Government Business Enterprise Monitoring Practices

Selected Agencies

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Australian National
Audit Office

Canberra ACT
24 September 1997

Dear Madam President
Dear Mr Speaker

In accordance with the authority contained in the *Audit Act 1901*, the Australian National Audit Office has undertaken a performance audit in selected agencies and I present this report and the accompanying brochure to the Parliament. The report is titled *Government Business Enterprise Monitoring Practices.*

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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Abbreviations/Glossary

AIDC	Australian Industry Development Corporation
AN	Australian National
ANAO	Australian National Audit Office
CSOs	Community Service Obligations
DoCA	Department of Communications and the Arts
DoD	Department of Defence
DoF	Department of Finance
DTRD	Department of Transport and Regional Development
EAT	Earnings After Tax
EBIT	Earnings before Interest and Tax
EBITAD	Earnings before Interest, Tax, Amortisation and Depreciation
GBE	Government Business Enterprise
GTE	Government Trading Enterprise
HLIC	Housing Loans Insurance Corporation
JCPA	Joint Parliamentary Committee of Public Accounts
NRC	National Rail Corporation
ROA	Return on Assets
Tsy	Department of the Treasury
USO	Universal Service Obligation

Part One

Summary and Recommendations

Summary

1. Currently, there are fourteen Commonwealth Government Business Enterprises (GBEs) which are a mixture of companies and statutory authorities. In 1995-96, GBEs generated revenues of nearly $21 billion; provided dividends of $1.6 billion; and controlled assets of some $41 billion. They incur different business risks resulting from, among other things, different levels of competition in their product markets and from their varying capital structures. On average, the businesses produced a 12.8 per cent return on assets in 1995-96.

2. Effective government monitoring of GBEs is necessary for a variety of reasons. First, there is a need to ensure that there is an efficient allocation of resources particularly given the magnitude of public resources invested and the potential losses which can arise from inappropriate management of those resources. Second, a number of GBEs play a central role in the economy and dominate certain strategic industries, including postal services and telecommunications. The trend has been for governments to pursue market liberalisation policies, which have increased the overall business risk of most GBEs by allowing greater competition in what largely had been closed markets. Third, the enhanced commercialisation of GBEs has allowed them to enter new fields of commercial activity such as joint ventures and to use financial derivatives. These activities may see reduced risk transparency given the complexity and rapid risk transformation that can take place as a result of developments in financial markets. Finally, because GBEs are publicly controlled organisations, ultimately

the Government is accountable to the Parliament for their overall performance and their strategic direction.[1]

3. Over the past decade governments of the day have significantly reduced externally imposed shareholder controls on GBEs and have relied on an arms length approach involving performance monitoring for accountability purposes. Following a request from the Prime Minister for a review of GBE governance arrangements, on 23 December 1996 the Minister for Finance announced the appointment of Mr Richard Humphry AO, Managing Director of the Australian Stock Exchange, to undertake the review.[2]

4. The review report was released in June 1997 and made recommendations for changes or refinements to the arrangements governing the various relationships between the Commonwealth and GBEs which it owns in full or part. The recommendations were aimed at maintaining a coherent, prudent and effective policy for the management of individual GBEs and of the GBE sector overall. The Government issued revised governance arrangements for GBEs in June 1997, following their consideration of the review report. These governance arrangements replace the 1993 *Accountability and Ministerial Oversight Arrangements* which applied until July 1997 and against which this audit tested monitoring of selected GBEs by agencies. In preparing this report, the ANAO has had regard to the recently issued governance arrangements which incorporate improvements recommended by the *Review of GBE Governance Arrangements*.

Audit approach

5. The Auditor-General's current mandate does not include performance audits of GBEs that are

[1] Management Advisory Board and its Management Improvement Advisory Committee, Report No. 11 *Accountability in the Commonwealth Public Sector*, page 17.
[2] Minister for Finance press release, 23 December 1996

companies unless he receives a request to do so by the responsible portfolio Minister or by resolution of both Houses of Parliament. Against this background, this audit has not sought to review the actual performance of the GBEs. The audit was confined to an examination of monitoring by the responsible portfolio departments and the Department of Finance regarding the performance of selected GBEs.

6. The objectives of the audit were to examine:

- the effectiveness of the GBE monitoring arrangements in providing appropriate performance information to the Government;

- the extent to which agencies and the selected GBEs comply with the monitoring arrangements and legislative requirements; and

- whether the GBE monitoring system provides an effective level of accountability to Ministers and to the Parliament.

7. The approach taken in the audit was to review the application by the Department of Finance and the portfolio departments of the 1993 *Accountability and Ministerial Oversight Arrangements for GBEs* which applied until July 1997 and any statutory monitoring and reporting requirements applying to the selected GBEs provided under their own establishing legislation.

8. In identifying the sample of agencies whose monitoring activities were to be reviewed, the ANAO sought to include some of those agencies with the major responsibility for GBEs. The agencies selected were the Department of Defence with regard to its monitoring of ADI Limited; the Department of Communications and the Arts with respect to the Australian Postal Corporation (Australia Post); the Department of Transport and Regional Development with respect to the Australian National Railways

Commission (Australian National); and the Department of the Treasury with respect to the Housing Loans Insurance Corporation (HLIC).

9. In March 1997, the Government invited expressions of interest in tendering for Australian National's businesses. On 28 August 1997, the Ministers for Finance and Transport and Regional Development announced that the businesses were to be sold to three different consortia for a total of $95.4 million. In addition, in the 1997 Budget, ADI Limited was included among the $15 billion asset sales program. An overview of the four selected GBEs' financial position for 1995-96 is outlined in the following exhibit.

Selected GBEs' financial position : 1995-96

Selected GBEs	Total Assets $ m	Shareholders Equity $ m	Operating Turnover $ m	Net Profit $ m
Australia Post	2239.3	880.1	2820.2	237.6
HLIC	277.1	73.1	51.9	11.5
ADI Limited	641.4	318.5	515.1	(19.5)
Australian National	908.4	(11.9)	290.1	(210.5)

Source: Selected GBEs 1995-96 annual reports

Conclusions

Performance information

10. The improvement in GBE corporate planning information available to agencies as a result of developments in the GBE monitoring arrangements has generally increased agencies' understanding of the GBEs' businesses, where this information has been provided. However, the Department of the Treasury has yet to ensure compliance by HLIC with the requirements of the GBE guidelines with regards to submitting a corporate plan approved by the relevant Minister.

11. Considerable effort has been devoted in recent years by both portfolio Departments and the Department of Finance to develop economic rate of return targets for GBEs.

12. The 1993 arrangements included provision for regular reviews of the capital structure of GBEs to be carried out at least every five years. In respect of the selected GBEs considered by this audit, adequate capital structure reviews have been conducted in accordance with the arrangements.

Risk transparency

13. In the corporate plans examined by the audit there was not uniformly explicit identification of risks and options for their treatment. Consistent with the better practice developments in both the private and public sectors, the ANAO considers it desirable that governance arrangements be further strengthened in regard to risk management. The development of well considered risk management strategies, which are directly linked to the overall corporate plan of GBEs, would enhance transparency of exposures. This approach should allow the Government, as shareholder, to be assured that exposures are being adequately managed; that the GBEs are managing effectively within their business environment; and that GBE exposures should not result in future unnecessary calls upon the Budget.

Accountability

14. There have been improvements in recent years in internal reporting mechanisms, including: the introduction of periodic reporting to Ministers; surveys conducted by the Department of Finance of GBEs use of derivatives and explicit Commonwealth guarantees; and increased reporting requirements.

15. Accountability has been further enhanced by the introduction of the June 1997 *Governance Arrangements* which require GBEs, in consultation with Shareholder Ministers, to prepare an annual Statement of Corporate Intent for tabling in the Parliament. In addition, during the financial year, the Minister for Finance may require a GBE to prepare an interim report for tabling in the Parliament by the relevant portfolio Minister.

Key Findings

Reporting

1. Effectiveness of Commonwealth oversight has continued to improve with the introduction of periodic reports to Ministers and surveys by the Department of Finance of GBEs use of derivatives and off-balance sheet exposures.

Oversight by portfolio departments

2. Agencies' understanding of GBEs' businesses has generally benefited from the improvement in GBE corporate planning information in recent years, where this has been provided. However, comprehensive appreciation of some GBEs' risks and their management practices is still largely unreflected in the information provided to agencies.

Corporate plans

3. Generally, selected GBEs provided corporate plans in accordance with the Government's GBE guidelines, with the exception of HLIC. The Department of the Treasury advised the ANAO that it was impractical to require HLIC to provide the Government with a corporate plan while HLIC was undergoing sale or restructure and that, in any case, the portfolio had access to sufficient information to monitor the performance of HLIC during this period.

4. Nonetheless, the ANAO considers that provision of corporate plans is good practice, as clearly evidenced by the Government's GBE guidelines, and suggests that action should be taken to meet the requirement of the guidelines that three-year corporate plans, updated annually, be submitted and agreed with the portfolio Minister and the Minister for Finance, unless otherwise agreed by the responsible Ministers.

Economic rate of return targets

5. GBEs are required to work towards an economic rate of return target. The Department of the Treasury considers that the methodology for calculating economic rate of return targets under the 1993 Ministerial Oversight and Accountability Arrangements for GBEs was inapplicable to financial GBEs such as HLIC. The Department of the Treasury further advised that any methodology for calculating such financial targets needs to take account of the operating characteristics of financial GBEs, on a case-by-case basis, and that this has now been incorporated into the 1997 Governance Arrangements.

6. The ANAO found that there was no exclusion provided for financial GBEs in the 1993 oversight arrangements from the general obligation for GBEs to agree an economic rate of return target, or other appropriate financial targets, with their portfolio Minister and the Minister for Finance.al structure reviews

7. In accordance with the requirements of the 1993 *Ministerial Oversight and Accountability Arrangements*, adequate reviews of the capital structure of the selected GBEs have been carried out at least every five years.

Risk management

8. Consistent with the better practice developments in both the private and public sectors, the ANAO considers it desirable that governance arrangements be further strengthened in regard to risk management. The development of well considered risk management strategies, which are directly linked to the overall corporate plan of GBEs, would improve transparency of exposures and should allow the Government, as shareholder, to be assured that exposures will not result in future unnecessary calls upon the Budget.

Recommendations

Set out below are the ANAO's recommendations with Report paragraph reference and agencies' abbreviated responses. More detailed responses and any ANAO comments are shown in the body of the report.

Recommendation No. 1 Para. 2.53	The ANAO *recommends* that portfolio departments periodically commission an independent assessment of the corporate plans of GBEs within their portfolio to provide objective assurance to Ministers and the Parliament on an important element of the governance framework. Agree: DoCA, DoD and DTRD. Agree with qualification: DoF and Tsy.
Recommendation No. 2 Para. 3.37	The ANAO *recommends* that departments ensure that GBEs within their portfolios comply with the requirements of the 1997 *Governance Arrangements*, including the preparation and submission of corporate plans, when they are being sold or restructured unless and until otherwise agreed by the Shareholder Ministers. Agree: DoCA, DoD and DoF. Agree with qualification: DTRD and Tsy.
Recommendation No. 3 Para. 4.18	The ANAO *recommends* that the 1997 *Governance Arrangements* be amended to require GBEs to specify in their corporate plans and progress reports their material risks and strategies for treating these risks. Agree: DoCA, DoD and DTRD. Agree with qualification: DoF and Tsy.

