

The Auditor-General
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Performance Audit

Management of Airport Leases: Follow up

Department of Transport and Regional Services

Australian National Audit Office

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Canberra ACT
8 February 2007

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Transport and Regional Services in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *Management of Federal Airport Leases: Follow-up*.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee'.

Ian McPhee
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 and Glossary

| | |
|----------------------------|--|
| ABC | Airport Building Controller |
| AEO | Airport Environment Officer |
| AGS | Australian Government Solicitor |
| Airports Act | <i>Airports Act 1996</i> |
| ALC | Airport Lessee Company |
| ANAO | Australian National Audit Office |
| AOOL | Airport Owners and Operators Liability |
| CRIS | Cost Recovery Impact Statement |
| DOTARS | Department of Transport and Regional Services |
| Finance | Department of Finance and Administration |
| FTE | Full Time Equivalent |
| JCPAA | Joint Committee of Public Accounts and Audit |
| Terrorism Insurance Act | <i>Terrorism Insurance Act 2003</i> |
| The original audit | ANAO Audit Report No.50 2003–04, <i>Management of Federal Airport Leases</i> |
| Tripartite Deed | Tripartite Security Deed |
| VHST | Very High Speed Train |

Summary

Summary

Introduction

1. Between 1997 and 2003, 22 Federal Airports were privatised raising more than \$8.5 billion in Commonwealth sale proceeds. The airports privatisation program involved leasehold, rather than freehold, sales. As a result, the Commonwealth has an ongoing interest in airport operations, both as landlord and because 21 of the 22 airport sites revert to the Commonwealth at the conclusion of the Airport Lease.¹

2. Post-sale management of the rights and obligations established by the sale documentation is the responsibility of the Department of Transport and Regional Services (DOTARS). In June 2004, the Australian National Audit Office (ANAO) tabled a report titled *Management of Federal Airport Leases*² (referred to in this report as the original audit). The objectives of the original 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.

3. In the original audit, ANAO recognised the significant changes that had occurred in the aviation environment since the first sales in 1997. However, ANAO found that DOTARS had taken too long to develop procedures to administer important aspects of lessees' contractual obligations. In addition, although DOTARS had, from 2002, taken steps to improve its approach to contract administration, there was room for improvement in a number of areas. The nine recommendations related to the administration of the cost recovery provisions of the sale documentation, management of contingent liabilities (specifically, letters of comfort), conduct of lease reviews, the administration of airport insurance policies and oversight of aeronautical infrastructure development at the airports. DOTARS agreed with six of the recommendations, and agreed with qualification to the remainder.

4. The Joint Committee of Public Accounts and Audit (JCPAA) reviewed the original audit and made three recommendations relating to cost recovery

¹ The exception being Hoxton Park. It was sold with a shortened five-year 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.

² ANAO Audit Report No.50 2003–04, *Management of Federal Airport Leases*, Canberra, 4 June 2004.

in future asset sales, administration of the airport insurance arrangements and performance reporting in Annual Reports.³

5. The objective of this follow-up audit was to assess the extent to which DOTARS had implemented the nine recommendations contained in the original audit.

Overall audit conclusions

6. Since the report on the original audit tabled in June 2004, DOTARS has significantly improved and enhanced its practices and procedures across the full range of its lease administration responsibilities. Specifically, a comprehensive framework for lease administration has been developed and is being progressively implemented. Of particular note is that:

- through the timely and effective conduct of lease reviews, DOTARS is now in a position to be able to identify and address all significant areas of concern in respect to lease administration;
- DOTARS has procedures in place to effectively manage airport insurance risks with it assessing that as of August 2006, each airport had in place insurance cover that has removed most Commonwealth risk; and
- six of the ten lessees that committed in their respective sale agreements to a specified amount of aeronautical infrastructure development expenditure over the first ten years of the lease have been assessed by DOTARS to have fully met their contractual obligation. The remaining four lessees have been assessed as meeting the first five year stage of this commitment.

7. In this context, significant attention is now being given to post-sale management of leased Federal Airports. This reflects the extent and significance of the Commonwealth's rights and obligations under the sale documentation.

³ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005.

Key Findings

Cost recovery (Chapter 2)

8. The cost recovery clause in the Airport Lease was drafted to reflect DOTARS' preferred position, enunciated at the time of the first sales in 1997, that it be able to recover its reasonable lease administration costs. This was to address the risk that future costs were greater than expected and/or that the lease management function was not Budget-funded.

9. DOTARS has addressed a recommendation of the original audit that the Department consider the merits of exercising the contractual right to recover its lease administration costs. In doing so, DOTARS found that a statement made to bidders by the Commonwealth in the second phase of the sales (in 1998) had undermined the Commonwealth's contractual rights to recover lease administration costs for 14 of the Federal Airports. In this context, DOTARS has concluded that implementing a cost recovery process for only some of the airports could be perceived as being inequitable, would be difficult to administer and may be an inefficient use of resources. Accordingly, a decision has been made not to recover lease administration costs except in special circumstances.

10. DOTARS' decision not to seek to recover lease administration costs is consistent with the Department of Finance and Administration's (Finance) response to a JCPAA recommendation arising from its review of the original audit.

Lease reviews (Chapter 3)

11. DOTARS conducts lease reviews 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. ANAO found that significant improvements have been made since the original audit to the conduct of lease reviews. Of note is that:

- a risk assessment of the management of airport lease reviews has been conducted, with risk treatments designed for all medium and high risks;
- lease review guidelines and document templates have been developed and implemented;

- there has been a noticeable improvement in the frequency with which lease reviews have been conducted, with the leases of all Federal Airports reviewed at least once since the original audit; and
- there has been continuing improvement in the documentation of lease review assessments, providing a sound basis for more effective follow-up of issues with lessees and finalisation of reviews.

Airport insurances (Chapter 4)

12. Insurable risks for airports arise both from their aviation-specific activities and general commercial activities. As part of the privatisation process, the Commonwealth sought to limit its risk from operations on the leased Federal Airports by imposing insurance coverage requirements on airport lessees, addressing aviation liability and property damage and business interruption.

13. Following the completion of the original audit, a number of initiatives were taken by DOTARS to improve the administrative framework for oversight of insurance obligations. Notable enhancements include:

- consolidation of responsibility for oversight of airport insurance arrangements to one section of the DOTARS' Airports Branch;
- finalisation in November 2005 of Guidelines for the Assessment of Insurance Coverage at Leased Federal Airports;
- maintaining contractual arrangements that provide ongoing access to expert, independent advice on lessees' insurance policies;
- a significant improvement in the timeliness of follow-up of reports from the contracted insurance adviser; and
- a more active interest being taken in administering the insurance provisions, including taking action to address deficiencies in insurance cover at certain airports.

Letters of Comfort (Chapter 5)

14. 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 a legal obligation. Commonwealth policy is that, in general, letters of comfort should be avoided because they may lead to an actual liability. The letters of comfort issued in relation to Federal Airport leases relate 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.

15. Since the original audit, only one new letter of comfort has been issued (in February 2005). In terms of this and the five other letters of comfort, ANAO found that DOTARS has improved its administrative arrangements. All letters of comfort are included in the Department's Indemnities Register and safe custody arrangements for the instruments are now in place.

Airport Development Obligations (Chapter 6)

16. 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. In total, the 10 airports were required to undertake capital expenditure of \$699.8 million. The Obligations are divided into two five year periods (referred to as Period One and Period Two).

17. Four of the nine recommendations in the original audit related to the administration of the airport Development Obligations. In this context, action has been taken by DOTARS to address each of these recommendations, as follows:

- in September 2005, administrative responsibility for Development Obligations was consolidated in one section to improve the consistency of assessments and subsequent decision making;
- in October 2005, revised administrative guidelines were promulgated;
- in most instances, DOTARS is now obtaining Annual Expenditure Plans from lessees, although most Plans are not received on time;
- Annual Airport Development Cost Reports on airport development expenditure by the lessees are being obtained in a more timely manner, although timeliness could be further improved; and
- there has been greater rigour apparent in the analysis of information provided by lessees and more timely follow-up of concerns with lessees.

18. ANAO identified opportunities for further improvements in DOTARS' approach to assessing the achievement of relevant airport's obligations to undertake capital expenditure. Specifically, there was variation in the level of detail provided by different lessees, there have been inconsistencies in the

nature of expenditure that has been accepted or rejected for different lessees and there is some uncertainty that some of the expenditure that has been accepted by DOTARS fairly reflects aeronautical infrastructure development expenditure. In addition, DOTARS could have been more timely in its analysis and raising of concerns with lessees. This would have better protected the Department's ability to exercise its rights under the Sale Agreements to have any shortfall in expenditure paid to the Commonwealth.

19. As of December 2006, ten lessees had been assessed as having met their Period One Development Obligations. In addition, six lessees have been assessed as meeting their Period Two Development Obligations in advance of the due date (2007 for some lessees and 2008 for others). Accordingly, ANAO has not made any further recommendations in this area.

Agency Response

20. DOTARS provided a summary comment on the report, as follows.

As previously stated in response to Australian National Audit Office Performance Audit Report No.50, *Management of Federal Airport Leases 2003–04* the Department remains committed to continued development and implementation of initiatives for the efficient and effective oversight of the leased Federal airports. This will continue to be achieved through improvement of the Department's regulatory, contractual and operational oversight processes, and the continued appropriate allocation of resources according to risk.

Effecting long-term, sustained change does not occur spontaneously and requires considerable time to ensure that any new procedures and processes are adequately developed and 'bedded down'.

As part of its continuous improvement, the Department has, as noted by the ANAO, made significant progress in the management of its oversight of the Federal Airport leases and Sale Agreements since the tabling of the Audit Report No.50, and developed a range of strategies and initiatives to improve its oversight activities. Significant focus has also been placed on the review and improvement of the Department's performance reporting in regard to this matter.

The Department considers that it has implemented the recommendations contained in Audit Report No.50 and put in place ongoing processes and procedures for the Department to discharge its ongoing lease management responsibilities effectively.

In particular, management of airport leases and sale agreements has been improved by implementing a broad range of measures including:

- centralising airport insurance and airport development obligations oversight;
- relevant guidelines being reviewed, updated and implemented;
- implementing improved procedures and processes for annual lease reviews to ensure they are undertaken in an efficient, effective and consistent manner;
- development and implementation of a Register of Contingencies and appropriate safe custody arrangements for Letters of General Assurance issued by the Department; and
- consideration of the Department's cost recovery of administrative costs associated with lease oversight.

In view of these improvements the Department's performance reporting on these matters has also been enhanced to include further details of the airports' compliance with their contractual obligations.

The Department is cognisant of the need to continually improve its processes and will take into account comments made by the ANAO in this audit.

The Department acknowledges the effort of the leased Federal airports in responding to the Department's implementation of the recommendations in Audit Report No.50.

Audit Findings and Conclusions

1. Introduction

This Chapter outlines the background to the sale of the 22 Federal Airports, summarises the major sale documentation and explains the audit approach.

Privatisation of the Federal Airports

1.1 Prior to privatisation, the Federal Airports Corporation owned and operated one of the world's largest and most successful integrated airport networks.⁴ Legislation to facilitate the sale of the 22 Federal Airports was passed in 1996, with the *Airports Transitional Act 1996* providing for the leasehold sale of the Federal Airports and the *Airports Act 1996* (Airports Act) establishing a framework for the regulation of leased Federal Airports.

1.2 In total, the privatisation program raised more than \$8.5 billion in proceeds for the Commonwealth. It was conducted in a number of stages, as follows:

- Phase 1 involved the sale of separate long-term leases over Brisbane, Melbourne and Perth airports.⁵ In total, Phase 1, which was completed in 1997, 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.
- Phase 2 comprised eight major, or core regulated, airports and seven non-core regulated airports.⁶ Between 10 June 1998 and 30 June 1998, long-term leases were granted over 14 of the Phase 2 airports to 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.
- Essendon Airport was originally included in Phase 2 but was withdrawn from sale in April 1998 because it was concluded that the tenders received at this time did not adequately address the Government's sales and ongoing privatisation objectives. A separate

⁴ Federal Airports Corporation, *1997–98 Annual Report*, October 1998, p. 1.

⁵ Phase 1 initially comprised Sydney (Kingsford Smith) Airport and the proposed Sydney-West, Melbourne, Brisbane and Perth airports. Sydney (Kingsford Smith) Airport and the proposed Sydney-West Airport were removed following the March 1996 Federal election. Adelaide was included in Phase 1 for a time but was later removed to allow time for resolution of issues relating to the extension of the runway.

⁶ The Airports Act established the regulatory regime for the major Federal Airports, defined in the Act as core-regulated airports. The Airports Act also allows for the regulatory regime, or parts of it, to apply to the non-core regulated airports.

tender process for the sale of Essendon Airport was conducted in 2001. On 10 August 2001, the sale of Essendon airport was announced for a price of \$22 million.⁷

- The sale of Sydney (Kingsford Smith) Airport was completed on 28 June 2002. In addition to acquiring all the shares in Sydney Airports Corporation Limited for a purchase price of \$4.233 billion, the purchaser was granted 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.
- The sale of the remaining three airports (Bankstown, Camden and Hoxton Park) was completed on 15 December 2003. All three were sold to the same purchaser for \$211 million.⁸

1.3 The ANAO has conducted audits of the Phase 1 Sales (Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*), the Phase 2 Sales (Audit Report No.48 1998–99, *Phase 2 of the Sales of the Federal Airports*) and the Sale of Sydney (Kingsford Smith) Airport (Audit Report No.43 2002–03, *The Sale of Sydney (Kingsford Smith) Airport.*) Audits have not been conducted of the sales of Essendon, Bankstown, Camden and Hoxton Park Airports.

Post-sale management of leased airports

1.4 The airports privatisation program involved leasehold, rather than freehold, sales. As a result, the Commonwealth has an ongoing involvement in airport operations. This is both in terms of the Commonwealth's role as landlord and because the airport sites revert to the Commonwealth at the conclusion of each Airport Lease.⁹

1.5 Post-sale administration of the rights and obligations established by the sale documentation is the responsibility of DOTARS. Specifically, the Department's Airports Branch's responsibilities include oversighting

⁷ 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.

⁸ Department of Finance and Administration, *2003–04 Annual Report*, October 2004, p. 48.

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

contractual obligations outlined in the airport sale and lease agreements.¹⁰ In this context, the major sale documentation comprised:

- A Sale Agreement between the Commonwealth, the lessee and its parent entities. The Sale Agreements provide for the transfer of all the relevant assets, liabilities and employees for each airport to the successful bidder. The Sale Agreements also grant the purchaser the Airport Lease.
- An Airport Lease between the Commonwealth and an Airport Lessee Company (ALC). This sets out the terms on which the Commonwealth agreed to grant a lease of the airport site.
- For 12 of the 22 airports sold, a tripartite security deed (tripartite deed) between the Commonwealth, the lessee and the lessee's financiers. The tripartite deeds vary the terms of the Airport Lease to provide the financiers with limited step-in and cure rights should a termination event occur under the lease. 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.

Original audit

1.6 In June 2004, ANAO tabled a report titled *Management of Federal Airport Leases*¹¹ (referred to in this report as the original audit). The objectives of the original 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. 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.

¹⁰ Department of Transport and Regional Services, *2004–05 Annual Report*, October 2005, p. 97.

¹¹ ANAO Audit Report No.50 2003–04, *Management of Federal Airport Leases*, Canberra, 4 June 2004.

1.7 Since the first sales in 1997, 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 Severe Acute Respiratory Syndrome pandemic and the Iraqi war. In the original audit, ANAO noted that the changes in the aviation environment have increased the challenges facing DOTARS in its regulatory and contract management roles.

1.8 Whilst recognising the changes in the aviation environment, ANAO found that DOTARS had taken too long to develop procedures to administer important aspects of lessees' contractual obligations. In addition, although DOTARS had, from 2002, taken steps to improve its approach to contract administration, there was room for improvement in a number of areas. ANAO considered that the following measures would improve DOTARS' management of the Federal airport leases:

- Consideration of the merits of exercising the Commonwealth's contractual right to recover reasonable lease administration costs from lessees. At the time of the original audit, insufficient attention had been given to managing the contracts over the period since privatisation. The cost recovery arrangements provided by the leases were seen as one possible means to increase the resources allocated to the contract management function.
- Lease review meetings to be held with all airports at least once a year with review outcomes to be documented, including an assessment of the level of compliance by lessees. Improved communication of review outcomes to lessees was also expected to add value, including by specifying outstanding issues that lessees are expected to address.
- The consistent and rigorous implementation of the comprehensive reporting process provided by the Sale Agreements to enable effective monitoring of lessee achievement of their aeronautical infrastructure Development Obligations. Revised procedures promulgated in 2003 were expected to assist in this regard, but the key performance issue was the timely and effective implementation of these procedures.

