Agreements for at least ten years. To manage the Commonwealth's ongoing risks under the sale documentation, it is important that arrangements be made for the ongoing storage and safe custody of these important legal documents.
- *Commonwealth Procurement Guidelines:* To ensure value for money and open and effective competition when contracting for services in future asset sales, advisers who are authorised to let contracts on behalf of the Commonwealth should be required to comply with the Commonwealth Procurement Guidelines.
- *Tender evaluation committees:* The establishment of a formal tender evaluation committee comprising OASITO, relevant portfolio departments, major advisers and, possibly, independent members would assist in ensuring transparency and accountability in the bid evaluation process in future trade sales. It may also lead to

[3] Under provisions in the *Development Allowance Authority Act 1992* (as amended), the Development Allowance Authority (DAA), an independent statutory authority, is responsible for the approval, management and monitoring of infrastructure bonds.

administrative savings by enhancing coordination and consolidation of the evaluation process including production of reports for Ministers.

Recommendations

1. The ANAO made eleven recommendations, all of which were agreed or agreed with qualification by the relevant agencies with the exception of part (b) of Recommendation 4 (concerning capping of contracts, where applicable) with which OASITO disagreed.

Recommendations

Set out below are the ANAO's recommendations with abbreviated responses from the agencies. More detailed responses are shown in the body of the report together with the findings. The ANAO considers that agencies should give priority to Recommendations 2,3,4,5,6,7, 9 and 10.

Recommendation No. 1 **Para 2.21**	The ANAO *recommends* that, where applicable for future trade sales, the Office of Asset Sales and IT Outsourcing ensure more flexible data access arrangements in order to minimise the costs of buyer due diligence and assist potential buyers to develop bids. ***Agreed:*** AGS. ***Agreed with qualification****:* OASITO.
Recommendation No.2 **Para 2.35**	The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing institute procedures to improve transparency and accountability in future trade sales by requiring bid documents to be numbered consecutively on opening, recorded in a register of tenders and formally signed-out to officers and/or contractors. ***Agreed:*** AGS. ***Agreed with qualification****:* OASITO.

Recommendation No.3

Para 2.51

The ANAO *recommends* that, the Office of Asset Sales and IT Outsourcing strengthen its contracting for services by:

a) improving planning for major contracts by identifying the critical path for the selection and appointment of all major consultants and competitively tendering contracts wherever possible; and

b) improving its contract management by including performance monitoring arrangements in all major contracts such as reports on progress, resources used and costs incurred.

***Agreed with qualification**:* OASITO.

Recommendation No.4

Para 2.64

The ANAO *recommends* that, where applicable for future trade sales, the Office of Asset Sales and IT Outsourcing in outsourcing tasks, include:

a) provisions in major adviser contracts that require advisers who are authorised to let contracts on behalf of the Commonwealth to comply with the Commonwealth Procurement Guidelines; and

b) caps for sub-contractor fees and expenses in major adviser contracts to ensure that the Commonwealth does not bear the commercial risk of cost overruns.

Agreed: AGS and OASITO part (a).

Disagreed: OASITO part (b).

Recommendation No.5

Para 2.77

The ANAO *recommends* that, for future asset sales, the Office of Asset Sales and IT Outsourcing ensure that logistics consultants are engaged early in the sale process to allow:

a) a formal, written contract, including indemnities and confidentiality provisions, to be drafted and signed prior to work commencing;

b) expert advice on logistical aspects to influence the tender timetable and procedures;

c) appropriate planning of logistical activities; and

d) efficient and effective management of sale costs.

***Agreed with qualification**:* OASITO.

Recommendation No.6

Para 3.12

The ANAO *recommends* that, for future trade sales, the Office of Asset Sales and IT Outsourcing enhance transparency and accountability of decision making in the tender process by evaluating the merits of incorporating, as part of the tender evaluation planning process, the development of appropriate priorities which set out the relative importance attaching to each evaluation criterion.

Agreed: AGS.

Agreed with qualification: OASITO.

Recommendation No.7

Para 3.67

The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance transparency and accountability in future major trade sales by considering structures such as a tender evaluation committee.

Agreed: AGS.

***Agreed with qualification**:* OASITO

Recommendation No. 8

Para 4.20

The ANAO *recommends* that the Department of Transport and Regional Development develop a comprehensive framework and procedures to monitor and ensure lessee compliance with the airport leases.

***Agreed with qualification**:* DoTRD.

Recommendation No.9

Para 4.33

The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in consultation with the Department of Transport and Regional Development:

a) for future airport trade sales, develop an agreed framework for the post-sale disposition of sale documentation including providing for appropriate safe custody arrangements for the original signed sale documentation in an appropriate legal form for the duration of the lease term, and placing, in the records of each agency, a full set of copies of the signed sale documentation; and

b) establish appropriate safe custody arrangements for the original signed sale documentation relating to the Phase 1 airports sales, in an appropriate legal form, for the duration of the lease term.

Agreed: OASITO; DoTRD; and AGS.

Recommendation No.10

Para 5.12

The ANAO *recommends* that the Department of Transport and Regional Development develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the *Airports Act 1996* and airport leases.

***Agreed with qualification**:* DoTRD.

Recommendation No.11 **Para 5.36**	The ANAO *recommends* that, in future trade sales, agencies ensure adequate disclosure of all costs connected with the purchase of Commonwealth assets is made to bidders prior to requiring the submission of binding bids. ***Agreed:*** DoTRD. ***Agreed with qualification****:* OASITO.

Part Two

Audit Findings and Conclusions

1. Introduction

This chapter outlines the background to the sale of long term leases over Melbourne, Brisbane and Perth airports, the Government's sales objectives and the audit approach.

Background

1.1 On 1 July 1997, leases over Melbourne, Brisbane and Perth airports were granted to Australian Pacific Airports Corporation, Brisbane Airport Corporation Ltd and Airstralia Development Group respectively. The airports had previously been owned and operated by the Federal Airports Corporation (FAC). The leases are for an initial term of 50 years with the option of a further 49 years.

1.2 Gross proceeds from the sale of the airports was $3.31 billion. 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 pursuant to an agreement with the Commonwealth[4], and a total reimbursement of $47 million for designated FAC capital expenditure at the airports since 1 July 1996. The direct costs of the sale (including $94.4 million for ex gratia payments to the State Governments in lieu of stamp duty on the airport leases) are estimated to be $153 million or 4.6 per cent of gross proceeds. Indirect costs were $688 million from the Commonwealth's assumption of FAC debt.

1.3 As illustrated in Exhibit 1.1, the sale proceeds compare favourably with current market values of previous privatisations of international airports in Europe. The price earnings ratios of the privatised European international airports are high relative to other publicly traded stocks.[5] Vienna airport's price earnings ratio is 23.5, Copenhagen airport's ratio is 20.9, and BAA's ratio is 18.3.[6] All of these trade at premium to their respective markets.

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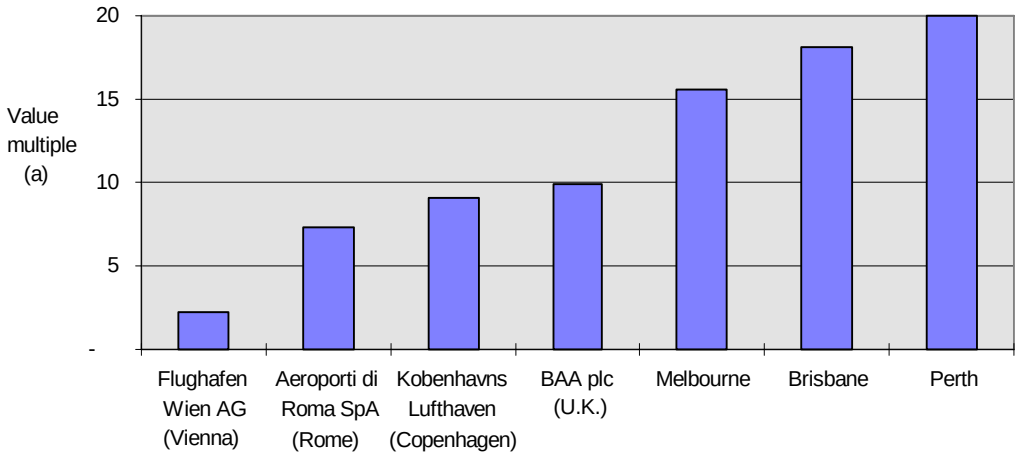
[4] This payment was received on 16 February 1998.

[5] Rome airport's ratio of 7.9 is 58 per cent of the Italian ratio, reflecting the oversubscription of this July 1997 offering. Price earnings ratios were not available for the Phase 1 airports as the financial information contained in the information memorandum on each airport produced for the sale did not extend to calculating earnings after tax.

[6] BAA plc owns and operates seven United Kingdom airports including Heathrow, Gatwick and Stansted international airports.

Exhibit 1.1

Comparison of international airport privatisations: 1997 values



Notes:

a) Value multiple is calculated for the privatised European airports as Enterprise Value (market capitalisation plus net debt (short and long term debt less cash equivalents)) divided by Earnings Before Depreciation, Interest and Tax (EBDIT). For the Phase 1 airports, value multiple is calculated as the total consideration for each airport as at 1 July 1997 divided by EBDIT figures for the year ending 30 June 1996.

b) 47.9 per cent of Vienna International Airport was sold by public float in June 1992. The low multiple is in part a reflection of the very high holdings of cash equivalents. The enterprise value is as at 15 April 1997 and EBDIT is for the year ended 31 December 1996.

c) Aeroporti di Roma was floated in July 1997 and the enterprise value is at 15 August 1997. EBDIT is for the year ending 31 December 1996.

d) 25 per cent of Copenhagen Airport was floated in April 1994. The enterprise value is as at 15 April 1997 and EBDIT is for the year ending 31 December 1996.

e) BAA was sold by public float in March 1987. The public and employee offer was 9.3 times subscribed and the tender offer was 6.1 times subscribed. The enterprise value is as at 15 April 1997 and EBDIT for the year ending 31 March 1997.

Source: ANAO analysis based on information provided by BZW in November 1997

1.4 The sale of Melbourne, Brisbane and Perth airports represents the first step in the break-up of the FAC's former national network of 22 airports. The FAC is a Commonwealth Government Business Enterprise which commenced operations on 1 January 1988. The value of the Commonwealth's equity in the FAC increased from $649 million in 1987-88[7] to $2.7 billion in 1996-97.[8] In

[7] *FAC 1988 Annual Report*, p 17.

[8] *FAC 1997 Annual Report*, p.64.

1996-97, the FAC's airport network handled traffic of more than 60 million passengers, 3.19 million aircraft movements and 32 million tonnes of freight. Total revenue for the year was $635 million, operating profit after tax was $110 million, total assets were $2 957 million and the return on total assets was 8.3 per cent. In addition, until 1 July 1997, the FAC owned some 19 000 hectares of land around the country.[9]

Sale preparation

1.5 The sale of the three airports represented the culmination of the first phase of a sales process initiated in April 1994 by the then Government when it announced its in-principle decision to sell the 22 airports[10] under the control of the FAC and the proposed Sydney West Airport. This decision was contingent on the outcome of two studies. The first was a scoping study into the viability of the sale of the FAC's network of 14 Regular Public Transport airports and eight General Aviation airports to be conducted by a joint task force comprising officers of the then Department of Finance[11] and the then Department of Transport.[12] The second was a regulatory study which involved preparatory work by the then Department of Transport on a post sale regulatory scheme.

1.6 The scoping study and regulatory studies were closely interrelated. The Federal Airports Scoping Study Task Force's activities included examination of alternative sale options and strategies; specification of the actions required to achieve the sale timetable and prepare the federal airports for sale; and identification of the impacts of alternative sale strategies on airport users.

Legislation

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[9] Ibid, pp.57-64.

[10] The 22 FAC airports were: Brisbane, Melbourne, Perth, Jandakot, Darwin, Tennant Creek, Alice Springs, Parafield, Adelaide, Mt Isa, Townsville, Archerfield, Coolangatta, Hoxton Park, Camden, Bankstown, Sydney, Canberra, Essendon, Moorabbin, Launceston and Hobart. Cairns Airport is owned and operated by the Cairns Port Authority, a Queensland Government entity. Avalon Airport Geelong Limited which was previously owned by the Commonwealth was sold in late 1996 to a private operator.

[11] The Department of Finance was reorganised in October 1997 to form the Department of Finance and Administration (DoFA).

[12] The Department of Transport was reorganised in March 1996 to form the Department of Transport and Regional Development (DoTRD).

1.7 Following consideration of the recommendations of the scoping and regulatory studies, the then Government announced in April 1995 its decision to sell the airports in two phases. Phase 1 was to comprise Sydney and the proposed Sydney West Airport as a package (in order to ensure a coordinated and capital efficient approach to the development of both airports) plus Melbourne, Brisbane and Perth Airports by means of separate, simultaneous trade sales of long-term airport leases.

1.8 The Airports Bill 1995 (which sought to establish the post sale regulatory framework) and the Airports (Transitional) Bill 1995 (designed to facilitate the sale of leases of the airports) were introduced into the Parliament in September 1995 but had not been passed by the time of the March 1996 Federal Election. The new Government decided in May 1996 to defer the sale of Sydney airport from the Phase 1 sales process pending the resolution of noise issues over Sydney and the completion of an environmental impact study in respect of Sydney West. Adelaide airport was included in Phase 1 for a time by the new Government but later removed to allow time for resolution of issues related to the extension of the runway. The Government decided to continue with the sale of leases on the remaining Phase 1 airports, with the aim of completing these sales prior to 30 June 1997.

1.9 The amended Airports and Airports (Transitional) Bills were introduced into the Parliament in May 1996 to give effect to the new Government's decision to lease the airports and to provide the post sale Commonwealth legislative framework. The Bills were passed in September 1996 and received Royal assent on 9 October 1996.[13]

1.10 The framework put in place by the *Airports (Transitional) Act 1996* allows for the revesting of the land and operating assets and liabilities (other than debt) of the Federal airports in the Commonwealth; a flexible disposal strategy for the airports; protection of the rights of existing FAC staff who wish to remain employed at the airports; and the assumption or repayment by the Commonwealth of the FAC's debt.

1.11 The *Airports Act 1996* provides a regulatory framework[14] for the Phase 1 airports following their lease. The Act imposes obligations on operators such as: the development of 20 year master plans; the preparation of major development plans; a requirement to seek approvals for building activities; the

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[13] There is other Commonwealth legislation relevant to the post sale operation of the airports including the *Air Navigation Act 1920* and the *Civil Aviation Act 1988*. Some State legislation may also be applicable.

[14] The following regulations have been made: Airports Regulations; Airports (Building Control) Regulations; Airports (Environment Protection) Regulations; Airports (Ownership - Interests in Shares) Regulations; Airports (Protection of Airspace) Regulations; and Airports (Control of On-Airport Activities) Regulations.

development of, and compliance with, an environmental strategy; and provision of prescribed accounts, statements and reports to the Australian Competition and Consumer Commission (ACCC) to complement prices oversight; and compliance with various regulations made under the Act relating to matters including quality of service monitoring by the ACCC, ownership and control, and protection of airspace.

Commonwealth sale objectives

1.12 The Government's sale objectives and on-going privatisation objectives for the Phase 1 airports sales were set out in both the September 1996 Invitation to Register an Expression of Interest and the October 1996 Request for Proposals. The Commonwealth'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 entitlements.

1.13 In addition, the Government nominated ongoing privatisation objectives that addressed the provision of quality airport services; responsive economic development of the airports; diversity of ownership; pricing policy at the airports; and access by air service operators.

Audit approach

1.14 The ANAO objectives for the audit were to review the efficiency and effectiveness of the conduct of the Phase 1 airports sales process in so far as:

- the extent to which the Government's sale objectives were achieved;
- the effectiveness of the management of the sale process to ensure the Commonwealth received fair value;

- determining whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing risk; and
- identification of principles of sound administrative practice to facilitate improved administrative arrangements for future trade sales, particularly the later phases of airport sales.

1.15 The scope of the audit extended from the initial proposal to sell the FAC airports, to the negotiation of the final sale contract and sale completion. The audit also examined measures taken by DoTRD and the Office of Asset Sales and IT Outsourcing (OASITO - the entity which eventually undertook the Phase 1 FAC airport sales)[15] and its advisers in pursuit of the ongoing privatisation objectives.

1.16 The approach taken in the audit was to review data relating to the sales held by OASITO, its advisers, DoTRD (which had responsibility for the development of post sale regulatory framework) and the ACCC. Accordingly, the ANAO conducted field work at OASITO and its advisers BZW, KPMG, Clayton Utz and the Office of the Australian Government Solicitor (AGS)[16]; DoTRD; DoFA; the Department of the Treasury; the Development Allowance Authority (DAA); and the ACCC. In addition, other key stakeholders such as the State Governments and a selection of bidders were consulted. Fieldwork was undertaken between July and October 1997.

1.17 The ANAO engaged the Office of the Australian Government Solicitor to provide a range of legal opinions on matters including tender and sale documentation issues.

1.18 The ANAO developed criteria which addressed whether the Government's sale objectives were achieved; the management of the sale process including sale planning and preparation; sale coordination; contracting processes and contract management; and the bidding process.

1.19 The audit was conducted in accordance with ANAO Auditing Standards. The cost of the audit to the ANAO was $396 000.

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[15] See also footnote 1 on page vi.

[16] Clayton Utz initially was sub-contracted by AGS to provide certain legal services in connection with the Phase 1 airports sales but was later directly contracted by OASITO.

2 . Sale Management

This chapter discusses sale timing, due diligence, the bidding process, sale coordination, management of outsourcing and the engagement and management of logistics consultants.

Background

2.1 Overall responsibility for the management and completion of the Phase 1 airports sales was initially assigned to the Airports Sales Task Force (ASTF) within the Task Force on Asset Sales (a Division of the then Department of Finance). In October 1996, the Task Force was replaced by OASITO. OASITO was assisted by BZW as Business Adviser; the AGS and Clayton Utz as Legal Advisers; and KPMG as the Investigating Accountant.

2.2 The DoTRD played an important role in the sale being primarily responsible for the development of legislation and regulations; the airport lease and tripartite deed; a paper on the pricing policy to be applied post sale by the ACCC; and review of bids from a transport policy perspective.

2.3 The then Government announced in April 1995 its intention to sell all 22 FAC airports by way of individual trade sales and that the first tranche of airports would be Sydney/Sydney West, Melbourne, Brisbane and Perth. The first tranche (Phase 1) was to be completed by 31 December 1996.

2.4 Following the March 1996 Federal Election, Sydney/Sydney West was removed from Phase 1 and the new Government endorsed a revised timetable with completion planned by June 1997. On 3 May 1997, the Minister for Finance advised the successful bidders of his decision. The Sale Agreements were executed on 7 May 1997 with payment of deposits totalling $325 million. The balance of $2 923 million was paid on 1 July 1997.[17]

2.5 Finding: The ANAO considers that the sale was substantially completed in 1996-97 in accordance with the Government's timetable. The Sale Agreements were signed on 7 May 1997 with settlement occurring on 1 July 1997.

[17] See footnote 2 for further details of the composition of total gross proceeds to the Commonwealth.

Due diligence

2.6 Due diligence is a process undertaken to verify the accuracy and completeness of information provided to prospective purchasers. It usually involves the gathering of information to assist with vendor disclosure and enabling potential purchasers to undertake their own review of the sale entity. A properly structured due diligence process is important to manage the Commonwealth's potential civil liability in a trade sale. OASITO had intended to complete vendor due diligence by March 1996 but this was not achieved.