Part Two

Audit Findings and Conclusions

1. Introduction

This chapter outlines the background to performance monitoring of Government business enterprises, audit approach and overall conclusions for the audit.

Background

1.1 Government business enterprises (GBEs) form a major component of the Australian economy, particularly in the communications and transportation industries. The economic effects of GBEs are particularly significant in terms of employment and fixed capital investment.

1.2 Currently, there are fourteen Commonwealth GBEs[3] which are a mixture of companies and statutory authorities. The trend in recent years has been to establish more of the GBEs which had previously been statutory authorities as companies under the Corporations Law. A recent example is the decision to restructure the Housing Loans Insurance Corporation (HLIC) as a company, although this process is yet to be finalised This trend has also been supported by a recent Government decision that GBEs should be public companies limited by shares and incorporated under the Corporations Law.

1.3 The final tranche sales of Qantas and the Commonwealth Bank in 1995 and 1996 respectively have represented major changes in the Government's involvement in the transport and banking industries. However, changes have not been confined to divestment. In 1995, the Commonwealth conducted a buy-back of the shares it did not already own in the subsidiary of the Australian Industry Development Corporation (AIDC), AIDC Limited, that it had floated in 1989.

[3] The list of Commonwealth GBEs as at July 1997 is: Australian Postal Corporation, Telstra Corporation Limited, Defence Housing Authority, ADI Limited, Public Employment Placement Enterprise, Health Services Australia Limited, Australian Industry Development Corporation, Export Finance and Insurance Corporation, Australian Technology Group Limited, Snowy Mountains Hydro-Electric Authority, Australian National Railways Commission, ANL Limited, Housing Loans Insurance Corporation and the Federal Airports Corporation.

1.4 In 1995-96, GBEs generated revenues of nearly $21 billion; provided dividends of $1.6 billion; and controlled assets of some $41 billion. On average, the businesses produced a 12.8 per cent return on assets in 1995-96. GBEs incur different business risks resulting from, among other things, the different levels of competition in their product markets and from their varying capital structures, that is, their debt and equity mix.

1.5 Although the general characteristics of GBEs are widely accepted, the Administrative Review Council, in its February 1995 report to the then Minister for Justice on Government Business Enterprises and Administrative Law, noted that legislation usually only defines GBEs by reference to a schedule.[4]. Such schedules list entities which are GBEs, without outlining criteria for the identification of those entities for inclusion in the schedule However, the explanatory memorandum to the Commonwealth Authorities and Companies Bill 1996 sought to distinguish GBEs from other Commonwealth companies and statutory authorities by stating that in general GBEs should satisfy three criteria. They are commercial; trade outside the public sector; and are not primarily regulatory bodies.[5]

1.6 Over the past decade governments of the day have significantly reduced externally imposed shareholder controls on GBEs and have relied on an arms length approach involving performance monitoring for accountability purposes. Effective government monitoring of GBEs is necessary for a variety of reasons. First, there is a need to ensure that there is an efficient allocation of resources given the magnitude of public resources invested and the potential losses which can arise from the inappropriate management of those resources.

1.7 Second, a number of GBEs play a central role in the economy and dominate certain strategic industries, including postal services and telecommunications. The trend has been for governments to pursue market liberalisation policies which have increased the overall business risk of most GBEs by allowing greater competition in what had largely been closed markets.

1.8 Third, the enhanced commercialisation of GBEs has

[4] Administrative Review Council, Report to the Minister for Justice, Government Business Enterprises and Commonwealth Administrative Law, Report No. 38, 23 February 1995, pp. 9-10.

[5] Explanatory Memorandum to the Commonwealth Authorities and Companies Bill 1996, p.3

allowed them to enter into new fields of commercial activity such as joint ventures; and be able to use financial derivatives which may see reduced risk transparency given the complexity and the rapid risk transformation that can take place as a result of developments in financial markets.

1.9 Finally, because GBEs are publicly controlled organisations, ultimately the Government is accountable to the Parliament for the overall performance of its GBEs and their strategic direction.[6]

Review of Governance Arrangements for GBEs

1.10 Following a request from the Prime Minister for a review of GBE governance arrangements, the Minister for Finance announced on 23 December 1996 the appointment of Mr Richard Humphry AO, Managing Director of the Australian Stock Exchange, to undertake the review.[7] The terms of reference for the *Review of Governance Arrangements for Commonwealth Government Business Enterprises* were determined through consultation with relevant Ministers. The review report was released in June 1997.

1.11 The review made recommendations for changes or refinements to the arrangements governing the various relationships between the Commonwealth and GBEs which it owns in full or in part so as to maintain a coherent, prudent and effective policy for the management of individual GBEs and of the GBE sector overall. The Government issued revised governance arrangements for GBEs in June 1997, following consideration of the review report. These governance arrangements replace the 1993 *Accountability and Ministerial Oversight Arrangements* which applied until July 1997 and against which this audit tested monitoring of selected GBEs by agencies. In preparing this report, the ANAO has had regard to the recently issued governance arrangements which incorporate improvements recommended by the *Review of GBE Governance Arrangements*.

Audit approach

1.12 The Auditor-General's current mandate does not include performance audits of GBEs that are companies unless he receives a request to do so by

[6] Management Advisory Board and its Management Improvement Advisory Committee, Report No. 11 *Accountability in the Commonwealth Public Sector*, p. 17.
[7] Minister for Finance press release, 23 December 1996

the responsible portfolio Minister or by resolution of both Houses of the Parliament. Against this background, this audit has not sought to review the actual performance of the GBEs. The audit was confined to an examination of monitoring by the responsible portfolio departments and the Department of Finance of the performance of selected GBEs.

Objectives

1.13 The objectives of the audit were to examine:

- the effectiveness of the GBE monitoring arrangements in providing appropriate performance information to the Government;
- the extent to which agencies and the selected GBEs comply with the monitoring arrangements and legislative requirements; and
- whether the GBE monitoring system provides an effective level of accountability to Ministers and to the Parliament.

Methodology

1.14 In identifying the sample of agencies whose monitoring activities were to be reviewed, the ANAO sought to include some of those agencies with major responsibility for GBEs. The agencies selected were the Department of Defence with regard to its monitoring of ADI Limited; the Department of Communications and the Arts with respect to the Australian Postal Corporation (Australia Post); the Department of Transport and Regional Development with respect to the Australian National Railways Commission (Australian National); and the Department of the Treasury with respect to the Housing Loans Insurance Corporation (HLIC).

1.15 In March 1997, the Government invited expressions of interest in tendering for Australian National's businesses. On 28 August 1997, the Ministers for Finance and Transport and Regional Development announced that the businesses are to be sold to three different consortia for a total of $95.4 million. In addition, in the 1997 Budget, ADI Limited was included in the $15 billion asset sales program.

1.16 Fieldwork on the preliminary study was undertaken in 1995-96 in the Departments of Finance, Transport and Regional Development, Communications and the Arts, Defence and the Treasury. On the basis of that work, it was decided in August 1996 to conduct a performance audit. Fieldwork was completed in departments in April 1997.

1.17 The approach taken in the audit was to review the application by the Department of Finance and the portfolio departments of the 1993 *Accountability and Ministerial Oversight Arrangements for GBEs* that applied until 30 June 1997 and any statutory monitoring and reporting requirements applying to the selected GBEs provided under their own establishing legislation.

1.18 Relevant files held by the portfolio departments and the Department of Finance were reviewed. As well, the corporate plans submitted by each of the selected GBEs during the period 1991-92 to 1996-97 were examined. The most recently available corporate plans of the selected GBEs were examined in detail against the requirements of the 1993 *Accountability and Ministerial Oversight Arrangements for GBEs* and the relevant statutory provisions.

1.19 The cost of the audit was approximately $196,000. The audit was conducted in accordance with ANAO Auditing Standards.

1.20 An overview of the four selected GBEs' financial position for 1995-96 is outlined in Exhibit 1.1.

1.21 Australia Post[8] and Telecom were established as statutory authorities in 1975 to take over the functions of the then Postmaster-General's Department.[9] The Australian Postal Corporation was established on 1 January 1989 and operates under the *Australian Postal Corporation Act 1989*.

1.22 The *Postal Services Act 1975* required the then 'Commission' to perform its functions in such a manner as will best meet the social, industrial and commercial needs of the Australian people for postal services and shall, so far as it is, in its opinion, reasonably practicable to do so, make its postal services available throughout Australia for all people who reasonably require those services. This was translated to Australia Post as a universal service obligation (USO) to provide a letter service at a uniform standard rate.

1.23 Australia Post is one of the top ten employers in Australia, with 32 040 full-time and 5 689 part-time employees in 1995-96. In 1995-96, Australia

[8] Formally established under the *Postal Services Act 1975.*

[9] The Commonwealth has a constitutional power to provide postal, telephonic and like services.

Post's gross revenue was $2.9 billion, placing it in the top 40 Australian corporations. It earned net profit of $237.6 million in 1995-96. At 30 June 1996, its assets were valued at over $2.2 billion.

Exhibit 1.1:
Selected GBEs' financial position : 1995-96

Selected GBEs	Total Assets $ m	Shareholders Equity $ m	Operating Turnover $ m	Net Profit $ m
Australia Post	2239.3	880.1	2820.2	237.6
HLIC	277.1	73.1	51.9	11.5
ADI Limited	641.4	318.5	515.1	(19.5)
Australian National	908.4	(11.9)	290.1	(210.5)

Source: Selected GBEs 1995-96 annual reports

1.24 Australia Post's core business activities are letter and parcel delivery - domestic and international - and retail agency business. The Corporation has some 4 300 postal outlets through which it provides private and business customers with access to these services, as well as philatelic products, financial services and related products.

HLIC

1.25 HLIC was established under the *Housing Loans Insurance Act 1965.* Following the passage of the *Housing Loans Insurance Corporation (Transfer of Assets and Abolition) Act 1996*, HLIC is undergoing a restructure which is yet to be completed. This will see it cease operations as a Commonwealth statutory authority and incorporated as a public company, HLIC Limited. The new company will be subject to the Corporations Law and regulation by the Insurance and Superannuation Commission. The aim of the restructure is to make HLIC more commercially oriented.

1.26 HLIC insures lenders against losses on loans secured by mortgage, principally housing loans; and to a lesser extent loans for the purchase, construction or re-financing of non-residential buildings. HLIC may also enter into reinsurance contracts with lenders.

1.27 HLIC operates in competition with other insurers and is currently the largest mortgage insurer in Australia, having insured over 1.3 million loans since its establishment. HLIC employed 95 staff (76 full-time and 19 part-time) and earned a net profit of $11.5 million in 1995-96.

ADI Limited

1.28 ADI Limited is a public company which was formed in 1989 to take over, and operate on a commercial basis, defence production operations previously conducted by the Department of Defence. ADI is involved in a wide range of activities including project management, systems and communications engineering, precision and heavy engineering, ship building and maintenance, ordnance and the provision of environmental and logistic support services.

1.29 ADI employs over 3 000 people and has manufacturing and service operations in most States, the Australian Capital Territory and overseas. Its headquarters are in Sydney, but ADI generates employment in several regional centres such as Woomera-Nurrungar in South Australia, Bendigo and Benalla in Victoria and Mulwala, Lithgow, Newcastle and Albury in New South Wales.

1.30 ADI Limited has undergone considerable restructuring since 1989 aimed at enhancing its capacity to compete effectively in the market place. The restructuring program has included a significant reduction of ADI's work force (by 53 per cent) and included the closure of several old munition factories in Victoria and New South Wales. However, in restructuring its munitions operations, ADI has constructed a new munitions plant at Benalla, in north-eastern Victoria. In 1995-96, ADI recorded a net loss of $19.5 million, largely due to a cessation of production during the restructuring of its munitions operations.

