

The Auditor-General
Audit Report No.50 2003–04
Performance Audit

Management of Federal Airport Leases

Australian National Audit Office

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Canberra ACT
4 June 2004

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Management of Federal Airport Leases*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, which appears to read 'P. J. Barrett', is positioned above the printed name.

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/Glossary

ABC	Airport Building Controller
AEO	Airport Environment Officer
AGS	Australian Government Solicitor
Airports Act	<i>Airports Act 1996</i>
ANAO	Australian National Audit Office
CASA	Civil Aviation Safety Authority
DOCITA	Department of Communications, Information Technology and the Arts
DoTRD	Department of Transport and Regional Development
DOTARS	Department of Transport and Regional Services
Finance	Department of Finance and Administration
MUIT	Multi-User Integrated Terminal
SACL	Sydney Airports Corporation Limited
SARS	Severe Acute Respiratory Syndrome
Transitional Act	<i>Airports Transitional Act 1996</i>
VHST	Very High Speed Train

Summary and Recommendations

Summary

Introduction

1. Between 1997 and 2003, a total of 22 airports owned and operated by the Commonwealth were privatised. The sales were conducted in five stages and raised aggregate proceeds of \$8.5 billion. The Australian National Audit Office (ANAO) has conducted performance audits of the sales of 18 of these airports.¹

2. Since the commencement of the airports privatisation process, significant changes have occurred in the aviation environment. This has included successive aviation industry shocks caused by the Asian economic crisis of 1998–99, the events of September 11 2001, the collapse of Ansett on 12 September 2001, the October 2002 Bali bombing, the SARS pandemic during 2002–03, and the Iraqi war. In this environment, the transition from public to private sector management has been successfully completed for all airports.

3. The airports privatisation program involved leasehold, rather than freehold, sales. As a result, the Commonwealth has an ongoing involvement in airport operations. The Department of Transport and Regional Services (DOTARS) is responsible for administering the Commonwealth's ongoing interests in the operation and management of Federal airports under both the statutory regulatory framework of the *Airports Act 1996* (Airports Act), and the contractual arrangements entered into as part of the sales processes.

4. The Airports Act and its regulations provide for regulatory oversight of the operations at the privatised Federal airports. The stated objectives of the Act include: promotion of the sound development of civil aviation in Australia; establishment of a system for the regulation of airports that has due regard to the interests of airport users and the general community; and promotion of the efficient and economic development and operation of airports.

5. A number of legal agreements were used to facilitate each of the sales. In terms of ongoing Commonwealth involvement in airport operations, the major sale documentation comprised: a Sale Agreement between the Commonwealth, the lessee and its parent entities; an Airport Lease between the Commonwealth and an airport lessee company; and, for the major airports, a tripartite deed between the Commonwealth, the lessee and the lessee's

¹ The first sales (referred to as Phase 1) occurred in 1997 and were reported on in ANAO Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, Canberra, March 1998. Phase 2 of the sales program, completed in 1998, was reported on in ANAO Audit Report No.48 1998–99, *Phase 2 of the Sales of the Federal Airports*, Canberra, June 1999. ANAO also audited the 2002 sale of Sydney (Kingsford Smith) Airport, which is reported on in ANAO Audit Report No.43 2002–03, *The Sale of Sydney (Kingsford Smith) Airport*, Canberra, May 2003. ANAO has not audited the 2001 sale of Essendon Airport or the 2003 sale of the remaining three Sydney Basin Airports.

financiers. DOTARS' administration of these agreements is the focus of this audit.

Audit scope and objectives

6. The objectives of the audit were to assess whether DOTARS had developed and implemented an appropriate framework and procedures to administer lessee obligations entered into as part of the 1997 and 1998 leasehold sales of 17 Federal airports.² In particular, the audit sought to:

- review DOTARS' monitoring of lessee compliance with the Airport Leases and supporting sale documentation;
- examine the effectiveness of the framework and procedures developed by DOTARS to administer lessee development commitments; and
- assess the impact of changes in the aviation environment on the management and monitoring of lessee obligations.

7. The scope of the audit included assessing the Department's management of lessees' development obligations under the sale documentation and its management of lessee compliance with other contractual obligations. A follow-up of relevant recommendations from the ANAO audit of the first three sales was also conducted. This performance audit does not examine the administration of the Airports Act regulatory framework.

Key Findings

Resourcing

8. Managing airport lessee compliance with the lease and sale agreement requirements is one aspect of the Department's overall post-sale activities. ANAO recognises that DOTARS must prioritise available human and financial resources. In this context, the Department sees its primary responsibility to be the administration of the Airports Act and related regulations. Nevertheless, effective administration of the sale documentation is necessary both to achieve the intended sale outcomes, and to manage the Commonwealth's residual risks and liabilities, which are substantial.

9. While giving priority to regulatory responsibilities, we found that, over the period since the first sales were completed in 1997, DOTARS has given insufficient attention and resources to important aspects of managing the

² Post-sale contract management related to Essendon Airport, Sydney (Kingsford Smith) Airport and the three Sydney basin airports (Bankstown, Camden and Hoxton Park) was excluded from the audit scope as these are relatively recent sales.

Airport Leases and Sale Agreements. With limited budget-funded resources currently available for both the regulatory and contract management functions, DOTARS needs to identify other means of appropriately resourcing its contract management responsibilities. This includes considering the merits of exercising the power provided by the lease for DOTARS to recover its reasonable lease administration costs from the lessees.

10. Recovery of various costs is provided for in the airport sale documentation, as follows:

- under the leases, airport operators pay the Commonwealth's costs of providing an Airport Environment Officer (AEO) at the airport. For 2003–04, DOTARS advised ANAO that total costs recovered under the leases in respect of Airport Environment Officers would be \$1.584 million;
- under the Sale Agreements, for the first five years following the sales, airport operators paid the costs of Airport Building Controllers (ABC). The ABC costs were only recovered to the extent they are not recovered from fees paid by third parties under the relevant regulations, and were subject to a maximum annual cap; and
- under the leases and tripartite deeds, the Commonwealth's reasonable administration costs can be recovered from the lessees.

11. Prior to this performance audit, DOTARS had not estimated its reasonable lease administration costs. In March 2004, DOTARS advised ANAO that the cost of administering the leases and other sale documentation in 2003–04 was estimated to be \$558 000. This figure includes the costs of 4.75 full time staff. As DOTARS' administration costs had not previously been identified, the Department was not in a sound position to make decisions about the extent to which it would recover, or not recover, its administration costs. Very few administration costs have been recovered.

Annual lease reviews

12. Annual meetings with each airport lessee are an important element of DOTARS' approach to managing lessee compliance with the Airport Leases. The Department's objective in conducting lease reviews is to ensure that it is sufficiently well informed to be able to assess an airport operator's compliance with the requirements of the Airport Lease.

13. A lease review should have been conducted each year with each of the seventeen airports included in the scope of this audit. Of the 68 annual lease review meetings that should have been held by 30 June 2004, with lessees of these 17 airports, 26 (38 per cent) had not been conducted or arranged by the

completion of this report. This level of performance has not been reflected in DOTARS' performance reporting on the conduct of annual lease reviews.

14. Major improvements were made by DOTARS in 2002 to its conduct of lease review meetings. At that time, almost five years after the first lease agreements commenced, DOTARS began the process of reviewing the Airport Leases in a methodical and structured fashion. Also in that year, DOTARS systematically reviewed the individual leases on a clause-by-clause basis and sought specific information from lessees to ensure that they were meeting their obligations under the leases. ANAO considers that this more methodical and structured approach, combined with DOTARS seeking written confirmation or evidence from lessees demonstrating compliance, provides greater assurance that the Commonwealth's interests, within the terms of the lease contract, are being adequately protected.

Insurance

15. Appropriate insurance cover for the privatised airports is important to the Commonwealth for a number of financial and other (public interest) reasons. These include protecting the Commonwealth against claims made against it as landlord, and having the proceeds of insurance claims used to rebuild damaged or destroyed structures. The insurance requirements of lessees are set out in both the Airport Leases and the Sale Agreements.

16. After the first airport sales in 1997, DOTARS entered into a contract with an insurance adviser for annual assessments of lessee insurance policies. This contract ended on 30 November 2001. However, it was not until June 2002 that DOTARS formally commenced a tender process to appoint a new insurance adviser. DOTARS has advised ANAO that the reason for the delay in implementing a formal tender process was due to the turmoil in the insurance industry following the September 11 event. A new contract was signed in September 2002. Since that time, DOTARS has obtained reports on insurance policies in place at all of the 22 privatised airports.

17. Insurance reports were completed between December 2002 and August 2003 in relation to each of the 17 airports included in the scope of this audit. Most of the insurance reports were qualified on the grounds that the airports had not provided all necessary information to DOTARS' insurance adviser. In addition, for a number of the airports, the adviser concluded that certain insurances were either not in place as required, or there were deficiencies in the insurance policies that had been put in place.

18. DOTARS has reviewed all insurance reports and has contacted each airport to provide feedback on the results and seek a response to issues that were identified. However, ANAO found that this follow-up action was not timely. This finding is based on the fact that DOTARS did not formally raise

matters arising from the first series of insurance reviews with the airport lessees until at least two months, and up to 14 months, after the reports were completed. On average, eight months elapsed between the insurance report being finalised and provided to DOTARS, and DOTARS following-up issues with the relevant lessee. Some issues still remain unresolved.

Airport development commitments

19. The Sale Agreements for 10 of the airports included a commitment from the lessee to a specified amount of capital expenditure on aeronautical infrastructure development over the first 10 years of the lease. Total Development Commitments of \$699.8 million were specified across the various Sale Agreements.

20. The 10-year Development Commitments are divided into two five-year periods, defined in the Sale Agreement as Period One and Period Two. For the three Phase 1 airports, Period One was originally specified to end on 30 June 2002. For the seven Phase 2 airports that have Development Commitments, Period One was originally specified to end on 30 June 2003.³

21. The respective Sale Agreements contain a reporting regime to assist DOTARS in monitoring lessees' compliance in achieving their Development Commitments. The contracted monitoring regime requires lessees to:

- provide DOTARS each year with a detailed expenditure plan for the balance of the relevant five-year Period, indicating how the lessee intends to comply with its obligations. Annual expenditure plans have been required since July 1997 for the Phase 1 airports and July 1999 for the Phase 2 airports;⁴
- provide DOTARS with annual audited reports prepared by an Approved Auditor setting out the Airport Development Costs for the 12 month period. Annual audited cost reports have been required since September 1998 for the Phase 1 airports and September 1999 for the Phase 2 airports; and
- provide DOTARS with fully audited reports prepared by an Approved Auditor setting out the Airport Development Costs at the conclusion of Period One and Period Two. Except where DOTARS has agreed to extend Period One for certain airports, Period One ended on

³ These dates can be extended with the Commonwealth's agreement. DOTARS has agreed to an extension in relation to three airports. The extensions range from one year to four years.

⁴ In February 2004, DOTARS advised ANAO that it had, in effect, waived the requirement for the Phase 2 airports to provide an expenditure plan for the first year following privatisation.

30 June 2002 for the Phase 1 airports and on 30 June 2003 for the Phase 2 airports.

Administrative procedures

22. The airports were advised by DOTARS in February 1999 that, although airport lessees must report annually on their progress in meeting their development obligations, the main task for DOTARS would occur after the expiration of each of the five-year periods. DOTARS advised ANAO in February 2004 that, with this clear principle in mind, the Department commenced work in early 2003 to prepare and implement its *Development Obligations for leased Federal airports—Procedures and Guidelines* document to ensure that the Period One reports from the relevant Phase 1 and 2 airports would be assessed on a consistent basis. DOTARS further advised that the timing of preparation of this document clearly reflects the fact that the airports' medium term Development Commitments are a contractual, not regulatory, obligation.

23. ANAO found that DOTARS' development of procedures to administer these Commitments was not timely. In particular, the Department did not commence the development of procedures until 2003, more than five and a half years after the Phase 1 sales were completed. ANAO recognises that the Period One and Two reports are the key documents in assessing the extent to which the relevant lessees have met their Development Commitments. Nevertheless, the following observations are relevant:

- Annual expenditure plans and annual audited costs reports have been required since 1997 and 1998 respectively. The annual expenditure plans and annual audited cost reports provide important monitoring information to DOTARS and an opportunity⁵ for DOTARS to provide timely feedback to lessees. ANAO considers that obtaining and using these annual plans and reports, in the manner now outlined in DOTARS' December 2003 procedures document, would have facilitated the timely finalisation of Period One outcomes by promoting a shared understanding with lessees of the contractual requirements.
- In 2000, DOTARS agreed to a four-year extension to Period One for one airport. Further extensions were agreed in 2003 and 2004 in relation to another two airports. The approach taken to the first extension in 2000 would have benefited from the earlier development and finalisation of DOTARS' procedures, particularly to achieve more timely resolution of the appropriate interest rate to apply to the deferred development expenditure.

⁵ The Sale Agreements do not require DOTARS to respond to the expenditure plans and annual audited cost reports.

Administration of reporting requirements

24. As is evident from Table 1, DOTARS has not obtained a significant number of the expenditure plans and audited cost reports from the lessees. In addition, where reports were obtained, they were often obtained after the due date. Of particular significance is that consolidated reports for the first five years, which are a prerequisite for DOTARS to assess the degree of compliance with the expenditure commitment, were not obtained until after the due date for all airports.

Table 1

Administration of Development Commitment Reporting Requirements: March 2004

Type of report	Number of reports due ⁶	Number and per cent received on time	Number and per cent received late	Number and per cent not received
Annual expenditure plan	54	6 (11%)	29 (54%)	19 (35%)
Annual audited report of costs	52	22 (42%)	24 (46%)	6 (12%)
Consolidated report for first five years	10	None	10 (100%)	Information obtained from all lessees

Source: ANAO analysis of DOTARS data and DOTARS advice to ANAO

Outcomes

25. Had there been full compliance with the requirements of the Sale Agreements, outcomes for the first five years should have been known by the end of 2002 for the Phase 1 airports and by the end of 2003 for the Phase 2 airports. Due to delays in DOTARS obtaining compliant audited reports from the lessees, ANAO was unable to assess the extent to which the contracted Period One aggregate Development Commitment of \$259.3 million had been achieved. As of March 2004, DOTARS had received some information in respect of Period One achievements from each of the 10 lessees. The information provided to DOTARS indicated the following:

- For five airports, the lessee claimed to have met, or exceeded, its Period One Commitment. In one instance, the airport lessee indicated it had met its full 10 year Commitment within the first five years. However, as DOTARS had only recently received the necessary audit reports, a final outcome had not yet been confirmed.

⁶ See Chapter 3 (Tables 3.3, 3.4 and 3.5) for further explanation of the number of reports that are due.

- For the remaining five airports, the information provided to DOTARS indicated that the Period One Commitment had not been met. Lessees of four of these airports have requested an extension to Period One. This has been granted in three instances and is being considered by DOTARS in relation to the fourth.

Follow-up of earlier audit recommendations

26. Audit Report No.38 1997–98 *Sale of Brisbane, Melbourne and Perth Airports* made eleven recommendations.⁷ Three of these related to DOTARS' post-sale contract management role. Outlined below is ANAO's summary assessment of the implementation of the relevant recommendations.

Recommendation No.8: Comprehensive framework and procedures for leases

27. ANAO recommended that DOTARS develop a comprehensive framework and procedures to monitor and ensure lessee compliance with the Airport Leases. DOTARS' response to the recommendation was that it agreed with qualification, as follows:

DOTARS accepts that some further measures will be required in both areas, although there has been active management of the lease obligations underway since day 1 of the lease – the report notes some of the matters involved. DOTARS will initiate a formal lease meeting, with a mechanism involving each airport (and its major users) to review key lease clauses and issues associated with it. These meetings will be conducted annually. This will involve up to 18 separate meetings, with the Phase 2 sales now nearing completion. However, the key task will remain to continue to actively oversight those lease obligations which arise on a day-to-day basis.

28. Chapter 2 of this report examines DOTARS' administration of the Airport Leases including the conduct of annual lease reviews with individual airports. The specific undertaking made by DOTARS in its response to the recommendation was for annual lease review meetings to be conducted with each airport and its major users. For the seventeen airports included in this current ANAO audit, DOTARS conducted a lease review meeting with each airport in 2000–01 and has conducted, or arranged to conduct, a meeting with each airport in 2003–04. In other years, meetings were conducted with between three to seven lessees. DOTARS has advised ANAO that regulatory events and industry shocks in 2001–02 and 2002–03 diverted resources from conducting planned lease reviews.

⁷ The recommendations established benchmark principles for both Phase 1 and future airport sales.

Recommendation No.9: Safe custody arrangements for signed sale documentation

29. To manage the Commonwealth's ongoing risks under the sale documentation, ANAO's 1998 Audit Report found that it was important that arrangements be made for the ongoing storage and safe custody of this important documentation in an appropriate legal form. ANAO recommended that the Office of Asset Sales and IT Outsourcing, in consultation with DOTARS:

- for future airport sales, develop an agreed framework for the post-sale disposition of sale documentation including providing for appropriate safe custody arrangements for the original signed sale documentation in an appropriate legal form for the duration of the lease term, and placing, in the records of each agency, a full set of copies of the signed sale documentation; and
- establish appropriate safe custody arrangements for the original signed sale documentation relating to the Phase 1 airport sales, in an appropriate legal form, for the duration of the lease term.

30. All agencies, including DOTARS, agreed with this recommendation with the Australian Government Solicitor (AGS) noting that the Office of Asset Sales and IT Outsourcing had requested AGS to arrange for the safe keeping of all original sale documentation once same had been returned from relevant State Stamps Offices. In April 2004, AGS advised ANAO that, in relation to the Phase 1 and Phase 2 airports, it holds all original Sale Agreements and all original Tripartite Deeds. However, in respect of the Airport Leases, AGS holds the originals except in relation to three airports, where it holds a copy of the Airport Lease with the original initials on the front, and Brisbane, where AGS holds no Airport Lease and appears never to have done so.