2.7 The objectives and arrangements for the conduct of due diligence were set out in a Planning Memorandum. It included the roles, responsibilities and reporting duties of the Due Diligence Committee, the various sub-committees and advisers. The Planning Memorandum[18] was not executed until late February 1996, some four months later than planned. The FAC advised the ANAO that *the delays in execution of the Memorandum resulted from early drafts of the Memorandum being very preliminary and not being in a position to be finalised.*

Federal Airports Corporation

2.8 The FAC was restructured in advance of the sales to facilitate the sale of the three airports as free standing businesses. During the scoping study, the FAC expressed concern about the level of comfort given under the Finance Directions to Board members in discharging their responsibilities. To address these concerns, in July 1995 the then Minister for Finance provided an indemnity intended to enable the Board to assist in the sale process.

2.9 In October 1995, the FAC Board advised the ASTF that it had received legal advice that, until the Airports (Transitional) Bill was passed, it did not have the power to participate in the marketing component of the sales process.[19] The FAC advised the ANAO that:

> *While the Corporation received legal advice that it was prevented from participating in the marketing/roadshow aspect of the airport sales, the Corporation, at all times, indicated it could legally proceed with due diligence activities. Within the limits of that advice the FAC did all it could to facilitate the due diligence process. Agreement to amend the FAC Act in the necessary way was received from the*

[18] AGS advised the ANAO that the Planning Memorandum was ultimately a negotiated document.

[19] The AGS advised the ANAO that it disputed this legal interpretation by the FAC. However, the matter was not able to be resolved.

ASTF in April 1996. We reiterate that there were no delays to the Information Memoranda as a result.

2.10 The FAC sought confidentiality agreements with OASITO's advisers and negotiated Third Party Consents for confidential information held by the FAC involving other parties to be released to OASITO and its advisers. As of 5 June 1996, the FAC had written to 162 third parties, of which some 91 per cent had provided consents at that time. The FAC advised the ANAO that:

> *The matters regarding the confidentiality undertakings were required to avoid the Corporation breaching its own contracts, and, therefore, diminishing the value of the Commonwealth's assets. Notwithstanding that the ASTF's advisers had entered into confidentiality agreements with the Commonwealth, the Corporation required the ASTF's advisers to sign confidentiality agreements in order to fulfil the Corporation's legal obligations to third parties. Failure to have the advisers execute confidentiality agreements would have placed the Corporation in a position where, although it would be liable to third parties for a breach of confidentiality, it would have no redress against the adviser.*
>
> *In order to protect the interests of the Commonwealth and the Corporation and to prevent the Corporation from being sued for breach of contract it was also necessary to obtain the consent of third parties prior to their confidential information being released. The Corporation made the initial approaches to its customers to obtain consent, however, the ASTF had responsibility to follow up with certain customers/stakeholders who had initially refused consent. Some customers used the refusal of consent as an opportunity to discuss unrelated commercial issues and, as a result, the obtaining of consents took considerably longer than the sales timetable allowed.*

2.11 In July 1996, the Minister for Finance clarified the indemnity which had been provided to the FAC Board in an attempt to meet the concerns put forward by the Board.[20] In October 1996, the enactment of the *Airports (Transitional) Act 1996* resolved any doubt because the Act amended the *Federal Airports Corporation Act 1986* to make clear the responsibility of the FAC Board to assist the Commonwealth in the sales process. The FAC advised the ANAO that:

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[20] In addition, on 3 October 1996, the then Acting Minister for Finance advised the FAC Chairman of the removal of an exclusion from the July 1995 indemnity.

The amendments that the Corporation sought to the Board indemnity were, in fact, not tied specifically to the privatisation process but were general amendments. These were notified in full in December 1995 in a letter from the Company Secretary to the ASTF and included:

- *concerns that the indemnity could be read to apply only to those Board members appointed at the time the indemnity was provided and, therefore, might not apply to any of the existing Board members; and*
- *in light of the opening wording of the July 1995 indemnity, concerns were expressed that the scope of the indemnity was limited to the privatisation process. The Board was concerned that any non-privatisation decisions which it made based on Government policy would not be covered by the indemnity and sought assurances that the indemnity was intended to cover the full range of decisions that it made.*

Despite this matter remaining unresolved the Corporation continued to assist in every possible way with the due diligence process.

Information Memoranda

2.12 The due diligence process for the Phase 1 sales involved the gathering and analysis of information for the preparation and verification of Information Memoranda and the establishment of buyer data rooms. The Information Memoranda were designed to assist bidders in formulating their due diligence investigations and to provide a framework upon which bidders could assess and review the airports.[21]

2.13 OASITO advised the ANAO that:

…the Information Memoranda provided to bidders in Stage 2 (the first formal bidding round) were designed to: provide a concise summary of the business and activities of the FAC at each of the Phase 1 airports; highlight value potential; consolidate certain key information in a single document to assist bidders in their due diligence and bid preparation. The Information Memoranda included certain confidential data which was not capable of being released to bidders in advance of Stage 2. The need to provide

[21] A detailed Information Memorandum was prepared for each of the three airports together with a General Information Memorandum containing information relevant to all three airports, including the proposed post-sale regulatory framework. The principal objective of the airport specific Information Memorandum was to provide bidders with a summary of the business and activities of each of the airports.

quality Information Memoranda was driven by a number of additional considerations: that such a document would provide a convenient road map for bidders' own due diligence, which was important given the large number of documents in the data rooms and the tight timeframe; it allowed bidders to commence credit and financing approvals processes early on the basis of a quality Information Memoranda without the need for extensive due diligence; and the quality of the documents would contribute to bidders' confidence in the process overall.

2.14 The Information Memoranda were developed over a twelve month period with OASITO initially having primary responsibility for coordinating and managing the process. This responsibility was transferred to the Business Adviser in late July 1996. In the short time remaining, the Business Adviser coordinated the development, verification and production of the Information Memoranda. The Business Adviser advised the ANAO that the development of the Information Memoranda was initially hampered by the difficulties experienced in obtaining access to FAC information,[22] delays in finalising the framework for the conduct of due diligence and the initial lack of business focus of the documents. The FAC advised the ANAO that:

Responsibility for the drafting of the Information Memoranda (IM) was with the ASTF's Information Memoranda Sub-Committees (Sub-Committees). These Sub-Committees comprised members of the ASTF, AGS, BZW and KPMG. The Corporation's role was restricted to that solely of an observer. The minutes of the Sub-Committees show the progress made by the Sub-Committees prior to the responsibility being transferred to the Business Adviser (BZW).

When the number of ASTF officers in the Airports Group was reduced from approximately 40 people to less than 10, the responsibility for the IM was transferred to BZW without a corresponding increase in employees for the advisers. Following BZW's assumption of responsibility for the IM in late July 1996, the Corporation's role changed quite markedly. [23]

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[22] The FAC advised the ANAO that: *We are surprised that BZW should find itself "hampered" from accessing any information as all information was formally released by the Corporation to ASTF at its offices in Sydney. The Corporation commenced releasing information informally to the ASTF and its advisers in late 1995 and formally commenced releasing information to the ASTF in February 1996, once the Planning Memorandum was signed.*

[23] The FAC further advised the ANAO that: *…until July 1996, the FAC was not a member of the ASTF's IM Drafting Sub-Committee and our role was expressly one of an observer; the Corporation sought to clarify its role with the ASTF on a number of occasions during July and August, and received on 5 September 1996 confirmation that its role was limited to informally reviewing IM drafts and drafting only two sections; and on*

2.15 The AGS advised the ANAO that with respect to the preparation of the Information Memoranda:

> *It was not until a late stage of the process for the preparation of the Information Memoranda that those involved in the drafting of the Information Memoranda met as a group to review all comments received. AGS would recommend that in future a drafting committee be established at an early stage in the sales process which committee comprises members who are directly involved in inputting data into the Information Memoranda. This drafting committee should have overall responsibility for the preparation of the IM and for managing all input processes to the IM.*

2.16 **Finding:** The suggestion made by the AGS for a drafting committee with overall responsibility for the preparation of the Information Memoranda and for managing all input processes to the Information Memoranda warrants consideration by OASITO for future trade sales.

Data rooms

2.17 Buyer data rooms containing financial information and other relevant documentation were made available during the bidding process to assist short-listed bidders in undertaking their own due diligence enquires. All documents included in the buyer data rooms were classified as either of high or low sensitivity by the FAC. The FAC advised the ANAO that:

> *… only one third of the documents provided by the Corporation for inclusion in the data rooms were classified as sensitive by the Corporation and only a very small number of documents, primarily legal advices relating to the Corporation's airports on a network basis, were not provided to bidders. One reason for the Corporation's sensitivity was our concern to protect the value of all the Corporation's airports especially given the number of bidding consortia who were to be provided with the Corporation's documents. In addition, the classification of highly commercially sensitive documents did not create a delay for bidders in receiving that information. When the ASTF had highly commercial sensitive documents ready for release into the data rooms, a member of*

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20 September 1996 the FAC Board was informed that the ASTF required the Corporation to draft and verify a substantial proportion of the IM. Once the Corporation was required to verify, and sign-off to the Commonwealth on, a large proportion of the IM, the Corporation immediately took an active role in the production of the IM.

Corporate Office Management visited the data rooms on that day to approve the release of information to bidders.

2.18 Notwithstanding that bidders had signed confidentiality agreements prior to being given access to the data rooms, these documents were only available in the data rooms and could not be copied for remote examination. Bidders have expressed concerns about these restrictions in the light of the confidentiality agreements and commented that only one copy of plans, drawings and diagrams was included in the data rooms.[24]

2.19 The FAC advised the ANAO that:

The set up and control of the data room was entirely the responsibility of the ASTF. The ASTF made the decision to operate a data room which did not allow documents to be removed. The Corporation did, however, receive and agree to a number of requests for release of documents outside the data rooms. The fact that only one copy of plans, drawings and diagrams was available to bidders was entirely a matter for the ASTF.

2.20 Finding: The lengthy due diligence process did not focus sufficiently early on the development of Information Memoranda and buyer data room arrangements. The ANAO questions the effectiveness of the document access arrangements for bidders as they added to the costs of the sale for both the vendor and bidders.

Recommendation No.1

2.21 The ANAO *recommends* that, where applicable for future trade sales, the Office of Asset Sales and IT Outsourcing ensure more flexible data access arrangements in order to minimise the costs of buyer due diligence and assist potential buyers to develop bids.

2.22 Agencies responded to the recommendations as follows:

- ***OASITO's* response: Agreed with qualification.** OASITO had arranged for such an approach for the Phase 2 airport sales with the FAC shortly after the Phase 1 sales were completed. The agency with GBE

[24]The Business Adviser advised the ANAO that*: It was originally the case that only one copy of plans, diagrams and maps was included in the data rooms. After a number of discussions with the FAC, permission was granted to allow the outsized maps, plans and diagrams to leave the premises to be photocopied and for copies of these documents (together with an aerial photograph of each airport) to be provided directly to bidders outside the data rooms. These documents were provided to bidders during the week commencing Monday 11 November 1996 (the data rooms opened on 4 November 1996).*

ownership or control of the relevant information may preclude such arrangements in some cases.

- ***AGS response*: Agreed.** While AGS agrees with this recommendation it is noted that the arrangements which were put into place for the provision of data room material to purchasers in Phase 1 of the airports sales was largely as a result of restrictions imposed by the FAC. The FAC was concerned to ensure the security and confidentiality of the documentation made available to bidders for review. During the course of the Phase 1 data room process, the Federal Airports Corporation's agreement was ultimately obtained for the release of maps etc to bidders outside the data room facilities.

  A further factor in considering the data room arrangements for Phase 1 was the need to ensure that appropriate arrangements were in place to protect third party confidentiality. A number of the documents in Phase 1 required the consent of third parties before same could be made available to bidders for review. The data room arrangements which were put in place went partly towards providing these third parties with a degree of security that the documentation would be appropriately protected. It should be noted, that more flexible data access arrangements have been put into place for the Phase 2 airport sales process with material being provided to bidders by way of CD-Rom.

Bidding process

2.23 Following the Business Adviser's appointment in August 1995, a marketing campaign was developed to increase the number of interested investors and convert interested parties into bidders. The Business Adviser has advised the ANAO that the marketing campaign was an important success factor in the Phase 1 sales. Approximately 170 parties registered an interest in the sale process and 60 of these participated in the bidding process.

2.24 The sale involved a staged approach to bidding. Exhibit 2.1 highlights the major stages, the progressive shortlisting of bidders and time taken. Interested parties were invited to lodge Expressions of Interest in one or more of the Phase 1 airports by 10 October 1996. The request for Expressions of Interest outlined the requirements for participating in the bidding process and provided a basis for shortlisting consortia for Stage 2. Bidders proceeding to Stage 2 were provided with a Request for Proposals which specified the requirements for the preparation and lodgement of offers, a Tender Procedures Memorandum, a copy of the General Information Memorandum and the relevant airport specific Information Memorandum.

2.25 The October 1996 Request for Proposals reserved the Commonwealth's right to:

- accept any offer which did not conform with the requirements set out in the Request for Proposals and which was ranked more highly against the evaluation criteria;[25]
- at any stage cancel, add to or amend the information, terms, procedures and protocols set out in the Request for Proposals and tender procedures memorandum;
- terminate further participation in the sales process by any bidder;
- reject any offer at any time for any reason;
- negotiate with one or more bidders; and
- accept any offer notwithstanding that the net proceeds of sale derived from that offer would be less than those which may be derived from another offer.

2.26 The key objective of Stage 2 was to obtain high quality, binding offers from bidders on terms that were consistent with the Government's tender requirements and stated sales and ongoing privatisation objectives. OASITO and the Business Adviser concluded that, although most Stage 2 bids were of very high quality and demonstrated a high degree of conformity with each key assessment element, it was not possible to select a preferred bidder for any of the airports. OASITO and the Business Adviser recommended to the Minister for Finance that a reduced number of the stronger candidates be allowed the opportunity to present revised bids. It was believed this would improve the offers in terms of conditionality, conformity with the tender requirements and, potentially, price.

2.27 Bidders proceeding to Stage 3 were advised that the Commonwealth wished to be able to make a final decision on the successful bidder for each of the Phase 1 airports on the basis of the Stage 3 offers without the need for further discussion or negotiation. They were encouraged to review and improve any or all of the terms of their Stage 2 offers.

2.28 Stage 3 offer requirements were based on the Request for Proposals issued to bidders in Stage 2. Importantly, bidders were asked to confirm their acceptance of the revised sale documentation; agree to payment of a 10 per cent deposit on execution of the Sale Agreement; and nominate specific

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[25] The Request for Proposals required offers to be binding; be unconditional or otherwise have as few conditions as possible; be on the basis of all the assets, contractual rights and obligations, liabilities and employees relating to the airport; and to state the total purchase price which will paid in full in immediately available funds on sale completion.

development commitment amounts over the initial ten year period of the lease. On 30 April 1997, at the conclusion of Stage 3, a prospective selected bidder was chosen for each airport. Each prospective selected bidder then addressed some outstanding issues advised to it and, on 3 May 1997, the Minister for Finance advised the prospective selected bidders that they had been selected as successful bidders. The Sale Agreements were executed on 7 May 1997.

Administrative arrangements

2.29 Arrangements for the lodgement of Stage 2 offers (an original and six copies) were outlined in the Request for Proposals. Upon the lodgement of offers, bidders were issued with a receipt signed by a nominated Business Adviser representative for Stage 2 and Business Adviser and OASITO representatives for Stage 3. Receipts were countersigned by a representative of the lodging party. The original receipt was given to the lodging party and a copy retained by the Business Adviser. The offers were then transferred by OASITO and Business Adviser representatives to a secured room within the data room complex and remained unopened until all bids had been received.

2.30 Stage 2 offers were opened by OASITO and Business Adviser representatives before being made available to the legal advisers and specialist bid evaluation consultants. Certain price sensitive information was removed. Stage 3 offers were opened by an expanded group of OASITO and Business Adviser personnel.

2.31 All advisers and bid evaluation consultants were required to relocate to the data room complex for their examination of the offer documentation. OASITO prohibited the removal of offer documentation from the data rooms. The security of the data room complex was addressed through its design, access controls and electronic 'sweeps' of the complex.

2.32 At the completion of the tender process, the Business Adviser managed the destruction of the bid documentation. Original copies of all bid documentation were to be retained by OASITO. The Business Adviser also retained a set of offers and DoTRD has copies of the three successful offers. The ANAO was advised that the remaining documentation was destroyed and destruction certificates issued. However, the destruction certificates identified the quantity and serial numbers of the security bins in which documents earmarked for destruction had been placed rather than identifying the particular documents destroyed. The ANAO was unable to locate key original documentation in relation to one Stage 2 bid for Melbourne and one Stage 2 bid for Brisbane.

2.33 Finding: Sound administrative practice requires agencies to have procedures in place for receiving, storing, opening, registering, handling and filing offers. Although physical security procedures were in place during the bid evaluation process regarding access to the bid documentation, improvements can be made to procedures for the receipt, opening, registering, handling and filing of offer documents.

2.34 The Business Adviser advised the ANAO that:

> *The finding leaves open the suggestion that security procedures may have been compromised by the administrative procedures adopted in relation to receiving, storing, opening, registering, handling and filing offers. BZW rejects any such implication and stresses that an extremely high level of security procedures and protections were put into place and maintained to ensure the confidentiality of the bid evaluation process.*

Recommendation No. 2

2.35 The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing institute procedures to improve transparency and accountability in future trade sales by requiring bid documents to be numbered consecutively on opening, recorded in a register of tenders and formally signed-out to officers and/or contractors.

2.36 Agencies responded to the recommendations as follows:

- ***OASITO's response:*** **Agreed with qualification**. OASITO accepts the substance of the recommendation but does not accept that the arrangements adopted in Phase 1 had any adverse implications or undue risk.
- ***AGS response*****: Agreed.** Whilst agreeing with the recommendation AGS notes that the arrangements which were put into place for the safe keeping of the bid documentation in Phase 1 were designed to ensure their overall security and safekeeping. The bid evaluation in Phase 1 was conducted out of the premises formerly occupied by the Department of Finance's regional office in Sydney. All members of the Government Sales Team involved in the bid evaluation process were required to be co-located in these premises throughout the entire bid evaluation phase of the process. Appropriate security arrangements were put into place to ensure that only authorised personnel could access those parts of the building where the bid documentation were housed. No copies of the bid documentation were

allowed to be removed from the premises during the course of the bid evaluation process.

Sale coordination

2.37 Asset sales are invariably complex, resource intensive activities undertaken within tight timeframes. OASITO relied heavily on its major advisers and other consultants to undertake the sale. More than 30 contracts were let by OASITO and its major advisers over the three year period of the sale. In these circumstances, prudent contracting and contract management practices are important to ensure value for money and accountability.

2.38 For the Phase 1 airport sales, the major advisers comprised a Business Adviser, Legal Advisers and an Investigating Accountant. These contracts were executed in 1995 and expired on 31 December 1996. The Business Adviser's and Legal Advisers' contracts had to be extended to 30 June 1997 in order to complete the sale. Whereas the Business Adviser's contract included provision for an extension in time to complete the sale, the Legal Advisers' contracts did not.

Business Adviser

2.39 Following a competitive tender, BZW was engaged in June 1994 to provide business advice to the then Department of Transport/Department of Finance Scoping Study Task Force. Its role was to advise on sale options and strategies and the actions required to achieve the Government's sale timetable and prepare the FAC airports for sale. The consultancy ran from June 1994 to June 1995 at a cost of $1.26 million.

2.40 A further competitive tender was undertaken in June 1995 for a business adviser to assist with marketing, due diligence, tendering and bid evaluation, and bidder contract negotiations.[26] The contract was awarded to BZW and was expected to run until at least December 1996 but provided for an extension until 30 June 1997. The contract included base fees of $8 million[27] and fixed fees of $3 million, payable upon completion of the Phase 1 sales. The contract required BZW to act as Business Adviser throughout the implementation phase of the sale of leasehold interests in Melbourne, Sydney

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[26] At this time, the Phase 1 airports comprised Sydney and Sydney West, Melbourne, Brisbane and Perth.

