T h e   A u d i t o r - G e n e r a l

Audit Report No.10
Performance Audit

Sale of One-third of Telstra

A u s t r a l i a n   N a t i o n a l   A u d i t   O f f i c e

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Canberra ACT
19 October 1998

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit of the sale of one-third of Telstra in accordance with the authority contained in the *Auditor-General Act 1997.* I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Sale of One-third of Telstra*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage - http://www.anao.gov.au.

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

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

ADRs	American Depository Receipts
AGS	Office of the Australian Government Solicitor
ANAO	Australian National Audit Office
APS	Australian Public Service
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CBA	Commonwealth Bank of Australia
CBA2	Second tranche sale of shares in the Commonwealth Bank of Australia
CBA3	Third tranche sale of shares in the Commonwealth Bank of Australia
CSL	CSL Ltd Public Share Offer
DoCA	Department of Communications and the Arts
DoF	Department of Finance
DoFA	Department of Finance and Administration
EBDIT	Earnings Before Depreciation, Interest and Tax
NYSE	New York Stock Exchange
OAS	Office of Asset Sales
OASITO	Office of Asset Sales and IT Outsourcing
Qantas	Qantas Airways Limited Public Share Offer
RBA	Reserve Bank of Australia
SEC	United States Securities and Exchange Commission
Telstra	Telstra Corporation Ltd

Summary and Recommendations

Audit Summary

Background

1. The Telstra Corporation Ltd (Telstra) public share offer was completed in November 1997. The offer involved the sale of one-third of the company's issued share capital, with concurrent listings on the Australian, New York and New Zealand Stock Exchanges. The Commonwealth remains Telstra's majority shareholder, retaining a two-thirds ownership stake.

2. Gross proceeds from the sale are estimated to be $14.24 billion, of which $5.85 billion is to be received by the Commonwealth in November 1998. The proceeds are to be used to fund the Natural Heritage Trust ($1.15 billion) and the Regional Telecommunications Infrastructure Fund ($250 million) with the balance expected to contribute to a reduction in Commonwealth public debt. The Commonwealth's direct costs of the sale are estimated to be $260 million. Telstra estimated its own sale costs at $15 million.

3. The offer was structured into Australian retail and institutional tranches and a multi-tranche international offering. A sale by instalment structure was adopted, adapted from the approach developed by the Commonwealth for the 1996 third tranche sale of the Commonwealth Bank. Investors were required to pay for shares in two instalments with a first instalment of $2.00 per share, discounted to $1.95 per share for Australian retail investors. The second instalment, payable in November 1998, is set at $1.40 per share, discounted to $1.35 per share for Australian retail investors who hold their instalment receipts continuously until this time.

4. Overall responsibility for the sale was assigned to the Office of Asset Sales & IT Outsourcing (OASITO).[1] In accordance with Government policy, OASITO outsourced project management to three Global Coordinators. OASITO was assisted in its role by a number of contractors notably, a Sale Business Adviser, Investigating Accountant, Accounting Adviser and domestic and international legal advisers.

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1 The Office of Asset Sales (OAS) was established in October 1996 to manage the Commonwealth Government's major asset sales, reporting directly to the Minister for Finance. In November 1997, information technology outsourcing functions formerly managed by the Office of Government Information Technology were transferred to OAS, which became the Office of Asset Sales and IT Outsourcing (and is referred to as OASITO throughout this report).

5. The Government's objectives for the one-third sale of Telstra were to:

- achieve an optimum financial return from the sale;
- establish a broadly based and orderly market for Telstra shares;
- secure a timely sale process, conducted to high standards of probity and accountability;
- promote an internationally competitive, low cost and innovative telecommunications industry; and
- build investor support for the Government's asset sales program.

Audit approach

6. ANAO's objectives in auditing the sale were to assess the extent to which the Government's sale objectives were achieved; assess the effectiveness of the management of the share offer; assess whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing Commonwealth risk exposure; and to identify principles of sound administrative practice to facilitate improved administrative arrangements for future public share offers. The audit scope extended from the 1996 scoping study to preparation for the sale, management of the offer, post-offer management of settlement; and monitoring of the aftermarket.

Audit conclusions

7. The Telstra public share offer was completed in November 1997 in accordance with the Government's sale timetable, during a period of significant equity market volatility. This represents a significant achievement, given the unprecedented scale of the offer. It was achieved through cooperation and coordination by all parties and effective management by OASITO of the relationship between the Commonwealth, as selling shareholder, and Telstra.

8. In undertaking Commonwealth asset sales, OASITO outsources the services required extensively to the private sector which places considerable focus and emphasis on contract management, including the underlying risks involved. While the commercial nature of the arrangements and services has to be recognised and understood, there are overlaying public accountability concerns being expressed by the Parliament which also need to be addressed. Consequently, there are inevitable tensions and pressures confronting those concerned which need to be well managed to achieve required outcomes effectively and efficiently.

9. ANAO considers that overall value for money in future sales could be improved by giving greater emphasis to financial issues when tendering for advisers; encouraging more competitive pressure on selling commissions and fees; paying fees only for services actually provided; and instituting a more effective and commercial approach to administering payment for shares by investors. ANAO has made eleven recommendations to improve the future management of Commonwealth public share offers.

Financial returns

10. Gross proceeds from the sale of Telstra shares are estimated to be $14.24 billion. ANAO estimates the Commonwealth's direct costs to be $260 million. As a matter of interest, these direct costs are 1.8 per cent of gross proceeds compared to 1.5 per cent for the 1996 third tranche sale of the Commonwealth Bank of Australia (an offering of shares in a previously listed company with proceeds of $5.15 billion) and 2.8 per cent for the Qantas initial public offering (proceeds of $1.45 billion). Selling commissions totalling $124.1 million and a $35.6 million project management fee paid to the Global Coordinators comprised the majority of sale costs.

Issue pricing

11. The Global Coordinators advocated valuing Telstra by comparison to other telecommunications stocks on a cashflow earnings multiple basis, suggesting a valuation for the one-third sold of between $12.0 billion and $14.2 billion, or $2.80 per share to $3.30 per share. The Global Coordinators considered advising the top of the indicative price range be set at $3.30 or $3.50. On balance, they recommended the more conservative value because they held reservations about the capacity to attract adequate institutional demand at the higher range. The Minister for Finance's[2] decision to increase the top of the indicative price range from $3.30 to $3.40 and strike the issue price at the top of the final indicative price range increased Commonwealth sale proceeds by $426 million.

12. With the advantage of hindsight, the size of the initial listing premium and ongoing strong secondary market trading performance indicate that the issue was not fully priced. At the close of the first day of trading, Telstra instalment receipts stood at a premium of 67 cents, or 34 per cent over the institutional first instalment price of $2.00, the largest initial premium of any Commonwealth public share offering. This was equivalent to 20 per cent on a fully paid basis ($3.40). On a fully paid

2 The Department of Finance (DoF) and Department of Administrative Services were reorganised in October 1997 to form the Department of Finance and Administration (DoFA). In this report, the Department of Finance and Administration will be referred to by its current title and acronym. The Minister for Finance and Administration will be referred to by his title at the time of the sale - the Minister for Finance.

basis, over the eleven months since listing, the trading price of Telstra instalment receipts has risen more than 160 times the increase in the Australian Stock Exchange (ASX) All Ordinaries Index and more than 20 times the increase in the ASX All Industrials Index.

13. The institutional bookbuild process and allocation criteria were intended to provide guidance on pricing the offer. An open priced bookbuilding approach was adopted, intended to maximise the extent to which pricing decisions would reflect demand for shares.[3] ANAO's review of the institutional book suggests the bookbuild process and allocation criteria did not provide sufficient incentive for bidders to reveal their individual price elasticity of demand for Telstra shares.

Investor support

14. After settlement of the first instalment, Telstra had the largest share register in Australia with more than 1.8 million shareholders. The majority of these were investors holding fewer than 10 000 shares. More than 60 per cent of the offer was allocated to Australian retail investors with 85 per cent of retail investors receiving all the shares they applied for. The size of the retail tranche, the degree of scaleback of retail applications and the allocation policy were consistent with the sale objective of building investor support for the Commonwealth's asset sales program. Maximising the size of the retail tranche also had a positive effect on bidding for shares in the institutional bidding process because of the resultant scarcity of stock to institutional investors relative to index weighting.

15. At the issue price of $3.40 per share, the offer of one-third of Telstra's shares was more than four times subscribed. The Australian retail offer, which closed on 3 November 1997, provided sufficient demand to sell all 4.29 billion shares on offer while the institutional offer was 6.2 times subscribed.

Probity and accountability

16. A sound framework to address probity and accountability in the management of the sale process was provided by the establishment of a Process Review Committee and the development of appropriate Process Guidelines.

Outsourcing arrangements

17. Project management of the offer was outsourced to three private sector firms known as the Global Coordinators. The Global Coordinators were appointed in March 1997 although a contract was not signed with

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[3] See further at paragraph 5.12.

them until 22 August 1997. They were required to take a broader management role and provide more extensive corporate, strategic and financial advice regarding Telstra's corporate and financial structure than in previous Commonwealth public share offers. The Global Coordinators were paid a project management fee of $35.6 million and reimbursed $4 million in expenses.

18. The Global Coordinators' project management fee comprised a base fee of $16 million and an additional success fee linked to the net present value of the proceeds received by the Commonwealth from the sale of Telstra shares. The variable component of the fee was intended to encourage and reward the Global Coordinators for the achievement of increased offer proceeds. However, the benchmarks used were significantly below the September 1996 scoping study estimates of likely sale proceeds and OASITO's March 1997 estimate of likely sale proceeds. Use of these latter benchmarks would have reduced sale costs by between $5.4 million and $10.3 million by reducing the Global Coordinators' success fee.

19. ANAO identified a number of elements of the calculation of the project management fee that varied from the signed contract, which required fees to be calculated on proceeds actually received by the Commonwealth. Payments made by OASITO included project management fees for free shares for which the Commonwealth received no proceeds (fees of $458 492) and shares not actually sold (fees of $26 512). ANAO considers it would have been sound administrative practice for the contract to have accurately reflected the agreement that OASITO advises was negotiated with the Global Coordinators to include a nominal proceeds value for the free shares.

Logistics and marketing

20. Overall, sale logistics were effectively coordinated by the Global Coordinators and OASITO with the pre-registration process, preparation and distribution of offer documents, application processing and distribution of allocation details to investors proceeding in accordance with the sale timetable.

21. An effective retail marketing campaign was implemented which generated retail demand of some $25.5 billion, including $17.7 billion from brokers applying to reserve a firm allocation of shares for distribution to their private clients. The use for the first time of a short form offer document generated cost savings. This document was the main source of information used by Australian retail investors when deciding whether to invest. As provided for in the Government's electoral commitment to the sale, a large number and wide range of incentives were employed to generate strong retail demand in order to sell all available shares and increase demand

and price tension in the institutional offer. The value of the Commonwealth concessions in the incentive package is estimated at $337 million.

Market stabilisation

22. The international tranche was over-allotted to allow the Global Coordinators potentially to stabilise the aftermarket price, thereby increasing investor confidence that the offering would not trade below its issue price and allowing for more precise pricing of the offer. The over-allotment reduced in part the underwriters' risk as it provided a buffer to cover investor default.

23. The underwriting arrangements included a 'Green Shoe' option to offset the underwriters' market exposure caused by their over-allotment.[4] The Global Coordinators have advised ANAO that Green Shoe options have been included in a large number of privatisations. Although previous large scale Australian privatisations demonstrated no adverse consequences indicating a need for a Green Shoe option, the Telstra offer was unique in its size and international component. In the absence of the Green Shoe option, the Commonwealth would have received binding offers at the time of pricing for all shares sold to institutions with the underwriters bearing any risk in the international tranche as a result of the secondary market price falling to below the issue price. OASITO considered the pricing premium international investors would attach to an offer that included a Green Shoe over-allotment option would offset the risk of reducing initial offer proceeds by up to $635 million if the Green Shoe option was not exercised.

Financial administration

24. ANAO considers that, for future public share offers, administrative practices could be strengthened in the following areas:

- ***Managing exchange rate risk:*** Through a forward foreign exchange agreement with the Reserve Bank of Australia, OASITO effectively managed exchange rate risk on sale proceeds to be received in United States dollars. However, OASITO's policy on hedging exchange rate risk did not extend to payments of $7.5 million made by the Global Coordinators to sub-contractors and subsequently reimbursed by OASITO. Unhedged exposure to exchange rate risk between the date these contracts were signed and the date of invoicing increased sale costs by up to $700 000.

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4 An outline of the Green Shoe over-allotment option is included at paragraphs 4.30 - 4.47.

- ***Management of Commonwealth expenditure:*** OASITO was responsible for reimbursing the Global Coordinators for payments to sub-contractors. Payments reimbursed to the Global Coordinators for the international 'roadshow' coordinator ($3.02 million) were not independently verified by the Global Coordinators through appropriate supporting documentation and an effective audit trail was not maintained of this Commonwealth expenditure.
- ***Processing of retail applications:*** Retail applicants were required to include the first instalment payment when applying for shares. Initial processing of retail applications was well below the target set by OASITO, resulting in delays in the banking of funds involving foregone interest estimated at between $1.2 million and $2.0 million. Specifying performance standards in contracts and linking fee payments to achievement of these standards could provide sub-contractors with a greater incentive to achieve OASITO's processing targets.
- ***Settlement procedures:*** Settlement generally proceeded as planned with the exception of payments from some Australian and New Zealand institutions. As a result, proceeds of $52.3 million were not received in time for banking on the due date. Most institutions later forwarded payment. However, OASITO's decision not to enforce payment on the due date or sell the shares allowed some investors to complete the purchase, having had the benefit of observing Telstra's aftermarket performance. Settlement default by domestic institutions also resulted in the Commonwealth retaining ownership of 1.77 million shares intended to be sold to institutions for $6.0 million. The market value for the instalment receipts underlying these shares was $10.8 million as of 6 October 1998.
- ***Calculation of underwriting fees:*** The underwriters contracted to pay the Commonwealth the first instalment for the 597 million shares allocated to investors in the international tranche, with an option of purchasing a further 187 million shares. In accordance with the underwriting agreement, this payment was net of the underwriting discounts. The underwriting discounts included underwriting fees of $9.16 million, although a number of other initiatives had already been taken to reduce the risk of settlement default. In addition, although settlement risk was not underwritten on the first instalment of the Green Shoe optional shares or the second instalment for either the firm or optional shares, the underwriters were paid a fee of $1.3 million on the first instalment of the Green Shoe optional shares and $3.7 million on the value of the second instalment of the firm and optional shares.

Recommendations

25. ANAO made eleven recommendations. DoCA agreed and DoFA agreed with qualifications with Recommendation 7. All other recommendations related to OASITO alone which agreed with qualifications to nine recommendations and disagreed with two recommendations (Recommendations 3 and 10).

Recommendations

Set out below are ANAO's recommendations arising from this report, with report paragraph references and abbreviated responses from the agencies. More detailed responses are shown in the body of the report together with the findings. Recommendations 1, 2, 3, 4, 6, 7, 9 and 11 have the highest priority.

Recommendation No.1
Para. 2.29

ANAO recommends that the Office of Asset Sales and IT Outsourcing enhance its ability to maximise value for money in future tenders for project managers by:

(a) including project management fee arrangements as one of the selection criteria;

(b) undertaking a comprehensive comparative assessment of shortlisted candidates' project management fee proposals as part of the tender evaluation process; and

(c) structuring any future success fee component so that it is only payable where sale proceeds exceed independent third party benchmark valuations.

OASITO: Agreed with qualifications.

Recommendation No.2
Para. 2.37

ANAO recommends that the Office of Asset Sales and IT Outsourcing, in future asset sales:

(a) appropriately document <u>all</u> fee negotiations; and

(b) ensure that the signed contract fully captures the commercial understanding of the parties as to the basis on which fees will be calculated and paid.

OASITO: Agreed with qualifications.

Recommendation No.3
Para. 2.45

ANAO recommends that the Office of Asset Sales and IT Outsourcing, as part of its overall risk management strategy, develop a consistent and considered approach to the management of exchange rate risk including the identification of all instances where contractual arrangements leave it exposed to exchange rate risk and the evaluation of options for cost-effective management of these risks.

OASITO: Disagreed.

Recommendation No.4
Para. 3.26

ANAO recommends that the Office of Asset Sales and IT Outsourcing seek to enhance value for money in future asset sales by requiring its contracted project managers, as part of their project management responsibilities, to independently verify sub-contractors' invoices to appropriate supporting documentation and maintain an effective audit trail for Commonwealth expenditure.

OASITO: Agreed with qualifications.

Recommendation No.5
Para. 3.43

ANAO recommends that the Office of Asset Sales and IT Outsourcing enhance logistics management in future sales by specifying performance standards in logistics contracts and linking fee payments to achievement of these standards.

OASITO: Agreed with qualifications.

Recommendation No.6
Para. 3.55

ANAO recommends that the Office of Asset Sales and IT Outsourcing improve the administration of settlement in future public share offers by:

(a) developing and implementing institutional settlement default procedures that protect the Commonwealth's cash management interests and remove the potential for institutions to benefit from any delay in settlement; and

(b) applying a commercial approach to enforcement of the Commonwealth's contractual rights to maximise value for money.

OASITO: Agreed with qualifications.

Recommendation No.7
Para. 3.62

ANAO recommends that the Office of Asset Sales and IT Outsourcing, in consultation with the Department of Communications and the Arts and the Department of Finance and Administration as the relevant shareholder portfolio departments, investigate the viability and merits of the sale of the 1.77 million shares excluded from the initial sale of Telstra shares because of institutional settlement defaults.

DoCA: Agreed.

OASITO and DoFA: Agreed with qualifications.

Recommendation No.8 Para. 4.29

ANAO recommends that, for future public share offers, the Office of Asset Sales and IT Outsourcing:

(a) investigate methods of analysing institutional aftermarket trading from the Telstra initial offering as an input to future investor quality rating processes; and

(b) assist in creating a more stable aftermarket by including in the allocation approach explicit consideration of the minimum level of allocation that institutional investors would require to be prepared to hold and build on their allocation as a long term investment.

OASITO: Agreed with qualifications.

Recommendation No.9 Para. 4.50

ANAO recommends that the Office of Asset Sales and IT Outsourcing improve value for money in future public share offers by:

(a) re-assessing the merits of paying settlement underwriting fees given the level of risk assumed by the underwriters and other steps available to reduce the risk of settlement default; and

(b) where underwriting fees are paid, calculating them on the basis of only those shares and instalments that are underwritten.

OASITO: Agreed with qualifications.

Recommendation No.10 Para. 5.18

ANAO recommends that the Office of Asset Sales and IT Outsourcing encourage price leadership in institutional bidding in future public share offers by rewarding in the allocation process bidders who quantify their demand for stock at different prices thus indicating their price elasticity of demand.

OASITO: Disagreed.

Recommendation No.11
Para. 5.43

ANAO recommends that, for future public share offers, the Office of Asset Sales and IT Outsourcing:

(a) encourage competitive pressure on selling commissions and fees by seeking shortlisted firms' binding agreement with its own fee proposals;

(b) set commissions on broker firm sales at a level that reflects the contribution of this component of the offer, having regard to other steps taken to generate demand from retail investors; and

(c) implement settlement procedures for broker firm allocations that require brokers to make direct payment of immediately available funds to the Commonwealth for shares they have reserved for allocation to their private clients.

OASITO: Agreed with qualifications.

Audit Findings and Conclusions

1. Introduction

This chapter outlines the background to the sale of one-third of Telstra and the audit approach.

Background

1.1 The Telstra Corporation Ltd[5] (Telstra) public share offer was completed in November 1997. The offer involved the sale of one-third of the company's issued share capital (see Figure 1.1), with concurrent listings on the Australian, New York and New Zealand Stock Exchanges. The Commonwealth remains Telstra's majority shareholder, retaining a two-thirds ownership stake.

1.2 Gross proceeds from the sale are estimated to be $14.24 billion, of which $5.85 billion is to be received by the Commonwealth in November 1998. The proceeds are to be used to fund the Natural Heritage Trust ($1.15 billion) and the Regional Telecommunications Infrastructure Fund ($250 million) with the balance expected to contribute to a reduction in Commonwealth public debt.[6] The Commonwealth's direct costs of the sale are estimated to be $260 million or 1.8 per cent of gross proceeds. Telstra estimated its own sale costs at $15 million.

1.3 Shares are to be paid for in two instalments with a first instalment of $2.00 per share, discounted to $1.95 per share for Australian retail investors. Following payment of the first instalment, investors were issued with an instalment receipt, which will be exchanged for a fully paid ordinary share following payment of the second instalment in November 1998. On listing, the instalment receipts traded at a significant premium to the issue price and have subsequently increased further in price. Based on its 2 October 1998 closing trading price, Telstra is the fifth largest listed company in Australia, with a market capitalisation for the one-third sold of $20.5 billion.[7]

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5 The Australian and Overseas Telecommunications Corporation (AOTC) was established on 1 February 1992 through the merger of Australia's domestic and international carriers (Telecom Australia and OTC Limited). AOTC was renamed Telstra Corporation Ltd in April 1993. Telstra is Australia's principal telecommunications carrier. Its fixed telecommunications network carries over 90 per cent of calls and serves the vast majority of Australian homes and a substantial majority of Australian businesses. Telstra is also the largest mobile communications provider in Australia.

6 Australian Public Offer Document, 29 September 1997, p. 4.

7 On a fully paid basis, the one-third of Telstra sold would be capitalised at $26.5 billion making it the third largest listed company in Australia.

1.4 The Government's objectives for the one-third sale of Telstra, as notified to candidates for the major sale adviser roles, were to:

- achieve an optimum financial return from the sale;
- establish a broadly based and orderly market for Telstra shares;
- secure a timely sale process, conducted to high standards of probity and accountability;
- promote an internationally competitive, low cost and innovative telecommunications industry; and
- build investor support for the Government's asset sales program.

Figure 1.1
Key Offer Terms

Issuer:	Telstra Corporation Limited
Total Issued Shares:	12 866 600 200 $A0.50 ordinary shares
Selling Shareholder:	Commonwealth of Australia
Global Offering:	
Securities Offered	4 288 866 733 ordinary shares (one-third of the issued shares)
Australian Offering	3 504 393 733 shares (82% of securities offered) by way of a public offering in Australia and New Zealand to retail investors (including Telstra employees) and institutional investors
International Offering	784 473 000 shares (18% of securities offered), in the form of shares or American Depository Shares (ADS) through a syndicate of global underwriters
Instalment Payment Structure:	Instalment Receipts, representing one ordinary share and interim American Depository Receipts (ADR), representing the right to receive 20 instalment receipts
Offer Price:	
Indicative Price Range	Initial - 29 September 1997: $2.80 to $3.30 per share Final - 12 November 1997: $2.80 to $3.40 per share
Final Pricing:	15 November 1997
• First instalment	$2.00 per share, discounted to $1.95 per share for Australian retail investors Payable on application by Australian and New Zealand retail investors and on 25 November 1997 for all other investors
• Second instalment	$1.40 per share, discounted to $1.35 per share for Australian retail investors who hold their instalment receipts continuously until this time Payable on 17 November 1998
Offer period:	
Australian Public Offer	15 October 1997 to 3 November 1997
Global Institutional Bookbuild	27 October 1997 to 14 November 1997

Source: ANAO analysis based on information provided by OASITO, Global Coordinators and Sale Business Adviser.

1.5 Telstra had operating revenue in 1996-97 of $16.0 billion (a 26 per cent increase over a five year period); total shareholders funds of $9.9 billion and total assets under management of $25.9 billion (see Figure 1.2). Dividends of $4.1 billion were paid in 1996-97, including a $3.0 billion special dividend to the Commonwealth, which substantially reduced the balance of Telstra's franking credit account.[8] Figure 1.2 provides further details of Telstra's financial performance.

Figure 1.2

Telstra's financial performance: 1992-93 to 1996-97

	1992-93 $bn	1993-94 $bn	1994-95 $bn	1995-96 $bn	1996-97 $bn
Operating Revenue	12.7	13.4	14.1	15.2	16.0 [a]
EBDIT [b]	5.3	5.7	5.6	6.0	6.6
Operating Profit Before Income Tax	2.0	2.5	2.4	3.4	2.1
Income Tax	1.1	0.8	0.6	1.1	0.5
Operating Profit	0.9	1.7	1.8	2.3	1.6
Shareholders Funds	10.9	10.8	11.7	12.7	9.9 [c]
Total Assets	23.2	21.1	24.1	24.4	25.9
Dividends	0.7	0.7	0.9	1.4	4.1 [c]
Earnings Per Share (cents)	8.2	13.7	13.6	17.9	12.6

(a) Telstra yearly results were announced on 26 August 1998 with revenues growing by 8.3 per cent to $17.3 billion compared to the prospectus forecast of growth of 4.7 per cent.

(b) Earnings Before Depreciation, Interest and Tax (before abnormals).

(c) Includes a $3.0 billion special dividend paid to the Commonwealth on 30 June 1997 as part of a recapitalisation of the company.

Source: ANAO analysis based on information from the 1997 Australian Public Offer Document.

Sale preparation

1.6 The Government announced a scoping study into the proposed sale of one-third of Telstra on 11 April 1996. The scoping study was to advise on the legal, technical, commercial, policy, public communications and management advice needed to promptly proceed with the sale. A Task Group was formed within the then Department of Finance (DoF) to progress the scoping study. The Task Group included officers seconded from the Department of Communications and the Arts (DoCA). The Department of the Treasury provided input at various stages.