Recommendation No.10: Procedures to monitor airport development

31. ANAO recommended that DOTARS develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the Airports Act and airport leases. DOTARS agreed with qualification to the recommendation. DOTARS commented that:

The Department considers that the comprehensive reporting process [outlined in paragraph 21 above] is sufficient to ensure effective monitoring. However, the area which requires further work is better defining the terms in the lease for assessing whether the site is being developed as an effective international airport. The activity in this area is essentially longer term (in our view all airports are likely to meet demand effectively over the next few years) but we accept that we can and should develop some guidance for both the airport operators and ourselves in this area now.

32. The first aspect of DOTARS' response was that the comprehensive reporting process outlined in the Sale Agreements was sufficient to ensure effective monitoring of airport development. ANAO's assessment of DOTARS' administration of the Sale Agreement reporting requirements is summarised above at paragraph 24 and Table 1.

33. The other aspect of DOTARS' response was that guidance should be developed for airport operators and the Department on the terms in the lease, for assessing whether the site is being developed to an appropriate standard over the term of the lease. In this respect, in February 2004, DOTARS advised ANAO that the need for guidance had been overtaken by the submission and approval of Master Plans for all of the Phase 1 and Phase 2 airports. DOTARS further advised that it has taken the approach that monitoring of the ongoing development of the leased airports is best addressed having regard to the approved Master Plans and Major Development Plans.

Overall conclusions

34. The focus of this audit was on DOTARS' management of contracts entered into as part of the 1997 and 1998 leasehold sales of 17 Federal airports. Since the sales, significant changes have occurred in the Australian aviation market. This has included challenges arising from the Asian economic crisis, the 11 September 2001 events in the United States, the collapse of Ansett, the Bali bombing, the SARS pandemic and the Iraqi war. The changes in the aviation environment have increased the challenges facing DOTARS in its regulatory and contract management roles.

35. In terms of the audit objective, ANAO found that DOTARS took some time to develop procedures to administer important aspects of lessees' contractual obligations. The Department has indicated to ANAO that the approach taken was influenced by the impact of changes in the aviation environment. Commencing in 2002, the Department has taken steps in a number of areas to improve its contract management approach. ANAO considers that further attention is required in a number of areas, most notably as follows:

- Consideration of the merits of exercising the Commonwealth's contractual right to recover reasonable lease administration costs from lessees. At the time of the audit, insufficient attention had been given to managing the contracts over the period since privatisation. The cost recovery arrangements provided by the leases are one possible means to increase the resources allocated to the contract management function.
- Lease review meetings should be held with all airports at least once a year. Review outcomes should be documented, including an

assessment of the level of compliance by lessees. Improved communication of review outcomes to lessees would also add value, including by specifying outstanding issues that lessees are expected to address.

- The comprehensive reporting process provided by the Sale Agreements to enable effective monitoring of Development Commitment progress has not been consistently and rigorously implemented. Revised procedures promulgated in 2003 should assist in this regard, but the key performance issue will be the timely and effective implementation of these procedures.
36. The audit also identified inaccuracies in DOTARS' reporting on its performance in managing the Airport Leases and Sale Agreements.⁸

Recommendations and agency response

37. ANAO made nine recommendations concerning DOTARS' management of post-sale contractual obligations. DOTARS agreed with six recommendations and agreed with qualification to the remainder.

38. DOTARS' full response to the section 19 proposed audit report can be found at Appendix 1. The following was DOTARS' summary response.

The Performance Audit has provided the Department with an opportunity to review its administrative policies and practices in relation to the oversight of Lease and Development Obligations. The views and recommendations contained in the Report are being seriously considered by the Department as part of its commitment to continuous improvement in the oversight of and reporting on the performance of the Federal airport lessees. Nevertheless, whilst agreeing with all the specific recommendations made by ANAO, the Department has difficulty in accepting some of the analysis undertaken by ANAO in developing their conclusions.

The Department's approach to the oversight of the airports' Lease and Development Commitments obligations has consistently reflected the Government's policy objectives as articulated in the *Airports Act 1996* and the use of the available resources. In particular, the Department firmly believes that it has achieved the prescribed policy outcomes envisaged by the Sale Agreements through the totality of its regulatory, contractual and operational oversight processes and the appropriate allocation of resources to risk.

⁸ ANAO Audit Report No.11 2003–04, *Annual Performance Reporting*, Canberra, November 2003, examined performance reporting by five agencies, not including DOTARS. The focus of the audit was to identify whether the selected agencies' annual reports demonstrated the overall characteristics required to make annual reports appropriate instruments of accountability. In addition, in conjunction with the Department of Finance and Administration (Finance), ANAO published in April 2004 a Better Practice Guide on annual reporting.

The Department considers that the conclusions reached by the ANAO in this Audit do not adequately recognise either its wide-ranging oversight responsibilities in relation to lease management, or the substantial achievements of the airports themselves. The Department believes that this has resulted not only in a skewed assessment of the Department's lease oversight performance but also in insufficient regard being paid to the broad-ranging commercial and risk management systems implemented by the Department since privatisation of the Federal airports.

The audit review does not fully recognise the strategic policy basis under which the 22 Federal airports have been privatised. The Australian Government has achieved a significant aggregate revenue outcome (\$8.5 billion) through the various Federal airport sales between July 1997 and December 2003. In return the Australian Government's contractual oversight framework provided by the airport leases clearly recognised that the privatised airports were to operate as closely as possible to freehold, in a business sense, for the 99 years of their leases. All airports have not only survived the transition from public to private sector ownership but have done so in a highly testing economic and aviation industry environment. In addition in aggregate terms they have delivered substantial new development well above that required under the terms of the Sale Agreements, representing capital expenditure (aeronautical and non-aeronautical) across the capital city airports since privatisation (excluding Sydney Airport) in the order of \$570 million. Such capital investment has resulted in a significant increase in the value of the Australian Government's asset and reflects the success of the privatisation program.

It is also the Department's view that the conclusions reached in the Report insufficiently recognise the contractual nature of the lease and sale agreements that require, by their very nature, a degree of 'reasonableness' from both parties in their application. Nor is adequate account taken of the economic challenges faced by the airports arising from the commencement of the airports' privatisation process and in particular the collapse of Ansett and the repercussions arising from the September 11 events. More specific comments about individual issues raised in the Report, such as Insurance and Development Obligations, are addressed in the Department's detailed response.

Recommendations

Recommendation

No.1

Para 2.23

ANAO *recommends* that DOTARS assure itself that the required insurance policies are in place at privatised Federal airports by:

- (a) adopting contracting procedures that provide the Department with ongoing access to expert, independent advice on lessees' insurance policies; and
- (b) promptly resolving any uncertainty where it is not clear that the required insurance is in place.

DOTARS response: Agreed.

Recommendation

No.2

Para 2.42

ANAO *recommends* that DOTARS record the letters of comfort issued in relation to airport sub-lessees on the Department's Register of Contingencies and implement appropriate safe custody arrangements for the instruments.

DOTARS response: Agreed.

Recommendation

No.3

Para 2.52

ANAO *recommends* that, consistent with the Commonwealth's cost recovery policy for regulatory agencies, DOTARS implement a rigorous system for quantifying the reasonable costs of its administration of the 22 Federal Airport Leases, in order to:

- (a) identify the amount of resources required to administer the contracts entered into at the time of the various sales; and
- (b) consider the merits of exercising the Commonwealth's contractual rights to recover from lessees the Department's lease administration costs.

DOTARS response: Agreed.

**Recommendation
No.4
Para 2.60**

ANAO *recommends* that DOTARS improve its management of the Airport Leases by developing and implementing reliable systems for the scheduling and conducting of annual lease review meetings, and reporting on its performance in conducting these reviews.

DOTARS response: Agreed with qualification.

**Recommendation
No.5
Para 2.66**

ANAO *recommends* that DOTARS enhance its conduct of lease review meetings by, at the conclusion of each review:

- (a) documenting review outcomes, including the Department's assessment of the degree to which the lessee complies with the sale documentation requirements; and
- (b) providing a written response to the lessee specifying outstanding issues that are to be addressed.

DOTARS response: Agreed.

**Recommendation
No.6
Para 3.32**

ANAO *recommends* that DOTARS include in future Annual Reports comprehensive and accurate performance information on the timeliness and completeness of receipt of expenditure plans and audited reports on Development Commitment expenditure from relevant airport lessees.

DOTARS response: Agreed with qualification.

**Recommendation
No.7
Para 3.41**

ANAO *recommends* that DOTARS more closely analyse annual expenditure reports when they are provided in order to promptly advise lessees of any items that the Commonwealth would not accept as expenditure towards the Development Commitment obligations.

DOTARS response: Agreed.

Recommendation**No.8****Para 3.47**

ANAO *recommends* that, having regard to the delays that occurred for Period One, DOTARS expedite the finalisation of Period Two Development Commitment outcomes, currently due in 2007 and 2008, by taking early administrative action to obtain, analyse and assess financial reports prepared by Approved Auditors.

DOTARS response: Agreed.

Recommendation**No.9****Para 3.56**

ANAO *recommends* that DOTARS report achievement against the Period One Development Commitment for each airport in its next Annual Report.

DOTARS response: Agreed with qualification.

Audit Findings and Conclusions

1. Introduction

This chapter outlines the background of the sale of Federal airports, summarises the major sale documentation and explains the audit approach.

Background

1.1 A program to privatise 22 Federal airports was completed in December 2003. In aggregate, the airports privatisation program raised sale proceeds of \$8.5 billion. The sales involved the granting of leases over each of the airport sites, which remain Commonwealth-owned. All but one of the leases is for an initial term of 50 years, with the lessee having the option to extend for a further 49 years.⁹

1.2 The Commonwealth's ongoing interests in the operation and management of the Federal airports are governed by the *Airports Act 1996* (Airports Act) and its regulations, as well as by the sale documentation. In this context, the major sale documentation comprised:

- an Airport Lease between the Commonwealth and an airport lessee company. The Airport Lease sets out the terms on which the Commonwealth agreed to grant a lease of the airport site. The Lease was drafted to contain only those terms that were considered essential to protect the Commonwealth's interests as landlord; the intention being to grant the lessees rights that as far as possible equated with freehold;
- a Sale Agreement between the Commonwealth and the lessee and its parent entities. The Sale Agreements were the core documents by which the Commonwealth agreed to grant the Airport Lease and transfer all of the relevant assets, contractual rights and obligations, liabilities and employees for each airport to the successful bidders; and
- a tripartite security deed (tripartite deed) between the Commonwealth, the lessee and the lessee's financiers for each of the core regulated airports.¹⁰ The tripartite deeds vary the terms of the Airport Lease to provide the financiers with step-in and cure rights should a termination

⁹ Hoxton Park was sold with a shortened five-year Airport Lease, after which time it is to revert to freehold title. The five-year lease can be extended a further two years upon agreement between the Commonwealth and the lessee.

¹⁰ The Airports Act established the regulatory regime for the major Federal airports, defined in the Act as core regulated airports. The Act also allows for the regulatory regime, or parts of it, to apply to the non-core regulated airports. There are thirteen core regulated airports specified in the Act, being Brisbane, Melbourne, Perth, Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville, Sydney (Kingsford Smith) and Sydney West (which does not, at this point in time, exist).

event occur under the lease.¹¹ They were intended to address the concerns of lenders that lease termination would mean that their borrower's main asset and, thus, a substantial part of the lenders' security value, could be lost without the lenders having an opportunity to rectify the problem prior to termination.

1.3 The documentation for each sale placed a number of significant ongoing contractual obligations on the lessee. The Department of Transport and Regional Services (DOTARS) administers these obligations on behalf of the Commonwealth. The administration of these obligations is the subject of this audit.¹²

Airports privatisation program

1.4 The airports privatisation program began in April 1994, when the then Government announced its in-principle decision to sell the 22 airports owned and operated at that time by the Federal Airports Corporation. Legislation to facilitate the sales was passed in 1996. The *Airports Transitional Act 1996* (Transitional Act) provided for the leasehold sale of the Federal airports, whereas the Airports Act established the framework for the regulation of leased Federal airports.

1.5 The then Government announced in April 1995 its intention to sell all 22 Federal airports by way of individual trade sales. The first tranche (Phase 1) was to be completed by December 1996. Following the March 1996 Federal election, the new Government announced a revised timetable, with completion planned by June 1997. Phase 1 of the airports privatisation program was completed by 1 July 1997 with the sale of separate long-term leases over Brisbane, Melbourne and Perth airports. The Australian National Audit Office (ANAO) reported on those sales in Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. In total, Phase 1 raised proceeds of \$3.31 billion, with the direct costs of the sale estimated to be \$153 million, or 4.6 per cent of proceeds.

1.6 On 12 June 1997, the Government announced the commencement of Phase 2 of the airports privatisation program. Phase 2 comprised eight major, or core regulated, airports and six non-core regulated airports. Between 10 and 30 June 1998, long-term leases were granted over the 14 Phase 2 airports to

¹¹ The Tripartite Deeds do not, however, provide any rights in relation to a termination of the lease which may occur under Section 15 of the Airports Act. Section 15 provides that the lease terminates if the lessee ceases to be a qualified company being one that: is a constitutional corporation; is incorporated, or taken to be incorporated, under the *Corporations Act 2001*; and has a share capital.

¹² Post-sale contract management related to Essendon Airport, Sydney (Kingsford Smith) Airport and the three Sydney basin airports (Bankstown, Camden and Hoxton Park) was excluded from the audit scope as these are relatively recent sales.

nine different consortia, raising proceeds of \$730 million for the Commonwealth. The total direct sale costs to the Commonwealth were estimated to be \$35.4 million, or 4.8 per cent of proceeds. The Phase 2 sales were reported on in ANAO Audit Report No.48 1998–99, *Phase 2 of the Sales of the Federal Airports*.

1.7 Essendon Airport, a non-core regulated airport, was originally included in Phase 2 but was withdrawn from sale in April 1998 because it was concluded that the tenders received at that time did not adequately address the Government's sales and ongoing privatisation objectives. Subsequently, a separate tender process for the sale of Essendon Airport was conducted in 2001. The sale of Essendon airport for a price of \$22 million was announced on 10 August 2001.¹³ That sale has not been audited by ANAO.

1.8 The sale of Sydney (Kingsford Smith) Airport was completed on 28 June 2002. The purchase price paid was \$4.233 billion. Direct sale costs for the sale of Sydney were \$32.36 million, or less than one per cent of gross proceeds. The successful bidder acquired all the shares in Sydney Airports Corporation Limited (SACL), the company that holds the long-term lease¹⁴ over the airport site. The Sale Agreement also granted the purchaser a 30 year right of first refusal over the development and operation of a second Sydney airport, if the Government of the day decides it is needed. This sale was reported on in ANAO Audit Report No.43 2002–03, *The Sale of Sydney (Kingsford Smith) Airport*.

1.9 The airports privatisation program was completed on 15 December 2003 with the sale of the remaining Sydney Basin Airports (Bankstown, Camden and Hoxton Park) for a price of \$211 million.¹⁵ That sale has not been audited by ANAO.

1.10 Since the commencement of the airports privatisation process, significant changes have occurred in the aviation environment. This has included successive aviation industry shocks caused by the Asian economic crisis of 1998–99, the events of September 11 2001, the collapse of Ansett on 12 September 2001, the October 2002 Bali bombing, the SARS pandemic during 2002–03, and the Iraqi war. In this environment, the transition from public to private sector management has been successfully completed for all airports.

¹³ The Hon. John Fahey MP, Minister for Finance and Administration and The Hon. John Anderson MP, Minister for Transport and Regional Services, Media Statement, *Sale of Essendon Airport*, 10 August 2001.

¹⁴ The lease commenced on 1 July 1998 for a term of 50 years, with the lessee having the option to renew the lease for a further term of 49 years.

¹⁵ Senator Nick Minchin, Minister for Finance and Administration, Media Release, *Sydney Basin Airports Sale Completed*, 16 December 2003.

Role of the Department of Transport and Regional Services

1.11 DOTARS is the Commonwealth agency responsible for administering the Airport Leases and managing the lessees' compliance with their obligations as specified in the leases and other sale documentation. Within a strategic objective of achieving transport systems that are sustainable and accessible, DOTARS has a key strategy to 'encourage operation of airports for which the portfolio has responsibility in a way that balances commercial and public interests.'¹⁶

1.12 The Airport Planning and Regulation Branch within DOTARS is responsible for managing the Airport Leases and administering the Airports Act regulatory regime. The Branch's stated objective is to protect the interests of airport users and the general public, while promoting the efficient economic development and operation of airports. The Branch is responsible for:¹⁷

- development of policies and legislation that protect community and consumer interests in the operation of airports and air transport services;
- continued development and implementation of a Commonwealth environment and building control regulatory regime for leased Federal airports which achieves an appropriate balance between the public interest and private sector objectives;
- provision of analysis and advice to the government on the requirements of the Airports Act, in particular as they relate to airport Environment Strategies and Major Development Plans at the privatised Federal airports;
- working with stakeholders in administering the requirements of the Air Navigation Regulations and the Airports Act and Regulations and in minimising the adverse effects of aircraft operations;
- ongoing oversight and enforcement of Airport Environment Officer (AEO) and Airport Building Controller (ABC) decisions;
- full implementation of aircraft movement scheduling ('slot management') at Sydney Airport;
- the protection of airspace at leased Federal airports;

¹⁶ DOTARS, *Annual Report 2002–03*, pp.63–64.