[27] The Business Adviser's contract provided that its base fee was payable on 31 December 1996 and was apportioned as follows: $3.5 million in respect of Sydney/Sydney West; $2.0 million in respect of Brisbane; $1.8 million in respect of Melbourne; and $0.7 million in respect of Perth. A monthly retainer of $175 000 was rebateable against the base fee up to 31 December 1996. Thereafter, the monthly retainer was not rebateable.

(including Sydney West), Brisbane and Perth airports and in preliminary sale preparation to be carried out during Phase 1 in respect of the remaining FAC airports.

Legal Advisers

2.41 AGS was initially engaged in August 1995 to advise on Commonwealth related interests at an expected cost of $1.2 million per annum. In December 1995, after a competitive tender process, AGS was awarded the contract[28] as Legal Adviser for the sale process with Clayton Utz sub-contracted to AGS 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.[29] Fees were capped at $5 million (later reduced to $4.85 million based primarily on the removal of Sydney and Sydney/West from Phase 1) for AGS and $1.25 million for Clayton Utz. Payments made were within these caps.

2.42 The agreement with Clayton Utz was renegotiated in December 1996 with Clayton Utz contracted directly to OASITO from 1 January 1997 to 30 June 1997. AGS' contract was also extended for a further six months. The new AGS contract was capped at $300 000 per month, which was significantly less than average monthly payments under the previous contract. Given that the services required of AGS were similar to those required under the initial contract, the ANAO considers this contract demonstrates value for money for the Commonwealth.

2.43 The Clayton Utz contract was not fully capped and payments averaged $250 000 per month, significantly in excess of average monthly payments under the previous contract.[30] OASITO and AGS have advised the ANAO that the resource commitment required from Clayton Utz between January and June 1997 was significantly in excess of that required of Clayton Utz during 1996 and this justified the increased fees. Clayton Utz has advised the ANAO that:

> *…there was a re-balancing of responsibilities between AGS and Clayton Utz. Clayton Utz became primarily responsible for the preparation and completion of all transaction documentation (except the airport lease) during the period January to June 1997 and was obliged to provide, as requested, specialist legal advice in relation to superannuation, tax, stamp duty, industrial relations and employment law, environmental law and competition law. Clayton Utz was called upon to provide significant specialist resources*

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[28] It was decided by OASITO to roll the earlier AGS contract into this contract.

[29] AGS has advised the ANAO that *this sub-contract arrangement was put into place on the specific request of the Office of Asset Sales. The AGS did not tender in conjunction with Clayton Utz for the project and was required as a result of the tender process conducted by the Office of Asset Sales to enter into this sub-contract arrangement.*

[30] For the last six months of 1996, payments to AGS averaged $500 000 per month. For this same period, payments to Clayton Utz averaged $150 000 per month.

between January and June 1997 in order to assist the OAS meet the Government's timetable.

Contracting process

2.44 The core principles and policies of Commonwealth procurement include the achievement of value for money; open and effective competition; ethics and fair dealing; and accountability. The use of competitive tendering promotes open and effective competition by calling for offers which can be evaluated against clear and previously stated requirements to obtain value for money. This in turn creates a framework for a defensible, accountable method of selecting a service provider. For a variety of reasons, a small number of contracts arranged by OASITO were not competitively tendered.[31]

2.45 To manage the cost of the sale, OASITO introduced fixed fee arrangements or fee caps in a number of instances. To enforce fixed fee arrangements and otherwise constrain costs, requests for proposals need to identify as far as possible the full scope and nature of services required, which can then be reflected in the contract. In a number of instances OASITO was unable to enforce fixed fee arrangements or otherwise constrain costs because the contractor was required to undertake work outside the scope specified in the Request for Proposals and included in the contract.[32]

2.46 A signed written contract is a fundamental tenet of sound contracting processes. The ANAO noted that contracts were not finalised and signed in a small number of instances during the sale process.[33] There were also instances where contracts were not signed until after the contractor had commenced work although the ANAO has been advised that the terms had generally been established.[34]

2.47 Successful contract management requires articulation of standards of service and deliverables in the contract together with specified obligations for the provider to submit verifiable information regarding progress and

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[31] This comprised superannuation advice ($130 000); passenger and traffic forecasts ($245 000); and property valuation ($215 000).

[32] This comprised contracts for the Investigating Accountant (total value: $1.4 million); establishment and management of buyer data rooms (total value: $1.1 million); environmental advice (total value: $158 000) and passenger and traffic forecasts (total value: $245 000).

[33] This comprised design, typesetting and printing of the tender documentation ($912 000); provision of superannuation advice ($130 000); provision of legal services by AGS between August 1995 and December 1996 ($4.85 million); and the provision of insurance advice ($18 000).

[34] These included the Clayton Utz subcontract with AGS ($1.3 million); establishment and management of buyer data rooms ($1.1 million); Stages 2 and 3 of the scoping study Business Adviser consultancy ($900 000); property valuation services ($215 000); passenger and traffic forecasts ($245 000); updating of the airports financial model ($52 000); and the initial legal services agreement with AGS (expected value of $1.0 million but only $70 000 in actual payments as the agreement was replaced after the first month).

performance. A number of contracts let during the sale did not include performance monitoring arrangements such as regular reports on progress, resources used and costs. The Investigating Accountant contract was the most significant of these as it did not include provisions for monitoring costs incurred but not invoiced. As a result, OASITO was unaware of the increasing likelihood of cost overruns during the contract period. OASITO has advised the ANAO that:

> *…while performance standards and monitoring arrangements were not explicitly included in all contracts, all of the OAS' major advisers participated in a weekly project priorities meeting to monitor progress of the sale. These meetings considered all material issues. At crucial periods of the sale, issues were monitored on a daily basis by way of an issues list produced and distributed to all members of the Government Sales Team by BZW.*

2.48 Structuring contracts so that the Commonwealth can ensure that the consultant delivers on the full range of services assists protection of the Commonwealth's interest. Amendments to the Business Adviser's contract made in September 1996 required it to advise on options for dealing with the FAC 's debt and to implement the Government's FAC debt strategy. The ANAO found that OASITO primarily undertook development and implementation of the debt assumption strategy. The Business Adviser's fees were not reduced to reflect this change in scope. OASITO has advised the ANAO that the Business Adviser:

> *…did advise on the options for dealing with the FAC debt and assisted in the implementation of a strategy. Accordingly, there was no reduction in the scope of the work performed by BZW and its consultancy contract with the Commonwealth.*

2.49 Finding: Sound administrative principles and policies for Commonwealth procurement include the achievement of value for money and open and effective competition. However, during the sale process sound contracting practices were not consistently adopted to implement these principles and policies. A small number of contracts were not competitively tendered; contracts were not finalised and signed in a number of instances; and a number of contracts let during the sale did not include performance monitoring arrangements such as reports on progress, resources used and costs incurred.

2.50 The OASITO advised the ANAO that it does not agree with the finding and stated that it:

…accepts that, as a consequence of changed organisational arrangements and maintained time and resource pressures, some contractual matters were handled in an expeditious manner. Which while cost effective and representing adequate risk management, may not have been fully documented. In the overall scheme, OASITO considers that its contract management represented value for money and satisfactory risk management.

Recommendation No. 3

2.51 The ANAO *recommends* that, the Office of Asset Sales and IT Outsourcing strengthen its contracting for services by:

a) improving planning for major contracts by identifying the critical path for the selection and appointment of all major consultants and competitively tendering contracts wherever possible; and

b) improving its contract management by including performance monitoring arrangements in all major contracts such as reports on progress, resources used and costs incurred.

2.52 OASITO's response to the recommendation was that it **agreed with qualification.** OASITO accepts the thrust of this recommendation, subject to risk management and cost-effectiveness considerations on a case-by-case basis. OASITO considers that competitive tendering should be undertaken when "appropriate" rather than where ever "possible". OASITO considers that its contract management in Phase 1 was cost effective and provided satisfactory risk management and that the outcome of the sale demonstrated that value for money was achieved in an overall sense.

2.53 ANAO comment: The ANAO recognises that contracting practices and procedures should be directed primarily at achieving value for money in the acquisition of services. To achieve such outcomes, successful contract management requires articulation of standards of service and deliverables in the contract together with specified obligations for the provider to submit verifiable information regarding progress and performance. The ANAO, as noted above, did not find evidence of this occurring in respect of all contracts let during the sale process. Contracting deficiencies identified included the absence of written contracts and performance monitoring arrangements.

Management of outsourcing

2.54 In July 1996, the Business Adviser was asked to assume primary responsibility for management and completion of the Information Memoranda, and assisting the FAC to clarify the Domestic Terminal Leases with Ansett and Qantas. Contract fees and expenses were increased by $550 000 to reflect this increased scope.

2.55 The Business Adviser contract was further extended in August 1996 to allow the Business Adviser to take responsibility for project planning; management of existing consultants and contracting further consultants; due diligence; coordination and resolution of Commonwealth-State issues and industrial relations issues; and FAC debt strategy implementation.[35] Fees payable under the contract were increased by $4.4 million to reflect the Business Adviser's expanded role and by $1.05 million to reflect extension of the sale to 30 June 1997 (making the total value of the contract $15.8 million). OASITO did not renegotiate the Business Adviser's base fee to reflect the removal of Sydney and Sydney West from Phase 1 but did remove the relevant completion fee.[36]

2.56 The ANAO advised OASITO on 10 September 1997 of a possible overpayment of $79 030 to the Business Adviser which it had detected. The ANAO's scrutiny of OASITO's financial records indicated that the Business Adviser had been paid twice for the latter half of December 1996. OASITO has advised the ANAO that the Business Adviser has confirmed the error and repaid the amount of $79 030 on 20 October 1997.

2.57 The Business Adviser's contract required it to conduct tenders, negotiate contracts and confidentiality agreements and manage contractors in accordance with OASITO's directions. However, the contract did not require the Business Adviser to implement the Commonwealth Procurement Guidelines. Regulations issued under the *Financial Management and Accountability Act 1997* require officials performing procurement duties to have regard to the Commonwealth Procurement Guidelines.[37]

2.58 The Business Adviser recommended, and OASITO endorsed, a number of contractors for the sale. The contracts for bid evaluation advice on

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[35] OASITO was to be responsible for top level project management and control; playing a key role in bid evaluation and contract negotiations; protection of the Commonwealth's policy and other interests; ensuring accountability; management of the Business Adviser and legal advisers; and risk management.

[36] OASITO advised the ANAO that:*...a considerable component of BZW's overall fee comprised the completion fees. The removal of the relevant completion fee involved a significant reduction in BZW's total remuneration. Given that BZW's total remuneration had been significantly reduced by the removal of the completion fee, OASITO did not consider it reasonable or commercially justifiable to also seek to reduce the base fee.*

[37] At the time of sale of the Phase 1 airports, regulations issued under the *Audit Act 1901* included the same requirement.

airport planning and environmental matters; review of the capital expenditure

reimbursement amounts; and an audit of the working capital adjustment statements arranged by the Business Adviser were not competitively tendered.[38]

2.59 The Business Adviser also managed the contracts arranged by it as well as managing some contractors previously appointed by OASITO. The Business Adviser did not bear the effective financial risks associated with these contracts. Instead, OASITO met all fees and expenses of contracts arranged and managed by the Business Adviser, including meeting any cost overruns although the business adviser contract only required OASITO to meet the agreed costs of sub-contractors.

2.60 The major contracts arranged and/or managed by the Business Adviser were the Investigating Accountant; establishment and management of buyer data rooms; and design, typesetting and printing of tender documentation. These contracts involved significant cost overruns with the final total cost ranging from almost 1.5 times to more than 3.5 times the initial estimate.

2.61 OASITO has advised the ANAO that:

> *Contracts with advisers provided that payment would be made where the specified work was carried out as required under their relevant contract. Payment would only be made on successful completion of work carried out in accordance with the contract. There were no consultants in Phase 1 who did not perform to the requirements of their contracts. It is important to note that the contract with BZW for the sale of the Phase 2 airports provides for BZW to bear any cost overruns incurred by sub-consultants, except where the cost overrun arises directly from a Commonwealth Government decision.*

2.62 Finding: The Commonwealth Procurement Guidelines state that value for money is the essential test against which any procurement outcome must be justified. However, OASITO's management of the outsourcing of the selection, appointment and management of contractors did not always demonstrate value for money. The major outsourced contracts involved cost

[38] The evaluation contract for accounting, tax and superannuation advice was not competitively tendered but was awarded to the investigating accountant whose original contract was competitively tendered. OASITO advised the ANAO that *it was not known, when KPMG was first engaged very early in the sale process, what consultants would be required for the purpose of bid evaluation. It was not clear, at that time, what issues would need to be considered. At that stage, the tender documentation and sale documentation had not been specified and the bid evaluation process had not been determined. In light of this, it was not cost-effective to include bid assessment tasks in the scope of KPMG's initial contract.*

overruns with the final total cost ranging from almost 1.5 times to more than 3.5 times the initial estimate. The Commonwealth retained the effective financial risks associated with the outsourcing.

2.63 OASITO advised the ANAO that:

> *OASITO accepts that its process documentation may not have always demonstrated narrowly based value for money to the satisfaction of the ANAO. However, OASITO suggests that the outcome of the sale demonstrated that value for money was achieved in the more relevant context of the overall sale process.*

Recommendation No.4

2.64 The ANAO *recommends* that, where applicable for future trade sales, the Office of Asset Sales and IT Outsourcing in outsourcing tasks, include:

a) provisions in major adviser contracts that require advisers who are authorised to let contracts on behalf of the Commonwealth to comply with the Commonwealth Procurement Guidelines; and

b) caps for sub-contractor fees and expenses in major adviser contracts to ensure that the Commonwealth does not bear the commercial risk of cost overruns.

2.65 Agencies responded to the recommendation as follows:

- ***AGS* response**: **Agreed.** It should be noted that, in all contracts let by the Office of Asset Sales for the Phase 1 airports, contractors were required to comply with all applicable Commonwealth legislation. It should also be noted that in contracts relating to the engagement of the Business Adviser and Legal Advisers, contractors were required to act in accordance with the directions of the Office of Asset Sales. Accordingly, the contractual arrangements in Phase 1 were drafted in such a way as to enable the Office of Asset Sales to ensure that Government Procurement Guidelines were followed.

  In relation to the recommendation that sub-contractor fees and expenses be put into place, AGS notes that whilst it agrees with this proposal, the observation should be made that the ability to put in place effective fee cap arrangements is contingent on the contract being comprehensive enough to fully describe the consultancy services required to be provided by the relevant sub-contractor. To the extent that the description of services to be provided is not complete this leads to the possibility of sub-contractors

seeking to argue for amendments/variations to any agreed fee cap at a later date.

- ***OASITO's response:*** **Agreed (a). Disagreed (b).** OASITO disagrees with Recommendation No. 4(b) because it is not always cost-effective to require contractors to carry all risks. While Recommendation 4(b) only applies "where applicable", it establishes an unbalanced presumption. While a contractor should bear commercial risk from its own commercial conduct and judgement, many contractors act, in effect, as agents of the Commonwealth. In that capacity it is often neither equitable or cost-effective to expect them to bear the commercial risk of cost overruns arising from the risks that are inherent in the underlying assignment.

2.66 ANAO comment: The ANAO recognises that effective contract management requires an agency to identify and manage the commercial risks arising from outsourcing. This includes establishing a contractual relationship that ensures the Commonwealth does not bear cost overruns in relation to tasks that are the responsibility of the contractor. Indeed, OASITO advised the ANAO that the contract with the Business Adviser for the sale of the Phase 2 airports provides for the Business Adviser to bear any cost overruns incurred by sub-consultants, except where the cost overrun arises directly from a Commonwealth Government decision (see para 2.61). The ANAO considers that this represents a sound management framework for outsourcing and is in line with Recommendation No. 4(b).

Logistics consultants

2.67 The appointment and management of logistics consultants is an important element of the coordination of any sale. Efficient sale coordination necessitates the early appointment of consultants to advise on logistical aspects of the sale and properly plan assignments. The major logistics consultancies for the Phase 1 airports sale involved the establishment and staffing of buyer data rooms and the design, typesetting and printing of tender documentation.

2.68 The major logistics contracts were arranged during the period when OASITO staffing levels were being reduced and particular tasks were outsourced from OASITO to the Business Adviser. In both instances contractors were appointed very late in the preparatory phase of the sale process (early September 1996) allowing little time for them to plan their assignment and precluding them from advising on logistical aspects of the sale before the tender timetable and procedures had been decided. As a result,

both contractors claimed fees that were well in excess of the Business Adviser's initial estimate of costs.

Printing contract

2.69 Information memoranda perform an important marketing role.[39] They are generally issued before shortlisted bidders are provided with an opportunity to review detailed information in buyer data rooms. Difficulties experienced by OASITO in producing the Information Memoranda and other tender documentation for the Phase 1 airports sale had the potential to delay the sale process and led to a significant increase in costs for this aspect of sale preparation.

2.70 OASITO planned to seek expressions of interest in September 1996 and release the Information Memoranda in October 1996. In mid-August 1996, OASITO requested the Business Adviser to arrange a printing contract. On 28 August 1996, the Business Adviser invited five printers to submit quotes for printing of 400-500 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. A printer was selected in early September 1996. Based on fee rates quoted, the Business Adviser estimated design, typesetting and printing would cost in the vicinity of $250 000.

2.71 The printer designed the style and format of the tender documentation and produced 800 copies of the Invitation to Register Expressions of Interest ahead of schedule on 12 September 1996 and commenced work on the remaining tender documentation. After commencing work on producing the Invitation to Register Expressions of Interest, 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 advised the Business Adviser on 26 September 1996 that it would not agree to the indemnity clauses contained in the proposed contract and the confidentiality deeds the Business Adviser requested be signed by all employees.

2.72 After deciding to change printers, the Business Adviser approached the firm ranked second following the initial tender. The second printer was told that the tender documentation needed to be completed within a very short time frame and was asked if it would be able to complete the job by the deadline and whether it would be prepared to take on the job. The firm agreed to take over the job and provided fee rates but not a total fee estimate.

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[39] In May 1995, the Business Adviser advised OASITO that to maximise competitive tension and instil confidence in the process and the suite of documentation on which offers would be based, the tender documentation needed to be of the highest quality in terms of presentation, clarity, consistency across all three airports, accuracy and establishment of the investment case; and delivered on time.

2.73 A draft contract including Commonwealth standard form indemnity clauses and standard confidentiality agreements used in the sale was provided to the second printer on 28 September 1996. Confidentiality deeds were signed but no contract was signed. On 30 September 1996, the first draft of the tender documentation was provided. The ANAO has been advised that at least nine further drafts followed with comments being provided direct to the printer. The tight timeframe and absence of a detailed plan and coordination arrangements were reflected in the number and extent of difficulties that arose between the printer and the Business Adviser. Printing of the tender documentation was completed on 28 October 1996.

2.74 The Business Adviser disputed the invoice amount but the absence of a contract meant there were no agreed performance standards to assess the printer's performance and limit costs. Negotiations between OASITO, the Business Adviser and the printer resulted in payment by OASITO of $880 000 in June 1997, some eight months after the job was completed.[40] Including payments to the first printer for the initial phase of the task, the total cost of designing, typesetting and printing tender documentation was $912 000.

2.75 Finding: Contracts for the design, typesetting and printing of the tender documentation and the establishment and management of buyer data rooms were not let sufficiently early to allow appropriate planning and reasonable time to complete the task. Indeed, there were no written contracts for the design, typesetting and printing of the tender documentation, a task which had a total cost of over $900 000, more than 3.5 times the initial estimate.

2.76 OASITO advised the ANAO that:

> *OASITO considers that this finding should also have noted the associated circumstances, particularly the requirement for BZW to assume responsibility for some work which previously was envisaged to be handled by OASITO. We accept that in a better resourced, ideal world some matters may have been handled differently, although probably with no material effect on risk or outcome. OASITO considers that the variation in sale costs that the ANAO mentions are not material, when taken in the overall context of the sale.*

[40] There were 400 bidder packs produced and distributed among OASITO, its advisers and the twelve consortia shortlisted to proceed to Stage 2.