1.9 In this context, ANAO's original audit made nine recommendations concerning DOTARS' management of post-sale contractual obligations. DOTARS agreed with six recommendations and agreed with qualification to the remainder.

Review of original audit by the JCPAA

1.10 The JCPAA conducted a public hearing on the original audit in March 2005.¹² The report of the original audit and hearing was subsequently published by the JCPAA in November 2005.¹³ The Committee made the following recommendations in its review, relating to cost-recovery, insurance and performance reporting:

The Committee recommends that in future privatisation programs, government agencies include a clause in all sales contracts which provides for the Commonwealth's cost recovery of administrative expenses. Government agencies should then ensure that they undertake cost recovery of such expenses as a matter of course.

The Committee recommends that DOTARS adopts a procedure which ensures that follow-up administration on all insurance reports from the audit contractor are finalised within a three month timeframe. The Department's annual report should include a report on the status of all insurance reports from the audit contractor, including the date of the report, and date of any departmental actions arising from the report.

The Committee recommends that the annual report of DOTARS include a matrix reporting on each airport lease - including the status of annual lease reviews, insurance reports, Development Obligations, letters of comfort and cost recovery of administrative expenses. Where time extensions for Development Obligations have been granted, DOTARS must provide a comprehensive explanation detailing why the extension has been approved.

1.11 The Minister for Transport and Regional Services provided the Committee with his Department's response to the second and third of these recommendations in May 2006 (relating to insurance and performance reporting). Also in May 2006, Finance responded to the remaining recommendation (relating to cost recovery). Further details are provided in relation to these responses in Chapters Two, Four and Six of the Report.

Follow-up audit approach

1.12 This follow-up audit was conducted under Section 15 of the *Auditor-General Act 1997*. The objective of this follow-up audit was to assess the

¹² Following the hearing, the Chair of the Committee wrote to the Minister for Transport and Regional Services. In the letter, the Chair stated that it expected a higher level of knowledge of the issues highlighted by the Audit Report No.50 than that shown by DOTARS officials appearing at the hearing.

¹³ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005.

extent to which DOTARS had implemented the nine audit recommendations contained in the original audit. In order to demonstrate how DOTARS has improved its oversight processes, the report of this follow-up audit necessarily includes references to the processes in place prior to the 2004 original audit. Nevertheless, the focus of the report of this follow-up audit is on action taken by DOTARS in response to the original audit.

1.13 The original audit examined post sale management in respect to 17 Federal airports. Essendon, Sydney (Kingsford Smith), Bankstown, Camden and Hoxton Park Airports were excluded, as they were relatively recent sales at the time of the original audit. Given the time that has now elapsed since the sales, the scope of the follow-up audit included all 22 privatised airports.

1.14 Audit fieldwork was conducted between December 2005 and March 2006. The audit was conducted in accordance with ANAO Auditing Standards, at a cost of \$285 000.

2. Cost Recovery

This chapter examines the work undertaken by DOTARS to identify its lease administration costs, and DOTARS' assessment of the merits of exercising the Commonwealth's contractual rights to recover these costs from lessees.

Commonwealth cost recovery policy for regulatory agencies

2.1 In December 2002, a new cost recovery policy for the Commonwealth was announced.¹⁴ It was expected that the adoption of a formal cost recovery policy would improve the consistency, transparency and accountability of Commonwealth cost recovery arrangements and promote the efficient allocation of resources.¹⁵ 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.¹⁶

2.2 The Commonwealth's cost recovery policy was first documented in *Commonwealth Cost Recovery Guidelines for Information Agencies and Regulatory Agencies* issued by Finance. The Guidelines were rewritten and updated in July 2005, to focus more on activities, rather than agencies, and to clarify certain areas.¹⁷ The revised Guidelines (entitled the *Australian Government Cost Recovery Guidelines*) adopt a five stage process for deciding the appropriate approach to cost recovery for regulatory agencies.¹⁸ Key points in the Guidelines include the following:

- agencies should set charges to recover all the costs, where it is efficient to do so, with partial cost recovery to apply only where new arrangements are phased in, where there are Government endorsed community service obligations, or for explicit Government policy purposes;

¹⁴ Department of Finance and Administration, Finance Circular 2002/02, *Cost Recovery by Government Agencies*, December 2002.

¹⁵ *ibid.*

¹⁶ ANAO Audit Report No.50 2003–04, *Management of Federal Airport Leases*, Canberra, 4 June 2004, para 2.51, p. 48.

¹⁷ Department of Finance and Administration, Finance Circular 2005/09, *Australian Government Cost Recovery Guidelines*, July 2005.

¹⁸ The five stages are: policy review; design and implementation; Cost Recovery Impact Statement process; ongoing monitoring and periodic review.

- cost recovery should not be applied where it is not cost effective, where it is inconsistent with Government policy objectives or where it would unduly stifle competition or industry innovation; and
- agencies should ensure that all cost recovery arrangements have clear legal authority for the imposition of charges.

The Commonwealth's contractual right to recover lease administration costs

2.3 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;¹⁹
- under the Sale Agreements, for the first five years following the sales, airport operators paid the costs of Airport Building Controllers (ABC);²⁰ and
- under the leases and tripartite deeds, the Commonwealth's reasonable administration costs can be recovered from the lessees.

2.4 At the time of the original audit, DOTARS was recovering AEO and ABC costs. However, the provisions relating to the recovery of reasonable lease administration costs had remained largely unused.²¹

The provisions of the lease for recovering administration costs

2.5 Clauses were included in both the Airport Leases and the related tripartite deeds to enable DOTARS to recover the reasonable costs of administering the lease and the tripartite deeds. These clauses were in substantially the same form. In this respect, the Airport 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

¹⁹ The AEO's are statutory officeholders appointed by the Secretary of DOTARS to administer the *Airports (Environment Protection) Regulations 1997*.

²⁰ The ABC's have responsibility for approving all building activities on an airport site.

²¹ In June 2006, DOTARS advised ANAO that the Commonwealth's legal expenses are recovered where amendments are made to the tripartite deeds.

obligation under this sub-clause shall not include any costs arising out of the Lessor performing any functions or powers pursuant to any legislation.

2.6 In the original audit, ANAO found that DOTARS had 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 deeds. In this respect, Recommendation No.3 of the original audit related to cost recovery, as outlined below.

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.

2.7 DOTARS agreed to the recommendation.

2.8 On the issue of recovering lease administration costs, the JCPAA made the following recommendation in its report on the original audit:²²

The Committee recommends that in future privatisation programs, government agencies include a clause in all sales contracts which provides for the Commonwealth's cost recovery of administrative expenses. Government agencies should then ensure that they undertake cost recovery of such expenses as a matter of course.

2.9 Finance responded to this recommendation on 30 May 2006. It advised the JCPAA that it did not support this recommendation for the following reasons:

Based on past experience, asset sales do not typically trigger ongoing post-sale expenses for Government to administer. On the rare occasion that this might be the case, Finance considers this a valid cost to Government and should not be borne by the purchaser.

Estimates of the cost to administer the airport leases

2.10 In order to recover costs from airport lessees, it is first necessary to determine the 'reasonable costs' of administering the lease. This can then inform any decision on the merits of recovering costs. However, prior to the original audit, DOTARS had not estimated its lease administration costs.

²² Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005, Recommendation No.15, p. 86.

Estimates made during the original audit

2.11 In February 2004, in response to ANAO raising the issue, 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. In June 2006, DOTARS advised ANAO that:

The February [2004] figures were provided by us as an estimate in order to meet the ANAO's timeframe. Given the Department's position at that time on cost recovery of lease administration costs, it had no need prior to the ANAO's request to undertake a cost analysis. The fact that these figures were subsequently revised in March 2004 was a reflection of the time required to undertake a complex investigation of costs incurred.

2.12 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' of the total cost for lease oversight administration was likely to be some \$558 000, including overheads for some 4.75 full time equivalent (FTE) staff and \$60 000 representing the costs of the insurance adviser.

2.13 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 were not capable of being identified during the original audit.

Estimate made after the original audit

2.14 Under the new cost recovery policy, as part of an agreed review schedule, DOTARS reviewed its existing cost recovery arrangements against the Guidelines.²³ As part of this review, an accounting firm prepared costings of the resources required to administer the contracts entered into as part of the airport sales. DOTARS was advised that lease administration was estimated at

²³ The assessment resulted in Cost Recovery Impact Statements (CRIS) for the following: noise amelioration for Sydney and Adelaide Airports; vehicle safety standards; and minor cost recovery arrangements. The latter included costs associated with administration of the Airport Leases. As required by the Guidelines, a summary of each CRIS was included in DOTARS' 2005–06 Portfolio Budget Statements.

1.49 FTE's across various staff levels, with an estimated cost of \$301 964 per annum. This comprised:

- \$128 859 for lease reviews (including travel costs of \$34 640);
- \$21 416 for oversight of contracts with AEO's and ABC's;
- \$73 010 for airport Development Obligations;
- \$6 896 for managing the insurance adviser contract and \$60 000 for payments to the insurance adviser; and
- \$11 783 for administration of land tax.

2.15 After the original audit, DOTARS invested a relatively significant amount of resources in responding to the audit. For this reason, the costs involved in administering some aspects of the leases at the time of this current audit are likely to be greater than the above estimates (particularly, for example, in relation to airport insurance). In June 2006, DOTARS advised ANAO that:

Given this Department's extensive consideration of all the issues involved, to take any further action regarding cost recovery of lease administration expenses would have run counter to Section 44 of the *Financial Management and Accountability Act 1997* which requires Chief Executives to promote "efficient, effective and ethical use of Commonwealth resources". Whether it is recovery of \$300 000 pa or \$500 000 pa – in our view the costs involved in recovering these costs could not be regarded as an efficient use of Commonwealth resources.

Contractual rights to recover lease administration costs no longer exist for some airports

2.16 The cost recovery clause in the Airport Lease was drafted to reflect DOTARS' preferred position, enunciated at the time of the Phase 1 sales, that it be able to recover from lessees its costs of administering the leases. In March 2004, during the original audit,²⁴ DOTARS advised 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.

²⁴ ANAO Audit Report No.50 2003–04, op. cit., p. 47.

2.17 In addressing the recommendation of the original audit, DOTARS found that, during the Phase 2 sales, a clarifying statement had been made by the Commonwealth to bidders in relation to the Airport Lease cost recovery clause. This statement was provided in response to questions raised by a number of bidders about the cost recovery clause of the Airport Lease. Specifically, a document called the Report on Recent Developments issued on 6 January 1998 to all bidders stated:

Clause 11.2 of the draft Airport Lease requires the Lessee to pay the reasonable costs of administering the lease. These costs will be dependent upon events arising during the life of the lease. The potential quantum of these costs cannot be anticipated and the Commonwealth is not willing to limit the liability of the Lessee under this Clause. It should be noted however, that:

- these costs will not include the Commonwealth’s ongoing administrative costs (ie the salary costs of Australian Public Service employees and the related running costs of these officers).

2.18 In March 2005, DOTARS obtained legal advice from the Australian Government Solicitor (AGS) on the effect of this statement on its ability to recover lease administration costs. The advice concluded as follows:

In the case of Phase 2 airports, if the Commonwealth were to attempt to recover under clause 11.2 internal departmental administrative costs, there would be legal arguments of substance available to the airport lessees arising from the Report on Recent Developments statements to support the contention that the Commonwealth is not entitled to recover those costs as a result of the statement made in the Report on Recent Developments. It is not clear whether those arguments would be successful if the matter were litigated given the extensive disclaimers and acknowledgements given in the context of the sale process. However, it is reasonably likely that if the Commonwealth did seek to recover internal departmental administrative costs from airport lessees, the lessees would simply refuse to pay and thus force the Department to litigate in order to recover the costs. Given the relatively small amount of money involved compared with the likely expenditure necessary to resolve the matter, it may not be worthwhile to pursue this issue.

Unless similar statements were made in the context of the Phase 1 sales, there is nothing to suggest that the Commonwealth is not, in reliance upon clause 11.2, able to recover internal departmental administrative costs from those airports.

2.19 In effect, the statement made to Phase 2 bidders gave a commitment that the Commonwealth would not recover airport lease administration costs associated with employee expenditure or related operating costs. In assessing

the action it had taken in relation to the recommendation of the original audit, DOTARS acknowledged that the statement made to Phase 2 bidders had undermined the Commonwealth's contractual rights. On this issue, DOTARS commented as follows to ANAO in June 2006:

While there is no doubt that a specific effect of the clarifying statement made at the time of sale conflicts with the Commonwealth's contractual rights in relation to Phase 2 airports, it is important to note that the clarifying statement was prepared by the Commonwealth (and not by DOTARS) having regard to input from the business and legal advisers at the time of sale and released by the Office of Asset Sales (now Finance) as the only agency permitted to release information to bidders. In addition, the leases were drafted by the Department of Finance as part of the sale process and effectively responsibility for all sale documentation rested with that Department until after the sale and finalisation of the contractual agreements. It was only at that stage that responsibility for the ongoing oversight of both the regulatory and contractual obligations post-sale was then transferred to DOTARS.

2.20 In terms of the Phase 1 airports, DOTARS concluded that implementing a process for only some of the airports would bring a separate set of issues including perceived inequity and difficulties in disaggregating administration costs, and may also be an inefficient use of resources. As a result, in May 2005, DOTARS decided not to recover lease administration costs from any of the lessees of the privatised Federal Airports.

3. Lease Reviews

This chapter analyses the significant improvements made since the original audit to the conduct of lease reviews.

Administrative framework

3.1 As part of the sale process, the Commonwealth entered into 22 Airport Leases. All but one of the leases is for an initial term of 50 years, with the lessee given the option to extend for a further 49 years.

3.2 The Airport Leases set out the terms on which the Commonwealth agreed to grant leases of the airport sites. The leases include obligations on the lessees relating to:

- maintenance of insurance;
- development and maintenance of the airport site;
- sub-leasing at the airport; and
- payment of rates and taxes.

3.3 In response to an ANAO recommendation made in the audit report on the Phase 1 Airport Sales, DOTARS stated that it would initiate a formal lease review meeting to review key lease clauses and issues associated with them.²⁵ In this context, 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.

3.4 The original audit made two recommendations in relation to DOTARS' administration of airport lease reviews, as outlined overleaf:

²⁵ ANAO Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, Canberra, 24 March 1998, p. 63.

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.

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.

3.5 DOTARS agreed with qualification to the first, and agreed without qualification to the second. The qualification to the first recommendation related to advice from the Department that it would:

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. ...As the Department noted in its response to ANAO's 1998 Audit Report [on the Phase 1 airport sales], 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.'

3.6 DOTARS conducted a risk assessment of the management of its airport lease reviews during December 2004 and January 2005. This assessment specifically focussed on lessee compliance with Airport Lease obligations, and the Department's oversight of the lease review process. In the risk assessment, risks associated with lease review performance, particularly lease review meetings and reporting, were identified and analysed to identify the likelihood and consequence of each risk and consequently determine the risk level and any control measure required.

3.7 Of the 26 potential risk events identified, 21 were considered to have an unacceptable level of risk associated with them, and required treatment in the form of specific departmental action.²⁶ Each identified event and issue analysed was allocated a risk level rating using a 'consequence versus likelihood' matrix. Those events with a low level of risk were considered acceptable and as a consequence did not require any further management action. However, all actions having a medium to high risk were considered significant and unacceptable to the Department and required an appropriate risk treatment.

²⁶ These included: unacceptable level and type of insurance coverage maintained by lessee (high risk); major environmental incident at a leased Federal airport (medium risk); and failure of lessees to develop the airport site (medium risk).

3.8 In addition, since the original audit, DOTARS has developed guidelines to assist in its administration of the lease reviews. The new guidelines consist of two parts. The first is a general introduction and guidance for officers undertaking the lease review process, from initial preparation for a lease review to the finalisation of the process. The second part consists of document templates developed to assist in maintaining a consistent approach to obtaining and documenting information required for scheduled lease review meetings, and accurately reporting and finalising the outcomes.²⁷ Significant outputs of the new Lease Review Guidelines and Document Templates (the Guidelines) include:

- the lease review assessment sheet, which documents the assessment of an airport lessee's compliance with individual clauses of the Airport Lease;
- a record of meeting outcomes; and
- a letter to the lessee at the end of the review which finalises the review or indicates whether there are any outstanding issues arising from the review for the lessee to address.