Australian National

1.31 The Australian National Railways Commission[10] is a

[10] Commonwealth provision of rail services commenced in 1917 when the trans-

statutory authority established in 1975 to acquire the former Commonwealth Railways, the non-urban rail operations of South Australian Railways and the operations of Tasmanian Railways. Actual operational responsibility for the consolidated rail network was not assumed by the Commission until March 1978. After the enactment of the *Australian National Railways Commission Act 1983*, the Commission began trading as Australian National.

1.32 Australian National operates eight component businesses.[11] In 1995-96, Australian National incurred losses of $210.5 million. As at 30 June 1996, Australian National's liabilities exceeded its assets by $11.9 million. Australian National advised the ANAO that:

AN's 1995/96 Annual Report clearly highlights the Government's decision to form National Rail and the Government's inaction on AN's growing debt burden as major factors.

1.33 Australian National has been an unprofitable GBE for a number of years. Australian National would not have declared an operating profit for over ten years but for Commonwealth grants and supplements. In the ten years to 30 June 1996, the Commonwealth paid $634 million in grants and subsidies to Australian National, including supplements of $39.9 million and grants of $5.9 million in 1995-96.

1.34 As part of a reform of the rail services, the Minister for Transport and Regional Development announced in November 1996 that Australian National would be offered for sale. On 29 August 1997, the Minister announced that Australian National's businesses based in South Australia and Tasmania (its South Australian intrastate freight and maintenance business, its interstate passenger business and its Tasmanian freight business) were to be sold to three different consortia for a total of $95.4 million.

Australian railway connecting the eastern States and Western Australia was completed.

[11] RailFleet - which is a provider of wagon services; Powerail - which provides a one-stop locomotive service to operators of trains; Railmec - which operates in the field of maintenance, engineering and construction for the rail and heavy engineering sectors; Infrastructure Services - which constructs, modifies and maintains AN's rail infrastructure; SA Freight - which controls intrastate rail operations in South Australia; AN Tasrail - which performs a full range of railway activities in Tasmania; AN Passenger Rail - which provides long distance train journeys including the Indian Pacific and the Ghan; and the Track Access Business Unit - which is responsible for the management of access to the mainline interstate network owned by the Commission.

Report outline

1.35 The following two chapters of the report discuss in turn: the 1993 GBE monitoring framework, and the June 1997 arrangements where relevant; and the monitoring of selected GBEs by the relevant Commonwealth agencies. The concluding chapter provides an overview of issues and the conclusions of the audit.

2. Monitoring Framework

This chapter discusses the framework against which agencies have undertaken monitoring of the performance of portfolio GBEs.

Background

2.1 In October 1987, the then Minister for Finance issued a statement on *Policy Guidelines for Commonwealth Statutory Authorities and Government Business Enterprises.*[12] The objectives for GBEs in the policy statement were to implement performance oriented management practices, improve Australian competitiveness and achieve the highest level of operational and financial efficiency.

2.2 The focus of the policy statement was primarily Budget dependent statutory authorities. However, unless specifically excluded, they also applied to statutory marketing authorities and GBEs. The policy statement included a section on issues specific to GBEs such as corporate plans, financial targets, dividends, the capital structure and finance of GBEs and the costing of Community Service Obligations (CSOs) in annual reports. Responsibility for GBE accountability and performance rested with each GBE Board and the relevant portfolio Minister, although some consultation with other Ministers was also required.

2.3 In May 1988, the then Minister for Transport and Communications issued a ministerial statement[13] outlining a reform program for the transport and communications GBEs. This statement outlined the framework for new accountability mechanisms including corporate plans and financial targets, achievement of CSOs and removal of numerous operational controls.

2.4 The challenge for the Commonwealth monitoring agencies is to ensure that the

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[12] The then Minister for Finance had previously issued a discussion paper in June 1986 on the same topic.

[13] ‘Reshaping the Transport and Communications Government Business Enterprises ‘.

accountability arrangements are effective at two levels. The first is to ensure that the mechanisms are at least on par with those for the private sector which has corporate entities subject to scrutiny by participants in the capital markets. Some GBEs have explicit Commonwealth guarantees for all or part of their operations, either through legislative or other arrangements. More commonly, GBEs are seen as being implicitly guaranteed by virtue of their ownership by the Commonwealth; which lessens debt holders scrutiny as the latter rely on the Commonwealth's credit rating. In this circumstance, the Commonwealth has an interest arguably greater than an ordinary shareholder in ensuring that GBE accountability arrangements are effective as it may be responsible for the entities' liabilities as well as their equity holdings.

2.5 The second aspect relates to the purpose for which GBEs were established: to act as public bodies operating commercially and not as commercial bodies operating in the public arena.

1993 GBE monitoring framework

2.6 The 1987 policy statement was replaced by the 1993 *Accountability and Ministerial Oversight Arrangements for GBEs* issued jointly by the then Minister for Finance and the then responsible portfolio Ministers in May 1993 for implementation in July 1993. These arrangements sought to clarify the previous statement and emphasised the importance of government properly exercising its shareholder role by:

- encouraging best possible performance and operation at world's best practice in terms of financial and non-financial performance;
- increasing the Minister for Finance's role;
- more frequently being informed about GBE strategies, plans and performance; and
- encouraging responsible Ministers to take quick remedial action when a GBE was under-performing.

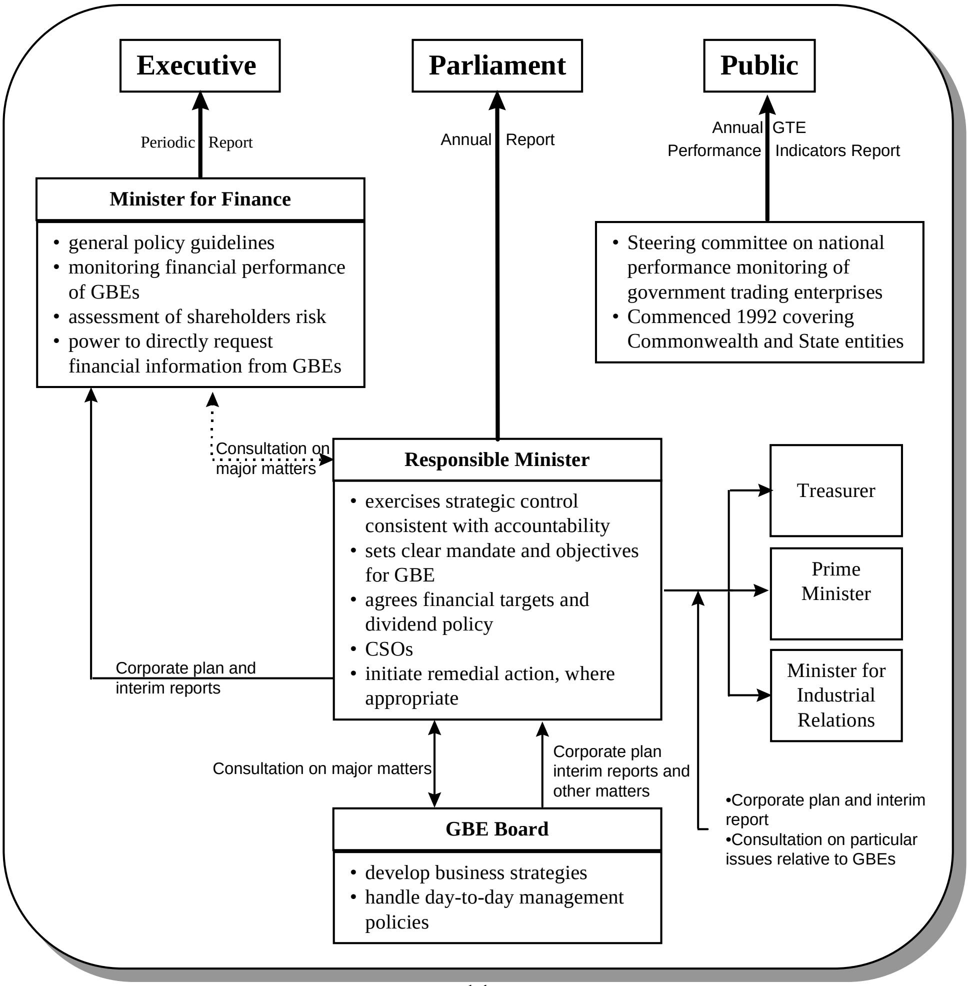
2.7 These arrangements formed the centrepiece of the 1993 framework for monitoring GBEs which applied until 1 July 1997. The stated objectives of these arrangements included encouraging GBEs to deliver the best possible performance and providing an opportunity for the Government to exercise its shareholder role properly, including being fully informed of GBE strategies, plans and performance. The arrangements did not deal with the question of partial Commonwealth ownership of GBEs.

2.8 The broad monitoring arrangements for GBEs under the 1993 Arrangements are outlined in Exhibit 2.1.

2.9 The major changes between the 1993 monitoring framework and the monitoring framework provided by the governance arrangements to apply from 1 July 1997 include:

- the introduction of joint Shareholder Ministers (the portfolio Minister and the Minister for Finance), rather than a portfolio Minister having sole responsibility and being required to consult the Minister for Finance on major

Exhibit 2.1 Summary of 1993 GBE Monitoring Arrangements



Source: Department of Finance and 1993 Accountability and Ministerial Oversight Arrangements matters and risk management;

- an increased emphasis on financial performance;
- clarification of the application of governance arrangements to GBEs involved in a sale or restructuring process;
- GBEs to be public companies limited by shares and incorporated under the Corporations Law;
- GBEs to table a Statement of Corporate Intent in Parliament annually; and
- a differentiation between financial and trading GBEs in the setting of target rates of return.

2.10 The two main accountability mechanisms required as part of the 1993 arrangements, and the 1997 arrangements which have succeeded them, are corporate planning and reporting.

Corporate planning

2.11 The 1993 arrangements required each GBE Board to submit a three to five year corporate plan to its portfolio Minister each year. This requirement remains under the 1997 arrangements. The corporate plan is the central element of the GBE accountability arrangements to government in that it details the strategic direction the GBE is planning to take and so provides the major avenue for GBE strategic oversight. The corporate plan sets out the broad objectives and business strategies for the GBEs. The information GBEs are required to provide in their plans includes their mission and objectives, reviews of past performance, overall business strategies, general assumptions and non-financial performance measures.

2.12 The 1993 arrangements required GBEs to include in their corporate plans information such as corporate objectives, ministerially agreed financial targets and dividend policy, assumptions about the business environment in which the GBE operates, business strategies and the investment and financing programs.[14]

2.13 The main changes the 1997 arrangements have introduced relate to improvements in the guidance on

[14] In addition, GBEs were required to include: strategies for managing financial exposure; financial projections, non-financial performance, CSOs details and costs, including strategies for minimising costs; review of performance against past plans and targets; pricing/service quality controls (for monopoly provided services); human resource management and industrial relations strategies; analysis of critical factors most likely to affect achievement of targets; and analysis of critical factors most likely to expose the GBE or the shareholder to risk.

each of the issues set out above, the recognition of the Minister for Finance as a joint Shareholder Minister with Portfolio Ministers and some more detailed requirements upon GBEs in regard to corporate plans.[15]

2.14 Other elements of both the 1993 and 1997 GBE accountability frameworks relate to the reporting requirements which generally arise from strategies and targets set out in the corporate plan. They comprise both external reporting to the Parliament and the public and internal reporting to the executive and monitoring agencies.