¹⁷ DOTARS website 'About Airport Planning & Regulation Branch'
<http://www.dotars.gov.au/transreg/apr_index.htm>

- administration of the liquor licensing regime at Sydney, Bankstown, Hoxton Park and Camden Airports;
- the Parking Infringement Notice Regime at some leased Federal airports;
- ownership and control issues at leased Federal airports;
- administration of the Commonwealth's interests and provision of policy advice on the wind-down of the FAC and on local and regional aerodromes; and
- oversight of leases at leased Federal Airports.

1.13 DOTARS reported on its performance in monitoring the leased Federal airports' compliance with contractual obligations under the sale documentation in its 2002–03 Annual Report. DOTARS stated that it had:

Conducted comprehensive lease review meetings with all major airport lessee companies, except for the Sydney Basin Airports. Through those meetings, the department was able to ascertain that the airport lessee companies were compliant with all sale agreement and lease obligations.¹⁸

Audit approach

1.14 The audit was conducted under Section 15 of the *Auditor-General Act 1997*. The objectives of the audit were to assess whether DOTARS has developed and implemented an appropriate framework and procedures to administer lessee obligations entered into as part of the 1997 and 1998 leasehold sales of 17 Federal airports. In particular, the audit sought to:

- review DOTARS' monitoring of lessee compliance with the Airport Leases and supporting sale documentation;
- examine the effectiveness of the framework and procedures developed by DOTARS to administer lessee development commitments; and
- assess the impact of changes in the aviation environment on the management and monitoring of lessee obligations.

1.15 The scope of the audit involved examining the Department's management of lessees' development obligations under the sale documentation and its management of lessee compliance with other contractual obligations. As part of the current audit process, ANAO provided airport lessees with an opportunity to express any views they may have on matters relating to the audit. A number of lessees provided comments, which

¹⁸ DOTARS, *Annual Report 2002–03*, p.65.

have been taken into account in conducting the audit and preparing this report.

1.16 A follow-up of relevant recommendations from the ANAO's audit of the 1997 Phase 1 sales was also conducted as part of this current audit. Those recommendations, each of which was agreed or agreed with qualification by DOTARS, were that:

- DOTARS develop a comprehensive framework and procedures to monitor and ensure lessee compliance with the airport leases (Recommendation No.8);
- the Office of Asset Sales and IT Outsourcing, in consultation with DOTARS:
 - for future airport sales, develop an agreed framework for the post-sale disposition of sale documentation including providing for appropriate safe custody arrangements for the original signed sale documentation in an appropriate legal form for the duration of the lease term, and placing, in the records of each agency, a full set of copies of the signed sale documentation; and
 - establish appropriate safe custody arrangements for the original signed sale documentation relating to the Phase 1 airport sales, in an appropriate legal form, for the duration of the lease term (Recommendation No.9); and
- DOTARS develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the Airports Act and airport leases (Recommendation No.10).

1.17 The audit scope did not include administration of the airports regulatory framework under the Airports Act. In addition, post-sale contract management relating to Essendon Airport, Sydney (Kingsford Smith) Airport and the three Sydney basin airports (Bankstown, Camden and Hoxton Park) was excluded from the audit scope as these are relatively recent sales.

1.18 Audit fieldwork was conducted between July 2003 and January 2004. Issues papers were provided to DOTARS in January and February 2004. A draft report was also provided in March 2004.

1.19 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of \$297 000.

2. Lease Management

This chapter examines administration of the Airport Leases and related sale documentation including the management and reporting of ongoing Commonwealth risk exposures, cost recovery arrangements and the conduct of annual lease reviews with individual airports.

Airport Leases

2.1 The airports privatisation program involved leasehold, rather than freehold, sales. Accordingly, the Commonwealth retains a continuing risk of liability as landlord and owner. It has also accepted a level of ongoing involvement in airport operations because of the need to administer the Airport Leases and related sale documentation.

2.2 All 22 Airport Leases were granted under Section 22 of the Transitional Act.¹⁹ The Airport Lease was originally developed as part of the Phase 1 sales, with the leases used in subsequent sales being modelled on the Phase 1 documents. Table 2.1 outlines the commencement date of the Airport Leases examined as part of this performance audit. All leases are for a term of 50 years plus an option for the lessee to extend for a further 49 years. The airport sites revert to the Commonwealth at the end of the respective leases.

Table 2.1

Federal Airport Leases: Grant Time

Airports	Grant Time
Brisbane, Melbourne and Perth	2 July 1997
Adelaide, Parafield, Canberra, Launceston, Coolangatta	29 May 1998
Alice Springs, Darwin, Tennant Creek, Hobart, Townsville, Mount Isa	11 June 1998
Archerfield, Moorabin	19 June 1998
Jandakot	1 July 1998

Source: ANAO analysis of Airport Leases

2.3 To manage the Commonwealth's ongoing risks under the sale documentation, ANAO's 1998 Audit Report found that it was important that arrangements be made for the ongoing storage and safe custody of this important documentation in an appropriate legal form. Consistent with Recommendation No.9 from ANAO's audit of the Phase 1 sales, the Office of the Australian Government Solicitor (AGS) was to hold the originals of the leases and other sale documentation, with copies being held by DOTARS for

¹⁹ *Airports Transitional Act 1996.*

administrative purposes. In April 2004, AGS advised ANAO that, in relation to the Phase 1 and Phase 2 airports, it holds the following:

- all original Sale Agreements;
- all original Tripartite Deeds;
- Certificates of Title where issued²⁰ except for Jandakot, where it has for some time been in the process of obtaining a replacement Certificate; and
- original Airport Leases for all airports except:
 - at Moorabbin, Hobart and Townsville, where it holds a copy with the original initials on the front; and
 - at Brisbane, where it holds no airport lease and appears never to have done so.

Insurances

2.4 In privatising the operation of the airports, the intention was that the leases be as close as possible to freehold arrangements. Accordingly, the leases contain only those terms which the Airports Act requires be included,²¹ and those that were considered essential to protect the Commonwealth's interests as landlord.

2.5 At the time the leases were originally developed during the Phase 1 sales, the Commonwealth's main interests as landlord were identified. These were considered to be primarily to protect the Commonwealth against claims made against it as landlord, and to ensure the Commonwealth receives the airport site back in good repair at the end of the lease. The leases address these issues as follows:

- to protect the Commonwealth from claims made against it as landlord, there are comprehensive indemnity provisions in the leases, as well as an obligation on the lessee to take out comprehensive insurance in all areas where it or the Commonwealth may be at risk and to name the Commonwealth as co-insured; and

²⁰ AGS further advised that Queensland does not issue Certificates of Title and the one for Canberra has been cancelled and a computer one has been issued instead.

²¹ The Airports Act states that airport leases are subject to five key rules. These are that: there must be a single lessee; the lessee must be a qualified company; the term of the lease must not be longer than 50 years (with or without an option to renew for up to 49 years); the lease must provide for the use of the site as an airport, or for the use of the leased area for purposes in connection with the airport; and the lease must provide for access by interstate and/or international air transport. The Act also includes an obligation that a lessee may not acquire more than one airport site.

- to ensure the Commonwealth receives the airport site back at the end of each lease in good repair, the leases provide that the respective lessees must insure the structures on the airport site and use the proceeds of any insurance to rebuild any damaged or destroyed building, unless the Commonwealth agrees otherwise. The leases also provide that the respective lessees have an obligation to give back the airport lease in good repair, as well as to develop the airport during the term of the lease.

2.6 Adequate insurance cover for the privatised airports is relevant to the Commonwealth for a number of financial and other (public interest) reasons. It is important that insurances are in place to protect the Commonwealth against claims made against it as landlord and owner, and to ensure that damaged or destroyed airport property is replaced or rebuilt. Appropriate insurance cover is also important for the Commonwealth to have confidence in the financial viability of lessees. Furthermore, in the event of failure of an operator, insurance arrangements need to continue in order to protect the Commonwealth if it steps in to operate the airport.

2.7 The sale documentation puts extensive insurance obligations on the lessees. For example, lessees are obliged to maintain policies to cover: loss, damage to, or destruction of structures, plant, machinery and other property on the airport site; consequent loss of revenues and/or increased working costs; and legal liability for claims made by third parties for injury or death or damage or destruction of property arising out of the lessee's use of the airport site or its operations. Insurance policies must also be structured to give effect to the comprehensive indemnities by the lessee to the Commonwealth specified in the Airport Lease.

2.8 In addition, the insurers, the policies, and any changes to the policies, are subject to ongoing approval by the Commonwealth. The lessees are obliged to effect further policies of insurance in substitution for policies already in effect, or new policies, to cover the same or additional risks, as requested by the Commonwealth. The Commonwealth may also, acting reasonably, request additional insurance be taken out.

2.9 Effective administration of the insurance clauses involves a number of responsibilities for DOTARS. These include:

- obtaining from lessees duplicate or certified copies of all policies so as to satisfy itself that policies are in full force and effect;
- approving the terms and conditions of each insurance policy;

- approving the insurance companies and insurance brokers used by lessees to obtain insurance cover²²;
- approving material changes to insurance policy terms;
- where required, confirming that lessees obtain revaluations of structures every three years, to ensure that structures are fully insured; and
- confirming that all insurance proceeds paid out for the damage or destruction of any structures were used for the re-building or re-instatement of those structures, or the building of other structures as the Commonwealth approves.

2.10 During the Phase 1 and Phase 2 sales processes, consultants were engaged to advise on whether the insurance taken out by the lessees at the commencement of the leases were in accordance with the Commonwealth's requirements. After the Phase 2 sales, DOTARS entered into a contract with the same firm for the conduct of annual assessments of lessee insurance policies. This firm was selected, without a competitive tender, for the following reasons:

- a tender was conducted in March 1998 as part of the Phase 2 sales process;
- as a result of undertaking the Phase 2 work, the firm gained a very good knowledge of the complex Commonwealth requirements and lessee obligations in relation to insurance; and
- the firm had no conflict of interest in the provision of consulting services. This factor was noted as contributing to their selection during the sales process, because the majority of other firms in the industry were actively involved in providing services to lessees and, therefore, had potential conflict of interest issues.

2.11 The contract was signed on 30 November 1998. Another firm acquired the contracted firm in late 1998, with the contract being novated to the acquiring firm in October 1999. The contract involved a fee of \$24 000 payable in three instalments over the three year duration of the contract.

2.12 The original contractual arrangements ended on 30 November 2001. DOTARS initially proposed to extend the consultancy services. However,

²² Approval of insurers may be withdrawn where DOTARS considers the financial stability or capability of the insurer changes materially from what it was at the time the insurer was approved.

concerns about emerging conflicts of interest²³ and the time that had elapsed since the original contract had been let resulted in DOTARS undertaking a tender process to appoint an insurance adviser. This process commenced in June 2002.

2.13 A new contract for an adviser to monitor airport lessees' compliance with their insurance obligations to the Commonwealth was signed on 10 September 2002. Accordingly, there was a nine-month period between December 2001 and September 2002 during which DOTARS did not have contractual arrangements in place to obtain expert, independent advice on lessees' insurance policies. In March 2004, DOTARS advised ANAO that the delay reflected that the Department initially proposed to extend the contract and that, following the September 11 event, it was necessary for the insurance industry to settle down before tenders could realistically be called for. DOTARS' response to the draft of this performance audit report (see Appendix 1) includes further discussion on the effect of the instability of the insurance industry on the tender process.

2.14 The insurance market was significantly affected by the events of 11 September 2001 in the United States of America. This led to significant increases in the cost of many types of aviation-related insurance, as well as difficulties in availability of some types of insurance. In this context, a number of airports approached DOTARS requesting permission to exclude cover for war and terrorism from their first party industrial special risk insurance.²⁴ Where airports did not contact DOTARS, the Department was unaware of the status of the relevant airports' insurance status, including in relation to the impacts of war and terrorism.

2.15 In October 2002, DOTARS wrote to those airports that had not contacted the Department seeking lessee advice on the current status of first party industrial special risk insurance, including coverage in relation to war and terrorism risks. This process revealed that a number of airports did not hold appropriate insurance cover for war or terrorism risk. On this issue, DOTARS advised ANAO in April 2004 as follows:

²³ The original contract stated: *'If during the performance of the Consultancy Services a conflict of interest arises, or appears to have arisen, the Consultant agrees to: (a) notify the Commonwealth immediately in writing; (b) make full disclosure of all relevant information relating to the conflict; and (c) take such steps as the Commonwealth may reasonably require to resolve or otherwise deal with the conflict...'* The contracted advisor informed DOTARS in July 2001 that it was providing insurance broking and risk management advice to a number of privatised airports.

²⁴ From mid-September 2001, DOTARS managed the provision of Commonwealth indemnities to Australian airlines, airports and aviation service providers that were unable to obtain sufficient third party war and terrorism risk insurance. As of 30 June 2002, DOTARS reported that it held 28 Deed Polls of Indemnity valued at \$27.2 billion. With the return of insurance cover to the aviation industry, by 30 June 2003 DOTARS reported that only one carrier (and no airports) remained indemnified, to the value of \$US1 billion.

The Department had a good understanding of the broader insurance situation applying at that time to the Federal leased airports. The Department played a key role in developing and implementing arrangements to provide an indemnity scheme for third party war and terrorism damage, including entering into Commonwealth Aviation Liability Indemnity Deeds arrangements with 15 of the Federal leased airports.

The provision of first party terrorism insurance was a major issue for those airport lessee companies who were seeking to renew their policies following September 11. With some airports having only just renewed their first party insurance policies prior to September 11, the Department anticipated that it could take up to 12 months before all airports would have to deal with renewal of their policies. For this reason it was not until October 2002 that the Department made formal approaches to those airports who had not yet advised the Department about their first party industrial special risk insurance arrangements.

It is also important to note that the Australian Government's Terrorism Risk Insurance Scheme as established by the *Terrorism Insurance Act* and the *Terrorism Insurance Regulations 2003* came into effect from 1 July 2003. This scheme put in place short-term arrangements directed at alleviating problems faced by commercial property owners, including for the Federal leased airports, who were unable to obtain terrorist risk insurance.

The Department's existing contract with a business insurance adviser enables the Department to obtain the necessary expert advice to ensure that the current status of insurance policies held by all the Federal leased airports is consistent with their lease obligations. In this regard, the Department has reviewed all insurance reports provided in 2003 and written to all airports where the insurance contractor's audit reports have indicated that action is warranted. This follow up action is ongoing and the 2004 insurance audit is expected to commence shortly.

Adviser review of lessee insurances

2.16 The September 2002 contract requires the insurance adviser to undertake inquiries with the lessees and prepare reports dealing with each of the airports in respect of:

- whether insurance policies comply with the requirements of the sale documentation, including advice on the suitability of proposed insurers;
- the suitability of the insurance policies generally, including the identification of any matters that may be prejudicial to the interests of the Commonwealth;
- any amendments, and the form of such amendments, that would be required to lessee insurance policies in the event the Commonwealth has to take over the operation of the airports; and

- the form of evidence to be supplied to the Commonwealth by the lessees to show that the insurance policies specified in the sale documentation have been renewed as required.

2.17 The adviser is also contracted to provide information on wider aviation insurance issues and general developments/trends in the broader insurance industry. The total fee cap for the consultancy specified in the contract is \$214 500 over the three year term of the contract.²⁵

2.18 As of February 2004, in the seventeen months that the contract had been in place, the adviser had provided DOTARS with reports on the insurance policies in place at all privatised airports.²⁶ The contract with the insurance adviser does not specify the frequency with which insurance arrangements at each airport are to be examined. However, fees are calculated on a per-airport basis and the contract fee arrangements include fee caps that permit each airport to be examined each year. This reflects the original intention that insurance reviews be conducted annually.

2.19 Most of the reports have been qualified on the grounds that the airports had not provided all necessary information to DOTARS' insurance adviser. In addition, for a number of the airports, the adviser concluded that certain insurances were either not in place as required, or there were deficiencies in the insurance policies that had been put in place.

2.20 In March 2004, DOTARS advised ANAO that it raises outstanding matters (such as insurance) with airport operators at lease review meetings and in tailored follow-up letters. Furthermore, in April 2004 when responding to a draft of this performance audit report, DOTARS advised ANAO that the Department had responded to the reports by writing to all relevant airport operators about insurance matters raised by the insurance contractor. However, this view is not reflected in correspondence to ANAO from some of the lessees. In April 2004, also in response to the draft audit report, the following observations are relevant:

- For one airport where DOTARS' insurance adviser concluded that certain information had not been provided, the lessee advised the

²⁵ DOTARS' 2002–03 Annual Report stated (p.228) that the contract price for the consultancy was \$100 000. In terms of the different figures, DOTARS advised ANAO in March 2004 that the figures are not considered inconsistent because the amount quoted in the Annual Report relates only to the amount to be paid to the consultant for 2002–03, not the total value of the contract over the three year term. However, the *Requirements for Annual Reports for Departments, Executive Agencies and FMA Act Bodies* approved by the Joint Committee of Public Accounts and Audit under subsections 63(2) and 70(2) of the *Public Service Act 1999* requires (p.25) the contract price to be disclosed including, where applicable, the total fixed price for the consultancy agreement.

²⁶ The first report was provided in October 2002, in relation to Sydney (Kingsford Smith) Airport. The next report was provided in December 2002, in relation to Adelaide and Parafield airports. Reports on a further 18 airports were provided between May and August 2003.

ANAO that it was unable to ascertain what information was missing as at no time had the lessee been approached by DOTARS to furnish additional information. In April 2004, DOTARS advised ANAO that it had met with this lessee in February 2004 and that, in March 2004, the airport had provided all requested documents.