Scheduling of lease reviews

3.9 Until the time of the 2004 original audit, it had been DOTARS practice to schedule lease reviews on an ad hoc basis also taking into account other priorities arising from the Department's regulatory requirements (such as consideration and approvals of Master Plans, Major Development Plans and Environment Strategies) as well as the general industry environment. During the course of the original audit, DOTARS explained to ANAO that the unexpected major regulatory and industry shocks occurring between 2001 and 2003 had also had a substantial effect on the allocation of Branch resources.

3.10 Consistent with the focus in the 2004 original audit on the scheduling of lease reviews, the Branch has developed Lease Review Guidelines which include a requirement that lease reviews be held on an annual basis and include a scheduled meeting with each airport lessee. In this respect, DOTARS advised ANAO in July 2006 that:

The Department endeavours to manage its broad-ranging regulatory and lease oversight responsibilities in the most efficient and effective manner possible

²⁷ There are two sets of guidelines and document templates. One set is for Phase 1 airports whilst the other is for the remaining airports.

bearing in mind that visits to interstate airports constitute a significant cost. Accordingly where possible, reviews are scheduled for when key regulatory and lease matters are able to be dealt with at the same time in face to face visits by Department staff with the airports concerned. They may also need to be rescheduled because, for example, a significant regulatory issue relating to a particular airport must take priority.

Comparison of lease review scheduling before and after the original audit

3.11 The previous audit analysed lease review meetings conducted since the sale of the Phase 1 airports, as at March 2004. Figure 3.1 includes the data from the original audit up to and including 2002–03, and extends the analysis to 2005–06. It also includes Essendon Airport, Sydney (Kingsford Smith) Airport and Bankstown, Camden and Hoxton Park Airports.

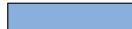
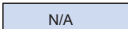

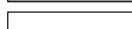

3.12 Figure 3.1 demonstrates that, since 2003–04, there has been a noticeable improvement in the frequency with which lease reviews have been conducted. In particular, the Department has reviewed the leases of all Federal Airports at least once. In most instances, this was done through a meeting with the Lessee, the outcomes of which have been documented. Further, many of the leased Federal Airports had a lease review in both 2004–05 and 2005–06, with DOTARS advising ANAO that a further four lease reviews were held in July 2006.²⁸

²⁸ Mount Isa Airport was an instance where ANAO noted that a low level of DOTARS oversight appeared to be occurring. In July 2006, DOTARS acknowledged to ANAO that Mount Isa did not have lease review meetings in 2004 and 2005, but commented that a lease review was held in 2005 and advised that the 2006 lease review meeting was held on 18 July 2006.

Figure 3.1

Lease review meetings: 1998–99 to 2005–06

| Airport | Year | | | | | | | |
|---------------------------------------|---------------|-----------|-----------------------|-----------|---------------|--------------------------|-------------|-----------------------------|
| | 1998-99 | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
| Brisbane | November 1998 | | July 2000 | May 2002 | | May 2004 | | July 2005 May 2006 |
| Melbourne | | | July 2000 | May 2002 | | August 2003 | August 2004 | August 2005 |
| Perth | June 1999 | | DOTARS did not advise | May 2002 | | February 2004 | April 2005 | |
| Adelaide & Parafield | N/A | | July 2000 | | December 2002 | May 2004 | June 2005 | June 2006 |
| Darwin, Alice Springs & Tennant Creek | N/A | July 1999 | DOTARS did not advise | | | May 2004 | | July 2005 |
| Canberra | N/A | | August 2000 | | June 2003 | June 2004 | June 2005 | June 2006 |
| Coolangatta | N/A | | July 2000 | | October 2002 | | July 2004 | July 2005 |
| Hobart | N/A | | September 2000 | | August 2002 | April 2004 | March 2005 | April 2006 |
| Launceston | N/A | | July 2000 | | August 2002 | April 2004 | April 2005 | June 2006 |
| Townsville | N/A | July 1999 | November 2000 | | | Desk top review | | July 2005 |
| Mount Isa | N/A | July 1999 | November 2000 | | | | | Desk top review |
| Archerfield | N/A | | July 2000 | | October 2002 | May 2004 | June 2005 | |
| Jandakot | N/A | June 1999 | DOTARS did not advise | | August 2002 | February 2004 | April 2005 | |
| Moorabbin | N/A | | July 2000 | June 2002 | | June 2004 | June 2005 | May 2006 |
| Essendon | N/A | N/A | N/A | N/A | N/A | August 2003 June 2004 | June 2005 | May 2006 |
| Sydney | N/A | N/A | N/A | N/A | N/A | May 2004 | May 2005 | March 2006 |
| Bankstown, Camden and Hoxton Park | N/A | N/A | N/A | N/A | N/A | N/A | May 2005 | March 2006 (Bankstown only) |

| | | | | |
|---|---|---|-----------------|---|
|  | Lease review meeting conducted |  | N/A | No lease review necessary (No lease review due in first full year of privatisation for Phase 2 Airports, Essendon Airport and Sydney (Kingsford Smith) Airport. Bankstown, Camden and Hoxton Park Airports sold in December 2003, so no lease review necessary in 2003-04). |
|  | Lease review meeting conducted, however no formal record made of discussion | | | |
|  | No lease review meeting conducted |  | Desk top review | No lease review meeting conducted. Desk top review only |

Source: ANAO analysis of DOTARS documentation.

3.13 DOTARS advised the JCPAA in March 2005 that the Lease Review Guidelines and Document Templates would be implemented for the next round of lease reviews.²⁹ However, at the time of audit fieldwork, the Guidelines had yet to be fully implemented.

3.14 At the March 2005 JCPAA hearing, DOTARS further advised the JCPAA that 'essentially they have all been done' in relation to the 2003–04 lease reviews.³⁰ However, a desk top review of Mt Isa Airport did not commence until September 2005. In addition, DOTARS provided an updated lease review meeting schedule to the JCPAA in its response to Questions on Notice, dated 27 April 2005. However, ultimately, some of the lease reviews were not conducted when DOTARS advised the JCPAA they had been scheduled. On this point, DOTARS advised ANAO as follows in July 2006:

At the time the updated scheduled review meeting dates were provided to the JCPAA, the dates identified were those that had been agreed between the Department and the airports. However, though the Department endeavours to meet these scheduled dates in good faith, unforeseen circumstances or mutual agreement between the Department and the airport for a particular reason sometimes cause the meetings to be rescheduled.

3.15 There was also an error in DOTARS' advice to the JCPAA that a lease review meeting was held in June 2004 for Townsville/Mount Isa (with Mount Isa reported as being 'not treated separately.'). Whilst a desk top review commenced in February 2004 for Townsville, Mount Isa Airport was not reviewed. On this issue, in July 2006, DOTARS provided ANAO with the following advice:

While it is true to say that a lease review meeting was not held in 2004 for Mount Isa Airport, it is not accurate to lead a reader to conclude that the airport was not considered for review in that year. Mount Isa is a non-core regulated airport and as it was considered there were no material issues requiring attention, it was decided that a formal lease review was not required until 2005. Since 2004, reviews have been held for Mount Isa Airport in both 2005 and 2006 reflecting the positive implementation of the Audit Recommendations.

²⁹ Joint Committee of Public Accounts and Audit, *Review of Auditor-General's Reports Fourth Quarter 2003–04*, Official Committee Hansard, Canberra, Monday 7 March 2005, pp. 12-13.

³⁰ *ibid.*, p. 9.

Conduct of lease reviews

Assessment of information received

3.16 In the previous audit, ANAO found that, in 2002, DOTARS had improved its approach to conducting lease reviews. At this time, DOTARS started focussing on lessee's compliance with specific lease obligations, rather than compliance with the regulatory framework under the Airports Act. As part of this improved approach, DOTARS:

- analysed the lease clauses and identified those that should be considered during annual lease reviews;
- started requesting written confirmation or evidence from each lessee to demonstrate compliance with specific lease clauses; and
- wrote to ABC's and AEO's seeking their advice on whether they were aware of any lease compliance matters.

3.17 This approach has been maintained in the current Lease Review Guidelines and Document Templates.

3.18 In the original audit, ANAO identified deficiencies in DOTARS' assessment process. In particular, ANAO found that there was only limited evidence of DOTARS undertaking a comprehensive assessment of all information gathered. As a result, ANAO recommended that DOTARS enhance its conduct of lease review meetings by, at the conclusion of each review, documenting review outcomes, including the Department's assessment of the degree to which the lessee complies with the sale documentation requirements.

3.19 The Lease Review Guidelines and Document Templates introduced in 2005 address this recommendation. The Guidelines require that, when conducting a lease review, DOTARS officers formally document their assessment of an airport's compliance with individual clauses of the Airport Lease, and provide this to the General Manager of the Airports Branch at the conclusion of the review. A template is provided in the Guidelines to assist with this task. The template includes a list of clauses, against which the assessing officer is to indicate whether information has been obtained. In this context, Table 3.1 illustrates that the percentage of assessments documented at the conclusion of the review has increased since the introduction of the new Lease Review Guidelines and Document Templates.

Table 3.1**Assessment performed at conclusion of lease review**

| Year | Number of reviews | Number of assessments performed | Assessments performed as a percentage of annual lease reviews (%) |
|---------|-------------------|---------------------------------|---|
| 2003–04 | 15 | 10 | 67 |
| 2004–05 | 13 | 13 | 100 |
| 2005–06 | 15 | 13 | 87 |

Note: An assessment has occurred where DOTARS has conducted an examination of information received from the lessee and information obtained in the lease review meeting, in order to determine whether the lessee has met its obligations under the Airport Lease.

Source: ANAO analysis of DOTARS documentation.

3.20 One deficiency identified by ANAO within the Guidelines is that they do not require that the assessments be updated to reflect additional information obtained after the lease review meeting. On this point, in July 2006 DOTARS advised ANAO that it proposed to amend the Guidelines to reflect that the assessment is a ‘live document’ which should be prepared prior to the lease review meeting, then updated following the meeting and, if required, updated following receipt of further information from the airport after the meeting and/or after the letter to the lessee.

Finalisation of the review

3.21 In the original audit, ANAO recommended that DOTARS enhance its conduct of lease review meetings by, at the conclusion of each review, providing a written response to the lessee specifying outstanding issues to be addressed. Under the new Guidelines, the assessing officer is required to prepare correspondence to the airport lessee at the conclusion of a review either advising the lessee of any outstanding issues, or that there are no outstanding issues and the review is finalised.

3.22 The number of follow-up letters provided in 2003–04, 2004–05 and 2005–06 is illustrated in Table 3.2. Table 3.2 demonstrates that, since the original audit, DOTARS has increased the frequency with which it writes to airport lessees following lease review meetings.

Table 3.2**Correspondence to airport lessees following lease review meetings**

| Year | Number of reviews conducted | Number of follow-up letters written | Follow-up letters written as a percentage of reviews performed (%) |
|---------|-----------------------------|-------------------------------------|--|
| 2003–04 | 15 | 10 | 67 |
| 2004–05 | 13 | 13 | 100 |
| 2005–06 | 15 | 13 | 87 |

Source: ANAO analysis of DOTARS documentation.

3.23 Although procedures for corresponding with lessees now exist, no timelines are specified in the Guidelines for the follow-up of issues resulting from the lease review. There is a risk that, without guidance on targeted timeframes, issues will not be finalised in a timely manner. In this context, ANAO observed delays in following-up a number of lease reviews, ranging from three to six months. On this issue, DOTARS provided the following advice to ANAO in July 2006.

We do not question the view that timely resolution of any issues arising from airport lease reviews should be achieved wherever possible. However, as with the annual insurance reviews, finalisation of lease reviews depend on the complexity of any issues outstanding and the availability of the information required by the Department. Therefore any timeframes set for various stages of lease reviews need to be flexible enough to fit changing circumstances.

Whilst a timeline for responses from airports is included in the current Guidelines (within ten working days from the date of the Department's letter), we accept your point as a valid one and propose to make changes to the Guidelines to include a recommended timeline of 10 working days from the receipt of all outstanding information to the finalisation letter (noting these are Guidelines).

3.24 As noted above, the rate of follow-up of issues arising from the lease review meeting has improved since the original audit. However, it is also important for DOTARS to ensure that any outstanding issues are resolved, and that this is communicated to the airport lessee. In this respect, ANAO identified a number of instances where information requested from an airport lessee subsequent to the lease review meeting was either not received, or was not received in a timely manner. DOTARS advised ANAO in July 2006 that, in its view, none of the examples provided by ANAO related to material issues,

they were the subject of ongoing discussion between the lessee and the Department, or were not lease-related issues but arose during the discussions as part of the Department's ongoing regulatory role.

3.25 The Guidelines also state that for those airports with outstanding issues that are subsequently resolved, another letter is to be sent to the airport lessee to finalise the lease review. At the time of ANAO's audit work, this was not occurring in respect of all reviews. In July 2006, DOTARS advised ANAO that:

We acknowledge that the Department has not sent final letters to the three examples provided and we proposed to standardise the processes further to enhance consistency of applying the Lease Review Guidelines as part of a commitment to a continual improvement process. However it is important to recognise that in these three cases there were no material issues arising from the reviews.

Performance reporting on lease reviews

3.26 DOTARS significantly improved its performance reporting of the lease administration function in 2003–04, 2004–05 and 2005–06, consistent with the recommendations of the original audit.

Reporting on conduct of lease reviews

3.27 DOTARS has reported its conduct of annual lease review meetings in its Annual Reports. The original audit found that DOTARS' performance reporting had not accurately reflected the extent to which reviews had actually been conducted. In this respect, in the November 2005 report of its review of the original Audit Report, the JCPAA stated that:

The Committee will note with interest the future performance reporting on lease reviews in DOTARS' Annual Report for 2004–05. The Committee stresses the importance of open and transparent reporting of performance in annual reports to ensure optimal accountability for all Commonwealth entities and the Australian public.³¹

3.28 In this follow-up audit, ANAO found that DOTARS' reporting in its 2003–04 and 2004–05 Annual Reports did not reflect actual performance. In this respect, in its 2005–06 Annual Report, the Department disclosed that:

³¹ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005, para 6.66, p. 96.

The 2004–05 annual report indicated the 17 reviews were completed by 30 June 2005, another four reviews were completed in July 2005 with the remainder to be completed by October 2005. This was correct at the time the annual report was being prepared. Due to unforeseen circumstances, the number of reviews shown to have been completed or expected to have been completed by the end of July 2005 varied. For this reason, the form of reporting of lease reviews has been changed in this annual report to reflect the actual dates of lease review meetings held.

Reporting of the level of lessee compliance

3.29 In the original audit, ANAO noted³² that DOTARS' 2002–03 Annual Report stated that lessees were compliant with all Sale Agreement and lease obligations.³³ However, ANAO found that 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.

3.30 In its 2004–05 Annual Report, DOTARS stated that no significant issues affecting lease compliance were identified. This assurance was not qualified in its scope. However, in July 2006, in response to ANAO concerns that audit analysis of DOTARS' records had indicated that DOTARS identified a number of compliance issues with airports lessees, including in relation to required insurance coverage, DOTARS advised ANAO that:

While the Department's 2004–2005 Annual Report did not include any performance reporting on the oversight of airport insurance obligations, it is intended to do so in the Department's 2005–2006 Annual Report in line with the JCPAA Recommendation.

3.31 As outlined in the next Chapter, the 2005–06 Annual Report included information on DOTARS' administration of the insurance requirements.

³² ANAO Audit Report No.50 2003–04, *Management of Federal Airport Leases*, Canberra, 4 June 2004, para 3.31, p. 67.

³³ Department of Transport and Regional Services, *2002–03 Annual Report*, September 2003, p. 65.

4. Airport Insurances

This chapter examines action taken by DOTARS to improve its oversight and management of airport insurances.

Background

4.1 Insurable risks for airports arise both from their aviation-specific activities and general commercial activities. Aviation liability coverage is generally obtained through an Airport Owners and Operators Liability (AOOL) policy. These policies address liabilities such as those relating to property damage (including loss of use), bodily injury or death, and war and terrorism. The major insurance products for general commercial activities at airports relate to industrial special risks (property damage and business interruption), non airside and/or off airport liability, motor fleet, machinery breakdown and contract works.