8 The Appendices to the Australian Public Offer Document (p. 25) stated that *the Board expects the fiscal 1998 dividends to be fully franked and will endeavour to ensure that the Company provides shareholders with fully franked dividends in future years.*

1.7 The Task Group was assisted by a Business Adviser, domestic and international Legal Advisers, an Accounting Adviser, a Capital Expenditure Consultant and a Communications Consultant. Each adviser was appointed solely for the purpose of the scoping study and produced a separate report in September 1996.

1.8 The report of the Scoping Study Business Adviser (C.S. First Boston Australia Limited) provided the principal commercial basis for the Task Group's recommendations to Government on the sale process. Its report drew upon the findings contained in the other advisers' reports and was developed in close consultation with the Task Group officials. The report included recommendations relating to: offer structure including sale by instalment, offer tranches, listing on the New York Stock Exchange, underwriting and market stabilisation; selling syndicate structure; and the number, composition and role of global coordinators.

1.9 The *Telstra (Dilution of Public Ownership) Act 1996* provided for the sale of one-third of the Commonwealth's equity in Telstra by way of amendment to the *Telstra Corporation Act 1991*.[9] The Act permitted the Commonwealth to sell one-third of its equity interest in Telstra; imposed ongoing reporting obligations on Telstra; set aggregate and individual foreign ownership limits;[10] and reaffirmed that the sale would not affect the Universal Service Obligations that apply to Telstra and other telecommunications carriers.[11] The Act also included sale scheme provisions to govern the sale process; provided exemptions from State stamp duties; and established a standing appropriation to fund sale costs.

Audit approach

1.10 The objectives for the audit were to:

- assess the extent to which the Government's sale objectives were achieved;
- assess the effectiveness of the management of the public share offer;

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9 The *Telstra (Dilution of Public Ownership) Act 1996* received Royal Assent on 19 December 1996 and was proclaimed on 1 May 1997.

10 Aggregate foreign ownership is restricted to 11.6667 per cent of Telstra's equity (35 per cent of the non-Commonwealth equity) and individual foreign ownership is restricted to 1.6667 per cent of Telstra's equity (5 per cent of the non-Commonwealth equity).

11 The Act also amended the *Telecommunications Act 1991* to extend the statutory obligation on general telecommunications carriers to provide the option of untimed local calls to all customers in local call areas; introduced a scheme for a customer service guarantee including the setting of performance standards and penalties for non-compliance with the standards; and extended AUSTEL's functions of developing indicative performance standards on quality and annual reporting of carrier performance against these standards.

- assess whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing Commonwealth risk exposure; and
- identify principles of sound administrative practice to facilitate improved administrative arrangements for future Commonwealth public share offers.

1.11 The scope of the audit extended from the 1996 scoping study to preparation for the sale, management of the offer, post-offer management of settlement, and monitoring of the aftermarket. The scope did not include assessing the longer term effects of the sale on Australia's telecommunications industry as the audit commenced soon after completion of the sale.

1.12 The approach taken in the audit was to review data relating to the sales held by the Office of Asset Sales and IT Outsourcing (OASITO) and its advisers, the Department of Finance and Administration (DoFA)[12] and DoCA. ANAO's fieldwork was undertaken between January and June 1998. ANAO engaged the Office of the Australian Government Solicitor (AGS) to provide legal advice on a number of matters including payment of fees and commissions, offer structure issues, and the Commonwealth's post-sale liabilities.[13] The audit was conducted in accordance with the ANAO Auditing Standards at a cost of $397 000.

Report outline

1.13 The following chapter of the report discusses the major elements in the management of the sale including the outsourcing of project management. Chapter 3 reviews the marketing of the sale to potential investors, sale logistics and settlement of the first instalment. The structure of the public share offer, including the Green Shoe over-allotment option and underwriting arrangements, is outlined in Chapter 4. The final chapter outlines the major financial outcomes of the sale.

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12 The Department of Finance and the Department of Administrative Services were reorganised in October 1997 to form the Department of Finance and Administration (DoFA).

13 The audit criteria considered the achievement of the sale objectives; the management of the sale, including the selection of the selling syndicate, its fees and selling commissions; the appointment and management of contractors; the offer structure including the nature of the sale, the bidding and allocation procedures; post-sale financial management; and the Commonwealth's exposure as a result of the offer structure, sale contracts, and indemnities.

2. Sale Coordination

This chapter discusses major elements in the management of the sale including the outsourcing of project management.

Background

2.1 Project management of the offer was outsourced to three private sector firms appointed by OASITO in March 1997. These three firms, known as the Global Coordinators, were ABN AMRO Rothschild, Credit Suisse First Boston, and JB Were & Son. The outsourcing arrangements required the Global Coordinators to take a broader management role, including management of logistics and marketing activities, and provide more extensive corporate, strategic and financial advice regarding Telstra's corporate and financial structure than in previous Commonwealth public share offers.

2.2 OASITO retained responsibility for overseeing the sale process in terms of policy issues and facilitating liaison between firms involved in the sales process and the Government. OASITO also monitored operational and financial issues and approved relevant sales process decisions that did not require Ministerial approval. OASITO was assisted in its role by a number of contractors including a Sale Business Adviser, domestic and international Legal Advisers and an Investigating Accountant.

2.3 Cooperation and coordination by all parties were crucial to a successful sale, as was effective management of the relationship between the Commonwealth, as selling shareholder, and Telstra, particularly in relation to due diligence, offer document preparation and marketing activities. The public share offer coordination arrangements included the establishment of a committee structure[14] to progress sale planning and preparation, including a Steering Committee whose role was to ensure coordination of offer preparation, particularly with Telstra, and that timely progress was being made.[15] The committees were chaired by the Global Coordinators, with the exception of the Steering Committee which was chaired by OASITO.

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14 Five main project management committees were established: Logistics Committee; Retail Marketing Committee; Institutional Marketing Committee; Offer Structure Committee; and Due Diligence Committee. These committees were chaired by the Global Coordinators and included OASITO representation. They reported to the Sale Steering Committee which reported directly to the Government and was chaired by the OASITO with the Chair of the Global Coordinators acting as Chief Executive.

15 The Steering Committee's membership included the Department of Communications and the Arts and Telstra.

2.4 Telstra's participation in sale preparation was underpinned by the *Telstra (Dilution of Public Ownership) Act 1996* which required it to comply with requests for assistance from the Minister for Finance or the Minister for Communications and the Arts. Three requests for cooperation were made.[16] OASITO advised ANAO that this process put beyond doubt the consistency between cooperation with the sale process and the duties of the directors. In addition, OASITO and senior representatives of the Global Coordinators met regularly throughout the sale process with Telstra to coordinate major sale related matters.

2.5 After considering the 1996 scoping study and passage of the enabling legislation, the Government directed OASITO in December 1996 to plan and prepare for a sale in the latter half of 1997. Major appointments were decided on by early March 1997 and, by early May 1997, OASITO had appointed its Global Coordinators, Legal Advisers and Sale Business Adviser and commenced sale planning and preparation.

2.6 Over the course of the next five months until the offer was launched on 29 September 1997, the due diligence process was completed,[17] the offer structure developed and agreed with the Minister for Finance, and marketing and logistics arrangements put in place. The offer period comprised a seven week period in which marketing activities were undertaken, retail applications received and processed, an institutional bookbuilding process conducted, the issue price set and shares allocated to investors.

2.7 The Telstra public share offer was successfully completed in November 1997, in accordance with the timetable set by the Government and during a period of significant equity market volatility.[18] The majority

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16 The first request was signed by the Minister for Finance on 1 July 1997 and covered issues such as access to information, preparation of business and financial forecasts, the due diligence process and participation in marketing activities. A revised request was signed by the Minister for Finance on 4 September 1997 involving a widening in the indemnities given to Telstra and its directors. On 10 July 1997, the Minister for Communications and the Arts requested Telstra to assist with the sale scheme in relation to a buy back of partly paid shares.

17 The Telstra sale was the first share offer in which the Government decided that the Commonwealth would be bound by the fund raising provisions of Chapter 7 of the Corporations Law. This meant that the Commonwealth would be liable under the Corporations Law for any misleading statements or omissions made in the prospectus, as well as being required to comply with the advertising/pre-prospectus publicity provisions. A number of exemptions were granted by the Australian Securities Commission including for the conduct of market research; the dispatch of letters to potential investors to reserve a prospectus; the conduct of roadshow presentations to potential investors; advertising; and displays at Commonwealth Bank branches and the opening of the share information centre.

18 During the offer period there was considerable volatility in financial markets. For example, the Australian Stock Exchange All Ordinaries Index fell by almost 15 per cent in the two week period between the opening of the public and institutional offers.

of sale proceeds ($8.39 billion) were received when first instalments were paid in November 1997. The balance of $5.85 billion is to be received following payment of the second instalment due in November 1998.

Finding

2.8 OASITO effectively coordinated the activities of its advisers and the Global Coordinators, and the relationship with Telstra. The Telstra public share offer which raised Commonwealth proceeds of $14.24 billion was completed in November 1997 in accordance with the Government's sale timetable, during a period of significant equity market volatility. This represents a significant achievement, given the unprecedented scale of the offer.

Probity and accountability

2.9 To address probity and accountability in the first Commonwealth offer involving outsourced project management, OASITO formed a Process Review Committee. Its role was to ensure the work undertaken by committees involved in the offer met the Commonwealth's accountability, integrity and probity requirements. The Committee concluded that the offer committees met these requirements.

2.10 The Committee met for the first time in May 1997. It was chaired by a representative from one of the Global Coordinators and included a representative from each of the remaining Global Coordinators as co-deputy chairs. The Committee also included a representative from OASITO,[19] OASITO's domestic legal adviser and the Investigating Accountant.[20] The secretariat was provided by one of the Global Coordinators. None of the private sector representatives were involved in the project management of the offer.

2.11 To discharge its responsibilities, the Committee established Process Guidelines which were adopted by all offer committees. The Guidelines set procedural standards in relation to the establishment and membership of committees; decision making and project management processes; security and confidentiality; and documentation. The Guidelines were discussed with the offer committees and approved by the Steering Committee on 20 June 1997.

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19 OASITO's Sale Business Adviser was also represented in an observer status.

20 ANAO attended early meetings of the Committee as an observer to assist with its establishment.

Finding

2.12 The establishment of a Process Review Committee and the development of appropriate Process Guidelines provided a sound framework to address probity and accountability issues in the management of the sale process.

Global Coordinators

2.13 On 20 December 1996, OASITO invited 31 firms to submit proposals for the roles of global coordinator and/or lead manager in the selling syndicate.[21] The request for proposals stated that the global coordinator (or coordinators) would be contracted to undertake a broader management role[22] than in previous Commonwealth public share offers and outlined the selection criteria.[23] To assist candidates develop their proposals, they were given a briefing session that included a presentation by Telstra, a summary of regulatory issues and an outline of the main findings of the scoping study.

2.14 On 20 January 1997, 28 submissions were received,[24] including 17 for the role of global coordinator. The selection panel comprised the Chief Executive of OASITO, the Secretary of the Department of Finance and two external private sector members nominated by the Minister for Finance. The panel shortlisted twelve firms for interview in mid-February 1997. The selection process distinguished between candidates on the basis of the value each could add to the syndicate in terms of distribution capabilities, research capacity, corporate advisory skills, project management capabilities, and the quality, experience, location and availability of the personnel committed to the project. OASITO has advised ANAO that, after reviewing the proposals, the panel decided that the selection process would

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21 OASITO selected Global Coordinators and Lead Managers through a single selection process.

22 This role was to include: project management of the offer; management of the selling syndicate including preparation and presentation of advice to OASITO and the Government; coordination of other advisers including legal advisers and accountants; manage, arrange and participate in all aspects of sale preparation; manage and arrange a domestic marketing campaign and offer logistics; and monitor and participate in aftermarket activity.

23 The criteria comprised: distribution strength; experience with telecommunications sector transactions, privatisations and other large global public offers; capacity, including financial capacity, to sustain a leading role in the transaction; capacity to represent the interests of the vendor throughout the transaction; ability to work harmoniously and effectively with other parties in the sale process; the expertise and skills of the team offered for the project; quality of information presented in the submission and interview; and demonstrated appreciation of the roles of various parties in the proposed transaction, including the issues associated with a partially privatised entity under relevant legislation and regulatory issues.

24 Of the 28 submissions received, two were joint submissions with only one of the 31 invited firms declining to lodge a submission.

not differentiate between contenders on the basis of fee proposals submitted, but that fees would be negotiated with the selected firms on the range of fee proposals offered.[25]

2.15 At the conclusion of the selection process, ABN AMRO Rothschild, Credit Suisse First Boston and JB Were & Son were invited on 13 March 1997 to act as Global Coordinators and as Lead Managers in Europe, the Americas and Australia respectively. The appointment of other Lead Managers was made at the same time. These appointments were subject to the satisfactory conclusion of fee and contract negotiations.[26] Figure 2.1 outlines the syndicate structure.[27]

Figure 2.1
Telstra Selling Syndicate Structure

Joint Global Coordinators

ABN AMRO Rothschild | Credit Suisse First Boston | JB Were & Son

UK/Europe Tranche	Americas Tranche	Rest of the World Tranche	Australia Tranche
Lead Managers • ABN AMRO Rothschild • Deutsche Morgan Grenfell	**Lead Managers** • Credit Suisse First Boston • Goldman Sachs/ Macquarie Underwriting	**Lead Managers**[a] • ABN AMRO Rothschild • Credit Suisse First Boston • JB Were & Son	**Lead Managers** • JB Were & Son • Ord Minnett
4 Co-Lead Managers	**4 Co-Lead Managers**	**1 Co-Lead Managers**[a]	**4 Co-Lead Managers**
5 Co-Managers[a]	**4 Co-Managers**[a]	**4 Co-Managers**[a]	**5 Co-Managers**[a]

(a) Two firms, Daiwa Securities (appointed Joint Lead Manager in the Rest of the World and co-manager in Europe, Australia and the United States) and Nikko Securities (appointed co-manager in the Rest of the World) were suspended from participation in the syndicate on 19 September 1997 and 2 October 1997 respectively. Daiwa was replaced as Lead Manager in the Rest of the World by the Global Coordinators, who were previously Co-Lead Managers in this tranche.

Source: ANAO analysis based on information from OASITO, Global Coordinators and Sale Business Adviser.

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25 OASITO further advised ANAO that the panel was of the view that the expected outcome in terms of sale proceeds was a far more important consideration than expected sale costs.

26 The contract with the Global Coordinators and Lead Managers was signed on 22 August 1997, some five months after their selection.

27 Syndicate managers in each tranche were selected in July 1997 by panels that included the OASITO, the Sale Business Adviser, Global Coordinators and the respective Lead Manager. Selection was based on a review of written proposals against the following criteria: relevant capital raising experience in Australia; privatisations and telecommunications experience; equity research coverage; distribution capabilities; and secondary market trading. Written evaluation reports were prepared and provided to the Minister for Finance.

2.16 ANAO was advised by Credit Suisse First Boston that:

> *in addition to overall management of the offer, the Global Coordinators provided significant advice regarding accounting and business strategy for Telstra, advised on the $3 billion special dividend structure and recapitalisation, resolved the Commonwealth's shareholder position in respect to Telstra's investment in Pay TV and provided extensive review of several regulatory matters.*

Global Coordinator's remuneration

2.17 Payments to the Global Coordinators reflected their multi-faceted role in the sale process and amounted to $91.22 million (see Figure 2.2). OASITO paid the three firms $35.57 million for their project management of the sale plus $4.01 million in reimbursed expenses. In addition, commissions and fees totalling $21.39 million were paid to them by OASITO for the sale of Telstra securities in Australia and they received $30.25 million in discounts on the sale of securities to international institutions.

Figure 2.2
Global Coordinator Payments

	$m	$m	%
• **Project Management**			
Project Management Fee			
Fixed Fee	16.00		
Success Fee	19.57		
Total Fee		35.57	
Expenses Reimbursed by OASITO[a]		4.01	
Total Project Management		**39.58**	**43**
• **Domestic Retail & Institutional Tranches**			
Domestic Institutions	11.57		
Broker Firm	4.92		
Broker Stamped	4.90		
Total Domestic Commissions and Fees		**21.39**	**24**
• **International Institutional Tranche**			
Selling Commission - Competitive	22.99		
Management Fee	4.41		
Underwriting	2.85		
Total International Commissions and Fees		**30.25**	**33**
• **Total Direct Commonwealth Payments**		**91.22**	**100**

(a) Comprises out of pocket expenses for travel and accommodation of $2.13 million and legal expenses of $1.88 million.

Source: ANAO analysis based on information from OASITO, DoFA, Global Coordinators and Sale Business Adviser.

2.18 Assessing value for money when contracting for advisory services is a complex exercise that requires the application of professional judgement.[28] Global Coordinator candidates were asked to provide their views on an overall fee structure for selling, public offer management and, if required, underwriting. The selection criteria excluded reference to the scale and nature of proposed fees and charges. The tender evaluation report did not, therefore, include a detailed and comprehensive assessment of the project management fees proposed in addressing the value for money offered by each candidate.[29]

2.19 The approach adopted in the 1996 third tranche sale of the Commonwealth Bank of Australia (CBA3) was to ask candidates to submit their views on an appropriate fee structure. The then Department of Finance considered these proposals, developed a schedule of fees it proposed to pay and asked candidates to agree to this schedule of proposed fees prior to making any decision on appointments. OASITO advised ANAO that it considers the process it followed in the Telstra sale was generally consistent with that followed in CBA3 except that the appointments were agreed in principle and reported to the Minister before the fees were agreed.

Project management fee

2.20 Due to the increased role to be played by the Global Coordinators in offer management, the majority of candidates included a separate project management fee in their proposal. The three firms selected to be Global Coordinators each included fee proposals in their tenders, which ANAO estimates ranged from $12 million to $28.25 million, based on assumptions made in each firm's tender. Other candidates' proposals were generally in the range of $1 million to $5 million, where fees were specified.

2.21 Following selection, OASITO negotiated selling commissions and a project management fee with the Global Coordinators. The project management fee comprised a base fee of $16 million and an additional variable fee linked to the net present value of the proceeds received by the

28 The *Commonwealth Procurement Guidelines: Core Principles and Policies* (March 1998, p. 4) state that *while value for money should be assessed as objectively as practicable, it is not possible or desirable to eliminate subjective judgement. Deciding which alternative offers best value in particular circumstances will often depend on professional judgements about a range of criteria relating to performance, technical issues, financial issues, assessment of risk and valuation of benefits.*

29 *Commonwealth Procurement Guidelines* (July 1997) state that value for money is the essential test against which any procurement outcome must be justified (p. 9). The revised *Commonwealth Procurement Guidelines* issued by the Minister for Finance and Administration in March 1998 reaffirmed this principle.

Commonwealth from the sale of Telstra shares.[30] The project management fee was capped at $40 million. In addition to the project management fee, OASITO reimbursed the Global Coordinators $4.01 million in 'out of pocket' and legal expenses. OASITO agreed to these arrangements although only one of the Global Coordinators explicitly sought reimbursement in its proposal.[31]

2.22 The project management fee paid by OASITO to the Global Coordinators was some 16 times greater than the management and advisory fees paid for the 1996 CBA3 public share offer and associated share buy-back that raised proceeds of $5.15 billion (see Figure 2.3). OASITO advised ANAO that it considers comparison to previous Commonwealth public share offers as presented in Figure 2.3 to be misleading on two grounds: it fails to distinguish between the very different natures of initial public offers (Qantas and Telstra) and offerings of shares in already publicly traded companies (CBA2 and CBA3); and it fails to reflect the fact that the fee substitutes for a significant proportion of the selling commissions that would otherwise have been levied as a global coordinator 'praecipium' on applicable selling commissions.

2.23 ANAO recognises there are differences between public share offers making it difficult to compare fees between offers. Nevertheless, ANAO considers a comparison of advisory fees paid by the Commonwealth in its various public share offers is a useful indicator of the value for money obtained from the fee arrangements negotiated by OASITO for the Telstra sale. On the basis of this comparison, there has been a material increase in the remuneration received by the Commonwealth's major advisers even allowing for their broader management role and provision of more extensive corporate finance advice.

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30 A fee of 0.345 per cent was payable for offer proceeds between $8 billion and $10 billion; 0.375 per cent for offer proceeds between $10 billion and $12 billion; and 0.450 per cent for offer proceeds of $12 billion or more. To protect the Commonwealth against the size of the offer rising because of a rise in the equity market, these thresholds were indexed to reflect movements in the Australian All Ordinaries Index and Standard & Poor's 500 Index from the twenty days prior to lodgement of submissions for the Global Coordinator positions, to the twenty days prior to pricing of the offer.

31 The Commonwealth also separately funded that part of the Global Coordinators' travel and accommodation expenses incurred as part of the international roadshow.

Figure 2.3

Comparative Project Management Fees: Commonwealth public share offers

	CBA2[a] (1993) $m	Qantas[b] (1995) $m	CBA3[a] (1996) $m	Telstra[b] (1997) $m
Transaction Size	1 700	1 450	5 145 [c]	14 241
Fees				
Global Coordinators/ Lead Managers	1.25	1.4	1.5	35.57
Co-lead managers	1.0	0.8	0.6	nil
Co-managers	0.3	0.18	0.08	nil
Total Payments	2.55	2.38	2.18	35.57

(a) Offering of shares in an already publicly traded company.

(b) Initial public share offers.

(c) Includes $1.0 billion from the buy-back by the Commonwealth Bank of Australia of 100 million shares.

Source: ANAO analysis.

2.24 OASITO advised ANAO that the project management fee was designed to reflect both the characteristics of the Telstra offer and the Global Coordinators' unusual level of responsibility for overall management and success of the offer, compared with customary commercial practice and previous Commonwealth public share offers.

2.25 Previous fee arrangements in Commonwealth public share offers have recognised that the Global Coordinators/Lead Managers are provided with a significant marketing advantage through their position in the selling syndicate which assists these firms increase the commissions they earn on the sale of securities.[32] This advantage was also apparent in the Telstra offer where the Global Coordinators received 61 per cent of selling commission designations from institutions. ANAO has been unable to identify a comparable fee internationally[33] in terms of the scale of the project management fee paid to the Global Coordinators in the Telstra sale.[34]

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[32] The Scoping Study Business Adviser proposed in its report that the global coordinators *perform their obligations during the preparatory phase* [of the sale] *for a modest fee (eg a monthly retainer if it is to be for an extended period) and ultimately derive the greatest proportion of their remuneration from their role as lead managers of the offering.*

[33] In recent United Kingdom privatisations the global coordinators have been required to compete with the rest of the selling syndicate for commissions and fees with no global coordinator fee (or 'praecipium') paid on British Energy sale (July 1996) or Railtrack sale (March 1996). Global coordinator fees were paid on the March 1995 second sale of shares in National Power and PowerGen (£2.9 million fee), the July 1993 third tranche sale of British Telecommunications plc (£4.5 million fee) and the December 1991 second tranche sale of British Telecommunications plc (£2.5 million fee).

[34] The Sale Business Adviser informed OASITO that previous project management fees in Australian global industrial offerings have been in the range of $200 000 to $700 000 with the median being $500 000 per Global Coordinator.

Success fee component

2.26 The variable component of the project management fee (the success fee) was intended to encourage and reward the Global Coordinators for increased offer proceeds. To achieve this objective, the starting benchmark should reflect the best available independent estimate of sale proceeds at the time of the Global Coordinator's appointment so that they are only rewarded for increased sale proceeds.

2.27 The starting benchmark for the success fee was $8 billion ($1.87 per share).[35] The September 1996 scoping study estimate of sale proceeds was between $9.4 billion ($2.19 per share) and $10.6 billion ($2.47 per share), after allowing for a public share offer discount of 10 per cent. OASITO's sale budget approved in March 1997 was based on the then current estimate of sale proceeds of $10 billion ($2.33 per share). If the scoping study estimates or the sale budget estimates had been used as the starting benchmark for calculating the success fee, Commonwealth sale costs would have been reduced by between $5.4 million and $10.3 million, by reducing the success fee.

Finding

2.28 The Global Coordinator selection process did not include fee arrangements as one of the selection criteria. Instead, OASITO negotiated fee arrangements with the Global Coordinators after their appointment. The contractual arrangements with the Global Coordinators involved the Commonwealth paying a project management fee of $35.6 million and reimbursing $4 million in expenses.

Recommendation No.1

2.29 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance its ability to maximise value for money in future tenders for project managers by:

(a) including project management fee arrangements as one of the selection criteria;

(b) undertaking a comprehensive comparative assessment of shortlisted candidates' project management fee proposals as part of the tender evaluation process; and

35 OASITO advised ANAO that this was the proceeds level that formed the basis of political commitment to the sale. On 28 May 1998, the Sale Business Adviser advised OASITO that it considered the starting benchmark *should be increased from $8 billion to at least $10 billion to reflect real value added achievements.*

(c) structuring any future success fee component so that it is only payable where sale proceeds exceed independent third party benchmark valuations.

OASITO response

2.30 OASITO ***agreed with qualifications*** to the recommendation. In respect of the sub-recommendations:

(a) OASITO noted that in this type of transaction, the essential cost effectiveness judgement should - as it was in this case - be far more concerned with maximising the net outcome rather than with minimising the expected cost. OASITO doubts that variations in fee proposals made at the proposal stage by separate individual firms for a major public share offer will be a significant or determining consideration in the selection of global coordinators, especially given the need to strike a composite fee structure for a team of firms selected from among competitors for the roles but required to work thereafter as a cohesive unit. That said, OASITO notes that the selling commissions struck were set at levels well below those tendered by two of the three global coordinators and below the average of the three successful proposals. The separate project management fee was almost exactly in line with the level tendered by the selected global coordinator that proposed it, albeit structured differently.

(b) OASITO considers that this assessment is of more value in developing a post-selection negotiating position on fees (as it was in this case) than assisting in the selection exercise itself.