- Another lessee advised ANAO that it has maintained the required insurances at all times including war and terrorism cover (other than the period during which the Commonwealth indemnity arrangement applied and during 2002 when some cover was not available) and that it has annual meetings with DOTARS to go over the insurance arrangements to ensure that they are in order. However, DOTARS' insurance adviser concluded that certain information had not been provided and that the Industrial Special Risks and Terrorism Property Damage insurance policies of this lessee did not comply with the Sale Agreement and Lease requirements because the Commonwealth was not named as an insured. ANAO noted that DOTARS did not write to the lessee providing feedback on the insurance review until March 2004.
- A third lessee also advised ANAO that it had met its insurance obligations to the Commonwealth. However, DOTARS' insurance adviser identified a number of non-compliances with the contractual requirements for some policies including that the Commonwealth was not named as an insured and that they did not provide for the possibility of the Commonwealth resuming possession of the Airport site under the provisions of the Airport Lease. Feedback to this lessee on its first insurance review was not provided by DOTARS until February 2004.

2.21 In responding to the draft of this performance audit report, DOTARS provided ANAO with copies of its correspondence with airports on the results of the first round of insurance reviews. This documentation evidenced that the Department has reviewed all insurance reports completed between December 2002 and August 2003 and has contacted each airport to provide feedback on the results and seek a response to issues that were identified. However, as outlined in Table 2.2, DOTARS did not formally raise matters arising from the first series of insurance reviews with the airport lessees until at least two months, and up to 14 months, after the reports were completed. Some issues still remain unresolved.

Table 2.2**DOTARS Follow-up of Insurance Adviser Reports**

Airport	Date of Insurance Adviser Report	Date of Transport Follow-up	Delay (Months)
Adelaide & Parafield	December 2002	26 February 2004	14
Perth	May 2003	15 April 2004	11
Brisbane	June 2003	27 February 2004	8
Darwin, Alice Springs & Tennant Creek	June 2003	15 April 2004	10
Melbourne & Launceston	July 2003	29 March 2004	8
Archerfield	August 2003	31 March 2004	7
Moorabbin	August 2003	23 December 2003	4
Townsville & Mount Isa	August 2003	26 February 2004	6
Canberra	August 2003	27 February 2004	6
Hobart	August 2003	11 March 2004	7
Coolangatta	August 2003	16 March 2004	7
Jandakot	January 2004	5 April 2004	2

Source: ANAO analysis of DOTARS information.

2.22 The contract ends on 30 June 2005, with DOTARS having the option of two one-year extensions. Having regard to the importance to the Commonwealth of appropriate levels of insurance coverage at the airports, DOTARS need to have procedures in place for a timely appraisal of the merits of exercising the extension options, as required by the Commonwealth Procurement Guidelines.²⁷ In addition, in advance of the earliest potential expiry of the contract, which will occur on 30 June 2005, DOTARS should take steps to secure continuing advice on the adequacy of airport lessee insurances. In March 2004, DOTARS advised ANAO that it considers the appropriate time to review the contract will be in December 2004, following receipt of the 2003–04 reports.

²⁷ Procurement Circular PC 03/3, *Evaluating Options in Procurement Contracts*, Department of Finance and Administration, 13 October 2003.

Recommendation No.1

2.23 ANAO *recommends* that DOTARS assure itself that the required insurance policies are in place at privatised Federal airports by:

- (a) adopting contracting procedures that provide the Department with ongoing access to expert, independent advice on lessees' insurance policies; and
- (b) promptly resolving any uncertainty where it is not clear that the required insurance is in place.

DOTARS response

2.24 DOTARS agreed with the recommendation and commented as follows:

The Department considers that its current contracting procedures, that is a three year contract which commenced in September 2002 with an option to renew for further two years, provides it with "ongoing access to expert, independent advice on lessees' insurance policies". The Department's planned review of the current contract six months prior to the renewal option date will enable the Department to assess as part of this process the incumbent contractor's 2004 annual insurance audit reports.

Contingencies

Tripartite deeds

2.25 The tripartite deed document was developed late in 1997, during the Phase 1 sales process. The document was prepared to address the concerns of financiers to the bidders for each of the major airports.²⁸ In the absence of such a document, the financiers considered that they could lose all of their debt funds if a termination event occurred and the Commonwealth cancelled the Airport Lease (over which they had taken security). Tripartite deeds are in place for each of the 12 core regulated airports.

2.26 There are only two events in the long-term Airport Leases that can result in the lease being cancelled:

- the failure of the airport operator to use the airport as an airport by denying access to air transport; and
- a situation where the Civil Aviation Safety Authority (CASA) withdraws the airport operator's aerodrome licence.

²⁸ DOTARS has advised ANAO that the same level of Commonwealth policy interest was not identified in relation to the smaller airports.

2.27 Should a termination event occur, the tripartite deed provides for the Commonwealth to step-in in order to attempt to rectify the problem that led to the potential closure of a core regulated airport. The deed provides for a 28-day period in which the Commonwealth can rectify the problem with the aim of keeping the airport open. In addition to the Commonwealth, the financiers can also rectify the situation.

2.28 If rectification is not possible, the contingent liability to the financiers will need to be addressed. The Commonwealth will do this by either on selling the Airport Lease or obtaining a valuation for the airport site to realise the asset. However, the airport's financiers have limited ability to recover their loans from the funds realised via the above two options because the financiers rank fifth in line as a creditor. The Commonwealth ranks as the first creditor. DOTARS advised ANAO in March 2004 that, in this sense, the tripartite deeds may, in preference to other contractual arrangements, yield benefits to the Commonwealth by confirming the position of the Commonwealth as first creditor.

2.29 At the time of the sale of the leases the Commonwealth rejected, as a matter of policy, that it had a responsibility to provide guarantees to minimise the risks associated with lending for the purposes of private sector investment. Nevertheless, it was acknowledged that the sale of the leases for large up-front premiums presented financiers with a new form of investment with new risk management challenges.

2.30 The deeds terminate not more than 20 years after the deed has been entered into. In particular, they terminate automatically on the earlier to occur of three events:

- twenty years after the date of the deed²⁹;
- the date the lessee first becomes entitled to discharge the loan securities specified in the deed; and
- the date the loan securities specified in the deed are discharged.

Size of the Commonwealth's exposure

2.31 The loan security is in respect of secured moneys as defined in the respective tripartite deeds.³⁰ The secured moneys include the financial

²⁹ The Phase 1 deeds were dated 1 July 1997, the Phase 2 deeds were dated the day before each lease commenced (see Table 2.1 above) and the Sydney (Kingsford Smith) Airport deed was signed on 25 June 2002.

³⁰ In July 1997, the then Minister for Finance advised the then Minister for Transport and Regional Development that, in the event the Commonwealth is exposed to a liability under a tripartite security deed, unless funds could be provided from the Budget or Additional Estimates, the appropriate mechanism to cover any immediate requirement for Commonwealth funding would be to call on the Advance to the Minister for Finance, as funding would be both urgent and unforeseen.

accommodation under the facility and other financial accommodation taken out subsequently in relation to the airport. That is, money borrowed to purchase the lease and other financial accommodation that fits within the definition of secured money, which is separately defined in each deed.

2.32 DOTARS has agreed to amendments to a number of tripartite security deeds. Most amendments involved the restructuring of existing debt instruments or replacement of financiers. DOTARS has advised ANAO that only one of these amendments resulted in an increase in exposure, by \$0.9 million in respect of the Commonwealth's liability for Townsville airport. A delegate within DOTARS approved this increase under Financial Management and Accountability Regulation 10.³¹ The Department obtained the Minister for Finance and Administration's written authorisation prior to the Departmental delegate granting his approval to the increase.³²

2.33 The potential liability of the Commonwealth under the tripartite security deeds can vary considerably, depending on whether the Airport Lease is able to be sold on to a third party or not.³³ In March 2004, DOTARS advised ANAO that:

The potential maximum exposure is limited to the value of the lease at the time of termination and this is offset by the return from the on-sale of the lease. In reality, the impact is more one of timing rather than exposure.

2.34 The tripartite security deeds have been disclosed by DOTARS as a remote administered contingent liability in the Department's financial statements, but without the Commonwealth's exposure being quantified.³⁴ During the course of this audit, ANAO canvassed with DOTARS the possibility of quantifying the extent of the Commonwealth's exposure. ANAO raised this possibility having regard to the information sharing arrangements in the deeds enabling the Commonwealth to request advice from financiers on the amount of secured moneys under each deed and details of the nature and calculation of this amount. On this point, DOTARS advised ANAO in March 2004 that:

³¹ Under Regulation 10, where no appropriation exists to support a spending proposal should a liability become payable, the written authorisation of the Finance Minister, or a delegate, is required before the expenditure proposal is approved.

³² In his authorisation, the Minister for Finance and Administration stated that he had reservations about the inclusion of a dividend payment amount in the deed of variation (it was this dividend payment that resulted in the increased Commonwealth exposure). Accordingly, he authorised the Minister for Transport and Regional Services to consider including this amount in the deed on this occasion only, and on the condition that should the liability be realised, this amount would be funded from existing portfolio appropriations.

³³ *Mid-Year Economic and Fiscal Outlook 2001–02*, October 2001, pp. 82 and 83.

³⁴ Similar disclosures are made in the Statement of Risks within the Mid-Year Economic and Fiscal Outlook and Budget Papers and in the Commonwealth's Consolidated Financial Statements.

...to request sensitive information of this nature with its inherent additional administrative burden on the airport without any true value to the Commonwealth cannot be supported.

2.35 Nevertheless, DOTARS advised ANAO that it intends to discuss the treatment of the tripartite deeds as a contingent liability with its financial statement auditors in preparation for settling the Department's 2003–04 audited statements.

Letters of comfort

2.36 A letter of comfort is an instrument that is used to facilitate an action or transaction but is constructed with the intention of not giving rise to legal obligations.³⁵ Commonwealth policy on letters of comfort is that they should be avoided.³⁶ This is because a letter of comfort may lead to an actual liability, even where this is not the intention.³⁷

2.37 In 1998, when granting a letter of comfort relating to a proposed development at Melbourne Airport, DOTARS developed a general administrative policy on the provision of letters of comfort in relation to sub-leases. The policy was that the Commonwealth would be prepared to continue sub-lessee tenure on airport sites for the remainder of the term of sub-leases providing the following three criteria are met:

- the sub-lease continues to have an identifiable and substantial ongoing revenue stream;
- the airport lessee has undertaken to indemnify the sub-lessee or the sub-lessee's financiers if the Airport Lease needs to be terminated; and
- the sub-lease complies with the requirements of the Airports Act and the obligations of the Airport Lease.

2.38 This approach was endorsed by the Minister for Transport and Regional Services in March 1999 and advised to all privatised airports in May 1999.

2.39 Between December 1998 and January 2004, DOTARS issued five letters of comfort in relation to the Commonwealth allowing sub-lessees to remain on the airport site as a lessee in the event of early termination by the Commonwealth of the Airport Lease. In relation to these letters, in March 2004, DOTARS advised ANAO that:

³⁵ *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, Financial Management Guidance No.6, September 2003, p.5.

³⁶ *ibid.*

³⁷ *ibid.*

In the case of DOTARS' letters of general assurance, they are neither intended to be a legally binding contract or agreement nor an arrangement which would give rise to any legal consequences such that public money may become payable because:

- there is no statement of promise in the letters;
- the letters make it clear that it is a general assurance only and is not intended to give rise to any legal obligations and, in any case, there is no consideration; and
- the letters are not given in the course of business.

2.40 ANAO recognises that, in providing the letters of comfort, DOTARS took appropriate steps to avoid a legal liability being created.³⁸ Furthermore, although the documents are referred to as letters of comfort, including in correspondence to the entities that requested the letters, this does not mean that a court will determine that the letters give rise to legally enforceable obligations. Nevertheless, there is always a risk that the letters issued by DOTARS could be found to give rise to a legal obligation.

2.41 In September 2003, the Department of Finance and Administration (Finance) updated its guidance to agencies on issuing and managing indemnities, guarantees, warranties and letters of comfort.³⁹ The updated guidance states that agencies are required to maintain a register of all indemnities, guarantees, warranties and letters of comfort to assist in transparent reporting and disclosure.⁴⁰ However, at the time of this performance audit, there was no evidence of steps being taken by DOTARS to include the five letters of comfort issued in relation to airport sub-leases on a register of contingencies, or of appropriate safe custody arrangements being implemented.

Recommendation No.2

2.42 ANAO *recommends* that DOTARS record the letters of comfort issued in relation to airport sub-lessees on the Department's Register of Contingencies and implement appropriate safe custody arrangements for the instruments.

DOTARS response

2.43 DOTARS agreed with the recommendation and advised that, in April 2004, all letters of comfort issued in relation to airport leases were recorded on

³⁸ These steps included taking legal advice on the form and content of the various letters.

³⁹ Finance Circular No.2003/02, covering the *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*.

⁴⁰ *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, op. cit., p.12.

the Department's Register of Contingencies, and safe custody arrangements for the instruments were put in place.

Cost recovery arrangements

2.44 Recovery of various costs is provided for in the airport sale documentation, as follows:

- under the leases, airport operators pay the Commonwealth's costs of providing an Airport Environment Officer (AEO) at the airport.⁴¹ For 2003–04, DOTARS advised ANAO that total costs recovered under the leases in respect of Airport Environment Officers would be \$1.584 million;
- under the Sale Agreements, for the first five years following the sales, airport operators paid the costs of Airport Building Controllers (ABC).⁴² The ABC costs were only recovered to the extent they are not recovered from fees paid by third parties under the relevant regulations, and were subject to a maximum annual cap; and
- under the leases and tripartite deeds, the Commonwealth's reasonable administration costs can be recovered from the lessees. To date, the provisions relating to the recovery of administrative costs have remained largely unused by DOTARS.

Lease administration costs

2.45 Clauses were included in both the Airport Leases and the related tripartite security deeds to enable DOTARS to recover the reasonable costs of administering the lease and the tripartite security deeds. These clauses were in substantially the same form. Clause 11.2 of the lease provides as follows:

Within 28 days of receiving notice from the Lessor, the Lessee must pay to the Lessor the Lessor's reasonable costs of administering this lease, including all matters relating to the monitoring by the Lessor of the Lessee's compliance with the Lessee's covenants. For the avoidance of doubt, the Lessee's obligation under this sub-clause shall not include any costs arising out of the Lessor performing any functions or powers pursuant to any legislation.

2.46 Clause 11.2 of the lease was drafted to reflect DOTARS' preferred position, enunciated at the time of the Phase 1 sales, to be able to recover from lessees its costs of administering the leases. In March 2004, DOTARS advised

⁴¹ These arrangements do not apply to the two airports that are subject to State/Territory environmental legislation rather than the environmental management part of the Airports Act.

⁴² These arrangements did not apply to the two airports that are subject to State/Territory land use, planning and building control legislation rather than the land use, planning and building control part of the Airports Act.

ANAO that the Department insisted on retaining the power to recover administrative costs to address the risk that Commonwealth involvement in managing the lease was greater than expected and/or that the lease management function was not budget funded.

2.47 ANAO found that DOTARS has not developed and implemented a comprehensive, documented approach to quantifying, and then assessing the merits of recovering, the costs of administering the leases and tripartite security deeds.

2.48 Prior to this current performance audit, DOTARS had not estimated its lease administration costs. In February 2004, DOTARS advised ANAO that it estimated its lease administration costs, excluding those functions associated with the Airports Act but including the costs of its insurance contractor, were in the order of \$1.5 million for 2003–04.

2.49 In March 2004, DOTARS advised ANAO that the Department's further examination of its February estimate revealed that its calculations included activities more appropriately related to regulatory oversight, rather than under the lease. Based on total staff workload indicators contained in the Branch's 2003–04 Business Plan, DOTARS estimated that its 'best guess'⁴³ of the total cost for lease oversight administration is likely to be some \$558 000⁴⁴, including overheads for some 4.75 full time staff and \$60 000 representing the costs of the insurance adviser.

2.50 DOTARS further advised ANAO that, noting the complexities of identifying costs for 2003–04, the Department considered that it would not be appropriate to extrapolate the \$558 000 figure back to past years, when the activity level was not necessarily the same. In this context, the resources invested by DOTARS in administering the leases since they commenced are not capable of being identified. It is also not possible to identify the lease administration costs that DOTARS has chosen not to recover.

2.51 In December 2002, a new cost recovery policy for the Commonwealth was announced.⁴⁵ For the purposes of the policy, cost recovery encompasses fees and charges related to the provision of goods and services, including compliance monitoring activities such as those undertaken by DOTARS in relation to the Airport Leases. As part of an agreed review schedule, DOTARS is to review all existing cost recovery arrangements over two years starting in

⁴³ DOTARS advised that, before a more precise figure can be derived, it would be necessary for a full costing activity process to be put in place to capture the actual effort involved in delivery of this activity.

⁴⁴ This figure included \$87 130 in costs identified for managing the Development Commitments (see Chapter 3).

⁴⁵ Finance Circular 2002/02, *Cost Recovery by Government Agencies*, December 2002.

2003–04, and immediately apply the policy to all new or significantly amended cost recovery arrangements.

Recommendation No.3

2.52 ANAO *recommends* that, consistent with the Commonwealth’s cost recovery policy for regulatory agencies, DOTARS implement a rigorous system for quantifying the reasonable costs of its administration of the 22 Federal Airport Leases, in order to:

- (a) identify the amount of resources required to administer the contracts entered into at the time of the various sales; and
- (b) consider the merits of exercising the Commonwealth’s contractual rights to recover from lessees the Department’s lease administration costs.

DOTARS response

2.53 DOTARS agreed with the recommendation.

Annual Lease Reviews

2.54 In the 1998 Audit Report on the Phase 1 sales, ANAO found that DOTARS had not yet developed a comprehensive framework or procedures to discharge its obligations concerning monitoring and enforcing lessees’ compliance with the Airport Leases.⁴⁶ DOTARS agreed with qualification to an ANAO recommendation that a comprehensive framework and procedures be developed. In response to the ANAO recommendation, DOTARS stated that it would:

initiate a formal lease meeting, with a mechanism involving each airport (and its major users) to review key lease clauses and issues associated with it. These meetings will be conducted annually. This will involve up to 18 separate meetings, with the Phase 2 sales now nearing completion. However, the key task will remain to continue to actively oversight those lease obligations which arise on a day-to-day basis.⁴⁷

2.55 At the time of this current performance audit, DOTARS advised ANAO that annual lease review meetings are held either in person or by telephone. Its objective in conducting the lease review is to ensure that the Department is sufficiently well informed to be able to assess an airport operator’s compliance with the requirements of an Airport Lease.

