The Auditor-General
Audit Report No.43 2007–08
Performance Audit

Third Tranche Sale of Telstra Shares

Department of Finance and Deregulation

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 81025 7

Canberra ACT
24 June 2008

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Finance and Deregulation 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 *Third Tranche Sale of Telstra Shares.*

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

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

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Summary

Introduction

1. Telstra Corporation Limited (Telstra) is Australia's largest telecommunications and information services company. The process of disposing of the Commonwealth's Telstra shareholding occurred between April 1996, when a scoping study into an initial sale of one-third of the company was announced, and May 2008, when the final instalment for the third tranche sale of shares (Telstra 3) was payable. The privatisation involved three public share offers, with the Commonwealth's unsold shares transferred to the Future Fund.[1]

2. The three Telstra sale transactions were conducted in substantially different market conditions. Specifically:

- the November 1997 Telstra 1 sale was an initial public offering of one-third of a company (33.3 per cent of issued shares) which was seen, at the time, to have strong growth prospects. It returned gross proceeds of $14.2 billion with direct costs of $276 million (1.9 per cent of gross proceeds);
- the October 1999 Telstra 2 transaction was a secondary sale in a sector for which there was strong demand for shares. Although the number of shares sold (16.6 per cent of issued shares) was less than half that of Telstra 1, the Telstra 2 sale returned proceeds of $16.0 billion with sale costs of $169 million (1.1 per cent of proceeds); and
- Telstra 3 involved the disposal of control of a company perceived to be facing challenges in generating future growth. The Telstra 3 offer returned proceeds of $15.4 billion with sale costs of $204 million (1.3 per cent of proceeds). Of the remaining 6.4 billion shares held by the Commonwealth prior to the sale, 66 per cent were sold, with the residual transferred to the Future Fund.[2]

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1 In the 2005–06 Budget, the Government had announced that, to offset its unfunded superannuation liabilities, it would use budget surpluses to build a dedicated financial asset fund called the Future Fund.

2 Except for 93.5 million shares, which were transferred to the Telstra Sale Company Limited to be held as Bonus Loyalty Shares.

3. The Telstra 3 sale objectives agreed by the then Minister for Finance and Administration in August 2005 were as follows:

- achieve an appropriate financial return from the sale;
- promote orderly market trading of Telstra shares;
- secure a timely sale process, conducted to the highest standards of probity and accountability;
- support Australia's reputation as a sound international investment location;
- continue to build investor support for the Government's asset sale programme and broaden share ownership; and
- remove the Government's conflict of interest as owner and regulator of Telstra.

4. The *Telstra (Transition to Full Private Ownership) Act 2005* was assented to on 23 September 2005, enabling the sale to proceed. In late August 2006, the Government made the decision to undertake the Telstra public share offer in October and November 2006. Following the completion of sale preparations, the Telstra 3 share offer was officially launched on 9 October 2006, with the retail offer conducted from 23 October to 9 November 2006. The institutional offer opened on 15 November and closed on 17 November 2006. Trading commenced on the Australian Stock Exchange on 20 November 2006.

5. The offer price was set at $3.70 per share, payable in two instalments. The first instalment amount was $2.10 per share, discounted to $2.00 per share for Australian retail investors. The final instalment amount was $1.60 per share, payable on or by 29 May 2008. The final instalment could be prepaid. After payment of the first instalment, purchasers received instalment receipts. Following payment of the final instalment, purchasers received shares.

Audit objectives

6. The objectives for the audit of the third tranche sale of Telstra shares were to:

- assess the extent to which the Government's sale objectives were achieved, including maximising overall value for money;
- assess the effectiveness of the management of the sale; and

- identify principles of sound administrative practice to facilitate potential improvements in any future asset sales.

Overall audit conclusion

7. Prior to November 1997, Telstra was wholly-owned by the Commonwealth. The Telstra 1 Initial Public Offer (Telstra 1) was completed in November 1997, involving the sale of nearly one-third of the company's issued share capital. In October 1999, the Commonwealth divested a further 16.6 per cent of its shareholding in the company through the Telstra 2 share offer. The ANAO has audited each of the Telstra public share offers.[3]

8. Prior to the Telstra 3 sale, the Commonwealth held over 6.4 billion shares in Telstra (representing 51.8 per cent of the company's shares). The large number of shares to be sold presented challenges in completing the privatisation of Telstra in a single tranche whilst achieving an appropriate financial return. Finance and its advisers developed and implemented an array of offer structure mechanisms that were successful in achieving a high level of demand for shares. These mechanisms, together with an effective bookbuild pricing process, enabled more than 4.2 billion Telstra shares to be sold in November 2006 at a price of $3.70 per share. The available evidence is that, at this price, the offer was fully priced.

9. The Telstra 3 sale was conducted seven years after Telstra 2, in a very different market environment. Significant changes in Telstra senior management and regulatory issues also made sale preparation and marketing more difficult. Nevertheless, as well as achieving a fully priced offer, the transaction was completed in accordance with the timetable and within budget indicating that overall planning and management of the sale by the then Department of Finance and Administration (Finance)[4] and its advisers was effective.

10. Selling commissions and adviser costs comprised a significant proportion of the Telstra 3 sale costs of $204 million. Obtaining value for money in the procurement of services requires a balancing of considerations,

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[3] The report of the November 1997 first sale was tabled in October 1998 (ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998). The report of the October 1999 second tranche sale was tabled in November 2000 (ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, Canberra, 30 November 2000).

[4] The Administrative Arrangement Orders made on 25 January 2008 established the Department of Finance and Deregulation, which was previously known as the Department of Finance and Administration. In this report, both are referred to as Finance.

with the financial framework placing the obligation on the individual approving each spending proposal to undertake reasonable inquiries to be satisfied that the proposed expenditure represents efficient and effective use of public money. A range of factors, including cost, were considered by Finance when making key adviser appointments but there was limited competitive pressure for some appointments. ANAO has made one recommendation to improve probity and accountability processes for marketing roadshows in future public share offers.

Key findings

Sale management and coordination (Chapter 2)

11. Finance was responsible for the management of the sale. Finance undertook its role with extensive support from the private sector. In total, between November 2004 and November 2005, 12 major advisory appointments were made involving total estimated contract expenditure of $32.8 million. The remaining advisers and a range of marketing and logistics suppliers (mainly under sub-contract to the Project Management Joint Global Coordinators (PMJGCs)) were subsequently engaged.