(c) ANAO misrepresents the success fee developed in this transaction. The success fee was set so that it was *benchmarked* at $22.9 million on then expected proceeds of $10 billion, *reducing* progressively to a floor of $16 million if proceeds had fallen short, or *increasing* to up to $40 million with additional proceeds. Thus the fee provided for the possibility of either sanctions or rewards related to performance. It also reflected the fact that the global coordinators accepted liability to the Commonwealth in connection with their project management role. OASITO notes that performance-related fee arrangements are inherently complex and need to be settled on a case-by-case basis having regard to all relevant considerations, and often need to be set in advance of a full knowledge of all relevant parameters.

ANAO comment

2.31 An important outcome in any contractual arrangement is maximising value for money for the Commonwealth. Good administrative practice suggests that the fees proposed by candidates should be considered and evaluated as part of the selection process, when the Commonwealth is able to maximise its negotiating position. In relation to part (c), advice from OASITO to the Minister for Finance in April 1997 and August 1997, after agreeing the project management fee with the Global Coordinators, was that the fee was set at a base of $16 million and rising with sale proceeds above $8 billion to $22.9 million at proceeds of $10 billion. The fee was capped at $40 million.

Analysis of the Calculation of the Project Management Fee

2.32 The Global Coordinators were appointed on 13 March 1997 and negotiations commenced between OASITO and the Global Coordinators on the remuneration package. The negotiations involved discussions and exchange of correspondence between OASITO and the Global Coordinators which continued until July 1997. The agreement reached was then formalised in a written contract and side letter signed on 22 August 1997, some five months after the Global Coordinators' appointment. The method of calculating the project management fee was specified in the side letter.

2.33 The side letter required the project management fee to be calculated according to the present value of the gross proceeds received by the Commonwealth from the sale of the shares in the Telstra offer. ANAO reviewed the calculation of the project management fee by the Global Coordinators and identified a number of instances (see Figure 2.4) where elements of the calculation varied from the signed contract and side letter. The major items in this variation are fees of $458 492[36] paid to the Global Coordinators on the notional value of shares provided at no cost by the Commonwealth to Telstra employees and fees of $26 512[37] paid to the Global Coordinators on shares the Commonwealth did not actually sell.[38]

[36] OASITO paid fees of $411 577 by including as proceeds received by the Commonwealth a notional value for the 28 245 395 free shares allocated to eligible Telstra employees. Telstra employees were allocated one free share for every four shares they purchased, up to a maximum of 500 free shares. In addition, OASITO paid fees of $46 915 by including as proceeds received by the Commonwealth a notional value for the 3 219 615 shares withheld from initial allocation to provide eligible Telstra employees with one free loyalty share for every ten shares purchased in the public offer and held continuously for twelve months.

[37] The Commonwealth retained ownership of 1 766 125 shares intended to be included in the one-third offer of Telstra shares. These shares were allocated to domestic institutions but, because of settlement default by some institutions, they were not sold, with the Commonwealth retaining ownership of the shares. The project management fee calculation included proceeds from these shares although no proceeds were received by the Commonwealth.

[38] See further at paragraphs 3.48 - 3.61.

Figure 2.4
Project Management Fee Recalculation

	Adjustments $	Outcome $
Project management fee paid by OASITO		**35 570 850**
Adjustments:		
Employee ‘One for Four’ Shares	+411 577	
Employee ‘One for Ten’ Provision	+46 915	
Domestic institutional default	+26 512	
Offer size overstatement [a]	+55	
Under-invoicing	-24	
Net difference [b]		**485 035**
ANAO recalculation of project management fee		**35 085 815**

(a) The Global Coordinators’ calculated the project management fee on an offer size of 4,288,868,793 shares, or 2,060 more shares than the one-third of Telstra shares available for sale (see Figure 1.1).

(b) Excluded from this amount is $206 124 in additional fees from including, as proceeds received by the Commonwealth, underwriting discounts deducted from the proceeds actually received by the Commonwealth. OASITO has provided ANAO with an early draft of the project management fee side letter that recognised that the project management fee was to be calculated on the basis of gross proceeds prior to the deduction of commissions and any other selling fees and charges. OASITO advised ANAO that, whilst this wording was not included in the final, signed version of the side letter, the side letter provided the framework for a commercial agreement and was not expected to reflect precisely what had been agreed. OASITO stated that it believed the contractual documentation allowed more than one interpretation, however the intention of OASITO and the Global Coordinators was to include the value of the underwriting discounts when calculating gross proceeds received by the Commonwealth from the sale of Telstra shares.

Source: ANAO analysis based on information provided by OASITO, Global Coordinators, Sale Business Adviser, Share Registrar and DoFA.

2.34 ANAO advised OASITO on 10 March 1998 that there may have been an error in the project management fee calculation by including, as proceeds received by the Commonwealth, a value for the free shares for Telstra employees.[39] In response, OASITO advised ANAO on 4 May 1998 that:

> *The Government wanted to see maximum allocations to Australia; maximum allocations to the retail segment within Australia; and maximum take up of the employee share offer within that retail segment, consistent with a*

[39] ANAO obtained legal advice on the treatment of employee free shares given the significant amount of Commonwealth money involved. AGS advised ANAO that *the documentation provided shows that employee share offers and loyalty bonuses were the subject of deliberation and correspondence both before and after the signature of the First Side Letter of 22 August 1997. … Given the circumstances existing prior to 22 August 1997, one would expect the First Side Letter of 22 August 1997 to make some reference to the inclusion of a notional value for any employee free share or discounted share. There is none, even though the Global Coordinators knew of some sort of special free share plan and loyalty bonus for employees well before signature of the First Side Letter. Indeed the use of the term “proceeds” rather than “price” or “value” suggests that no notional value should be included when calculating the Global Coordinators fee.*

balanced overall allocation. The inclusion of a notional value of the free shares in the sale proceeds for the purposes of the Global Coordinators Fee was consistent with this purpose. Had that value been excluded, then the Global Coordinators would have been financially motivated against promotion of the employee offer in order to free up more shares for sale at the issue price, to the benefit of their fee determinant.

Both we and the Global Coordinators were always of the view that the "value" of these bonus and loyalty shares was to be included in the fee basis. Had that not been the case the Global Coordinators would have been more reluctant to accept the fee formula that was negotiated.

2.35 Oral advice from OASITO on 7 July 1998 was that there is no documentation to support its view that the parties agreed to include a notional value for the employee free shares. OASITO advised that the contractual documentation did not capture the terms of the agreement it reached with the Global Coordinators to include a notional value for the employee free shares.

Finding

2.36 ANAO identified a number of elements of the calculation of the project management fee that varied from the signed contract, which required fees to be calculated on proceeds actually received by the Commonwealth. Payments made by OASITO included project management fees for free shares for which the Commonwealth received no proceeds (fees of $458 492) and shares not actually sold (fees of $26 512).ANAO considers it would have been sound administrative practice for the contract to have accurately reflected the agreement that OASITO advises was negotiated with the Global Coordinators.

Recommendation No.2

2.37 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in future asset sales:

(a) appropriately document <u>all</u> fee negotiations; and

(b) ensure that the signed contract fully captures the commercial understanding of the parties as to the basis on which fees will be calculated and paid.

OASITO response

2.38 OASITO ***agreed with qualifications*** to the recommendation. OASITO advised that, while early maximum contractual certainty is a highly desirable objective, OASITO considers that constructive commercial flexibility that could benefit the Commonwealth in terms of outcome should not be sacrificed too readily. It will often be the case that agreement in principle on fee structures may need to be reached before, for example, offer structures are settled. Commercially pragmatic approaches may need to be adopted in recognition of changes in the nature of a transaction as it evolves. Nonetheless, OASITO accepts that, within the limits of what is foreseeable, all known contractual issues should be agreed and adequately documented at the earliest possible stage with as few issues as possible being left to be resolved in any closing settlement.

Managing exchange rate risk

2.39 The Management Advisory Board has issued guidelines on managing risk in the Australian Public Service (APS).[40] These guidelines recognise the effective management of risk as an integral part of the APS reform program and recommend that risk management be central to agencies' business planning and incorporated as part of agencies' management policies. Given individual agencies will have different risk profiles it is important that each agency assess its own risk profile and develop a considered and consistent policy approach to managing its risks.

2.40 For the Telstra sale, OASITO was potentially exposed to exchange rate risk in two situations: the receipt of proceeds for sales to international investors who purchased interim American Depository Receipts (ADRs) and payments in foreign currencies to certain contractors to the Global Coordinators. Exchange rates[41] can be volatile and may therefore be a source of significant risk to agencies where contract payments or receipts are specified in foreign currencies. There are a number of ways to manage (or hedge) exchange rate exposure including forward rate agreements and foreign exchange futures contracts. ANAO considers a consistent and considered approach to managing financial risks such as material exchange rate risk represents good administrative practice.[42]

2.41 First instalment proceeds for the sale of ADRs totalled $US186 million. The exchange rate risk associated with payment of the first instalment for ADRs was effectively managed by way of a forward foreign

[40] Management Advisory Board and its Management Improvement Advisory Committee, *Guidelines for Managing Risk in the Australian Public Service*, 1996.

[41] Adverse movements in exchange rates can reduce receipts and/or increase costs. This is known as currency or exchange rate risk.

[42] DoFA advised ANAO that *ANAO's view that there is a need for a consistent and considered approach for managing foreign exchange risk is fully supported although we see it as best addressed in the more holistic context of business planning where all material business risks, including foreign exchange risk, if appropriate, should be assessed. Having said that, it is appropriate to stress the need for the articulation of a policy approach to exchange rate management which focuses on the needs of the business being conducted (eg the possible desirability of locking-in a rate which meets business objectives) rather than on the likelihood and direction of possible exchange rate movements. Once articulated, it is important that the policy be consistently applied.*

exchange contract with the Reserve Bank of Australia (RBA). The arrangements involved the RBA setting the exchange rate[43] for payment on 25 November 1997.[44]

2.42 The contractual arrangements between OASITO and the Global Coordinators required OASITO to reimburse the Global Coordinators for the actual costs of any approved sub-contracts. The international printer's and roadshow coordinator's fees were specified in foreign currency,[45] and the exchange rate was not fixed. Accordingly, OASITO faced the risk that adverse exchange rate movements would increase Commonwealth sale costs. They could also have reduced sale costs. OASITO did not develop a mechanism to manage the Commonwealth's exchange rate exposure for these transactions. ANAO estimates that the Commonwealth's 'exposed' position between the time the contracts were signed and the date of invoicing increased sale costs by up to $640 000. The cost of hedging this risk would have offset some of the potential savings from any hedging arrangements.

2.43 A different approach was adopted for the contract with the bookbuild software supplier, for whose costs OASITO also reimbursed the Global Coordinators. Contract fees were specified in a foreign currency.[46] However, the supplier requested that exchange rate risk be fixed for variations within specified limits (an exchange rate collar).[47] This provided OASITO and the supplier with a partial hedge of exchange rate risk. The collar did not prove effective, being exceeded on all but the first invoice. As a result, the Commonwealth remained exposed to exchange rate risk with sale costs increasing by up to $60 000.

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43 The arrangements set the exchange rate at $US1 : $A0.6978. As a result, at the time of pricing, OASITO knew it would receive $A266 million on 25 November 1997 for the $US186 million payable by international investors on this date. The hedge arrangements also included payment of $US1.25 million from the ADR Depository to OASITO, also due to be received on 25 November 1997.

44 Foreign exchange risk on the second instalment is also to be managed through the RBA. Second instalment notices sent to ADR holders will include an indicative foreign exchange rate with the exact amount due to be calculated using the spot foreign exchange rate on the payment due date of 17 November 1998. Any shortfall between the amount paid, based on the payment notices, will be collected from ADR holders and any excess refunded.

45 Payments to the international printer were required to be in United States dollars while the roadshow coordinator was required to be paid in English pounds sterling.

46 Payments were required to be made in English pounds sterling except for disbursements which were capped at $A98 000.

47 The contract set the exchange rate at the spot rate that applied at the time the contract was signed, except where movements in exchange rates increased or decreased by greater than 1.5 per cent. Where movements were greater than 1.5 per cent, payments were to be calculated using the exchange rate applying on the invoice date.

Finding

2.44 Through a forward foreign exchange agreement with the Reserve Bank of Australia, OASITO effectively managed exchange rate risk on sale proceeds to be received in United States dollars. However, OASITO's policy on hedging exchange rate risk did not extend to payments of $7.5 million made by the Global Coordinators to sub-contractors and subsequently reimbursed by OASITO. Unhedged exposure to exchange rate risk between the date these contracts were signed and the date of invoicing increased sale costs by up to $700 000.

Recommendation No.3

2.45 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, as part of its overall risk management strategy, develop a consistent and considered approach to the management of exchange rate risk including the identification of all instances where contractual arrangements leave it exposed to exchange rate risk and the evaluation of options for cost-effective management of these risks.

OASITO response

2.46 OASITO ***disagreed*** with the recommendation. OASITO noted that exchange rate risk is clearly one of many risks to be addressed and managed cost-effectively in each transaction. This is best done on a case by case basis. This was done in this transaction, where the exchange rate exposure of the contracts in question was not considered to be sufficiently material in the context of a $10 billion plus transaction to warrant the diversion of limited management resources to developing a specific hedging strategy. OASITO does not consider that it would be cost effective for it to adopt a standardised policy, other than to list exchange rate risk as a checklist item for review in each case. Indeed, OASITO would be concerned that any attempt to do so could risk undue neglect of the transaction and context-specific issues that are more material in any case than any general considerations that may apply. OAISTO notes that subsequent review indicates that, had the issue been analysed at the time it would have been unlikely that hedging would have been undertaken (even in cases where hedging was possible) because of the levels of relative forward markets in the currencies in question.

ANAO comment

2.47 The exchange rate exposure on $7.5 million in contract payments was sufficiently material to have warranted a systematic risk management approach. ANAO agrees that it is appropriate to review exchange rate risk on a case by case basis, having regard to an agency's overall risk management strategy for the efficient management of Commonwealth resources. Moreover, ANAO considers that the review should encapsulate an explicit evaluation of the potential options for managing exchange rate risk, from specifying contract payments in Australian dollars through to purchasing commercial cover for all or part of the risk.

3. Sale Marketing and Logistics

This chapter outlines the marketing of the sale to potential retail and institutional investors, sale logistics and settlement of the first instalment.

Retail marketing

3.1 Maximising Australian retail demand was important to generate sufficient demand to sell all offered shares and create a perception of scarcity of stock to encourage strong institutional bidding at an optimal price. Vendors can employ a number of strategies to stimulate retail demand including offering deferred payment for shares,[48] a cost-effective package of incentives and an effective marketing campaign.

3.2 Total allocable retail demand of some $25.5 billion was generated with 1.8 million applications allocated 2.58 billion shares or 60 per cent of the total offer. The direct costs of retail marketing were $14.4 million, comprising mainly advertising expenditure of $12.4 million. In addition, certain logistics activities such as the prospectus pre-registration process[49] provided significant support to the retail marketing strategy. Direct costs were contained through the use of a short-form retail offer document and a reduction in the scale of the advertising campaign[50] when it became clear that there was a high level of public awareness of the float following the pre-registration phase and initial advertising and public relations campaigns.

3.3 OASITO's management of retail advertising expenditure was generally sound, although late payment of some accounts incurred additional costs of $25 437 in penalty interest in an aggregate billing amount of $10.1 million. The interest on overdue accounts included $22 214

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[48] The sale by instalment arrangements adopted provided yield and time value advantages to investors. Retail investors applied for more than 3 billion shares, or 70 per cent of the offering with post-sale market research finding that the purchase in two instalments was important to 38 per cent of investors' decision to invest.

[49] Investors who reserved a prospectus were guaranteed an entitlement to an amount of shares which would not be less than 50 per cent higher than the final minimum public allocation amount. More than 2.5 million responses were received. The incentive appeared effective in converting pre-registrants into investors with 1.36 million pre-registrants applying for shares (a conversion rate of 53 per cent) and pre-registrants represented 73 per cent of all retail applicants. The final allocation of shares did not reward pre-registrants as all retail applications were accepted in full for the first 2 000 shares.

[50] Advertising expenditure was reduced to $12.4 million compared to a contract value of $15.2 million and sale budget of $20 million.

(87 per cent) where cheque payments had been prepared before the due date but were not received by the Commonwealth's master buying agency until after the due date. The Commonwealth's contract with its master buying agency for advertising requires payment to be credited to the master buying agency's bank account within 40 days from the end of the month following media usage or penalty interest will be charged for late payment.[51]

Retail prospectus

3.4 To assist in achieving a wide distribution of Telstra shares to the public by providing user friendly information, the Telstra retail prospectus was produced as a short form offer document.[52] OASITO advised ANAO that this was the first use of this form of offer document in an Australian public share offer and that it required special regulatory consideration by the Australian Securities Commission (ASC).

3.5 The aim of the retail prospectus was to provide information in a simple, clear and concise format for the Australian investment market and ensure that appropriate disclosure was made of the source for further information should the investor require this extra detail. More than 3.8 million short form offer documents were produced and 84 per cent of these were distributed to potential investors.[53]

3.6 The retail prospectus was supplemented by separately available appendices that contained detailed information considered to be primarily of interest to professional advisers and investors with specialist information needs. A total of 500 000 appendices[54] were produced with 72 000 distributed to the public and a further 6 000 copies downloaded from the Internet site.

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[51] Under the terms of the Central Advertising System, the Commonwealth's master buying agency settles the agency's accounts with the media before seeking reimbursement from the relevant Commonwealth agency.

[52] The use of a retail prospectus was in keeping with the report of the 1997 Financial System Inquiry which recommended the use of short form profile statements and shorter prospectuses to promote more effective disclosure to retail investors. Source: Financial System Inquiry, *Financial System Inquiry Final Report*, 18 March 1997, pp. 264-269.

[53] The production of prospectuses to be issued to international investors was undertaken as a separate exercise to the production of the Australian public offer document. A total of $3.5 million was paid for the production and distribution of international prospectuses. A number of items invoiced to the Global Coordinators and reimbursed by OASITO were significantly in excess of estimates included in the contract. The Global Coordinators advised ANAO that a major factor in the increased costs was the requirement to reprint the preliminary international prospectus in all jurisdictions outside of Australia due to an additional disclosure requirement related to threatened litigation against Telstra.

[54] The ASC's agreement to the short form offer document required availability of appendices to all who asked for them.

3.7 Post-sale market research commissioned by the Global Coordinators on behalf of OASITO found the short form offer document was the main source of information used by Australian retail investors when deciding whether to purchase Telstra instalment receipts. Furthermore, the research revealed that some two-thirds of pre-registrants read the short form offer document and reported a very high level of satisfaction (81 per cent) with the information contained in it.

Finding

3.8 An effective retail marketing campaign was implemented which generated retail demand of some $25.5 billion. The use for the first time of a short form offer document generated cost savings. It was the main source of information used by Australian retail investors when deciding whether to invest.

Retail incentives

3.9 The offer included a range of direct financial incentives to Australian retail investors (see Figure 3.1) and additional incentives for eligible Telstra employees. The incentive package was put in place in order to meet the Government's electoral commitments[55] to provide retail investors and Telstra employees with incentives to participate in the offer, and to increase sale proceeds by increasing retail demand. Increasing retail demand was expected to increase pricing tension in the institutional offer and sustain the aftermarket price by encouraging investors to become long-term Telstra shareholders. It is not possible to quantify the incremental effect that the incentives may have had on pricing tension in the institutional offer.

3.10 The incentive package was developed on the basis of the Government's election commitments and advice from the Global Coordinators and Sale Business Adviser. This advice considered: the Government's election commitments; incentives included in previous Australian and international offers; and market research of investor attitudes. OASITO advised ANAO that the incentive package was effectively constrained by the nature of the Government's electoral commitments.

[55] OASITO advised ANAO that the only variation to the electoral commitment, which went to form rather than substance, was to substitute a loyalty discount on the second instalment for the unspecified loyalty 'bonus' that had been put forward.

Figure 3.1
Direct Financial Incentives to Retail Investors

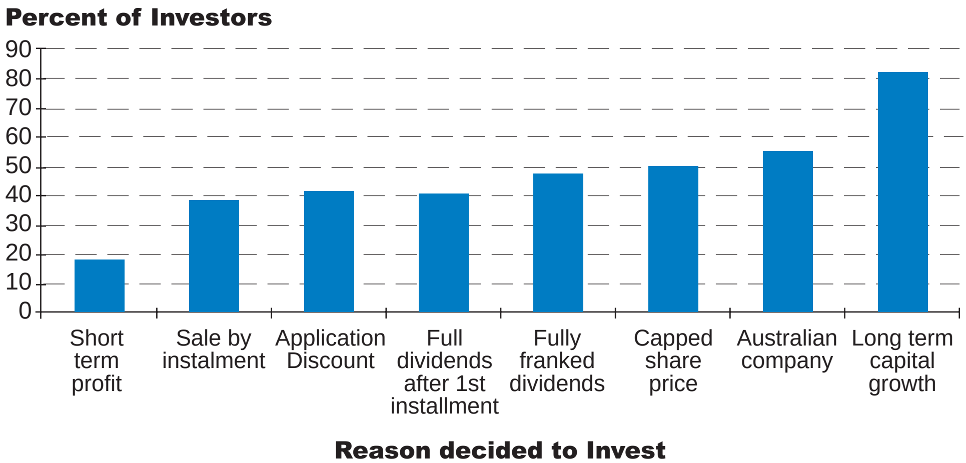
Incentive	Expected Offer Benefits	Outcome
Retail application discount of five cents per share on the first instalment.	Encourages retail demand which increases demand and price tension in the institutional offer by creating a scarcity of stock.	Sufficient demand generated to allocate 60 per cent of the offer to retail investors. Post-sale market research found that the application discount was important to 41 per cent of investors' decision to invest. Sale proceeds were reduced by $126 million.
Maximum total price payable by Australian retail investors capped at $3.30 per share.	Provides certainty to investors as they knew their maximum exposure before deciding to apply for shares.	Post-sale market research found that the capped share price was important to 49 per cent of investors' decision to invest.
A **loyalty discount** of five cents per share to all retail investors who hold their instalment receipts continuously until payment of the second instalment.	Intended to encourage share ownership and discourage aftermarket selling. Pre-sale market research found 83 per cent of investors intended to hold their instalment receipts for twelve months.	Market research indicates that most retail investors are aware of the date for the second instalment but only two-fifths were aware of the loyalty discount if they do not sell their shares. 84 per cent intend to hold their shares, reducing proceeds by $106 million.

Source: ANAO analysis based on information from OASITO, Global Coordinators, and Sale Business Adviser.

3.11 In March 1998, the Global Coordinators commissioned post-sale market research to evaluate the effectiveness of the sale process from the Australian retail market's perspective and identify motivating and inhibiting factors in retail investors' investment decision. The research found that long term capital growth was the principal reason for purchasing Telstra instalment receipts followed by Telstra being an Australian company, the capped share price and fully franked dividends (see Figure 3.2).

Figure 3.2

Retail Investors’ Investment Decision - Post-sale Market Research



Source: DBM Consultants Pty Ltd, *Telstra Float Evaluation Research*, April 1998, page 39.

Employee incentives

3.12 Telstra employees could participate in the offer by purchasing shares in the public offer and/or in a special employee offer. In addition to the incentives available to all Australian retail investors, and in fulfilment of a 1996 election commitment, employee participation was encouraged by guaranteeing:

- that 2 000 shares would be made available for each eligible employee;
- one free share for every four shares purchased in the public and/or employee offers up to a maximum of 500 extra free shares per employee. Over 28.2 million free shares were allocated to Telstra employees, representing reduced sale proceeds of $94 million; and
- one free loyalty share for every ten shares purchased in the public offer and held continuously for twelve months, up to a maximum of 200 loyalty shares per employee. To provide for the loyalty share allocation, some 3.2 million shares were withheld from the allocation to investors. If this provision is utilised in full, the value of the loyalty shares at the issue price will have been $11 million. The Commonwealth will be able to sell any loyalty shares not taken up.

3.13 Proceeds foregone from issuing free shares to Telstra employees were reduced by a subdivision of Telstra’s share capital.[56] The subdivision

[56] On 6 August 1997, the Telstra Board approved dividing each of Telstra’s 6 433 300 100 $1.00 ordinary shares into 12 866 600 200 ordinary shares with a par value of 50 cents each.

halved the value of each Telstra share (but doubled the number of shares) thus halving the proceeds foregone from issuing free shares to Telstra employees. The subdivision did not change the total amount of Telstra's issued capital but made it possible for the Commonwealth to sell exactly one-third of its shareholding.

3.14 Telstra, at its own initiative and cost, also encouraged employee participation, most particularly by offering an interest free loan to each employee to enable them to purchase up to 2 000 shares. Provided employees remain employed with the Telstra group, the loan is to be repaid through after-tax dividends.[57] For employees who leave the Telstra group, the loan is repayable either by selling the shares or from the employee's own money. Over 90 per cent of eligible employees purchased shares under the loan scheme with Telstra providing funding of $213 million for the first instalment.[58] Telstra is also required to fund the second instalment.

Finding

3.15 A large number and wide range of incentives were employed to generate strong retail demand in order to sell all available shares and increase demand and price tension in the institutional offer. The value of the Commonwealth concessions in the incentive package is estimated at $337 million.

Institutional marketing

3.16 The objective of institutional marketing was to generate strong demand from institutions. Telstra institutional marketing proceeded in two major stages: pre-marketing[59] between 12 September 1997 and registration of the Australian offer document on 29 September 1997; followed by marketing during the offer phase. The final pricing decision was then made based on bookbuild demand and prices,[60] the allocation policy and likely secondary market trading levels.