⁴⁶ ANAO Audit Report No.38 1997–98, op. cit., p.63.

⁴⁷ *ibid*, p.64.

2.56 Table 2.3 summarises the annual airport lease review meetings held, or arranged to be held during 2003–04, since the 1997 sale of the Phase 1 airports, and the 1998 sale of the Phase 2 airports. This analysis revealed that, of the 68 annual lease review meetings that should have been conducted by 30 June 2004, 26 (38 per cent) had not been conducted or arranged by the completion of this audit. In a further seven instances, there was some evidence of a review being conducted, or DOTARS advised ANAO that a review had been conducted, but there were no formal minutes of the review.

Table 2.3

Annual Lease Review Meetings Conducted Since Sale of Phase 1 & 2 Airports: March 2004

Sale	Airport	Year					
		1998–99	1999–2000	2000–01	2001–02	2002–03	2003–04
Phase 1 (July 1997) Core regulated	Brisbane	Yes	No	Yes	Yes	No	Yes ^B
	Melbourne	No	No	Yes	Yes ^A	No	Yes
	Perth	Yes	No	Yes ^A	Yes	No	Yes
Phase 2 (June 1998)	Adelaide & Parafield	N/A	No	Yes ^A	No	Yes	Yes ^B
	Darwin, Alice Springs & Tennant Creek	N/A	Yes	Yes ^A	No	No	Yes ^B
	Canberra	N/A	No	Yes	No	Yes	Yes ^B
	Coolangatta	N/A	No	Yes	No	Yes	Yes ^B
	Hobart	N/A	No	Yes ^A	No	Yes	Yes ^B
	Launceston	N/A	No	Yes	No	Yes	Yes ^B
	Townsville & Mount Isa	N/A	Yes	Yes	No	No	Yes ^B
	Archerfield	N/A	No	Yes ^A	No	Yes	Yes ^B
	Jandakot	N/A	Yes	Yes ^A	No	Yes	Yes
	Moorabbin	N/A	No	Yes	Yes	No	Yes ^B
Notes: Yes Meeting held and minutes of meeting recorded. Yes ^A DOTARS advised that meeting occurred but no formal record made of the meeting. Yes ^B DOTARS advised ANAO in April 2004 that a meeting had been arranged. No No meeting held in this financial year. N/A For Phase 2 airports, no lease review due in first year of privatisation.							

Source: ANAO analysis of DOTARS information.

2.57 In recent years DOTARS has reported on its conduct of annual lease review meetings in its Annual Reports. However, the Department's performance reporting has not accurately reflected the extent to which reviews have actually been conducted, as follows.

- In its 2001–02 Annual Report, DOTARS stated that, by 30 June 2002, it had conducted lease review meetings with the larger capital city airports, with reviews of the remaining airports to be completed by 30 September 2002.⁴⁸ However, DOTARS had not conducted reviews of three of the larger capital city airports by 30 June 2002 (Adelaide, Canberra and Hobart). In April 2004, DOTARS advised ANAO that reporting of lease review meetings in the 2001–2002 Annual Report was, through necessity, abbreviated. However the Department considers that the information presented is accurate, that is lease reviews were conducted for the larger capital city airports (Brisbane, Perth and Melbourne) and not on the smaller capital city airports (such as Adelaide, Canberra and Hobart).
- In its 2002–03 Annual Report, DOTARS stated that it had conducted comprehensive lease review meetings with all major airport lessee companies, except the four Sydney Basin Airports.⁴⁹ However, DOTARS had not conducted six of the 13 meetings it should have conducted with Phase 1 and Phase 2 airports, including five major, or core regulated, airports.

2.58 In relation to the accuracy of its performance reporting, DOTARS advised ANAO in March 2004 that, when the information relating to lease review meetings was supplied to meet the deadline for inclusion in the two Annual Reports, it was fully expected that the relevant reviews would have been conducted. However, in 2001–02 and 2002–03 there were a number of unexpected regulatory events and industry shocks.

2.59 ANAO recognises regulatory events and industry shocks diverted resources from conducting planned lease reviews. However, the Department should have taken steps to accurately reflect actual performance as opposed to planned performance in its Annual Report. For example, the 2002–03 Annual Report was presented to the Minister on 12 September 2003, by which time the Department would have been aware that some reviews planned for 2002–03 had not been conducted.

⁴⁸ DOTARS, *Annual Report 2001–02*, p.58.

⁴⁹ DOTARS, *Annual Report 2002–03*, p.65.

Recommendation No.4

2.60 ANAO *recommends* that DOTARS improve its management of the Airport Leases by developing and implementing reliable systems for the scheduling and conducting of annual lease review meetings, and reporting on its performance in conducting these reviews.

DOTARS response

2.61 DOTARS agreed with qualification to the recommendation. The Department advised ANAO that it will review its existing arrangements for the scheduling and conducting of lease review meetings with a view to determining an appropriate risk management strategy on an airport-by-airport basis for undertaking future airports lease reviews. In addition, the Department will examine the most appropriate approach for reporting on its performance in conducting these reviews.

Management systems

2.62 In 2000, DOTARS used a database to keep track of the annual lease reviews. The database recorded action arising from each annual lease review meeting, the person responsible, progress to date, and whether the item was active or completed. In November 2000, it was noted within DOTARS that, to obtain value from the database, it would need to be monitored to ensure that specific follow-up action had occurred, and that this would be a shared responsibility. It was suggested that the then Airports Planning and Operation Branch conduct quarterly reviews to determine the progress of follow-up action. DOTARS records examined by ANAO did not reveal any further use of the database after this time, including for the proposed quarterly reviews.

2.63 In 2002, major improvements were made to DOTARS' approach to conducting lease review meetings. Prior to 2002, the annual lease reviews that did occur tended to focus on compliance with the regulatory framework under the Airports Act rather than specific lease obligations. Between April and November 2002, DOTARS advised lessees as follows:

This year we have systematically examined the lease on a clause by clause basis and will be seeking specific information to ensure that the [lessee] is meeting its obligations under the lease. As it is almost five years since the Phase 1 airports were leased, I consider it timely that we begin the process of reviewing the airport leases in a more methodical and structured fashion. This year we will be focusing on the requirements of the lease that, if not met, allow the Commonwealth to terminate the lease, and also on the broad requirements relating to maintaining and developing the airport site.

2.64 As part of this improved approach, the Airport Planning and Regulation Branch analysed the lease clauses and identified those that should be considered during every annual lease review. It was recommended that the

clauses or sub-clauses outside this group be reconsidered each year when setting the agenda, because actions by the lessee or the lessor/Commonwealth may make them relevant to the annual review.

2.65 A further element of the improved approach was that written confirmation or evidence was requested from each lessee to demonstrate lease compliance with nine specific lease clauses (refer Table 2.4). The Department also wrote to Airport Building Controllers and Airport Environment Officers seeking their advice on whether they were aware of any lease compliance matters. However, there was limited evidence of DOTARS undertaking a comprehensive assessment of all information gathered by this process, and from other sources, to complete an assessment of lessee compliance.

Recommendation No.5

2.66 ANAO *recommends* that DOTARS enhance its conduct of lease review meetings by, at the conclusion of each review:

- (a) documenting review outcomes, including the Department's assessment of the degree to which the lessee complies with the sale documentation requirements; and
- (b) providing a written response to the lessee specifying outstanding issues that are to be addressed.

DOTARS response

2.67 DOTARS agreed with the recommendation.

Table 2.4**Lease compliance assurance sought from lessees: 2002 and 2003**

Issue	Information required
Reservation of Lessor's rights	Written confirmation from lessee that it has not granted any easements over or rights of access or rights of way on, over, under, through or across the Airport Site that exceeds the terms of its Lease.
Lessee must provide for the use of the site as an airport	Evidence that lessee is providing for use of the Airport Site as an airport and is providing access to the airport for international, interstate and intrastate air transport – this may include traffic data and details of any complaints received by, or referred to, the lessee about lack of access to the airport.
Lessee provides for access to the airport by air transport	
Refusal of access in certain circumstances	Written details from lessee of aircraft owners/operators to whom they have refused access and evidence that the Department was notified at least 14 days prior to refusal of access.
Maintenance of insurance	Evidence that lessee has insurance in place for: <ul style="list-style-type: none"> • loss and/or damage to or destruction of structures; • loss and/or damage to or destruction of plant, machinery and other property on an airport site; • loss of gross revenues and/or additional increase in the cost of working consequent upon loss and/or damage to or destruction of structures, plant, machinery and other property; and • legal liabilities for, but not limited to, claims made by third parties for bodily injury or death or damage to or destruction of property (including the loss of use of such property arising out of the use or occupation of the airport site or any operations occurring on or in respect of the airport site).
Insurance for construction work	Written confirmation (or evidence) that lessee's procedural policies require insurance for construction work on the Airport Site.
Proceeds of insurance	Evidence from lessee that where it has received insurance payments in respect of damage or destruction of any structures, that such proceeds have been used to rebuild or reinstate those damaged or destroyed structures or build such other structures as approved by the Department.
Environment	Written confirmation that lessee is maintaining the environment of the Airport Site in accordance with legislative requirements and meeting the commitments set out in the Airport Environment Strategy.
Legislation, Licences and Statutory Powers— Legislation and notices	Written confirmation that lessee has complied with all notices issued to it by CASA, Airservices Australia and other Commonwealth, State or Local Government Authorities.

Issue	Information required
Legislation, Licences and Statutory Powers— Licences	Evidence that lessee has the required licence(s) and approval(s) from CASA relevant to its role as an airport operator and the operation of the Airport Site as an airport (e.g. certified copy of Aerodrome Licence).
Maintenance of site	Evidence that lessee is maintaining the Airport Site in good and substantial repair—this may include copies of recent audits or inspections by CASA and details of expenditure on maintenance.
Sub-leasing that breaches the Airports Act	A list of the sub-leases and licences that lessee has granted that breach the requirements of the Airports Act (and hence for which lessee should have sought Departmental approval).
Sub-leasing to a trust	A list of the sub-leases and licences that lessee has granted to trusts (and hence for which lessee should have sought Departmental approval).
Development of Airport Site	Evidence that lessee is developing the Airport Site to the standard specified in the Lease.
Loan security	A list of the Loan Securities that lessee has granted over the Lease, Airport Site or Structures (hence for which lessee should have sought Departmental approval).

Source: ANAO analysis of DOTARS information.

3. Airport Development Obligations

This chapter outlines the lessees' contractual obligations to develop the airport sites, and examines DOTARS' administration of those obligations.

Background

3.1 The future development of the privatised federal airports was addressed in the Government's ongoing privatisation objectives for both the Phase 1 and Phase 2 sales. The relevant objectives were that each lessee:

- operate with a demonstrable commitment to the effective provision of quality airport services; and
- act to promote the economic development of its airport in a way that is responsive to the interests of users, the environment and the region in which the airport is located.

3.2 In the Phase 1 sales, these objectives were addressed by requiring bidders to include, in their binding offers, a plan for the development of aeronautical infrastructure at the airport site for the first 10 years of the lease. Bidders were also asked to indicate their commitment to the implementation of these airport development plans, as distinct from other forms of commercial development planned for the site.

3.3 Tender evaluation by the then Office of Asset Sales, the then Department of Transport and Regional Development (DoTRD)⁵⁰ and the Commonwealth's advisers identified a high degree of variability between the quality of bidders' airport development plans and their commitment to those plans. Following discussions with the then Minister for Transport and Regional Development⁵¹, the then Finance Minister required an evaluation of options for securing greater commitment from bidders to the 10-year development plans. The Minister also required that bidders provide a contractual undertaking to continue to develop the airports throughout the lease period. As a result, additional clauses were included in the Airport Leases and Sale Agreements.⁵² Similar clauses were included in the sale documentation for the Phase 2 sales.

⁵⁰ The Department became the Department of Transport and Regional Services as part of the Administrative Arrangements Orders issued following the October 1998 federal election.

⁵¹ Following the October 1998 federal election, the portfolio Minister was appointed as Minister for Transport and Regional Services.

⁵² Any development undertaken pursuant to either the Sale Agreement or the Airport Lease is required to comply with the provisions of the Airports Act, including, where relevant, the submission of major development plans.

Airport Leases

3.4 The Airport Lease for each privatised airport contains an ongoing obligation on the lessee to develop the airport site to a quality standard reasonably expected of such an airport in Australia, and good business practice, having regard to the actual and anticipated future growth in traffic demand. In addition, lessees of Phase 1 airports are required to develop the airport site to a standard consistent with a major international airport. The leases provide that, if the Commonwealth believes a lessee is not complying with this obligation, it has the power to require the lessee to produce a plan for bringing the airport up to the required standard within five years.

3.5 In February 2004, DOTARS commented to ANAO that the broader requirements under the leases in relation to the ongoing long-term development of the airports are most appropriately examined through regulatory oversight, in particular through the master planning process under the Airports Act. DOTARS also advised ANAO that it has had no occasion to invoke the power contained within the lease for the lessee to be required to bring an airport up to the required standard within five years.

Sale Agreements

3.6 The Sale Agreements for 10 of the 11 core regulated airports sold in Phases 1 and 2 included a commitment from the lessee to a specified amount of capital expenditure on aeronautical infrastructure development over the first 10 years of the lease.⁵³ Total commitments of \$699.8 million were specified across the various Sale Agreements, representing 18 per cent of the purchase prices paid (see Table 3.1). In March 2004, DOTARS advised ANAO that, for 2003–04, it anticipates the staff costs in administering the Development Commitments to be \$87 130.

⁵³ The other core regulated airport sold in Phase 2, Townsville, did not have any Development Commitments included in the Sale Agreement.

Table 3.1**Airport Development Commitments**

Airport	Purchase Price (\$m) ^A	Development Commitments (\$m)		
		Period One	Period Two	Total
Brisbane	1314.0	44.4	292.9	337.3
Perth	631.0	54.6	33.3	87.9
Melbourne	1254.7	78.3	29.0	107.3
Adelaide	323.2	41.4	22.6	64.0
Alice Springs	23.6	1.2	1.9	3.1
Darwin	84.1	3.3	2.8	6.0
Canberra	65.0	11.0	46.9 ^B	57.9
Coolangatta	101.1	19.2	8.5	27.7
Hobart	35.0	3.8	1.7	5.5
Launceston	16.6	2.2	0.9	3.1
Total	3848.3	259.3	440.5	699.8
<p>Note:</p> <p>^A Purchase prices taken from ANAO audits of the Phase 1 and Phase 2 sales. Purchase prices include amounts paid to reimburse the Commonwealth for capital expenditure made between the signing of Sale Agreements and sale completion, and to reflect movements in working capital balances.</p> <p>^B On 19 April 2004, Canberra International Airport advised ANAO that: <i>Canberra International Airport had an obligation to negotiate access arrangements with the developers of the Very High Speed Train (VHST) proposal if it was to proceed and that ultimately the development did not proceed. The airport was an enthusiastic supporter of the proposal committing \$25.97 million to developments linked and dependent on the VHST proposal. With the VHST not going ahead, Canberra Airport now understands that their commitment to Period Two in Table 3.1 should read \$20.94 million, not the \$46.9 million as currently shown and recorded in Schedule 11 to the Sale Agreement.</i></p>				

Source: ANAO analysis of sale documentation and ANAO audit reports on the Phase 1 and 2 sales.

3.7 The 10-year Development Commitments are divided into two five-year periods, defined in the Sale Agreement as Period One and Period Two. For each of the three Phase 1 airports, Period One ended on 30 June 2002 and Period Two ends on 30 June 2007, unless otherwise agreed by the Commonwealth. For the seven Phase 2 airports that have Development Commitments, Period One ended on 30 June 2003 and Period Two ends on 30 June 2008, unless otherwise agreed with the Commonwealth.

Other contracted development obligations

3.8 In addition to the Development Commitments, additional infrastructure development obligations were included in the Sale Agreements for Melbourne, Canberra and Adelaide Airports, as follows:

- the purchaser of Melbourne Airport provided an additional commitment that total capital expenditure at the airport site during the

first 10 years, including the aeronautical infrastructure Development Commitment of \$107.3 million, would be at least \$165.7 million. The lessee has advised DOTARS that this additional commitment has been achieved. As at March 2004, DOTARS was assessing that claim contemporaneously with assessing achievement of Development Commitments at Melbourne Airport;

- the purchaser of Canberra Airport was required to negotiate in good faith concerning access arrangements with the proponents or developers of the Very High Speed Train (VHST) proposal if: construction of the VHST proceeded to completion and operation; and the proponents or developers of the VHST wished to locate the Canberra VHST terminal at the airport site. The VHST proposal did not proceed to completion and operation;
- the purchaser of Adelaide Airport undertook to complete the extension of the main runway and associated works. DOTARS has assessed that this commitment has been met; and
- in a separate clause to its Development Commitment obligation of \$64 million between 1998 and 2008 (clause 11), the purchaser of Adelaide Airport also contracted to ensure that a Multi User Integrated Terminal (MUIT) be built at the airport at a cost of not less than \$150 million, with completion in 2001 (clause 11B).⁵⁴

3.9 ANAO notes that the Tender Evaluation Reports prepared in respect of the sale of Adelaide Airport assessed the Development Commitments and the MUIT as separate commitments. In particular, the rationale stated for selecting the successful bidder assessed the Development Commitment and planned MUIT as separate commitments.