Tendering and contracting for advisers

12. Immediately after the 13 December 2004 Ministerial announcement that a Telstra 3 scoping study would be conducted, Finance commenced tender processes for advisers to prepare the scoping study. Finance was aware of the advantage conferred by scoping study engagements and addressed this by requiring tenderers for roles that would potentially continue through into a sale process to also include their bid for any subsequent sale role as part of their scoping study tender. Tender evaluations took into account the competitiveness of both the scoping study and sale role bids. Each of the scoping study engagements was the subject of a probity review.

13. The scoping study adviser contracts provided Finance with an option to re-appoint the scoping study advisers to the sale process. On 26 August 2005, the then Minister for Finance and Administration announced that Finance had exercised the respective contractual options.[5] The final key adviser appointments, involving three firms as PMJGCs and an International

[5] At that stage the Government had only decided to commence preparations for sale and the re-engagements were subject to the passage of the required sale legislation and the Government subsequently deciding to proceed with the sale.

Legal Adviser were made in November 2005. The PMJGCs were responsible for overall project management and logistics of the possible sale as well as a key role in the provision of selling services to retail and institutional investors.

14. Competition is a key element of the procurement policy framework as it is an important foundation in achieving value for money.[6] This framework recognises that value for money is more likely to be achieved when businesses that are capable of supplying goods or services for government have the opportunity to respond to requests and to be considered on their merits.

15. Competitive and open tender processes were undertaken for most of the key adviser appointments, as well as being required for the appointment of sub-contractors to the PMJGCs. One of the challenges for Finance was generating sufficient competitive tension amongst potential providers for the advisory services required to complete the sale. The results of the processes employed showed varying degrees of success. Of note is that, without detracting from the importance of selecting candidates that possessed the necessary skills and experience, the open tender processes employed for the key commercial roles of Independent Business Adviser and PMJGCs gave attention to maximising competitive pressure on fees and commissions. The result was that:

- the Independent Business Adviser fee was of a similar magnitude to Telstra 2;
- the PMJGC's project management fee was lower than that paid in Telstra 2; and
- institutional selling commissions were reduced but, in the more difficult marketing environment of Telstra 3, higher commissions were paid on public offer (including broker firm) sales. This was done to complement the various offer structure mechanisms that were developed to tighten the demand for shares for pricing purposes during the institutional bookbuild (and to ensure the maximum number of shares could be sold).

16. By way of comparison, there was less competition and reduced price pressure evident in the selection processes for Finance's in-house counsel (which occurred through a direct engagement), the Domestic Legal Adviser

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6 *Commonwealth Procurement Guidelines—January 2005*, issued under Regulation 7 of the *Financial Management and Accountability Regulations 1997*, 1 December 2004, pp. 10–11.

(where a small number of responses were received from the market with significant differences in the tendered fees) and the Communications Consultant (where key decisions concerning the number and identity of the parties invited to tender were taken by the then Ministerial Committee on Government Communications—MCGC—rather than by Finance).

In-house counsel

17. A competitive procurement process was not followed by Finance for the appointment of its in-house counsel, the first adviser appointed. Engagement of contract counsel services (similar to those obtained in Telstra 1 and Telstra 2) was planned in Telstra 3 preparations as a critical path activity but, in November 2004, Finance directly engaged an in-house counsel for a role that subsumed the contract counsel activity. The firm that was engaged was included on the department's legal panel.

18. The Commonwealth Procurement Guidelines (CPGs) that were in place at the time of the firm's engagement permitted Finance to direct source the in-house counsel appointment from its Legal Panel if it could satisfy itself that the proposed arrangements constituted a value for money outcome for the Commonwealth. However, the CPGs that commenced on January 2005 were expected to result in an increase in the number and scope of procurement opportunities offered to the full market.

Domestic Legal Adviser

19. The firm appointed as Finance's Domestic Legal Adviser had worked on both of the previous Telstra share offers and on the sale of Sydney (Kingsford Smith) Airport. The firm's tendered fee cap for the sale process of $4.9 million (plus GST) was significantly higher than the other three firms[7] but the Tender Evaluation Committee considered this was more than offset by its superior understanding of the assignment and demonstrated ability to deliver. Through negotiation, the capped sale fee was initially reduced to $4.4 million and then further to $4.2 million. The Tender Evaluation Committee concluded that the successful firm's tender presented good value for money.

Communications Consultant

20. The firm appointed as Communications Consultant had performed this role in Telstra 2 and for the sale of Sydney (Kingsford Smith) Airport. Under the then applicable arrangements for government advertising, a select tender

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7 The next highest tendered price was $3.5 million (plus GST).

process was undertaken, with the then MCGC deciding the number and identity of firms invited to tender. Fewer firms were invited to participate in the selection process than in the first two Telstra sales and two were shortlisted (the same number as had been shortlisted in the first two Telstra sales). The firm that had undertaken the role in Telstra 2 was ranked more highly in terms of its demonstrated understanding of the assignment and demonstrated ability to conduct the assignment to a high professional standard and deliver services in a timely manner. However, its tendered fees were more than double those of the second shortlisted tenderer. Although negotiations resulted in the price being reduced by 19 per cent, from $3.63 million (plus GST) to $2.95 million (plus GST), it remained considerably higher than that of the other shortlisted tenderer.

Roadshow

21. As is typically the case, an institutional and retail roadshow was conducted as part of the marketing effort. Finance has advised ANAO that the conduct of a global institutional roadshow assumed a higher level of importance than was the case during Telstra 2.[8] Telstra management availability affected the duration and cost of the Telstra 3 roadshow with total expenditure by Finance being $1.7 million (plus GST).

22. When ANAO conducted its Telstra 3 audit fieldwork, the Joint Project Secretariat (which was established by the PMJGCs), who administered the Global Roadshow Coordinator contract, did not hold a complete set of invoices relating to underlying expenditure on the roadshow managed by the Global Roadshow Coordinator and there were shortcomings in the certification of roadshow costs (in relation to the amounts certified not aligning with the specific amounts paid). In this latter respect, Finance has advised ANAO that, subsequently, invoices were obtained for other expense items and that 'no significant exceptions' had been identified.

Financial returns (Chapter 3)

23. One of the Government's key objectives for the Telstra 3 sale process was that taxpayers achieve an 'appropriate' financial return. This objective varied from the comparable objective for each of Telstra 1 and Telstra 2, which involved achieving an 'optimum' financial return. While a range of similar

[8] This was due to a substantial reduction in the level of interaction by the company with institutional investors compared to that in the lead-up to and following Telstra 2 combined with substantial changes to the Telstra Board and to senior management.

factors required consideration, Finance advised ANAO that achievement of an appropriate return for Telstra 3 required closer attention to be paid to the alternative use of the proceeds, particularly following the introduction of the Future Fund, and the trade-off between the quantity of shares sold and the price achieved.