57 Employees can repay the loan in full at any time using their own funds but the shares will not be made available for a period of three years after allocation. Alternatively, three years after allocation, the loan can be repaid by selling some or all of the shares, providing the proceeds are sufficient to repay the loan in full and any sale costs.

58 Telstra Half Year Results Announcement - 31 December 1997, p. 8.

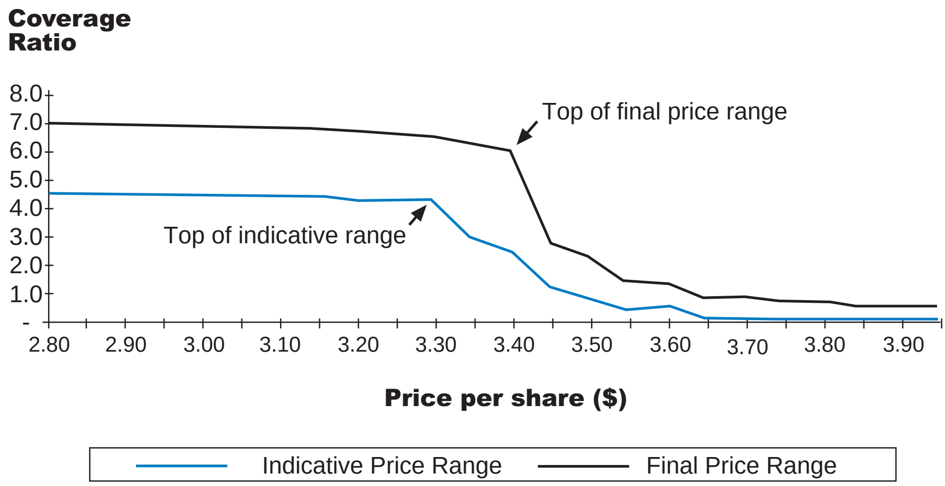
59 Pre-marketing involved the lead managers presenting the investment opportunity to Australian and international institutional investors and obtaining feedback on their views of Telstra. Pre-marketing was undertaken to: assist setting the indicative price range; build momentum towards the bookbuild period; act as the basis for establishing initial tranche size indications; and highlight the key institutional investors to be focused on during the international roadshow.

60 Bookbuilding is a process by which investors submit bids in advance of the pricing of the share offer and, on the basis of this information, shares are allocated to qualifying bidders.

3.17 At the issue price of $3.40, total institutional demand of $36 billion was generated for Telstra instalment receipts with institutions bidding for 10.5 billion shares, or 6.2 times the shares available to them (see Figure 3.3). The majority of the demand (52 per cent) came from Australian institutions and brokers, followed by European institutions (23 per cent), American institutions (17 per cent) and institutions in the rest of the world (8 per cent).

Figure 3.3

Bookbuild Coverage Ratio



Source: ANAO analysis of data provided by Sale Business Adviser.

International roadshow

3.18 The culmination of the institutional marketing effort was a series of institutional investor presentations, known as a roadshow, undertaken between 17 October and 7 November 1997[61]. The roadshows were conducted by two separate speaker teams[62] of three Telstra management presenters, accompanied by up to six representatives of the Global Coordinators and one OASITO representative. In total, over 20 group presentations and more than 150 individual meetings with institutions were conducted in 39 different cities in Australia, New Zealand, Asia, North America and Europe.

61 Roadshows are generally seen to represent the key element of the selling effort to institutional investors because of the effect that personal access to senior management can have on investors' decision making and the assistance they provide in assessing the likely response to the offer. The Telstra roadshow targeted international investors.

62 The first team comprised Telstra's Chief Executive Officer; Group Managing Director, Retail Products and Marketing; and Director of Finance. The second team comprised Group Managing Director, Finance and Administration; Group Managing Director, Commercial and Consumer; and Manager, Float Secretariat, Investor Relations Unit.

3.19 The Global Coordinators and Lead Managers developed a proposed roadshow schedule incorporating a combination of one-on-one meetings with core investors and group presentations in major financial centres. The schedule was reviewed by OASITO, its Sale Business Adviser and a specialist investor relations firm contracted by OASITO to advise on the appropriateness of the institutions proposed for inclusion. Input from the investor relations consultant lead to a number of changes to the roadshow program. The consultant's recommendations addressed the need to focus the roadshow on high quality investors, suggested the removal of some cities and investors from the program, and the inclusion of other investors. At a cost of $23 000, the specialist adviser provided OASITO with an important source of independent advice on the composition of the roadshow.

Roadshow costs

3.20 The total cost to the Commonwealth of the international roadshow was $3.06 million, or $139 000 per day. OASITO's sale budget included provision of $1 million for the roadshow. The roadshow for the 1996 third tranche sale of the Commonwealth Bank of Australia (CBA3) was conducted over two and a half weeks and covered Asia, the United Kingdom, Europe and the United States. In comparison to the Telstra sale roadshow, the total cost to the Commonwealth of the CBA3 international roadshow was $359 000, or $20 000 per day.[63] OASITO advised the ANAO that:

> *The comparison with the CBA3 roadshow is incomplete and misleading because, inter alia, of the different circumstances and the different basis for paying for the costs involved. In order to maintain better control over the roadshow and improve its value as a marketing effort, we decided on a higher professional standard and more intensive meeting schedule as well as central control over management and funding. Costs met indirectly in CBA3 were met directly in Telstra. Cost 'per day' is not a valid benchmark.*

3.21 ANAO recognises the difficulties in comparing roadshow costs in the Telstra sale (which were borne directly by the Commonwealth) and CBA3 (some of which were borne by the international Joint Lead Managers as part of their contractual responsibility for marketing the offer).

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63 Credit Suisse First Boston advised ANAO that: *CBA3 was a totally different offering as it was not an Initial Public Offering. It should be noted that the Telstra roadshow was completed following several comparable roadshows for France Telecom, Telecom Italia and China Telecom earlier in 1997. In order to produce a roadshow of similar calibre to these offerings, a much higher quality roadshow was required which incurred additional audiovisual, staging, personnel and travel costs. The comparison in terms of aggregate cost of the Commonwealth should also note that the Telstra figure of $3.02 million includes domestic roadshow costs as well as all personnel and audiovisual support required in Australia prior to the start of the roadshow.*

Nevertheless, there has been a significant increase in roadshow costs between the 1996 CBA3 offer and the 1997 Telstra offer. Given the quantum of the cost increase, and the absence of a comprehensive reconciliation of roadshow expenditure to supporting documentation, the ANAO was not able to determine whether cost management in relation to the Telstra roadshow was fully effective.

3.22 The Global Coordinators contractual responsibilities included managing and arranging international marketing campaigns such as roadshows. With OASITO's approval, the Global Coordinators sub-contracted a Roadshow Coordinator to prepare presentation materials, arrange technical and staging facilities, and coordinate travel and accommodation for the two roadshow teams.[64] A total of $3.02 million was paid by the Global Coordinators to the Roadshow Coordinator comprising fees and personnel charges ($664 545) and reimbursement of roadshow costs ($2.35 million).[65] The Global Coordinators certified to OASITO that it was proper for the Global Coordinators to have paid the Roadshow Coordinator this 3.02 million.[66] On this basis, OASITO reimbursed the Global Coordinators $3.02 million.

3.23 The Global Coordinators contract with the Roadshow Coordinator required the Roadshow Coordinator to provide the Global Coordinators with sufficient documentation, including copies of receipts and third party invoices, to enable validation of its invoice. The Global Coordinators were unable to provide ANAO with a comprehensive reconciliation[67] of costs to

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64 In CBA3, the two international Joint Lead Managers organised and coordinated the roadshow as part of their contractual responsibility for marketing the offer.

65 The major elements of the direct costs were $532 928 for scheduled flights; $466 601 for private aircraft charter; $254 990 for venues; $228 969 for equipment and local technicians; $223 546 for speaker team accommodation; and $136 779 for private chauffeur and limousine services.

66 The Global Coordinators contract with OASITO states that they are liable in respect of any incorrect payment made by OASITO as a result of a wrongly issued certificate.

67 The Global Coordinator primarily responsible for organising the roadshow advised ANAO on 1 July 1998 that [The Global Coordinator] *did not attempt to validate each third party cost invoiced by* [the Roadshow Coordinator]. *We have worked with* [the Roadshow Coordinator] *on many roadshows and are comfortable with their ability to collate accurately all expenses incurred on a roadshow.* [The Roadshow Coordinator] *maintains a detailed invoicing system to process the thousands of receipts incurred during the average roadshow in different currencies (up to 15 for Telstra) and therefore* [the Global Coordinator] *did not attempt to reconcile every component of the invoice from hardcopy receipts.*

supporting documentation and the roadshow itinerary.[68] OASITO advised ANAO that:

> *the Global Coordinators' provision of information in response to ANAO requests was delayed by the need to obtain documents from overseas.*

3.24 On 5 August 1998, the relevant Global Coordinator provided ANAO with supporting documentation for most roadshow costs. ANAO's analysis of a small sample of the supporting documentation identified a number of anomalies in the roadshow expenditure. For example, certain expenditure did not appear to relate to organising and conducting the Telstra roadshow; certain travel expenses exceeded entitlements by a significant margin; and some expenditure did not reconcile to the roadshow itinerary. ANAO has provided OASITO with this documentation to enable OASITO to complete a reconciliation.[69] OASITO has advised ANAO that:

> *OASITO has continued dialogue with the Global Coordinators pursuant to the Chief Executive's obligations under Section 47 of the Financial Management and Accountability Act to enable a view to be formed on whether there is a material recoverable debt and if so whether recovery action would be economical.*

Finding

3.25 The culmination of the institutional marketing effort was an international roadshow undertaken in Australia and overseas. The total cost of the Telstra sale roadshow to the Commonwealth was $3.06 million - more than eight times the costs incurred by the Commonwealth for the 1996 third tranche sale of the Commonwealth Bank of Australia roadshow. Despite the significant amount of Commonwealth expenditure involved, payments reimbursed to the Global Coordinators for the Roadshow Coordinator ($3.02 million) were not independently verified by the Global Coordinators through appropriate supporting

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68 Credit Suisse First Boston advised ANAO on 31 August 1998 that *the Global Coordinators and Lead Managers Agreement ('the Agreement') did not stipulate that a complete reconciliation prepared with examination of all supporting documentation was required for any of the expenses incurred by the Commonwealth for the subcontractors appointed for the Telstra share offer. In the example of the Roadshow Coordinator, Credit Suisse First Boston in accordance with the Agreement did not reconcile all third party expenses as it was outside the scope of our project management role to the Commonwealth. However, in order to certify the Telstra roadshow invoice, Credit Suisse First Boston performed a detailed review of the invoice and supporting documentation and appointed an external consultant to determine that the project management fees, underlying production numbers/quantities and personnel rates were correctly invoiced.*

69 Section 47 of the *Financial Management and Accountability Act 1997* requires Chief Executives to pursue recovery of each debt for which the Chief Executive is responsible unless: the debt has been written off as authorised by an Act; the Chief Executive is satisfied that the debt is not legally recoverable; or the Chief Executive considers that it is not economical to pursue recovery of the debt.

documentation and an effective audit trail was not maintained of this Commonwealth expenditure. ANAO's analysis of a small sample of the supporting documentation identified a number of anomalies in the roadshow expenditure and ANAO has provided OASITO with this documentation to enable OASITO to complete a reconciliation.

Recommendation No.4

3.26 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing seek to enhance value for money in future asset sales by requiring its contracted project managers, as part of their project management responsibilities, to independently verify sub-contractors' invoices to appropriate supporting documentation and maintain an effective audit trail for Commonwealth expenditure.

OASITO response

3.27 OASITO ***agreed with qualifications*** to the recommendation. OASITO did notify the Global Coordinators that it expected them to 'independently check all suppliers' documentation, rather than relying on statements from the suppliers that goods and services were provided and invoices correctly rendered'. OASITO has already decided on changed arrangements for any future transactions of this scale, and has instituted measures to align its contractors' certification of expenditure with standards to be provided for in OASITO's Chief Executive instructions. However, OASITO disagrees that this is a 'value for money' measure, and suggests that it may increase administration costs rather than save money, albeit providing an enhanced audit trail. OASITO has noted that the level of trust in suppliers' invoicing in the commercial sector appears to be higher than that in the Commonwealth sector. This is probably indicative of a more highly developed relationship management approach and a greater private sector sensitivity to cost effectiveness that has more regard for the opportunity cost of management time in undertaking detailed checking. OASITO considers that it is not cost effective to require the 100 per cent verification of all invoices to the level sought by ANAO on this occasion (which has included many very minor issues).

ANAO comment

3.28 ANAO considers that agencies' procedures for controlling expenditure should concentrate controls in areas of greatest risk and seek the most economical ways of reducing risk. Accordingly, ANAO considers that 100 per cent verification of invoices is rarely cost-effective when there are adequate control structures. Small claims will need only minimal checking on a risk management basis, whereas large claims will invariably require more rigorous scrutiny. Given the amount of Commonwealth money involved, and the inherent nature of much of the expenditure on the international roadshow, sound administrative practice suggests expenditure charged, ultimately, to the Commonwealth should have been subjected to systematic review.

Sale logistics

3.29 The contract with the Global Coordinators required them, subject to OASITO approval and direction, to arrange and manage float logistics. OASITO's role was to maintain an oversight of logistical aspects. This division of responsibilities differed from previous Commonwealth public share offers where the former Task Force on Asset Sales within the then Department of Finance managed sale logistics directly.

3.30 Overall, sale logistics were effectively coordinated by the Global Coordinators and OASITO. A framework for coordination and project management was established through the Retail Marketing and Logistics Committee and regular coordination meetings of sub-contractors. Day-to-day coordination was effected by one of the Global Coordinators monitoring the activities of the sub-contractors and other parties involved in sale logistics.

3.31 The scale of the logistics (see Figure 3.4) for the Telstra offer exceeded any previous Commonwealth share offer. Compared to the CBA3 sale, the preregistration process generated ten times the number of responses; almost three times as many offer documents were distributed to potential Australian investors with the added complexity of distributing offer document appendices to those who requested them; and there were more than six times the number of retail applicants.

3.32 ANAO estimates the total cost of sale logistics to be $46 million. The major element of this cost were payments made to sub-contractors. The major logistics contracts involved the share registry/application processing centre, mailhouse, share information centre,[70] banker to the issue/secondary distribution network, design and production of an Internet web site, and production of the offer document. To provide for compliance with Commonwealth procurement principles and policies, OASITO required the Global Coordinators to competitively tender each contract and seek its endorsement of sub-contracts prior to their execution.

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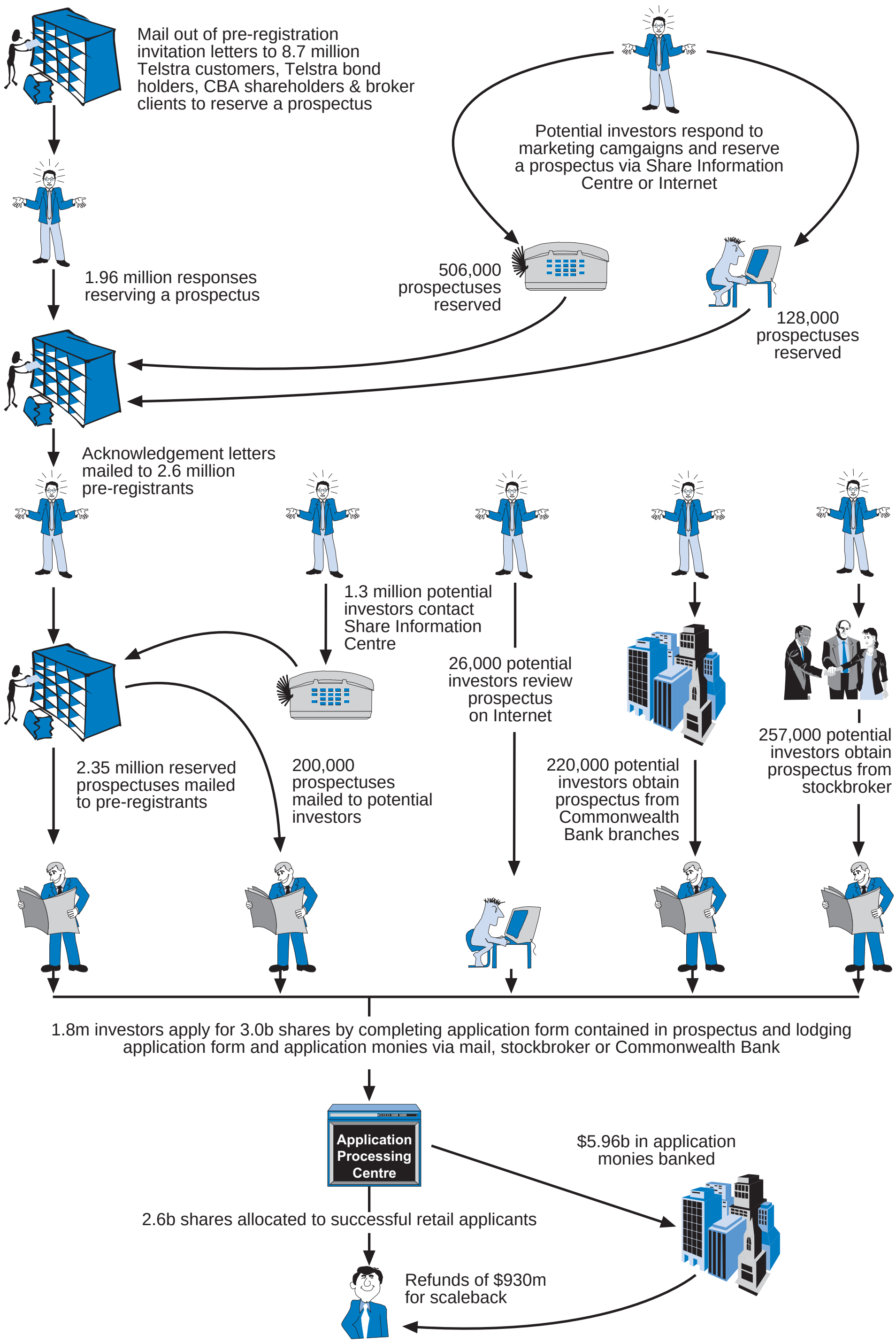
[70] The share information centre involved a telephone call centre established to respond to general enquires regarding the float, pre-registration and other requests for public offer documents, and allocation enquires.

Figure 3.4

Telstra Offer Retail Logistics



Source: ANAO analysis of information from OASITO and Global Coordinators

3.33 Tenders for the major logistics contracts were conducted between May and July 1997. Following selection, the successful tenderers were provided with draft contracts but were asked to commence work immediately. Due to contractors' concerns about the draft contracts, particularly the proposed allocation of risks, the major logistics contracts[71] were not finalised until September 1997, after a lengthy period of negotiation involving OASITO, the Global Coordinators and the various sub-contractors.

3.34 Following commencement of the tender process for the share registrar, mailhouse, and banker to the issue contracts, the Global Coordinators came to the view that an integrated approach involving these suppliers should be adopted. They considered integration of the management and technical capacities of these sub-contractors would deliver the efficiencies necessary to manage the expected high volume of processing. It was agreed with OASITO that, following the selection of these logistics sub-contractors, they would be asked to work together to develop an integrated proposal for submission to OASITO.

3.35 The Share Registrar, Banker to the Issue and the Mailhouse contractors submitted an agreed integrated approach to the Global Coordinators on 18 June 1997. The Share Information Centre and the Internet Site Provider were not involved in the development of the integrated approach because these contracts were tendered at a later stage, although both were involved in offer logistics, including the capture and transfer of data on pre-registration. The Share Information Centre and Internet Site Provider did, however, become members of the supplier working group that assisted coordination of the integrated approach.

3.36 Payments to sub-contractors were made either directly by the Global Coordinators with subsequent OASITO reimbursement or directly by OASITO. The Global Coordinator allocated primary responsibility for managing sale logistics maintained detailed records of activities and costs and insisted sub-contractors provide complete supporting documentation for all invoiced costs, before it recommended payment. ANAO's review of the administration of these contract payments concluded that payments were generally in accordance with the terms and conditions of the relevant contract with any additional payments authorised by OASITO based on advice from the Global Coordinators.

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71 The Share Registrar advised ANAO that: *we believe that an adequate timetable is the most important factor in the success of a project of this nature. The appointment of logistics suppliers is frequently left until last while offer structure decisions are often made without regard for the practicalities of implementation. Improvements in this area would, in our opinion, provide significant increased assurance regarding the overall success of the project.*

Finding

3.37 Overall, sale logistics were effectively coordinated by the Global Coordinators and OASITO with the pre-registration process, preparation and distribution of offer documents, application processing and distribution of allocation details to investors proceeding in accordance with the sale timetable.

Application processing

3.38 All retail applications were processed by the deadline of 12 November 1997.[72] The Share Registrar was responsible for processing applications by retail investors and banking of funds into an account at the Banker to the Issue. These funds were required to be transferred daily to the RBA. Timely processing and banking of funds was dependent on the technology and procedures adopted by the Share Registrar and Banker to the Issue as well as the Share Distribution Network which collected and delivered applications deposited with it. Processing efficiency was also dependent on the quality of the data captured during the pre-registration process.

3.39 A processing target of 100 000 to 200 000 applications per day was advised to candidates for the share registry, mailhouse and banker to the issue contracts. Candidates were advised in the Request for Tender that a

> *key element of the Telstra float will be the ability to process between 100 000 and 200 000 application forms per day in order to meet the strict timeframe between the close of the offer and the commencement of trading*

and tenderers were assessed partly on their claims to possess the capacity to handle the anticipated application processing volumes. However, the daily application processing target and other targets were not included as specific performance standards in these contracts.[73]

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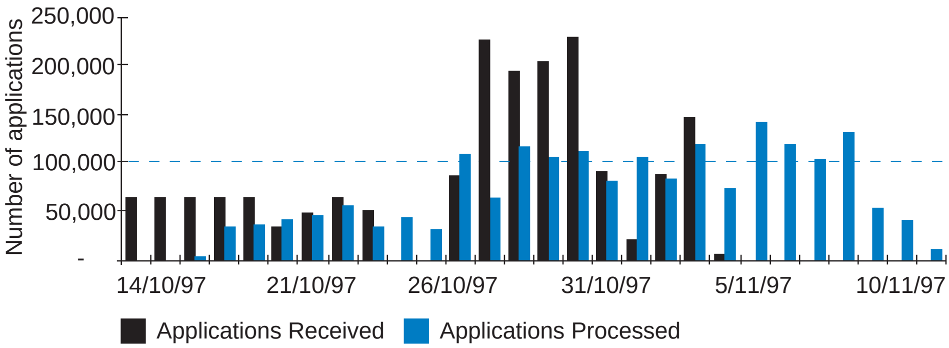
[72] This involved processing over 3.7 million documents for more than 1.8 million applications. In comparison, the previous largest floats in Australia requiring the capture of new applicant information and the collection of application monies were Woolworths with some 330 000 applications and CBA3 with 306 000 applications.

[73] The Global Coordinator primarily responsible for managing sale logistics advised ANAO that: *The Share Registrar was contracted 'to resource the Application Processing Centre to cope with a maximum of 2 million applications.' In addition, all subcontractors including the share registry, were required to perform against the agreed project timetable that was included in all supplier subcontracts. Therefore, according to the agreed and contracted performance as per the timetable all application processing (up to 2 million applications) by the share registry had to be completed by a target date which necessitated the share registry achieving processing rates between 100 000 to 200 000 applications per day.*

3.40 In the early stages of the public offer period, application processing performance was significantly less than the lower (100 000 per day) processing target (refer Figure 3.5).[74] Reasons for this included unexpected problems with optical character recognition equipment performance and inconsistencies in some of the pre-registration data.[75] Delayed processing of applications resulted in delays in banking of funds which resulted in foregone Commonwealth interest estimated at between $1.2 million and $2.0 million.[76]

Figure 3.5
Receipt and Processing of Retail Applications



Source: ANAO analysis of information from OASITO and Global Coordinators

[74] The Share Registrar advised ANAO that the *performance targets were met following deployment of additional resources by us. We believe that the apparent judgement against interim standards misses the critical factor that primary focus throughout the assignment (by all suppliers) was to achieve the outcome of completing each task by the milestone dates. While lessons have, naturally, been learnt, the outcome of processing the applications by 12 November 1997 was accomplished.*

[75] The Share Registrar advised ANAO that, after the network and data management problems were identified and corrected, there were other factors why the processing rate did not exceed 150 000 per day. The Share Registrar advised that these factors were primarily outside of its control.

[76] The Share Registrar advised ANAO that *for a project of this nature, where volume, timetable and offer complexity were taken to completely new levels, it does not seem reasonable for potentially substantial penalties to be linked with performance when: completely new and largely untested processing techniques were, of necessity, required to handle the anticipated volumes; the supplier's ability to perform is so inextricably linked with the performance (or otherwise) of other parties over which the supplier has no control; the tendering process is specifically designed to produce the lowest cost result for the Commonwealth, thereby further restricting a supplier's ability to absorb penalty charges; and the timing of appointments, authorisation of expenditures, critical offer structure decisions and offer opening dates, are all critical to the supplier's performance, but are matters over which the supplier has little if any control.*

3.41 JB Were & Son advised ANAO that:

> *the logistics process must support the offer rather than drive the offer. All suppliers have to meet the performance standards set out in the timetable for the offer. Failure to deliver to timetable would essentially threaten the offer. Therefore there are very definite performance standards in all supplier contracts.*[77]

Finding

3.42 Initial processing of retail applications was well below target, resulting in delays in the banking of funds leading to Commonwealth interest foregone estimated at between $1.2 million and $2.0 million. Contract management could be assisted by specifying performance standards in contracts and linking fee payments to achievement of these standards. Although the successful candidates for the major logistics contractors were required to process between 100 000 and 200 000 applications each day, the contracts did not specify this performance standard or link payment of fees to its achievement.