3.10 The construction of the MUIT at Adelaide Airport has been the subject of discussion between the lessee and DOTARS. In addition, in October 2003, DOTARS obtained legal advice on the issue. In November 2003, DOTARS advised the lessee that it would accept relevant MUIT expenditure towards meeting Adelaide Airport's Development Commitment. In relation to this decision, DOTARS advised ANAO in February 2004 as follows:

In considering the matter, the Department is obliged to consider legal advice obtained on any particular matter in the context of the overarching policy and the best interests of the Australian Government. The decision taken to recognise the claims of Adelaide Airport in regard to the treatment of the

⁵⁴ The lessee is required to use all reasonable endeavours to obtain all requisite planning and regulatory approvals, negotiate terminal and access arrangements with the domestic airlines, finalise the proposed MUIT design, and finalise construction costings. However, the lessee is not required to accept any conditions or requirements imposed by other entities that would render the MUIT uneconomic having regard to the lessee's cost of capital and MUIT usage projections.

MUIT was taken noting that in addition to the delivery of the MUIT, as required under the Sale Agreement, Adelaide Airport was committed to total development expenditure greatly in excess of that anticipated at the time of the sale of the Airport. The advice to Adelaide Airport therefore reflects DOTARS' consideration of the AGS legal advice in its totality, together with an appreciation of the broader policy implications pursuant to the *[Airports]* Act.

3.11 In commenting on a draft of this performance audit report, the Adelaide Airport lessee advised ANAO in April 2004 as follows on the MUIT:

Adelaide Airport Limited (AAL) has always been of the opinion that the expenditure on the MUIT would expunge its development commitment as set out in Schedule 11 of the Sale Agreement. This was always the thrust of discussions with the Commonwealth at the sale time and, in fact, the Schedule 11 commitments, as agreed, consisted primarily of expenditures which in fact would not be required if the MUIT were constructed. The MUIT commitment was only to the extent that it was commercially viable to construct and was not additional to, but would replace, the Schedule 11 commitments, which would only ever proceed should a MUIT not be built. The total spend committed to in Schedule 11 was more important than its classification.

Unfortunately, agreements were not reached with the airlines as early as expected and the MUIT process was negatively affected, initially by the entry into the market of Impulse and Virgin Blue and then totally aborted, following the events of 11 September 2001 and the demise of Ansett Airlines, which resulted in a much further delayed start. Completion is now expected by November 2005.

The position has since been resolved with DOTARS, with confirmation that DOTARS will accept relevant claims for New Terminal expenditure towards meeting the total of Development Obligations under the Sale Agreement.

Administrative framework

3.12 The respective Sale Agreements contain a reporting regime to assist DOTARS in monitoring lessees' compliance in meeting their Development Commitments. The contracted monitoring regime requires lessees to:

- provide DOTARS each year with a detailed expenditure plan for the balance of the relevant five-year Period, indicating how the lessee intends to comply with its obligations, and including details of its intended Airport Development;
- engage an Approved Auditor to ascertain the extent of the lessee's compliance with its obligations;
- provide DOTARS with annual audited reports prepared by the Approved Auditor setting out the Airport Development Costs for the 12 month period; and

- provide DOTARS with fully audited reports prepared by the Approved Auditor setting out the Airport Development Costs at the conclusion of Period One and Period Two.

3.13 In the 1998 Audit Report on the Phase 1 sales, ANAO found that DOTARS:

has not developed comprehensive administrative procedures to monitor the ongoing development of the Phase 1 airports. This includes comprehensive and direct indicators of whether the airports are being developed in accordance with the requirements of the leases and monitoring development expenditure the lessees have committed themselves to over the initial 10 years of the lease.⁵⁵

3.14 ANAO recommended that DOTARS develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the Airports Act and Airport Leases.⁵⁶ In its response to the 1998 Audit Report, DOTARS agreed with qualification to the recommendation with the following comment:

The Department considers that the comprehensive reporting process [outlined in paragraph 3.11 above] is sufficient to ensure effective monitoring. However, the area which requires further work is better defining the terms in the lease for assessing whether the site is being developed as an effective international airport. The activity in this area is essentially longer term (in our view all airports are likely to meet demand effectively over the next few years) but we accept that we can and should develop some guidance for both the airport operators and ourselves in this area now.

3.15 In February 2004, DOTARS advised ANAO that the need for guidance had been overtaken by the submission and approval of Master Plans for all of the Phase 1 and Phase 2 airports (17 in total). DOTARS further advised that it has taken the approach that monitoring of the ongoing development of the leased airports is best addressed having regard to the approved Master Plans and Major Development Plans for the following reasons:

- apart from providing a 20-year vision of an airport operator's development indications, Master Plans are required to be updated on a five yearly cycle, with the second Master Plan cycle now underway. As the approved Master Plans were not in place at the time of the 1998 Audit Report, DOTARS was not in a position to give them formal consideration at that time;

⁵⁵ ANAO Audit Report No.38 1997–98, op. cit., p.75.

⁵⁶ *ibid.*, Recommendation No.10.

- the five-year Master Plan cycle ties in neatly with the key Period One and Period Two assessments of Development Commitment compliance required under the airports' Sale Agreements;
- airport operators are required under the Airports Act to specify development objectives for the airport and their assessment of the future needs of civil aviation and other users of the airport for services and facilities; and
- the Master Plans would not have been approved by the Minister unless, amongst other things, pursuant to the Airports Act the Minister was satisfied with the extent to which carrying out the Master Plan would meet present and future requirements of airport users.

Administrative procedures and guidelines

3.16 The airports were advised by DOTARS in February 1999 that, although airport lessees must report annually on their progress in meeting their development obligations, the main task for DOTARS would occur after the expiration of each of the five-year periods.

3.17 DOTARS advised ANAO in February 2004 that, with this clear principle in mind, the Department commenced work in early 2003 to prepare and implement its *Development Obligations for leased Federal airports—Procedures and Guidelines* document to ensure that the Period One reports from the relevant Phase 1 and 2 airports would be assessed on a consistent basis. DOTARS further advised that the timing of preparation of this document clearly reflects the fact that the airports' medium term Development Commitments are a contractual, not regulatory, obligation.

3.18 ANAO considers that DOTARS' development of procedures and guidelines in this area was not timely. DOTARS advised ANAO that the first iteration of the *Procedures and Guidelines* document was produced in June 2003. This was 12 months after the expiration of the first five-year period for the Phase 1 airports. A second iteration of the *Procedures and Guidelines* was finalised in December 2003.

3.19 The stated objectives of the *Procedures and Guidelines* document are to:

- assist Departmental officers to assess the performance of lessees in meeting their development obligations as specified in the Sale Agreements;
- summarise the lessees' contractual obligations to the Commonwealth in relation to development obligations;

- document the structure and process to be applied by the Department in administering and assessing the performance of lessees in meeting their development obligations during Period One and Period Two;
- consider issues and options relating to any non-compliance, including the effect of the external environment on lessees' ability to meet development obligations, and management strategies to deal with lessees that might be in breach of their obligations;
- provide a checklist for undertaking analysis of annual audited reports and Period One/Period Two reviews; and
- highlight some key issues that could be raised with lessees on a regular basis at the annual lease review meetings.

3.20 DOTARS acknowledged to ANAO in February 2004 that, without agreeing that its flexible approach is inappropriate, earlier implementation of standardised processes and guidelines would have been beneficial. DOTARS further stated that measures are now in place to remedy the issue.

3.21 Had the processes outlined in the latest *Procedures and Guidelines* document been developed and implemented shortly after the Phase 1 sales, it is likely that there would have been a marked improvement in the effectiveness of DOTARS' management of contracted airport development obligations over the period since privatisation. Looking forward, if promptly, consistently and effectively implemented, DOTARS' *Procedures and Guidelines* will result in a significant improvement to the Department's administration of the development obligations.

Compliance monitoring

3.22 DOTARS' *Procedures and Guidelines* document outlines a three-stage process for analysing compliance in order for the Department to form a view on whether or not each lessee has complied with its Development Commitment obligations. This process is summarised in Table 3.2.

Table 3.2**DOTARS' Process for Analysing Compliance With Development Commitments**

Stage	Purpose	Outputs
Stage 1: Aggregation of Reports	Assessment of whether DOTARS is satisfied with the lessee's regularity of reporting to date, whether the amount of information that has been provided is sufficient to enable assessment, and whether the lessee has met all the reporting requirements of the Sale Agreement.	Completion of a checklist
Stage 2: Assessment and Activity Report	An assessment and analysis of the lessee's financial and activity reporting for the period under review.	Completion of a Development Obligations Status report
Stage 3: Overview of Performance and Recommendations for Further Action	<p>Finalisation of analysis and assessment of performance. Involves a summary statement of:</p> <ul style="list-style-type: none"> • whether the lessee has met reporting deadlines; • the lessee's performance in implementing its Development Commitments and any mitigating circumstances specifically identified by the lessee; • whether the Audit Opinion prepared by an Approved Auditor is in an appropriate form and is limited to aeronautical infrastructure development costs; • any compliance issues needing resolution; and • recommendations for any further action required. 	<p>Completion of a Summary Statement Overview of Performance</p> <p>Preparation of correspondence to lessee</p>

Source: DOTARS, *Development Obligations for Leased Federal Airports: Procedures & Guidelines*, December 2003.

3.23 Although DOTARS advised ANAO that the *Procedures and Guidelines* had been operative since June 2003, by March 2004 the Department had not completed any of the analytical outputs required under its three-stage process for any of the airports. This was the case in respect of Period One cost reports due in September 2002 (for Phase 1 airports) and September 2003 (for Phase 2 airports), annual expenditure plans due on 1 July 2003 and annual cost reports due by the end of September 2003.

Annual expenditure plans

3.24 Each year, the 10 lessees with Development Commitments are required to provide DOTARS with a detailed expenditure plan for the balance of Period One or Period Two, as appropriate. For the first year, this plan was to be

provided within 90 business days of 1 July, falling due in early November 1997 or 1998, depending on the year the airport was sold. For subsequent years, the plan was due on 1 July. As summarised in Table 3.3, of the 53 reports that should have been obtained by DOTARS by December 2003, 35 had been received (66 per cent). Of the 35 received, only six were obtained by the due date. Only one plan has been provided on time since 1999.

Table 3.3

Provision of Expenditure Plans from 1997 to 2003

Date Due	Received on time	Received late	Not received	Total
1 July 1997	3	0	0	3
1 July 1998 ^A	0	3	0	3
1 July 1999	2	4	4	10
1 July 2000	0	7	3	10
1 July 2001	0	4	6	10
1 July 2002 ^B	0	5	4	9
1 July 2003	1	6	2	9
Total	6	29	19	54
Percentage of total	11%	54%	35%	100%

Notes:

^A In February 2004, DOTARS advised ANAO that it had, in effect, waived the requirement for the Phase 2 airports to provide an expenditure plan for the first year following privatisation.

^B DOTARS has advised ANAO that no plan was required from Melbourne Airport from 2002 onwards as the lessee of this airport had advised DOTARS that it had spent the full amount of the 10-year commitment.

Source: ANAO analysis of sale documentation, DOTARS data and written advice from DOTARS.

3.25 In terms of the annual expenditure plans, in April 2004 the lessee of Adelaide Airport advised ANAO that it has:

submitted an annual expenditure report showing expenditures for each year and proposed spending for the remainder of the commitment period. DOTARS has been satisfied with those reports until last year, following further changes in personnel, when AAL was formally requested to provide audited 2003 and Period One expenditure reports. These were duly provided, reviewed and resubmitted. AAL awaits formal confirmation that the expenditures in the reports are acceptable airport development expenditures.

Airport Development cost reports

3.26 The Sale Agreements state that the lessee must engage an Approved Auditor to prepare annual cost reports, and Period One and Period Two

reports setting out the cost of aeronautical infrastructure development carried out at the airport site.

3.27 The term 'Approved Auditor' is defined in the Sale Agreements by reference to the Airports Act. In turn, the Airports Act defines an Approved Auditor as a person registered as an auditor, or taken to be registered as an auditor, under Part 9.2 of the Corporations Act.

3.28 Each year the 10 lessees with Development Commitments are required to provide DOTARS with an audited report prepared by the Approved Auditor that sets out the Airport Development Costs incurred in the previous 12 months. DOTARS' *Procedures and Guidelines* document states that the annual cost reports may be used to raise issues with the lessees as part of the Development Commitment monitoring process, but that it is not possible to formally determine whether a lessee has complied with its Development Commitment until the end of each five year period.

3.29 The Sale Agreements require the lessees to provide annual audited cost reports to DOTARS within 60 business days of 1 July, falling due in late September each year. ANAO found that DOTARS has obtained annual cost reports from most lessees in most years, with 88 per cent of required reports being obtained (see Table 3.4). However, of the 46 reports that DOTARS obtained, more than half were obtained after the due date, on occasions up to six months late. In terms of the lodgement of annual cost reports, DOTARS advised ANAO in February 2004 as follows:

In the light of global and local aviation industry shocks, airport lessees have been presented with significant and unprecedented business risks. Management of these issues has required a particular focus on the stabilisation of their aeronautical businesses. Given this context, the achievement of development obligations, and aeronautical infrastructure development more broadly, have been secondary considerations for some airport operators. DOTARS has taken an understanding approach to this circumstance and, on balance, has chosen not to increase the administrative burden and distractions on airport lessees from their stabilisation tasks, but only where the Commonwealth is not being exposed to additional commercial risk.

In DOTARS' view, the provision of annual reports, the purpose of which is only to report progress, falls into this category. DOTARS has taken the view that failure to lodge annual reports was not a matter that increased the Commonwealth's exposure to commercial risk, and that Departmental resources were better directed towards regulatory activities and areas of greater commercial risk. In addition, unlike other aspects of the sale agreements (that is, ABCs and AEOs), DOTARS is not contractually required to conduct efficiency or other reviews to determine whether arrangements are functioning effectively.

Table 3.4
Provision of Annual Airport Development Cost Reports from 1997 to 2003

Date Due	Received on time	Received late	Not received	Total
September 1998	2	1	0	3
September 1999	4	4	2	10
September 2000	6	3	1	10
September 2001	4	5	1	10
September 2002	2	6	2	10
September 2003 ^A	4	5	0	9
Total	22	24	6	52
Percentage of total	42%	46%	12%	100%

Note:

^A DOTARS has advised ANAO that no reports are required from Melbourne Airport from 2003 onwards as the lessee of this airport had advised that it had spent the full amount of the 10-year commitment.

Source: ANAO analysis of sale documentation and DOTARS data.

Performance reporting

3.30 ANAO found the overall level of compliance by lessees with the Sale Agreement provisions requiring the lodgement of annual expenditure plans and annual audited cost reports to be 27 per cent. In total, 73 per cent of expenditure plans and cost reports were either not obtained by DOTARS or were obtained after the required date.

3.31 This level of non-compliance with the contractual requirements is not reflected in DOTARS' performance reporting. DOTARS' 2002–03 Annual Report stated that lessees were compliant with all Sale Agreement and lease obligations (emphasis added).⁵⁷ There was no disclosure of the numerous instances of non-compliance with important elements of the Sale Agreement monitoring requirements for Development Commitments during that year. In particular, for 2002–03, ANAO found that:

- of the nine annual expenditure plans due on 1 July 2002, none were obtained by the due date and four were never obtained;
- 10 annual audited cost reports were due by the end of September 2002, but only two had been obtained by this date. Of the remainder, six were obtained after the due date and two have never been obtained; and

⁵⁷ DOTARS, *Annual Report 2002–03*, p.65.

- three Period One audited cost reports were due by the end of September 2002, but none of these had been obtained by 30 June 2003 (see further below).

Recommendation No.6

3.32 ANAO *recommends* that DOTARS include in future Annual Reports comprehensive and accurate performance information on the timeliness and completeness of receipt of expenditure plans and audited reports on Development Commitment expenditure from relevant airport lessees.

DOTARS response

3.33 DOTARS agreed with qualification to the recommendation. The Department stated that it considers it important that, prior to including in its Annual Report any performance information that identifies a particular airport, airports should be given advance notice of this intention. On this basis, the Department advised that it will include performance information relating to annual reports and expenditure plans from the 2004–2005 Annual Report onwards.

Out-of-scope expenditure

3.34 In March 1997, the then Finance Minister and the then Minister for Transport and Regional Development were advised that the 10-year Development Commitments related to aeronautical developments (runways, taxiways, passenger terminals and ground access infrastructure), but not to commercial property, maintenance expenditure or financing charges. This approach was intended to address the Ministers' concern that the Sale Agreements ensure future development of suitable airport capacity.

3.35 Airport Development, and expenditure that may be counted as Airport Development Costs, are defined in the Sale Agreements. Firstly, the Sale Agreements define Airport Development as:

- aeronautical infrastructure development, which is further defined as including, but not limited to:
 - constructing or extending a runway, taxiway, apron or freight facilities;
 - constructing a new passenger terminal;
 - extending a passenger terminal where the extension increases the capacity of the airport to handle movements of passengers, freight or aircraft; or

- constructing or extending a road, vehicular access facility, car park, railway or rail handling facility where it increases the capacity of the airport to handle movements of passengers, freight or aircraft; and
- such other development projects as may be agreed between DOTARS and the respective lessee, for the purposes of the Development Commitment clauses.⁵⁸

3.36 The Sale Agreements also define expenditure that may, and may not, be counted as Airport Development Costs for the purposes of the Development Commitment clauses of the respective Sale Agreements. The Sale Agreements:

- permit lessees to count required expenditure on Airport Development which is carried out at the airport site at the expense of the lessee, but not expenditure by a third party;
- permit lessees to count amounts it has paid to consultants, contractors or suppliers engaged on an arms length basis for work performed, materials or goods supplied or services provided in undertaking Airport Development. Other recipients of payments (such as the cost of employees involved in Airport Development) or amounts paid to consultants, contractors or suppliers engaged on other than an arms length basis are not to be counted as Development Commitment expenditure;
- exclude from Airport Development any amounts paid for or in connection with the maintenance of the airport site; and
- exclude from Airport Development any financing costs or charges.