Offer pricing

24. The scoping study advised that the ability to maximise proceeds in a further sale of Telstra would be determined by the ability to reduce the size of an offer (via structural mechanisms) and maximise demand. This latter aspect would in turn depend to some extent on the ability of Telstra to increase the attractiveness of its investment case.

25. On 25 August 2006, the then Government announced its intention to offer in the order of $8 billion of Telstra stock to retail and institutional investors through a sale by instalment mechanism, and that any remaining unsold shares would be transferred to the Future Fund.

26. An array of offer structure mechanisms were developed to tighten the demand for shares. These included:

- a mechanism to increase the size of the offer should there be sufficient demand; and
- a substantial allocation of stock to brokers through the broker firm component which, together with the conduct of a Japanese public offer without listing (POWL), resulted in 57 per cent of the base offer shares being allocated prior to the start of the Australian public offer.

27. In addition, an institutional entitlement offer was designed and implemented to combat the tendency for the share price to fall in the lead up to a major sale.[9] The Telstra share price rose one cent over the period from the announcement of the offer launch to the end of the bookbuild, indicating the entitlement incentives assisted in preventing the share price falling. By way of comparison, in Telstra 2, the share price fell 28 cents from the offer launch to the end of the bookbuild.

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9 Finance has advised ANAO that, in the lead up to a major sale, the main reason for the share price fall is supply and demand—more securities are to come onto the market and price falls in anticipation of the additional supply and a potentially discounted sale clearing price. Some investors will sell in anticipation of these price falls which may be exacerbated by short-selling. As the issue price is often based on the preceding closing price there is no incentive for investors to buy on-market if they believe they will be allocated shares in the offer.

28. The Telstra 3 bookbuild period was three days, commencing at 9am on 15 November 2006 and concluding at 6pm on 17 November 2006. Overall, 277 valid institutional bids were received, resulting in total demand for shares of 2 688.9 million shares at the strike price.

29. On 18 November 2006, a final strike price of $3.70 was recommended to, and agreed by, the then Minister for Finance and Administration. The available evidence is that, at $3.70 per share, the offer was fully priced. In particular:

- the institutional bookbuild was conducted in a manner and over a timeframe (three days) that enabled an effective 'price discovery' process;
- based on the results of the bookbuild, the PMJGCs recommended a price of $3.70 per share. The Independent Business Adviser considered that the sale could be priced at either $3.70 or $3.75 but on balance recommended the sale price be set at $3.75. Finance advised the then Minister for Finance and Administration that the price should be set at $3.70, principally due to concerns about the aftermarket trading performance were the price set at the higher level; and
- in the period after the listing of Telstra 3 Instalment Receipts, the Telstra share price experienced a steady increase but not of a magnitude and at a rate to suggest the offer was under-priced.

30. In preparing for the sale, a base offer size of 2.15 billion shares was set. Due to the success of the offer structure and pricing mechanisms, the offer size was increased to 4.25 billion shares, leading to a significant increase in cash proceeds. The Commonwealth's remaining 2.13 billion shares were transferred to the Future Fund.[10]

Sale proceeds and costs

31. The various components of the offer structure were successful in achieving a high level of demand for shares, such that the upsizing option was employed resulting in a significant increase in cash proceeds. In total,

[10] The completion of the share sale and transfer of residual shares to the Future Fund was important in the context of the sale objective of removing the potential for the Government's conflict of interest as owner and regulator of Telstra.

4.23 billion shares[11] were sold, realising cash proceeds of $15.4 billion with sale costs of $204 million, or 1.3 per cent of proceeds.

32. While less than that budgeted, the Telstra 3 sale costs represented a higher percentage of gross sale proceeds than in Telstra 2 (1.1 per cent) but remained lower than in Telstra 1 (1.9 per cent). The costs (as a percentage of gross sale proceeds) were also higher than had been expected at the time of the scoping study (which ranged between 0.8 per cent and 1.1 per cent of gross sale proceeds). In this latter respect, the increase was, to a large extent, a reflection that actual sale proceeds were significantly less than the figures used in the scoping study (of $32 billion[12]).

33. The reduced sale proceeds from those used by the scoping study were not matched by a similar reduction in aggregate sale costs. A significant reduction was achieved in sale logistics costs, an area that the scoping study saw as offering potential savings, and a number of other costs were maintained at or around the same level as Telstra 2 (including fees and expenses paid to the PMJGC's and the Independent Business Adviser). However, costs increased significantly in relation to:

- selling commissions and fees, with lower rates on institutional sales offset by higher public offer commissions as part of the strategy to create a shortage of stock for those bidding for shares in the institutional bookbuild;
- advertising and marketing, with Finance advising ANAO that the increased costs of delivering the advertising campaign (which comprised the largest element of advertising and marketing costs) reflected increased media rates and changes in media consumption since Telstra 2;

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11 The number of shares ultimately sold (4.23 billion) was less than the final offer size of 4.25 billion shares (see paragraph 30) largely because, on 28 June 2007, 21.89 million shares were transferred to the Future Fund. The then Minister for Finance and Administration advised the then Prime Minister that this transfer related to some of the shares originally allocated to the buffer stock not ultimately being needed to resolve disputes arising from the retail offer.

12 Cost estimates were produced for the three demand and allocation scenarios (worst-case demand with a share buy-back, mid-case demand with a share buy-back and high-case demand with a share buy-back) together with a worst-case cost scenario which assumed a low buy-back amount with a large equity offer and high proportion of institutional allocations. Under all four scenarios, overall gross proceeds were $32 million, with different amounts for the amount (if any) of shares retained by the Australian Government, the value of the equity sell-down and the combined size of the Future Fund allocation and a share buy back by the company.

- legal advice obtained by Finance, the PMJGCs and Telstra, that was paid for by Finance; and
- the reimbursement of costs incurred by Telstra, with Finance advising ANAO that change of control issues increased the range of sale cost pressures faced by the company and that, due to the interests of other shareholders, such costs were necessarily fully passed on to the Commonwealth.

Cost of legal advice

34. The total cost to Finance of legal advice associated with the Telstra 3 sale was $12.74 million (plus GST), including $3.74 million in legal advice costs reimbursed to Telstra. Excluding Telstra's legal costs, on a comparative basis, the amount paid by Finance to its legal advisers and by Finance for the PMJGCs' legal advisers was $9.00 million (plus GST), the majority of which related to professional fees ($8.26 million plus GST).