Reporting

2.15 During the period in which the 1993 oversight arrangements applied, the two external reporting mechanisms in the Federal system were the GBE's annual reports and the annual report by the Steering Committee on National Performance Monitoring of Government Trading Enterprises (GTEs). The Special Premiers' Conference (now the Council of Australian Governments) established the steering committee five years ago and members of the committee are drawn from the Commonwealth, State and Territory Governments. The Industry Commission[16] provides the secretariat for the steering committee.

2.16 The steering committee's annual report includes GTEs from the Commonwealth, States and Territories in key sectors and provides benchmark comparisons on both financial and non-financial performance measures. The report provides coverage for six Commonwealth

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[15] The 1997 Governance Arrangements: require that corporate plans cover at least three years, rather than requiring a three to five year projection; require that corporate plans include planning for subsidiaries of the GBE; have enhanced the obligations of the GBEs to report variations to the corporate plan. The 1993 arrangements required GBEs to report in circumstances where they would be required to disclose the information along the lines of the Australian Securities Commission or Australian Stock Exchange requirements. In contrast, the 1997 arrangements require GBEs to report to Shareholder Ministers <u>any</u> variations to the corporate plan or the inability to achieve the objectives of the plan. The 1997 arrangements also require GBEs to report on financial projections and targets using the profit and loss statement, balance sheet and cash flow statement. The 1993 arrangements required financial projections but only specified the form of interim financial statements. The 1997 arrangements recognise the need to report on price and quality control for goods produced by GBEs as well as services they provide. The 1993 arrangements referred only to pricing/service quality controls. The 1997 arrangements make the Minister for Finance a joint Shareholder Minister with the Portfolio Minister, and strengthen the role of the Shareholder Ministers in requiring changes to any draft corporate plan.

[16] The Industry Commission has been merged administratively with the Bureau of Industry Economics and the Economic Planning Advisory Commission to form the Productivity Commission, which will continue providing the secretariat for the steering committee.

GBEs[17] including two of the four GBEs considered by this audit, namely Australia Post and Australian National.

2.17 In addition to these requirements, under the 1997 Governance Arrangements there are two further mechanisms which provide for external reporting. First, GBEs will be required to prepare annually a Statement of Corporate Intent which Shareholder Ministers are to table within fifteen sitting days of the start of the new financial year. In addition, the Minister for Finance may require a GBE to prepare an interim report at any time in the financial year which must be provided within two months of the end of the nominated period and be tabled by the portfolio Minister in both Houses of the Parliament. This reflects a provision in the proposed Commonwealth Authorities and Companies Act.

Reporting by companies

2.18 ADI Limited was the only company GBE included in the audit. The only requirements with which ADI Limited must comply regarding its annual report are those specified in the Corporations Law. When the current restructure of HLIC is completed, HLIC will no longer be a statutory authority and will only be obliged to report as required under the Corporations Law. Under the 1997 arrangements, wholly owned GBE companies are required to produce Statements of Corporate Intent, and interim reports when requested by the Shareholder Ministers, for tabling in Parliament.

Statutory authorities reporting

2.19 Australia Post, Australian National and HLIC are required by their establishing legislation to provide an annual report. Australia Post's legislation specifies the matters to be addressed. Australian National's legislation requires it to inform the Minister concerning the general conduct of its operations and to furnish the Minister with such information in relation to its operations as the Minister requires. HLIC's legislation requires it to report annually to the Minister on its operations together with financial statements in respect of that year in such form as the Treasurer approves.

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[17] Snowy Mountains Hydro-Electric Authority; Australian National Railways Commission; ANL Limited; the Australian Postal Corporation; the Federal Airports Corporation and Telstra Corporation. The steering committee's annual report has to date included Airservices Australia. However, Airservices Australia is no longer included in the Government's list of GBEs. The National Rail Corporation Limited, jointly owned by the Commonwealth, New South Wales, Victoria, Queensland and Western Australia, is also included in the report.

2.20 HLIC, Australia Post and Australian National must also comply with the *Guidelines for the Content, Preparation and Presentation of Annual Reports by Statutory Authorities,* tabled in the Senate on 11 November 1982. These guidelines do not override statutory requirements imposed by legislation but where the guidelines require a higher standard than the relevant legislation these GBEs are obliged to comply with that higher standard.

2.21 Subject to the need to protect commercially sensitive material, the guidelines require the following information to be presented in the annual reports of statutory authorities:

- enabling legislation of the organisation;
- Ministerial powers and exercise of those powers;
- powers, functions and objectives of the organisation;
- members and senior staff of the organisation, and general staff numbers;
- financial statements;
- principal programs and activities and relating these to objectives and achievements;
- interaction with other organisations and publications;
- major operational problems and action required to rectify them; and
- subsidiaries and interests in other companies (with inclusion of the subsidiary's annual report where practical).

2.22 The Joint Committee of Public Accounts (JCPA) 1995 Report 336, *Public Business in the Public Interest*, recommended that these guidelines be revised as soon as practicable.[18] The Department of Finance circulated a draft of new guidelines around June 1995 with a view to them being issued as a Finance Minister's Order under section 9 of the proposed Commonwealth Authorities and Companies Act. Currently, these draft guidelines are being refined as implementation has been delayed pending the passing of the replacement legislative package for the *Audit Act 1901*.[19]

2.23 The annual reporting requirements for these GBEs have remained general, providing a standard of reporting significantly below the financial reporting against corporate plans which is provided to the portfolio

[18] JCPA 1995 Report 336, *Public Business in the Public Interest*, Recommendation 23, page 169.

[19] The replacement legislative package for the *Audit Act 1901* includes: the Auditor-General Bill 1996, the Financial Management and Accountability Bill 1996, and the Commonwealth Authorities and Companies Bill 1996.

departments and the Department of Finance for internal monitoring purposes. A significant proportion of the information provided for internal monitoring purposes is, of course, commercially sensitive and this explains in part the disparity between the two standards. However, notwithstanding the need to appropriately acknowledge and handle commercial sensitivities which exist, the current annual reporting arrangements provide limited accountability to the Parliament regarding GBEs' performance.

2.24 Despite the requirement for GBEs to achieve social, economic and community service objectives, the annual reporting guidelines do not provide the basis for public scrutiny of a GBEs' non-financial performance in relation to the Commonwealth's interests. Scrutiny under the guidelines is limited to those GBEs which are statutory authorities and is focused on financial aspects due to the need to satisfy the Minister for Finance's requirements with regard to financial statements. Parliamentary committees have the power to review GBE operations through annual reports.

2.25 The 1997 *Governance Arrangements for Commonwealth Government Business Enterprises* will improve public access to GBE objectives through the introduction of an annual Statement of Corporate Intent, prepared in consultation with Shareholder Ministers, to be tabled in Parliament. The first Statements of Corporate Intent will be prepared for the financial year 1998-99. These Statements will be an integral part of future GBE corporate plans but will not include commercial-in-confidence information. The contents of the Statements, which are to be no more than five pages in length, include:

- business description and mission statement;
- corporate vision;
- objectives;
- code of ethics;
- statement of accountability (including reporting obligations); and
- broad expectations on financial and non-financial performance.

New Zealand practice

2.26 The *Public Finance Act 1989 (New Zealand)* details the accountability reporting obligation for Crown Entities.[20] Those Crown Entities listed in the Sixth Schedule to the Act are required

[20] Some Crown Entities' enabling legislation requires them to prepare accountability documents that are referred to as Documents of Accountability and Performance Agreements.

to prepare an annual Statement of Intent. The statement is a public document that is required to cover a three-year period and contain information about the particular Crown Entity's objectives, activities and financial and non-financial performance targets.

2.27 Crown Entities are required to provide their Minister with a draft of the Statement of Intent by 1 July each year. The Minister must, in turn, table in Parliament a Crown Entity's Statement of Intent within 12 sitting days of receipt.

2.28 A 1996 study of the monitoring of six Crown Entities undertaken by the New Zealand Controller and Auditor-General found that:

The Statements of Intent for four of the six Crown Entities contained little direct reference to the Crown's ownership interests. The statements were predominantly output focussed, and did not generally address the broader interests of the Crown, such as long-term financial viability, corporate behaviour, standards of service, relationships with the community or human resource management. Two of the six Crown Entities had included benchmarks in their Statements of Intent as an objective basis for measuring performance.[21]

Internal reporting

2.29 The 1993 and 1997 arrangements both provide for three main reporting mechanisms:

- GBE Boards are required to report to the portfolio Minister on financial performance, either biannually or quarterly as agreed between the responsible Minister and the Minister for Finance; and
- GBE Boards are also expected to adequately notify their responsible Minister of material significant events and to provide an outline of the business's planned strategic direction for comment; and
- the Minister for Finance's periodic reports to Ministers on GBEs financial performance.

2.30 The two accountability mechanisms of corporate planning and reporting provide the basis for GBE monitoring arrangements undertaken by the Minister for Finance, the relevant portfolio Minister; other Ministers and each GBE itself.

2.31 Finding: The Government's 1993 *Accountability and Ministerial Oversight Arrangements for Government*

[21] *Report of the Controller and Auditor-General on Governance Issues in Crown Entities,* New Zealand, November 1996, pp. 37-38.

Business Enterprises provided Boards and management with increased commercial freedom, while establishing a corporate governance framework that emphasised direct accountability to the responsible Ministers for performance.

Functional responsibility

2.32 During the period examined by the audit, the 1993 arrangements applied. Under the 1993 arrangements, GBEs were responsible for providing information to their portfolio Minister and the Minister for Finance to satisfy accountability requirements. Their objectives included the requirement to manage their business to achieve a financial target (including dividend policy). This financial target was to be agreed in advance with their Portfolio Minister in consultation with Minister for Finance. An ultimate objective for each GBE was to operate at world best practice (modified, if appropriate, to allow for any non-commercial government requirements or unique Australian conditions).[22]

2.33 Ministers were responsible for the performance and accountability of GBEs within their portfolios. However, the Minister for Finance was to be consulted regarding all performance and accountability issues.

2.34 The 1997 arrangements provide that the Commonwealth's interest is represented jointly by two 'Shareholder Ministers', the portfolio Minister and the Finance Minister. A Protocol on Working Arrangements for joint Shareholder Minister Oversight for GBEs has been established in connection with the 1997 arrangements to clarify which shareholder Minister has primary carriage for particular functional responsibilities. The Minister for Finance has primary responsibility for all financial accountability and oversight issues which translates to responsibility for GBE corporate plans, progress reports, investment proposals and periodic reporting to Ministers. The portfolio Minister has primary responsibility for policy and regulation, CSOs, service quality and other non-financial issues. While the Protocol assigns primary carriage to one or other of the joint Shareholder Ministers, both Ministers are to be consulted on all accountability issues.

2.35 To fulfil Ministerial responsibilities the Minister for Finance and portfolio Ministers are assisted by officers from their respective departments.

[22] Refer page 2 of *1993 Accountability and Ministerial Oversight Arrangements for Government Business Enterprises.*

Departmental officers are tasked with monitoring GBE matters on an ongoing basis, providing briefings to their Minister on the adequacy of the corporate plan, reports and all other matters relating to accountability and performance of GBEs.