Recommendation No.5

2.77 The ANAO *recommends* that, for future asset sales, the Office of Asset Sales and IT Outsourcing ensure that logistics consultants are engaged early in the sale process to allow:

a) a formal, written contract, including indemnities and confidentiality provisions, to be drafted and signed prior to work commencing;

b) expert advice on logistical aspects to influence the tender timetable and procedures;

c) appropriate planning of logistical activities; and

d) efficient and effective management of sale costs.

2.78 OASITO's response to the recommendation was that it **agreed with qualification.** OASITO notes that externally mandated timetables that can often only be met by cost-effective "fast-track" management techniques may limit the scope for such an approach. Where the benefits of a faster timetable outweigh the risks and cost of such fast-tracking, it will still be appropriate and cost effective to proceed without such extensive and formal pre-planning.

3 . Bid Assessment

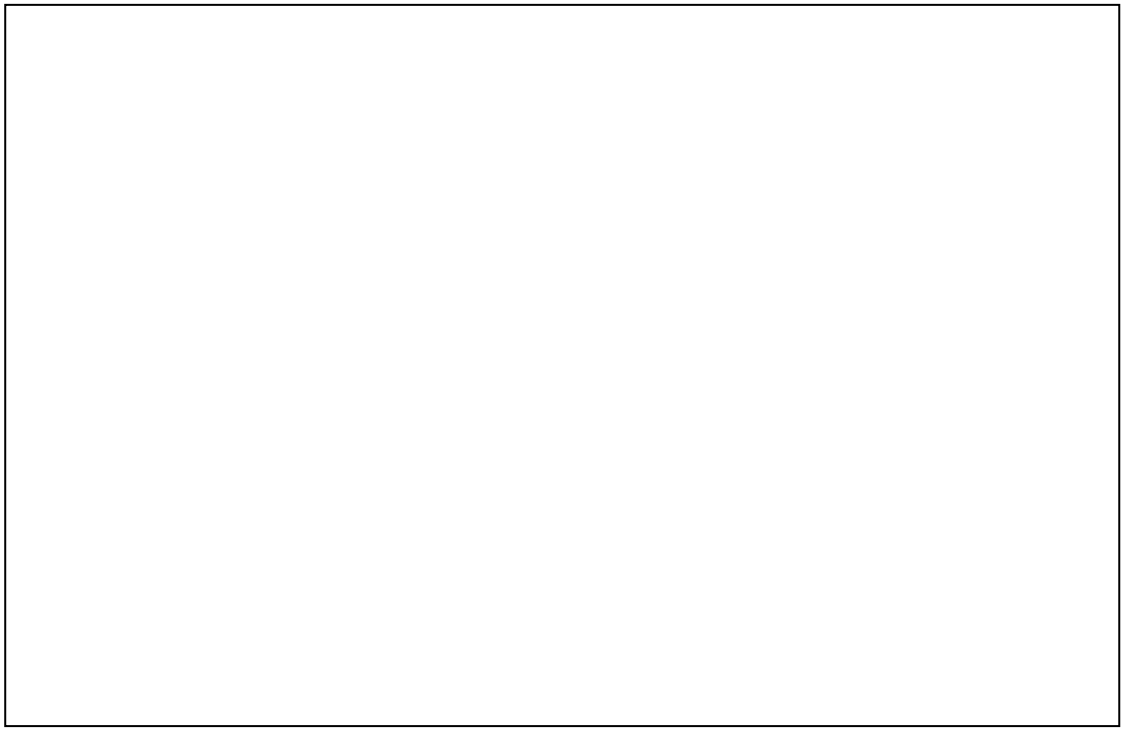
This chapter outlines the bid evaluation methodology, process and outcome.

Evaluation methodology

3.1 The Business Adviser was responsible for managing and coordinating the overall bid evaluation process, in consultation with OASITO. Exhibit 3.1 outlines the division of bid evaluation responsibilities between OASITO and its advisers and the role of specialist bid evaluation consultants and the DoTRD.

Exhibit 3.1

Bid Evaluation Process



Source: ANAO analysis based on information provided by OASITO and DoTRD.

3.2 The Request for Proposals issued to bidders in October 1996 for Stage 2 (see Exhibit 2.1) of the bidding process stated that the evaluation criteria would involve consideration of the extent to which offers maximised net sale proceeds to the Commonwealth; their conformity with the transaction documentation; the certainty and clarity of offers; the extent to which they satisfied the Government's stated sales and ongoing privatisation objectives; and their conformity with the Government's preferred terms of sale. The Request for Proposals also advised bidders that no particular weighting or priority should be inferred from the order in which the criteria were specified.

3.3 The Business Adviser discussed and agreed with OASITO a set of key assessment criteria which accorded with the evaluation criteria specified in the Request for Proposals. These key assessment criteria were applied in the assessment of bids. They comprised the total bid price; allocation of risk; financial strength; conformity with the Request for Proposals, policy and regulatory requirements; quality of service commitment; certainty and clarity of offers; and management commitment and capability.[41]

Specialist consultants

3.4 An important element of the bid evaluation process was the contracting of specialist consultants to undertake a qualitative assessment of each bidder's development plan; assess compliance with the Request for Proposals and the Airports Act; and advise on issues that should be considered in bid evaluation and negotiations with bidders; and assess environmental matters pertaining to each airport in terms of key environmental features; compliance with the Request for Proposals; and compliance with the Airports Act and draft Airports (Environment Protection) Regulations. Each consultant provided a copy of its report to the Business Adviser.[42] The Business Adviser recommended against contracting specialist expertise to evaluate Stage 3 offers. Instead the Business Adviser took primary responsibility[43] for the Stage 3 evaluation of development plans and commitments and environmental issues.

3.5 Most of the issues identified by the environmental consultant were referred to bidders proceeding to Stage 3. The Business Adviser's Stage 3 evaluation reports concluded that the information provided by most bidders

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[41] Assessment against the conformity and management criteria is included in Chapter 4.

[42] The Business Adviser advised the ANAO that: *The two specialist sub-consultant's work was undertaken to inform, and not direct, the broader analysis being undertaken by the DoTRD, the OAS and the OAS' advisers in relation to the assessment process. It was never intended to be incorporated, as a matter of course, directly into the body of the main evaluation reports and, in any event, it was understood that the OAS' principal business and legal advisers reserved discretion as to what, if any, use was made of the specialist sub-consultants' reports.*

[43] The Business Adviser advised the ANAO that: *… there was some sharing in this regard with the DoTRD.*

satisfied the issues for clarification raised by the consultant. Some bidders did not address all the issues raised by the consultant but this was not commented on in the Business Adviser's Stage 3 evaluation reports.[44]

3.6 The Business Adviser advised the ANAO that it considers:

> *…the Stage 2 and 3 evaluation reports addressed all material issues relevant to the assessment and decision making process (including all material issues raised with bidders)…In relation to the environmental issues…very limited new environmental material was sought and received by the Government in Stage 3. Such material that was provided, was reviewed by relevant members of the Government Sales Team. None of the new material reviewed was considered sufficiently material to justify comment in the Summary Evaluation Report provided to Ministers.*[45]

Ranking of criteria

3.7 At the request of OASITO, the Business Adviser developed and agreed with OASITO and the legal advisers an approach to ranking each bid against the non-price assessment criteria. The rankings involved ranged from good to poor. The Commonwealth Procurement Guidelines indicate that evaluation criteria should clearly identify the relative importance of all relevant factors and provide a sound basis for a decision on a tender.[46] Sound administrative practice suggests that a sale tender evaluation plan be prepared detailing the overall objectives of the tender and how the outcomes are to be achieved. The tender evaluation plan, that may or not be available to prospective bidders, will include the tender evaluation methodology to be employed. The relative importance attached to each criterion should be included in the tender evaluation methodology. This provides for transparent and accountable decision-making.

3.8 OASITO and the Business Adviser did not specify in the evaluation methodology used for assessing bids, at any time during the tender process,

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[44] The Business Adviser's Stage 3 evaluation reports also did not re-assess the environmental features of each bid, or compliance with the Request for Proposals, Airports Act and draft Airports (Environment Protection) Regulations.

[45] OASITO advised the ANAO that: *in relation to the rationale for accepting or rejecting the views of specialist bid consultants, the following might be noted. The reports prepared were considered by BZW, OAS and DoTRD for relevance to areas of their own reports and briefing, and incorporated as they considered appropriate. The reasons why the findings of specialist bid evaluation consultants did not necessarily translate directly into the criterion to which they related are: the reports were critically examined rather than accepted at face value (which was important given that the specialist sub-consultants often had incomplete information); and the reports were only one element in determining a rating against the criterion to which they related and were, in some cases, counterbalanced by other considerations.*

[46] *Commonwealth Procurement Guidelines*, July 1997, p.11.

weightings or priorities for each assessment criterion which set out their relative importance for evaluation purposes. Stage 2 bids were given a ranking against each criterion but no overall ranking was developed. Bids which were considered uncompetitive did not proceed to Stage 3.

3.9 At the end of Stage 3, each bid was given an overall ranking in order to select a preferred candidate. The primary determinant of rankings was the offer price with most bids similarly ranked on non-price criteria. OASITO advised the ANAO that:

> *The broad approach adopted by the Government Sales Team in relation to the issue of weightings and assessment was as follows:*
>
> - *no weightings were specified in the tender documentation issued to bidders. This decision was made on the basis that the Government Sales Team did not consider the evaluation criteria conducive to a comprehensive, predetermined, weightings based approach given that the criteria included both quantitative and qualitative objectives and elements;*
> - *in discussions with bidders, bidders were advised that price was clearly an important criterion but that bidders should ensure that they address all of the assessment criteria;*
> - *bidders were also made aware that certain assessment issues (such as compliance with the Airports Act requirements) was mandatory under all circumstances;*
> - *as no weighting had been pre-specified in the tender documentation, Ministers were provided with a full evaluation summary table including assessments against each specific evaluation criterion. This was designed to ensure maximum transparency against the Government Sales Team's selection recommendations;*
> - *selection recommendations at the end of Stage 2 for Stage 3 were based on whether or not a particular candidate was considered as having a reasonable prospect of emerging as a successful candidate in Stage 3 based on its Stage 2 offer and the stated evaluation criteria;*
> - *bids were evaluated against the full range of the Government's stated evaluation criteria and (with the exception of price and bidder's contractual development commitments) assigned ratings on a five tier scale of "Good" to "Poor"; and*
> - *as the qualitative elements of the bids lodged at the end of Stage 3 were broadly similar (with most bidders being assigned*

a reasonably high rating in the range of "Medium" to "Good"), bids were ultimately distinguished on the basis of price on a risk adjusted basis. This methodology was made clear to Ministers in the Stage 3 presentation and was consistent with advice provided to bidders throughout the Phase 1 tender process.

3.10 Finding: Sale objectives were addressed during the bid evaluation process by predetermined assessment criteria and a structured approach to ranking against individual criteria. OASITO and the Business Adviser did not specify in the sale tender evaluation methodology, at any time during the tender process, weightings or priorities for each assessment criterion which set out their relative importance for evaluation purposes. Sound administrative practice suggests that the relative importance attaching to each criterion should be included in the tender evaluation methodology to be employed.

3.11 The Business Adviser advised the ANAO that:

BZW considers the development of evaluation criteria priorities is only suitable where the prioritisation adopted reflects an accepted policy position endorsed by relevant parties within the Government (which, BZW believes, may be frequently difficult to determine on an advance basis given the complex balancing which often needs to occur in assessing trade-offs between different Government sales objectives); and the prioritisation can be articulated in clear and useful way.

If these basic preconditions are not satisfied, BZW considers a literal application of ANAO's recommendation could potentially result in unnecessary complication and reduced flexibility in the subsequent evaluation and decision making processes…BZW rejects any suggestion that the evaluation undertaken in Phase 1 was not consistent with "sound" administrative practices.

Recommendation No. 6

3.12 The ANAO *recommends* that, for future trade sales, the Office of Asset Sales and IT Outsourcing enhance transparency and accountability of decision making in the tender process by evaluating the merits of incorporating, as part of the tender evaluation planning process, the development of appropriate priorities which set out the relative importance attaching to each evaluation criterion.

3.13 Agencies responded to the recommendation as follows:

- ***OASITO's response:*** **Agreed with qualification.** OASITO considers that the development of such evaluation criteria priorities, but of course consistent with the need to observe proper tender procedures, needs to preserve the scope for political judgement to be applied to the final balancing of bid attributes, in order to properly allow for the application of high level qualitative judgements. Flexibility is also important, when developing tender criteria, to allow proper scope to evaluate innovative proposals that may not have been properly considered by an unduly rigorous ex ante evaluation framework.
- ***AGS response:*** **Agreed.** AGS would agree that where possible tender evaluation criteria should be prioritised in a manner which sets out the relevant importance attaching to each evaluation criterion.

  Having said this, it should be noted that the evaluation criteria applicable to the Phase 1 airports sales did not lend themselves effectively to a mechanical weighting system. It should also be noted that Ministers needed to be given the opportunity to make important relativity judgements between the evaluation criteria in light of a thorough briefing on the bids by the Office of Asset Sales and its business adviser BZW.

3.14 OASITO advised the ANAO that it considers such an approach would not have been appropriate in the circumstances of this sale, given that the evaluation criteria were not conducive to mechanical trade-offs. Instead, Ministers needed to be given the opportunity to make important relative judgements regarding bid information in the light of thorough briefings on the bids.

Price criterion

3.15 Each bidder was required to state the purchase price it was prepared to pay for the grant of the airport lease and the transfer of the assets, contractual rights and obligations, liabilities and employees of the FAC relevant to the operation of the airport. The purchase price was to be on the basis of payment in full in Australian dollars in immediately available funds on completion; that there would be no adjustments to the purchase price except as provided for in the draft Sale Agreement; and, in addition to the purchase price, the lessee would reimburse the Commonwealth for designated capital expenditure incurred at the airport between 1 July 1996 and three days prior to completion.

3.16 The accepted Stage 3 purchase prices totalled $3.2 billion. In addition to the purchase prices, a total of $47 million in reimbursed capital expenditure has been paid to the Commonwealth. Upon signing of the Sale Agreements

on 7 May 1997, the Commonwealth received 10 per cent of the purchase price and the estimated capital expenditure reimbursement. The balance of the purchase price and capital expenditure reimbursement together with initial payments for the building control and environmental officers was received on 1 July 1997. A further payment of $61 million from the successful bidder for Brisbane was received on 16 February 1998 pursuant to an agreement between the bidder and the Commonwealth.

3.17 The bid accepted for Perth of $631 million offered the highest purchase and highest net price. The bid accepted for Brisbane of $1.314 billion was the highest net price offer after the highest indicative proposal was considered to be non-compliant with major aspects of the Request for Proposals and after factoring in a further contingent payment by the successful bidder. The bid accepted for Melbourne of $1.255 billion was the highest net price offer after the highest offer price was adjusted for the estimated taxation revenue impacts of infrastructure bonds.

Market risk

3.18 Bidders were required to hold their Stage 2 bids open until 31 May 1997. The highly leveraged nature of most bids meant they were sensitive to interest rate movements. This sensitivity, together with the lengthy acceptance period, led to four of the consortia including conditions in their Stage 2 bids entitling them to review or adjust their bid price in the event of an increase in interest rates. Any decision to seek a further round of bids involved giving all bidders the opportunity to review their bid prices and, if interest rates rose, had the potential to lead to a reduction in bid prices.

3.19 OASITO has advised the ANAO that:

> *The Stage 2 Summary Evaluation Report provided to Ministers included a summary of the major conditions included in Stage 2 offers. The report noted that a number of bids included conditions entitling the bidder to review its bid price or its offer in the then current interest rate regime. The report also noted that there was a risk that such clauses could be triggered but noted that the evaluation had not assigned a significant discount for such conditions given, amongst other things, the requirement that bids must remain open for acceptance until 31 May 1997. It also recommended that the Commonwealth seek effective removal (or at least limitation) of such conditions in the further offers.*
>
> *Ministers were also advised verbally in the Stage 2 presentation of the existence of such conditions and the potential for increases in interest rates to adversely affect Stage 3 prices.*

3.20 Written advice was not provided by OASITO to Ministers regarding the potential impact of adverse interest rate movements on offer prices, based on the nature of the interest rate conditions included in Stage 2 offers. OASITO has advised the ANAO that:

> *The issue of market and interest rate risk was considered by the BZW and OAS in the context of evaluating Stage 2 and 3 offers and in assessing the merits of allowing a reduced number of bidders the opportunity to proceed to Stage 3. BZW's assessment included, inter alia, a consideration of the then current market conditions and interest rate regime and the potential implications of any significant changes on the then current interest rate regime.*[47]
>
> *A more detailed analysis was given to assessing interest rate sensitivity in Stage 3. This included active monitoring and regular reporting to the OAS on interest rate movements and closer analysis of the interest rate sensitivity of each of the Stage 3 bids given the substantially less conditional nature of Stage 3 bids overall, the Government Sales Team's assessment that a successful bidder was capable of being selected for each airport on the basis of Stage 3 offers submitted and the prospect that final selection decisions would be taken at that time.*

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[47] OASITO advised the ANAO that:

This judgement was made having regard to the following considerations:

the speculative nature of the subject;

- *the fact that only a small number of Stage 2 bids and bidders included interest rate conditions and that, at least in relation to one of these, it was not possible to determine the sensitivity of price to the condition. In the other two cases, bid adjustment was not automatic;*
- *in relation to other bids, there was no clear and necessary relationship between interest rate movements and bid prices. Ministers were nevertheless advised, in the Stage 2 presentation, of the potential for an increase in interest rates to adversely impact Stage 3 offer prices;*
- *in the Government Sales Team's view, the Commonwealth was not in a position at the end of Stage 2 where it could have accepted, without further discussion and likely negotiation and delay, any of the more highly ranked Stage 2 offers. This was because most of the leading Stage 2 offers were highly conditional. In addition, emerging policy and sales issues (eg environmental and building control officer costs etc), not previously resolved with or disclosed to bidders in Stage 2, meant that new conditions would need to be imposed and agreed to by bidders in Stage 3 whatever action was taken post Stage 2; and*
- *the Government Sales Team was also of the view that allowing a further round of bids for a reduced number of candidates in Stage 3 would create the most competitive framework in which to reduce conditionality, improve conformity and provide a stronger basis upon which a successful candidate for each airport could be selected.*

In the context of the above considerations, both BZW and OAS considered that attempting, at the end of Stage 2, to quantify the potential impact on Stage 2 offer prices of possible future changes in interest rates would be potentially misleading and would be unlikely to assist decision making and Stage 2 bid analysis.

3.21 The ANAO recognises the views expressed by OASITO and the Business Adviser but considers that, in accordance with sound risk management practices, quantification needs to be undertaken to ensure that risks can be properly assessed. Between submission of Stage 2 bids on 30 January 1997 and bidders being advised of a further round of bids on 11 March 1997, the five year swap rate rose by 44 basis points and the ten year bond rate rose by 37 basis points.[48]

3.22 The Business Adviser advised ANAO that:

> *Whilst quantifying interest rate risk exposure may be a useful exercise in some instances, BZW considers that the issue of interest rate and market risk were appropriately analysed and managed moving forward into Stage 3 of the Phase 1 process.*
>
> *At the end of Stage 2, the Commonwealth was presented with 21 bids for the three Phase 1 airports from nine consortia. Only three bidders included interest rate conditions. Each of the conditions was generally framed and, with one exception, was not capable of ready quantification. In addition, none of the interest rate conditions were expressed to give rise to automatic adjustments to bid price.*

3.23 A number of the bidders who had included an interest rate condition in their Stage 2 bids reduced their Stage 3 bids.[49] With the exception of one bidder who reduced its offer after agreeing to the Commonwealth's preferred position that bidders assume stamp duty risk, the only bidders who reduced their offers between Stages 2 and 3 were those who had included an interest rate condition in their Stage 2 offer.