35. The total cost of Finance's and the PMJGC's legal advisers was nearly double the equivalent costs in Telstra 2. Key factors in the overall increase in legal advice costs compared with Telstra 2 were significant increases in the amounts paid by Finance to its Domestic and International Legal Advisers (recognising that Telstra 2 involved a smaller number of shares being offered, over a shorter period of time and in closer proximity to the prior transaction) and new costs associated with the engagement by Finance of an in-house counsel (an in-house counsel was not engaged for Telstra 1 and Telstra 2, although there were costs associated with a firm being engaged following a select tender to draft contracts for all advisory engagements).[13]

36. The $8.26 million in professional fees paid for legal advice in the Telstra 3 sale was higher than the project management fee paid to the three PMJGCs ($8.18 million plus GST). The significant continuing growth in the cost of legal advice associated with asset sales is an area that warrants consideration by Finance. This would include identifying opportunities to rationalise the number of parties providing legal advice at Commonwealth expense (Finance paid for legal advice for itself, the PMJGCs and Telstra) and examination of the cost of that advice.

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[13] This firm was paid $165 739 for work on contractual matters for the Telstra 1 sale, and $225 460 for Telstra 2.

Agency response

37. Finance provided a response to the audit as follows:

Finance welcomes ANAO's conclusions that the Telstra 3 share offer employed offer structure mechanisms that were successful in achieving a high level of demand for shares, which together with an effective pricing process, enabled the offer to be fully priced.

The Telstra 3 sale process achieved the Government's sale objectives, delivering $15.5 billion in proceeds within the timeframe set by Government and bringing to an end the conflict between the Government's roles as owner and regulator of the major telecommunications company.

The sale represented a substantial challenge, including the first public share offer by the Australian Government in seven years, a business that was seen in an increasingly negative light by the investment community and a substantial deterioration in relations between the company and the Government, its majority owner. From the base of a comprehensive scoping study Finance undertook a flexible approach to sale preparations enabling it to progress the sale in a timely fashion in a highly dynamic environment. Following the 25 August 2006 Government decision to proceed with the sale, Finance completed a highly successful share offer on 24 November 2006 with proceeds almost doubling the base announced by the Prime Minister.

Finance acknowledges ANAO's recognition that overall planning and management of the sale was effective.

Finance agrees with the Recommendation that a threshold be set, above which project managers are required to obtain underlying receipts of roadshow expenditure prior to certifying that expenditure. This approach will provide clarity to all participants in relation to their obligations, noting that in setting the threshold the costs involved need to be commensurate with the risks being managed.

Recommendation

Recommendation No. 1

Paragraph 2.74

ANAO *recommends* that, having regard to the particular risks involved, the Department of Finance and Deregulation further improve probity and accountability processes for marketing roadshows in future public share offers by establishing a threshold above which its contracted project managers are required to obtain receipts for roadshow expenditure (including the acquittal of any cash floats) prior to providing certification of roadshow costs.

Finance: Agreed

Audit Findings and Conclusions

1. Introduction

Background

1.1 Telstra Corporation Limited (Telstra) is Australia's largest telecommunications and information services company. Telstra's reported revenue for the year ended 30 June 2007 was $23.7 billion. Its reported profit for the same year was $3.3 billion.

1.2 Prior to November 1997, the company was wholly-owned by the Commonwealth. The Telstra 1 Initial Public Offer (Telstra 1) was completed in November 1997, involving the sale of nearly one-third of the company's issued share capital. In October 1999, the Commonwealth divested a further 16.6 per cent of its shareholding in the company through the Telstra 2 share offer.

1.3 Two share buybacks were undertaken by Telstra in 2003 and 2004. Because the Commonwealth did not participate in these buybacks, this increased the total percentage of the Commonwealth's shareholding in Telstra, as illustrated in the following table.

Table 1.1

Commonwealth ownership of Telstra

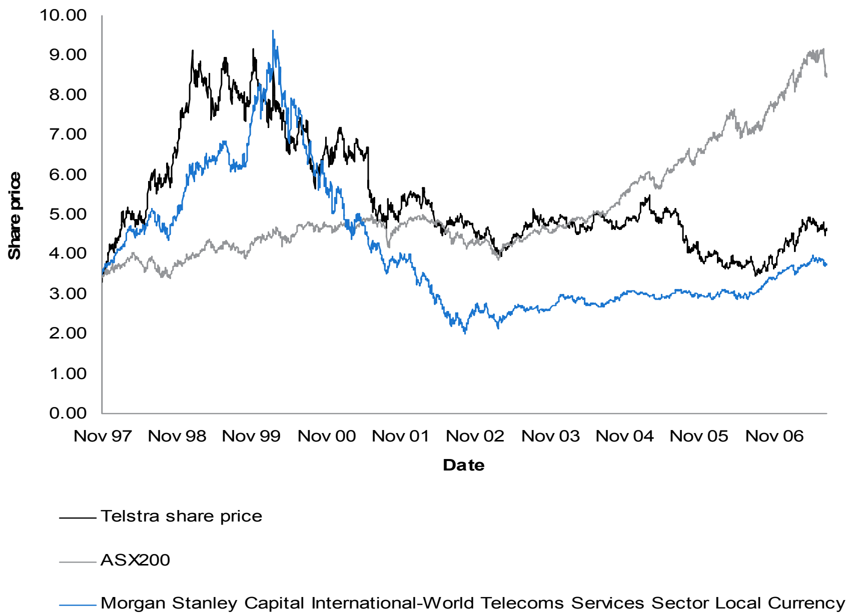
	Shares
Telstra shares on issue	12 866 600 200
Shares sold during Telstra 1	4 287 202 608
Shares held by Commonwealth following Telstra 1	8 579 397 592
Percentage of shares held by Commonwealth of total shares issued, following Telstra 1	66.68%
Shares sold during Telstra 2	2 133 190 469
Shares held by Commonwealth following Telstra 2	6 446 207 123
Percentage of shares held by Commonwealth of total shares issued, following Telstra 2	50.10%
Share buyback No. 1 (November 2003)	238 230 580
Share buyback No. 2 (November 2004)	185 284 269
Total shares held by the Commonwealth following the buybacks	6 446 207 123
Percentage of shares held by Commonwealth of total shares issued following the buybacks	51.81%

Source: Telstra media releases and analysis undertaken in ANAO Audit Report No.10 1998–99 and ANAO Audit Report No.20 2000–01.

1.4 From the initial public offer listing on 17 November 1997 to 16 June 2005, (immediately prior to the finalisation of the Telstra 3 scoping study), Telstra's shares appreciated by 47 per cent. During the same period the ASX 200 Index appreciated by 75 per cent.[14]

Figure 1.1

Closing share price of Telstra Corporation Limited from November 1997 to November 2006



Note: The share price until November 1998 has been adjusted to include the Telstra 1 final instalment.