Recommendation No.5

3.43 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance logistics management in future sales by specifying performance standards in logistics contracts and linking fee payments to achievement of these standards.

OASITO response

3.44 OASITO ***agreed with qualifications*** to the recommendation. OASITO commented that it needs to be remembered that the primary objective is to get the functional job done, rather than applying sanctions to any failure or shortcomings. Unforeseen issues will arise that have to be handled in parallel with continuing progress. This requires a complete relationship management approach, rather than the legalistic yet naive 'carrot and stick' philosophy that appears to underlie the ANAO recommendation. In this case, the target performance standards were reflected in the contract by the explicit annexation of the relevant proposal

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77 *We should also stress that, on many occasions, suppliers are asked to process and produce materials at volumes, and within timeframes, not envisaged when first asked to tender. This generally results from the changing nature of the offer structure etc during the course of the offer. When this occurred for the Telstra offer all suppliers responded positively and thus the timetable was adhered to. Again it is the timetable requirement that drives performance as opposed to contracted processing rates.*

In our opinion therefore it could be disadvantageous to the Commonwealth to set specific performance targets and payment of fees for specific performance targets. It is more important to contract the appropriate unit rates for particular processes and also ensure that suppliers have adequate capacity to meet contingency situations. In this manner suppliers always have an obligation to meet their timetable commitments and costs are simply a function of unit costs and volumes requested.

and 'request for proposals' to the contract. The prospect of fee reductions for inadequate performance was not only explicitly provided for in the contract, but the process of invoking that provision was actually exercised effectively in the course of the contract management in support of remedial action. However, where unforeseen technical difficulties arise in an exercise of unprecedented scale and complexity, it is naive ideology to suggest that their incidence or resolution may be affected by the linking of fees to performance standards in the contract.

ANAO comment

3.45 Significant fees were paid to sub-contractors to reflect the increased scale and complexity of the Telstra sale logistics. In the first week of the retail offer period some 315 000 applications were received but only 71 000 applications were processed (see Figure 3.5). No proceeds were banked in the first two days of the offer although it is estimated that 126 000 retail applications were received in these two days. ANAO considers specifying indicators of contractor performance in the contract and, wherever possible, linking contract payments to performance should be accepted elements of good contract management practice.[78] The success of the Telstra share offer was closely related to retail demand which required the prompt and efficient processing of more than 1.8 million applications for shares from retail investors. Although the major logistics contractors were required to process between 100 000 and 200 000 applications each day, the specification of this standard of performance in the contract could have been improved. In addition, payment of fees was not linked to this performance standard.

Settlement

3.46 Effective administration of the receipt of sale proceeds assists in maximising the financial return from the offer. Settlement was planned to occur progressively from 15 October 1997. Retail applicants were required to include the first instalment when applying for shares during the public offer period of 15 October 1997 to 3 November 1997.[79] As a result of the allocation policy, investors who applied for more than 2 000 shares were mailed a cheque refunding the application money for any shares they applied for but were not allocated.[80]

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78 For example, see *Competitive Tendering and Contracting: Guidance for Managers*, Department of Finance and Administration, March 1998, p. 18.

79 Telstra provided payment for shares allocated to employees under the employee loan scheme on 13 and 14 November 1997.

80 Investors who applied for up to 2 000 shares received all the shares they applied for. Investors who applied for more than 2 000 shares received 2 000 shares plus 20 per cent of shares applied for in excess of 2 000.

3.47 Different settlement arrangements applied in the international and Australian institutional tranches. In the international offer, a syndicate of underwriters acquired the instalment receipts for on-sale to the ultimate purchasers (purchase and re-sale). The Australian offer involved a non-underwritten direct sale of instalment receipts to Australian and New Zealand institutions and brokers. Institutional investors were advised of their allocations on 16 November 1997 with payment due on 25 November 1997. Institutional settlement proceeded as planned with the exception of payments from some Australian and New Zealand institutions and brokers.

Domestic institutions

3.48 Through the legal framework of the bookbuild process, Australian institutional investors made firm and binding bids directly with the Commonwealth. As a result, the Commonwealth retained settlement risk with the Global Coordinators contracted to arrange and manage settlement as part of their logistics responsibilities.

3.49 Australian and New Zealand institutions and brokers were advised of their allocation on 16 November 1997. Payment was to be forwarded to the Application Processing Centre by 9:00am Melbourne Australia time on 25 November 1997 with cheques to be in Australian dollars and drawn on an Australian branch of an Australian bank. It was important that funds be received by 9:00am on 25 November 1997 to allow the Application Processing Centre sufficient time to process and bank all funds on 25 November 1997.[81] Any delays could mean the Commonwealth would forego interest as it would not receive value for the offer proceeds on 25 November 1997.

3.50 A total of 920 million instalment receipts, representing total first instalment proceeds payable of $1.84 billion, were to be allocated. By 9:30am on 25 November 1997, total payments for these instalment receipts was $1.37 billion, a shortfall of $473 million or 26 per cent of the amount payable to the Commonwealth. A further $421 million (23 per cent) was received by 10:00am and included in the amount of $1.79 billion banked on 25 November 1997. A total of $52.3 million was not received and banked on 25 November 1997. Over the course of the next week, institutions and brokers continued to provide payment but, by 1 December 1997, $3.5 million had still not been paid to the Commonwealth.

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81 Bidders were encouraged to lodge payment as early as possible and were advised that cheques received before 25 November 1997 would not be banked before 25 November 1997.

3.51 As a result of the delays and defaults in settlement by Australian and New Zealand institutions and brokers, allocation in the domestic institutional tranche proceeded in three stages:

- 667 million instalment receipts were allocated on 25 November 1997 to those institutions who had provided full payment by 9:30am on 25 November 1997;
- a further 251 million instalment receipts were allocated on 1 December 1997 to those institutions who provided payment after 9:30am on 25 November but on or before 1 December 1997; and
- institutions paid for 1.3 million shares between 2 December 1997 and 12 February 1998 and were allocated instalment receipts from within the retail buffer stock.[82] The remaining 457 293 shares were not paid for.

3.52 Although OASITO had an enforceable right to ensure settlement, it elected not to enforce this right and instead undertook a second institutional allotment on 1 December 1997 and then allocated shares to institutional investors from the retail buffer stock.[83] This had the effect of allowing some institutional investors to complete the purchase at the time of their choosing, having had the benefit of continuing to observe the aftermarket performance.[84] OASITO advised ANAO that:

> *The approach adopted to the enforcement of settlement was commercial, and amounted to a commercial enforcement of the obligation to settle. Sale of the shares for which settlement appeared to be in doubt would have been highly risky given the practical uncertainty about whether payment had been proffered by the due time but remained unprocessed and unreconciled. This was a consequence of the scale of the transaction. Accepting that apparently unsettled transactions are voided, as ANAO suggest, would also set an inappropriate precedent for any future transactions where aftermarket prices may trade below the issue price.*

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82 Buffer stock involves withholding a small number of shares from the initial allocation to retail investors. The buffer stock is used to satisfy, on a case-by-case basis, retail applicants who claim that they did not receive the stock they applied for as a result of lost or faulty applications or application processing problems. The practice of withholding buffer stock is aimed at rectifying genuine errors as much as possible and is not intended to allow for the lodgement of late applications.

83 OASITO's domestic Legal Adviser advised ANAO that institutions were contractually bound to complete the purchase until the Commonwealth decided to accept the repudiation of contract which the non-payment represented, and either retained or sold the shares. The domestic Legal Adviser advised that re-selling the defaulted shares was not seriously considered because, as of 25 November 1997, it was not possible to be certain that institutions had not in fact paid for their shares.

84 Australian Stock Exchange trading commenced eight days before the settlement date.

3.53 OASITO's options for addressing the non-payment included enforcing the contract or accepting the contract repudiation that non-payment represented and re-selling the shares.[85] OASITO did not pursue either course of action. Given Telstra's strong aftermarket performance, taking steps to sell the 26.2 million shares not paid for on the due date would have increased sale proceeds by $17.5 million, based on the closing price on 26 November 1997.[86]

Finding

3.54 Settlement generally proceeded as planned with the exception of payments from some Australian and New Zealand institutions. As a result, proceeds of $52.3 million were not received in time for banking on the due date. Most institutions later forwarded payment. However, OASITO's decision not to enforce payment on the due date or sell the shares allowed some investors to complete the purchase, having had the benefit of observing Telstra's aftermarket performance.

Recommendation No.6

3.55 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing improve the administration of settlement in future public share offers by:

(a) developing and implementing institutional settlement default procedures that protect the Commonwealth's cash management interests and remove the potential for institutions to benefit from any delay in settlement; and

(b) applying a commercial approach to enforcement of the Commonwealth's contractual rights to maximise value for money.

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[85] OASITO advised ANAO that *on 25 November 1997, the Commonwealth could not determine with certainty the complete list of institutions that had paid on time … it would have been imprudent for the Commonwealth to take action against any institution at this point in time for late payment as it could not be determined with certainty that any particular institution was a late payer. If the Commonwealth had taken action in these circumstances, it risked breaching the contract itself in cases where payment had actually been received on time. By 1 December 1997, it was possible to accurately determine which institutions were still in default of their contract. … the Commonwealth had the choice to withdraw the shares, sue for payment or pursue via non-legal means, late payment from investors. Given the success of the float, suing for payment was not considered to be likely to deliver payment any earlier (or more cheaply) than simply requesting that defaulters pay up. Withdrawal of shares was considered as an option but this was not taken up because of the relatively small number of shares involved and the complexity of resale.*

[86] Telstra instalment receipts were then trading at $2.67, a 67 cent premium to the first instalment issue price. Sale at this market price would have allowed the Commonwealth to obtain the benefit of this aftermarket premium.

OASITO response

3.56 OASITO ***agreed with qualifications*** to the recommendation. OASITO commented that there was no legal scope in this transaction for any default to the detriment of the Commonwealth or for institutions to choose to benefit from delay in settlement. OASITO considers that the approach it adopted to the enforcement of settlement was commercial. However, OASITO was somewhat surprised at how aspects of the customary settlement process operated in practice at this scale, and accepts that there is room for improvement in the operational procedures for the management and reconciliation of the settlement process.

Reduced sale proceeds

3.57 By 1 December 1997, domestic institutions had paid for all but 1.77 million shares. Institutional investors who paid for their shares after 1 December 1997 were allocated instalment receipts from within the retail buffer stock. Allocating shares to institutions from the retail buffer stock, together with OASITO's decision not to enforce payment for the remaining 457 293 shares originally allocated to institutions, reduced the size of the offer by 1.77 million. This reduced offer proceeds by $6.0 million. OASITO advised ANAO that:

> *OASITO's decision to request the Global Coordinators to satisfy 1 308 832 of the late settling institutional shares out of the buffer, rather than out of the residual 1 766 125 shares held by the Commonwealth, was a decision made by the Commonwealth with the benefit of knowledge of the aftermarket performance of the shares. The Commonwealth took clearly the appropriate commercial decision to seek to settle remaining purchases out of the buffer, the upside and risk of which had passed to the Global Coordinators (who held it), rather than its own holding, so that it could keep the (by then) very substantial upside on the relevant shares, rather than allowing the Global Coordinators to enjoy that.*

3.58 There is a possibility of investor default in any public share offer that is not fully underwritten. The ability to identify quickly the existence of any unsold stock enables all options, including the possible sale of these shares, to be considered.

3.59 OASITO advised ANAO that the application of insider trading laws may have adverse implications for any sale of the 1.77 million shares.[87] The United Kingdom Government has also faced the risk that it may have been perceived to be in possession of market sensitive information at the

87 See also paragraph 4.38.

time of its sales of residual shareholdings in privatised companies.[88] To manage this risk, the United Kingdom Treasury established a specific disclosure regime.[89] In relation to the Telstra sale, the Office of the Australian Government Solicitor (AGS) advised ANAO that steps could be taken to minimise the risk that the Commonwealth possesses materially price sensitive information at the time of the sale.[90]

3.60 The Commonwealth has retained ownership of the 1.77 million shares and the Telstra (Dilution of Public Ownership) Act permits the sale of these shares. If sold at the time of the initial non-payment, proceeds would have been $7.1 million. If sold following the closure of the second institutional settlement on 1 December 1997, proceeds would have been $7.2 million. The Telstra instalment receipt trading price at 8 October 1998 of $4.74 per instalment receipt would have generated sale proceeds of $10.8 million comprising $8.3 million from the first instalment and $2.5 million from the second instalment.

Finding

3.61 Settlement default by domestic institutions resulted in the Commonwealth retaining ownership of 1.77 million shares intended to be sold to institutions for $6.0 million. The market value for the instalment receipts underlying these shares was $10.8 million as of 8 October 1998.

Recommendation No.7

3.62 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in consultation with the Department of Communications and the Arts and the Department of Finance and Administration as the relevant shareholder portfolio departments, investigate the viability and merits of the sale of the 1.77 million shares excluded from the initial sale of Telstra shares arising from institutional settlement defaults.

88 The United Kingdom Treasury commenced a program in the mid-1990s to sell off the Government's minority shareholdings in previously privatised companies. In 1995-96, the Treasury sold the Government's remaining shares in British Petroleum (£514 million), British Airports Authority (£145 million) and British Airways (£15 million). The sales are generally completed as 'bought deals' which involves financial intermediaries such as investment banks and brokers purchasing the shares in a competitive auction for on-sale to professional investors.

89 United Kingdom National Audit Office, *Sales of the Government's Residual Shareholdings in BP, BAA and in Other Privatised Companies*, 27 February 1997.

90 AGS also noted that the longer the period of time between the public offer and the sale of the Commonwealth's residual holdings, the more likely it is that there could be additional information held by the Commonwealth of a price sensitive nature.

3.63 Agencies responded to the recommendation as follows.

DoCA response

3.64 ***Agreed***. DoCA agrees provided that the sale could be effected cost effectively having regard to the need to convert the shares to instalment receipts.

OASITO response

3.65 ***Agreed with qualifications***. OASITO stated that it is concerned that the Commonwealth might be precluded from selling these shares (or their instalment receipt equivalents) in an on-market transaction because of the reasonable apprehension that it may be in possession of inside information for the purposes of the 'insider trading' provisions of the Corporations Law.[91] OASITO will seek to vest these shares with the Telstra Instalment Receipt Trustee for sale at its discretion to the Commonwealth's benefit concurrently with its sale of shares necessary to meet defaults on the second instalment payment.

DoFA response

3.66 ***Agreed with qualifications***. DoFA supports OASITO's comments on this issue.

ANAO comment

3.67 ANAO has recommended OASITO, in consultation with the relevant shareholder portfolio departments, investigate the viability and merits of the sale of the 1.77 million shares excluded from the initial sale of Telstra shares arising from institutional settlement defaults. The identification of issues such as the application of the insider trading provisions of the Corporations Law to the Commonwealth, and the obligations this would impose on any sale, would be one of the matters to be investigated.

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[91] See also paragraph 4.38.

4. Domestic and International Offers

This chapter outlines the offer structure including the composition of the global offering; underwriting; and the Green Shoe over-allotment arrangements.

Background

4.1 The offer of one-third of Telstra's issued shares was launched on 29 September 1997 with the registration of the Australian public offer document with the Australian Securities Commission (ASC). At this time, the Minister for Finance announced the following offer features:

- an indicative price range of $2.80 to $3.30 per share with a price cap of $3.30 per share for Australian retail investors who hold their instalment receipts for 12 months;
- payment for shares in two instalments with a first instalment of $2.00 per share, discounted to $1.95 per share for Australian retail investors. The second and final instalment would be due on 17 November 1998. In addition to the retail discount of five cents per share on the first instalment, there would be a loyalty discount of five cents per share on the second instalment for Australian retail investors who hold their instalment receipts continuously for the full twelve months;
- a minimum retail application of 400 shares with preregistrants guaranteed an entitlement of 600 shares; and
- Australian investors were guaranteed at least 70 per cent of the offer.[92]

4.2 The offer involved the first approach to international public equity markets for an Australian privatisation with listings on the New York[93] and New Zealand stock exchanges and public offers without listing in Japan and Canada. Private placement of stock was undertaken in the Americas (outside of the United States and Canada), Europe and the rest of the world.

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[92] The *Telstra (Dilution of Public Ownership) Act* required at least 65 per cent of the one-third of Telstra's equity included in the sale to be allocated to Australian investors.

[93] On the New York Stock Exchange, the listing is in the form of interim American Depository Receipts (ADRs) traded in United States dollars with each interim ADR representing the right to receive 20 instalment receipts.

Telstra instalment receipts are also quoted on SEAQ International in London, to create a centre for European trading.[94]

4.3 After settlement of the first instalment, Telstra had the largest share register in Australia with more than 1.8 million shareholders. The majority (56 per cent) of these were investors holding less than 10 000 shares. Subsequent to listing there has been some consolidation of multiple holdings. As at 31 March 1998, Telstra had 1.5 million shareholders with 47 per cent of shares held by investors holding less than 10 000 shares.

Sale by instalment

4.4 The sale by instalment arrangements were adapted from the instalment receipt structure developed by the Commonwealth for the 1996 third tranche sale of the Commonwealth Bank of Australia (CBA3). They were intended to help the market digest the offering and enhance the investment case through yield and time value advantages.

4.5 After paying the first instalment, investors were issued with an instalment receipt. The instalment receipt evidences the holder's beneficial interest in the corresponding Telstra share with the legal title to the share held by the Telstra Instalment Receipt Trustee Ltd until the final instalment is paid. In the event of default on the payment of the final instalment, the trustee is empowered to sell the shares and apply the proceeds to the satisfaction of the outstanding payment and administrative costs, with the instalment receipt holder remaining liable for any deficiency. Instalment receipt holders receive the dividend, voting and other benefits of ownership of the underlying shares.

4.6 The major differences between the CBA3 sale by instalment arrangements and the Telstra offer related to the absence of a prepayment facility[95] and the reduced period between instalments. A prepayment facility was not included because, unlike CBA3, it would be difficult to achieve a deep and active market in fully paid Telstra shares before the second instalment date as there was no existing secondary market. Also, the CBA3 prepayment approach was found by OASITO to have been administratively cumbersome.[96]

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94 SEAQ International is administered by the London Stock Exchange and involves trading through a system of 'market makers', member firms of the exchange who quote continuous buying and selling prices for the securities for which they are registered. The prices are displayed on the exchange's automated screen based price information system.

95 The primary reason a prepayment facility was included in CBA3 was to address concerns that exposure to capital gains tax could affect adversely international demand from non-tax treaty countries.

96 ANAO's audit of the CBA3 sale, prior to final payment of the second instalment, found that the prepayment facility may see the Commonwealth incur additional costs of up to $2.5 million. Source: Audit Report No.13 1997-98, *Third Tranche Sale of the Commonwealth Bank of Australia*, p. 30.

4.7 Compared to CBA3, the period between the first and second instalment payment dates was reduced from 17 months to 12 months, which OASITO and its advisers concluded was a prudent period having regard to marketing considerations and market liquidity. By reducing the period until the second instalment is due, OASITO reduced the risk of systemic default on the second instalment.

4.8 Maximising the price of the first instalment relative to the total share price also assists in managing the risk of systemic default on the second instalment.[97] The price of the first instalment, $2.00 per share discounted to $1.95 for Australian retail investors, is 59 per cent of the total purchase price payable by these investors. This was similar to CBA3 and compares to the average of 51 per cent for United Kingdom sales involving two instalments.[98]

Finding

4.9 The sale by instalment arrangements were a refinement of the approach adopted in the 1996 third tranche sale of the Commonwealth Bank. The major differences related to the exclusion of a prepayment facility, which reduced sale by instalment administrative costs, and a reduced period between payment of the first and second instalment. This reduced period, together with maintaining the Commonwealth Bank precedent of setting the first instalment price at approximately 60 per cent of the total share price, minimised the risks to the Commonwealth of systemic defaults on the second instalment.

Offer tranches

4.10 Decisions on the size of the various tranches and the allocation of shares within tranches directly influenced the achievement of two of the objectives of the sale; namely, establishing a broad based and orderly market for Telstra shares and building investor support for the Government's asset sales program. The offer was structured into Australian retail and institutional tranches and a multi-tranche international offering. To retain maximum flexibility to allocate stock between the institutional and retail offers, and between Australian and international tranches, in the event that demand levels in any area varied from expectations, predetermined minimum tranche sizes were not prescribed.

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97 If the second instalment is too high, it increases the risk that, if the share price subsequently falls to below the amount of the second instalment, investors may be better off defaulting, forfeiting their shares, and buying in the aftermarket if they still wish to hold Telstra shares. ANAO notes that, where investors default on the second instalment and the share price exceeds the amount of the second instalment, the Commonwealth would be in a position to recover the full amount of the second instalment on liquidation of the shares.

98 Audit Report No.13 1997-98, *Third Tranche Sale of the Commonwealth Bank of Australia*, p. 65.

4.11 Institutional pre-marketing conducted from 12 September 1997 included indicative tranche sizes of 2.8 billion instalment receipts for Australian retail and institutional investors; 1.2 billion instalment receipts for international institutional investors;[99] and an over-allotment option of 289 million instalment receipts. Figure 4.1 outlines the actual allocable demand for shares within and across the various offer tranches and the final allocation of shares. The Australian retail offer was three times subscribed while the institutional offer was 6.2 times subscribed.

Figure 4.1
Share Demand and Allocation

	Demand (millions)	Allocation (millions)	Coverage Ratio[a]
Australian Retail Offer			
Public Offer	2 366	1 932	1.2 : 1
Broker Firm	5 350	649	8.2 : 1
Total Australian Retail Offer	7 716	2 581	3.0 : 1
Institutional Offer			
Australian Tranche	5 490	920	6.0 : 1
European Tranche	2 447	370	6.6 : 1
Americas Tranche	1 721	277	6.2 : 1
Rest of the World Tranche	848	138	6.1 : 1
Total Institutional Offer	10 506	1 705	6.2 : 1
Total Offer	**18 222**	**4 286**	**4.3 : 1**

(a) The coverage ratio is the number of shares bid for at, or above, the issue price to the number of shares available to be sold.

Source: ANAO analysis based on information from OASITO, Global Coordinators, Sale Business Adviser and Share Registrar.

Finding

4.12 At the issue price of $3.40 per share, the offer of one-third of Telstra's shares was more than four times subscribed. The Australian retail offer, which closed on 3 November 1997, provided sufficient demand to sell all 4.29 billion shares on offer.

99 Comprising 480 million in the Americas, 480 million in Europe and 240 million in the Rest of the World. Source: Draft Registration Statement filed with the United States Securities and Exchange Commission on 12 September 1997.

Retail offer

4.13 The Australian retail offer opened on 15 October 1997 and closed on 3 November 1997. The retail offer comprised:

- retail investors in Australia and New Zealand, who applied directly to the Commonwealth for at least 400 shares. Applications were required to be accompanied by payment of an amount equal to the number of shares applied for multiplied by the first instalment price of $1.95 for Australian investors and $2.00 for New Zealand investors;
- members of the Australian Stock Exchange (ASX), who could bid for a firm allocation of shares on behalf of their private clients (broker firm) in addition to processing individual share applications from clients; and
- eligible Telstra employees.[100]

4.14 Through the public offer and broker firm components, retail investors bid for 7.7 billion shares representing allocable demand of $25.5 billion. By making an offer for a firm allocation of shares, the brokers were committed to deliver completed applications and payment for the full amount of the firm allocation. This allows the Commonwealth to treat broker firm applications as if they were underwritten.[101]

4.15 Scaleback of the public offer was small with 2.6 billion shares allocated to more than 1.8 million retail investors - 60 per cent of available shares (see Figure 4.1). Compared to the public offer, the broker firm offer was subject to much higher levels of scaleback with a cap on individual allocations of 8 000 instalment receipts.

4.16 The allocation of shares in the public offer was made through application of an objective scaleback and allocation process. Investors were allocated all shares applied for up to 2 000 and 20 per cent of all shares applied for above 2 000. As a result, 85 per cent of applicants received all shares they applied for; this was significantly higher than in CBA3.

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[100] Eligible Telstra employees comprised persons employed at 20 September 1997 by Telstra or any company in which Telstra owned more than 50 per cent of the issued capital. Excluded were certain part-time employees, fixed term employees, casual staff, contractors, employees on certain types of leave and employees living outside Australia.

[101] OASITO advised ANAO that *it is naive to consider that the broker firm applications for 5 350 million shares represented allocable demand. Much of it was tactical bidding in anticipation of a scaleback.*

Finding

4.17 Some 60 per cent of the offer was allocated to over 1.8 million retail applications with 85 per cent of applications receiving all the shares applied for. The size of the retail tranche, scaleback and allocation policy was consistent with the sale objectives relating to a broad based market for Telstra shares and building investor support for the Government's asset sales program. Maximising the size of the retail tranche also had a positive effect on bidding for shares in the institutional bidding process.

Institutional offer

4.18 The institutional offer involved institutions, the selling syndicate and members of the ASX bidding for shares (broker sponsored bids) in a bookbuilding process between 27 October 1997 and 14 November 1997. The minimum bid size was 150 000 shares and thereafter in multiples of 50 000 shares.[102] A three-week bookbuild period with two phases was adopted. The first two weeks focused on volume bids (that is, those lodged without a price) which were assessed in terms of timing and consistency. Institutions could submit price orders but bidders would not be rewarded or penalised if they changed. In the third week the focus of bids was to be on price with all allocation criteria applied to assessing bids.