3.24 **Finding:** The decision to conduct a further round of bids involved risks for the Commonwealth since bidders had the opportunity to revise or even withdraw their bids. OASITO has advised the ANAO that a further round of bids was undertaken to maximise competitive pressures as a means of

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[48] The five year swap rate rose by a further 14 basis points and the ten year bond rate by a further 17 basis points between 11 March 1997 and the submission of Stage 3 bids on 10 April 1997.

[49] In addition, one of the successful bidders increased its purchase price ofer by $2 million between Stages 2 and 3 but stated in its Stage 3 offer that it was…*pleased to be able to continue to offer this priace notwithstanding significant increases in interest rates since 30 Jaunuary, which, in the absence of corrective action by [the consortium] would have resulted in a price reduction of $85 million*.

managing overall risks to the Commonwealth and that the Business Adviser identified and assessed the risk that adverse movements in interest rates could adversely impact on offer prices.

Taxation implications

3.25 The numerous issues that could affect future Commonwealth tax receipts from the operation of the Phase 1 airports include gearing levels, whether tax effective financing structures (either in Australia or overseas) are adopted to reduce the after-tax cost of finance, and the taxation rules in the home countries of foreign investors.[50] Bidders' financial forecasts disclosed a wide range of tax positions at the airport lessee company level. Some bidders were forecasting company tax payments throughout the forecast period whereas others did not expect to pay company tax for a number of years. Higher geared bids generally offered higher sale prices but many also forecasted not paying company tax for some considerable time after the grant of the lease.

3.26 Bidders were initially advised that the Commonwealth reserved the right to assess the tax impacts of bids, including financing structures, in the mid term review meetings held with bidders in early December 1996, prior to lodging Stage 2 bids. Bidders were informed in a letter dated 6 January 1997 that, while it was not expected that tax considerations would form a major part of the bid assessment process, the Commonwealth nonetheless reserved the right to assess tax impacts in such a manner as it considered appropriate. Bidders were further advised on 11 March 1997 that, in assessing the net sales proceeds, the Commonwealth would have regard to the financing and other structures submitted by bidders and in particular the effect of such on any expected future tax receipts.

Infrastructure bonds

3.27 OASITO has advised the ANAO that *all Stage 3 bidders were advised that the Commonwealth intended to assess the tax impacts of infrastructure bonds.* The outcome of this assessment was that one bidder's ranking for Melbourne Airport in relation to the price criterion changed from first to third.

3.28 Infrastructure bonds aim to encourage private sector involvement in public infrastructure projects by providing a tax effective mechanism for raising project finance. Interest received is tax exempt or rebatable at 36 per cent; capital gains on disposal of the bonds are tax exempt; borrowing costs are tax

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[50] KPMG advised OASITO on 29 July 1996 that other major infrastructure projects had shown that the particular rules of foreign tax regimes can give overseas bidders competitive advantages compared to Australian bidders. OASITO and the Business Adviser have advised the ANAO that this issue…was only considered in the broad sense rather than on a country specific basis. In general, both KPMG and BZW concluded that, regardless of whether or not a competitive advantage did exist, there was no evidence that this element created any necessary and material negative tax implications for future Commonwealth tax receipts in any of the bids.

deductible; and lower risk financing structures are possible.[51] Under provisions in the *Development Allowance Authority Act 1992* (as amended), the Development Allowance Authority (DAA)[52], an independent statutory authority, is responsible for the approval, management and monitoring of infrastructure bonds.[53]

3.29 The Treasurer announced on 14 February 1997 that the Government would introduce legislation to prevent the lodging of any new applications, the issue of any further infrastructure bonds certificates and re-engineering in respect of existing certificates to increase tax benefits. The Treasurer also announced that the decision would *not otherwise affect already issued certificates continuing and operating unchanged.*[54]

3.30 At the time of the Treasurer's announcement, the DAA had issued infrastructure bond certificates for projects representing a total investment of $8 billion.[55] These included infrastructure bond certificates issued on 30 January 1997, 5 February 1997 and 11 February 1997 to one of the bidding consortia for its bids for each of the Phase 1 airports. The applications involved an arrangement familiar to the DAA. The DAA advised the ANAO that the applications involved financing structures which were acceptable[56] and satisfied all relevant legislative requirements. There was no suggestion that the bidder to whom the infrastructure bond certificates had been issued was making improper use of the facility.

3.31 The Department of the Treasury advised the ANAO that:

> *We consider that assessment of the tax impact of bids is required only if the tax system is non-neutral between alternative investments. For bids using conventional debt and equity*

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[51]George Brouwer, then Chairman and Chief Executive of the Development Allowance Authority, *Infrastructure Investment: Benefits for Investors*, ASX Perspective, 2nd Quarter 1996, p. 44.

[52]The previous DAA, Mr George Brouwer, retired on 2 November 1997, and the Commissioner for Taxation, Mr Michael Carmody, has been appointed to replace him. The DAA Secretariat, previously part of the Department of the Treasury, was subsequently transferred to the ATO. A Senior Executive Service officer within the ATO has been appointed delegate of the DAA and is responsible for managing the DAA administrative unit.

[53]Infrastructure bonds were initially introduced in the then Government's 1992 *One Nation Statement* and were extended to a wider range of projects and a larger base of investors in the then Government's 1994 *Working Nation Statement*.

[54] Treasurer Press Release No. 8, Infrastructure Borrowings Taxation Concession, 14 February 1997, p.2.

[55] These projects included the Eastern Distributor Toll Road and M2 Motorway in Sydney, City Link Toll Road in Melbourne, Goldfields Gas Pipeline in Western Australia and Collinsville Power Station in Queensland.

[56] The DAA has advised the ANAO that the Treasurer's announcement resulted from concerns initially raised by the DAA, and after a close examination of existing applications revealed that schemes were being proposed (principally by financial packagers and high marginal tax rate investors) to exploit the concession for tax minimisation purposes.

arrangements, no assessment of the revenue costs is necessary as there are no substantive non-neutralities favouring such approaches. In such cases, the varying *marginal tax rates of participants will not affect overall taxation revenue.*[57]

On the material we have seen, it does not appear that the bids other than that utilising infrastructure bonds involve any substantive tax non-neutrality. On the other hand, use of the infrastructure tax concession involves a clear and identified non-neutrality, a specific tax concession introduced into the Income Tax Assessment Act 1936 by the Government to encourage investment in infrastructure. Consequently, it is appropriate to consider the tax impact of bids using such an approach.

3.32 AGS advised OASITO and the Business Adviser that there was no legal impediment to assessing the tax effects of the use of infrastructure bonds in reaching a decision to select or reject an offer, providing the decision was reached according to due process, in good faith and the tax impacts of all bids were assessed. Clayton Utz advised OASITO that:

We believe that KPMG should be asked to advise whether there are other examples of specific tax incentives or expenditure of a specific kind involved in any of the bids. If it is the case that the proposed use of IBC's [Infrastructure Bond Certificates] *by one bidder is the only example of specific tax incentives or expenditure of a specific kind involved in the bids then, we believe that the application of the tax impacts of the use of IBCs in the assessment process would not require consideration of the more general tax considerations of the other bids.*

3.33 The ANAO was advised by OASITO and its advisers that in the bid evaluation process they examined and assessed the tax effects of all bids on a consistent and non-discriminatory basis to identify whether they involved substantive tax revenue costs. OASITO and its advisers concluded that, with the exception of infrastructure bonds, there were no issues that needed to be taken into account in a comparative price evaluation.

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[57]The Department of the Treasury also advised the ANAO that: *The general proposition is that, provided that the tax system does not give a tax advantage to the privatised asset vis a vis other assets, total government revenue does not vary with the selected bidder. An economist/tax theorist's way of stating this is that if the tax system is neutral across assets, including financing arrangements, then you do not need to consider the tax rate of the bidder or the financial structure that they are using to value the bids from the Government's perspective.*

Methodology

3.34 Until 30 June 1997, regulations issued under section 93Y of the *Development Allowance Authority Act 1992* provided for a cap on the maximum cost to taxation revenue of infrastructure bonds certificates issued in that year.[58] The DAA, in consultation with the Department of the Treasury, developed a methodology in 1995 to estimate the annual cost to Commonwealth revenue of infrastructure bonds. At the Government's request, this methodology and the determinants of the cost to revenue of infrastructure bonds was the subject of a joint review by the Department of the Treasury, the DAA and ATO in the latter half of 1996.[59]

3.35 A revised methodology was agreed by the Department of the Treasury, the DAA and the ATO and provided to the Treasurer on 28 January 1997. The stated purpose of the January 1997 methodology (which was not made public) was to estimate the cost to the Commonwealth revenue of the taxation effects of infrastructure borrowing certificates issued.

3.36 OASITO has advised the ANAO that:

> *Ministers were advised in the 26 February 1997 presentation that a reduction in future Commonwealth tax receipts arising from the use of infrastructure bonds could potentially offset a substantial portion of the proceeds of* [the consortium's] *higher bid amounts. Ministers were also advised that such an assessment could result in a change in the price rankings. As a result of this advice, the Ministers agreed that the Government Sales Team should develop an appropriate methodology for assessing the tax impacts of infrastructure bonds.*
>
> *To ensure that an appropriate methodology was developed, BZW contacted both the DAA and Treasury early in Stage 3 to obtain an understanding of their views on the issue and other relevant information. During these initial discussions, Treasury advised BZW that it was currently reviewing the previous methodology agreed with the DAA. Treasury considered such a methodology was deficient when used to assess retail structures which were not*

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[58] On 30 June 1997, the *Taxation Laws Amendment (Infrastructure Borrowings) Act 1997* received Royal assent. This Act gave legislative effect to the Government's decision to end the Development Allowance Bond scheme by repealing the relevant provisions of the *Development Allowance Authority Act 1992*, including section 93Y. The Revenue Cap Regulations (Statutory Rules 1995 Number 30 dated 21 February 1995) which were issued under section 93Y stated that expenditure on the tax rebate from infrastructure bonds is capped at $150 million in 1996-97 and $200 million in 1997-98.

[59] On 10 September 1996, the Treasurer had directed the DAA to not accept further applications for infrastructure borrowing certificates until 30 June 1997 in order to allow a full assessment of the cost to revenue of the infrastructure borrowing provisions to be made as part of the review.

envisaged at the time the DAA methodology was developed. Treasury indicated that the generic methodology only applies to certain situations and that it was valid to adjust the methodology to suit particular facts.

As a result of its consideration of information provided by [the consortium]*, DAA and Treasury, BZW produced a paper outlining a suggested methodology. The paper, together with copies of all relevant information provided by* [the consortium] *was provided to the Treasury for senior level Treasury review. The papers included alternative evaluation methodologies proposed by* [the consortium] *and DAA. The OAS consulted the Treasury in order that the OAS could be sure that the methodology developed by the Business Adviser was acceptable to the Treasury as the Commonwealth's principal policy adviser on tax matters.*[60]

3.37 The Department of the Treasury has advised the ANAO that further work by the Department on the January 1997 methodology, informed by the work undertaken by the Business Adviser, led the Department to conclude that the January 1997 methodology was not an appropriate basis for costing the revenue impact of the airport bids that utilised infrastructure bonds. The methodology developed by the Business Adviser and endorsed by the Department of the Treasury was applied in bid assessment to discount the purchase prices of bids that included infrastructure bonds.

3.38 The Business Adviser's methodology was similar to the methodology provided to the Treasurer on 28 January 1997 by the Department of the Treasury, the DAA and the ATO. However, the Business Adviser's methodology differed in one significant respect in that it included the tax impact of investor gearing relating to the total infrastructure bond issue, whereas the January 1997 methodology only included the tax impact of investor gearing

[60] The Secretary to the Department of the Treasury advised OASITO and its Business Adviser *that the proposed methodology differs in some respects from the methodology generally adopted by Treasury, especially in respect of estimating the cost to the revenue of gearing by retail investors. However, we consider that convincing arguments have been presented for using the methodology you propose for the cases concerned. Our experience is that it is not possible to estimate the total cost of the use of Infrastructure Bonds other than in an operating situation which provides information on the price and terms on which the bonds are sold at the retail level. In addition, as retail purchasers can also engage in tax effective practices, the cost can be magnified there as well. Clearly, that information is not available. Hence, any methodology can only estimate a minimum cost. With these caveats, we believe that the methodology prepared for the Asset Sales Task Force by BZW is adequate and clearly the most comprehensive of the alternatives examined.*

associated with a premium (if any) derived from the issue of the infrastructure bonds to the retail market, which is a minor proportion of the total gearing.[61]

3.39 In April 1997, the DAA advised the Department of the Treasury, OASITO and the Business Adviser that it disagreed with the Business Adviser's methodology as it differed significantly from that used by the DAA and provided by the Department of the Treasury, the DAA and the ATO to the Treasurer in January 1997. The DAA advised that gearing, for the most part, was not a cost which existed because of the special tax treatment provided by infrastructure bonds and therefore should not be assessed. Nevertheless, the ANAO notes that it would be accepted practice for OASITO to rely on Department of the Treasury advice on this aspect of the sale given its functional responsibility.

3.40 Finding: The process undertaken by OASITO and the Business Adviser in seeking the views of relevant Commonwealth agencies on their methodology was appropriate. The methodology adopted was developed by the Business Adviser and endorsed by the Department of the Treasury, the department with policy responsibility, but was different from the one developed jointly by the Department of the Treasury, the DAA and the ATO and which had been provided to the Treasurer on 28 January 1997. The ANAO notes that it would be accepted practice for OASITO to rely on Department of the Treasury advice on this aspect of the sale given its functional responsibilities. The adoption of the methodology developed by the Business Adviser and endorsed

[61] The DAA Secretariat advised the ANAO in its response to the draft audit report of the sequence of events relating to the DAA's involvement in the tender process for the sale of the Phase 1 airports, namely …*the DAA developed a model for calculating the cost to revenue of DABs* [Development Allowance Bonds] *in early 1995 which was agreed with Treasury (& ATO). In September 1996, the Government requested that this methodology be reviewed. The DAA duly commissioned Access Economics to do a study to determine the costs to revenue of DABs, to validate the existing model, and/or advise on appropriate modifications to it. Access Economics' study found the original model to be "capable of generating adequate estimates" and made some suggestions on its detailed implementation. In January 1997, a joint DAA/ATO/Treasury report, based on the Access Economics' findings, was submitted to the Government and adopted by the DAA as the basis of a revised methodology for calculating the cost to revenue of DABs. Meanwhile, from early 1996, the DAA had become progressively aware of the developing range of financial structures for the retailing of DABs, including schemes using negative gearing. The original methodology dealt with such retail transactions, including those using negative gearing, on the basis of the simple principle that the cost to revenue should be measured by summing the tax that would have been paid each year in the absence of DABs (in other words, if negative gearing would have occurred in any case it would be double counting to include it as a cost to revenue). The Access Economics study validated this principle. In relation to the DAB applications for the three airports, the DAA found that, based on the information provided by the applicant, the types of financial structures for retailing DABs that were being proposed were similar to those covered the Access Economics Report and revised methodology. The DAA therefore calculated the revenue cost of the DAB applications for the three airports using the revised methodology, completing this work in February 1997. On 8 April 1997, Treasury/BZW advised that the circumstances of the airoports projects (namely that investor gearing would be used in a retail sale of the bonds) warranted deviating from the revised methodology. DAA responded on 10 April 1997 that the circumstances outlined were covered by the model and warned that to deviate from the revised methodology as proposed might affect the outcome of the tendering process.*.

by the Department of the Treasury led to a different bidder ranking for Melbourne Airport in relation to the price criterion.

Financial strength criterion

3.41 The Business Adviser extracted key assumptions from each bidder's financial models and tested these using its Financial Strength Model. OASITO has advised the ANAO that the Business Adviser also constructed a model which was used to compare all bidder financial statements and traffic forecasts to the FAC's 20 year forecasts and to cross compare bids. The Business Adviser also applied its Financial Strength Model to test each bidder's debt structure using cash flows from the bid with the lowest cash flow.

3.42 The Business Adviser did not specify acceptable parameters for financial strength ratios. This could have been done by reference to generally accepted industry benchmarks. The Business Adviser advised the ANAO that:

> *BZW strongly disagrees with such a formulaic approach and questions the relevance of industry benchmarks given that airports are mostly state-owned around the world. BZW recommended against the publication or setting of minimum financial strength tests on the basis that this would be likely to lead to sub-optimal capital structures and lower proceeds.*

3.43 The ANAO noted that there was often a wide range in gearing levels between bidders but this was not necessarily reflected in the ratings. However, OASITO has advised the ANAO that:

> *In regard to comparative benchmarks of financial strength, BZW considered financial structures of the listed airport groups BAA, Copenhagen and Vienna. These were of limited value as comparisons but were nonetheless considered. In the absence of other privately owned airports of similar scale, BZW focused on analysis of interest cover and ability to repay the principal. This is consistent with the approach adopted by many analysts who focus on thorough analysis of the company and its cash flows rather than using benchmarks that are not directly comparable to the circumstances.*
>
> *In the absence of directly comparable benchmarks, BZW focused on: analysing the interest servicing and principal repayment profile of each bid; cross comparing each of the bids; comparing each of the bids' financial data with the FAC 20 Year Projections; re-running*

the financial results of each bid using the lowest cash flows of the various bids; and undertaking sensitivity tests.

3.44 The Business Adviser's evaluation report addressed the total debt burden, maturity profile and refinancing risks, principal and interest serviceability, sensitivity to reduced cash flows and access to additional capital. These factors were used to decide how each bidder's financial strength would be rated, although the relative importance of each was not apparent. The ANAO notes that there appears to be scope for significant variations in the operating cashflow that can be generated from the Phase 1 airports. There were marked differences in the operating cashflows forecast by bidders for each airport for the initial ten year period of the lease.

3.45 All bids were ranked "good" or "medium" in terms of financial strength. Each of the successful bidders was assessed by OASITO and its Business Adviser to have the necessary financial strength and managerial capabilities to operate and develop the airports over the lease term.

Gearing levels

3.46 The Business Adviser recognised bidders could propose highly leveraged financing structures to offer higher sale prices or implement post-sale refinancing plans to substitute debt for equity. In either case, highly leveraged financing structures could impair the financial stability of the airport and the lessee's ability to finance future development.

3.47 OASITO and Business Adviser did not impose any gearing restrictions on bids in order to allow bidders to optimise their capital structures. The Business Adviser advised OASITO that the imposition of gearing limits or minimum equity requirements may have led to significantly lower proceeds and it would have remained possible for bidders to subsequently restructure their capital because no restrictions were placed on post-sale refinancing. The Business Adviser examined the debt levels of bidders and their ability to service this debt as part of its bid evaluation. The evaluation treated convertible notes[62] and subordinated debt as equity.[63]

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[62] Convertible notes are a debt security that includes an option to convert into ordinary shares. They usually involve scheduled payments of interest and principal which constitute a financial liability of the issuer as long as the interest is not converted. Sources: *Australian Accounting Standard AAS33* and *International Accounting Standard IAS 32*.

[63] In all instances, the convertible notes of bidders were treated as equity for the purposes of bid assessment although, in one instance, a bidder advised in its offer that, for the purposes of the foreign ownership and control provisions of the *Airports Act 1996*, DoTRD considered the convertible notes were not equity and therefore did not constitute an interest in shares of the lessee company for the purposes of those provisions of the Act.