Source: Project Management Joint Global Coordinators

Scoping study

1.5 On 13 December 2004, the then Government announced a scoping study into the possible sale of the Government's remaining shares in Telstra. On 29 March 2005, the then Department of Finance and Administration (Finance) signed contracts with two business advisers to provide business

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[14] From the listing of Telstra 2 on 18 October 1999 to 16 June 2005, Telstra's share price had depreciated by approximately 30 per cent. During the same period the ASX 200 Index appreciated by approximately 56 per cent.

advice on issues associated with the conduct of a scoping study. For one of the advisers, this included the preparation of a scoping study, in consultation with other advisers appointed by Finance.

1.6 The Report of the Scoping Study into the Further Sale of the Australian Government's Telstra Shares (the scoping study) was delivered to Finance on 1 July 2005. Finance advised ANAO that:

> The report was prepared against a background of, inter alia:
>
> - the regulatory framework being reviewed separately and contemporaneously by the then Department of Communications, Information Technology and the Arts;
> - the new Telstra Chief Executive Officer taking up responsibilities after completion of the report; and
> - Telstra's management plan for 2006–08 was yet to be signed off by the Board.
>
> In recognition the report noted that a number of key findings would need review following its completion.

1.7 The scoping study concluded that a divestment of the Government's entire shareholding in Telstra, in a way that would provide an appropriate financial return for taxpayers was achievable by the end of calendar 2006, subject to a number of conditions being met. These conditions included:

- the Government providing certainty to Telstra and the investment community by announcing and implementing the new regulatory framework as early as possible;
- Telstra agreeing to undertake a significant selective buy-back of the Government's shareholding;
- the Government completing a fully marketed retail and institutional offer in October/November 2006 while also retaining full flexibility in relation to other possible offer structure elements, including the use of an accelerated offer, and the issuance of equity-linked securities;
- the Government taking appropriate preparatory steps to enable completion of a fully marketed offer in October/November 2006; and
- there being no material adverse change in either general market conditions or Telstra's investment case and attractiveness to retail and institutional investors.

1.8 The scoping study further concluded that the Government's ability to maximise proceeds in a further sale of Telstra would be determined by its ability to reduce the size of an offer (via structural mechanisms) and maximise demand, which in turn depended to some extent on the ability of Telstra to increase the attractiveness of its investment case. Finance advised ANAO that:

> In conjunction with the Scoping Study, the [then] Minister for Communications, Information Technology and the Arts examined the adequacy of the existing telecommunications regulatory regime. At the time the Scoping Study Report was finalised the [then] Minister was in the final stages of consulting Telstra in relation to proposed enhancements to the regulatory regime, in particular implementation of operational separation.
>
> During meetings with Ministers and departmental officials in mid July 2005, the Chairman and the new Chief Executive of Telstra expressed a higher level of concern with important aspects of operational separation than had been apparent during the Scoping Study, and in addition expressed concerns with the operation of other elements of the regulatory regime and the effect they may have on Telstra's financial performance.

1.9 Finance wrote to its legal advisers and its two business advisers on 19 July 2005 requesting that some follow-up work be done to review particular scoping study findings and recommendations as a result of the issues raised by Telstra. Specifically, advisers were asked for supplementary advice to address the matters raised by Telstra and review any new material subsequently provided, particularly in relation to the telecommunications regulatory framework, selective buyback negotiations and valuation fundamentals. The work would form the basis of a supplementary report for the then Minister for Finance and Administration.

1.10 The 'Scoping Study Report for the Further Sale of the Australian Government's Telstra Shares—Ongoing Advice' was provided to Finance on 2 August 2005. The advisers:

- concluded that Telstra had not provided any further information that materially changed any of the valuation conclusions outlined in the scoping study; and
- reiterated their earlier advice that adoption of a model closer to the Australian Competition and Consumer Commission proposal for operational separation would be highly likely to preclude the Government from completing a fully marketed offer by the end of calendar 2006 on acceptable commercial terms.

1.11 On 14 August 2005, Finance's advisers provided a further update on this advice, specifically relating to the regulatory framework, the cooperation of Telstra management and board required as part of a further sale, timing of procurement of advisers and Telstra share price analysis.

1.12 On 26 August 2005, the Government announced that tenders were being sought for PMJGCS as part of the preparations for a possible sale. The then Minister also announced that Finance had exercised the option to reappoint scoping study advisers for sale services.

Sale objectives and timing

1.13 On 25 August 2006, the Australian Government announced its intention to offer in the order of $8 billion of Telstra share stock to retail and institutional investors through a sale by instalment mechanism and to transfer any remaining unsold shares to the Future Fund.[15] The sale objectives agreed by the then Minister for Finance and Administration in August 2005 were to:

- achieve an appropriate financial return from the sale;
- promote orderly market trading of Telstra shares;
- secure a timely sale process, conducted to the highest standards of probity and accountability;
- support Australia's reputation as a sound international investment location;
- continue to build investor support for the Government's asset sale programme and broaden share ownership; and
- remove the Government's conflict of interest as owner and regulator of Telstra.

1.14 The *Telstra (Transition to Full Private Ownership) Act 2005* was assented to on 23 September 2005. The Act amended the *Telstra Corporation Act 1991* to repeal the provisions that required the Commonwealth to retain at least 50.1 per cent of its equity in Telstra. The Telstra (Transition to Full Private Ownership) Act also:

- provided for the Minister for Finance to make a written determination setting out rules that are to be complied with by a 'Telstra sale scheme';

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[15] In the 2005–06 Budget, the Government had announced that, to offset its unfunded superannuation liabilities, it would use budget surpluses to build a dedicated financial asset fund called the Future Fund.

- added additional matters that a 'Telstra sale scheme' may involve;
- expanded the list of designated matters which are exempt from stamp duty or other tax which is payable under a law of a State or Territory;
- temporarily 'switched off' various appropriation provisions in the Telstra Corporation Act;
- gave the Minister for Finance and Administration the (temporary) power to direct Telstra not to engage in specified equity dilution conduct or specified security issue conduct;
- reaffirmed the universal service obligation, the digital data service obligation and the customer service guarantee;
- made amendments to various Acts and regulations as a consequence of Telstra ceasing to be Commonwealth controlled; and
- repealed Division 3 of Part 2 and Part 3 of the Telstra Corporation Act relating respectively to Telstra's reporting obligations and the Minister's power to give Telstra directions. The repeal of these provisions took effect post sale at a specified percentage of Commonwealth shareholding.