3.37 ANAO found that DOTARS' administration of the requirement for Development Commitments to relate to aeronautical infrastructure development has been inconsistent, particularly in relation to the treatment of commercial developments.⁵⁹ ANAO also noted a number of instances where the reports obtained by DOTARS included certain items of expenditure that may not be within the permissible categories of Airport Development Costs for the purposes of the Development Commitments. These items included: office buildings, motor vehicles, fax machines, and car auction facilities. Those items

⁵⁸ To date, the only specific project accepted by DOTARS under this category is a hangar at one airport, although at the time of audit, it was considering a request from another lessee that the cost of acquiring the former Ansett Domestic Terminal Lease be accepted as contributing towards that lessee's Development Commitment.

⁵⁹ In April 2004, the Adelaide Airport lessee advised ANAO that it is of the opinion that certain "commercial developments" would meet the criteria for "Airport Developments" as they provided infrastructure and funding for subsequent aeronautical developments.

were not questioned by DOTARS at the time the relevant annual cost reports were provided.

3.38 On this issue, DOTARS advised ANAO, in February 2004, that it does not view the annual reports, or their content, with the significance attached to them by ANAO. DOTARS also made the following comments:

Whilst acknowledging that the process of receiving and analysing the annual reports has not been undertaken with rigour, DOTARS considers that its responsibility relating to the delivery of the prescribed policy outcomes has been achieved. Not only have all the airports survived the transition from public to private sector ownership in a very testing economic and travel environment, in aggregate they have delivered substantial additional development well above that required under the terms of the Sale Agreements.⁶⁰

It is important to recognise that an annual audited report does not form the basis for the Branch reaching a view on whether, or not, a lessee will achieve its contractual obligations to the Commonwealth. Airport operators are not obliged to include any aeronautical capital expenditure item that may have been identified in their annual development commitment statements into their Period One or Two formal audited reports. The only obligation on the lessees is that they are required to have expended the agreed funds on aeronautical capital development by the conclusion of Period One and Two respectively.

Whilst annual returns are provided, as detailed in the Sale Agreements, they in no way reflect the actual expenditure items that the Airport will rely on to demonstrate that they have met the Period One obligations. This assurance can only come from an examination of the detail provided in the Period One (and Two) audited statements. It should not be assumed that expenditure that has been listed in individual annual statements will "add up" to the five year Period One Statement.

3.39 ANAO considers that the usefulness of the annual reports as a monitoring tool is diminished where they are not used to identify circumstances where lessees may be counting items of expenditure that may not be accepted by DOTARS as valid airport development costs at the end of the relevant Period. Furthermore, as the annual reports are required to be prepared on the same basis as the Period One and Two reports, ANAO considers that it would promote the timely finalisation of Period One and Two outcomes, if DOTARS took steps to rigorously analyse the annual reports, in order to develop a shared understanding with lessees of expenditure that will be counted towards achieving Development Commitments.

⁶⁰ The Sale Agreements require expenditure on aeronautical infrastructure development of \$259 million in the first five years of privatisation. DOTARS advised ANAO that total capital expenditure (aeronautical and non-aeronautical) across the capital city airports (excluding Sydney) has been in the order of \$570 million.

3.40 The absence of a shared understanding about this and other aspects of the Development Commitment requirements was apparent to ANAO from comments made by lessees on extracts of the draft audit report provided to the lessees. In particular, the following are relevant to this issue:

- Perth Airport commented to ANAO that
one of the problems with the Sale Agreement is that there is no clear-cut definition or guidance on “other unspecified airport development”. In Schedule 1 to the Sale Agreement there is reference to “other development projects that may be agreed between the Commonwealth and the Transferee for the purpose of clause 11, however there is no further clarification in regard to what may be permissible. In our view, given this lack of definition it is inconclusive whether certain items of expenditure may or may not be permissible for the purposes of the Development Commitments and therefore inappropriate to draw conclusions in this regard.
- As noted above in Table 3.1, Canberra Airport considers its Period Two Commitment to be \$20.94 million rather than the \$46.9 million specified in the Sale Agreement. This is because one of the individual projects envisaged at the time of the sale, with planned expenditure of \$25.97 million, is not proceeding. However, this approach is inconsistent with DOTARS’ *Procedures and Guidelines* which record the Canberra Airport Period Two Commitment as \$46.9 million and approach administration of these Commitments from the perspective that the Commitment is to an aggregate amount of expenditure and not to individual projects.

Recommendation No.7

3.41 ANAO *recommends* that DOTARS more closely analyse annual expenditure reports when they are provided in order to promptly advise lessees of any items that the Commonwealth would not accept as expenditure towards the Development Commitment obligations.

DOTARS response

3.42 DOTARS agreed with the recommendation. DOTARS stated that the formal Guidelines now in place facilitate the careful analysis of annual expenditure reports and provide for the formal advice to airport lessees regarding the appropriateness or not of their expenditure.

Period One outcomes

3.43 The relevant Sale Agreements contain an acknowledgement that the Commonwealth entered into the Agreement and accepted the purchase price on the basis of the respective Development Commitments. The intention of this clause was to reinforce the understanding between the parties that lessee

obligations under the Development Commitment clauses were central to the agreement between the Commonwealth and the lessees.

Period One audited cost reports

3.44 Under the terms of the respective Sale Agreements, within 60 business days of the end of each five-year period, lessees are to provide DOTARS with fully audited cost reports setting out the amount expended by the lessee on aeronautical infrastructure development. The purpose of those reports is to enable DOTARS to assess the extent to which lessees have met their Development Commitments for the relevant Period. For the Phase 1 airports, apart from Perth⁶¹, Period One reports were due by the end of September 2002. For the Phase 2 airports, these reports were due by the end of September 2003.

3.45 ANAO found that there were significant delays in DOTARS obtaining Period One reports from the lessees. For all but two airports, information on Period One expenditure was not obtained until after the due date. In this context, ANAO found that DOTARS' pursuit of the provision of Period One reports has not been timely. Reports from Phase 1 airports were not obtained until January and February 2004, more than sixteen months after the September 2002 due date. In addition, a number of Phase 2 airports did not provide any audited information on their Period One achievements until some months after the September 2003 due date.

3.46 In February 2004, DOTARS advised ANAO that it accepts that its follow-up of Period One reports for the Phase 1 airports was not timely but considers that, as both Melbourne and Brisbane airports were expected to meet their commitments, the timely provision of these reports would have made no material difference to this positive outcome. DOTARS advised ANAO that it is continuing to thoroughly assess the remaining issues associated with the Period One reports, having already sought additional information and clarification.

Recommendation No.8

3.47 ANAO *recommends* that, having regard to the delays that occurred for Period One, DOTARS expedite the finalisation of Period Two Development Commitment outcomes, currently due in 2007 and 2008, by taking early administrative action to obtain, analyse and assess financial reports prepared by Approved Auditors.

⁶¹ DOTARS approved a four-year extension to Period One for Perth Airport on 9 November 2000. Perth's Period One Airport Development Cost report is due in late September 2006.

DOTARS response

3.48 DOTARS agreed with the recommendation. DOTARS stated that formal Guidelines are already in place to provide the necessary administrative framework to ensure that Period Two Development Commitment outcomes will be finalised expeditiously. These Guidelines will continue to be applied.

Assessment of Period One outcomes

3.49 As of February 2004, DOTARS had received some information in respect of Period One achievements from each of the 10 lessees. However, DOTARS advised ANAO in March 2004 that, in all instances, it was either awaiting further information requested from the lessee or was still assessing whether or not the information that had been provided was in the correct form, of sufficient detail and prepared on the required basis to enable DOTARS to complete an assessment.

3.50 In this context, Table 3.5 summarises DOTARS' progress as at March 2004 in obtaining, analysing and assessing Period One audit reports from each lessee. In some instances, lessees had indicated to DOTARS that they had fully met their Commitment. However, as DOTARS had only recently received the necessary audit reports, a final outcome had not yet been confirmed. In other instances, DOTARS had agreed to an extension to the timeframe for achieving Period One commitments, but was awaiting a consolidated report from the relevant lessees quantifying the actual amount achieved in the original Period One timeframe.

Table 3.5**DOTARS' Analysis and Assessment of Period One Outcomes: April 2004**

Airport	Contracted Period One Expenditure \$m	Status
Lessees that claim to have met their Period One Commitment		
Brisbane	44.4	Lessee has advised that Commitment met, indicating that \$82 million has been spent in Development Commitments. Report received by DOTARS on 3 February 2004. DOTARS is assessing whether this report meets the requirements of the Sale Agreement and, if so, whether Period One Commitment has been met.
Melbourne	78.3	Lessee has advised that total 10-year Commitment met in first five years. Report received by DOTARS on 21 January 2004. DOTARS is assessing whether this report meets the requirements of the Sale Agreement and, if so, whether the full Development Commitment has been met.
Launceston	2.2	Lessee has advised that Period One Commitment met. Report received by DOTARS on 21 January 2004. DOTARS is assessing whether this report meets the requirements of the Sale Agreement and, if so, whether the full Period One Development Commitment has been met.
Canberra	11.0	Lessee advised on 28 October 2003 that Commitment met, indicating that \$32 million has been spent on Development Commitments. This report was rejected by DOTARS on 18 December 2003 as not meeting the requirements of the Sale Agreement. Further report obtained on 6 February 2004. Lessee advised ANAO on 19 April 2004 that DOTARS had advised it on 23 March 2004 that the Department accepts that the Period One Commitment has been met although it has sought further information on a number of minor projects, totalling \$5.195 million, before agreeing that the full \$32.21 million is accepted as airport development expenditure under clause 11 of the Sale Agreement.
Darwin	3.3	Information obtained from lessee on 2 October 2003. DOTARS advised lessee on 2 December 2003 that the audited statements did not meet the requirements under the Sale Agreement. Lessee submitted a five year consolidated audit report on 4 March 2004, indicating expenditure greater than the Commitment (\$4.8 million). DOTARS is assessing whether this report meets the requirements of the Sale Agreement and, if so, the amount of the shortfall. DOTARS also sent lessee a letter on 16 March 2004 requesting confirmation of the further details relating to the status of the auditor. DOTARS has advised ANAO that, following preliminary assessment of the Period One audited statement received on 8 March 2004, DOTARS wrote on 14 April 2004 to the Airport seeking further information.

Airport	Contracted Period One Expenditure \$m	Status
Lessees that have requested an extension to Period One (as Commitment not met at this time)		
Perth	54.6	Period One extended in 2000 by four years to 30 June 2006. In October 2003, DOTARS sought a consolidated audit report for the first five years to assess the extent of the shortfall leading to the need for an extension. Information was received on 5 February 2004 but further information has been requested. In April 2004, the lessee advised ANAO that it was not until a letter was received from DOTARS dated 28 November 2003 that the final specific requirements of the consolidated audit report were confirmed.
Hobart	3.8	In October 2003, DOTARS extended Period One deadline to June 2004 based on information provided by the lessee in July 2003, including a five year consolidated audit report. In April 2004, the lessee advised ANAO that it will not meet the June 2004 deadline and will be writing to DOTARS accordingly.
Alice Springs	1.2	Lessee has requested an extension, which DOTARS is considering. Information provided on 8 October 2003 but DOTARS recently advised the lessee that this information did not meet the requirements of the Sale Agreement. Lessee submitted a five year consolidated audit report on 4 March 2004. On 9 March 2004, DOTARS gave in-principle agreement to a four-year extension, subject to a number of conditions being met. DOTARS sent lessee a further letter on 16 March 2004, requesting confirmation of further details relating to the status of the auditor.
Adelaide	41.4	Report obtained on 29 October 2003 claiming expenditure less than the Commitment. DOTARS sought a compliant report, which was received on 22 January 2004. DOTARS sought further clarification on 27 January 2004 and is assessing whether this report now meets the requirements of the Sale Agreement and, if so, the extent to which the Commitment has been met. In April 2004, the lessee advised ANAO that it is awaiting official confirmation of the underspend for Period One and approval to carry forward that underspend into Period Two for set-off against New Terminal expenditure.
Other lessees		
Coolangatta	19.2	Report obtained on 22 September 2003 indicating Commitment not met. In December 2003, DOTARS decided that the report submitted did not meet the requirements of the Sale Agreement and the lessee was asked to provide a compliant report. DOTARS has advised ANAO that the Airport sent a report to the Department on 13 April 2004, which is now being assessed.
Total	259.3	

Source: ANAO analysis of sale documentation and DOTARS data and advice from DOTARS.

3.51 Accordingly, at the time of ANAO's performance audit, it was not possible to assess the extent to which the contracted Period One aggregate Development Commitment of \$259.3 million had been achieved.

3.52 There has been no public reporting by DOTARS on the extent to which individual airport lessees have met their Development Commitments. This approach contrasts to that taken by the Department of Communications, Information Technology and the Arts (DOCITA) on development commitments included in the contracts signed under the Information Technology (IT) Outsourcing Initiative. To date, DOCITA has published four reports⁶² on outcomes that have been achieved under the industry development commitments for each of the five IT outsourcing contracts awarded between 1997 and 2000. As is the case in respect to DOTARS, there is no legal requirement for DOCITA to produce a public report.⁶³

Expenditure shortfalls

3.53 Under the Sale Agreements, shortfalls in achievement by lessees against their contracted Development Commitments may be addressed in two ways.

- Where there have been mitigating circumstances (such as reduced growth in target passenger and aircraft numbers) that make the Commitments financially unjustifiable, or a force majeure event occurs, DOTARS and the relevant lessee are required to negotiate in good faith to agree upon the period of any extension and the amount by which the Commitment will be increased to ensure it is not eroded in real terms by the delay. The Sale Agreements require that, when negotiating an extension and the related increase to the Commitment, DOTARS and the lessee will have regard to:
 - the extent to which the lessee has complied with its development obligations in the past;
 - the likely period that will elapse before the event causing the delay will no longer make performance of the obligation financially unjustifiable for the lessee;
 - the steps the lessee should be taking to overcome or minimise the adverse effects of the event leading to the delay; and

⁶² The most recent report, for 2002–03, was titled *Information Technology Outsourcing Initiative: Industry Development Progress Report on 1997–2000 Contracts*.

⁶³ ANAO Audit Report No.36 2002–03, *Monitoring of Industry Development Commitments under the IT Outsourcing Initiative*, Canberra, March 2003, p.72.

- the assumed inflation rate over the period the lessee's obligation to comply with the Development Commitment will be extended.
- Alternatively, if the Commonwealth gives the lessee notice within 60 business days of receiving the Period One or Two report, the lessee may be required to pay the Commonwealth the amount of any shortfall if actual expenditure is less than 90 per cent of the Period One Commitment or less than 80 per cent of the Period Two Commitment.⁶⁴ The purpose of this "use it or lose it" contractual mechanism was to provide the strongest possible legal incentive for lessees to meet their Development Commitments. In addition, the lease expressly provides for the Commonwealth to exercise any other right or remedy it may have, in seeking to redress a shortfall in expenditure.

3.54 As DOTARS has yet to finalise its analysis and assessment of Period One outcomes, there have been no occasions to date where DOTARS has required a lessee to pay any shortfall to the Commonwealth.

3.55 As noted in Table 3.5, in three instances, lessees have sought extensions to the time frame for achieving their Period One Development Commitments.⁶⁵ Extensions have been granted in each instance as follows.

- In October 2000, DOTARS gave in-principle agreement to the extension of time for Perth Airport to meet its Period One expenditure Commitment.⁶⁶ In November 2000, DOTARS advised the lessee that it agreed to a four-year extension to Period One and that the assumed inflation rate to be used in adjusting the total Commitment would be determined after the end of the original Period One (that is, July 2002). On 10 March 2004, DOTARS advised the lessee that it has determined that the appropriate interest rate to apply to the deferred development expenditure is the risk free nominal interest rate, approximated by the interest rate on Treasury 10 year bonds.

⁶⁴ In March 2004, DOTARS obtained internal legal advice that the 60 business days period in which the Commonwealth can exercise its rights to have any shortfall paid to it by the lessee does not commence until such time as the lessee provides DOTARS with a report that satisfies all the requirements of the Sale Agreement. This is subject to the proviso that, if the Commonwealth has waived the requirement for a Period One or Two report, it cannot then exercise its rights to have the shortfall paid. The legal advice also stated that, if the Commonwealth's delay in advising a lessee of their failure to provide a compliant Period One or Two audit report was significant, the Commonwealth could not exercise its rights to have the shortfall paid by the lessee. The advice concluded that, at present, it appears that there has not been any significant delay in advising lessees of potential shortcomings in their Period One reports.

⁶⁵ This does not include Adelaide Airport which, as noted in Table 3.5, advised ANAO in April 2004 that it is awaiting approval from DOTARS to carry forward its Period One underspend into Period Two.

⁶⁶ This agreement was based on correspondence from the lessee indicating that it expected to spend \$32.85 million in the first five years, a shortfall of some 40 per cent against the Period One Commitment of \$54.6 million.