Finance portfolio

2.36 The 1993 GBE arrangements required the portfolio Minister to consult the Minister for Finance on all major matters affecting GBE performance and accountability. The Minister for Finance also determines the guidelines to be followed by those GBEs which are statutory authorities regarding the form and content of their financial statements. In addition, the Minister is responsible for periodically reporting to Ministers on the financial performance of all GBEs. The established methodology is to assess GBEs' performance against their corporate plan objectives, agreed financial targets and the forecasts provided in their corporate plans.

2.37 As other portfolio Ministers needed to consult the Minister for Finance, with a view to reaching agreement, the Department of Finance officers supported their Minister by being involved in:

- an annual examination of performance;
- the assessment of GBE mandates and objectives, corporate plans and interim reports;
- the setting of accounting and economic rates of return;
- reaching agreement on dividend targets (dividend policy agreed by Ministers);
- analysis of non-financial indicators including world's best practice;
- reviews of GBE capital structures;
- any review of legislation and other legal constraints applying to GBEs which may prevent application of the arrangements;
- consultation with GBEs regarding the arrangements; and
- considering, from the point of view of a shareholder, whether the accounting policies used meet the Government's best interests.[23]

2.38 Until July 1997, the GBE monitoring process within the Department of Finance was divided into a policy and coordination function on one level, and the monitoring of specific GBEs by the relevant

[23] Refer pages 3 and 7, Department of Finance GBE Circular 1993.

supply areas of the Department at another. The former area was responsible for the development of guidelines, other publications and training courses that outline government requirements, such as the roles and responsibilities of Ministers, departments and GBEs for the performance and accountability of GBEs and coordinated preparation of reports to Ministers.

2.39 The supply areas combined monitoring of specific GBEs with their portfolio oversight functions. They were responsible for liaison with the responsible departments and, on occasion, with the GBEs themselves. Supply areas were responsible for evaluating compliance of the corporate plans and the annual, biannual and quarterly reports of GBEs and preparing a report on the adequacy[24] of these instruments for the Minister for Finance. Supply areas also negotiated financial targets and dividend estimates and reviewed the capital structure of GBEs on a five yearly basis.

2.40 The Department of Finance has established a GBE Oversight Unit which since July 1997 has taken responsibility for all Department of Finance GBE monitoring functions. Under the 1997 arrangements, this unit will continue to assist the Minister for Finance in much the same way that the Department has done so in the past.

2.41 In the context of considering the potential risk to which the Commonwealth is exposed by its GBEs, the Department of Finance recently has carried out surveys of GBE liabilities backed by explicit Commonwealth guarantee and their use of derivatives. However, both of these surveys provided incomplete results.

2.42 Economic rate of return reporting is proving difficult to implement for a number of GBEs. However, the 1997 arrangements provide some clarification noting that a different basis may be used for setting target rates of return with regard to financial (for example, AIDC and HLIC) as opposed to trading GBEs (for example, ANL Limited).

2.43 Finding: Effectiveness of Commonwealth oversight has continued to improve with the introduction of periodic reports to Ministers and surveys by the Department of Finance of GBEs use of derivatives and off-balance sheet exposures.

[24] Adequacy is not only assessed against compliance with oversight arrangements but also issues raised in periodic reports to Ministers, Loan Council applications and any other relevant policy considerations.

Portfolio responsibilities

2.44 The 1993 oversight arrangements required portfolio Ministers to provide a set of clear objectives for the GBEs operating within their portfolios and to influence the strategic direction of the businesses by approving financial targets and dividend policies, approving borrowing limits under Loan Council processes and also through assessing shareholder risk. This was to be achieved by the Minister providing comment to the GBE Board on the strategic directions covered by the corporate plan. The Prime Minister, Treasurer, the Minister for Finance and the Minister for Industrial Relations were also provided with copies of the corporate plan and had the option of commenting on it.

2.45 Portfolio Ministers were also responsible for addressing capital structure issues and for analysing significant proposals put forward by the GBE boards.

2.46 Portfolio Ministers are accountable to Parliament for the overall performance of the GBEs and are required to monitor whether GBEs:

- adhere to the objectives as stated in their legislation;
- adhere to the objectives explicitly stated by the Government in other policies or directions;
- are meeting their objectives in relation to commercial performance and, in doing so, whether GBEs are operating ethically within the commercial environment; and
- are meeting their non-commercial objectives including any CSOs.

2.47 A significant portion of the GBE oversight was undertaken by the various portfolio departments and there exists within these departments a variety of skills and experience. The effectiveness of monitoring can be affected by staff changes within portfolio departments. One weakness which does apply across the departments reviewed is the small number of officers involved in the monitoring process and the potential for a relatively large loss of corporate memory and expertise if these officers leave.

2.48 Departmental officers also serve at times on some of the GBEs' boards. For example, officers from the Department of Transport and Regional Development have at times served on the boards of the Federal Airports Corporation, Airservices Australia, ANL Limited and Australian National.

2.49 Representatives of the Department of Finance, the Department of Communications and the Arts and its predecessor, the Department of Transport and Communications, contributed to the development by the Steering Committee on National Performance Monitoring of Government Trading Enterprises of its methodology for establishing economic rate of return targets. This methodology has subsequently been adopted by the Commonwealth.[25]

2.50 Portfolio departments have varying degrees of understanding of such matters as the key economic drivers of individual GBEs, where those GBEs sit in the economic cycle, the maturity of the industry in which they operate and the threats to their future performance. When monitoring staff are selected, often a compromise is made between knowledge and experience in the industry, an understanding of the business including CSO requirements and commercial and financial experience.

2.51 Departments have from time to time used external advisers to conduct specific reviews of individual GBEs within their portfolios. Most notably, in the case of Australian National, a series of reviews of various aspects of the conduct of its businesses has been commissioned over the last five years.

2.52 Finding: Agencies' understanding of GBEs' businesses has generally benefited from the improvement in GBE corporate planning information in recent years, where this has been provided. However, comprehensive appreciation of some GBEs' significant risks and their management practices is still largely unreflected in the information provided to agencies.

Recommendation No.1

2.53 The ANAO *recommends* that portfolio departments periodically commission an independent assessment of the corporate plans of GBEs within their portfolio to provide objective assurance to Ministers and the Parliament on an important element of the governance framwork.

2.54 Agencies responded to the recommendation as follows:

- *Agree:* DoCA, DoD and DTRD.

[25] The methodology is set out in the steering committee's report, *An Economic Framework for Assessing the Financial Performance of Government Trading Enterprises* which built on the Treasury Economic Paper No. 14 (1990) *Financial Monitoring of GBEs : An Economic Framework.*

- *Agree with qualification:*DoF and Tsy*.*

2.55 Specific comments by departments are set out below.

- *DoD response:* Agree. Based on our experience, the sentiments expressed in Recommendation 1 are relevant, especially given the small numbers of staff involved in the monitoring process. The recommendation is supported not only from the viewpoint of providing assurance for responsible Ministers, but also when it is necessary to fill gaps caused by loss of expertise and corporate knowledge.

- *DoF response:* Agree with qualification. Finance would need to be involved in the commissioning of assessments, consistent with the joint shareholder Ministerial oversight model for GBEs.

- *Tsy response:* Agree with qualification. Considering that Ministers, as joint shareholders, are ultimately responsible to the public through Parliament for the conduct and performance of GBEs, Treasury suggests that it is up to Ministers, jointly, as how best to assess the performance of their GBEs. In this regard, the new GBE oversight unit in the Department of Finance could be expected to play an important role. An agreement, in principle, to Recommendation No. 1 may provide scope to strengthen the *1997 Governance Arrangements*.

1.1

3. Monitoring within the Selected Agencies

This chapter discusses performance monitoring of the selected GBEs by the responsible agencies.

Background

3.1 The four GBEs, whose performance monitoring experience and outcome have been selected for consideration in this audit (HLIC, ADI Limited, Australia Post and Australian National) all have undergone considerable change. The industries in which these four GBEs are operating are quite different from one another and they are also in different financial positions.

3.2 Australia Post had a net profit in 1995-96 of $237.6 million, while Australian National incurred a loss of $210.5 million. Similarly, the rate of return on assets in 1995-96 varied from negative 13 per cent for Australian National to 18 per cent with Australia Post.

3.3 Exhibit 3.1 below presents a comparison over time of the financial position of the four selected GBEs. The considerable diversity in the financial performance of GBEs has significant implications for departmental monitoring of GBEs.

3.4 The GBE monitoring functions within the departments are generally combined with a policy role. The monitoring sections are in frequent contact with the GBEs, not only on issues arising from the Government's 1993 *Accountability and Ministerial Oversight Arrangements for GBEs* but also on matters for Ministerial briefing, such as electorate visits and complaints to Ministers. The GBE monitoring function typically involves about one full-time officer equivalent's time.

3.5 Contact with the GBEs is focussed through a senior member of the GBE, usually one level below the General Managers or equivalent. GBEs were found generally to have a high level of cooperation with the portfolio departments in providing necessary information. This level of cooperation was generally considered by departments to have improved markedly in the years since the introduction of the 1993 oversight arrangements.

Exhibit 3.1:
Selected GBEs financial performance 1991-92 to 1995-96

	1991-92 $ 000	1992-93 $ 000	1993-94 $ 000	1994-95 $ 000	1995-96 $ 000
Australian National					
EBIT[1]	(101,512)	44,027	48,244	(9,835)	(145,080)
EBITAD[2]	(61,942)	83,724	89,955	32,385	(114,496)
EAT[3]	(137,181)	2,010	2,829	(61,442)	(210,462)
Gearing[4]	71%	79%	45%	40%	n/a[5]
ROA[6]	(9%)	5%	5%	0%	(13%)
ADI Limited					
EBIT	(95,854)	25,081	24,255	15,921	(37,105)
EBITAD	(80,395)	40,310	39,851	30,124	(22,681)
EAT	(84,677)	23,980	27,912	33,434	(19,471)
Gearing	0%	16%	20%	21%	24%
ROA	(9%)	6%	5%	6%	(4%)
Australia Post					
EBIT	216,213	209,139	253,800	335,700	365,700
EBITAD	286,289	302,682	335,700	441,400	479,500
EAT	136,816	125,370	179,400	238,700	237,600
Gearing	4%	4%	23%	25%	27%
ROA	12%	12%	14%	17%	18%
HLIC					
EBIT	7,133	3,115	18,294	9,866	2,045
EBITAD	7,448	3,513	18,539	10,170	2,409
EAT	4,309	6,438	16,629	14,224	11,471
Gearing	0%	0%	0%	0%	0%
ROA	5%	7%	13%	9%	7%

Notes:

1. EBIT - Earnings before Interest and Tax.
2. EBITAD - Earnings before Interest, Tax, Amortisation and Depreciation.
3. EAT - Earnings After Tax.
4. Gearing Ratio is calculated as Interest Bearing Debt divided by the sum of Interest Bearing Debt and Total Equity
5. Australian National's gearing ratio exceeds 100% because it had negative equity of $11.879 million as at 30 June 1996.
6. Return on Assets (ROA) ratio is calculated as Earnings Before Interest Expense and Tax divided by Average Total Assets for the year.

Source: Selected GBEs Annual Reports 1991-92 to 1995-96.

Corporate planning

3.6 The corporate planning process is the key mechanism through which the 1993 and 1997 GBE arrangements seek to monitor performance of the GBEs. The arrangements give particular attention to the development of corporate plans and monitoring performance against those plans. The arrangements require that plans are updated annually and are to cover a three to five year horizon. The arrangements specify certain information and analysis which must be included in the plan. The 1993 arrangements require the relevant Minister and the Minister for Finance to respond to the plan within 60 days of receipt. The 1997 arrangements require the Minister for Finance to respond on behalf of the Shareholder Ministers within 45 days of receipt.