4.19 To create competition for shares between the domestic and international markets, the bookbuild involved competition among institutional tranches, with no pre-determined allocation of shares between tranches, subject to the Minister for Finance's announcement of a 30 per cent upper limit on foreign ownership. Allocation was to be on the basis of bids lodged and not withdrawn during the bookbuild. The allocation criteria were developed before the bookbuild by the Global Coordinators, reviewed by OASITO and its Sale Business Adviser, and approved by the Minister for Finance.

New York Stock Exchange listing

4.20 On 30 July 1997, the Minister for Finance agreed to a recommendation from OASITO and the Global Coordinators that the offer include a New York Stock Exchange (NYSE) listing.[103] The NYSE listing required the offering to be registered with the United States Securities and

[102] Australian institutions were able to bid through a selling syndicate member or directly by facsimile to the Bookbuild Centre. International institutions were required to bid through syndicate members in the Americas, European or Rest of the World tranches. The regional books were updated into the global book daily at the close of business in the respective regional centres.

[103] OASITO advised ANAO that Telstra would otherwise have been the largest international telecommunications company not quoted on the NYSE. The 1996 scoping study had recommended that planning proceed on the basis of a NYSE listing.

Exchange Commission (SEC)[104] with Telstra shares to be listed in the form of American Depository Shares represented by American Depository Receipts (ADRs).[105] ABN AMRO Rothschild advised ANAO that:

in comparison to previous Commonwealth privatisations, the NYSE listing and SEC registered offer document increased costs of the offer.

4.21 The alternative to a registered public offer would have been a private placement pursuant to the Rule 144A exemption from the registration requirements of the United States Securities Act for sales to Qualified Institutional Buyers. Compared to a Rule 144A private placement used in previous Commonwealth public share offers, the registered public offer was considered by the Global Coordinators to be likely to incrementally increase demand and pricing tension[106] by: enhancing the profile of the float, and therefore investor interest; broadening the investor base; and increasing liquidity.[107] It will also assist any future sales of Telstra shares in the United States by the Commonwealth and assist Telstra to access United States capital markets.[108]

4.22 International investors were able to elect to receive instalment receipts or interim ADRs[109] but only the interim ADRs could be traded on the NYSE. Of the 784 million instalment receipts allotted to international investors, 137 million, or 17 per cent, were delivered in the form of 6.9 million interim ADRs.[110] This represented 3.2 per cent of the shares on offer.

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104 The SEC administers the Securities Act, which regulates the offer and sale of securities by an issuer or by the person who controls the issuer, and the Exchange Act, which regulates the secondary market trading of securities and prescribes the ongoing reporting obligations of the issuer.

105 An ADR is a negotiable certificate issued by a United States bank evidencing ownership of shares or debt securities in a foreign corporation with the underlying shares held by a custodian in the country in which they are issued. ADRs are quoted and traded in United States currency. By issuing ADRs, United States investors do not have to become the registered holder of the foreign securities, can trade their interests on United States exchanges without changes to the company register, and can receive dividends in United States dollars.

106 The Global Coordinators advised that the pricing impact was impossible to quantify but the increased demand and interest from United States investors could, in a receptive market, push the price to the high end of the range.

107 Registered securities are considered significantly more liquid than Rule 144A securities as they can be offered on a retail basis to all United States investors.

108 After twelve months as a reporting company, Telstra will become eligible to use a short-form shelf registration statement, providing it with unrestricted future access to the United States capital markets, including access to the public debt and equity markets. Future Commonwealth share offerings in the United States will be facilitated by the ability to incorporate by reference the Exchange Act reporting documents into the offering document.

109 Following payment of the second instalment, the interim ADRs will be converted into ADRs.

110 One interim ADR represents the right to receive 20 instalment receipts.

4.23 The interim ADRs commenced trading on the NYSE on 17 November 1997. Since this time there has been significant reduction in interim ADR holdings traded on the NYSE in favour of holding instalment receipts which can be traded on the ASX. The number of interim ADRs fell by 50 per cent to 3.4 million by 29 December 1997 and by a further 19 per cent to 2.1 million by 30 January 1998. As of 31 July 1998, the number of interim ADRs had fallen to 1.4 million, a reduction of 79 per cent since listing. OASITO advised ANAO that:

> *The main reason that ADR holdings and trading have reduced is because Telstra is well below the foreign ownership limit and so international investors can trade with confidence on the more liquid ASX without needing the security that they are trading on a 'foreign holder to foreign holder' basis. OASITO understands that the registered levels of foreign holdings are still broadly at the same level as at the time of allocation, albeit with significant changes in ownership.*

Finding

4.24 The offer included a New York Stock Exchange listing intended to incrementally increase demand for Telstra shares. The listing will assist Telstra to access United States capital markets and any future public offers of Telstra securities in the United States. Some 6.9 million interim American Depository Receipts, representing 17 per cent of the international offering, were initially listed on the New York Stock Exchange but since listing there has been a significant reduction in holdings of interim American Depository Receipts.

Quality rating

4.25 Telstra was the first Commonwealth public share offer that used an investor quality rating in the allocation process. The investor quality rating was an important element in determining the initial allocation to institutional investors. In view of the marked differences in weighting coefficients applied to the different quality ratings, a higher or lower rating could significantly influence the allocation.

4.26 The Global Coordinators, in coordination with their respective Lead Managers, evaluated institutional investors with regard to a number of factors[111] in order to develop a detailed database of potential institutional

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[111] The major factors considered were: total assets, total equity assets, international equity assets and Australian equity assets under management; and total value of telecommunications holdings (except for Australian investors). Other criteria referenced in the analysis comprised sophistication, propensity to buy and hold, and prospective influence on price.

investors.[112] To ensure an objective process, the Global Coordinators submitted their agreed categorisation to OASITO on 26 August 1997, prior to commencement of pre-marketing to investors.[113] In the event that an investor was not categorised, the Global Coordinators proposed to agree the categorisation among themselves for approval by OASITO and its Sale Business Adviser.

4.27 The objective of a stable aftermarket can also be assisted if the allocation policy encourages long term investors to retain and build on their initial allocation of shares. For this to occur, the initial allocation must be sufficient to be significant for the investor concerned.[114] A minimum threshold of 20 000 shares was set for allocations to investors in the European tranche.[115] However, minimum thresholds were not set for the other institutional tranches. As a result, there were some very small allocations to institutions including as few as 1 000 shares.[116] These allocations represent a very high level of scaleback.[117]

Finding

4.28 The allocation policy and criteria to be applied to bids in the institutional offer were developed before the bookbuild and clearly disclosed to all bidders. For the first time in a Commonwealth public share offer, the allocation approach for institutions included an investor quality rating intended to favour expected long-term holders of Telstra shares. Although a minimum threshold of 20 000 shares was set for allocations to investors in the European tranche to encourage these investors to retain and build on their initial allocation of shares, a similar approach was not adopted for the other institutional tranches with some institutions receiving very small allocations.

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[112] An investor quality database was compiled by the Global Coordinators to agree on the most important investors to focus on during the marketing program; ensure the allocation policy directed stock to those institutions most likely to be long term investors; and allow assessments to be made as to the level of any order inflation in the bookbuild.

[113] Of the 207 institutions rated likely to maintain a substantial long term shareholding (Category 1), 35 per cent were in the European tranche, 30 per cent in the Americas tranche, 20 per cent from Australia and New Zealand, and 15 per cent in the Rest of the World tranche. More than 800 institutions were rated Category 2, that is, likely to maintain a long term shareholding but less significant investors either in terms of size or telecommunications sector sophistication. Of these, 56 per cent were in the Rest of the World tranche, 26 per cent in the European tranche, 12 per cent in the Americas tranche and 6 per cent from Australia and New Zealand.

[114] In its CBA3 report, ANAO recommended OASITO examine the application of an investor quality rating coupled with a minimum threshold allocation to assist in creating a more stable aftermarket. Source: Audit Report No.13 1997-98, *Third Tranche Sale of the Commonwealth Bank of Australia*, Recommendation No.10.

[115] This threshold was the initiative of OASITO, as it was concerned that European investors in the France Telecom offer with minimal allocations had quickly sold out of their position.

[116] In comparison, Australian retail investors were allocated the first 2 000 shares they applied for.

[117] Bidders in the institutional bookbuild were required to bid for a minimum of 150 000 shares.

Recommendation No.8

4.29 ANAO *recommends* that, for future public share offers, the Office of Asset Sales and IT Outsourcing:

(a) investigate methods of analysing institutional aftermarket trading from the Telstra initial offering as an input to future investor quality rating processes; and

(b) assist in creating a more stable aftermarket by including in the allocation approach explicit consideration of the minimum level of allocation that institutional investors would require to be prepared to hold and build on their allocation as a long term investment.

OASITO response

4.30 OASITO ***agreed with qualifications*** to the recommendation. OASITO commented that it is concerned to achieve a proper balance between the desirable level of transparency and the need for commercial flexibility to respond in the interests of the offer to specific circumstances that present themselves in the allocation process. Reducing allocation simply to a mechanistic application of a predetermined formula precludes the necessary flexibility. The Commonwealth's practices in this respect are already less flexible than usual commercial practice. In respect of the sub-recommendations, OASITO commented that:

(a) This work was already contemplated as part of any future sale of Telstra shares by the Commonwealth, but was not relevant to the initial public offer.

(b) OASITO did ask the lead managers to develop such indicators in the sale process but it proved impracticable to obtain *a priori* information that would be sufficiently reliable to be a basis for a Commonwealth decision on allocation in this offer. In the event of a further major offer, a renewed effort will be considered, given that existing holdings (and trading records) in Telstra shares may then be available to support the exercise.

ANAO comment

4.31 ANAO does not consider implementation of this recommendation would reduce allocation to mechanistic application of a predetermined formula. Indeed, some institutional investors rated likely to be long-term Telstra shareholders significantly reduced their investment soon after trading commenced. Therefore, ANAO considers that, where appropriate, account should be taken in future allocation processes of previous public support for Commonwealth privatisations. The ANAO also considers that the large scale-back of investors can result in them being left with suboptimal size shareholdings reducing aftermarket stability. The application of an investor quality rating coupled with a minimum threshold allocation may assist achievement of the Government sale objective of an orderly market.

Market stabilisation

4.32 Stabilisation involves aftermarket trading by the selling syndicate to assist the creation of an orderly aftermarket by retarding any decline in the open market price in the short term (up to 30 days after the commencement of trading). The most common form of stabilisation in international offerings is a Green Shoe over-allotment option, which represents the right but not the obligation for the Global Coordinators to purchase additional shares from the offeror at the issue price in the event that the price increased in the aftermarket.[118]

4.33 Based on a recommendation from the Global Coordinators, the offer included a Green Shoe over-allotment option. The Global Coordinators advised ANAO that:

> *it was acknowledged in our advice to OASITO that the performance of the aftermarket in previous large scale Australian privatisations demonstrated no adverse consequences indicating a need for an over-allotment option; however, the Telstra public share offer was unique in its size and international component. The recommendation in favour of an over-allotment option was made to ensure that the 'firepower' (the Green Shoe shares) was available to support the market price of Telstra shares in what may have been difficult market conditions. The ability to stabilise in the aftermarket had a number of benefits for the Commonwealth:*
>
> - *The principal purpose of the over-allotment option was to protect the open market price of Telstra instalment receipts from any downward pressure arising from large amounts of supply in the aftermarket and/or to minimise the impact of any volatile market conditions. Any share issue may attract short term holders who wish to realise gains as quickly as possible. (It was recognised that whilst the allocation criteria would try to filter out these investors during the allocation process, it would be difficult to achieve a perfect outcome in practice.)*
> - *The ability to stabilise the share price provided comfort to investors in the near term trading performance of the Telstra public share offer which in turn could positively affect their bidding during the bookbuild process.*

118 The Global Coordinators advised ANAO that a Green Shoe over-allotment option was included in a large number of recent international privatisation offerings.

The existence of an over-allotment option could therefore result in greater demand and finer pricing of the offering. Most importantly for the Telstra offering, international institutional investors have come to expect that the underwriters will stabilise in the aftermarket and would have viewed the lack of an over-allotment option as a negative factor with a consequent effect on pricing.

- *The flexibility to absorb blocks of shares on offer at critical moments was considered important because if these shares were allowed to work through the market, they could have a disproportionately large effect on the confidence of investors who are keen observers of initial trading levels. Stabilisation is not market manipulation and is not used to support an indefensible share price. The procedures for stabilisation trades that were agreed with the Australian Securities Commission did not allow the stabilisation manager to lead the market or buy stock at above market prices.*

4.34 Due to concerns that the stabilisation arrangements proposed by the Global Coordinators might breach the Corporations Law provisions dealing with market manipulation, false trading, market rigging, and insider trading, application was made to the then Australian Securities Commission (ASC)[119] for a no-action letter.[120] The ASC issued a statement on 11 September 1997 that it approved the stabilisation proposal subject to:

clear and meaningful disclosure in the prospectus, identification of all stabilisation bids on SEATS,[121] limitations on the prices at which stabilisation bids are permitted,[122] and detailed reporting to the Australian Stock Exchange.

As a result of the ASC's announcement, stabilisation trading could have taken place on the ASX if it was required, although the over-allotment was limited to the international institutional tranche.

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119 The Australian Securities and Investments Commission commenced operations on 1 July 1998 taking responsibility for market integrity and consumer protection across the financial system.

120 The ASC issues no-action letters where it does not intend to take regulatory action over a particular state of affairs or particular conduct. Its policy is to exercise its discretion to issue a no-action letter where it considers there is doubt as to whether certain conduct would be lawful but is of the clear view that it would not advance the policy of the legislation to take enforcement action. Source: Australian Securities Commission, Policy Statement 108, *No-action letters*, 17 June 1996.

121 SEATS is the Stock Exchange Automated Trading System provided for the trading of securities of the ASX.

122 The ASC statement included the proviso that stabilisation bids were not to exceed the *most recent independent bid or trade in the principal market on which Telstra shares are traded*. This requirement was consistent with US practice where the underwriters are restricted to a price no higher than the highest current independent bid price and cannot lead the market.

4.35 The over-allotment involved the underwriters[123] purchasing 597 million shares from the Commonwealth on a firm commitment basis but selling 784 million shares to international investors. This resulted in an over-allotment of 187 million shares. Should the instalment receipts trade below their issue price in the aftermarket, the underwriters could choose to support the price by buying shares in the market with the effect of providing some offsetting buying support for the share price. The over-allotment reduced in part the underwriters risk as it provided a buffer to cover investor default.[124]

Finding

4.36 The international tranche was over-allotted to allow the Global Coordinators potentially to stabilise the aftermarket price, thereby increasing investor confidence that the offering would not trade below its issue price and allowing for more precise pricing of the offer.

International settlement risk underwriting

4.37 The underwriting agreement signed on 15 November 1997 required the underwriters to purchase 597 million shares from the Commonwealth on a firm commitment basis with an option of purchasing a further 187 million shares (the Green Shoe option). The Green Shoe was effectively a call option[125] granted to the international underwriters to offset their exposure to their 'short' position[126] which arose from their over-allotment of shares in the international tranche. Under the Green Shoe option, the underwriters had the right to purchase a further 187 million instalment receipts from the Commonwealth at the issue price of $2.00, less

123 US underwriting practice involves the underwriters purchasing the securities as principal from the vendor and then selling the purchased securities in the market place (purchase and re-sale). This subjects the underwriters to market risk with respect to the period between pricing and settlement; and the price at which the securities may be re-sold. The underwriting syndicate comprised the Global Coordinators (who underwrote 44 per cent of all shares underwritten), the Lead Managers and all other members of the selling syndicate plus a further four firms in the United States.

124 Bidders in the United States registered public offer were entitled to withdraw the non-binding offers made during the bookbuild period. If all instalment receipts had been sold on a firm commitment basis, the underwriters would have been required to cover any investor default. The over-allotment meant that the underwriter's risk was reduced as the underwriters could elect to reduce the offer size by the extent of investor default, up to 187 million instalment receipts, rather than pay for the defaulted shares.

125 A call option involves the right but not the obligation to buy from the grantor of the option at the strike price, any time between the grant of the option and its expiry.

126 A 'short' position denotes a trader who has sold more of a particular stock than the trader has purchased.

underwriting discounts, solely to cover their over-allotment in the event that the price increased in the aftermarket.[127]

4.38 To accommodate the Green Shoe option, the offer size was reduced by 187 million shares.[128] In the event the Green Shoe option was not exercised, the Commonwealth would have retained the 187 million shares (that is, sold less than the full one-third), resulting in a reduction in Commonwealth sale proceeds by $635 million. The Commonwealth could, however, have sold the 187 million shares following expiry of a 180 day escrow period.[129] OASITO advised ANAO that it considered that, in the circumstance that would lead to it retaining these shares, the offer would have been so much less than successful that retention for future sale would be an acceptable outcome. In those circumstances, OASITO considered that the Commonwealth would wish to withhold the shares from sale for a period in order to avoid depressing the share price further due to the 'overhang' of the potential sale of its holding.[130]

4.39 In the absence of the Green Shoe over-allotment option, the Commonwealth would have received binding offers at the time of pricing (15 November 1997) for all shares sold to institutions.[131] Implicit in OASITO's endorsement of the Global Coordinators recommendation of a Green Shoe over-allotment option was an assessment that the premium it believed international investors would attach to an offer that included a

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[127] The alternative to the Green Shoe was a short position for the underwriters. This would have required them to cover the over-allotment by purchasing instalment receipts in the market in all circumstances using their own funds. OASITO's Sale Business Adviser advised ANAO that there could be no assurance that the underwriters would have agreed to put themselves in the short position due to the risk of incurring significant trading losses. However, ANAO noted that, in its tender, one of the Global Coordinators offered to commit $500 million to aftermarket support.

[128] The *Telstra (Dilution of Public Ownership) Act* provided for a sale of up to one-third of the Commonwealth's Telstra shares. This meant that the Green Shoe option could not provide for the possible sale of more than one-third of the Commonwealth's shares. Instead, to accommodate the Green Shoe, the initial offer size had to be reduced by 1.4 per cent to 31.9 per cent of Telstra's share capital. Exercise of the Green Shoe option by the underwriters would return the offer to precisely one-third of Telstra's share capital.

[129] If the secondary market valued Telstra shares at less than the institutions participating in the bookbuild, the Commonwealth could have been left with some or all of the Green Shoe shares for a considerable period of time, or had to sell these shares for less than they could have been sold at the time of the offer. This scenario arose in the United Kingdom's sale of British Petroleum plc with the United Kingdom Government not disposing of its residual shares until December 1995. The final instalment of the United Kindgom's last sale of British Petroleum shares was paid in May 1989. Source: United Kingdom National Audit Office, *Sales of the Government's Residual Shareholdings in BP, BAA and in Other Privatised Companies*, 27 February 1997.

[130] See also Recommendation No.7, paragraph 3.62.

[131] Through the legal framework of the bookbuild, Australian institutions made binding bids directly with the Commonwealth. In the absence of the Green Shoe over-allotment option, the underwriting agreement signed on 15 November 1997 would have required the international underwriters to purchase all shares in the international tranche, with the underwriters bearing any risk from the secondary market price falling.

Green Shoe over-allotment option offset the risk that offer proceeds could be reduced by up to $635 million (albeit with retention of the Green Shoe shares).[132]

4.40 The underwriters exercised the Green Shoe option on 21 November 1997 requiring the Commonwealth to transfer the optional shares to them on 25 November 1997. At the time the option was exercised, OASITO advised the Minister for Finance that:

> *the secondary market price of Telstra instalment receipts of around $2.60 to $2.70 is well above the price of the first instalment of $2.00. Consequently, it is very unlikely that the Telstra share price could fall below $2.00 within the period of the over-allotment option. There would need to be a major market correction for the Telstra share price to fall below $2.00. Even in the event of a major market correction of this kind, any stabilisation activity done by the Global Coordinators would not have any material effect in arresting the decline in the share price.*

4.41 The Green Shoe arrangements involved the establishment of a collateral account into which the proceeds from the sale of the 187 million over-allotted shares were to be deposited. These funds were then to be made available to the underwriters to fund their short-covering activities, in the event the Green Shoe was not exercised or not fully exercised. The Commonwealth was to receive the interest on this account. OASITO advised ANAO that, because the purpose of the Green Shoe over-allotment option was to contribute to the success of the offer, OASITO and the Global Coordinators agreed that it was undesirable for the underwriters to have any incentive linked to a falling market. Accordingly, OASITO advised ANAO that the Global Coordinators agreed to forego any profits[133] on stabilisation trading by surrendering them to the Commonwealth.[134]

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[132] The Global Coordinators advised ANAO that *it is important to note, however, that in these circumstances the Government would have retained the portion of the Green Shoe not exercised which could have been later sold (either on-market after the expiry of the 180 day lock up period or in any future Government selldown). This was the case in the United Kingdom Government's sale of British Energy, where the Government was able to later benefit from the stock's strong market performance through a bought deal for its 12 per cent residual holding.*

[133] If the underwriters agree to sell shares to investors at the issue price and then buy shares in a falling aftermarket to satisfy these orders, they can make trading profits on the difference between the issue price and the price in the aftermarket, less costs.

[134] The contractual arrangements did not fully reflect this agreement with any trading profits made by the underwriters when short-covering to stabilise the share price to reduce the Global Coordinators' project management fee. The project management fee totalled $35.6 million and was capped at $40 million. If the underwriters bought back the option in the aftermarket at an average price that was at least 20 cents below the issue price, they would have made, and retained, trading profits in excess of the project management fee. OASITO advised ANAO that this would have been very unlikely and would have represented an unprecedented aftermarket problem, with much wider repercussions than this issue alone.

Finding

4.42 The underwriting arrangements included a Green Shoe option. The Green Shoe option offset the underwriters market exposure caused by their over-allotment. The Global Coordinators have advised ANAO that Green Shoe options have been included in a large number of privatisations. Although previous large scale Australian privatisations demonstrated no adverse consequences indicating a need for a Green Shoe option, the Telstra offer was unique in its size and international component. In the absence of the Green Shoe option, the Commonwealth would have received binding offers at the time of pricing for all shares sold to institutions with the underwriters bearing any risk in the international tranche as a result of the secondary market price falling to below the issue price. OASITO considered the pricing premium international investors would attach to an offer that included a Green Shoe over-allotment option would offset the risk of reducing initial offer proceeds by up to $635 million if the Green Shoe option was not exercised.

Commissions and fees

4.43 Both the firm and Green Shoe optional shares were sold to the underwriters at the institutional issue price of $3.40 per share, less underwriting discounts of $0.05839 per share.[135] The underwriting discount was calculated as 1.75 per cent of the present value of the institutional issue price of $3.40 per share. The underwriting discount was based on the contract (Schedule B) between the Commonwealth (represented and acting through OASITO and the Minister for Finance) and the Global Coordinators and Lead Managers which specified a gross fee on international sales of 1.75 per cent allocated as a management fee of 0.35 per cent, an underwriting fee of 0.35 per cent and a selling commission of 1.05 per cent.[136]

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[135] The purchase price was payable in instalments with a first instalment of $2.00 per share less the underwriting discounts and a final instalment of $1.40 per share.

[136] All fees were to be calculated on the present value of offer proceeds to be received by the Commonwealth, in accordance with a formula specified in the contract. OASITO and the Global Coordinators agreed on the commissions and fees in April 1997 after selection of Global Coordinators and Lead Managers.

4.44 The division[137] between the management fee, underwriting fee and selling commission affects the financial incentives of the selling syndicate[138] and underwriters.[139] The Scoping Study Business Adviser informed OASITO that the management fee is intended to compensate selling syndicate members for managing the offer, the underwriting fee is intended to reflect the underwriting of settlement risk between pricing and settlement, and the selling commission is paid to reward syndicate members for their selling efforts. OASITO advised ANAO that:

> *OASITO did not pay an underwriting fee of 0.35 per cent calculated on the sum underwritten. It agreed to an allocation within the syndicate of 0.35 per cent (of the 1.75 per cent gross selling commission or 'spread') pro-rata with underwriting risk. The split of the fees into the different components is of little concern to a vendor, but rather reflects how syndicate members agree to split the overall fee among themselves (so characterising a fee as an 'underwriting fee' simply means it is split among a wider group of organisations, than something characterised as a 'management fee').*

4.45 In comparison to the underwriting fees of $9.16 million paid to the Telstra underwriters, ANAO understands that the United Kingdom Government does not pay a premium or fee for settlement risk underwriting on its public share offers but manages the risk of settlement default by other means.[140] OASITO advised ANAO that its decision to adopt what it

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137 Credit Suisse First Boston advised ANAO that: *Although market practice has developed to divide the gross spread into the management fee, underwriting fee and selling commission each with its specific functions, the gross spread is generally viewed in aggregate by syndicate members in evaluation their decision to participate in the offer and commit to provide research and support the offer in the aftermarket. The fixed components (management and underwriting fees) are usually agreed in advance of the offer and are important in gaining early research and marketing support of the syndicate.*

138 ANAO's audit of the CBA3 sale recommended that OASITO review selling commission allocation rules to encourage greater emphasis on selling syndicate performance in the allocation of commissions. Source: Audit Report No.13 1997-98, *Third Tranche Sale of the Commonwealth Bank of Australia*, p. 47.

139 Selling commissions were paid in accordance with the number of shares sold. Underwriting fees were paid to the underwriters based on their respective underwriting commitment. The Global Coordinators deducted $1.09 million in expenses not reimbursed by the Commonwealth from the underwriting fees paid to the other underwriters. In the Americas tranche, management fees were paid to the managers (that is, excluding the four underwriters who were not managers) pro rata to the managers' underwriting commitment. In Europe and the Rest of the World tranches, a 25 per cent lead and co-lead manager praecipium was paid to all lead and co-lead managers with the residual management fee paid to all managers, including lead managers and co-lead managers, pro rata to their underwriting commitments.