4.2 As part of the privatisation process, the Commonwealth sought to limit its risk from operations on Federal leased airports by imposing insurance coverage requirements on airport lessees. In this respect, the Sale Agreements and Airport Leases contain a number of provisions relating to insurance cover to be obtained and maintained by the ALC's.³⁴ Specifically:

- the Sale Agreements set out details of the type of risks to be insured against and specifies certain provisions that are required to be included in those policies; and
- in turn, the Airport Leases required that the insurance cover obtained at grant time be maintained in future years and/or changed or added to as required by the Commonwealth. They also laid down terms and conditions to be applied to future policies to provide maximum protection for the Commonwealth.

4.3 Recommendation No.1 of ANAO's June 2004 Audit Report was that DOTARS improve its oversight and management of airport insurances in two ways. Recommendation No.1 is reproduced below. DOTARS agreed with the recommendation.

³⁴ While these provisions largely followed a common format, the airports were sold in several different processes and accordingly the requirements vary slightly, for example as to the amount of insurance required or the precise requirements specified for the policies. DOTARS advised ANAO in December 2006 that the amount of insurance required by airports at time of sale and therefore required to be maintained was also derived by the size and scale of business at each particular airport.

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.

4.4 In addition, in the November 2005 report of its review of the ANAO Audit Report, the JCPAA commented³⁵ that it was 'greatly concerned' about deficiencies in some of the insurance policies held by the lessees.

Are the contractual requirements effective?

4.5 Subsequent to the JCPAA hearing relating to the initial Audit Report, in May 2005 legal advice was sought by DOTARS from AGS in order to clarify a number of insurance-related questions. The advice concluded that:

While we cannot exclude the possibility of the Commonwealth being liable as landlord/owner of the land for activities of the ALC on the land where it has no active involvement, it is more difficult to identify any specific examples of how that liability may arise. There are no obvious circumstances at common law. A detailed review of legislation may reveal some obligations placed upon land owners but even if these applied on their face, there may be a question as to whether they were applicable to the Commonwealth in any case. Assuming that a liability did fall to the landlord albeit that the landlord had no active role in creating the circumstances leading to the liability, the indemnity in clause 4 of the airport lease will mean that the ALC must indemnify the Commonwealth.

The risk of legal liability of the Commonwealth is increased if a lessee is not insured against the type of claim made, or was insured for an amount inadequate to meet any judgement in favour of a claimant, or becomes insolvent or goes into liquidation as a result of its inability to meet any judgement.

The provisions of the Sale Agreements and Airport Leases are designed to strengthen the Commonwealth's position in the event that a claim is made against it. Any risk arising from approving the policies and other requirements is significantly offset by the benefit of knowing that the Commonwealth's position is appropriately protected by the insurance.

³⁵ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005, para 6.32, p. 87.

War and terrorism risks

4.6 Following the 11 September 2001 terrorist attacks in the United States, insurance cover for claims arising out of war and terrorism was withdrawn or significantly limited, placing global aviation operations at risk.³⁶ The Commonwealth implemented several measures to address this:

- The Commonwealth agreed to provide third party war indemnity up to \$5 billion per aircraft per event. As at 30 June 2002, DOTARS held 13 Deed Polls of Indemnity for aviation war risk cover for airports at a value of \$11.6 billion.³⁷ With the return of insurance coverage to the aviation sector, by 30 June 2003, no airports remained indemnified by the Commonwealth.³⁸
- The introduction of the *Terrorism Insurance Act 2003* (the Terrorism Insurance Act). The effect of this Act is to render exclusion clauses in eligible insurance contracts ineffective in relation to loss or liabilities arising from a declared terrorist incident.³⁹ In this respect, the Department of the Treasury advised Sydney Airport Corporation Ltd in July 2003 that airports leased from the Commonwealth are covered by the Terrorism Risk Insurance Scheme established by the Terrorism Insurance Act.

4.7 In this context, an area of airport insurance that has proven particularly difficult to administer has been third party liability cover for war and terrorism risk. The Sale Agreements require third party liability cover (including war and terrorism insurance) to the following levels:

- \$1.5 billion: Adelaide; Brisbane; Melbourne; Perth and Sydney.
- \$1 billion: Canberra; Gold Coast and Darwin.
- \$500 million: Alice Springs; Hobart; Launceston and Townsville.
- \$150 million: Archerfield; Bankstown; Camden; Essendon; Hoxton Park; Jandakot; Moorabbin and Parafield.
- \$25 million: Tennant Creek and Mount Isa.

³⁶ Department of Transport and Regional Services, *2001–02 Annual Report*, September 2002, p. 280.

³⁷ *ibid.*, p. 280.

³⁸ Department of Transport and Regional Services, *2002–03 Annual Report*, September 2003, p. 208.

³⁹ Terrorism Insurance Bill 2002, *Revised Explanatory Memorandum*, circulated by authority of the Treasurer, the Hon Peter Costello MP, para 1.3.

4.8 DOTARS has found that, since early 2003, the maximum third party war and terrorism cover that has been available on international markets has been US\$1 billion. Since September 2003, the increase in the value of the Australian dollar against the United States dollar has meant that the level of cover at Sydney, Brisbane, Melbourne, Adelaide and Perth has been below that required by the respective Sale Agreements. In this context, DOTARS advised each of the five airports in 2004 that, subject to a number of conditions,⁴⁰ they would not be considered to be in breach of their obligations as a result of exchange rate movements until such time as additional insurance cover is available in the market. On this issue, DOTARS advised ANAO in December 2006 that:

Following advice received in May 2006 that the required level of cover was available in the international market the Department wrote to the five major airports in June requesting they take out the additional cover. The cover is based on the difference between AUD \$1.5 billion and US \$1 billion. The five major airports had all taken out the maximum cover available in the market by mid October 2006.

Possible changes to the contractual requirements

4.9 In addition to annual reviews of insurances at individual airports (see further below), in August 2005, DOTARS' contracted insurance adviser was engaged⁴¹ to review the insurance requirements of the Sale Agreements and Airport Leases for all 22 airports to assess whether the insurance arrangements continue to meet the Commonwealth's best interests. The major findings and recommendations of this review, and the steps (if any) DOTARS proposes to take are presented in the following table.

⁴⁰ The conditions relate to the airport: actively seeking to obtain the minimum level of insurance cover; providing quarterly reports to DOTARS on action it has taken to obtain additional cover and evidence that cover is unavailable; and DOTARS retaining the right to vary or withdraw these arrangements.

⁴¹ The fee involved was \$12 000 plus Goods and Services Tax.

Table 4.1

Insurance review findings and Departmental response

| Findings | DOTARS actions |
|---|--|
| <p>Each airport’s risk exposure to war, hijacking and other perils should be considered separately to determine, in consultation with those airports, whether the cost of purchasing the relevant cover is consistent with their individual risk exposure.</p> | <p>It is not proposed to vary the current level of liability insurance required under the Sale Agreements. On 2 December 2005, the Department wrote to those airports with no cover or cover less than that specified in their sale agreements requesting that they either vary existing policies or take out further policies so as to effect insurance in respect of claims made by third parties for injury or death or damage to or destruction of property (including the loss of use of such property) arising out of the lessees’ use of the airport site or occupation of the airport site or any operations occurring on or in respect of the airport site arising from war and terrorism. All airports except Archerfield have taken out the requested cover. DOTARS advised ANAO that it is continuing to rigorously pursue the Commonwealth’s interests with Archerfield on this matter.</p> |
| <p>Lessees have difficulties complying with the Airport Lease requirement that they forward policies to the Commonwealth within 21 days prior to renewal. It was recommended that the Lease be amended to accord generally with current market practice for each type of insurance cover required, subject to negotiation with each lessee, and to the perceived risk and cost.</p> | <p>As a preliminary step in considering this recommendation of the review, the Department sought legal advice on what measures are open to the Commonwealth to alter the provisions of Clause 5.5 of the Lease Agreement and whether there are any impediments or possible broader adverse consequences in doing so. In June 2006, DOTARS was advised that the Commonwealth may vary the period. The Department is currently considering its options in view of the international insurance market industry practices.</p> |
| <p>DOTARS review its method of handling the annual insurance reviews by completing a detailed insurance audit analysis form prior to sending each airport’s insurance documents to [the contracted insurance adviser] for review.</p> | <p>The proposed introduction of a template for DOTARS to complete a detailed insurance analysis form prior to sending each airport’s insurance documents to the then incumbent insurance adviser was discussed with the new contracted insurance adviser. They considered the merits of the recommendation and advised that it would duplicate their process, would be largely administrative and add no value to the process they would be applying to the reviews. DOTARS advised ANAO that it concurred with this assessment and accordingly, it has not pursued this proposal further.</p> |

Source: ANAO analysis of DOTARS documentation, and advice provided by DOTARS to ANAO in May and December 2006.

Administrative framework

4.10 Following the completion of the original Audit Report, a number of initiatives were taken by DOTARS to improve the administrative framework for its oversight of the leased airports' insurance obligations.

4.11 During 2004–05, responsibility for oversight of airport insurance arrangements was consolidated to one section in the Airports Branch. The role of this section is to:

- obtain from lessees evidence to demonstrate that the required policies are in full force and effect;
- assess and make recommendations regarding approval of material changes to insurance policy terms in place at the time of sale;
- confirm that insured property values are appropriately determined; and
- confirm that all insurance proceeds paid out for the damage or destruction of any structures are applied as required under the lease.

4.12 In addition, DOTARS reviewed the management of airport insurance records to assess the usability and accuracy of the filing system. This review revealed that past filing of airport insurance material had not been undertaken in a consistent manner due to varying responsibilities for insurance issues and the complex nature of these issues. As a result, steps were taken by DOTARS to consolidate and clearly identify airport insurance material.

4.13 The administrative framework was further enhanced in November 2005 when *Guidelines for Assessment of Insurance Coverage at Leased Federal Airports* were finalised. These Guidelines provide background information on the insurance requirements and administrative responsibilities (including the role of DOTARS' contracted insurance adviser). They also outline the process to be followed in undertaking the annual insurance reviews including:

- the documentation to be requested from each airport;
- a proforma for assessing the insurance adviser's report so as to inform decisions about what further action (if any) needs to be taken; and
- information on follow-up actions to be taken to communicate findings within DOTARS and with the relevant airport lessee.

Annual reviews of adequacy of airport insurance cover

4.14 DOTARS' oversight and management of airport insurance matters is dependent on contracting an insurance adviser to prepare reports on airport lessee insurance policies. It is intended that the insurance reviews be conducted each year, with the timing of each review based on the different renewal dates of policies at the various airports. The usual process involves:

- identifying the information that the airport needs to provide having regard to documentation previously provided by the airport;⁴²
- obtaining the necessary documentation from the airport;
- providing the documentation to the contracted insurance adviser for review and reporting to DOTARS;
- assessing the contracted insurance adviser's report; and
- where the outcome is satisfactory, advising the airport accordingly. Otherwise, the airport is advised of those matters requiring rectification and the timeframe in which this is to occur.

Contracting of insurance adviser

4.15 The initial Audit Report found that 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 this respect, since September 2002, AON Risk Services Australia Limited has been contracted by DOTARS as its insurance industry adviser.

4.16 The insurance adviser contract stipulated that three annual reports were to be provided in relation to the insurance arrangements at leased Federal airports. In May 2005, DOTARS wrote to the adviser stating that, due largely to difficulties in obtaining information necessary for preparation of the insurance adviser reports, it had become clear that only two series of reports would be completed before the expiration of the initial term of the contract on 30 June 2005. As a result, the contract was extended for one year to 30 June 2006.

⁴² For example, where full policy wording has previously been provided by the airport, it may only be necessary for the airport to provide placement slips or cover notes and to confirm that the policy wording was not varied when the insurance was renewed.

4.17 At the time of this follow-up audit, DOTARS was conducting a two stage procurement process for the selection and engagement of a new insurance adviser. The first stage involved the release of a Request for Expression of Interest on 1 March 2006. Following an evaluation of the submissions made, DOTARS was to then invite a short-list of suppliers to participate in the second stage of the procurement process, the Request for Tender. DOTARS advised ANAO in May 2006 that:

The Request for Expression of Interest was finalised on 4 May 2006. The top four ranked respondents were invited to participate in a Restricted Tender (RFT). It had been proposed to release the RFT through Austender in late May 2006, although this may slip back a week or two due to delays in receiving legal and probity advice.

4.18 DOTARS further advised ANAO in December 2006 that:

The RFT tender documentation [was] cleared by the Probity Adviser and the Department's legal services area [and] was released [on] 7 June 2006. On 22 September 2006 the General Manager of Airports Branch approved the engagement of the Department's new insurance adviser, Jardine Lloyd Thompson Pty Ltd. This occurred eight days before the contract of the previous insurance adviser expired.

Timeliness of annual insurance reviews

4.19 In the initial audit, ANAO found that DOTARS had reviewed all insurance reports completed between December 2002 and August 2003 and contacted each airport to provide feedback on the results and seek a response to issues that were identified. However, 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 remained unresolved at the time ANAO's report was finalised.

4.20 In the report of its review of the ANAO Audit Report, the JCPAA commented⁴³ that it was 'disappointed' to learn that DOTARS had not followed up on insurance reports in a timely manner, with two airport insurance reports taking over a year to be followed up. The JCPAA recommended⁴⁴ that:

⁴³ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, op. cit., para 6.32, p. 87.

⁴⁴ *ibid.*, Recommendation No.16, para 6.42, p. 90.

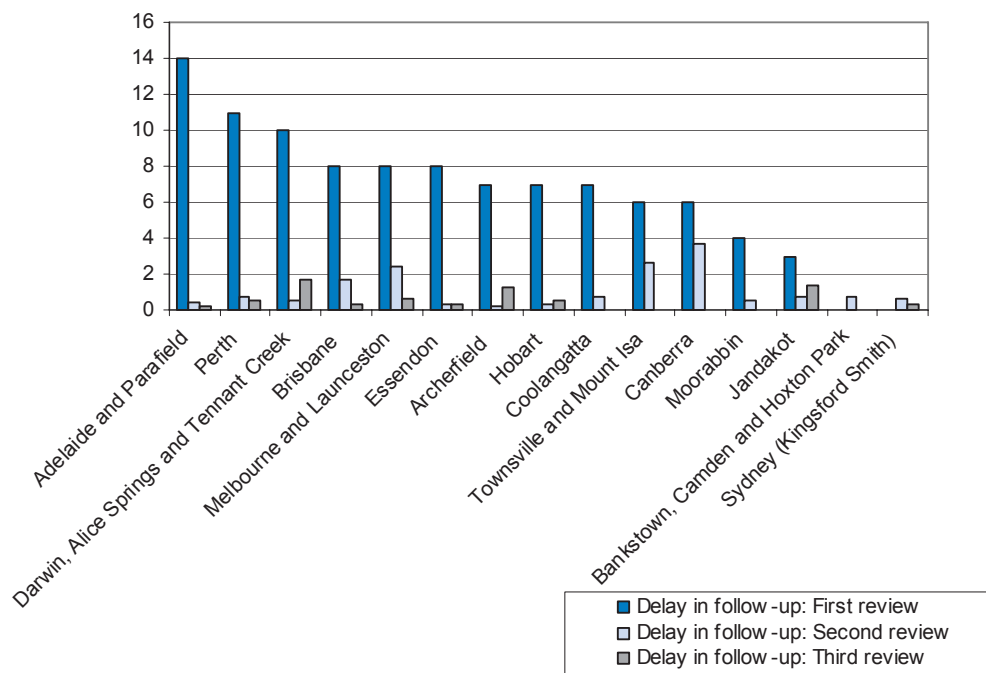
- DOTARS adopt a procedure which ensures that follow-up administration on all insurance reports from the insurance adviser are finalised within a three month timeframe; and
- the Department's Annual Report include a report on the status of all insurance reports from the insurance adviser, including the date of the report and date of any departmental actions arising from the report.

4.21 In respect to the second dot point, in its May 2006 response to the JCPAA report, DOTARS stated that it would provide details of the status of its annual airport insurance reviews from its 2005–06 Annual Report onwards, including key dates and timeframes. Consistent with this advice, the 2005–06 Annual Report included a table that indicates, for each airport: the date the insurance adviser's report was received by DOTARS; the date of DOTARS' first follow-up with the airport; the date final documents were received from the airport; and the date of the final letter to the airport.

4.22 In relation to the first part of the JCPAA recommendation, relating to more timely follow-up of insurance adviser reports, the ANAO found that there has been a significant improvement in the timeliness of DOTARS following-up the 2004–05 reports from its contracted insurance adviser. This is reflected in the following figure.