3.48 The Business Adviser advised the ANAO that:

> *Given the characteristics of subordinated debt in this case, BZW and the lenders to the bidder consortia considered subordinated debt should not be treated as debt for determining bidders' financial strength. This is common practice in the financial sector given that the subordinated debt was subordinated to all other loans and was provided by shareholders.*

3.49 OASITO has advised the ANAO that:

> *For the purposes of viability analysis, subordinated debt (including convertible subordinated debt) was treated as equity because the claims for the repayment of interest and debt are fully subordinated to other debt. Many finance texts support this view. For example (Hale, Roger, Credit Analysis, Wiley & Sons Inc) Hale states: "subordinated debt such as preferred stock is a hybrid, possessing some of the characteristics of debt and some of equity. As mentioned, a healthy firm must make the interest and principal payments on subordinated debt. Assuming the subordination is effective, in liquidation, senior creditors will ordinarily be paid in full before subordinated creditors receive any cash…*
>
> *In calculating a debt/equity ratio, subordinated debt is normally considered the equivalent of equity, because in reorganisation and liquidation, it is usually junior in its claim on assets.*
>
> *BZW also notes that the subordinated debt was being provided by shareholders. It should also be noted that the bankers to the transaction consistently treated the subordinated debt as equity in their lending covenants.*

3.50 The ANAO considers that convertible notes and subordinated debt do not represent equity but liabilities.[64] If this view is adopted, the Business Adviser's treatment of these instruments understated the debt levels and debt service obligations of all but one bid and had a material impact on the assessed debt levels and debt service obligations of most bids.

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[64] Statement of Accounting Concepts SAC 4 *Definition and Recognition of the Elements of Financial Statements*, March 1995, paragraphs 48 to 77; 85 to 87 and 95 to 97. Subordinated debt is also treated as debt for taxation purposes and bidders included the cost of servicing the subordinated debt in their cash flow forecasts.

3.51 The major privatised European international airports have debt to equity ratios of less than 60:40.[65] In comparison, the debt levels of the successful
Phase 1 airport bidders are high with each of the successful bidders having a ratio of between 79:21 and 93:7 at the time of the sale.[66] The Business Adviser advised the ANAO that:

> *…there is only one major European international airport company that has been fully privatised, namely BAA plc; and the remainder of major airports throughout the world are generally state (or public sector) owned and operated. In the circumstances and given the different characteristics and outlook of the Phase 1 airports, BZW believes comparisons between the proposed capital structures of the Phase 1 airports and overseas airports are of limited value.*

3.52 The Business Adviser's Stage 3 summary evaluation report stated that the increase in net prices between Stages 2 and 3 were mainly funded by equity rather than debt. The ANAO found that price increases were almost entirely funded by debt rather than equity. In relation to the successful bidders, increased prices were funded entirely by debt for Melbourne and Brisbane and mostly by debt for Perth.

3.53 **Finding:** In the bid evaluation process, subordinated debt was treated as equity. The ANAO considers that, given its characteristics, subordinated debt should be treated as debt for the purposes of determining bidders' financial strength. On this basis, bids were highly geared with the successful bidders' debt to equity ratios ranging from 79:21 to 93:7.

Risk allocation criterion

3.54 One of the assessment criteria was the extent to which offers involved a risk apportionment to the Commonwealth or increased the Commonwealth's liability beyond that prescribed in the sale documentation. This criteria was the main avenue by which it was sought to maximise achievement of the sale objective of minimising the Commonwealth's exposure to residual risks and liabilities.

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[65] BAA plc (owner and operator of seven United Kingdom airports including Heathrow and Gatwick) reported a debt to equity ratio of 58:42 as at 31 March 1997. Copenhagen Airport reported a debt to equity ratio of 57:43 as at 31 December 1996. Vienna Airport reported a debt to equity ratio of 1:99 as at 31 December 1996.

[66] Qantas has advised the ANAO that it considers that, in aggregate, the earnings before depreciation, interest and tax for the Phase 1 airports will have to triple if they are to service the total purchase price, assuming a weighted average cost of capital of 10.2 per cent.

3.55 Drafts of the proposed sale documentation were provided to bidders in November and December 1996. Bidders were advised that the Commonwealth considered the airport lease 'non-negotiable' and the balance of the sale documentation 'broadly non-negotiable'. Bidders were further advised that any amendments sought would be taken into account when evaluating offers. This strategy allowed OASITO to set out the Commonwealth's preferred position, leaving bidders to suggest changes and not vice-versa; enabled OASITO to indicate that the initial position would not be altered unless there was good reason; and enabled OASITO and the Business Adviser to maximise competitive pressure among bidders.

3.56 OASITO has advised the ANAO that:

> *The amendments made in Stage 3 to the standard sale documentation provided to bidders in Stage 2 were initiated by and designed exclusively for the benefit of the Commonwealth. None of these amendments involved any increase in risk allocation to the Commonwealth. To the contrary, they provided significant benefits to the Commonwealth both financially and in terms of risk management.*

3.57 Finding: The ANAO considers the strategy of providing bidders with draft sale documentation on a broadly non-negotiable basis assisted OASITO optimise its negotiating position in relation to the allocation of risk to the Commonwealth.

Certainty and clarity criterion

3.58 The main reason for undertaking Stage 3 of the bidding process was to reduce the conditionality of bids. Bidders with higher Stage 2 offer prices generally included a greater number of conditions than the bidders offering lower prices. The major conditions in Stage 2 offers related to adverse interest rate movements; material adverse change in the business of the airport between the offer date and completion; stamp duty on the sale documentation; title warranties, pre-sale litigation liability and pre-sale environmental liability.

3.59 Those bidders who had included conditions relating to stamp duty and pre-sale environmental liability in their Stage 2 bids removed them from their Stage 3 bids. Bidders who were concerned about pre-sale litigation liability also removed these conditions. Concerns about the Commonwealth's title to the airports were addressed by the inclusion of a Sale Agreement warranty which is capped to a nominal amount. Bidders did not remove conditions relating to interest rate movements until after preferred bidders were selected although some modified their condition, for example by including interest rate

collars [67] to reduce the risk of the condition being triggered. Two consortia removed the "material adverse change in circumstances" condition from their Stage 3 offers.

3.60 Interest rate and material adverse change conditions were motivated by bidder concerns over the lengthy acceptance period. The Business Adviser concluded in its Stage 2 bid evaluation report that the inclusion of interest rate and material adverse change conditions was reasonable protection for bidders given the requirement in the Request for Proposals that bids be capable of acceptance by the Commonwealth at any time up to 31 May 1997. The Business Adviser considered there was a strong likelihood that bidders would be prepared to consider the removal or limitation of these conditions if the acceptance period was shortened.

3.61 OASITO advised the ANAO that:

> *The decision to require offers to remain open for a four month period was based on a number of considerations. These included: the need to ensure an adequate period to properly evaluate bids and prepare appropriate reports; the need to allow adequate time for Ministerial decisions; and the desirability of allowing additional time to negotiate with preferred or selected candidates on the basis of such offers.*
>
> *A proposal for a minimum acceptance period of two to three months was initially considered but a four month period was decided upon on the basis that: this reflected the maximum period the Government Sales Team expected for negotiations with bidders to be concluded within the sales timetable; and it was open to bidders to place conditions in their offers which provided interest rate and market risks protection in the event that this was considered appropriate or necessary by the bidder having regard to the Commonwealth's desire for maximum certainty and minimum conditions.*
>
> *It is important to note that in discussion with bidders, both during and after lodgement of bids, no bidder indicated that their bids were discounted as a result of the four month acceptance period required when compared to a shorter period of say 2-3 months. Indeed, the OAS and BZW consider it highly unlikely that bid conditions in relation to interest rates and material adverse changes would have*

[67] Interest collars lock in the purchase price unless the prevailing market rate exceeds the ceiling or drops below the floor of a predetermined range (the 'collar').

been any different had the Government imposed a shorter minimum acceptance period of say, two to three months.

3.62 Finding: OASITO's decision to require offers to remain open for four months was made after considering the merits of a shorter acceptance period and the need to allow sufficient time to evaluate bids, advise Ministers and possibly negotiate with preferred bidders. The ANAO supports any moves to reduce the time exposure in future sales as a means of providing greater certainty.

Evaluation outcome

3.63 Based on the Business Adviser's evaluation reports, OASITO was responsible for advising the Minister for Finance on the outcomes of the evaluation process. In formulating its advice to the Minister, OASITO needed to satisfy itself that the bid evaluation approach had identified the best offer for each of the airports. OASITO has advised the ANAO that:

> *The summary evaluation assessment included in the summary reports provided to Ministers at the end of both Stage 2 and Stage 3 were reviewed and, to the extent of their respective areas of responsibility, agreed by OAS and AGS/Clayton Utz with BZW, prior to submission to Ministers. In relation to:*
>
> - *AGS/Clayton Utz, this included discussion and agreement with BZW on the specific ratings to be given in the summary assessment reports to the following three assessment elements: certainty and clarity of offer; allocation of risk; and conformity with the requirements of the Request for Proposals. It also involved the identification of any material legal issues to be included in the summary evaluation report;*
> - *OAS, this entailed a review of the full summary report prior to finalisation and submission to Ministers; and*
> - *DoTRD, this involved identification of issues which it was considered appropriate to raise with Ministers either in the summary report or in the Ministerial Presentations attended by DoTRD. It also included identification of issues which DoTRD considered were relevant to the assessment and discussions in relation to those issues between OAS, BZW, AGS/Clayton Utz and DoTRD prior to finalisation of the summary reports.*

Tender evaluation committee

3.64 An alternative to OASITO's approach would have been to use a tender evaluation committee. Such committees have successfully been adopted in previous Commonwealth asset sales. For example, for the sales of the Greenslopes and Hollywood Repatriation General Hospitals, a committee comprising the Deputy President of the Repatriation Commission (the agency previously responsible for operating the hospitals), the Sale Manager, an independent consultant and representatives from the relevant portfolio department, the then Department of Finance and Purchasing Australia was formed to oversight the tendering, evaluation, selection and contracting processes.[68]

3.65 Based on the Business Adviser's summary evaluation reports prepared at the end of Stage 2 and Stage 3, OASITO briefed the Minister for Finance on the sale and the Business Adviser's recommendations. The Stage 2 briefing comprised a presentation to the Minister for Finance and the Minister for Transport and Regional Development. Stage 3 involved the submission of a Minute to the Minister for Finance which recommended prospective selected bidders and enclosed a copy of the Business Adviser's summary evaluation report. The summary evaluation report outlined the reasons the prospective selected bidders were ranked as the leading bids.[69]

3.66 Finding: A tender evaluation committee comprising OASITO, its major advisers and, possibly, independent members would assist in ensuring transparency and accountability in the bid evaluation process. It can also lead to administrative savings by enhancing coordination of the evaluation process and consolidating the number of evaluation reports.

Recommendation No. 7

3.67 The ANAO *recommends* the Office of Asset Sales and IT Outsourcing enhance transparency and accountability in future major trade sales by considering structures such as a tender evaluation committee.

3.68 Agencies responded to the recommendation as follows:

- ***OASITO's response:*** **Agreed with qualification.** OASITO rejects any implication that there was a lack of transparency or accountability of decision making in the Phase 1 tender process by not establishing a formal

[68] These sales were reported on in Audit Report No. 20 1996-97, *Selected Commonwealth Property Sales*.

[69] On 30 April 1997, the prospective selected bidders were advised of their status and asked to resolve a small number of threshold issues by 2 May 1997. Each prospective selected bidder addressed these issues and was confirmed as the successful bidder on 2 May 1997.

tender evaluation 'committee'. The Stage 2 and Stage 3 bid evaluation was conducted at a single premise at which OASITO, DoTRD and all of OASITO's advisers were co-located. Co-location assisted in protecting the confidentiality of the bid documentation and in the coordination and integration of bid evaluation by government sales team members. Frequent meetings were held involving OASITO, DoTRD and OASITO's advisers, to discuss bid evaluation generally and, in particular, key issues and recommendations/assessments. Further, draft evaluation reports were circulated throughout the Government Sales Team and were extensively commented upon.

- ***AGS response:*** **Agreed.** AGS agrees with the recommendation that consideration should be given in tender evaluation processes to establishing a formal tender evaluation committee to oversee the process. Having said this however, it is noted that although in Phase 1 a formal "tender evaluation committee" was not established all parties involved in the tender evaluation process were co-located throughout the bid evaluation phase of the sale.

  As a result of the co-location of all members of the bid evaluation team there was regular and high level contact between all parties during the course of the bid evaluation phase of the sales process. Frequent meetings were conducted between members of the Office of Asset Sales, the legal advisers, business advisers, accounting advisers and members of the Department of Transport and Regional Development to discuss bids and issues arising therefrom. Draft reports were prepared by relevant advisers and same were circulated for comment to other advisers during the course of the bid evaluation process.

4 . Sale Outcome

This chapter outlines the major sale outcomes in relation to the sale objectives.

Sale proceeds

4.1 Gross proceeds from the sale of the Phase 1 airports was $3.31 billion as at February 1998 (see Exhibit 4.1). The direct costs of the sale (including $94.4 million in ex gratia payments to the State Governments in lieu of stamp duty on the airport leases) are estimated to be $153 million or 4.6 per cent of gross proceeds. Indirect costs were $688 million from the assumption by the Commonwealth of FAC debt.

4.2 The proceeds from the sale were significantly in excess of book values, the Business Adviser's 1995 scoping study estimates of minimum likely proceeds and estimated Budget receipts. They also compare favourably with current market values of previous privatisations of international airports in Europe.

4.3 OASITO and the Business Adviser sought to maximise sale prices by highlighting the value potential of the airports in the marketing campaign, the Information Memoranda and information presented in the buyer data rooms. For example, the Information Memoranda highlighted the investment opportunity presented by each airport's strong cash flow and asset backing, good growth prospects and important strategic attractions; unexploited commercial potential in retail and trading, car parking and property development; and modern, quality assets following recent FAC capital expenditure.[70] OASITO and its Business adviser also sought to maximise competitive pressures in the bidding process and minimise adverse price impacts from the regulatory framework.

4.4 The value inherent in the Phase 1 airports has also been reflected in a number of recent international comparative studies. For example, recent research has found that Melbourne, Brisbane and Perth airports are highly cost efficient compared to other major international airports.[71] Another study commissioned by the FAC compared the performance of 12 Australian and 24 European airports. It found that unit labour costs at the Phase 1 airports were low; although unit revenues were lower than European airports, concessions and rental income at the Phase 1 airports were high; and the Phase 1 airports were highly profitable.[72]

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[70] Total capital expenditure between 1992 and 1996 was $215 million at Melbourne, $255 million at Brisbane and $10 million at Perth.

[71] *Janes Airport Review* reported in its July/August 1997 edition that a study of operating efficiency and financial performance at 28 international airports by UK consultants Symonds Travers Morgan ranked Perth as second, Brisbane third and Melbourne sixth in terms of the ratio of revenue to costs. Adelaide and Sydney airports were ranked fourth and seventh with the FAC overall ranked twelfth.

[72] Cranfield University, *A Comparative Study of Value for Money at Australian and European Airports, October 1994*.

Exhibit 4.1
Phase 1 Sale Proceeds and Costs as at February 1998

	$m	$m	$m
• **Sale Proceeds**			
Melbourne Airport			
Purchase price		1,254.69	
Capital expenditure reimbursement		36.08	
Total consideration			1,290.77
Brisbane Airport			
Purchase price		1,314.00	
Further payment		60.98	
Capital expenditure reimbursement		3.44	
Total consideration			1,378.42
Perth Airport			
Purchase price		631.00	
Capital expenditure reimbursement		7.96	
Total consideration			638.96
Interest			2.67
Other[A]			0.98
Gross Proceeds			**3,311.80**
• **Minimum Sale Expenses**			
OASITO			
Business Adviser[B]	15.80		
Legal Advisers	10.16		
OASITO Running Costs	5.00		
Investigating Accountant	1.45		
Buyer Data Rooms	1.42		
Design, typesetting and printing[C]	0.97		
Other	1.15		
Total OASITO costs		35.95	
FAC[D]		19.10	
Scoping Study[E]		2.04	
DoTRD[E]		1.12	
Payment in lieu of stamp duty[F]			
1st tranche paid	40.80		
2nd tranche payable	53.60		
Total Payments in lieu of stamp duty		94.40	
Direct Sale Costs			**152.61**
• **Estimated Net Proceeds**			**3,159.19**
• **FAC Debt Assumed**[G]			**687.79**

Exhibit 4.1

Phase 1 Sale Proceeds and Costs as at February 1998 (cont'd)

Note:

[A] Cost recovery of marketing materials, payments for Airport Building Controller and Airport Environmental Officer.

[B] Including $1.26 million paid during the scoping study, total payments were $17.06 million.

[C] Involves payments for the tender documentation ($912 000) and marketing materials ($61 000).

[D] Involves direct privatisation costs incurred up to 30 June 1997 such as for advisers and consultants (including approximately $500 000 relating to Adelaide and Sydney Airports as they were originally part of the Phase 1 process); the cost of closing the FAC Corporate Office; and provision for staff rationalisation (and redundancy) costs of approximately $8.5 million associated with closing the FAC Corporate Office. Costs of staff that were not employed specifically for the sale and costs incurred subsequent to the completion of the Phase 1 sales, such as continuing costs incurred in relation to the transition of the Phase 1 airports to the new lessees, are excluded.

[E] Excludes labour on costs, which according to Department of Finance Guidelines, average 154.4 per cent of the salary costs.

[F] The *Treasury Portfolio Additional Estimates 1997-98* disclosed that, under the Inter-jurisdictional Taxation Agreement, the Commonwealth has agreed to make stamp duty equivalent payments to relevant State Governments on the sale of the Melbourne, Brisbane and Perth airport leases following the November 1996 *Allders* High Court decision which invalidated stamp duty at Commonwealth places.

[G] Figure calculated according to Ministerial Determinations issued at the time of assumption. Includes accrued interest at time of assumption of $15.22 million but not future interest payable of $293.84 million

Source: ANAO analysis based on information provided by DoFA; OASITO; DoTRD and FAC.

A further factor in the high sale prices was the market conditions at the time of the sale. World wide there have been very few airport privatisations and none previously in the Asia-Pacific region. The Phase 1 sales offered investors strategic opportunities to invest in airport infrastructure in the Asia-Pacific region. Indeed, the Information Memoranda informed shortlisted bidders that the sale represented a rare opportunity, both in domestic and global terms, to acquire a major international airport business.

4.6 Finding: Gross proceeds from the sale of the Phase 1 airports was $3.31 billion. The gross proceeds were significantly in excess of book values, the Business Adviser's 1995 scoping study estimates of minimum likely proceeds and estimated Budget receipts. They also compare favourably with current market values of previous privatisations of major European airports. 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 total gross proceeds, net sale proceeds are estimated to be $3.16 billion. The direct costs of the sale, excluding indirect costs of $688 million from the Commonwealth's assumption of FAC debt, were 4.6 per cent of gross proceeds.

Debt assumption

4.7 In April 1995, the then Government endorsed assumption of outstanding FAC debt at the time of the Phase 1 sales. At this time, the FAC's debt comprised a $A100 million loan in perpetuity from the Commonwealth, $A270 million under a domestic bond program[73] and two Eurobond issues of $US200 million[74] and $A100 million.[75] The assumption was necessary to meet concerns of lenders and credit rating agencies about reduced loan security and to manage the risk that a sale could trigger a default event for lenders who could then seek repayment of debt which had not expired.

4.8 OASITO developed and implemented a detailed plan and timetable to manage the assumption of the FAC's domestic bonds and Eurobonds:

- negotiations with the United Kingdom Trustee resulted in the substitution of the Commonwealth for the FAC as issuer for the two Eurobond issues on 5 March 1997. The $A409 million transaction represented the outstanding

[73] Comprising $A150 million 10.5 per cent bonds due on 15 July 1999 and $A120 million 8.25 per cent bonds due on 2 June 2003.

[74] The $US200 million Eurobond issue comprises 6.375 per cent notes due in November 2003. Together with a swap agreement, the total issue cost is 7.385 per cent.

[75] The $A100 million Eurobond issue comprises 7.0 per cent notes due in February 2004.

balance of the principal of the bonds and $A6.5 million in accrued interest[76]; and

- the domestic bonds were transferred to the Commonwealth on 2 May 1997. The amount of the transaction was $279 million representing the outstanding balance of the principal of the bonds and $8.7 million in accrued interest.