3.7 The plans provided by the selected GBEs to the monitoring agencies during the period examined by the audit varied in terms of the type of information included and the sophistication of the analysis contained in them, particularly on aspects of risk analysis.

Australia Post

3.8 Division 2 of the *Australian Postal Corporation Act 1989* lays down corporate planning requirements for Australia Post.[26] Under this division, Australia Post has been obliged to prepare corporate plans since 1989. However, both Australia Post's legislation and the 1987 policy guidelines only required that a new plan be prepared to follow on immediately from the previous three to five year plan. Accordingly, until the oversight arrangements were introduced in 1993, there was no obligation on Australia Post to update its corporate plan annually.

3.9 The legislation prescribes that Australia Post's corporate plans must contain the following:

- information regarding the Corporation's financial objectives;
- information regarding the Corporation's strategic objectives;

[26] Australia Post's legislation also sets out: the matters to be included in the organisation's corporate plans; the matters to be considered in setting a financial target for the organisation; when corporate plans are to be given to the portfolio Minister; the power of the Minister to direct certain variations to corporate plans and the obligations of the Board regarding notification of the Minister of significant events which may prevent or significantly affect the achievement of objectives under the corporate plan, its performance of its community service obligations or the achievement of the financial target under the corporate plan. Sections 35 to 41, Division 2 - Corporate Plans, *Australian Postal Corporation Act 1989.*

- outline of the policies to be implemented allowing the Corporation to achieve those objectives;
- strategies relating to Community Service Obligations (CSOs)[27]
- an estimation of the cost of CSOs and other obligations;
- financial performance indicators and;
- inclusion of a financial target and forecasts for revenue, expenditure and borrowings.

3.10 In its most recent corporate plan, Australia Post has comprehensively reported against all the requirements of its legislation and the Government's guidelines. Australia Post incorporated the necessary financial and strategic material, including appendices with supporting information, and outlined the intended strategies and policies it intends to pursue in relation to its objectives and targets.

3.11 Australia Post's corporate plans included the most comprehensive financial targets of the four GBEs reviewed. Australia Post has consistently exceeded revenue and profit targets and these targets have been revised upwards over successive corporate plans. Australia Post has also met or exceeded target dividends set out in its corporate plans. Consistent with the capital repayment schedule agreed between Australia Post and the then portfolio Minister in 1993, Australia Post made a final $50 million capital payment to the Commonwealth by 30 June 1997.[28] It is also achieving the rate of return on assets targeted in its corporate plans.

3.12 Australia Posts' CSOs relate to its obligation not only to operate commercially and efficiently, making reasonable return on its assets, but also to ensure that all Australians have reasonable and equitable access to a letter service which meets their postal needs. In 1995-96 the estimated annual cost of Australia Post's CSOs was $72 million.

Non-financial performance

3.13 Australia Post has since 1989 reported, including in its annual reports, non-financial performance in relation to:

- on time letter delivery;

[27] Australia Post's CSOs are defined in Section 27 of the *Australian Postal Corporation Act 1989* and include a universal service obligation to provide a postal service to most locations in Australia at a uniform price (currently 45 cents), even when the delivery cost is higher than the price charged.

[28] Note the then Minister agreed to a phased program of capital repayments between 1993-94 and 1996-97 of $450 million.

- time lost through industrial disputes; and
- customer familiarity and favourability measures.

3.14 Since December 1994, there has been provision in the *Australian Postal Corporation Act 1989* for the inclusion in the Australian Postal Corporation Regulations of performance standards to be met by Australia Post and for annual performance audit of Australia Post's compliance with any such performance standards by the Auditor-General[29]. Section 28C provides that the regulations may prescribe performance standards in relation to the frequency, speed or accuracy of mail delivery; or the availability or accessibility of post boxes or other mail lodgement points or offices of Australia Post or other places from which Australia Post products or services may be purchased.

3.15 No regulations setting out such performance standards have been made to date. The second reading speech introducing the *Australian Postal Corporation Amendment Bill 1994* commented that the regulations were not to be made until the then House of Representatives Standing Committee on Transport, Communications and Infrastructures' inquiry into Australia Post's community services was completed. The Committee had not reported when the March 1996 Election was called. In July 1996, the House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform announced that it was resuming the inquiry with revised terms of reference.[30]

3.16 In September 1996, the Committee released its report, *Keeping Rural Australia Posted.* The report dealt with the issue of performance standards and recommended that they be developed by Australia Post and the Steering Committee on National Performance Monitoring of Government Trading Enterprises; and that these standards contain a range of financial and non-financial indicators. The Committee's report also recommended that the Auditor-General's role be broadened to include the power to comment on the appropriateness of the performance targets set by Australia Post.

3.17 The Minister for Communications and the Arts

[29] Sections 28C and 28D of the *Australian Postal Corporation Act 1989.*

[30] Media release, Mr Mark Vaile MP, Chairman of the House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform, 1 July 1996.

tabled the Government's response to the Committee's report on 25 June 1997[31]. The Government has decided that it is the responsibility of Ministers to decide appropriate performance indicators for Australia Post. The Departments of Communications and the Arts, Finance and the Treasury are currently developing a set of performance measures in consultation with Australia Post. These measures are to be consistent with the framework established by the Steering Committee on National Performance Monitoring of Government Trading Enterprises.

3.18 In addition, the Minister for Communications and the Arts will be introducing minimum performance standards under section 28C of the *Australian Postal Corporation Act 1989* and these will provide a public measure of non-financial performance. The Government does not agree with the Committee's recommendation that the role of the Auditor-General should be expanded. Consequently, the Auditor-General will only be required under section 28D to assess the performance of Australia Post against the minimum performance standards established by the Minister.

Australian National

3.19 The *Australian National Railways Commission Act 1983* states that Australian National must meet certain reporting requirements. Australian National's legislation lays down requirements regarding:

- setting Australian National's financial target ;
- conduct and timing of reviews of the financial results of Australian National's operations;
- interim notification to the Minister of progress towards attaining the annual target and measures for addressing any shortfall;
- notification to the Minister, within 60 days of the end of the financial year, of measures that will be adopted should Australian National be unable to meet its financial target;
- Australian National's dividend policy and the dividend intended for payment to the Commonwealth; and
- details of biannual reviews of Australian National's financial operations.

[31] Government response to the report of the House of Representatives Standing Committee "Keeping Rural Australia Posted".

3.20 In addition, Australian National's legislation[32] requires that not more than 12 months be allowed to elapse between the submission of reports concerning the objectives, strategies and policies of the Commission. Australian National's business plans have fulfilled this role. However, it is not apparent whether this statutory requirement has been routinely adhered to by Australian National. To some extent this has been a consequence of periodic uncertainty regarding Australian National's future which has led responsible Ministers to agree to delays in the provision of corporate plans.

3.21 Australian National's business plans have included a limited number of financial targets, primarily profit, revenue and expenditure targets. In the last five years, Australian National has consistently failed to meet its profit targets and has only occasionally met revenue and expenditure targets. Australian National advised the ANAO that:

AN has been without any clear Government direction since the formation of the National Rail Corporation and has seen its revenue and profitable assets progressively stripped to service NRC without any financial recompense or other consideration.

HLIC

3.22 The *Housing Loans Insurance Act 1965* requires the production of an annual report. In addition, the Minister can ask the corporation to provide reports, documents and information concerning the its operations, and quarterly reports on the status of insurance contracts. The *Housing Loans Insurance Corporation (Transfer of Assets and Abolition) Act 1996* will require the restructured HLIC, to be called HLIC Limited, to comply with the reporting requirements of the Corporations Law and for the existing HLIC to provide a final report to the Parliament.[33]

3.23 From the time of the introduction of the Policy Guidelines for Commonwealth Statutory Authorities and Government Business Enterprises in October 1987, there has been a requirement for HLIC to develop and submit to the Government a three to five year corporate plan. Following the introduction of the 1993 arrangements, there was an additional requirement that HLIC

[32] Section 22(5) of the *Australian National Railways Commission Act 1983*.

[33] This will take the form of a final report to be presented to the Treasurer and tabled in the Parliament.

annually update its corporate plan.

3.24 ANAO fieldwork established that in the period since the 1987 requirement was introduced, HLIC has submitted only one draft corporate plan (for 1994-95, which was not approved).

3.25 There have been three attempts in the past 18 years to sell HLIC. HLIC was first offered for sale in 1979 when the then Government decided that it no longer required a presence in the lenders mortgage insurance market. However, the sale attempt was halted as a result of the election of the then Labor Government in 1983. In the 1989 Budget it was again announced that HLIC would be sold. On 30 October 1990, the then Minister for Finance stated that HLIC would be sold subject to satisfactory negotiations with the buyer regarding contractual arrangements, with a sale date expected early in 1991. The sale did not occur because the buyer was unable to satisfy the proposed contractual obligations.

3.26 A further sale attempt was made in 1993. When a satisfactory purchaser had not been found by December 1994, the then Government took the decision to undertake a restructure of HLIC, to place it on a more commercial footing, in order to address factors which had precluded successful completion of the sale. Although originally forecast to be completed by June 1996, HLIC's restructuring from a statutory authority to an incorporated unlisted public company is close to completion. Initially, the March 1996 election and the incoming Government's need to re-examine the legislation (which was not passed by the Senate prior to the election) delayed the restructure. The remaining issues to be finalised before completion of the restructure relate to the negotiation of various contracts and agreements with the management of the new company.

3.27 HLIC has spent much of the last two decades awaiting sale. However, the 1987 policy guidelines gave no specific guidance regarding GBEs which were proposed be sold. The 1993 arrangements required boards and management of GBEs being sold to 'provide adequate co-operation and information to the Government in the period leading up to sale'. The 1993 arrange-ments did not address the issue of whether a GBE, in respect of which attempts were being made to arrange a sale, was excused from the obligation to provide corporate plans.

3.28 The 1997 arrangements specify that the arrangements are to be fully complied with in the case of the impending sale or restructuring of a wholly owned GBE until the Shareholder Ministers decide on any variations to the arrangements which might be necessary to facilitate the sale or restructuring process.

3.29 The Department of the Treasury advised the ANAO that it was impractical to require HLIC to provide the Government with a corporate plan while HLIC was undergoing sale or restructure. HLIC had advised the Department that the Corporation was unable to provide the three to five year financial forecasts required under the 1993 arrangements. Treasury advised that agreement was reached between officials of both the Departments of Finance and the Treasury and, subsequently, by their then respective Ministers, to excuse the HLIC from this requirement until the nature of the restructure was known.[34] Treasury noted that a draft HLIC business plan for 1997-98 currently existed and would be revised when the new corporation commenced operations. Treasury also noted that a range of special purpose reports have been produced as a result of the sale and restructuring processes which the Department believed possibly provided more information than a corporate plan.[35]

3.30 Letters dated 21 December 1994 and 9 March 1995 between the then Treasurer and the then Minister for Finance, state that both Ministers were agreed that financial forecasts beyond 1994-95 were too difficult to develop when the 1994-95 HLIC corporate plan was being developed, given the state of the sale process at the time. Accordingly, although in the absence of financial forecasts the Ministers did not approve the draft corporate plan, they were agreed that the HLIC draft corporate plan prepared for 1994-95 was an appropriate basis for guiding the Corporation's activities in the circumstances at the time.