- In October 2003, DOTARS agreed to extend Period One for Hobart Airport to June 2004 (a one year extension). In February 2004, DOTARS advised ANAO that it had applied indexation to the deferred development expenditure using the risk free nominal rate.⁶⁷ However, DOTARS determined that the resulting amount (\$2.41 million)⁶⁸ was considerably less than the amount the lessee plans to spend on a terminal upgrade which would, as such, more than offset any diminution in the real value of the contracted Development Commitment. As a result, the provisions of the Sale Agreement allowing DOTARS to increase the specified amount of the Period One Development Commitment were not exercised, with the Period One Commitment remaining \$3.8 million. In April 2004, the lessee advised ANAO that it will not meet the extended time and will be writing to DOTARS accordingly.
- In March 2004, DOTARS gave in-principle agreement to a four-year extension for Alice Springs Airport to meet its contracted Period One expenditure Commitment. DOTARS advised the lessee that it proposed to use the 30 June 2003 yield on 10-year Treasury Bonds to increase the contracted Period One amount to reflect the delay. Based on the information submitted by the lessee, DOTARS estimated that this approach would increase the expenditure commitment by \$24 148. The in-principle agreement was also subject to DOTARS undertaking a review of claimed development expenditure to satisfy itself that it is in accordance with the Sale Agreement requirements.

⁶⁷ The DOTARS *Procedures and Guidelines* document states that the risk free nominal rate is the Treasury Long-term Bond Rate. In this instance, DOTARS based its calculations on rates at the time of its consideration of the extension request (October 2003) rather than at the date the Period One Commitment was originally due to have been met (30 June 2003).

⁶⁸ DOTARS' October 2003 calculations were based on the lessee's May 2003 estimate of a likely shortfall of \$2.28 million rather than the lessee's July 2003 audited figure of a shortfall of \$2.40 million. In both instances, non-aeronautical expenditure was included as counting towards achievement of the Period One Commitment.

Recommendation No.9

3.56 ANAO *recommends* that DOTARS report achievement against the Period One Development Commitment for each airport in its next Annual Report.

DOTARS response

3.57 DOTARS agreed with qualification to the recommendation. DOTARS stated that, from its 2003-2004 Annual Report onwards, the Department will report the outcomes for those airports that have completed their Period One Development Commitments for that respective year.

Canberra ACT
4 June 2004



P. J. Barrett
Auditor-General

Appendix

Appendix : DOTARS Position on ANAO Findings

Introduction

A key factor that could not be foreseen at the time privatisation of the airports commenced, but which has subsequently influenced the Department's approach to oversight of the airports, has been the dramatic international and domestic shocks occurring since 1998. The resultant market volatility has, understandably, also affected the airports' capacity to complete their regulatory and operational obligations within the original timeframe envisaged by the Government.

In assessing the timeliness of an airport's performance in relation to any one of its responsibilities, such as Airport Development Commitments as provided for under the airports' Sale Agreements, the Department must also give consideration to the scope of the airports' activities and performance in other areas.

Ministerially approved Master Plans and Major Development Plans, which provide detailed information relating to significant on-airport developments, are the most significant monitoring mechanisms for overseeing the ongoing development of leased airports. Given the regulatory requirements relating to Master Plans, the Department's major focus during the first five years of privatisation has been to ensure that all airports had an approved Master Plan in place. At the same time, the Department has also been heavily involved in sale processes for some 18 Federal airports.

In late 2002 the Department refocused its attention to developing and implementing more formal mechanisms in relation to lease management of the airports. These have included a number of major initiatives relating to the development of a formal structured approach to lease reviews; guidelines for the oversight of ex-gratia payments in lieu of land tax and Airport Development Commitments; a framework for the conduct of insurance audits and oversight of insurance reports; and comprehensive analysis procedures for cost recovery relating to the reconciliation of advance payments for Airport Environment Officers (AEOs) and Airport Building Controllers (ABCs).

In dealing with any issues that have arisen from the Lease and Sale Agreement obligations, the Department has applied a test of "reasonableness". While at times this has resulted in a less prescriptive approach than ANAO has recommended in the Audit Report, nevertheless the Department strongly believes that its more flexible approach has more effectively achieved the Government's long term objectives for privatisation of the airports. This approach has demanded a high degree of agility to respond to a very complex risk management environment.

It is noted that while ANAO reviewed the Department's entire lease oversight responsibilities, ANAO has chosen only to comment in its Audit Report on an 'exception basis' that is where it considers deficiencies have occurred. For example, the ANAO extensively reviewed the arrangements the Department has in place for the recovery of costs from airports as required under the lease for the provision of AEOs (some \$1.584 million for 2003-2004), as well as the arrangements for the recovery of ex-gratia payments in lieu of land tax as required under the lease (estimated as some \$7.1 million for 2003-2004). However, ANAO has not reported on the Department's performance in these areas.

Insurances

The ANAO view in relation to insurance has been based on a review of circumstances that occurred following September 11, and its resulting significant impact on the insurance industry. The Department considers that its response at the time was appropriate given the unique and dramatic circumstances flowing from the September 11 event and more importantly should not be considered to reflect the approach that would be taken under more 'normal' circumstances.

These events resulted in uncertainties arising in the insurance industry, which affected the ability of airports to obtain war and terrorism insurance. The Australian Government's introduction of the *Terrorism Insurance Act 2003* and related regulations was a significant recognition of the effect of the withdrawal of this insurance cover for airports.

It was not until the later part of the 2001-2002 financial year that the Department felt confident that the insurance industry had recovered sufficient stability in regard to their arrangements with airports to enable a formal tender process for the general oversight of airport insurance requirements under the airport leases to be undertaken. In this regard the Department notes that the tender process it carried out amidst the uncertainty of mid-2002 took only three months to complete.

Given the major disruption and changes occurring in the aviation insurance industry at the time, the insurance contract entered into by the Department in June 2002 required a far more detailed and structured analysis of individual airports' insurance arrangements than had previously been in place and hence far more extensive responses from airports were required. Given the nature of these new inquiries and the detailed reports provided by the insurance contractor, it is not surprising that some time delays were experienced by both the Department and the airport lessees in responding to these new demands. As noted by ANAO, the Department has contacted each airport to provide feedback on the results of the initial audits and seek a response to issues identified. The Department considers that as the initial assessment task has

now been completed and with the base information now provided to the insurance contractor, subsequent insurance audit reviews will be significantly streamlined. The Department considers that ANAO has not given sufficient recognition to the extensive nature of these new arrangements and the considerable benefits this revised initiative has had on the oversight of airports' insurance cover.

Tripartite Deeds and the size of the Commonwealth's exposure

The Audit Report comments on the nature of Tripartite Deeds and the size of the Commonwealth's potential liability exposure arising from these Deeds. It is important to understand that the Commonwealth's potential liability is limited to the value of the lease at the time of termination and will not necessarily be equal to the value of the secured moneys. In addition any liability is offset by the return from the on-sale of the lease. As further protection, clauses included in the airport lease and the Tripartite Deed indemnify the Australian Government for all costs associated with undertaking step-in remedy and similar actions.

The Commonwealth's potential liability exposure is principally one of timing, rather than of a dollar amount. As confirmed in the then Minister for Finance's response of 29 July 1997 to the then Minister for Transport's letter of 7 April 1997:

Were the Commonwealth to be exposed to a liability under the Tripartite Deed, the appropriate mechanism to cover any immediate requirement for Commonwealth funding would be to call on the Advance to the Minister for Finance (AMF) as funding would be both urgent and unforeseen, unless funds could be provided from the Budget or Additional Estimates. The balance of any necessary Commonwealth funding would be met through appropriation.

I note that where the Commonwealth is required to enter into possession of an airport site there are a number of avenues by which it and therefore the Budget can recover its costs. These include airport revenue, the airport lessee, or if unsuccessful, from the airport lessee's financier. However, it should be noted that the Commonwealth could not apply these revenues to meet its expenditures without an appropriation.

Given that the step-in and remedy rights under the Tripartite Deeds enable any exposure to be recovered from either the lessor or the financier, contrary to ANAO's view the Department believes it is difficult to see how a contingent liability which relates more to timing than actual amounts can be realistically quantified.

The Department intends to re-examine the description of Tripartite Deeds as a contingent liability with its financial statement auditors in preparation for settling the Department's 2003-2004 audited statements. The Department

regards this approach as the best avenue to define any possible liability exposure.

Letters of comfort

As noted in the Audit Report, the Department has legal advice which confirms that its 'letters of comfort' do not constitute a contingent liability as they are neither intended to be a legally binding contract or agreement, nor an arrangement which would give rise to any legal consequences, such that public money may become payable. Nevertheless, as it considered the action recommended by ANAO to be prudent, in April 2004 the Department entered the five 'letters of comfort' onto the Department's Register of Contingencies and put in place appropriate safe custody arrangements for these instruments.

Cost recovery arrangements

The Department does not agree with the ANAO that the Lease Agreements mandate that the costs incurred in administering the airport leases be recovered. At the time that the leases were being developed the Department requested that the power to recover those costs as defined in Clause 11.2 of the lease should be retained. Given that the leases were likely to run for the full 99-year period, it was prudent to provide this discretionary power in case it was deemed necessary to recover these costs.

The Department's major focus for cost recovery has initially been on putting in place robust mechanisms for non-discretionary activities as required under the lease and sale documentation, such as AEOs and ABCs. Acknowledgement by the ANAO of the Department's performance in this area would have presented a more balanced assessment of its cost recovery arrangements and achievements.

It is also the Department's view that the activities undertaken in relation to the oversight of the Federal leased airports cannot be easily identified separately into those activities arising from the sale documentation, the Lease Agreement and the Act. Before a precise cost figure can be derived, it would be necessary for a full costing activity process to be put in place to capture the actual effort involved in delivery of this activity.

In accordance with Finance Circular 2002/02, 'Cost Recovery by Government Agencies' issued in December 2002, the Department is scheduled to commence its two-year review in 2003–2004 of all existing cost recovery arrangements and applying the new policy to all new and significantly amended cost recovery arrangements. The cost recovery arrangements provided for under the airport lease will form part of this review.

Annual Lease Reviews

The Department's view remains that lease reviews should be carried out on a rolling year program rather than against a fixed financial year timetable. As the Department noted in its response to the ANAO's 1998 Audit Report, whilst its intention is to hold formal lease meetings annually, 'the key task will remain to continue to actively oversight those lease obligations which arise on a day-to-day basis.'

A rolling year program for lease reviews better enables the Department to more efficiently deal with the range of regulatory, lease and sale oversight demands that the Federal leased airports place on the Department. It is acknowledged that doing so has led, in some cases, to lease reviews not occurring on a fixed 12 monthly cycle. The Department manages its broad regulatory and lease oversight responsibilities in the most efficient and effective manner possible and it is preferred that reviews are conducted when both key regulatory and lease matters are involved.

Since the sale of the airports commenced in the late 1990's, there has been the need for a major refocussing of the Department's priorities in response to the unexpected major regulatory events and industry shocks occurring since that time. In addition to the events previously mentioned, the major airport sale processes (including the sale of Essendon Airport in 2001, the two sale processes for Kingsford Smith Airport in 2001 and 2002, and the sale of Sydney Basin Airports in 2003) have also been conducted. The high priority and consequent resources required to respond to these events has meant that any outstanding lease reviews were not necessarily conducted when originally scheduled. This approach however is justifiable in the overall context of meeting the Australian Government's policy objectives in relation to the oversight of Federal leased airports and consistent with the views expressed by the Department at the time of its response to ANAO's 1998 Audit Report.

The Department acknowledges the Audit Report's comment that the Department did not accurately reflect in its 2001–2002 and 2002–2003 Annual Reports the extent to which reviews have been conducted. Reporting of lease review meetings in the Department's Annual Reports has, through necessity, been abbreviated. The Department will ensure that information relating to lease review meetings is appropriately reported in future Annual Reports.

The Department welcomes ANAO's acknowledgment that major improvements have been made in the Department's approach to conducting lease review meetings. The Department continues to develop and enhance its approach to the lease reviews to ensure 'best practice' is achieved, within its budgetary constraints.

Airport Development Obligations

Of necessity, the Department has to prioritise the allocation of its resources and strike a balance based on risk between the regulatory challenges and its Lease and Sale Agreement monitoring role. At the strategic level, much of the monitoring envisaged by the Sale Agreements is being delivered through the Department's regulatory oversight processes. For example, a detailed understanding and appreciation of the delivery of developments on airport is obtained through the processes associated with the planning and building approvals granted under the Act and its associated Regulations. The major role that these processes play in enabling the Department to maintain sound oversight of ongoing development at the major leased airports has not been acknowledged by ANAO.

Administrative Oversight

The Department therefore rejects ANAO's view that development of procedures and guidelines for the oversight of the administration of Development Commitments was not timely.

While the Department accepts that a one year earlier implementation of the Guidelines would have been beneficial in preparation for the formal assessment of the Period One reports, the Department was well aware at the time that only Melbourne and Brisbane airports were required to lodge their Period One reports in 2002 (the only other Phase 2 airport, Perth, had had its Period One extended until 2006) and that both Melbourne and Brisbane had already exceeded their Period One obligations. The Department took the view that of greater priority was the development of detailed Guidelines to enable all airports (but particularly the Phase 2 airports which were required to lodge Period One reports by September 2003) to be assessed in a consistent and rigorous manner, thus ensuring the Commonwealth receives 'value for money' from the Development Commitments consistent with the original sale objectives.

The Department notes comments made by ANAO regarding the non-completion, at the time of the audit, of analytical outputs required under the Department's Guidelines and that it was not possible for ANAO to assess the extent to which the contracted Period One aggregate Development Commitment had been achieved.

The Department is conscious that the production of these reports is dependent upon the airports' completion of fully audited annual company accounts. The impact of this requirement was not fully recognised when the timetable for the Sale Agreement obligations was put in place. The Department considers that it is not unrealistic that Development Commitment returns have been somewhat delayed.

However the Department considers that the delay in concluding Period One reports does not limit the Australian Government's ability to enforce the Period One Development Commitment provisions in the Sales Agreements with the respective airports.

The Department intends publishing information in its Annual Reports about Period One outcomes to confirm that this aspect of the Sale Agreement obligations has been properly addressed and the Australian Government has achieved value for money.

It is important to note that the achievement of Development Commitment obligations, and aeronautical infrastructure development more broadly, have through necessity been secondary considerations for some airport operators given the external environmental challenges they have had to respond to since privatisation. In recognition of this, the Department has not increased the administrative burden and distractions on airport lessees from their stabilisation tasks, but has done so only where the Commonwealth is not being exposed to additional commercial risk. In view of this, the Department believes it is premature to comment on the effectiveness of this aspect of the Department's lease oversight obligations as the assessment of the Period One outcomes is yet to be completed. The Department is aware, however, that the combined capital expenditure on aviation and non-aviation developments at the major capital city airports since privatisation totals some \$570 million. This significantly exceeds the total Period One airport Development Commitments of \$259 million, appreciably increasing the value of the Commonwealth's assets and a clear indicator of the success of the Australian Government's airports privatisation policy.

The Department also notes ANAO comments in relation to the timeliness of annual expenditure plans and annual cost reporting by lessees. The emphasis placed by ANAO in regard to these documents does not accord with the Department's view.

It is important to recognise that an annual audited report does not form the basis for the Department forming a view on whether a lessee will achieve its contractual obligations. Airport operators are not obliged to include expenditure items that may have been identified in their annual Development Commitment statements into their Period One or Two formal audited reports. The only obligation on the lessees is that they are required to have expended the agreed funds on aeronautical capital development by the conclusion of Period One and Two respectively. For this reason the Department considers that the better view is that the appropriate time to undertake analysis and detailed engagement with a lessee (as necessary) is at the conclusion of the 5 yearly Period One and Period Two.

The Guidelines recognise that with greater stability emerging in the industry and regulatory requirements becoming more routine, airports are better placed to address the reporting requirements in relation to Development Commitments. The Department is committed to the application of the Guidelines and the ANAO's concerns in regard to this matter will be appropriately addressed through this process.

In recognition of the increasing importance of these annual reports, the inclusion of performance information relating to both annual reports and expenditure plans in the Department's Annual Reports needs to be addressed. The Department considers, however, that prior to including any performance information identifying a particular airport, airports should be given advance notice of this intention. On this basis, the Department will include performance information relating to annual reports and expenditure plans from the 2004-2005 Annual Report onwards.

Out-of-scope expenditure

The ANAO comments that the Department's oversight in relation to the definition of aeronautical infrastructure development has been inconsistent, particularly in relation to the treatment of commercial developments. ANAO also notes that it has identified instances where annual reports submitted by the airports included certain items of expenditure that may not be within the permissible categories for the purposes of the Development Commitments.

The Department's Guidelines detail how expenditure reports need to be assessed to determine whether items of expenditure meet the definition of airport development. This specific assessment is part of a comprehensive rigorous assessment of Period One reports being followed by the Department's officers under the Guidelines. This approach ensures that out-of-scope expenditure is rejected but also recognises the individual circumstances of the airports and associated Sale Agreements involved.

Whilst commercial developments are generally not included as an approved Development Commitment obligation, there are circumstances where the inclusion of such a development can be considered appropriate, for example where a commercial development has been listed in the relevant airport's Sale Agreement.

Expenditure shortfalls

The ANAO has commented that there have been no occasions to date where DOTARS has required a lessee to pay any shortfall to the Commonwealth. Whilst the Department is yet to finalise its analysis and assessment of Period One outcomes, it considers that the provisions included in the Sale Agreements regarding the payment of a penalty to the Commonwealth for unexpended

Development Commitment expenditure would be applied as a last resort. It is in neither the Australian Government's nor the airports' interest to forgo necessary aeronautical development on airports. Given the dramatic industry shocks during Period One, the Australian Government's broader aviation policy interests are best served by working with the relevant airports to ensure that these investments are implemented at an appropriately agreed time as originally intended under the Sale Agreements.

The Department notes that ANAO has identified several instances where lessees have presented a different understanding of their obligations under Sale Agreement in relation to their Development Commitments. Given the complexity of these arrangements and the highly commercial nature of the airport businesses, the Department considers it is understandable that there will not always be a shared understanding on some specific issues. It would be unrealistic if there was complete agreement on all issues given the Department's role in protecting the Australian Government's interests. DOTARS' approach is to maintain ongoing discussions with airports to facilitate, wherever possible, a mutually acceptable outcome.

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