Figure 4.1

Delay in follow-up of insurance adviser reports



Notes: DOTARS did not advise the date of follow-up for the first review for Bankstown, Camden and Hoxton Park Airports (in 2003), and Sydney (Kingsford Smith) Airport (in 2002). Follow-up to the third insurance review occurred after ANAO's fieldwork. As a result, DOTARS relied on information contained in DOTARS' 2005–06 Annual Report and advice provided by DOTARS to ANAO in December 2006. DOTARS reported that no follow-up was required for the third review for Coolangatta, Townsville, Mount Isa, Canberra, Moorabbin, Bankstown, Camden and Hoxton Park Airports.

Source: ANAO analysis of DOTARS documentation.

4.23 The JCPAA recommendation addressed finalising the reviews. In this respect, most of the 2004–05 reviews were finalised five months or less after DOTARS initial follow-up letter to the airport lessee. The exception related to the Bankstown, Camden and Hoxton Park insurance review where the April 2005 review report (followed up by DOTARS in May 2005) had not been finalised as of January 2006. DOTARS advised ANAO in May 2006 that the review was finalised in late February 2006, and that the delay in finalising the review was due to a protracted delay by the airport in resolving issues identified in the report, despite continued follow-up contact by the Department with the airport.

4.24 In this respect, ANAO notes that the *Guidelines for Assessment of Insurance Coverage at Leased Federal Airports* finalised by DOTARS in

November 2005 did not initially include any timelines for the follow-up with airport lessees of any issues raised by the insurance adviser. ANAO considers that specifying relevant performance standards in these Guidelines, and measuring performance against such standards, would provide enhanced impetus to further improvement in the timeliness with which DOTARS acts on reports received from its insurance adviser. In this respect, DOTARS amended the Guidelines in May 2006 to include performance standards for timelines for responding to airports.⁴⁵

Have the airports met their insurance obligations?

4.25 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.

4.26 In April 2005, as part of the JCPAA's review of the initial audit, DOTARS provided responses to Questions on Notice including those relating to airport insurance. DOTARS's response included a schedule, reproduced as Appendix E to JCPAA Report No.404, that detailed the extent of cover required for each airport as detailed in the Sale Agreements and whether insurance cover had been confirmed by DOTARS.

4.27 In this current audit, ANAO found that DOTARS has taken a more active interest in administering the insurance provisions of the Sale Agreement and Airport Lease. As a result, on a number of occasions DOTARS has taken action to address deficiencies in insurance cover at certain airports. For example:

- In December 2005, DOTARS wrote to four airports that had minimal (Moorabbin and Essendon) or no (Archerfield and Jandakot) war and

⁴⁵ Section 5, paragraph (ii) of the *Guidelines for Assessment of Insurance Coverage at Leased Federal Airports* now states: 'The Branch contact officer sends a letter to the airport within 15 business days of receipt of the report from the insurance adviser specifying matters requiring clarification and/or rectification and stipulating a time frame in which they are to respond (this would normally be 20 business days, but a longer period may be appropriate depending on the specific issues.)'

terrorism cover asking that they either increase or obtain such cover.⁴⁶ DOTARS was concerned that such a situation could adversely affect the financial viability of the airports should any liability be established against them and, in turn, this would leave the Commonwealth exposed to an unacceptable degree of risk. As a result,

- Moorabbin and Jandakot responded to DOTARS shortly thereafter advising that the cover has been obtained.
- Essendon advised DOTARS in May 2006 that cover to AUS\$150 million has been taken out.
- Archerfield advised DOTARS in March 2006 that its Board was seeking advice on the reasonableness of the Department's request. In December 2006, DOTARS advised ANAO that:

While the insurance review process has been completed for Archerfield Airport, the matter of insurance coverage for war and terrorism events remains unresolved and the Department is rigorously pursuing the airport's compliance with this requirement. Action taken includes seeking legal advice on the extent of the Commonwealth's powers in relation to this matter. All other airports have now complied with the Department's request to take out this form of cover.

- The Commonwealth has not always been included as a named insured in the insurance policies. For example:
 - In August 2005, DOTARS wrote to Essendon Airport Pty Ltd as this airport's Industrial Special Risks and AOOL policies did not include the Commonwealth as a named insured, despite the Sale Agreement requirement that this be done.⁴⁷ As it was not feasible to amend the policies, DOTARS advised the airport that this issue would be examined as part of the 2005–06 insurance review.
 - In addition, DOTARS advised ANAO in December 2006 that, during the 2005–06 reviews, it was established that Sydney and Hobart airports had not complied with the provision of

⁴⁶ Moorabbin and Essendon airport were each asked to increase their cover from US\$50 million to the minimum amount of AUD\$150 million required under their respective Sale Agreements and Airport Leases. Archerfield and Jandakot were each asked to obtain cover that accorded with the AUD\$150 million specified in their respective Sale Agreements and Airport Leases.

⁴⁷ Similar issues arose during the 2004–05 review in relation to Bankstown, Camden and Hoxton Park airports, Melbourne and Launceston airports, Brisbane airport, Townsville and Mount Isa airports, Jandakot airport and Sydney airport.

sub-clause 2(b) requiring the Commonwealth to be included as a named insured in the insurance policies for the period under review. DOTARS further advised ANAO that due to improved administrative practices the policies were still current and therefore amended prior to completing the 2005 reviews for these airports, and that the remaining airports had complied with this provision of their Sale Agreements.

- DOTARS wrote to Adelaide Airport Limited in August 2005 indicating that the airport's advice that they could not buy business interruption cover for infectious or contagious diseases under the Industrial Special Risk policy was at variance with DOTARS' insurance adviser's advice that such cover had recently become available. Adelaide Airport Limited subsequently arranged cover.

4.28 The absence of full compliance by lessees with the insurance requirements was confirmed by a consultant, engaged by DOTARS in July 2005.⁴⁸ In his final report, the consultant concluded as follows:

For a range of reasons it has been difficult for the lessees to comply fully with the strict conditions of these [insurance] requirements in every year, and it has also proved difficult for DOTARS and its insurance industry advisors to confirm full compliance by the lessees in every year.

It was therefore proposed that DOTARS carry out a review to confirm that, in the possible absence of absolute compliance to the letter of the law, airport lessees and the Commonwealth were sufficiently covered by appropriate levels of insurance in all the years under review to assure the Commonwealth that its risk exposure was minimal.

This review has now been completed, except for some relatively minor pieces of data still being awaited. The result is that all airport lessees have met the practical base standard of compliance⁴⁹ proposed for this review.

⁴⁸ DOTARS advised ANAO in May 2006 that the consultant was engaged through a direct selection process (that is, without tendering) on the combination of his detailed technical expertise and corporate knowledge of the airport privatisation process, and that the company's procurement followed Department Guidelines and approval processes. The consultant was engaged to prepare a summary of the insurance requirements, an assessment of the performance of airports against these requirements, the Commonwealth's potential risk exposure from airport non-compliance and proposals to reduce the risk exposure. The resulting paper addressed insurance for the years 1998 to 2004. The report and associated work were not reviewed by an independent insurance industry expert.

⁴⁹ The consultant advised that, in his view, *'most Commonwealth risk is removed if AOOL and Industrial Special Risk cover is confirmed for each year. The risk is further diminished if the Commonwealth is identified as an insured on each policy. It is therefore proposed that this level of compliance (AOOL and Industrial Special Risks with the Commonwealth named as an insured) be fully confirmed with lessees for all years to provide a base standard for minimisation of risk exposure.'*

4.29 The abovementioned consultant's report noted that, while all airports had confirmed AOOL and Industrial Special Risk insurance for all years, certain information in relation to these policies was missing.⁵⁰ As a result, DOTARS was unable to meet the consultant's recommended base standard for minimisation of the Commonwealth's risk exposure. Accordingly, in November 2005, DOTARS wrote to lessees of ten airports⁵¹ seeking additional information. DOTARS advised ANAO in May 2006 that all airports had responded, and further advised ANAO in November 2006 that all issues had been finalised between June and August 2006.

⁵⁰ This related to: the Commonwealth being named as insured on relevant policies; apparent gaps in the period covered by some policies; and the amount of coverage for some policies.

⁵¹ Adelaide, Parafield, Brisbane, Canberra, Essendon, Coolangatta, Hobart, Melbourne, Launceston and Sydney.

5. Letters of Comfort

This chapter outlines how DOTARS has improved its procedures for issuing and maintaining safe custody of letters of comfort since the previous audit.

Background

5.1 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 a legal obligation.⁵² Letters of comfort represent contingent liabilities for the Commonwealth, in that they do not impact on the Commonwealth's fiscal or underlying cash balances unless the contingent event occurs.

5.2 Finance issued a Circular in September 2003,⁵³ introducing *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort* (the Guidelines). The purpose of these Guidelines is to advise officials of their responsibilities when considering entering into arrangements involving issuing indemnities, guarantees, warranties, or letters of comfort on behalf of the Commonwealth.⁵⁴ The Circular and the Guidelines represent Australian Government policy.⁵⁵

5.3 The ANAO has conducted three audits into the management of indemnities, guarantees, warranties and letters of comfort.⁵⁶ The most recent audit, completed in 2003, concluded that there remained scope for further improvement in a number of departments and agencies, particularly in the areas of recording relevant information, application of effective risk management and control of exposures.

⁵² Department of Finance and Administration, Financial Management Guidance No.6, *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, September 2003, p. 5.

⁵³ Department of Finance and Administration, Finance Circular No.2003/02, *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, September 2003.

⁵⁴ Department of Finance and Administration, Financial Management Guidance No.6, op. cit., p. 3.

⁵⁵ Department of Finance and Administration, Finance Circular No.2003/02, op. cit., p. 2.

⁵⁶ ANAO Audit Report No.6 1996–97, *Commonwealth Guarantees, Indemnities and Letters of Comfort*, Canberra, 11 September 1996. ANAO Audit Report No.47 1997–98, *Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, Canberra, 23 June 1998. ANAO Audit Report No.27 2002–03, *Management of Commonwealth Guarantees, Warranties, Indemnities and Letters of Comfort*, Canberra, 30 January 2003.

What letters of comfort have been issued?

5.4 The 2003 *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort* state that in general, letters of comfort should be avoided. This is because a letter of comfort may lead to an actual liability, either through a court finding that the party receiving the letter was entitled to rely upon its contents, or through a moral obligation for the Commonwealth to make good on its assurances.

5.5 ANAO found in the previous audit of Federal Airport Leases that, between 1998 and January 2004, DOTARS had issued five letters of comfort. Each related 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.

5.6 DOTARS sought legal advice in December 2003 in relation to one proposed letter of comfort. AGS advised that the proposed letter of comfort would not require the Minister for Finance's approval under the FMA Regulations, however there were a number of potentially adverse ramifications for the Commonwealth that came from signing this or future letters of comfort.

5.7 A sixth letter of comfort was issued to LEX Property Management Limited in February 2005. This related to the continuation of the ground lease for proposed premises at Adelaide airport.

5.8 In its review of the previous audit in November 2005, the JCPAA commented that DOTARS should limit the number of letters of comfort issued, in line with Commonwealth policy which states they should be avoided.⁵⁷ DOTARS advised ANAO in August 2006 that no letters of comfort have been issued by DOTARS in relation to airport leases since February 2005.

DOTARS' management of its letters of comfort

5.9 The Finance Guidelines provide that agencies are required to maintain a register of all indemnities, guarantees, warranties and letters of comfort to assist in transparent reporting and disclosure, in both financial statements and the Budget Papers. The register must contain the details of the instruments, including the scope and nature of the risks involved.⁵⁸

⁵⁷ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, Joint Committee of Public Accounts and Audit, November 2005, p. 93.

⁵⁸ Department of Finance and Administration, *Financial Management Guidance No.6*, op. cit., p. 13.

5.10 In the previous audit, ANAO found that 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. In this context, ANAO made the following recommendation:

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.

5.11 The JCPAA made the following comments on this matter in its report on the audit:⁵⁹

Where it is necessary for the Department to issue such a letter, it is important that they be placed on the Department's Register of Contingencies and that safe custody arrangements for the instruments be put in place.

5.12 In its formal response to the audit, DOTARS agreed with the recommendation and advised ANAO that, in April 2004, all letters of comfort issued in relation to airport leases were recorded on the Department's Register of Contingencies, and safe custody arrangements for the instruments were now in place.

Indemnities register

5.13 DOTARS currently maintains an Indemnities Register. This is a list of current and non-current contingent liabilities, namely:

- loan guarantees;
- non-loan guarantees;
- warranties;
- personal indemnities;
- other indemnities; and
- letters of comfort.

5.14 The Register identifies the beneficiary, the title of the instrument, the date of issue, the type of instrument, whether the instrument is current and its value. As of January 2006, the Register contained all six letters of comfort issued in relation to Federal Airport leases. In this Register, ANAO observed that some of these letters of comfort were incorrectly classified as non-current.

⁵⁹ Report 404, *Review of Auditor-General's Reports 2003–04 Third & Fourth Quarters; and First and Second Quarters of 2004–05*, op. cit., p. 93.

The updated version of the Register dated 21 July 2006 lists all six letters as current.

Safe custody arrangements

5.15 The Finance Guidelines state that an integral part of sound risk management is maintaining adequate physical security of instruments and associated documents. Loss, misplacement or destruction of instruments is likely to place the Commonwealth at a disadvantage. It may also increase the level of risk.

5.16 At the time of audit fieldwork, copies of the letters of comfort were maintained within the Corporate area of DOTARS. Copies were also held in a separate file in the Airports Branch. However, ANAO observed that one of the letters of comfort was unsigned.⁶⁰ DOTARS advised ANAO in August 2006 that this has now been rectified and the unsigned copy of the letter was replaced with a signed copy in the Indemnities Register.

⁶⁰ The letter of comfort issued to National Jet Systems Pty Ltd in September 2001.

6. Airport Development Obligations

This chapter examines the improvements made to the administration of airport Development Obligations under the Sale Agreements since the previous audit.

Background

6.1 Issues associated with airport development at leased Federal Airports have been addressed in the Airports Act, the individual Airport Leases and the Sale Agreements.

Airport development under the Airports Act

6.2 Whilst the Airports Act does not deal specifically with Development Obligations for leased Federal Airports, one of the Act's primary objectives is to promote the efficient and economic development and operation of airports.

6.3 In accordance with the Act, a master plan for each airport is developed which sets out, among other things, the airport's development objectives, the airport's assessment of the future service and facility needs of airport users, and land use and related development proposals. The Act includes public consultation processes for airport master plans. In addition, under the Act, a major development plan is required for each major development at an airport. DOTARS' administration of the Airports Act has not been examined as part of this or the previous audit.

Airport development under the airport leases

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

6.5 As part of the previous audit, 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 that it had had no occasion to invoke the power contained within the lease for the airport to be required to bring the airport up to the required standard within five years. DOTARS advised ANAO in November 2006 that this power had not been used since the previous audit.

Airport development under the Sale Agreements

6.6 The Sale Agreements for 10 of the 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. In addition, further infrastructure Development Obligations were included in the Sale Agreements for Melbourne,⁶¹ Canberra⁶² and Adelaide⁶³ Airports.

6.7 The 10-year Development Obligations are divided into two five year periods, defined in the Sale Agreement as Period One and Period Two. In total, the 10 airports were required to undertake capital expenditure of \$699.8 million.

6.8 As of December 2006, each of the ten airports with Development Obligations had been assessed by DOTARS as having met their Period One Development Obligations.⁶⁴ Six of these have also been assessed to have met their Period Two Development Obligations.

⁶¹ The purchaser of Melbourne Airport provided an additional commitment that capital expenditure at the airport site during the first 10 years, including the aeronautical infrastructure Development Obligation of \$107.3 million, would be at least \$165.7 million. DOTARS advised the airport in June 2004 that the expenditure identified in Schedule 12 to the Sale Agreement had been exceeded, and there was no need for further reporting in this respect.

⁶² 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.

⁶³ The purchaser of Adelaide Airport undertook to complete the extension of the main runway and associated works. As indicated in the original audit, DOTARS has assessed that this obligation has been met. In addition, the purchaser of Adelaide Airport contracted to ensure that a Multi User Integrated Terminal be built at the airport at a cost of not less than \$150 million. The Multi User Integrated Terminal commenced in November 2003 and was opened in October 2005, at a stated cost of \$260 million.