4.9 Following the assumption, the Commonwealth is liable to redeem the Eurobonds and domestic bonds at their face value of $672.6 million[77] when they fall due and make future interest payments of $293.8 million. The FAC has retained debt with a book value of $100 million.

4.10 Finding: OASITO developed and implemented a detailed plan and timetable to manage the assumption of the FAC's domestic bonds and Eurobonds. The assumption addressed the concerns of the FAC's lenders and was effected prior to the signing of Sale Agreements.

Residual risks and liabilities

4.11 A wide range of sale documentation was developed to facilitate the sale. The sale agreement, sale transition deed, airport lease and associated tripartite deed were the major sale documents. The legal advisers prepared these documents on behalf of OASITO and have assured OASITO that the sale documents represent an acceptable outcome for the Commonwealth, having regard to the nature of the transaction and the level of risk assumed by the Commonwealth. Both AGS and Clayton Utz provided assurance in relation to the airport lease, sale agreement and sale transition deed.[78] Assurance in relation to the tripartite deed and other sale documentation prepared for the sale was provided by Clayton Utz alone.

Sale agreement

[76] To manage the exchange rate risk associated with the $US200 million Eurobonds, the FAC had entered into a currency swap agreement. Because of the high cost of terminating the swap agreement, estimated to be $US43 million ($A55 million) in December 1996, the Department of the Treasury negotiated directly with the counterparty for the transfer of the swap agreement. The transfer occurred on 6 February 1997.

[77] The cost of the Commonwealth's assumption of FAC debt comprises the face value of the debt ($672.6 million) and interest accrued at the time of the assumption ($15.2 million).

[78] The Deeds cover the collection and payment to the FAC of receivables which relate to the period prior to 1 July 1997; payment by the FAC of debts owing which relate to the period before 1 July 1997; mutual cooperation; licensing of FAC software to the lessee to be used in the operation of the airport; and transfer of relevant FAC documents to the lessee.

4.12 The Sale Agreement was the core document by which the Commonwealth agreed to grant the airport lease and transfer all of the relevant assets, contractual rights and obligations, liabilities and employees of the FAC for each airport to the successful bidder. The parties to the Sale Agreement were the Commonwealth, the airport lessee company and its parent entities.

4.13 A number of steps were taken by OASITO to minimise the Commonwealth's post-sale risks and liabilities under the Sale Agreement:

- the Commonwealth's maximum liability was capped;
- limited warranties were provided;
- warranties given were subject to anything disclosed in the data rooms;
- a warranty review program was conducted by the FAC to identify any relevant information to be included in the data rooms by way of exception to the warranties;
- the Commonwealth will not be liable to the extent that the claim is, or should have been, within the lessee's or any parent entity's knowledge, or the lessee is insured in respect of the claim; and
- the lessee must give the Commonwealth specific notice of any claim within 12 months of the completion date.

4.14 Finding: The Sale Agreements included effective measures to minimise the Commonwealth's post-sale risks and liabilities. In particular, limited warranties were provided and the Commonwealth's liability was capped to a nominal amount. Further protection was gained through the conduct of a warranty review program and the inclusion of time limits within which lessees must notify the Commonwealth of any claim.

Airport leases

4.15 The airport leases and associated tripartite deeds were signed on 1 July 1997. The airport lease sets out the terms on which the Commonwealth agreed to grant a fifty year lease of the airport site (with a renewal option of forty-nine years).

4.16 As Phase 1 involved leasehold rather than freehold sales, the Commonwealth retains a continuing risk of liability as landlord and has accepted a level of ongoing involvement in airport operations because of the need to administer the airport leases. The development of an appropriate framework and procedures to administer the airport leases is therefore integral to management of these risks. DoTRD is responsible for administering the

leases including ensuring the obligations of both the Commonwealth and the lessee are carried out and enforcing any rights of the Commonwealth.

4.17 The lessees have no lease termination rights but the Commonwealth can terminate the lease where:

- the licence to operate the airport is suspended or cancelled;
- subject to *force majeure*[79], the lessee does not provide for use of the airport site as an airport; or
- subject to *force majeure*, the lessee does not provide for access to the airport by interstate or international air transport.

4.18 At the request of DoTRD, OASITO's legal advisers prepared an administrator's version of the lease. At the time of audit fieldwork, DoTRD was to commence documenting its obligations under the leases to develop a better understanding of these obligations. DoTRD has advised the ANAO that:

> *As the key policy instigators for much of the lease, DoTRD has a sound knowledge of the concept and sought the production of an annotated administrator's version of the lease to guide the oversight of the lease, in order to retain corporate memory on the rationale for various lease clauses. The administrator's version of the lease has been prepared by the OAS' legal advisers. There is no evidence that the lease is not being complied with. Most of the lease clauses are reactive rather than preventative in nature. DoTRD has initiated action under the lease with bidders in relation the provisions dealing with land tax, Airport Environment Officers and Airport Building Controllers and development commitments. No other actions are required at this time. DoTRD is yet to develop a more substantial framework and procedures to administer its obligations under the Lease including monitoring lessee compliance.*

4.19 Finding: DoTRD has not yet developed a comprehensive framework or procedures to discharge its obligations concerning monitoring and enforcing lessee's compliance with the airport leases. The ANAO considers the timely development of an appropriate framework and procedures important to manage the Commonwealth's ongoing risks.

Recommendation No. 8

[79] *Force majeure* are events which are beyond the control of a contracting party and which prevent the party from meeting its contractual commitments. Common examples are war, riots and earthquakes.

4.20 The ANAO *recommends* that the Department of Transport and Regional Development develop a comprehensive framework and procedures to monitor and ensure lessee compliance with the airport leases.

4.21 **DoTRD's response** to the recommendation was that it **agreed with qualification.** DoTRD accepts that some further measures will be required in both areas, although there has been active management of lease obligations under way since day 1 of the lease - the report notes some of the matters involved. DoTRD will initiate a formal lease review meeting, with a mechanism involving each airport (and its major users) to review key lease clauses and issues associated with it. These meetings will be conducted annually. This will involve up to 18 separate meetings, with the Phase 2 sales now nearing completion. However, the key task will remain to actively implement those lease obligations which arise on a day-to-day basis, as the Department has done to date.

Tripartite deeds

4.22 The tripartite deeds vary the terms of the airport lease to provide the lessee's financiers with step-in and cure rights should a termination event occur under the lease. They also place responsibility on the lessee and the financiers should the Commonwealth have to step-in to cure a termination event. The financier gains the benefit of the cure, protecting its debt; and the Commonwealth has a policy responsibility to keep a major international airport open so it too has every reason to favour a cure. The tripartite deed maintains the lease's powerful disincentives for lessees not to breach the lease; and adds to them the interest of the financier who will bear the responsibility for the Commonwealth's costs and liabilities incurred in curing any breach, should the lessee not be able to pay.

4.23 Many bidders included agreement on a tripartite deed as a condition of their Stage 2 bids. This was to address the concerns of lenders that termination would mean their borrowers' main asset and, thus, a substantial part of the lenders' security value, could be lost without the lenders having an opportunity to rectify the problem prior to termination. The tripartite deeds could be operative for up to twenty years but terminate earlier if the lessee is entitled to discharge or discharges the loan security.

4.24 A standard tripartite deed was developed by OASITO, its advisers[80] and DoTRD in response to comments and proposals from bidders. OASITO has advised the ANAO that:

> *To protect its policy interests, the Commonwealth resolved to adopt a standardised approach to the tripartite security document and that the document should be issued to bidders in Stage 3 following the Government's review of documents lodged at the end of Stage 2.*[81]

4.25 The tripartite deeds require the Commonwealth to notify the lender if it intends to terminate the lease for a breach of the requirement that the airport site be used as an airport and access be provided for interstate and international air transport. In the case of licence suspension or cancellation, the effect of the variations are that the Commonwealth can:

- be required to step-in and operate the airport for a defined period (which may be extended if agreed by the Commonwealth and the financiers);
- agree to implement a plan to remedy or overcome the events which resulted in the licence being suspended or cancelled; or
- otherwise retain its rights under the lease to choose to step-in and operate the airport.[82]

4.26 The tripartite deeds also provide that, following termination, the value of the airport accrues to the Commonwealth but the Commonwealth must either re-sell the lease or seek a valuation of the airport. The proceeds of sale or valuation are to be applied (in order) to the costs of the sale, outgoings with

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[80]AGS advised the ANAO that*: It should be noted that in terms of the preparation of the draft Tripartite Deed that Clayton Utz in its capacity as being directly contracted to the Office of Asset Sales had primary responsibility for this aspect of the sales process. Whilst AGS did provide comment on the draft Deed it was not directly involved in the drafting and/or negotiation of the Deed.*

[81]OASITO has further advised the ANAO that: *An alternative approach would have been for the Commonwealth to negotiate separate tripartite security deeds with the preferred candidates at the end of Stage 3. The pros and cons of this were considered by the Government Sales Team in conjunction with the DoTRD and it was agreed that the Commonwealth should maintain a standardised approach even if this meant that certain bidders might benefit from modifications that they had not requested. This approach was considered both sensible and appropriate given that the modifications being provided did not expose the Commonwealth to any additional risk or penalty*.

[82]AGS has advised the ANAO that: *The obligation on the Commonwealth to enter and take possession of the Airport Site and run the airport for the specified time in the event of a suspension or cancellation of the Lessee's aerodrome licence is a major one. Normally, the Commonwealth could be expected to draw back from taking such action, as, having made the decision to dispose of the airport, one would not ordinarily expect that the Commonwealth would wish to resume the task of running it again, whether on its own account or through agents. There will be a good deal of trouble and expense involved and, whilst the indemnity contained is a comprehensive one, there is always the potential for argument that some item of expense is not included. However, the Commonwealth has weighed all this in the balance against the need to ensure that the airport is not closed to interstate and international traffic, and has decided that the Deed is sufficiently advantageous to the Commonwealth to justify entering into it.*

a statutory priority, any costs incurred by the Commonwealth in operating the airport, and to the lender to pay out the balance of secured debt owed by the lessee. Any remaining proceeds accrue to the Commonwealth. This provision was introduced late in the bidding process at the request of two of the six bidding consortia.

4.27 Prior to the late change to the tripartite deeds, the airport lease allowed the Commonwealth to retain the full value of any re-sale of the lease. DoTRD has advised the ANAO that:

> *Our objective was not to let the Tripartite Deed undermine what had been achieved to protect the Commonwealth's policy interests, via the key Termination Events in the Lease. All bidders, at the direction of their banks and banks' lawyers, wanted no burden on the banks from Termination. Varying versions of this were thrown around, most particularly in bidders meeting with us and bankers' lawyers meeting with Clayton Utz. But all wanted the result that the late change to the Tripartite created. And so, with reluctance as you note, did DoTRD. While it was not our policy intent to profit from a Termination, the Lease left that judgement up to the Ministers of the day. The attitude of the financiers to bidders, however, did not allow such a luxury with the Tripartite. This became the only solution to the demands of the banks which still preserved the policy intent of the Lease.*

4.28 Finding: Amendment of the tripartite deeds to require the Commonwealth to compensate bid financiers for lease termination was not DoTRD's preferred position and imposes an additional ongoing obligation on the Commonwealth to redistribute the proceeds of any resale and re-grant of the airport lease. However, DoTRD's advice to the ANAO is that this amendment was necessary in order to preserve the policy intent of the lease.

Security and control of documents

4.29 The leases will be in operation for at least 50 years and up to 99 years. The tripartite deeds could be operative for up to twenty years but terminate earlier if the lessee is entitled to discharge or discharges the loan security. Provisions of the Sale Agreements will be operative for at least ten years. These documents impose obligations on both the Commonwealth and the lessees and are an important mechanism to manage the Commonwealth's ongoing risks as well as limit the Commonwealth's ongoing liabilities. In these circumstances, it is important that appropriate custodial arrangements are made for the long term safekeeping of the originals of these documents. In addition, it is necessary that DoTRD, as the relevant policy department largely

responsible for administering the Commonwealth's residual obligations, is provided with and maintains a full set of copies of the documents.

4.30 At the time of audit fieldwork, no long term custodial arrangements had been made for the safekeeping of the originals of the sale documents in an appropriate legal form and OASITO had difficulty in locating a complete set of the

original signed documentation for audit review.[83] Although DoTRD had copies of some of the documents, it did not at the time of audit fieldwork have a full set of the documents

4.31 The ANAO has previously commented on the importance of appropriate safe custody arrangements for important documentation.[84] One means of achieving this is the Attorney-General's Department's Commonwealth Security System. This system allows agencies to deposit and register important documentation that requires safeguarding. The AGS advised the ANAO on 27 January 1998 that:

> *…the Office of Asset Sales has now advised the AGS that it wishes to make arrangements with the AGS for the Commonwealth's security document system to be utilised for the safe handling of the original sale documentation for the Phase 1 airport sales.*

4.32 Finding: To manage the Commonwealth's ongoing risks under the sale documentation, it is important that arrangements be made for the ongoing storage and safe custody of this important documentation in an appropriate legal form.

Recommendation No. 9

4.33 The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in consultation with the Department of Transport and Regional Development:

a) for future airport trade sales, develop an agreed framework for the post-sale disposition of sale documentation including providing for appropriate safe

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[83] OASITO advised the ANAO in writing on 26 November 1997 that it was in the process of seeking the return of the Commonwealth's copy of the original signed sale documentation from its advisers. On 20 January 1998, OASITO advised the ANAO that: *The original signed versions of the sale documentation were, at the time of audit fieldwork, at the various State stamp duty offices for stamping. The stamping of the sale documentation was recommended by OASITO's legal advisers and was, at the time, being arranged by Clayton Utz.*

[84] *Audit Report No. 6 1996-97, Commonwealth Guarantees, Indemnities and Letters of Comfort,* pp. 42-43.

custody arrangements for the original signed sale documentation in an appropriate legal form for the duration of the lease term, and placing, in the records of each agency, a full set of copies of the signed sale documentation; and

b) establish appropriate safe custody arrangements for the original signed sale documentation relating to the Phase 1 airports sales, in an appropriate legal form, for the duration of the lease term.

4.34 Agencies responded to the recommendation as follows:

- **OASITO's response: Agreed.**
- **DoTRD's response: Agreed.**
- **AGS response: Agreed.** AGS agrees with the recommendation that appropriate arrangements be put into place for the safe custody of original sale documentation relating to the Phase 1 airport sales. In this regard, it is noted that original and copy sale documentation has not yet been returned to the Office of Asset Sales as same is currently in the process of being lodged with relevant State Stamps Offices for duty assessment. This part of the sales process has been handled until recently by Clayton Utz on behalf of the Office of Asset Sales. The AGS has recently been requested to assume responsibility for finalisation of this aspect of the Phase 1 sales process from Clayton Utz and we are presently in the process of obtaining an update report from Clayton Utz in relation to progress concerning the stamping of all relevant sales documentation. In addition, it is noted that the Office of Asset Sales has requested the AGS to arrange for the safe keeping of all original sale documentation once same has been returned.

Financial strength and managerial capabilities

4.35 The sale objectives included ensuring the new airport operators have the financial strength and managerial capabilities to operate and develop the airports over the lease term. In its recommendations on preferred bidders, the Business Adviser concluded that each had a strong financial structure.[85]

4.36 The major aspects of the management of the airports are airport management and operations, aeronautical infrastructure development and non-aeronautical commercial activities. Each of the successful bidders included companies with experience in commercial development. They also included equity participants with international experience in managing and developing airports. The experience and expertise of these airport operators is

[85] The parent entities of the airport lessee company were not required to guarantee the financial stability of the airport lessee company but did warrant their own solvency.

expected to be transferred to the airport lessee companies by the airport operator providing staff for some key management positions, staff transfers and secondments from the airport operator to the lessee company and secondment of former FAC staff to the international airport operator for training and experience.

4.37 In its recommendations on preferred bidders, the Business Adviser concluded that each of the consortia demonstrated the management capability and commitment to operate and develop the airports over the lease term.

4.38 Finding: Each airport lessee company includes as an equity participant an international airport operator to provide experience and expertise for the ongoing development of the Phase 1 airports. The proposed Sale Agreement restrictions on equity sell-downs in the initial two year period of the lease should ensure the availability of the necessary managerial capabilities. Contracts are also in place between each lessee company and its international airport operator for the provision of certain technical services.

Majority Australian ownership and control

4.39 The *Airports Act 1996* imposes a 49 per cent limit on foreign ownership and control of airport operator companies[86] and requires the airport operator company's to take all reasonable steps to ensure an unacceptable foreign ownership situation does not exist.[87] To assess achievement of the sale objective that the Phase 1 airports remained majority Australian owned and controlled, the ANAO applied the definitions of foreign ownership and control outlined in the Airports Act.[88] Compliance with this requirement would be consistent with majority Australian ownership and control.

4.40 DoTRD advised the ANAO that:

> *…the foreign ownership requirements of the Act, in setting a limit of 49 per cent for aggregate foreign stakes in an airport lessee company, are not (as, for example, the Broadcasting Act is) directed principally towards control issues. The intention of the legislation is to see that Australians are the principal beneficiaries of the*

[86] The Airports Act defines an airport operator company to be an airport lessee company or a company that has an airport management agreement with the airport lessee company.

[87] *Airports Act 1996*, section 42(1).

[88] The Airports Act prohibits a group of 'foreign persons' from owning or controlling more than 49 per cent of the total paid-up share capital of the airport lessee company; the voting power in the airport lessee company; or the rights to distributions of capital or profits.

operation of the airports. You will note that Division 3 of Part 3 is drafted in terms of "ownership". At the same time, in assessing whether 49 per cent limit is met, the Act requires that the four types of direct control interest identified in Clause 12 to the Schedule be considered. However, no evidence existed in the sales process to give rise to a concern that any lessee's arrangements varied the proportion of voting rights held by foreign persons from the proportion of paid up capital held by foreign persons. Therefore, we accepted that information provided to us by the lessees.

4.41 The ANAO was also advised by DoTRD that:

…this Department was satisfied that each of the lessees complied fully with the foreign ownership requirements of the Act and regulations. Their ownership positions were scrutinised in the bid processes - through review of ownership levels, Articles of Association and Shareholder Agreements - in some depth, and each was further required to warrant that it would comply at the time of lease take-up. Since leasing of the airports each lessee has been under an ongoing obligation to advise the Minister if it has any reason to believe that the ownership and control requirements of the Act may not be satisfied.

4.42 In addition, DoTRD advised the ANAO that foreign ownership was a major factor in the bid evaluation process and was addressed at the meeting with the Minister for Finance and the then Minister for Transport and Regional Development on the preferred bidders.

4.43 At the time the leases were granted, DoTRD considered each of the successful bidders complied with the foreign ownership and control provisions of the Airports Act. Two of the bidders were considered to be compliant at the time their offer was accepted. The third was required to provide evidence to DoTRD that less than 40 per cent of the capital of its major investor - an investment fund - was controlled by foreign persons.[89] The fund was granted declarations by DoTRD that a number of its shareholders were 'substantially Australian investment funds' and, on this basis, DoTRD concluded the airport lessee company complied with the foreign ownership and control provisions of the Airports Act.

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[89] The *Airports (Ownership - Interests in Shares) Regulations* provide for certain interests to be disregarded when determining the level of foreign ownership and control of the airport lessee companies: the Secretary of DoTRD may declare an investment fund to be a 'substantially Australian investment fund' where a beneficial interest in less than 40 per cent of the capital and income of the fund is held by foreign persons.

4.44 Finding:. DoTRD advised the ANAO that bid assessment appropriately and fully addressed the foreign ownership and control requirements of the *Airports Act 1996.* The ANAO was also advised by DoTRD that each of the lessees complied fully with these requirements at the time the leases were granted. Post-sale ongoing compliance is to be addressed through the Act's requirement that lessees provide a statutory declaration at 12 monthly intervals affirming their compliance.