1.15 There was some slippage in the original timetable planned for the share offer. The scoping study concluded that the only feasible timing window available to complete a fully marketed offer prior to the next election was October/November 2006. While initial planning programmed the offer launch as early as possible in the October/November timing window, by July 2006 the offer launch was moved to late in that window to accommodate Telstra's planned Investor Day.

1.16 The share offer was officially launched on 9 October 2006, with the retail offer conducted from 23 October to 9 November 2006. The institutional offer opened on 15 November and closed on 17 November 2006. Trading commenced on the Australian Stock Exchange on 20 November 2006.

1.17 The Telstra 3 Share Offer resulted in 66 per cent of the Commonwealth's remaining shareholding being sold. A further 1.5 per cent of the Commonwealth's shareholding was transferred to the Telstra Sale Company Limited on 24 November 2006 to be held as Bonus Loyalty Shares. The remaining shares in the company were transferred to the Future Fund on 28 February 2007 and 28 June 2007.

1.18 Purchasers of shares in the Telstra 3 offering were required to pay for the shares in two instalments. The first instalment amount was $2.10 per share, discounted to $2.00 per share for Australian retail investors. The final instalment amount was $1.60 per share, payable on or by 29 May 2008. The final instalment could be prepaid. After payment of the first instalment, purchasers received instalment receipts. Following payment of the final instalment, purchasers received shares.

Audit approach

1.19 ANAO has audited each of the Telstra public share offers. The report of the November 1997 first sale was tabled in October 1998 (ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998). The report of the October 1999 second tranche sale was tabled in November 2000 (ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, Canberra, 30 November 2000).

1.20 The objectives for the audit of the third tranche sale of Telstra shares were to:

- assess the extent to which the Government's sale objectives were achieved, including maximising overall value for money;
- assess the effectiveness of the management of the sale; and
- identify principles of sound administrative practice to facilitate potential improvements in any future asset sales.

1.21 The scope of the performance audit extended from November 2004 when Finance engaged its first adviser. It included an examination of relevant documentation from the lead-up to the sale, agency and contractor management of the offer, post-offer management and monitoring of the aftermarket. Application of the proceeds of the sale, and the transfer of the Government's remaining shares to the Future Fund, were not examined as part of this performance audit.[16]

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[16] Such issues are typically examined through separate performance audit activity. See for example, ANAO Audit Report No.14 1999–2000, *Commonwealth Debt Management* on the application of asset sale proceeds to debt reduction and ANAO Audit Report No.24 2003–04, *Agency Management of Special Accounts*, on the hypothecation of funds received from asset sales. A performance audit of the establishment and management of the $2 billion Communication Fund (which was established as a result of negotiations to secure passage of the Telstra sale legislation) is underway.

1.22 The audit involved a review of documentation held in Finance and major advisers engaged by the department. The majority of ANAO's fieldwork was undertaken between February 2007 and July 2007. Issues Papers were prepared and discussed between November 2007 and April 2008. The formal proposed report was issued in April 2008 to Finance, its major advisers, the Minister for Finance and Administration at the time of the sale and Telstra. Consistent with the requirements of the *Auditor-General Act 1997*, recipients were provided with a period of 28 days in which to provide any comments on the proposed report. A response was received from Finance, its in-house counsel, the Domestic Legal Adviser, two of the PMJGCs and the Communications Consultant.

1.23 The audit was conducted in accordance with the ANAO Auditing Standards at a cost of $570 000.

2. Sale Coordination and Management

This chapter examines the appointment of the Commonwealth's key sale advisers and the processes put in place to manage probity and accountability issues in an outsourced sale management model.

Introduction

2.1 Finance's management of the Telstra 3 sale was undertaken with extensive support from the private sector. The Telstra 3 scoping study noted that adviser and supplier costs for the sale would ultimately reflect the competitiveness of the procurement process. The scoping study expected that there would be a high level of competition for roles given the prestige associated with the transaction and that a further Telstra sale would constitute the largest ever equity offering in Australia as well as being the first Government public share offer for over six years.

2.2 Competition has long been recognised as a key element of the Commonwealth's procurement policy framework as it is an important foundation in achieving value for money.[17] This framework recognises that value for money is more likely to be achieved when businesses that are capable of supplying goods or services for government have the opportunity to respond to requests and to be considered on their merits.[18] As a corollary, it is recognised that reduced competition can lead to undesirable consequences, including higher costs to government through suppliers being able to charge premiums for goods or services provided.[19] Finance advised ANAO that:

> In the case of Telstra 3, some seven years passed between the establishment of most of the key contracts. Telstra 1 and Telstra 2 occurred in quick succession and took place in an active programme of asset sales by the then Government. Telstra 3 occurred in isolation from other major Australian Government asset sales. This has an affect on pricing consideration for tenderers. In addition, there had been substantial changes in the financial management and accountability framework governing asset sales.

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17 See, for example, *Commonwealth Procurement Guidelines—January 2005*, issued under Regulation 7 of the *Financial Management and Accountability Regulations 1997*, 1 December 2004, pp. 10–11.

18 ANAO, *Fairness and Transparency in Purchasing Decisions—Probity in Australian Government Procurement*, Better Practice Guide, August 2007, p. 15.

19 See, for example, ANAO, *Fairness and Transparency in Purchasing Decisions—Probity in Australian Government Procurement*, Better Practice Guide, August 2007, p. 15.

2.3 A further factor that was evident in the selection processes for a number of the key advisers was the benefit that experience on earlier transactions provided to firms when seeking appointment to a Telstra 3 role.

2.4 Immediately after the 13 December 2004 Ministerial announcement that a scoping study would be undertaken, Finance commenced tender processes for advisers to prepare the scoping study. Finance was aware of the advantage conferred by scoping study engagements and addressed this by requiring tenderers for roles that would potentially continue through into a sale process to also include their bid for any subsequent sale role as part of their scoping study tender.[20] Tender evaluations took into account the competitiveness of both the scoping study and sale role bids.[21] Each of the scoping study engagements was the subject of a probity review.[22]

2.5 The appointment of advisers for the scoping study and subsequent sale occurred at the time new Commonwealth Procurement Guidelines (CPGs) were being introduced. Specifically, on 1 December 2004, revised CPGs were issued which took effect from 1 January 2005. It was expected that the dominant impact of the revised CPGs would be an increase in the number and scope of procurement opportunities offered to the full market.[23] Amongst other matters, the changes to the CPGs gave effect to the Government procurement provisions of the Australia-United States Free Trade Agreement. Some of the major changes to the revised procurement requirements were:

- the classification of procurements over a specified value as covered procurements[24], to which mandatory procurement procedures apply;

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20 As is typically the case, some of the candidates for the various scoping study roles submitted proposals with a fee well below that which would be necessary to recover the resources committed to the scoping study. This reflects the competitive advantage that the scoping study advisers have traditionally had in securing a key role in the sale.