⁶⁴ DOTARS advised ANAO in December 2006 that: *'Alice Springs has a Period One extension until 30 June 2007 and as such has not yet submitted a Period One report. However, I note that it is apparent from the Airport's annual Airport Development Cost reports that the Period One Obligation (as defined in Schedule 11 [of the Sale Agreement]) was exceeded during 2004–05.'*

Administrative procedures

6.9 Under the Sale Agreements, each of the 10 airports with Development Obligations are required to provide DOTARS with certain documentation, to assist DOTARS in its assessment of whether the airport has met its Development Obligations specified in the Sale Agreement. The three reports that are required to be provided to DOTARS under the Sale Agreement are:

- an annual expenditure plan for the balance of the relevant five year period, indicating how the airport intends to comply with its Obligations, and including details of its intended Airport Development (an 'Annual Expenditure Plan');
- an annual audited report setting out the Airport Development Costs for the 12 month period (an 'Annual Airport Development Cost Report'); and
- an audited report setting out the Airport Development Costs at the conclusion of Period One and Period Two (a 'Period One Report' or a 'Period Two Report').

Findings from the previous audit

6.10 In the original audit, ANAO found that DOTARS' development of procedures and guidelines in this area was not timely. Specifically, the first iteration of the *Development Obligations for Leased Federal Airports: Procedures and Guidelines document* (the Procedures and Guidelines) 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.

Internal review

6.11 Following the previous audit, DOTARS undertook a review of the implementation of its Procedures and Guidelines. The overall conclusion of the review, contained in an internal minute of November 2004, was that the Procedures and Guidelines were used sporadically by the Branch. In addition, the review found:

- the application of the Procedures and Guidelines, including use of assessment templates, was inconsistent across the Branch;
- not all airports were submitting reports on time;

- there was misunderstanding across the Branch as to the correct reporting dates as required by the Sale Agreements;
- the Branch was not responding to all airport correspondence in a timely way as required by the Procedures and Guidelines; and
- some Branch files appeared not to have been kept up to date.

Appointment of external consultant

6.12 A consultant was engaged in March 2005 to undertake a review of the implementation of ex-gratia payments in lieu of land tax procedures. As part of the agreement, the consultant was to provide advice and assistance in relation to matters associated with the oversight of federally leased airports more broadly, as required. No additional quotes were obtained as the consultant, due to his previous involvement and experience, was considered the only consultant likely to be able to supply the service on time at a suitable standard.⁶⁵ Work related to Development Obligations was undertaken as a component of the consultancy. In total, \$29 994 was paid to the consultant through this agreement.

6.13 A cost ceiling of \$30 000 was imposed on the March agreement. As DOTARS wished to extend the engagement of the consultant, he was engaged under a new agreement in April 2005, which amongst other matters, required him to:

- review the Development Obligations of relevant airport operators and provide advice to the Branch on what action, if any, was required in relation to them; and
- review and update Branch guidelines on the assessment of Development Obligations.

6.14 Again, no quotes were sought as the nominated consultant, due to his previous involvement and experience, was considered the only consultant likely to be able to supply the service on time at a suitable standard. The total amount DOTARS paid in respect of the new agreement signed in April 2005 was also \$29 994.

6.15 The consultant completed his work in June 2005. He reported that, as of May 2005, all Period One matters were considered in light of the (original)

⁶⁵ In this respect, DOTARS advised ANAO in November 2006 that engagement of the consultant was undertaken with due consideration and adherence to Government and Departmental Procurement guidelines and as approved under Chief Executive Instructions 5.2 Procurement of Goods and Services.

ANAO report, and all Period One issues had been settled. Specifically, he noted that the three airports with active extensions, Hobart, Perth and Alice Springs, cannot be finalised for Period One until their extensions expire, and all airports had been issued reminders about their 2005 reporting deadlines. The consultant also reported all airports were in a satisfactory position with regard to their Development Obligations, except that Alice Springs and Canberra required close monitoring. In addition, the consultant revised the written Procedures and Guidelines (as outlined below).

Appointment of dedicated Branch officer to deal with Development Obligation monitoring

6.16 As part of his report to DOTARS, the Department's consultant recommended that consideration be given to the appointment of a dedicated officer or section in the Branch to deal with monitoring Development Obligations across all airports, rather than the responsibility being spread across sections. This approach, whereby one section is responsible for assessing airports' Development Obligations, was adopted in September 2005. DOTARS advised ANAO in November 2006 that this has considerably improved the consistency of assessments and subsequent decision making in relation to the administration of Development Obligations.

New Guidelines

6.17 The December 2003 Procedures and Guidelines were reviewed and updated by the aforementioned consultant during 2005. Following legal review, the revised Guidelines were promulgated in October 2005 (*Development Obligations for Leased Federal Airports: Revised Guidelines - the Revised Guidelines*).

6.18 The objectives of the Revised Guidelines are similar to the previous Procedures and Guidelines. However, the Revised Guidelines include a separate Statement of Principles which details the principles DOTARS aims to adopt in discharging its responsibility for ensuring airports comply with their Development Obligations. In addition, the Revised Guidelines contain an 'Expanded Definition of Aeronautical Infrastructure Development'. This section provides guidance on allowable and non-allowable airport development expenditure.

Receipt of Annual Expenditure Plans and Annual Airport Development Cost Reports

Annual Expenditure Plans

6.19 Under the Sale Agreements, those airports with Development Obligations must provide DOTARS with an Annual Expenditure Plan for the balance of the relevant period (that is Period One or Period Two), indicating how it proposes to comply with its Obligations. For the first year, this was to be provided within 90 business days of 1 July. For subsequent years, the Annual Expenditure Plan was due on 1 July.

6.20 In the previous audit, ANAO found, that of the 53 Annual Expenditure Plans that should have been obtained by December 2003, only 35 had been received (66 per cent). Further, of those received, only six were obtained by the due date. This follow-up audit found considerable improvement in this aspect of Development Obligations administration. Specifically, ANAO found that, for 2004 and 2005, only two of the sixteen Annual Expenditure Plans were not received. However, the timeliness of provision of the Annual Expenditure Plans remains a concern, with only one Plan received on time. Accordingly, further effort by DOTARS in this area is warranted. In this context, DOTARS advised ANAO in November 2006 that:

We agree with ANAO that further effort is required regarding the timeliness of provision by airports of Annual Expenditure Plans and Annual Airport Development Cost Reports. We note, however, that airports tend to submit their Annual Expenditure Plans at the same time as their Annual Airport Development Cost Reports because having audit results better informs the finalisation of their Annual Expenditure Plans. DOTARS is working towards enhanced performance reporting by the airports in this regard, with reminder letters being sent to airports with continuing Development Obligations in May this year. Email reminders for the Annual Expenditure Plans were sent to relevant airport contacts on 1 July 2006.

Table 6.1**Provision of Annual Expenditure Plans in 2004 and 2005**

| Date Due | Received on time | Received late | Not received | Total |
|--------------|------------------|---------------|--------------|-----------|
| 1 July 2004 | 0 | 7 | 2 | 9 |
| 1 July 2005 | 1 | 6 | 0 | 7 |
| Total | 1 | 13 | 2 | 16 |

Note: Any Annual Expenditure Plans received over one year late were considered not to have been received for that year, as another Annual Expenditure Plan will have superseded it at that point.

Source: ANAO analysis of Sale Agreements and DOTARS documentation.

Annual Airport Development Cost Reports

6.21 According to the Sale Agreements, the airports must provide an audited report setting out the Airport Development Cost incurred in the previous 12 months. Under the Sale Agreements, these are to be provided within 60 business days of 1 July, falling due in late September each year. The previous audit found that DOTARS had obtained 88 per cent of required reports between 1998 and 2003, however more than half were obtained after the due date.

6.22 This follow-up audit found that DOTARS also improved its performance in this area. Significantly, the required reports were obtained from all airports. However, although timeliness has improved, ANAO found that Annual Airport Development Cost Reports for 2004 and 2005 were still being received late.

Table 6.2**Provision of Annual Airport Development Cost Reports in 2004 and 2005**

| Date Due | Received on time | Received late | Not received | Total |
|----------------|------------------|---------------|--------------|-----------|
| September 2004 | 4 | 5 | 0 | 9 |
| September 2005 | 5 | 3 | 0 | 8 |
| Total | 9 | 8 | 0 | 17 |

Note: A report is considered late if it is received after 30 September. Where a number of versions have been submitted, ANAO have used the final version submitted.

Source: ANAO analysis of Sale Agreements and DOTARS documentation.

Performance reporting

6.23 The previous audit found that the level of non-compliance with the contractual requirements was not reflected in DOTARS' performance reporting. In particular, DOTARS' 2002–03 Annual Report stated that airports were compliant with all Sale Agreement and lease obligations. In this context, ANAO made the following recommendation:

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.

6.24 DOTARS agreed with qualification to the recommendation. The Department stated that it considered 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 would include performance information relating to Annual Airport Development Cost Reports and Annual Expenditure Plans from the 2004–2005 Annual Report onwards. This information has been included in both the 2004–05 and 2005–06 Annual Reports.

Compliance monitoring

6.25 Under the December 2003 Procedures and Guidelines, DOTARS officers were required to produce a number of outputs. The major outputs required under these Procedures and Guidelines were as follows:

- a Development Obligations Checklist to determine:
 - whether the Commonwealth was satisfied with the airport's regularity of reporting;
 - whether the amount of information that has been provided was sufficient to enable assessment; and
 - whether the airport has met all the reporting requirements of the Sale Agreement.
- a Development Obligations Status Report providing an assessment and analysis of the airport's financial and activity reporting for the period under review; and
- a Summary Statement Overview of Performance finalising the analysis and assessment of performance.

6.26 The previous audit found that, by March 2004, the Department had not completed any of the analytical outputs required under the process outlined in the Procedures and Guidelines, although DOTARS advised ANAO they had been operative since June 2003.

6.27 The completion of analytical outputs has improved since the previous audit, although there remains room for improvement. In total, of the 78 outputs required, only 48 (62 per cent) had been completed. However, ANAO also noted that the rate of non-completion for each of the outputs fell significantly from 2004 to 2005.⁶⁶ This is outlined in Table 6.3.

6.28 In this respect, DOTARS advised ANAO in November 2006 that where analytical outputs (in the form prescribed by the Guidelines and Procedures) were not completed, this did not mean that no analysis of reports occurred and that compliance was not monitored. DOTARS further advised ANAO that since September 2005, all analytical outputs have been in the required form.

Table 6.3

Completion of analytical outputs from the Procedures and Guidelines

| | Total required | Total not completed | % not completed |
|-------------------------------------|----------------|---------------------|-----------------|
| Checklist Period One Reports | 9 | 4 | 44 |
| Checklist 2004 | 9 | 4 | 44 |
| Checklist 2005 | 8 | 0 | 0 |
| Status Report Period One | 9 | 4 | 44 |
| Status Report 2004 | 9 | 5 | 56 |
| Status Report 2005 | 8 | 0 | 0 |
| Summary Statement Period One Report | 9 | 6 | 67 |
| Summary Statement 2004 | 9 | 6 | 67 |
| Summary Statement 2005 | 8 | 1 | 13 |
| Total | 78 | 30 | 38 |

Source: ANAO analysis of DOTARS documentation.

⁶⁶ Analytical outputs are required for both Annual Airport Development Cost Reports and Period One/Two Reports.

Acknowledgement of receipt of airport documentation

6.29 According to the Procedures and Guidelines, the Department should acknowledge the receipt of documentation from airports. Specifically, the Procedures and Guidelines state that:

- when reports are received on time, the Department should write to the airport within twenty business days of receiving the report acknowledging receipt of the report, and highlighting any deficiencies where these occur;
- when reports are received significantly late, the Department should write acknowledging the report within twenty business days, seeking explanation for delays in reporting; and
- when reports are not received, the Department should write to the airport within twenty business days of the deadline expiring seeking explanation for non-reporting.

6.30 Acknowledgement of receipt of documentation by DOTARS has been poor. For those reports which were received on time, only 50 per cent received formal acknowledgement from DOTARS within 20 business days of receipt that the report had been received (see Table 6.4). In this respect, DOTARS advised ANAO in November 2006 that all reports are acknowledged after departmental assessment, and in many cases reports and expenditure plans are acknowledged informally via telephone. DOTARS further advised that as formal acknowledgement is not required under the Sale Agreements, but rather is part of the recommended practice of the Guidelines and Procedures, non-acknowledgement does not constitute poor administration.

Table 6.4

DOTARS acknowledgement of reports received on time

| | No. of reports received on time | No. of reports acknowledged within 20 business days of receipt | % |
|---|---------------------------------|--|-----|
| Annual Expenditure Plans (2004 and 2005) | 1 | 1 | 100 |
| Annual Airport Development Cost Reports (2004 and 2005) | 9 | 4 | 44 |
| TOTAL | 10 | 5 | 50 |

Source: ANAO analysis of DOTARS documentation.

6.31 For those reports which were received late, or had not been received, ANAO found that reminder letters were largely not being sent within 20 business days of the deadline (see Table 6.5).

Table 6.5

DOTARS reminder letter for reports not received by due date

| | No. of reports not received by due date | No. of reminder letters sent within 20 business days of deadline | % |
|---|---|--|----|
| Annual Expenditure Plans (2004 and 2005) | 15 | 0 | 0 |
| Annual Airport Development Cost Reports (2004 and 2005) | 3 ^A | 1 | 33 |
| TOTAL | 18 | 1 | 6 |

Note A: This does not include those five reports that were not received by the due date, but were received within twenty business days of the deadline, and hence did not require a reminder letter.

Source: ANAO analysis of DOTARS documentation.

Achievement of Period One Development Obligations

6.32 The total Period One Obligation for the ten airports was \$259 million. For Phase 1 Airports, Period One ended on 30 June 2002. For Phase 2 Airports, Period One ended on 30 June 2003.

6.33 Under the Sale Agreements, shortfalls in achievement by airports against their contracted Development Obligations 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 Obligations financially unjustifiable, or a force majeure event occurs, DOTARS and the relevant airport are required to negotiate in good faith to agree upon the period of any extension and the amount by which the Obligation 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 Obligation, DOTARS and the airport will have regard to:
 - the extent to which the airport 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 airport;
 - the steps the airport should be taking to overcome or minimise the adverse effects of the event leading to the delay; and
 - the assumed inflation rate over the period the airport's obligation to comply with the Development Obligation will be extended.
- Alternatively, if the Commonwealth gives the airport notice within 60 business days of receiving the Period One or Two report, the airport 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 Obligation or less than 80 per cent of the Period Two Obligation. The purpose of this "use it or lose it" contractual mechanism was to provide the strongest possible legal incentive for airports to meet their Development Obligations. 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.

Period One extensions

6.34 At the time of the previous audit, DOTARS was assessing whether five of the airports had met their Period One Development Obligations, and whether to grant extensions to four airports.⁶⁷ As of January 2006, five of the ten airports had been provided with an extension for Period One. These are outlined in Table 6.6.

⁶⁷ Near the conclusion of the previous audit, DOTARS advised ANAO that it had received the other airport's Period One report, which was then being assessed.

Table 6.6
Extensions provided for Period One

| Airport | Original Period One End date | New Period One End Date |
|---------------|------------------------------|--|
| Adelaide | 30 June 2003 | 30 June 2004 ⁶⁸ |
| Alice Springs | 30 June 2003 | 30 June 2007 |
| Coolangatta | 30 June 2003 | 30 June 2004 ⁶⁹ |
| Hobart | 30 June 2003 | Initially 30 June 2004. Subsequently revised to 30 June 2005 |
| Perth | 30 June 2002 | June 2006 |

Source: ANAO analysis of sale documentation and DOTARS internal documentation.

Application of assumed inflation rate

6.35 When negotiating an extension, DOTARS and the airport are required by the Sale Agreement to have regard to the assumed inflation rate over the period of deferment.

6.36 The previous Procedures and Guidelines recommended the use of the risk free market interest rate, represented by the Treasury long term bond rate, as the discount rate in determining the appropriate value of deferred development expenditure.

6.37 The Revised Guidelines, promulgated in October 2005 reflect a change in DOTARS’ approach to the application of inflation. In particular, the Statement of Principles contained in the Revised Guidelines indicate that an estimated future consumer price index (for example, the Commonwealth Treasury’s estimated consumer price index in the Budget Papers) can be applied, rather than the risk free market interest rate, as was previously the case.⁷⁰ In this context, ANAO notes that DOTARS has not had a consistent approach to the application of inflation. In respect to the different approaches it has taken to calculating inflation, DOTARS advised ANAO in November 2006 that:

⁶⁸ DOTARS required Adelaide Airport to provide another audited Period One report following the granting of an extension. However, this was not required for Coolangatta Airport.

⁶⁹ DOTARS confirmed that the submitted report met the requirements under the Sale Agreement in July 2004. However, the airport was actually short of the Period One amount. An extension was subsequently provided in June 2005. DOTARS advised the airport in September 2005 that it had fulfilled the Period One reporting requirements.