Employee issues

4.45 One sale objective was to ensure fair and equitable treatment of FAC employees, including preservation of accrued entitlements.[90] To achieve this, negotiations were undertaken with the five unions representing FAC employees in mid 1995 and a *"Principles Agreement"* was reached on 14 December 1995. This Agreement formed the basis for further negotiations.

4.46 Employee terms and conditions have been preserved for a minimum 12 month period following completion of the sales. The Sale Agreement for each airport contains provisions whereby the lessee has undertaken not to seek to vary or terminate, in the first 12 months of the lease, awards and enterprise agreements applicable to the transferring FAC employees. In addition, the lessees have undertaken not to subject any former FAC employee to compulsory redundancy during the first 12 months of the lease or to establish a dual workforce[91] at the airport.[92]

4.47 Finding: The sale addressed the fair and equitable treatment of FAC employees at the sale airports including preservation of their accrued entitlements.

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[90] A joint superannuation working party comprising representatives of the ASTF and its Superannuation Adviser, FAC, FAC Unions and DoFA was established in May 1995 and negotiated the conversion of the FAC Superannuation Fund to a multi-employer fund. Each airport lessee company has undertaken to join the FAC Superannuation Fund as a participating employer and will be required to make contributions to the Fund in respect of the former FAC employees for the first 2 years of the lease.

[91] That is, all employees must be on similar terms and conditions of employment as the specified employees.

[92] One of the unions raised with the ANAO that some employees at some of the Phase 1 airports appear to have been disadvantaged in moving from the coverage of the Commonwealth workers' compensation legislation to State coverage. This necessitated the issue being pursued with the individual airports concerned.

5 . Post-sale Airport Management

This chapter discusses measures taken by DoTRD and OASITO in pursuit of the Government's ongoing privatisation objectives and to manage the Commonwealth's regulatory and lessor responsibilities.

Background

5.1 The Government nominated the following on-going privatisation objectives for the sale:

- diversity of ownership of Commonwealth airports is achieved consistent with other objectives, in the interests of innovation and competitive benchmarking;
- each airport lessee company ensures access to its airport for all air service operators on reasonable commercial terms, consistent with the intent of national competition policy;
- each airport lessee company continues to operate with a demonstrable commitment to the effective provision of quality airport services, consistent with the sound development of civil aviation, both in Australia and under Australia's international obligations;
- the pricing policy adopted by each airport is supportive of investments necessary to serve the interests of users and consistent with the interests of the Commonwealth and the development of the region; and
- each airport lessee company acts to promote the economic development of its Phase 1 airport in a way that is responsive to the interests of users, the environment and the region in which the airport is located.

5.2 The issue of diversity of ownership was considered by OASITO in its recommendation to the Minister for Finance on preferred bidders. Each of the Phase 1 airports was sold to different consortia and the sale Agreement includes restrictions on consortia members disposing of their shareholding in the lessee company during the first two year period of the lease without the Commonwealth's consent.

5.3 The airport leases require the lessee provide for access to the airport by intrastate, interstate and international air transport. However, the lessee will not be held to be in default of these obligations if the denial of access complies

with a demand management scheme under the Airports Act [93] or where an aircraft owner or operator has refused to pay to the lessee within 21 days after the due date any amount due to the lessee for the use of the airport site. If interstate or international air transport is denied access, the Commonwealth is entitled to terminate the lease two days after the breach, unless access was prevented due to any *force majeure* event.[94] The Commonwealth is also able to prevent a possible breach or cure an actual breach including by stepping in and operating the airport.

Quality airport services

Medium term development

5.4 The Sale Agreement required a contractual commitment from bidders to a specific amount of capital expenditure on aeronautical infrastructure development for the initial ten years of the lease (medium term development commitment).[95] The lessee is required to pay the Commonwealth the amount of any shortfall if actual expenditure is less than 90 per cent of committed capital in the first 5 year period and less than 80 per cent in the second 5 year period.

5.5 Independent arbitration is enforceable in the event of any dispute or disagreement between the Commonwealth and the lessee. Development may be delayed due to *force majeure* events or if the lessee believes the expenditure is not financially justifiable because, due to circumstances beyond the control of the lessee, the projected increases in either domestic or international passenger numbers and aircraft movements included in the lessee's bid have not occurred; or there have been material changes to other economic assumptions.

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[93] Part 13 of the Act allows the Minister for Transport and Regional Development to formulate schemes to apply to the management of demand for the handling of aircraft movements at the core regulated airports, which includes the Phase 1 airports. Such schemes may: prohibit specified categories of aircraft movements; allow the allocation of slots; limit the number of aircraft movements during specified times; or allow other demand management arrangements. Provision is made for submissions from specified parties before the Minister makes decisions under this Part on capacity and demand management at airports.

[94] It was a policy decision to impose an obligation on the lessee to provide for access by intrastate aircraft but not to make a breach of this obligation a lease termination event.

[95] The contractual commitments were introduced at the end of Stage 2 bids to ensure the airports continued to be developed to meet anticipated future growth in traffic demand.

5.6 To enable DoTRD to monitor compliance with the medium term development commitments, the lessee is required to submit an annual expenditure plan, with details of its intended developments and indicating how it intends to comply with the obligations; engage an approved auditor to ascertain the extent of the lessee's compliance with its obligations; provide the Commonwealth with an audited annual report setting out development costs for the 12 months; and provide the Commonwealth with audited reports at the conclusion of each of the two 5 year periods.

Long term development

5.7 The lease includes a covenant on the part of the lessee to develop the airport site at its own expense consistent with a major international airport throughout the term of the lease (long term development commitment). This obligation is based on actual and anticipated future growth in traffic demand; quality standards reasonably expected of an international airport; and good business practice.

5.8 The lease provides that if the Commonwealth believes the lessee is not complying with the long term development obligation it has the power to require the lessee to produce a plan to bring the airport up to the required standard within five years. The plan must be produced within 120 days and must contain at least the level of detail required for a major development plan under the Airports Act.

Monitoring development

5.9 Any development undertaken pursuant to either the Sale Agreement or lease is required to comply with the provisions of the Airports Act including, where relevant, the submission of major development plans. DoTRD has yet to develop administrative procedures to monitor the submission of development plans by the lessees. However, DoTRD has advised the ANAO that no development of any significance will be undertaken on-airport until the Airport Master Plans are approved in mid-1998, or later if the Minister so determines. DoTRD also noted that the development plans of the airport operators - or the absence thereof - will be made very transparent under the Master Plan process, an obligation of the Airports Act, and the actions of lessees triggered under the Domestic Terminal Lease obligations to airlines at Melbourne and Perth airports.

5.10 The ANAO notes that DoTRD also has not developed criteria to assess whether the airports are developed consistent with a major international airport. The lease requires development to this standard, assessed by having regard to actual and anticipated future growth in traffic demand, quality

standards reasonably expected of an international airport and good business practice. DoTRD has advised the ANAO that it considers traffic demand and quality standards to be related and that the crucial indicators of failure to satisfy demand and not provide quality services will become transparent under the quality of service indicators required under the Airports Act and now being finalised by the ACCC. Exposure drafts of these standards were circulated prior to the finalisation of the sales process and have now been agreed with lessees.

5.11 Finding: DoTRD has not developed comprehensive administrative procedures to monitor the ongoing development of the Phase 1 airports. This includes comprehensive and direct indicators of whether the airports are being developed in accordance with the requirements of the leases and monitoring development expenditure the lessees have committed themselves to over the initial ten years of their lease.

Recommendation No. 10

5.12 The ANAO recommends that the Department of Transport and Regional Development develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the *Airports Act 1996* and airport leases.

5.13 DoTRD's response to the recommendation was that it **agreed with qualification.** The Department considers that the comprehensive reporting process which is indicated in paragraph 5.6 above is sufficient to ensure effective *monitoring*. However, the area which requires further work is better defining the terms in the lease for assessing whether the site is being developed as an effective international airport. The activity in this area is essentially longer term (in our view all airports are likely to meet demand effectively over the next few years) but we accept that we can and should develop some guidance for both the airport operators and ourselves in this area now.

Pricing policy

5.14 The post-sale regulatory framework includes a pricing and quality of service monitoring role for the ACCC. The Government's Pricing Policy paper released in November 1996 sets out the post-sale pricing policy and was developed by DoTRD in consultation with ACCC and other stakeholders. The pricing policy includes price caps on aeronautical activities at leased airports

which are designed to protect airport users from the potential abuse of market power by airport operators. The price cap applies to the charges for aeronautical services, which include: aircraft movement areas, such as runways, aircraft parking, navigation aids; and passenger processing areas, such as departure lounges and holding lounges, airline support service areas, and airside buses. The price caps do not apply to rents and non-aeronautical service such as the domestic terminal infrastructure charge. However, the ACCC will undertake formal monitoring of some of these charges.

5.15 The price-cap uses a Consumer Price Index minus X formula, where the X value reflects the productivity improvements expected in the delivery of aeronautical services. Prices cannot increase on average by more than the cap in any one year. If the CPI-X is a negative number, average prices must fall by this amount. The X values have been set at 4.0 per cent for Melbourne Airport, 4.5 per cent for Brisbane Airport and 5.5 per cent for Perth Airport. Airport operators must notify the ACCC of price changes for services covered by the cap. The Business Adviser has informed the ANAO that the CPI-X regime will:

> *… result in real reductions in aeronautical charges of at least 18.5 per cent for Melbourne, 20.6 per cent for Brisbane and 24.6 per cent for Perth over the next 5 years. These and other benefits should ensure that the interest of the users and the airlines are protected and that the airports continue to be operated in accordance with the world's best practice.*

5.16 The ACCC will review the price cap arrangements after four years to determine what arrangements should apply in the future. Airport operators are also required under the Airports Act to submit to the ACCC annual financial reports. The ACCC will also monitor quality of service at airports to complement the prices oversight arrangements; assist the ACCC in its assessment of the airport operator's market conduct; and improve the transparency of information on airport performance for the benefit of airport users and the Government. The main focus of monitoring will be on quality of aeronautical and aeronautical-related services provided by the airport operator. It will not involve the setting of service standards.

5.17 The performance indicators against which airport operators quality of service is to be monitored are currently under development by the ACCC. It is intended that they will include those designed to measure the capacity utilisation of facilities, terminal crowding and waiting times at the various stages of passenger processing. The ACCC has not been provided with funding for its quality of service monitoring function. Accordingly, it appears likely that the

ACCC will be reliant upon information provided by the operators and the airlines to monitor quality of service.

Economic development

5.18 The *Federal Airports Corporation Act 1986* constituted a complete legislative code for matters relating to Federal airports. The airport land is Commonwealth owned and as such the airports are 'Commonwealth places'[96] - that is, because the airports are Commonwealth places under section 52 of the Constitution, the airports are places at which the Commonwealth has an exclusive right to apply its own laws, although State law can be applied as Commonwealth law. For airports to which the FAC Act applies, the operation of State/Territory law is excluded by the operation of the FAC Act.

5.19 A significant issue for the development of the post-sale regulatory regime has been that the leased Phase 1 airports remain Commonwealth places. While the operation of the airports remained in the control of a Commonwealth entity such as the FAC, Commonwealth law applied to most activities at the airport by virtue of the FAC Act. Upon transferring operation of the airports to the private sector, the Commonwealth had originally anticipated restricting Commonwealth regulatory control to on-airport land use, planning and building as well environment matters, because these were matters on which it was considered that a national approach was necessary. The Airports Act makes it clear that the regulation of planning, building controls and environmental management at the airports remains a Commonwealth responsibility and regulations have been made under the Act to control these matters.

5.20 It was envisaged by DoTRD that the State Governments would take responsibility for social planning matters such as gambling, commercial trading and trading hours, parking and vehicle movements, smoking and liquor licenses, which are seen as traditional areas of State responsibility. The Commonwealth retained the flexibility under Part 11 of the Airports Act to regulate these activities itself should the States prove unable or unwilling to do so within the required time frame and on terms which allowed existing activities at airports to continue. The then Minister for Transport and Regional Development wrote to all relevant State and Territory Ministers on 16 October 1996, following the enactment on 9 October 1996 of the Airports Act, seeking the views of the State Governments on which option should apply to the airports post sale, State or Commonwealth regulation. The then Minister noted with regard to the Phase 1 airports, that if State laws were to apply to these areas the Commonwealth would have to be satisfied of the State's capacity to

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[96] Commonwealth places are defined under section 3 of the *Commonwealth Places (Application of Laws) Act* 1970 as *a place (not being the seat of government) with respect to which the Parliament, by virtue of section 52 of the Constitution, has, subject to the Constitution, exclusive power to make laws for the peace, order and good government of the Commonwealth.*

provide a regulatory regime which accommodated existing on-airport activities by 31 March 1997.

5.21 The State Governments indicated a general desire to assume regulation at the leased airports. However, in the course of consultations with the State Governments, DoTRD considered that they would not be in a position to assume responsibility for regulation of liquor, commercial trading, vehicle movements, gambling and smoking at the airports on leasing because of:

- the short time frame available to adjust their regulatory regimes;
- the uncertainty raised by the *Allders* case[97] with regard to the application of State laws to Commonwealth places, particularly where the collection of revenue is involved which may be construed as taxing activities at Commonwealth places; and
- the difficulties created for State Governments by the special requirements of airports, which need to trade 24 hours a day, in relation to issues such as regulation of commercial trading and liquor.

5.22 Accordingly, by the end of January 1997 DoTRD considered that it would have to develop, under Part 11 of the Airports Act, regulations for the control of on-airport activities concerning liquor, commercial trading, vehicle movements, gambling and smoking. DoTRD used existing State legislation as the basis for the new regulations. The task was achieved by departmental officers and their legal advisers within a very short period with the *Airports (Control of On-Airport Activities) Regulations* gazetted on 20 March 1997.

5.23 DoTRD has advised the ANAO that the potential remains for State Governments to assume responsibility for regulation of on-airport activities including liquor, commercial trading, vehicle movements, gambling and smoking and the issue is continuing to be addressed in the Phase 2 sales process now under way.

Airport planning

5.24 Control of land use planning and airspace around airports remains with the Commonwealth. Airport operators are required to submit airport master plans and major development plans to the Minister for Transport and Regional

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[97] *Allders International Pty Ltd v Commissioner of State Revenue (Vic) (1996)* 140 ALR 189, 14 November 1996. In a majority decision, the High Court found that once a place is acquired by the Commonwealth for public purposes, so long as the place remains in the ownership or possession of the Commonwealth, it is subject to the exclusive legislative power provided by section 52(i) of the Constitution. On this basis, the High Court decided that Tullamarine Airport remained a Commonwealth place and did not cease to be Commonwealth place because part of it had been leased by the FAC. As a result, the Stamps Act 1958 (Vic) did not apply to the granting of a lease by the FAC over premises used to conduct a duty free shop.

Development for approval. Before they are submitted, the plans are subject to a public consultation process which will take into account the views of airport users (airlines, tenants, the community, State and local governments). Any variations of these plans will also be exposed to a public consultation process.

5.25 The Airports Act requires a master plan to be indicative of the airport-lessee's intentions and views in respect of the future of the airport; cover a 20 year period; demonstrate that it will meet the needs of users and signal the operator's intentions; and remain in force for five years, unless a replacement plan is approved beforehand. Airport operators must submit their first master plan to the Minister by 2 July 1998, though the Minister may allow an extension to this deadline. Before approving a master plan, the Minister must ensure that it meets the overall aviation operational requirements; consider the effect it would have on the use of the land within and around the airport; and consider the results of the consultations undertaken in preparing the plan.

5.26 Major development plans and associated building activities must be consistent with the approved master plan for the airport. Submission to the Minister of major development plans for the airport are the responsibility of the airport operator, including the submission of major development plans for tenants and airlines at their airport. The plans are aimed at minimising the risk that developments will not be in accordance with the airport's master plans. It also recognises the role of the airport operator in controlling overall planning and development for its airport.

Environmental management

5.27 The new airport operators are required to develop and implement an environmental strategy for the airport approved by the Minister for Transport and Regional Development. The strategy should be in place within 12 months of a new operator taking over a leased Federal airport, and is to cover a five year period. The strategy should set out how the airport will be operated so that its environmental health is maintained or improved.

5.28 In developing the strategy an operator is required to consult widely. The strategy is subject to Ministerial approval. After it has been approved, the airport operator must advertise the approved strategy, indicating where copies are available for public perusal or purchase. The airport operator must then take all reasonable steps to ensure that the strategy is complied with.

5.29 Finding: DoTRD has developed and is implementing a regulatory regime for planning and environmental management at the leased Federal airports.

Airport Environmental Officers and Airport Building Controllers

5.30 An important element of the environmental management regime at the leased Federal airports is the Airport Environment Officer (AEO) position. DoTRD has appointed an AEO for each airport, who is responsible for the day-to-day administration of environmental issues. The Department oversights the AEOs and retains overall responsibility for enforcement of environmental protection regulations.

5.31 The AEO positions at the airport are substantially funded by the individual airport operators under provisions in the airport leases. Under the leases, the operators are required to pay to the Commonwealth, six monthly and in advance, the Commonwealth's estimate of the costs of the AEO for the next six months less any costs recovered by the AEO from third parties. The amount nominated in the leases for each operator for the first six month period was $185 000.

5.32 DOTRD has also appointed an Airport Building Controller (ABC) at each leased Federal airport who will be responsible for ensuring that activities at the airports meet the appropriate building and engineering standards. The airport operators are also required under the Sale Agreement to fund the ABC position, but are only required to reimburse the Commonwealth to the extent that Building Controller costs incurred by the Commonwealth are not recovered by third parties through fees paid under the *Airports (Building Control) Regulations* and only up to a maximum annual cap. The maximum annual cap on the operators' obligations regarding the ABC positions is different for each of the airports; $195 000 for Melbourne, $220 000 for Perth and $180 000 for Brisbane. The Sale Agreements also provide that airport operators obligations regarding the costs of the Building Controllers ends on 30 June 2002, by which time it is anticipated that the positions will be self-funded through the collection of fees for services.

5.33 The bidders were notified of the decision to require airport operators to provide funding for the AEO and ABC positions very late in the sales process. DoTRD has advised the ANAO that its preferred position was to have these positions Commonwealth funded in order to best protect the public interest, particularly the AEOs given the important role they play in protecting the environment at the airports. Accordingly, DoTRD undertook action in the context of the development of the 1997-98 Budget to obtain supplementation for the costs involved. However, DoTRD was unsuccessful in its bid for additional funding and was not in a position to absorb the costs of these positions from its existing resources. An alternative method of funding them then had to be developed.

5.34 The decision to require the new operators to provide funding for the ABC and AEO positions was not notified to bidders until 30 April 1997, after Stage 3 bids had closed and three days before the preferred bidders were announced.

5.35 **Finding**: The ANAO considers that the introduction of additional cost burdens for bidders such as funding of the Airport Environment Officer and Airport Building Controller positions after the closing date for the submission of binding bids represented inadequate disclosure to bidders of the cost sharing arrangements to apply.

Recommendation No. 11

5.36 The ANAO *recommends* that, in future trade sales, agencies ensure adequate disclosure of all costs connected with the purchase of Commonwealth assets is made to bidders prior to requiring the submission of binding bids.

5.37 Agencies responded to the recommendation as follows:

- ***OASITO's response:*** **Agreed with qualification.** While the recommendation sets an ideal approach, it is necessary to allow for unforseen, unforeseeable or overlooked issues to be addressed during a process - as was necessary in the case of Airport Environmental Officers (AEOs) and Airport Building Control Officers (ABCOs) in this process, where the issue of funding the AEOs and ABCOs was not unforseen, but the decision for Airport Lessee Companies to fund them was.
- ***DoTRD's response:*** **Agreed.**

Canberra ACT
24 March 1998

P. J. Barrett
Auditor-General