21 As there was not a PMJGC role applicable to the scoping study, Finance conducted this tender after the scoping study and the Government's decision to commence preparations for sale.

22 The Process Adviser undertook all of the scoping study adviser probity reviews with the exception of the in-house counsel engagement and the Process Adviser engagement itself. Some of the process review tasks associated with the commencement of the engagements, which occurred before the Process Adviser's appointment, were undertaken by Finance's contracted internal auditor.

23 The Hon Dr Sharman Stone MP, Parliamentary Secretary to the then Minister for Finance and Administration, *$200 billion US procurement market open to Australian suppliers from January 1, 2005*, Media Release 04/2004, 31 December 2004.

24 Covered procurements are procurements, other than those which the Government has decided are exempt, which exceed specified procurement thresholds. For procurements in Financial Management and Accountability agencies (that is, Departments of State, Departments of the Parliament and agencies prescribed under the *Financial Management and Accountability Regulations 1997*), other than procurements of construction services, the procurement threshold is $80 000.

- a general presumption of open tendering with selective and limited tendering available only in specific circumstances; and
- the specification of time limits and other procedures for tender processes.[25]

2.6 In total, between November 2004 and November 2005, 12 major advisory appointments were made involving total estimated contract expenditure of $32.8 million.[26] With the exception of the firm appointed by Finance to undertaken market research, the various adviser appointments were announced by the then Minister for Finance and Administration. The announcements were made as follows:

- Sparke Helmore as Process Adviser (9 February 2005);
- Gavin Anderson as Communications Adviser (8 March 2005);
- UBS as Business Adviser to have overall responsibility for producing the scoping study together with Caliburn Partnership as Independent Business Adviser to provide specialist financial and strategic advice (29 March 2005);
- Freehills as Domestic Legal Adviser and AGS as Finance's in-house counsel (5 April 2005); and
- Econtech to investigate alternative selling methods (6 May 2005).

2.7 The scoping study adviser contracts provided Finance with an option to re-appoint the scoping study advisers to the sale process. On 26 August 2005, the then Minister for Finance and Administration announced that Finance had exercised contractual options to extend the contracts of Caliburn Partnership, Freehills, Gavin Anderson, DBM Consultants (market research) and Sparke Helmore. The then Minister also announced that AGS would continue to provide contractual advice and legal support to Finance and that tenders would be sought for the appointment of firms to act as Project Management Joint Global Coordinators (PMJGCs) or in other selling roles.

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25 ANAO Audit Report No.21 2006–07, *Implementation of the revised Commonwealth Procurement Guidelines*, Canberra, 31 January 2007, pp. 25–26.

26 Figure based on spending proposals approved by Finance for the purposes of Regulation 9 of the *Financial Management and Accountability Regulations 1997* which were based on estimates of total contract costs for each adviser that comprised fees for the scoping study, sale services (on the assumption that the option to re-appoint firms for the sale process were exercised) and estimated disbursements.

2.8 The appointment of three firms as PMJGCs was announced on 24 November 2005 followed by the announcement of the International Legal Adviser on 29 November 2005.

In-house counsel

2.9 Two Telstra 3 adviser appointments were made prior to the new CPGs taking effect as well as in advance of the 13 December 2004 Ministerial announcement that a scoping study would be conducted, as follows:

- the first (and more significant) engagement commenced on 22 November 2004 when an in-house counsel from the Australian Government Solicitor (AGS) commenced work; and
- the second appointment related to the direct engagement, from Finance's legal panel, of a firm to provide probity audit services for the appointment of a Process Adviser for the scoping study. This appointment, which involved an estimated total cost of $20 000 (including GST), was necessary because Finance's contracted internal audit provider, that typically carries out probity reviews for the department, had advised the department that it intended to tender for the Process Adviser role. Finance's contemporaneous records of the appointment state that a sole source quote[27] was obtained because of the urgency of the appointment and the need to control dissemination of information about a potential scoping study before a formal announcement by Government.

2.10 In Telstra 1 and Telstra 2, following a select tender process, a legal firm[28] was engaged to draft contracts for all advisory engagements.[29] In April 2008, Finance advised ANAO that procurement of contract counsel services was planned in Telstra 3 preparations as a critical path activity with services needing to be available by the beginning of December 2004. Finance further advised ANAO that:

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27 Finance's records of the appointment further state that of the four firms on the panel, one was not approached because it had indicated it would be tendering for the Process Adviser role. Finance's knowledge of the market indicated that a second firm did not specialise in providing probity audit services. Finance decided that it would approach the third firm and, should it not be available, approach the final firm on the department's panel.

28 It was paid $165 739 for work on contractual matters for the Telstra 1 sale, and $225 460 for Telstra 2.

29 Office of Asset Sales and IT Outsourcing, *Annual Report 1997–98*, 13 October 1998, p. 4.

> Prior to Government providing clearance to approach the market, in early November 2004 *[named individual]* from AGS approached *[a senior Finance official]* to discuss the potential for him and AGS to contribute to the Telstra 3 sale process. As part of this discussion the proposal for *[named individual from AGS]* to provide an in-house counsel role that would subsume the contract counsel activity was put forward by AGS. Following some refinement the potential for Finance to adopt an in-house counsel model for the Telstra 3 sale was canvassed with the Secretary, who supported the approach subject to agreement on satisfactory commercial terms.

2.11 AGS was first engaged for an initial period from 22 November 2004 to 3 December 2004, pending finalisation and appraisal of a longer-term engagement. The expected cost of this initial period was $20 000 (including GST). In this regard, Finance advised ANAO that:

> In view of the urgency of commencing work on Telstra 3 scoping study adviser appointment processes, *[named individual from AGS]* was engaged on an interim basis to commence work pending approval to the more substantive arrangement. The interim arrangements involved no ongoing obligations and were capable of speedy termination if the necessary approvals were not obtained. The approvals involved included: probity clearance under the Chief Executives Instructions, *[Financial Management and Accountability]* Regulation 10 approval and *[Financial Management and Accountability]* Regulation 9 approval.

2.12 After two further extensions,[30] on 16 December 2004, Finance made the decision[31] to enter into an ongoing arrangement with AGS at a total cost of $980 000 (including GST). This equated to an annual amount of $500 000 (including GST) for the period 13 December 2004 to 31 October 2006. On 7 March 2005, revised terms and conditions were discussed between Finance and AGS. A revised written proposal was submitted by AGS on 18 March 2005. A contract was signed on 25 May 2005. The financial terms included:

- an annual fee of $500 000 (including GST)[32] payable monthly in advance to cover the period 22 November 2004 to 21 November 2005 or

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[30] On 3 December 2004, AGS' engagement was extended for the period 6 December 2004 to 10 December 2004 at an additional cost of $10 000 (including GST). On 10 December 2004, it was further extended to cover the period 13 December 2004 to 17 December 2004 for an additional $10 000 (including GST).