⁷⁰ The Consumer Price Index was used to calculate the total Period One shortfall for Perth Airport.

The differences in DOTARS' application of an inflation rate reflect that extensions are negotiated between DOTARS and each individual airport. Consideration is given to, among other things, the amount of the shortfall and the length of the extension requested/granted.

Eligibility of expenditure claimed by airports

6.38 The Development Obligations relate to 'Airport Development.' 'Airport Development' is defined as (a) 'aeronautical infrastructure development' or (b) such other development projects carried out at the airport site as may be agreed between the Commonwealth and the Transferee for the purposes of Clause 11 of the Sale Agreement. The Sale Agreements outline that the term 'aeronautical infrastructure development' includes, but is not limited to, a range of activities including:

- constructing a new runway, taxiway or apron or extending an existing runway, taxiway or apron;
- constructing a new passenger terminal or extending an existing terminal; and
- constructing a new road or vehicular access facility (including car parking) where this increases the capacity of the airport to handle passenger movements.

6.39 Accordingly, a key issue in assessing achievement of Development Obligations is whether the expenditure reported by the airport is for 'aeronautical infrastructure development'.

6.40 In the previous audit, ANAO found that DOTARS' administration of the requirement for Development Obligations to relate to aeronautical infrastructure development had been inconsistent, particularly in relation to the treatment of commercial development. ANAO also noted that there was an absence of a shared understanding with airports of expenditure that would be counted towards achieving Development Obligations. As a result, ANAO made the following recommendation:

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.

6.41 DOTARS agreed with the recommendation. DOTARS stated that the formal Guidelines now in place facilitate the careful analysis of Annual Airport Development Cost Reports and provide for the formal advice to airports regarding the appropriateness or not of their expenditure.

6.42 At the time of this follow-up audit, Period One had been completed for the majority of airports that have airport Development Obligations. Accordingly, in this follow-up audit, ANAO analysed implementation of this recommendation in terms of the Period One Reports submitted by airports.

DOTARS analysis of reports submitted by airports

6.43 The Sale Agreements require the audit opinion to address the eligibility of expenditure. However, consistent with sound administrative practice, DOTARS' procedures recognise that the auditor is not an airport expert such that there may be projects the auditor has accepted but that DOTARS, following its subsequent review, may declare ineligible. DOTARS' procedures state that this would not render the audit opinion invalid.

6.44 For DOTARS to be able to satisfy itself that these reports includes only projects that involve 'aeronautical infrastructure development', the Department requires sufficient detail to be included in the Period One reports.⁷¹ In this respect, there was considerable variation in the level of detail provided by airports in their Period One Reports. Some provided details that clearly outlined the nature and purpose of the expenditure. Some simply provided DOTARS with categories of expenditure and associated total amounts. In these latter instances, which involved airports with some of the large Development Obligations, DOTARS was only able to rely upon the auditor's opinion.⁷² For example, Melbourne Airport's Period One report contained only seven items of expenditure, totalling \$107.8 million. No other details were sought by DOTARS in relation to this airport's reported expenditure on Development Obligations.

6.45 In this regard, DOTARS advised ANAO in December 2006 that it had sought and received further detail in relation to three airport's 2005–06 Annual Airport Development Cost Reports, especially where broad categories were used, although noting that the reports had been audited by a qualified auditor in accordance with the Sale Agreement.

⁷¹ The Sale Agreements provide for non-aeronautical infrastructure development projects to be included in an Airport's Development Obligations under the Sale Agreement, if agreed between the Commonwealth and the airport. In this context, ANAO noted that, in accordance with the Sale Agreements, \$168 758 of non-aeronautical infrastructure development was accepted for Alice Springs Airport, \$103 321 of non-aeronautical infrastructure development was accepted for Darwin Airport, and \$1 352 757 of non-aeronautical infrastructure development was accepted for Perth Airport.

⁷² ANAO notes that, on occasion, DOTARS requested additional information in respect to broad categories of expenditure. For example, in November 2004, DOTARS requested a more detailed breakdown of the ten broad items contained in Brisbane Airport's 2003–04 expenditure report.

6.46 ANAO also noted that, where details were provided, DOTARS did not treat expenditure by different airports on similar projects in a consistent manner. In addition, DOTARS has accepted expenditure from some airports that does not appear to relate to aeronautical infrastructure development. In particular, DOTARS has assessed that aeronautical infrastructure development includes:

- any equipment related to the aeronautical operations of the airport;
- strategies, surveys, plans and reviews; and
- expenditure associated with the fit out and refurbishment of airport administration offices.

6.47 A dedicated Development Obligation Officer commenced work in September 2005. DOTARS advised ANAO in November 2006 that the appointment of a dedicated officer has resulted, and will continue to result, in the consistent treatment of expenditure by different airports on similar projects. However, whilst the assessments have been consistent, they have not rigorously applied the terms of the Sale Agreements so as to identify items that do not appear to relate to aeronautical infrastructure development.

6.48 ANAO also noted a number of discrepancies in documentation provided by airports, which do not appear to have been identified by DOTARS or communicated to airports. Amongst other matters, these related to: errors in Annual Airport Development Cost Reports; inconsistencies between Annual Airport Development Cost Reports and Period One Reports; inconsistencies in supporting documentation and Annual Airport Development Cost Reports; Period One Reports and Annual Airport Development Cost Reports that are not compliant with the Sale Agreement; and Annual Airport Development Cost Reports prepared on an accrual rather than a cash basis. These have been drawn to DOTARS' attention.⁷³

Disputed expenditure

6.49 If DOTARS wished to exercise the Commonwealth's rights under Clause 11.5 of the Sale Agreement⁷⁴ on the basis that it disputes the amount of development expenditure included in a Period One or Period Two report, the

⁷³ On the issue of accrual versus cash reporting, DOTARS advised ANAO in December 2006 that it had written to two airports advising them that their reports need to be reaudited on a cash basis, rather than an accruals basis.

⁷⁴ This Clause provides for the airport to pay the Commonwealth the difference in the reported Period One or Period Two Development Obligations, and a percentage of the total required Period One or Period Two Development Obligations.

Sale Agreements make it a pre-condition that the airport has first been given a written Dispute Notice within 60 business days of the Commonwealth receiving the report. Accordingly, it is important that DOTARS complete its analysis of reported expenditure within this timeframe, and formally communicate any concerns via a Dispute Notice.

6.50 As outlined in Table 6.7, in most instances DOTARS' analysis of expenditure claimed by airports has been completed in sufficient time for consideration to be given to issuing a Dispute Notice. However, delays did occur in a number of instances. As a consequence, concerns have not been communicated to airports until after the 60 day Notice period, thereby adversely affecting the Commonwealth's right under Clause 11.5 to recover any shortfall in expenditure, should this have been necessary.

Table 6.7

Issuing of Dispute Notices

| Airport and Report | Date of Report | 60 Business Days | Date of DOTARS assessment | Date DOTARS wrote | Dispute Notice Issued |
|-----------------------|----------------|------------------|---------------------------|-------------------|-----------------------|
| Adelaide – initial | 29/10/03 | 27/01/04 | 18/11/03 | 18/11/03 | Yes |
| Adelaide – second | 5/12/03 | 4/03/04 | 8/06/04 | 8/06/04 | Yes |
| Adelaide - third | 11/03/05 | 8/06/05 | 13/05/05 | 8/06/05 | N/A |
| Alice Springs | 8/03/04 | 3/06/04 | 16/08/04 | 17/08/04 | Yes |
| Brisbane | 3/02/04 | 30/04/04 | 26/03/04 | 29/03/04 | N/A |
| Canberra-initial | 29/10/03 | 27/01/04 | 18/12/03 | 18/12/03 | Yes |
| Canberra-second | 11/02/04 | 10/05/04 | 16/03/04 | 23/03/04 | No |
| Coolangatta - initial | 22/09/03 | 16/12/03 | 10/12/03 | 10/12/03 | No |
| Coolangatta – second | 13/04/04 | 8/07/04 | 2/07/04 | 2/07/04 | N/A |
| Coolangatta - third | 3/03/05 | 31/05/05 | 23/09/05 | 26/09/05 | N/A |
| Darwin - initial | 8/03/04 | 3/06/04 | 14/04/04 | 14/04/04 | No |
| Darwin - second | 13/05/04 | 6/08/04 | 1/06/04 | 3/06/04 | Yes |
| Hobart - initial | 28/07/03 | 21/10/03 | 30/09/03 | 31/10/03 | N/A |
| Hobart - second | 18/10/04 | 13/01/05 | 17/12/04 | 12/01/05 | N/A |
| Launceston | 23/01/04 | 21/04/04 | 30/01/04 | 1/06/04 | N/A |
| Melbourne | 23/01/04 | 21/04/04 | 30/01/04 | 1/06/04 | N/A |
| Perth - initial | 6/02/04 | 5/05/04 | 10/03/04 | 10/03/04 | No |
| Perth - second | 4/08/04 | 28/10/04 | 16/09/04 | 16/09/04 | Yes |
| Perth - third | 23/11/05 | 20/02/06 | 21/12/05 | 17/01/06 | N/A |

Note: Shading indicates a delay of greater than 60 business days following the receipt of the report.

Source: ANAO analysis of DOTARS documentation.

Reporting of Period One Development Obligations

6.51 In the previous audit, ANAO made the following recommendation in respect of Period One Outcomes:

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

6.52 DOTARS agreed with the recommendation with qualification. DOTARS stated that, from its 2003–04 Annual Report onwards, the Department would report the outcomes for those airports that have completed their Period One Development Commitment for that respective year.

6.53 Starting with its 2004–05 Annual Report, DOTARS has included more detailed information than was previously the case in relation to Development Obligations. Specifically, it reported the amount of airport development expenditure for each individual airport as at 30 June 2004, against its Period One Development Obligation.⁷⁵ In its 2004–05 Annual Report, DOTARS reported that eight airports had met or exceeded their Period One Development Obligations as at 30 June 2004.⁷⁶ In the 2005–06 Annual Report, DOTARS reported that all ten airports had exceeded their Period One Obligations.

6.54 In addition, in its 2004–05 and 2005–06 Annual Reports, DOTARS provided aggregate totals for Annual Expenditure Plans and Annual Airport Development Cost Reports submitted and the total number that were submitted on time, late or not received. This is a considerable improvement on DOTARS' previous reporting on Development Obligations. However, the amounts reported under 'Period One commitment' for each airport did not include the effect of applied inflation for those airports that had received an extension to their Development Obligations. In this respect, DOTARS advised ANAO in November 2006 that:

DOTARS acknowledges the 2004–05 Annual Report does not include the effect of the applied inflation for those airports that had received extensions to their Development Obligations. In the 2005–06 report DOTARS again did not include the effect of the applied inflation, but clearly stated that the Development Obligation figures used were sourced from Schedule 11 of the

⁷⁵ Exclusive of any inflation adjustment resulting from an extension.

⁷⁶ In certain cases, the amount of expenditure reported in the Annual Report included 2003–04 expenditure, whilst in other cases it does not.

Sale Agreements. In future annual reports DOTARS may consider including the effect of the applied inflation.

6.55 However, DOTARS' 2005–06 Annual Report does not specifically state that the Development Obligation figures were sourced from Schedule 11 of the Sale Agreement, but refers more generally to the Period One and Period Two Development Obligations.

6.56 In its report on the previous audit released in November 2005, the JCPAA recommended that DOTARS report more fully on whether or not the ten airports have met their airport Development Obligations in a timely manner. This was to include reporting on airports who have not provided the Department with the information required or have not supplied the Department with information in a timely manner. It would also include DOTARS reporting on extension dates that have been granted to airports.

6.57 One of the formal recommendations of the report is also relevant here. Recommendation 17 states:

The Committee recommends that the annual report of DOTARS includes a matrix reporting on each airport lease-including the status of lease reviews, insurance reports, Development Obligations, letters of comfort and cost recovery of administrative expenses. Where time extensions for Development Obligations have been granted, DOTARS must provide a comprehensive explanation detailing why the extension has been approved.

6.58 DOTARS responded to the recommendation in April 2006, and advised the Committee that:

DOTARS reports on its performance in the oversight of Federal airport leases through its Annual Reports. Reporting in the 2004–2005 Annual Report was enhanced in relation to the status of annual lease reviews, Development Obligations and cost recovery of administrative expenses. It is proposed to increase the scope of performance reporting in the 2005–2006 Annual Report and the Committee's recommendations will be carefully considered in this context.

6.59 As the JCPAA report was released in November 2005, DOTARS was unable to specifically address any of its recommendations in its 2004–05 Annual Report.⁷⁷ In November 2006, DOTARS advised ANAO the following:

DOTARS acknowledges it has not provided details in its Annual Report where individual airports have not supplied their Annual Expenditure Plans or not provided them in a timely manner. This was a considered decision by the Department. It reflects the Department's view that these details could suggest to the reader that monetary commitments are not being met, rather than reporting deadlines. As the JCPAA Report did not come out until late 2005, the Department could not address any of its recommendations in its 2004–05 Annual Report. However, it is significant to note that the Department's 2005–06 Annual Report includes reporting on Period One extensions for those airports with continuing Development Obligations (namely Alice Springs and Coolangatta).

6.60 ANAO considers that clarity could be improved in DOTARS' Annual Report in respect to the reporting of extensions. In its 2005–06 Annual Report, DOTARS stated that 'extensions to Period One have been granted to Alice Springs Airport (four years) and Gold Coast (one year)...'. However, it was not clear from the Annual Report that it was only those airports with continuing Development Obligations that were reported.

6.61 The scope of performance reporting was further increased in the 2005–06 Annual Report to include more detailed information on Lease Reviews, Insurance Reviews, Development Obligations and Development Obligation extensions.

Period Two Development Obligations

6.62 The total Period Two Obligation for the ten airports was \$441 million.⁷⁸ For Phase 1 Airports, Period Two ends on 30 June 2007. For Phase 2 Airports, Period One ends on 30 June 2008.

⁷⁷ For example, the Committee recommended that DOTARS report on airports who have not provided DOTARS with the information required or have not supplied DOTARS with information in a timely manner. DOTARS did not provide details of individual airports that had not supplied their information in a timely manner. Also, DOTARS did not report on extension dates that have been granted to airports, either historically or in the 2004–05 financial year. For example, Hobart Airport was granted an extension until 30 June 2005, which was formally communicated to the airport on 18 May 2005. This extension was not addressed in the Annual Report.

⁷⁸ In a letter of 1 November 2005, DOTARS advised Brisbane Airport that its Period Two Development Obligation was \$332.2 million. However, it is actually \$292.9 million. DOTARS advised ANAO in November 2006 that it acknowledged that the correct figure is \$292.9 million, and that Brisbane Airport was advised of the correct figure in November 2006.

6.63 The previous audit found that there were significant delays in DOTARS obtaining Period One Reports from the airports. As a result, ANAO made the following recommendation in respect to Period Two Development Obligations:

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.

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

6.65 In this respect, the airports identified in the following table have been assessed as meeting their Period Two Development Obligation in advance of the due date.

Table 6.8
Period Two Development Obligations

| Airport | Period Two Obligation (\$) | DOTARS assessment |
|------------|----------------------------|--|
| Adelaide | 22 585 000 | Advised airport that Development Obligation met in June 2005. |
| Darwin | 2 750 000 | Advised airport that it had exceeded Development Obligation for Period Two in June 2006. |
| Hobart | 1 706 994 | Advised airport that it had exceeded the total Development Obligation set out in Schedule 11 of the Sale Agreement in July 2006. |
| Launceston | 895 000 | Advised airport that Development Obligation met in November 2005. |
| Melbourne | 29 000 000 | Advised airport that it had met the total Development Obligations set out in Schedule 11 in June 2004. |
| Perth | 33 322 247 | Advised airport that it had met the total Development Obligation set out in Schedule 11 in January 2006. |

Source: ANAO analysis of Sale Agreements and DOTARS documentation.