140 The United Kingdom Government addresses settlement risk by allocating shares to high quality investors who are unlikely not to pay for their shares; including stabilisation mechanisms such as Green Shoe over-allotment options as a means of reassuring investors about the risk of the price falling between allocation and payment for shares; and reducing allocations in future public share offers to investors who default on payment.

considers to be the customary international practice[141] of settlement risk underwriting was an integral element of the overall commercial fee negotiation and that it considered at the time that it provided a cost-effective contribution to risk management.

4.46 The underwriting fee paid to the international underwriters was intended to reflect the underwriters' exposure to settlement risk between pricing and settlement (ten days). Each underwriter was allowed an underwriting fee based on the number of shares they underwrote. Although settlement risk was not underwritten on the first instalment of the Green Shoe optional shares or the second instalment of either the firm or optional shares,[142] the calculation of the underwriting fee included the present value of proceeds for the first instalment of the Green Shoe optional shares and the second instalment of the firm and optional shares. As a result, the underwriters were paid a fee of $1.3 million on the first instalment of the optional shares and $3.7 million on the value of the second instalment of the firm and optional shares.[143] That is, the underwriting fees were not adjusted to reflect the underwriters' reduced risk for these shares.

4.47 ANAO's review of United Kingdom privatisations involving Green Shoe over-allotment options found that underwriting fees were not paid, and management fees generally not paid, by the United Kingdom Government on Green Shoe shares. Furthermore, in the third tranche sale of British Telecommunications plc, the United Kingdom Government paid only a proportion of the selling commission on the Green Shoe shares. In comparison, OASITO paid management fees of $2.2 million, underwriting fees of $2.2 million[144] and full selling commissions of $6.5 million on the Green Shoe shares. OASITO advised ANAO that this reflected the commercial understanding that underpinned the fee agreement, the fact that full selling effort was undertaken to secure orders for the relevant shares, and the fact that it was expected that the shares would be allocated and the option exercised.

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141 ABN AMRO Rothschild advised ANAO that settlement underwriting fees were paid in Deutsche Telekom, KPN I and II, Telecom Italia, China Telecom, Tele Danmark, Endesa IV, EDP I and II, ENI IV, Lufthansa, Repsol V and Telefonica III.

142 The underwriting agreement required the underwriters to pay the first instalment. The re-sale by the underwriters to investors in the international offering discharged them of any liability or responsibility for payment of the second instalment.

143 OASITO advised that it paid a fee that was set by reference to the second instalment while requiring no action in respect of the second instalment. OASITO disagreed that it paid a fee for the second instalment.

144 Comprising a fee of $1.3 million on the first instalment and $0.9 million on the second instalment.

4.48 The Global Coordinators have advised ANAO that:

it is not usual for global coordinators to be paid incremental fees for stabilisation activities; however, any profits or losses on stabilisation are usually for the account of the global coordinators.[145]

OASITO advised ANAO that paying full selling commissions on Green Shoe shares:

is usual industry practice (and has occurred in both of the two Australian offers since Telstra which have incorporated Green Shoes - NZ Telecom and HIH Winterthur; it was also to have occurred in the aborted Rocla offering).

Finding

4.49 The underwriters contracted to pay the Commonwealth the first instalment for the 597 million shares allocated to investors in the international tranche, with an option of purchasing a further 187 million shares. In accordance with the underwriting agreement, this payment was net of the underwriting discounts. The underwriting discounts included underwriting fees of $9.16 million, although a number of other initiatives had already been taken to reduce the risk of settlement default. In addition, although settlement risk was not underwritten on the first instalment of the Green Shoe optional shares or the second instalment for either the firm or optional shares, the underwriters were paid a fee of $1.3 million on the first instalment of the Green Shoe optional shares and $3.7 million on the value of the second instalment of the firm and optional shares.

Recommendation No.9

4.50 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing improve value for money in future public share offers by:

(a) re-assessing the merits of paying settlement underwriting fees given the level of risk assumed by the underwriters and other steps available to reduce the risk of settlement default; and

(b) where underwriting fees are paid, calculating them on the basis of only those shares and instalments that are underwritten.

OASITO response

4.51 OASITO ***agreed with qualifications*** to the recommendation. OASITO advised that the fees notionally allocated to underwriting of

145 In the Telstra sale, the first $35.6 million of any stabilisation profits would have accrued to the Commonwealth through a reduction in the Global Coordinators project management fee. See further at paragraph 4.39.

settlement risk were set as a designated portion of a previously agreed gross selling commission (or 'spread'). The lack of settlement risk on the second instalment was invoked in negotiation as a successful argument for reduction of this gross fee from the 'opening bid' levels sought by the global coordinators. The allocation to 'underwriting of the settlement risk' then affected the distribution of the fees within the selling syndicate (a matter primarily of interest to syndicate members among themselves), but not the total quantum paid by the Commonwealth. While it might be possible in a future transaction to reduce the negotiated gross fee payable on the basis that the Commonwealth accepts the settlement risk itself, it may be equally likely that the same cost effect could now be achieved without foregoing the benefits of underwriting (which include a more orderly settlement process). To do so could also preclude the adoption of an over-allotment option, which may be needed (or at least be a desirable safeguard) in future transactions. There are limits to the extent to which the Commonwealth can prudently seek unilaterally to change international market practice in respect of fee arrangements.

ANAO comment

4.52 ANAO considers that the issue of underwriting fees should be reassessed having regard to the overall structure of incentives for the selling syndicate. The components of the selling commission should be further improved to secure and reward performance. The payment of fees for the sale of Telstra shares was governed by the contract of 22 August 1997 between the Commonwealth and the Global Coordinators. Schedule B of this contract specified international offer fees of 0.35 per cent for underwriting, 0.35 per cent for management and 1.05 per cent for selling. OASITO paid underwriting fees of $3.7 million on the second instalment whilst requiring no underwriting of the second instalment. In addition, the first instalment of the Green Shoe optional shares was not underwritten but underwriting fees of $1.3 million were paid on the first instalment of these shares.

5. Commonwealth Sale Proceeds

This chapter outlines the financial returns to the Commonwealth from the sale of Telstra shares, the process undertaken to price the issue and the sale costs.

Background

5.1 Gross proceeds from the sale by the Commonwealth of one-third of Telstra's share capital are estimated to be $14.24 billion as at July 1998 (see Figure 5.1). Some $8.39 billion has already been received by the Commonwealth with the balance of $5.85 billion to be received upon payment of the second instalment in November 1998. After deducting the Commonwealth's direct costs of $260 million, net sale proceeds are estimated to be $13.98 billion.

Figure 5.1

Telstra Public Share Offer Proceeds as at July 1998

	$m	$m
• **Australian Retail Offer**		**8 777.77**
• **Australian Institutional Offer**		**3 134.00**
• **International Institutional Offer**		**2 667.21**
• **Other** [a]		**4.12**
Value of Shares Sold		**14 583.10**
• **Less Commonwealth Proceeds Foregone by:**		
Instalment Discounts[b]	232.34	
Employee 'One for Four' Free Shares	93.86	
Employee 'One for Ten' Free Loyalty Shares	10.62	
Settlement Default by Domestic Institutions	6.00	
Total Proceeds Foregone		**342.82**
Gross Offer Proceeds		**14 240.28**

(a) Comprises a $1.79 million payment from the Depository Trustee Company to offset ADR related expenses; interest on bank accounts ($0.90 million); contributions from brokers towards the costs of mailing of public offer documents to their clients ($0.69 million); contributions from brokers towards the costs of including their clients in the pre-registration mail out ($0.39 million); and sale of excess paper from printing of offer documents ($0.35 million).

(b) Comprises discounts to Australian retail investors of five cents per share on the first instalment and five cents per share on the second instalment. Estimated on the basis of OASITO post-sale market research that 84 per cent of applicants will hold their instalment receipts until payment of the second instalment and receive the 5 cent per share loyalty discount on the second instalment. All Australian retail investors received the five cent per share discount on the first instalment.

Source: ANAO analysis based on information provided by DoFA; OASITO; Global Coordinators and Share Registrar.

5.2 The proceeds from the sale of Telstra shares were significantly in excess of initial budget estimates, the Scoping Study Business Adviser's estimate of possible proceeds, the Global Coordinators' indicative valuation and broker analyst valuations undertaken immediately prior to the sale. In addition to proceeds from the sale of Telstra shares, $3 billion was paid to the Commonwealth by Telstra in June 1997 as part of a recapitalisation. The recapitalisation was undertaken to put in place the optimal capital structure for Telstra prior to the sale[146] and was effected through Telstra paying a $3 billion special dividend from retained earnings to the Commonwealth, with new loan raisings to be undertaken to replenish working capital.[147]

Issue pricing

5.3 An important role for the Global Coordinators and selling syndicate in marketing the offer was to develop a strategy to guide the market in valuing Telstra.[148] There is no single approach to valuing a telecommunications company. Commonly adopted methods include earnings multiples; discounted cash flows; and price/earnings ratios.[149] OASITO's Sale Business Adviser advised it in August 1997 that:

> *retail investors will be focused primarily upon domestic dividend yield comparables and price earnings comparables as a comfort check. Institutions, both domestic and international, will assess Telstra in broad terms relative to its global peer group and the core domestic industrial companies.*[150]

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146 Minister for Communications and the Arts and Minister for Finance, Joint Media Release, *Telstra - Recapitalisation*, 18 April 1997.

147 Telstra announced that the mandate for the bank syndicated loan had been given to J.P. Morgan Securities Australia Ltd and Credit Suisse First Boston. Source: Telstra Media Release, *Telstra Capital Structure*, 18 April 1997.

148 Guidance on the appropriate basis for valuing Telstra was important because there are no comparable telecommunications stocks traded on the Australian Stock Exchange.

149 In setting the indicative price range for the Qantas initial public share offer, consideration was given to a number of factors including price/earnings and cash flow ratios for comparable companies, yield return based on projected dividends, market valuations of other leading international airlines and their trading relativities to local markets, and the likely relativity to major industrial stocks listed on the Australian Stock Exchange.

150 The Sale Business Adviser considered that *Discounted Cash Flow analysis is likely to be undertaken by the more sophisticated institutions (whether domestic, regional or telecommunications company specific) and broking analysts as part of a comparative valuation of Telstra against its peer group. BZW believes that the views of these institutions and broking analysts will be fundamental to driving PSO pricing successfully towards the margin. Other less sophisticated institutions are likely to be focused principally on global telecommunications company comparable multiples, in particular EBDIT multiples, which remove the distorting effects of capital structure and accounting treatment.*

5.4 The Global Coordinators advised OASITO in September 1997 that Telstra should be valued according to European, United States and New Zealand telecommunications company benchmarks using cashflow earnings multiples. They advised OASITO that this method is the most commonly used to value telecommunication companies.[151] In comparison, Australian industrial stocks are generally valued on a price/earnings basis.

5.5 Broker analysts generally favoured the approach advocated by the Global Coordinators (cashflow earnings) or discounted cash flow analysis in their pre-marketing valuations of Telstra. Of the Global Coordinators analysts, ABN AMRO Rothschild suggested a price range of $2.75 per share to $3.25 per share, Credit Suisse First Boston a range of $3.30 per share to $3.45 per share, and JB Were & Son a range of $3.10 per share to $3.40 per share. OASITO's Sale Business Adviser suggested a range of $2.65 per share to $2.90 per share.

5.6 Based on the issue price of $3.40 per share, Telstra was valued on a price/earnings basis at a discount to the ASX All Industrials of some 8 per cent. Telstra's trading performance after listing prices Telstra on a price/earnings basis at a significant premium to the ASX All Industrials.[152] This is similar to a number of other major Australian industrial stocks and the price premium of the Telecom Corporation of New Zealand Limited relative to its market.

Pre-marketing

5.7 Telstra was the first Commonwealth public share offer that involved a formal pre-marketing period prior to including an indicative price range in the prospectus.[153] Pre-marketing was undertaken between 12 September 1997 and 29 September 1997 and involved Australian and international institutional investors providing feedback to the selling syndicate on their views of Telstra, including their demand for stock and price valuation. Pre-marketing feedback proved a sound guide to the high level of demand for Telstra shares.

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[151] One of the major reasons cash flow earnings multiples are favoured is that, because telecommunications companies are capital expenditure intensive businesses, differences between the accounting practices of different countries and companies can lead to distortions if multiples of accounting profit, such as price/earnings ratios, are used.

[152] At the 8 October 1998 fully paid price of $6.14 per share, the market valued the one-third of Telstra sold at $26.3 billion compared to the Global Coordinators' valuation recommendation of $12.0 billion ($2.80 per share) to $14.2 billion ($3.30 per share). The final price was set at $3.40. The 8 October 1998 fully paid share price of $6.10 per share represents a price/earnings premium of some 50 per cent to the ASX All Industrials.

[153] Pre-marketing was undertaken to assist setting of the indicative price range; build momentum towards the bookbuild period; act as the basis for establishing initial tranche size indications; and highlight the key institutional investors to be focused on during the international roadshow.

5.8 Pre-marketing suggested total indicative allocable institutional demand of $20.5 billion, comprising Australian and New Zealand demand of $9.5 billion, United States demand of $4 billion, European demand of $5 billion, and $2 billion in the Rest of the World.[154] Institutions generally valued Telstra shares in the range of $2.90 per share to $3.30 per share although some stated a willingness to pay up to $3.50 per share. Pre-marketing feedback indicated that domestic institutions would provide the price leadership in the bookbuild with Australian institutions supporting a price range of $2.80 per share to $3.50 per share.[155]

5.9 The setting of the price range was a complex process to balance various issues regarding valuation, public perception, retail participation and maximisation of proceeds. The Global Coordinators considered advising the top of the indicative price range be set at $3.30 or $3.50. On balance, they recommended the more conservative value because they held reservations about the capacity to attract adequate institutional demand at the higher range. Based on this advice, the Minister decided to set the indicative price range at $2.80 to $3.30.[156] The Sale Business Adviser indicated that the size of the range was broadly consistent with previous major Australian public share offers.[157]

5.10 The public offer opened on 15 October 1997 followed by the institutional offer on 27 October 1997. There was considerable volatility at this time with the ASX All Ordinaries Index falling by nearly 15 per cent in the two week period between the opening of the public and institutional

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154 Allocable institutional demand totalled $36 billion with institutions bidding for 10.5 billion shares or 6.2 times the number of shares available to them.

155 Australian institutions and brokers provided the price leadership in the bookbuild with 58 per cent of allocable demand at prices above the issue price of $3.40 per share.

156 In response to Questions on Notice taken by the Department of Finance and Administration on 6 May 1998, OASITO advised the Senate Environment, Recreation, Communications and Arts Legislation Committee on 8 May 1998 that: *Before reaching the decision to accept the advice proffered, the Minister asked the Global Coordinators to reconsider whether the upper end of the range might be increased to $3.40. This was the subject of a further debate among the advisers over several hours. In the end they confirmed their advice, but indicated that a later increase to $3.40 would be feasible if later stages revealed adequate support at higher prices. However, at that stage, the advisers were expressing serious reservations about the capacity to set the price towards the upper end of this range and still attract adequate institutional demand to fill the international component of the offer. There was then some concern that the 5 per cent fall in the Nikkei index over the preceding month might foreshadow a more widespread downward rating in the world's stockmarkets.*

157 The Business Adviser informed the Minister for Finance and OASITO on 26 September 1997 that the size of the price range in large Australian initial public offerings has generally varied from 10 per cent to 20 per cent of the bottom of the range. Except for the National Mutual and Colonial offers, these price ranges had been fixed not indicative. In the National Mutual offering the range was $1.35 to $1.55 (14.8 per cent range) with the final price struck at $1.60 for institutions. In the Colonial offering, the range was $2.50 to $2.90 (16.0 per cent range) with the final institutional price struck at $3.10.

offers and the Dow Jones Index falling by 7 per cent on 27 October 1997. JB Were & Son advised ANAO that:

> *given this volatility in the market so close to the institutional offer it is difficult to see how the top of the range could have been increased much more than the 10 cents that was recommended later during the bookbuild period.*

Finding

5.11 The Global Coordinators advocated valuing Telstra by comparison to other telecommunications stocks on a cashflow earnings multiple basis, suggesting a valuation for the one-third sold of between $12.0 billion and $14.2 billion, or $2.80 per share to $3.30 per share. The Global Coordinators considered advising the top of the indicative price range be set at $3.30 or $3.50. On balance, they recommended the more conservative value because they held reservations about the capacity to attract adequate institutional demand at the higher range.

Institutional bookbuild

5.12 The institutional bookbuild process and allocation criteria were intended to provide guidance on pricing the offer. An open priced bookbuilding approach was adopted, intended to maximise the extent to which pricing decisions would reflect market supply and demand economics. An open priced bookbuild was used in the second and third tranche sales of the Commonwealth Bank, whereas constrained price offers were used in the Qantas and CSL initial public offers. The Commonwealth Bank initial public offer was a fixed price fully underwritten offer.

5.13 The Bidding Procedures Manual distributed in Australia and New Zealand on 21 October 1997 advised potential bidders that the indicative institutional price range for Telstra shares was $2.80 to $3.30 per share; that this range had been set to assist bidders in the bidding process; but that bidders may bid, and the institutional price may be set, within or above the indicative price range.[158] The Commonwealth also reserved the right to adjust the indicative price range prior to the close of the institutional

[158] The Bidding Procedures Manual was only distributed to institutions and brokers in Australia and New Zealand. Syndicate members were responsible for advising bidders in the international tranches on bidding procedures and the allocation criteria.

offer and, on 12 November 1997, the Minister for Finance announced that the top of the indicative range had been increased to $3.40.[159]

5.14 Australian institutions and brokers bid strongly outside the price range - some up to prices that were reflected in the initial aftermarket pricing of Telstra instalment receipts. JB Were & Son advised ANAO that:

> *most prior Commonwealth privatisations have been priced as a function of Australian institutional supply and demand considerations, together with a recognition that it is beneficial to place part of the offer with international institutions. Based upon this combination of factors it tends to be that Australian institutions set the price with the international institutions tending to bid strategically and accepting the final price as opposed to determining the final price.[160] … Thus, from our viewpoint, the fairest way to consider the bookbuild process as a mechanism for price setting is to consider the Australian institutional book on a stand-alone basis.*

5.15 International institutions, particularly in the United States and to a lesser extent in Europe, exhibited a reluctance to bid above the top of the indicative price range (see Figure 5.2). OASITO advised ANAO that the interpretation of this bidding behaviour was the subject of intense discussion and debate in the process of increasing the price range, with some very senior and experienced international investment bank advice arguing strenuously that the bids above $3.40 were not indicative of genuine demand, but were tactical.[161]

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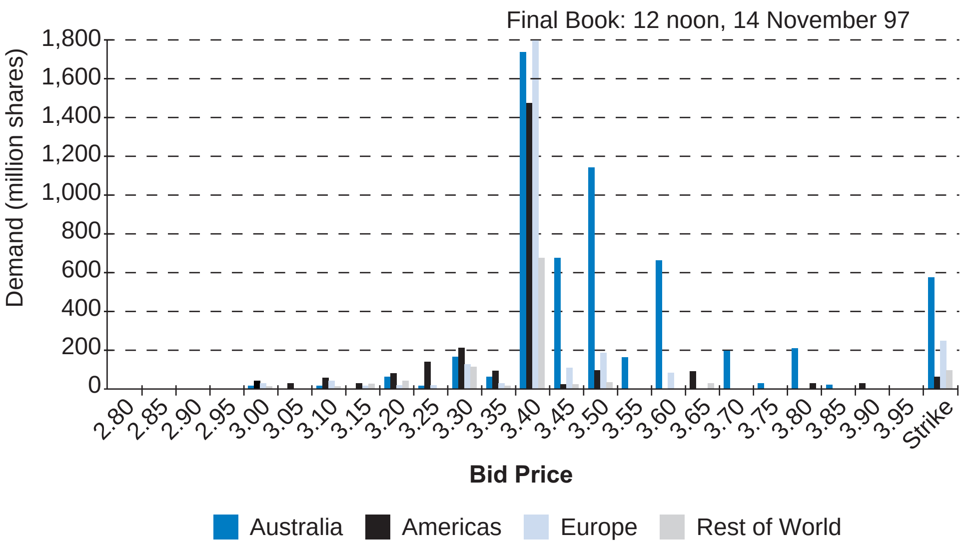
159 The Minister stated that *the decision to adjust the indicative price range upwards is in response to bids received from institutions. Specific price bids submitted by institutions have shown overwhelming support for the offer at or above the top end of the original $2.80 - $3.30 indicative price range. The upwards adjustment of the indicative price range provides an opportunity for institutions to revise their bids if they wish to without any penalty in the allocation process. In revising the price range, the Commonwealth is seeking to assess more accurately demand above the top of the original price range. Increasing the top end of the price range will help to ensure the Commonwealth sets the final price based on the best market information available under the institutional offer and to ensure the best possible price discovery process.* Source: Minister for Finance and Administration, Media Release 69/97, *Telstra Share Offer - Adjustment to Indicative Institutional Price Range*, 12 November 1997.

160 *Thus in Qantas most of the international institutions bid early at the cap price but Australian institutions set the final price by virtue of the coverage that was required to ensure secondary market stability. In CBA3 there was considerable international institutional bidding above an implied value of what CBA shares were trading at in the market - these could only be interpreted as strategic bids because it is not credible to believe that international institutions really expected to pay more in the bookbuild than they would need to pay in the existing market.*

161 This view was substantially reflected in the allocation process where bids above $3.50 were penalised for not providing price leadership.

Figure 5.2

Institutional Bookbuild: Demand at Specific Prices by All Bidders



Source: Sale Business Adviser.

5.16 Bidders were able to bid at the final price ('strike' price bids), at a single price or over a range of prices. Bids that outline the bidder's demand for stock at different prices can assist the bookbuilder assess the bidder's actual price elasticity of demand. Figure 5.2 indicates that the bookbuild process and allocation criteria may not have provided sufficient encouragement for bidders to submit bids that showed their demand for stock at different prices.[162] Advice to ANAO from OASITO's Sale Business Adviser is that rewarding in the allocation process bidders who submit a series of bids that show their demand at different prices was found in a recent Australian privatisation to be an effective means of encouraging bidders to reveal their individual price elasticity of demand.

Finding

5.17 ANAO's review of the institutional book suggests the bookbuild process and allocation criteria did not provide sufficient incentive for bidders to reveal their individual price elasticity of demand for Telstra shares.

[162] One of the Global Coordinators advised ANAO that the five largest bids from Australian institutions included different demand at different prices.

Recommendation No.10

5.18 ANAO *recommends* that in future public share offers the Office of Asset Sales and IT Outsourcing encourage price leadership in institutional bidding by rewarding in the allocation process bidders who quantify their demand for stock at different prices thus indicating their price elasticity of demand.

OASITO response

5.19 OASITO ***disagreed*** with the recommendation. OASITO commented that, while it will consider this as appropriate in the specific context of any future public share offer, it does not consider it appropriate to commit to this course as a matter of *a priori* policy. OASITO is concerned not to extend unduly the complexity of the allocation process further without clear benefit. OASITO doubts that purported measures of individual investor elasticity add much to overall aggregate demand estimates in the book as a whole, and could extend the scope for 'gaming' bids. At best this measure would be likely to be a very minor enhancement.

ANAO comment

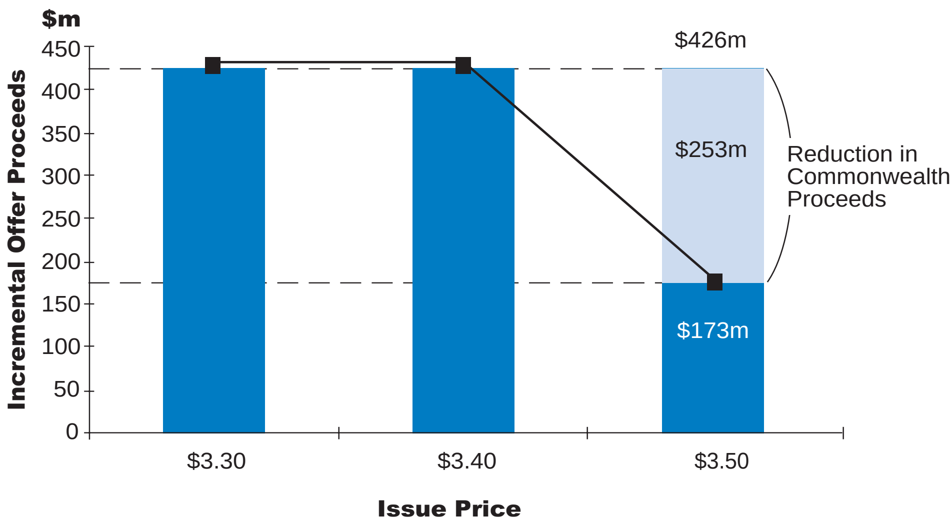
5.20 An open priced bookbuilding approach was adopted in the Telstra sale as a means of achieving the Government's objective of an optimum financial return from the sale. Analysis of the institutional bookbuild highlights bidders' overall reluctance to provide price leadership by bidding outside the price range. The allocation process represents a major mechanism by which the strategic bidding behaviour of investors may be influenced to generate improved financial returns to the Commonwealth.

5.21 Following the increase in the top of the indicative price range, many international institutions increased their bid prices to the top of the new indicative price range. This behaviour, together with Telstra's aftermarket trading performance, indicates that the price range parameters may not have encouraged sufficient price leadership by institutions to enable the Commonwealth to establish a clear picture of the market's valuation for the stock. One method of encouraging price discovery is to set the indicative price range such that the expected price is below the top of the range.[163] OASITO advised ANAO that the price range was set with a view to the expected issue price being within the range, and slightly below the top of the range.