3.31 The then Minister for Finance noted in his letter of 9 March 1995 that HLIC would need to reassess its plan in light of any decisions taken by the Government on restructuring the Corporation. In these letters, neither of the then Ministers excused HLIC on an ongoing basis from the requirement to

[34] Letter from Treasury to the ANAO, 4 July 1997, page 2.

[35] Ibid, page 3.

develop corporate plans, notwithstanding their concession that, at the time the 1994-95 draft corporate plan was developed, financial forecasts beyond 1994-95 were too difficult to develop.

3.32 The Department of the Treasury advised the ANAO that it:

acknowledges the important role that comprehensive corporate plans play in providing a necessary information to enable the Government adequately to ascertain, inter alia, the performance of GBEs. It therefore follows that corporate plans are a means to an end, not an end in themselves.

3.33 The ANAO clearly accepts this observation but notes that corporate planning is an integral part of good corporate governance and the guidelines at least implicitly recognise this.

3.34 Sound business practice involves articulation of business' objectives and targets within a framework, such as a corporate plan. Accordingly, even during sale and/or restructuring processes, particularly when such processes are as protracted as has been the case with HLIC, the development of appropriate corporate plans remains important.

3.35 Finding: Generally, selected GBEs provided corporate plans in accordance with the Government's GBE guidelines, with the exception of HLIC. The Department of the Treasury advised the ANAO that it was impractical to require HLIC to provide the Government with a corporate plan while HLIC was undergoing sale or restructure and that, in any case, the portfolio had access to sufficient information to monitor the performance of HLIC during this period.

3.36 Nonetheless, the ANAO considers that provision of corporate plans is good practice, as clearly evidenced by the Government's GBE guidelines, and suggests that action should be taken to meet the requirement of the guidelines that three-year corporate plans, updated annually, be submitted and agreed with the portfolio Minister and the Minister for Finance, unless otherwise agreed by the responsible Ministers.

Recommendation No.2

3.37 The ANAO *recommends* that departments ensure that GBEs within their portfolios comply with the requirements of the 1997 Governance Arrangements, including the preparation and submission of corporate plans, when they are being sold or restructured unless and until otherwise agreed by the Shareholder Ministers.

3.38 Agencies responded to the recommendation as follows:

- *Agree:* DoCA, DoD and DoF.
- *Agree with qualification:* DTRD and Tsy.

3.39 Specific comments by departments are set out below.

- *DoD's response:* Agree. As the report acknowledges, ADI is currently undergoing a privatisation process. The company was required to continue to comply with requirements for the preparation and submission of corporate plans for the five years from 1997-98 even though the Government had decided to go ahead with consideration of its possible sale. Recommendation 2 is therefore supported.
- *DTRD's response:* Agree with qualification. The Department believes that its role lies with ensuring that GBEs within the portfolio are aware of their responsibilities to comply with the *1997 Governance Arrangements*. Ensuring that they do comply is outside of the Department's power.
- *Tsy's response:* Agree with qualification. The Department of the Treasury agrees in principle with this recommendation.

The Department notes the desirability of the general application of the *1997 Governance Arrangements* and would prefer that any future exemptions are granted cautiously, on a temporary basis, through a joint recommendation by the Shareholder Ministers. In this regard, the Department notes that there may already be some temporary exemptions in place (such as in relation to the HLIC and the Export Finance Insurance Corporation), through agreements between Ministers, which need not be revisited. Grounds for a temporary exemption should only relate to a restructuring or sale processes, but would need to be considered on a case-by-case basis.

In terms of the HLIC, the Department notes that it was the intent of the exchange of letters between the former Treasurer and the Minister for Finance, dated 21 December 1994 and 9 March 1995 respectively, and discussions at the time between officials from both the

Departments of the Treasury and Finance, to excuse the HLIC from providing a complete and final corporate plan until such time as the HLIC was able to provide all of the necessary information required for such a plan, particularly in terms of the important finance information. In this context, it was recognised that this information would not be available until the completion of the restructure process and that a corporate plan which did not include the requisite financial information was of dubious value.

Notwithstanding the non-provision of an agreed corporate plan, officials from both the Departments of the Treasury and Finance recognised that as a result of the processes undertaken during the past sale attempts of the HLIC and the current restructuring process, the Commonwealth has been provided with sufficient information about, *inter alia*, the HLIC's operations and its strategies for managing its risks. The Department considers that this information has provided the Commonwealth with sufficient comfort in terms of the Commonwealth's exposure under the explicit Government guarantee provided to the HLIC's non-borrowing liabilities (largely its mortgage insurance policies).

The Department of the Treasury notes that following the completion of the restructure process, HLIC Limited will be required to meet all of the requirements set out in the *1997 Governance Arrangements*, including the preparation and submission of a corporate plan. HLIC Limited's corporate plan will include, *inter alia*, a target rate of return which will take account of the benefits resulting from the Government guarantee.

ADI Limited

3.40 ADI Limited has complied with the 1993 arrangements not only so far as submitting corporate plans on time but also regarding the matters to be reported on in GBEs' corporate plans under the arrangements.

3.41 ADI's corporate plans have included a range of financial targets for ADI both as a whole and for its constituent business units. ADI has generally met its targets. Performance against financial targets has been steadily improving, although ADI made an operating loss in 1995-96 after forecasting a profit, due largely to a cessation of production during the restructuring of its munitions operations.

Performance targets

3.42 As mentioned earlier in this report, each GBE is required under both the 1993 and 1997 arrangements to work towards a financial target agreed by the responsible Ministers. Under the 1993 arrangements the financial target included dividend policy. Under the 1997 arrangements, each GBE is to annually agree with Shareholder Ministers on a target optimal capital structure through the corporate planning process. Accordingly, the 1997 arrangements provide that the level of estimated dividends is also to be agreed annually through the corporate planning process having regard to the maintenance of, or progress towards, the GBEs' optimal capital structure.

3.43 Under the 1993 arrangements, the Government required that each GBE, as a minimum benchmark, achieve over time an economic rate of return on assets for their commercial operations equivalent to the long-term bond rate plus an appropriate margin for risk. In addition, the 1993 arrangements noted that it would also be appropriate to employ a range of other targets and indicators; including traditional accounting targets and non-financial indicators.

3.44 The 1997 arrangements refer to the requirement for all GBEs to add to shareholder value in their operations with a view to at least meeting a financial target agreed by the Shareholder Ministers. For GBEs that are classified as trading GBEs the target is the weighted average cost of capital. This requires the GBE to earn returns sufficient to cover the cost of debt and the required return on equity. For GBEs that are classified as financial GBEs, the target is a return on equity which is the risk free rate plus the proportion of market risk premium appropriate to the GBE.[36] Any other financial targets which might be set for particular GBEs, on a case-by-case basis, are expected to be consistent with the objective of increasing shareholder value.

3.45 HLIC has not had an economic rate of return target agreed with the Treasurer and the Minister for Finance. Letters dated 21 December 1994 and 9 March 1995 between the Treasurer and the Minister for

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[36] See Treasury Economic Paper No. 14 (1990) *Financial Monitoring of GBEs : An Economic Framework* and, more recently, the July 1996 paper produced by the Steering Committee on National Performance Monitoring of Government Enterprises*, An Economic Framework for Assessing the Financial Performance of Government Trading Enterprises.*

Finance, stated that Treasury and Finance officers should establish a financial rate of return for HLIC to assist the development of restructuring options. Treasury advised the ANAO that it considers the methodology for calculating economic rate of return targets under the 1993 arrangements not directly applicable to financial GBEs, but that the 1997 arrange-ments had now addressed this issue.

3.46 The Department of the Treasury advised the ANAO that:

The key point that the Department of the Treasury raised in respect of this matter is that any methodology for calculating such financial targets needs to take into account the operating characteristics of financial GBEs, on a case-by-case basis, and that this has now been recognised in the changes that have been incorporated into the 1997 Governance Arrangements.

To give effect to the above noted decision between Ministers, Treasury and Finance officials will consult on an appropriate rate of return target once the restructure processes have been completed. Consistent with 1997 Governance Arrangements, these targets will be included in HLIC Limited's first corporate plan and will take account of the benefits the company obtains as a result of the Government guarantee of the company's non-borrowing liabilities (ie. its mortgage insurance policies).

3.47 ADI Limited and Australian National have each had economic rate of return targets agreed. Only Australia Post and ADI have incorporated their economic rate of return target in their 1996-97 corporate plans. However, Australian National's 1996-97 corporate plan is still in draft form. ADI's economic rate of return target was not agreed in time to be included in corporate plans preceding the 1996-97 corporate plan. Accordingly, unlike Australia Post it did not discuss its performance against the economic rate of return target in its latest corporate plan.

3.48 Finding: GBEs are required to work towards an economic rate of return target. The Department of the Treasury considers that the methodology for calculating economic rate of return targets under the *1993 Ministerial Oversight and Accountability Arrangements for Government Business Enterprises* inapplicable to financial GBEs such as HLIC. The Department of the Treasury further advised that any methodology for calculating such financial targets needs to take account of the operating characteristics of financial GBEs, on a case-by-case basis, and that this has now been recognised in the changes that have been incorporated into the *1997 Governance Arrangements*.

3.49 The ANAO found that there was no exclusion provided for financial GBEs in the 1993 arrangements from the general obligation for GBEs to agree an economic rate of return target, or other appropriate financial targets, with their portfolio Minister and the Minister for Finance.

Capital structure reviews

3.50 The 1993 GBE monitoring arrangements required every GBE to have a capital structure review every five years. As noted above, the 1997 governance arrangements now require the GBEs' Directors and the Shareholder Ministers to agree on an optimal capital structure annually as part of the corporate plan consultation process along with the level of estimated dividends; having regard to the maintenance of, or progress towards the optimal capital structure.

3.51 ADI Limited's current capital structure was put in place in 1991-92 and ADI is intended for sale in the near future. In recent years, there has been considerable effort put into reviewing Australian National's capital structure. In mid-1992, in light of the decision to establish the National Rail Corporation, the then Government recognised the need to commission a consultant to review Australian National's operations, including its capital structure. This review was conducted in April and May 1993. The consultant's report included recommendations regarding Australian National's capital structure.

3.52 One of the recommendations of the 1993 review was that another review be carried out in mid-1995. An interdepartmental committee, comprised of representatives from the then Department of Transport and Communications, the Department of the Treasury and the Department of Finance was convened to conduct this review. It reported to the then Government in December 1995.

3.53 In April 1996 the present Government commissioned a further independent review into both Australian National and the National Rail Corporation. The Minister for Transport and Regional Development tabled the report summary in September 1996 and the Government took the decision to sell Australian National in November 1996.

3.54 Australia Post's capital structure was reviewed in 1992-93. As a result of this review the then Board of Australia Post and the then Minister for Communications and Transport agreed to a stream of capital repayments to be made by Australia Post over the period 1993-94 to 1996-97 totalling $450 million. The full $450 million has now been received.

3.55 HLIC is currently undergoing a major restructure as it is transformed, as required by the *Housing Loans Insurance Corporation (Transfer of Assets and Abolition) Act 1996*, from a statutory authority to a company subject to Corporations Law and the requirements of the Insurance and Superannuation Commission. HLIC's capital structure was previously reviewed following the passage of the *Housing Loans Insurance Corporation (Sale of Assets and Abolition) Act 1990* in January 1991.

3.56 Finding: In accordance with the requirements of the 1993 *Ministerial Oversight and Accountability Arrangements*, adequate reviews of the capital structure of the selected GBEs have been carried out at least every five years.

1.1

4. Overall conclusions

This chapter provides and overview of the issues and the conclusions of the audit.