Ian McPhee
Auditor-General

Canberra ACT
8 February 2007

Appendix

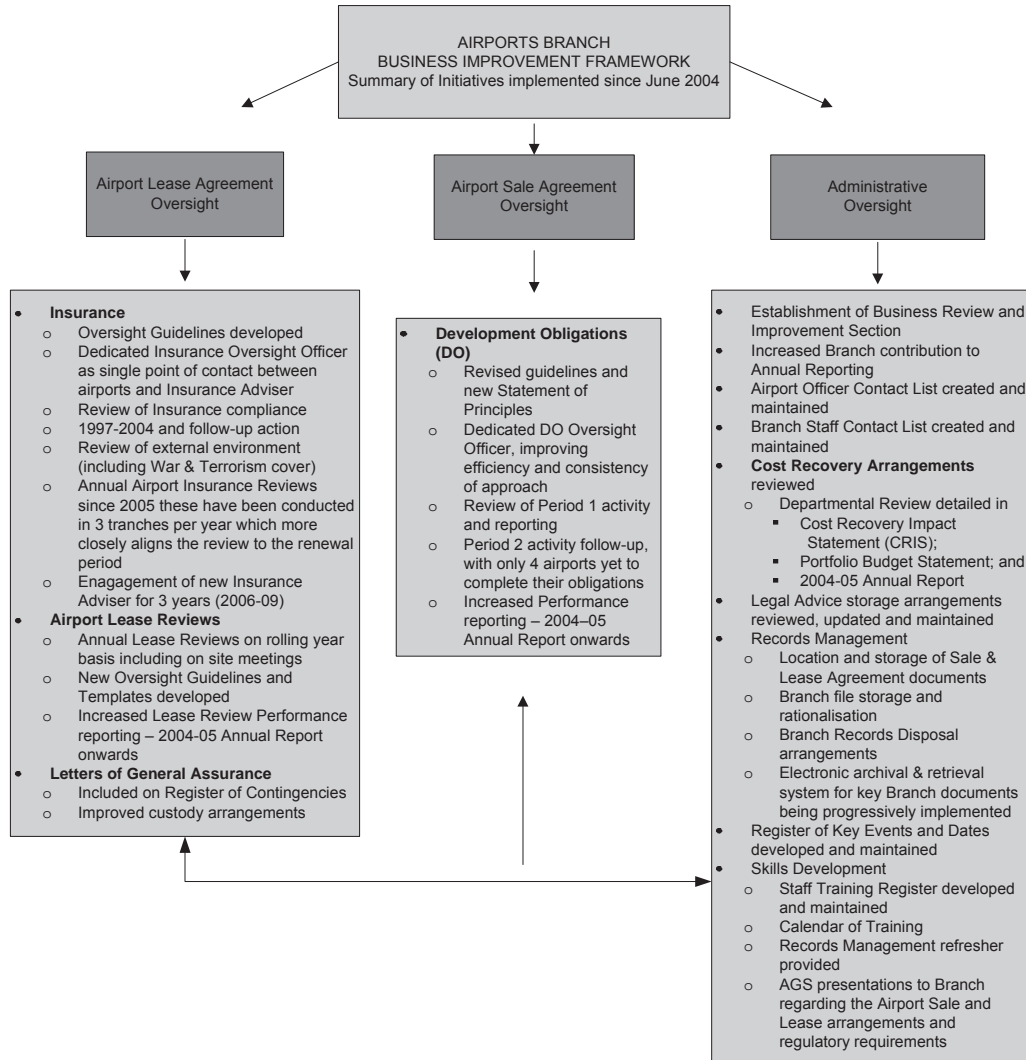
Appendix 1: Department of Transport and Regional Services' Comments on Proposed Audit Report

Introduction

The Department welcomed the ANAO's 2004 Performance Audit regarding the Department's oversight and management of the 22 leased Federal airports for it provided the Department with an opportunity to review its oversight of, and reporting on the performance of the airport lessees against their Sale and Lease Agreement obligations. The Department agreed to the recommendations contained in the report, some with qualification. Since the 2004 audit, the Department has made significant improvement in the way it administers and manages its oversight function.

In implementing the nine recommendations from the 2004 audit, the Department took a broad view of its oversight practices in the Airports Branch and from this developed a range of strategies and initiatives to improve its airport oversight activities. The matrix at Figure 1 below provides an overview of the initiatives and strategies undertaken by the Department.

Figure 1



Follow-up Audit

As a general comment, while the ANAO has reported on the progress made in improving the Department’s lease oversight responsibilities since the tabling of the 2004 Performance Audit, the Department considers that the way the ANAO has presented some of the data in its Follow-up Audit report (the Follow-up Report) does not fully reflect the outcomes and improvements achieved by the Department since that time.

The Department’s responses to specific issues raised in the Follow-up Report are detailed below and address this.

Chapter 2. Cost Recovery

This Department considers it has through its examination of the possible cost recovery of lease administration costs implemented the Government's Cost Recovery Guidelines. In addition, the Department has complied with Section 44 of the *Financial Management and Accountability Act 1997* in that any further exploration of the possible cost recovery of lease administration costs, beyond those costs already recovered, would not have been an efficient use of Commonwealth resources.

The Department notes its conclusion not to seek to recover lease administration costs is consistent with the Department of Finance and Administration's (Finance) recent view on this matter in relation to both cost recovery generally and the recovery of administrative expenses post-sale. Finance noted in their recent advice to the Joint Committee of Public Accounts and Audit (JCPAA), that administrative costs relating to post sale expenses are a 'valid cost to Government and should not be borne by the purchaser'.

Chapter 3. Lease Reviews

The Department acknowledges that the ANAO has noted substantial improvement in the Department's administration and management of airport lease reviews since the tabling of the 2004 Audit report.

Table 1: Scheduled Lease Review Meetings: 2004–2006

| Airport | Review Meeting 2004 | Review Meeting 2005 | Review Meeting 2006¹ |
|----------------------|----------------------------------|----------------------------|--|
| Adelaide | 25 May 2004 | 1 June 2005 | 22 June 2006 |
| Alice Springs | 19 May 2004 | 29 July 2005 | 24 August 2006 ⁵ |
| Archerfield | 25 May 2004 | 30 June 2005 | 19 July 2006 |
| Bankstown | No meeting held ² | 12 May 2005 | 29 March 2006 |
| Brisbane | 25 May 2004 | 11 July 2005 | 23 May 2006 |
| Camden | No meeting held ² | 12 May 2005 | 29 March 2006 |
| Canberra | 22 June 2004 | 28 June 2005 | 16 June 2006 |
| Darwin | 18 May 2004 | 29 July 2005 | 24 August 2006 ⁵ |
| Essendon | 28 June 2004 | 9 June 2005 | 5 May 2006 |
| Gold Coast | 27 July 2004 | 27 July 2005 | 18 July 2006 |
| Hobart | 30 April 2004 | 16 March 2005 | 5 April 2006 |
| Hoxton Park | No meeting held ² | 12 May 2005 | 29 March 2006 |
| Jandakot | 25 February 2004 | 21 April 2005 | 26 September 2006 |
| Launceston | 29 April 2004 | 5 April 2005 | 28 June 2006 |
| Melbourne | 24 August 2004 | 23 August 2005 | 22 August 2006 |
| Moorabbin | 3 June 2004 | 8 June 2005 | 4 May 2006 |
| Mount Isa | No meeting held ³ | November 2005 ⁴ | 18 July 2006 |
| Parafield | 25 May 2004 | 1 June 2005 | 22 June 2006 |
| Perth | 26 February 2004 | 22 April 2005 | 25 September 2006 |
| Sydney | 11 May 2004 | 11 May 2005 | 29 March 2006 |
| Tennant Creek | 18 May 2004 | 29 July 2005 | 24 August 2006 ⁵ |
| Townsville | 25/26 February 2004 ⁴ | 30 July 2005 | 18 July 2006 ⁶ |

Notes:

1. Scheduled lease review dates may change subject to unforeseen circumstances and as agreed between the Department and the airport.
2. No review was held as the sale process was completed December 2003. Airports had just completed a competitive sale and due diligence process where lease issues had been exhaustively examined. It was decided that given the new lease ownership arrangements, the lessees should be given time to establish their processes and that lease reviews not be conducted in the first year of the contractual arrangements.
3. No meeting was held as no material issues were assessed as requiring attention.
4. No face-to-face meeting held. Review conducted including requesting and receiving information from airport, followed by response by Department.
5. Date changed from 2 August to 24 August due to significant Major Development Plan under the Airports Act being dealt with by the relevant Section in the Airports Branch.
6. Meeting date changed from 17 July to 18 July as Townsville, Mt Isa and Gold Coast Airports all owned by same company and lease reviews conducted simultaneously.

NOTE: 2006 lease reviews for all 22 leased Federal airports have been finalised including letters sent from the General Manager to airports finalising the Lease Review process.

The Department has:

1. developed and implemented Lease Review Guidelines for the scheduling and conducting of annual reviews;
2. conducted annual lease reviews for all the airports on a rolling year basis;
3. assessed and documented review outcomes (albeit with some slight areas for improvement); and
4. reported in the Department's 2004–05 Annual Report on performance in conducting these reviews and further enhanced reporting in the 2005–06 Annual Report.

The Department considers Table 1 above presents a more accurate picture of the improvement in the Department's performance in scheduling and conducting lease reviews since the 2004 Audit Report compared to Figure 3.1 of the ANAO Report. In support, the Department notes that scheduled lease reviews have been held with all airports on a regular rolling year basis for the last two years with on-site lease review meetings being conducted for all airport lessee companies in 2006. All lease review meetings for 2006 were held by 26 September 2006 and all reviews finalised by the end of November 2006 (see Table 1 above).

As the Department has explained previously to the ANAO in relation to the 2004 Audit Report, the Department endeavours to manage its broad-ranging regulatory and lease oversight responsibilities in the most efficient and effective manner possible. Where possible, reviews are scheduled when key regulatory and lease matters are able to be dealt with at the same time in face to face visits by Departmental staff with the airport concerned to make the most effective use of resources.

While the Department acknowledges that the assessment and documenting of the lease review process and outcomes have not been consistent up until the time that the ANAO's 2004 audit report was tabled, since that time the Department has significantly improved the review process with lease review meetings having been held and assessments completed and documented for all Airport Lessee companies.

Chapter 4. Airport Insurances

The Department acknowledges that the ANAO has noted the improvement in the Department's administration and management of airport insurances achieved since the tabling of the 2004 Audit report.

The Department acknowledges that the adequacy of airport insurance cover held by the 22 leased Federal airports since the sale process has been an issue particularly in regard to some minor gaps in cover from 1997 to 2004, War and

Terrorism cover, and the Commonwealth being named as insured on all relevant policies. All issues have been resolved with the exception of War and Terrorism cover held by one of the general aviation airports. The Department continues to rigorously pursue this issue. All airports have advised the Department that appropriate cover was either held during the 1997 to 2004 period, or where cover was not available, relevant airports have made declarations that no evidence of damage to structures had occurred during the period that adversely affected the Commonwealth as Lessor. All airports currently name the Commonwealth as an insured in the relevant policies.

The Department recently engaged a new insurance adviser to ensure that it continues to receive expert advice during the conduct of its annual insurance reviews.

In regard to the timeliness of annual insurance reviews the Department endeavours to finalise all leased Federal airports annual insurance reviews within as short a period as possible. To ensure effective administration of the sale and lease provisions, insurance matters are now handled within the Department by an identified desk officer who acts as the central contact point on insurance matters and is responsible for day-to-day contact between the Department's contracted insurance adviser and the airports. The responsibilities of this officer include the follow-up of any matters identified in insurance reviews as a matter of priority following their receipt in the Department. Table 2 below outlines the progress with insurance reviews in 2006.

Table 2: Airport Insurance Reviews 2005–2006¹

| Airport | Adviser's report received by department | Date of department's first follow-up with airport | Date final documents received from airport | Date of final letter to airport |
|---|--|--|---|--|
| Adelaide/Parafield | 27 April 2006 | 4 May 2006 | 19 May 2006 | 26 May 2006 |
| Archerfield | 29 March 2006 | 8 May 2006 | One issue still under discussion with airport | 12 October 2006 |
| Bankstown/ Hoxton Park/ Camden | 6 June 2006 | No outstanding issues | N/A | 20 June 2006 |
| Brisbane | 14 March 2006 | 24 March 2006 | 6 April 2006 | 4 May 2006 |
| Canberra | 3 March 2006 | No outstanding issues | N/A | 20 March 2006 |
| Darwin/ Alice Springs/ Tennant Creek | 17 January 2006 | 7 March 2006 | 23 April 2006 | 13 June 2006 |
| Essendon | 14 March 2006 | 24 March 2006 | 16 May 2006 | 7 June 2006 |
| Gold Coast/ Townsville/Mt Isa | 1 June 2006 | No outstanding issues | N/A | 7 June 2006 |
| Hobart | 14 June 2006 | 29 June 2006 | 28 September 2006 | 13 October 2006 |
| Jandakot | 17 January 2006 | 27 February 2006 | 14 March 2006 | 4 April 2006 |
| Melbourne/ Launceston | 27 April 2006 | 17 May 2006 | 31 August 2006 | 4 September 2006 |
| Moorabbin | 17 January 2006 | No outstanding issues | N/A | 27 February 2006 |
| Perth | 14 March 2006 | 29 March 2006 | 21 June 2006 | 23 June 2006 |
| Sydney | 14 June 2006 | 23 June 2006 | 25 August 2006 | 5 September 2006 |

Note:

1. The renewal periods of insurance policies vary across airports. Therefore the information reflected above may not necessarily reflect financial year outcomes.

While many of the matters raised in insurance reports by the insurance adviser can be clarified or remedied by the Department relatively quickly (and reports finalised within a three month timeframe), some issues may take longer to be resolved. This is largely a function of how the international insurance industry operates, especially in relation to airport liability policy wording or amendments to policies, where documentation is often not available for a number of months following issuance of insurance cover.

Resolution by the Department of some matters can also be delayed because of the need for cross referral of information between the Department, its insurance adviser, airport management and each airport's insurance broker and their insurers. The Department continues to review its practices and procedures in order to ensure effective and efficient administration.

Chapter 5. Letters of Comfort (Letters of General Assurance)

The Department acknowledges the ANAO's comments regarding the improvement in the Department's administration and management of 'Letters of Comfort' achieved since the tabling of the 2004 Audit report.

The Department continues to support the view it outlined in its responses to the 2004 ANAO Performance Audit, in that:

- a. the letters provided to a number of major sub-lessees, whilst being titled 'letters of comfort', are clearly referred to in the letters as general assurances of a non-legal binding nature; and
- b. 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.

Chapter 6. Airport Development Obligations

The ANAO has noted the improvement in the Departments' administration and management of airport development obligations achieved since the tabling of the 2004 Audit report.

The Department notes that as at end 2006 only four airports have outstanding development obligations. Indications are that those airports all should meet their commitments before the expiry date.

The Department confirms that analytical outputs are required for both Annual Audited Reports and Period One/Two Reports, and is a requirement contained in the Department's Procedures and Guidelines.

All Annual Audited Reports and Period One/Period Two Reports have been completed and documented. Since September 2005, all analytical outputs have been in the required form. Where assessments were identified as not being completed at the time of the ANAO's field work for the Follow-up audit report, it should be noted that the Department was waiting for the relevant airport to submit audited expenditure reports as required by the Sale Agreement.

As a general comment in regard to the administration of development obligation compliance, the Department's policy is to acknowledge receipt of all documentation. This is sometimes done informally by telephone, as formal acknowledgement is not a requirement of the Sale Agreement.

The Department agrees however that further effort is required regarding the timeliness of provision by airports of Annual Expenditure Plans and Annual Airport Development Cost Reports. It should be noted that airports tend to submit their Annual Expenditure Plans at the same time as their Annual Airport Development Cost Reports because audit results better inform the finalisation of their Annual Expenditure Plans.

The ANAO comments that the Department's oversight relating to the eligibility of expenditure particularly in relation to expenditure claimed by the airports has been inconsistent. The 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, specifically the expanded definition of aeronautical infrastructure development, provide guidance to officers on whether items of expenditure in Development Cost Reports meet the definition of Airport Development. This approach ensures that out-of-scope expenditure is rejected but also recognises the individual circumstances of the airports and associated Sale Agreements involved. It should be noted that the Department has specialist knowledge of aeronautical development through its Airport Building Controllers, Airport

Environment Officers and general experience and knowledge of airport operations, and applies this expertise to the assessment of whether or not expenditure is eligible. In addition, some items identified by the ANAO as falling outside the definition are also specifically allowed as eligible expenditure in Schedule 11 of the relevant Sale Agreement.

It is also important to recognise that Annual Airport Development Cost Reports are audited by qualified auditors, who attest that the expenditure meets the Sale Agreement, before being submitted to the Department.

Where there is a query or dispute in regard to expenditure eligibility, the Department queries the expenditure item or sends out a letter or dispute notice as required under clause 11 of the Airport Sale Agreement seeking clarification. While there is no format for dispute notices in the Sale Agreements, the Department notes ANAO concerns and will clearly identify where items are disputed under clause 11.5 in future dispute notices.

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