[163] For example, the 1996 Deutsche Telekom AG offering was priced at DM28.5 per share, within the indicative price range of DM25 to DM30 per share (a 20 per cent range). The price range was determined in the light of analyst earnings multiple valuations which suggested a price of up to DM24 per share and pre-marketing feedback that identified significant price sensitivity above the DM26 to DM27 per share level.

5.22 The Minister for Finance's decision to increase the top of the indicative price range from $3.30 to $3.40 and strike the issue price at the top of the final indicative price range increased Commonwealth proceeds by $426 million with retail and institutional investors all paying an extra ten cents per share. However, every ten cent increase in the issue price above $3.40 would have seen the incremental increase in Commonwealth proceeds reduced by $253 million to $173 million (see Figure 5.3).[164] This is because Australian retail investors were allocated 59 per cent of the shares sold with the instalment discounts reducing the retail investor price to ten cents below the institutional issue price with the price to retail investors capped at $3.30 per share.[165]

Figure 5.3
Incremental Commonwealth Proceeds



Source: ANAO analysis.

[164] At an issue price of $3.30, Australian retail investors would pay $3.20 per share as a result of the five cent application discount and five cent loyalty discount (providing they hold their instalment receipts continuously for twelve months). At an issue price of $3.40, Australian retail investors would pay $3.30 per share as a result of the five cent application discount and five cent loyalty discount. At issue prices above $3.40 per share, the retail investor price cap of $3.30 would mean that retail investors would not pay $3.30 per share.

[165] Based on recommendations from the Global Coordinators, the price payable by Australian retail investors was capped at the top of the indicative price range ($3.30 per share). The purpose of the cap was to give retail investors certainty of the maximum cost of their investment.

Finding

5.23 Sale proceeds were increased by $426 million as a result of the Minister for Finance's decision to increase the top of the indicative price range from $3.30 to $3.40 and then strike the issue price at the top of the final price range. The price payable by Australian retail investors was capped at the top of the indicative price range so that any further ten cent increases in the issue price would have seen the incremental increase in Commonwealth proceeds reduced by $253 million to $173 million. The propensity for international institutions to bid at the top of the indicative price range, together with Telstra's aftermarket trading performance, suggests that the price range parameters may not have encouraged sufficient price leadership by institutions.

Aftermarket outcome

5.24 The final price of the shares was a critical decision that directly influenced the successful outcome of three of the major objectives of the sale; namely, achieving an optimal financial return for the Commonwealth, establishing a broad based and orderly market for Telstra shares, and building investor support for the Government's asset sales program.

5.25 Following briefing from the Global Coordinators, Sale Business Adviser and OASITO on the results of the institutional bookbuild, the Minister for Finance decided on 15 November 1997 to strike the issue price at $3.40 per share, the top of the final indicative price range. At this price, the institutional tranche was 6.2 times subscribed (see Figure 4.1). This compares to the third tranche sale of the Commonwealth Bank of Australia where the issue was 3.1 times subscribed at the issue price.

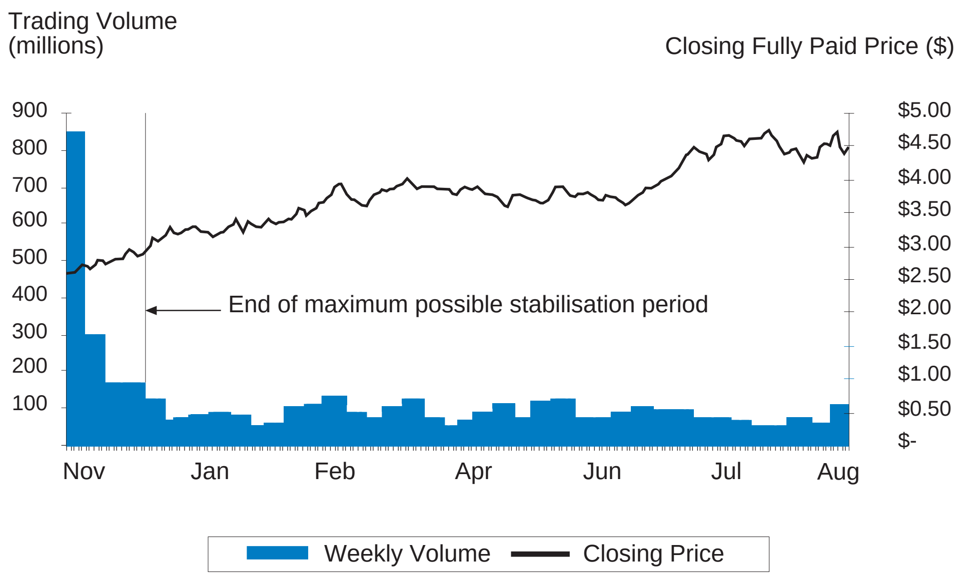
5.26 The final price involves a trade-off between maximising sale proceeds and achieving an orderly aftermarket. Consistent with these objectives, the issue price in public share offers is often set slightly below the expected market trading price (the public share offer discount) to secure a modest premium to the issue price in early trading. OASITO did not set an aftermarket premium target for the Telstra offering.[166] However, the Global Coordinators and Sale Business Adviser based their valuations on the expectation of a premium in the range of 5 per cent to 10 per cent.

[166] In United Kingdom privatisations aftermarket premium targets are often set. For example, in the March 1991 initial offering of shares in National Power and PowerGen, the United Kingdom Department of Energy sought to ensure that from the start of trading on the London stock market the share price would stand at a modest premium of between 2.9 per cent and 5.7 per cent. In the third tranche sale of shares in British Telecommunications plc the United Kingdom Treasury aimed to achieve an aftermarket premium of between 1.0 per cent and 1.2 per cent.

5.27 At the close of the first day of trading (17 November 1997), Telstra instalment receipts stood at a premium of 67 cents, or 34 per cent to the institutional first instalment price of $2.00, the largest initial premium of any Commonwealth public share offering. This was equivalent to 20 per cent on a fully paid basis ($3.40). Over the 30 day maximum possible stabilisation period, the price increased to a maximum of $2.93 (a 47 per cent premium to the first instalment price) before falling slightly to $2.91 (a 46 per cent premium) at the end of the maximum possible stabilisation period (see Figure 5.4).[167]

Figure 5.4

Telstra Instalment Receipts: 17 November 1997 to 28 August 1998



Source: ANAO analysis based on information provided by OASITO's Sale Business Adviser.

[167] The Sale Business Adviser has advised OASITO of the following reasons for the high aftermarket premium:

- the emerging impact of the Asian crisis has lead to investors seeking stocks that have little exposure to Asia;
- institutions have high levels of cash and Telstra is a relatively secure investment with good returns;
- institutions were generally significantly underweight at allocation whilst at the same time retail investors have been reluctant to sell leading to significant excess of demand over supply; and
- based on Telstra's half yearly 1997-98 net profit after tax of $1.55 billion, market expectations are for a 1997-98 net profit of $3.0 billion compared to a prospectus forecast of $2.8 billion.

5.28 On a fully paid basis, the trading price of Telstra instalment receipts rose by 73 per cent from $3.40 per instalment receipt upon listing to $5.87 per instalment receipt as of 8 October 1998. This increase is more than 160 times the increase in the ASX All Ordinaries Index and more than 20 times the increase in the ASX All Industrials Index. At the fully paid price of $6.14 per share, the market values Telstra at $79.0 billion, or $26.3 billion for the one-third sold, compared to the issue price valuation of $43.7 billion, or $14.6 billion for the one-third sold.

5.29 OASITO advised ANAO that, since listing, the Telstra instalment receipt price has experienced five major effects:

- a first day 'stag' premium attributable to the interaction of the customary expectation of investors that the issue price will be conservative, and the effect of deliberately leaving Australian institutions significantly underweight on allocation;
- continuing upward price pressure over the following weeks as institutions continued to seek stock to move towards index weight in the face of a stock shortage because retail investors elected, largely, to retain their shares - as intended by the loyalty discount incentive;
- a significant relative re-rating of Telstra as an Australian 'blue chip' as investors sought stocks that were defensive against Asian exposure and as international telecommunications companies were re-rated globally;
- a period of relative under-performance after the Government announced its intention to seek legislation to permit the post-election sale of the balance of the shares in Telstra. Institutions seeking market weight assessed this development as affording them the opportunity to achieve it more cost-effectively in the second sale process; and
- a period of further price escalation driven by two main considerations: the market's assessment of the better relative profit outlook for Telstra in the face of softening profit outlooks for other major Australian industrial stocks; and the political uncertainty over the prospects and timing of any further sale of Commonwealth equity in Telstra.

Finding

5.30 The size of the initial listing premium and ongoing strong secondary market trading performance indicate that the issue was not fully priced. Compared to the expected aftermarket premium of 5 per cent to 10 per cent, Telstra instalment receipts traded at an initial 34 per cent premium over the issue price of instalment receipts and a 20 per cent premium on a fully paid basis. On a fully paid basis, over the eleven months since listing, the trading price of Telstra instalment receipts has risen more than 160 times the increase in the Australian Stock Exchange (ASX) All Ordinaries Index and more than 20 times the increase in the ASX All Industrials Index.

Sale costs

5.31 The Commonwealth's direct costs of the sale are estimated to be $260 million (see Figure 5.5). In addition, Telstra incurred costs of $15 million that were not reimbursed by the Commonwealth. As a matter of interest, these direct costs are 1.9 per cent of gross proceeds with OASITO's costs being 1.8 per cent compared to 1.5 per cent for CBA3[168] (an offering of shares in a previously listed company with proceeds of $5.15 billion[169]), 2.8 per cent for the Qantas initial public share offering (proceeds of $1.45 billion), and 3 per cent for the CSL initial public share offering (proceeds of $299 million).

5.32 Based on estimated sale proceeds of $10 billion, the Government initially approved a sale budget of $210 million for OASITO comprising a fixed component of $90 million and a variable component of $120 million for selling commission expenses. Sale costs exceeded the initial budget provision by a significant margin for: sale logistics ($22 million); Global Coordinator and Business Adviser fees and expenses ($19 million); and the international roadshow ($2.1 million). The budget did not include provision for the costs of collecting the final instalment estimated at $12.0 million because, at the time of preparing the budget, OASITO expected that Telstra would bear these costs.[170] Savings of $8 million were achieved against the budget provision for retail marketing and advertising and $6 million for legal and accounting advice.

168 An ex-gratia payment of $11.98 million was made for ACT stamp duty in the sale of the third tranche of the Commonwealth Bank. Because no payments were made for stamp duty in the Telstra sale, the stamp duty payment is excluded from the calculation of the costs for the third tranche sale of the Commonwealth Bank. Including stamp duty in the calculation increases costs to 1.7 per cent of proceeds.

169 Including proceeds of $1.0 billion from the buy-back by the Commonwealth Bank of Australia of 100 million shares.

170 OASITO advised ANAO that Telstra were not formally asked to carry these costs once the Government decided formally to reject Telstra's application for its own costs to be reimbursed.

Figure 5.5
Telstra Public Share Offer Costs as at July 1998

	$m	$m
• **Commonwealth**		
Selling Commissions and Fees		
Domestic Retail[a]	53.73	
International Institutional[b]	45.80	
Domestic Institutional	24.53	
Total Selling Commissions and Fees		124.06
Logistics		45.99
Advisory Costs		
Project Management	39.58	
Sale Business Adviser	4.00	
Total Advisory Costs		43.58
Advertising and Marketing		17.94
Telstra Instalment Receipt Trustee		13.47
Legal, Accounting & Other Advice		11.10
OASITO Running Costs		1.87
Scoping Study		1.56
Regulatory Fees		0.87
Total Commonwealth[c]		**260.44**
• **Telstra Corporation[d]**		**15.30**
Total Cost		**275.74**

(a) Comprises broker firm commissions of $30.43 million and broker stamped commissions of $23.30 million.

(b) The commissions and fees payable on the underwritten international offer were characterised as a discount on shares purchased. As a result, the international underwriters received the full value of the first instalment on behalf of the Commonwealth and deducted selling commissions of $27.48 million, management fees of $9.16 million and underwriting fees of $9.16 million before remitting the net amount to the Commonwealth.

(c) Excluded from these costs are retail and employee incentives with an estimated value of $337 million. The proceeds foregone from these incentives were deducted from ANAO's estimate of Commonwealth gross proceeds (see Figure 5.1).

(d) Following the 1997-98 Additional Estimates Hearings, the Department of the Communications and the Arts advised the Senate Environment, Recreation, Communications and the Arts Legislation Committee that, as at 31 October 1997, Telstra had recorded directs costs of $15.3 million including $7.2 million in accrued expenses. These costs exclude the time spent by management and staff on float related activities.

Source: ANAO analysis based on information provided by DoFA; OASITO; and Global Coordinators.

Commissions and fees

5.33 The institutional selling commissions and fees set for the Telstra sale were the highest percentage rate paid in any Commonwealth public share offer (see Figure 5.6).[171] Selling commissions and fees totalled $124.1 million or 0.87 per cent of gross sale proceeds which was less than the budgeted proportion of up to 1.2 per cent of sale proceeds. The major reasons for the reduction were the higher than expected allocation of shares to Australian retail and institutional investors[172] and, within the Australian retail offer, the higher than expected proportion of 'clean skins'.[173]

Figure 5.6
Comparative commissions and fees: Commonwealth share offers

	CBA2 (1993)	Qantas (1995)	CBA3 (1996)	Telstra (1997)
Transaction Size	**$1 700m**	**$1 450m**	**$5 145m**	**$14 241m**
Institutional offer commissions				
• Domestic institutions	0.5%	0.75%	0.5%	0.8%
• International institutions	0.8%	1.5%	1.5%	1.75% [a]
Public offer commissions				
• Broker stamped	0.75%	1.0%	1.0%	1.10%
• Broker firm	1.0%	1.25%	1.5%	1.45%
• Employee/Entitlements	n.a.	n.a.	0.75% [b]	1.10% [c]

(a) Comprised a competitive selling concession of 1.05 per cent, management commission of 0.35 per cent and underwriting fee of 0.35 per cent.

(b) The CBA3 entitlements fee of 0.75 per cent was subject to a cap which was only paid on those entitlement applications that bore a broker's stamp.

(c) Applications by Telstra employees were included in the Australian retail offer with commissions paid on the same basis and at the same rate as other retail applications.

Source: ANAO analysis based on information from OASITO.

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171 In previous public share offers, the Task Force on Asset Sales had negotiated selling commissions generally at or below the lower end of levels for comparable international privatisations or Australian private sector transactions.

172 The strong bidding performance by Australian institutions combined with strong retail demand saw international institutions allocated 18 per cent of the issue. In comparison, OASITO's sale budget was predicated on international institutions being allocated 33 per cent of the issue. The *Telstra (Dilution of Public Ownership) Act* required that no more than 35 per cent of the offering be sold to foreign investors.

173 'Clean skins' are share applications lodged directly by the investor rather than through a stockbroker. No selling commissions are paid to brokers on 'clean skins'.

5.34 The quantum and calculation of selling commissions and fees was specified in the contract between the Commonwealth and Global Coordinators and Lead Managers. The quantum and calculation of proposed fees was not included as one of the selection criteria for Global Coordinators and Lead Managers and the tender evaluation process did not include a detailed and comprehensive assessment and comparison of candidates' commission proposals. Following their selection, the Global Coordinators and Lead Managers were invited to submit a joint proposal for commissions and fees. Negotiations on commissions and fees took place before the appointment of OASITO's Sale Business Adviser.

International commission rates

5.35 The Telstra sale continued the trend of increasing international institutional commission rates in Commonwealth share offers. In comparison, institutional commissions in United Kingdom privatisations[174] have generally been maintained at a lower level to recent Commonwealth privatisations (see Figure 5.6) while privatisations in other countries have paid higher commission rates (see Figure 5.7).

5.36 The commissions paid on international institutional sales (1.75 per cent[175]) were significantly higher than those paid on sales to Australian institutional investors (0.8 per cent). This significant cost differential had the effect of reducing the relative value to the Commonwealth of international sales and providing the selling syndicate with a direct financial incentive to maximise sales to international investors.

[174] OASITO advised ANAO that *the comparisons with the United Kingdom are incomplete and misleading. They fail to take account of the scale of the offer relative to domestic market size and experience. They fail to reflect that the Telstra offer fees overall are probably proportionately less than those payable in the United Kingdom, even if the percentage fee rates were higher. This is because in the United Kingdom full fees are paid on 98 per cent of retail applications, whereas in the Telstra offer the development of the 'direct application' approach for zero fee applications attracted 33 per cent of all applications. OASITO notes that care is needed to avoid reducing fee rates to levels that fail to recognise and reward the effort required to ensure a successful offer.*

[175] Each share sold in the international institutional offer cost the Commonwealth 5.839 cents. In comparison, Australian retail sales cost on average 2.072 cents per share and Australian institutional sales 2.671 cents per share.

Figure 5.7
Comparative international public share offer commission rates

Year	Public share offer	Offer Size ($bn)[a]	Commission (%)[b]
1997	Telstra	$A14.2bn	1.75
United Kingdom Privatisations			
1996	British Energy	£1.3bn	1.25
1996	Railtrack Group	£1.9bn	1.495
1995	National Power and PowerGen (Second tranche)	£3.5bn	1.00
1993	British Telecommunications (Third tranche)	£5.1bn	1.00
1991	British Telecommunications (Second tranche)	£5.2bn	1.16
Non-United Kingdom Privatisations			
1997	China Telecom (Hong Kong)	$US4.2bn	3.50
1997	France Telecom	$US7.0bn	2.50
1997	Electricidade de Portugal SA (Portugal)	$US2.3bn	2.75
1996	Deutsche Telekom (Germany)	$US13.0bn	2.50
1995	ENI SpA (Italy)	$US4.0bn	2.80
1995	Usinor Sacilor (France)	$US3.0bn	3.00
1994	KPN (Netherlands)	$US3.7bn	2.90
1994	Tele Danmark A/S (Denmark)	$US3.0bn	3.50
1993	BNP (France)	$US3.0bn	3.00
1993	YPF SA (Argentina)	$US3.0bn	4.00

(a) Exchange rates as of 24 August 1998 were $A/$US 0.5810 and $A/£ 0.3552.

(b) International commission rate.

Source: ANAO analysis of information provided by the United Kingdom National Audit Office and Credit Suisse First Boston.

5.37 In comparison to the approach taken by the Commonwealth, selling commissions paid by the United Kingdom Government on sales to institutional bidders do not discriminate between sales to international and domestic investors. For example, in the July 1993 third tranche sale of shares in British Telecommunications, all institutional commissions were set at 1.0 per cent. Credit Suisse First Boston advised ANAO that:

> *The reduction of fees on international sales to the same rate as domestic institutions would create a selling fee structure significantly lower than precedent offerings. Such lower fees would make participation uneconomical for many international firms and potentially reduce the quality and effectiveness of the selling syndicate. We would advise that it may have decreased demand and pricing tension resulting in a stronger negotiating position to Australian institutions thereby reducing pricing.*

5.38 OASITO advised ANAO that:

> *the fee rates were deliberately agreed at levels that were generally above those paid in previous offers.*[176] *This reflected the scale of this offer relative to domestic market size, the need to maximise retail demand to achieve unprecedented levels of new investors, the likelihood that a significant proportion of investors would submit applications independently of brokers ('clean skins') even though they may have benefited from broker advice and selling efforts, and the recent record of international fees paid on comparable telecommunications privatisations (such as Deutsche Telekom, STET and France Telecom - of which the latter two would be closely competing offers in the market at the same time as the Telstra offer). It also reflected internal OASITO views of the levels of investor support obtained in the Qantas offer and experience with the selling syndicate in the closing stages of the CBA3 offer.*

Broker firm commissions

5.39 Brokers participating in the Telstra offer were able to reserve a firm allocation of shares for distribution to their private clients and the clients of financial planners. The Scoping Study Business Adviser advised OASITO that brokers prefer firm entitlements of stock as they can guarantee an allocation to their clients. Broker firm can assist the offer by generating early positive momentum and demand tension. In addition, by making an offer for a firm allocation of shares, the brokers were committed to deliver completed applications and payment for the full amount of the firm allocation. However, in the Telstra offer, while some brokers provided payment themselves, others on-forwarded cheques from their clients. Some of these cheques were subsequently dishonoured, leading to post-allotment adjustments to the broker firm allocation of some brokers.[177]

5.40 As distinct from earlier Commonwealth public share offers, the Telstra offer included a retail investor pre-registration process and institutional pre-marketing. These initiatives showed there was a very high level of demand for shares from Australian retail investors[178] and from institutions in Australia and overseas.[179] This reduced the need for a broker firm component to generate early positive momentum and demand. In

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[176] The exception was a slight reduction in the broker firm fee to reflect OASITO's intention of maximising retail investor interest rather than favouring broker client investors.

[177] That is, brokers were not required to provide payment for the full amount of their firm allocation.

[178] There were over 2.5 million pre-registrants with market research conducted in September 1997 indicating 53 per cent would convert to applicants. Market research estimated 1.8 million retail applications overall, with a total demand of $10.4 billion.

[179] Pre-marketing feedback indicated total allocable institutional demand of $20.5 billion.

addition, the retail incentive package was expected to generate strong retail demand in order to sell all available shares and increase demand and price tension in the offer.

5.41 Brokers bid for a total of 5.25 billion shares (125 per cent of the offer) and were allocated 649 million shares (15 per cent of the offer).[180] Although other steps were taken to generate early positive momentum and demand tension, OASITO paid fees of 1.45 per cent on these shares, 0.35 per cent higher than broker stamped retail applications.[181] Paying fees on broker firm sales at the same rate as broker stamped sales would reduce Commonwealth sale costs in future public share offers.[182]

Finding

5.42 The largest component of the sale costs were selling commissions and fees of $124.1 million. The international institutional selling commission and fee rates were the highest ever paid in a Commonwealth public share offer although OASITO considers they were still low by international benchmarks when regard is had for the size of the offer relative to domestic market size and to the net fee levels paid having regard to the incidence of 'cleanskin' applications that carried no fee. In addition, the commissions paid on broker firm allocations were significantly higher than commissions paid on broker stamped sales to Australian retail investors. The settlement procedures employed for broker firm allocations did not require brokers to pay the first instalment price for their broker firm allocation although brokers committing to pay for the shares is one reason for the higher selling commission on broker firm sales.

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180 A similar level of over-subscription occurred in the CBA3 public share offer where brokers subscribed for 105 per cent of the offer.

181 OASITO advised ANAO that *broker firm stock allows (but does not require) the issuer to treat that allocation as if it were underwritten. The fee margin on broker firm over broker stamped sales was set at the same level as the underwriting allocation of the international selling fee (0.35 per cent).*

182 Credit Suisse First Boston advised ANAO that: *The role of broker firm in future Government equity offerings continues to merit being reviewed in the light of current international equity market practice. Higher fees for Broker Firm shares is consistent with Australian offering practice. This fee structure has developed as acceptance of Broker Firm allotment ensures that brokers will provide proceeds for the designated amount of shares attributable to that firm. The process is similar to the international underwriting commitment for which retail brokers should receive an additional fee for bearing the risk of 'underwriting' their broker firm shares. The brokers are committed to provide the applications irrespective of final price and should be paid additional fees to accept this incremental risk.*

Recommendation No.11

5.43 ANAO *recommends* that, for future public share offers, the Office of Asset Sales and IT Outsourcing:

(a) encourage competitive pressure on selling commissions and fees by seeking shortlisted firms' binding agreement with its own fee proposals;

(b) set commissions on broker firm sales at a level that reflects the contribution of this component to the offer, having regard to other steps taken to generate demand from retail investors; and

(c) implement settlement procedures for broker firm allocations that require brokers to make direct payment of immediately available funds to the Commonwealth for shares they have reserved for allocation to their private clients.

OASITO response

5.44 OASITO ***agreed with qualifications*** to the recommendation. In respect of the sub-recommendations, OASITO commented that:

(a) This approach does not reflect 'competitive pressure' as is claimed, but would be little more than a unilateral imposition. The outcome is better achieved by a process of commercial negotiation in which the merits of alternative fee options and structures are fully canvassed among the parties in reaching an agreed outcome. But OASITO accepts that the process might well proceed from a preferred fee that it stipulates, rather than from an asking offer submitted by the designated global coordinators.

(b) OASITO considers that this was done in this offer, given that the fee rates needed to be set at the outset, and not once the demand levels were known. OASITO considers that ANAO has not properly understood or reflected the effect that a highly successful 'broker firm' offer can have on international institutional pricing tension in the bookbuild process.

(c) OASITO agrees that brokers should be required to do more in the settlement process for 'broker firm' allocation than simply to on-forward client cheques and applications. But to be successful - and optimal - any changes would best be developed after consultation with the broking industry, rather than merely being imposed upon it as recommended. OASITO already contemplated this for any future major public share offer that it was required to conduct.

ANAO comment

5.45 ANAO recognises the significance of the broker firm category for the Telstra public share offer with part (b) of the recommendation relating to broker firm commissions. The Telstra offer included a retail investor pre-registration process and a large range of retail investor incentives. These initiatives were designed to generate strong retail demand in order to sell all available shares and increase demand and price tension in the offer. The pre-registration process was also intended to generate early positive momentum and provide a good indication of the likely level of retail demand. In these circumstances, and given the broker firm component was scaled back by 88 per cent in the Telstra offer and by 78 per cent in the 1996 CBA3 offer, ANAO considers OASITO should re-examine commission rates on broker firm sales.

Canberra ACT
19 October 1998

P.J. Barrett
Auditor-General

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