Introduction

4.1 The financial scale of GBE operations makes essential the provision of assurance to the Government and the Parliament that the interests of GBEs' shareholders are being preserved and promoted. The financial materiality associated with the Commonwealth's equity investment in its GBEs, coupled with the public policy issues which frequently arise in connection with the operation and regulation of GBEs, are seen as important areas of audit coverage and Parliamentary interest.

4.2 The previous Government began a program of privatisation of Commonwealth assets including GBEs and this has been accelerated under the current Government. Many of the GBEs which have already been sold or which are earmarked for sale represent the larger and some of the more profitable GBEs (such as the Commonwealth Bank and the intended one-third float of Telstra).

4.3 Over time, the mix of GBEs which remain in Commonwealth ownership is likely to change to one consisting of the higher risk businesses. Unlike companies in the private sector, GBEs ability to borrow funds tends not to be based on their future generation of cash but on the implicit or explicit government guarantee that is associated with their ownership structure. In this circumstance, the effectiveness of monitoring and reporting arrangements will become increasingly important to protecting the ongoing interests of the Commonwealth.

Exposure management

4.4 Commonwealth agencies face considerable difficulties in identifying, monitoring and controlling the risks incurred by the GBEs for which they have responsibility.

4.5 The broad range of exposures which can be associated with the operations of GBEs include:

- **Financial risks** - the operations of GBEs are either explicitly or implicitly guaranteed by the Commonwealth. Accordingly, the consequences can be considerable for the Commonwealth if risks associated with the financial obligations that GBEs take on are not adequately monitored and managed. In addition, there are risks that GBEs will provide risk adjusted returns below industry norms, possibly insufficient to offset the opportunity costs to the Commonwealth of its capital investment in them;
- **Equity risks -** the Commonwealth's investment in GBEs is very significant and it needs to be assured that its investment is adequately protected.
- **Reputational risks -** the Commonwealth needs to be assured that neither its reputation nor the reputations of the GBEs themselves (given the attendant financial implications) are put at risk because of the activities of GBEs.
- **Operational risks -** that a GBE will fail to deliver the services it was established to provide.
- **Environmental risks -** GBEs operations may impact on the environment, for example by contamination of land, and this may affect the achievement of GBEs' financial and environmental targets or expose GBEs or the Commonwealth to significant risk.[37]

4.6 Recently, in announcing the successful bidders for Australian National's businesses, the Government also announced the allocation of $50 million to restore land to an environmental standard appropriate for ongoing

[37] ANAO Audit Report No. 31 1995-96, *Environmental Management of Commonwealth Land, Site Contamination and Pollution Prevention,* p.70, noted high risk sites owned by GBEs have the potential to pose significant financial consequences for the Commonwealth as the shareholder. Recommendation No. 14 of the report recommended that as a part of GBE accountability and oversight processes, and in the absence of any other oversight mechanisms, Departments become more proactive in overseeing GBE operations that impact on the environment (with particular reference to contaminated sites) that are likely to affect the achievement of GBEs' financial and environmental targets or expose the GBEs or the Commonwealth to significant risk. In particular, departments, in association with their Minister, should reinforce with portfolio GBEs:

a) the Government's expectations of GBEs' environmental responsibilities; and
b) the need to keep the Minister and the portfolio Department aware of environment management issues, both as they arise (on an exception basis) and as part of the annual report and corporate planning and reporting processes.

railway use - including $10 million for Tasrail land and $33 million to South Australia, including the funding for restoration of Australian National land at Islington in Adelaide. This is in addition to the previously announced provision of $20 million through the Regional Assistance Package to assist local communities adjust to the changes brought by the Government's rail reform initiatives.[38]

4.7 Like any other shareholder having a controlling interest in a business, the Government needs to be assured that it is aware of the exposures that its GBEs represent and that adequate risk management strategies are in place. The Commonwealth is more at risk from its GBEs operations than another shareholder would be because, apart from explicit Commonwealth guarantees underpinning the operations of some GBEs, the market and the community perception is that the operations of all GBEs are at least implicitly guaranteed.

Corporate plans

4.8 The 1993 GBE arrangements required corporate plans to include the strategies for managing financial exposure and analysis of critical factors most likely to expose the GBE or its shareholder to significant risk. However, these requirements were not sufficient in all cases to generate corporate plans which included sufficient detail on these issues and/or lead to corporate performance which adequately protected the Commonwealth's position.

HLIC

4.9 HLIC is yet to submit a corporate plan accepted and agreed by the portfolio Minister. The Department of the Treasury advised the ANAO that various reports have been produced as a result of the sale and restructuring processes which the Department believes possibly provides more information than a corporate plan.

4.10 Nonetheless, a key mechanism for providing the Commonwealth with information about HLIC's strategies for managing its risks has not been not available. HLIC's operations are underpinned by explicit Commonwealth guarantee. The total value of all insurance contracts on HLIC's books at any given time is the total gross exposure under this guarantee. Accordingly, the Commonwealth's total gross exposure under this guarantee

[38] Joint Media Release, Minister for Finance and Minister for Transport and Regional Development, 28 August 1997.

exceeded some $36 billion as at 30 June 1995.[39] However, it is considered that this does not realistically reflect the potential risk to the Common-wealth[40]. The HLIC has never suffered a claim for the total value of any insurance contact, with claims on policies usually amounting to ten to twenty per cent of the policy value.[41] Nevertheless, the ANAO considers that the exposure under this guarantee is a risk warranting management by the Commonwealth.

Australian National

4.11 Another example of the types of risks that can arise can be seen in the exposure that arose in 1991 with regard to Australian National's gold and Samurai bond[42] borrowings. The *Australian National Railways Commission Act 1983* was amended in 1988 in line with changes to improve the efficiency of GBEs. As a result of these changes Australian National was given enhanced commercial freedom, with the Board to be responsible to the Government and the Parliament for its performance. Accordingly, since then, Australian National has not been required to obtain government agreement to its treasury operations. However, the Treasurer, or his delegate, must make a determination in writing if the such transactions are to attract explicit Commonwealth guarantee[43].

4.12 The *Sydney Morning Herald* of 27 April 1991 reported that Australian National was involved in innovative financing arrangements based on future gold prices and movements in the Yen. The attraction of off-shore borrowings was the potentially lower cost of funds than prevailing domestic rates. In October 1991, the then Department of Transport and Communications engaged a consultant to report on Australian National's $A200 million in foreign currency and commodity transactions. The consultant provided a report to the Department in January 1992 which found that two of Australian National's three such transactions were inherently high risk.

4.13 The transactions were eventually closed out, one in October 1993 and one in October 1994. The ANAO considers that the then Department of Transport and Communications responded

[39] Figure reported as at 30 June 1995 in the ANAO Commonwealth Guarantees, Indemnities and Letters of Comfort Audit, Report No. 6 1996-97.

[40] *Mid-year Economic and Fiscal Outlook 1996-97,* the Treasurer and the Minister for Finance, Appendix E Statement of Risks, Contingent Liabilities p.53

[41] Ibid p.53.

[42] Japanese yen denominated bond.

[43] Section 63 of the *Australian National Railways Commission Act 1983,* as amended in 1988.

in an appropriate manner in identifying the nature of the risk through engaging external expertise in the area of foreign currency transactions. Notwithstanding the concerted efforts of the then Ministers and their departments, Australian National was not persuaded to remedy this situation much earlier than it eventually did.

4.14 These foreign exchange and commodity transactions were entered into by Australian National before the introduction of the 1993 GBE arrangements. However, it was not for some time after these arrangements were introduced that the last of the transactions was closed out.

4.15 The 1993 arrangements for GBEs placed limited requirements on GBEs regarding the development and reporting of risk management strategies. The governance arrangements introduced in July 1997 will require directors to keep Shareholder Ministers informed of risk management strategies by outlining them in corporate plans and progress reports, and other reports when necessary. This information is to be provided in the form of a risk management statement from the Board, which includes policies and procedures and reports on achievement of compliance.

4.16 While the 1997 arrangements improve reporting in relation to risks, they do not require an inventory of risks, including risk quantification, to be included in risk management reporting.

4.17 Finding: Consistent with the better practice developments in both the private and public sectors, the ANAO considers it desirable that governance arrangements be further strengthened in regard to risk management. The development of well considered risk management strategies which are directly linked to the overall corporate plan of GBEs would improve transparency of exposures and should allow the Government, as shareholder, to be assured that exposures will not result in future unnecessary calls upon the Budget.

Recommendation No. 3

4.18 The ANAO *recommends* that the 1997 *Governance Arrangements* be amended to require GBEs to specify in their corporate plans and progress reports their material risks and strategies for treating these risks.

4.19 Agencies responded to the recommendation as follows:

- *Agree:* *DoCA,* DoD and DTRD.

- *Agree with qualification::* DoF and Tsy.

4.20 Specific comments by departments are set out below.

- *DoD response:* Agree. ADI has complied with requirements to identify in corporate plans areas of material risk for the company and to advise the strategies for managing any such risks. This requirement has been retained in 1997 Governance Arrangements for GBEs. Recommendation 3 is supported.
- *DoF response:* Agree with qualification. The adoption of the recommendation should not detract from the principle written into the Governance Arrangements that GBE directors are responsible for managing risks.
- *Tsy response:* Agree with qualification. Adoption of this recommendation should not shift responsibility for risk management from the Board of the GBE to the joint Shareholder Ministers.

4.21 ANAO comment: The ANAO agrees that responsibility for risk management should remain with GBE boards but it is a matter of providing assurance to the Government that these risk assessments have been done and that action is being taken to address material risks.

Conclusions

Performance information

4.22 The improvement in GBE corporate planning information provided to agencies as a result of developments in the GBE monitoring arrangements have generally increased agencies' understanding of the GBEs' businesses, where this information has been provided. However, the Department of Treasury has yet to ensure compliance by HLIC with the requirements of the GBE guidelines with regards to submitting a corporate plan approved by the relevant Minister.

4.23 Considerable effort has been devoted in recent years by both portfolio departments and the Department of Finance to develop economic rate of return targets for GBEs.

4.24 The 1993 arrangements included provision for regular reviews of the capital structure of

GBEs to be carried out at least every five years. In respect of the selected GBEs considered by this audit, adequate capital structure reviews have been conducted in accordance with the arrangements.

Risk transparency

4.25 In the corporate plans examined by the audit there was not uniformly explicit identification of risks and options for their treatment. Consistent with the better practice developments in both the private and the public sector, the ANAO considers it desirable that the governance arrangements be further strengthened in regard to risk management. The development of well considered risk management strategies, which are directly linked to the overall corporate plan of GBEs, would enhance transparency of exposures. This approach should allow the Government, as shareholder, to be assured that exposures are being adequately managed; that GBEs are managing effectively within their business environment; and that GBE exposures should not result in future unnecessary calls upon the Budget.

Accountability

4.26 There have been improvements in recent years in internal reporting mechanisms, including; periodic reporting to Ministers; surveys conducted by the Department of Finance of GBEs’ use of derivatives and explicit Commonwealth guarantees; and increased reporting requirements.

4.27 Accountability has been further improved by the introduction of the June 1997 Governance Arrangements which require GBEs, in consultation with Shareholder Ministers, to prepare an annual Statement of Corporate Intent for tabling in the Parliament. In addition, during the financial year, the Minister for Finance may require a GBE to prepare an interim report for tabling in the Parliament by the relevant portfolio Minister.

Canberra ACT
xx September 1997

P. J. Barrett
Auditor-General

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