[31] The decision (under Financial Management and Accountability Regulation 9) was to 'increase the existing contract …by $950 000 to a new total of $980 000.'

[32] In April 2008, Finance advised ANAO that the pricing obtained was 'highly advantageous involving a 33 per cent discount to panel rates'.

the period up to the commencement stage of the sale process (whichever was the earlier); [33] and

- the annual fee would be reviewed after 12 months or when the Government made a decision to proceed with a sale (whichever was the earlier).[34]

2.13 Unsolicited proposals can generate innovative suggestions that would be in the public interest to adopt, but the person who originates a good idea is not necessarily the best person to implement it.[35] Accordingly, there can be value in considering variations on the theme of open competition before deciding on direct negotiations as a course of action,[36] even when timing is tight.

2.14 In respect to its engagement and the value for money obtained, in May 2008, AGS advised ANAO that:

> We note that the Commonwealth Procurement Guidelines permitted the Department to engage a service provider from its legal panel if it could satisfy itself that the proposed arrangements constituted a value for money outcome for the Commonwealth. Whilst it is a matter for Finance to satisfy ANAO that it did obtain a value for money outcome and took the necessary steps to do so, we believe that in summary, the critical issues to consider in this regard include:
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> - the fact that AGS had already been appointed to the Finance Legal Panel as a result of a competitive process and that hourly and daily fees had been set and agreed with the Department in accordance with that panel arrangement;
> - that AGS specifically undertook not to bid for a role on Telstra 3 as Legal Adviser to the Department;
> - that AGS had identified no conflict of interest issues associated with undertaking the in-house role for the Department;

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33 Until December 2005, fees were paid at the originally agreed annual rate of $500 000 per annum (including GST). From January 2006, the annual rate was increased to $550 000 (including GST).

34 If the work intensified, the reviewed fee was to be costed on the basis of a ten hour day rather than the eight hour day that underpinned the $500 000 (including GST) annual fee, but with a minimum 25 per cent discount.

35 ICAC, *Direct negotiations—Guidelines for managing risks in direct negotiations*, May 2006, p. 17.

36 ibid. p. 22.

- that the nominated AGS in-house counsel had extensive and unique experience in advising government on privatisations over a significant (that is, 20 year) period of time; and
- that the eventual fees negotiated between AGS and Finance were the result of protracted discussions and represented a significant discount to the fees that a law firm would otherwise charge having regard to actual hours recorded over the course of the Telstra 3 project and applicable Finance panel rates.

2.15 As noted by AGS, the CPGs that were in place at the time of its engagement permitted Finance to direct source the appointment from its Legal Panel. Finance advised ANAO in June 2008 that the engagement was from the departmental legal services panel which had been established by competitive tender, and that the current CPGs state that such engagements are permitted provided that value for money can be demonstrated. However, the CPGs that commenced on January 2005 were expected to result in an increase in the number and scope of procurement opportunities offered to the full market. Amongst other things, agencies are only able to conduct non-construction procurements valued at more than $80 000 through direct sourcing in certain defined circumstances. For unsolicited innovative proposals, direct sourcing may only occur for purchases made under exceptionally advantageous conditions that only arise in the very short term.

2.16 AGS was paid a total of $1.05 million (plus GST)[37] for the outposted legal counsel.[38]

Business Advisers and Global Coordinators

Scoping study roles

2.17 As noted above, scoping study/planning study roles place a firm in a strong position for future advisory work on the sale process. In this context,

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37 In addition to the costs of the outposted legal counsel, the contract with AGS stated that, in the interests of ensuring high levels of cost effectiveness and project efficiency, the outposted counsel would (subject to compliance with Finance's internal guidelines and procedures) be able to refer professional work of an indicative value of $250 000 per annum (excluding GST and disbursements) on the project back to AGS. The total cost to Finance of AGS advice on the Telstra 3 transaction not covered under the outposted legal counsel fee was $106 309 (plus GST). This amount included $10 642 (plus GST) in Constitutional legal advice that, by virtue of the Legal Services Directions, is tied to AGS.

38 In December 2006, Finance decided to continue the engagement so that it would have legal services to support the novation of supplier contracts from the PMJGCs and Finance to the Telstra Sale Company Limited and in connection with the ANAO performance audit of the sale transaction. Finance negotiated a capped fee of $10 000 (plus GST) per month for the period 1 January 2007 to 30 June 2007.

Finance conducted a combined two stage procurement process for the appointment of:

- the Scoping Study Business Adviser (responsible for the management and production of the scoping study report and other business advice); and
- the Independent Business Adviser for the study and sale (responsible for providing independent advice to the scoping study process and, should it proceed, the sale).

2.18 On 17 December 2004, Finance advertised seeking Expressions of Interest for the two roles. Firms interested in undertaking both assignments submitted a single Expression of Interest that covered both the study and sale. Firms interested in a scoping study role, but not interested in undertaking the sale Business Adviser assignment on the basis that they wished to compete for a selling role in the sale, indicated so in their Expression of Interest.

2.19 Finance received Expressions of Interest from 17 firms, 12 of which were invited to tender. Each of the invited firms proceeded to submit a tender. All 12 firms tendered for the Scoping Study Business Adviser role. Three of these firms also tendered for the Independent Business Adviser role for the scoping study and sale. The result of the tender process was that:

- UBS AG was appointed as the Scoping Study Business Adviser with overall responsibility for producing the scoping study report. Consistent with its tender, the contract with UBS specified a fixed fee of $60 000 (including GST). On 18 August 2005 Finance advised the Scoping Study Business Adviser its services for the Telstra scoping study were completed. UBS was paid $108 364 (GST inclusive) for the scoping study comprising the $60 000 fee plus travel and accommodation expenses (which were not capped); and
- Caliburn Partnership was appointed as the Independent Scoping Study Business Adviser. The contract specified a fixed fee of $300 000 (plus GST) payable on completion of the scoping study report. Following the completion of the report on 30 June 2005, a capped monthly fee of $50 000 (plus GST) applied to any follow-on work required by Finance prior to any decision by the Government to proceed with a sale.

2.20 The Telstra 3 business adviser fees were comparable to those paid in previous outsourced Commonwealth public share offers.

Independent Business Adviser for the sale process

2.21 The contract with the Independent Scoping Study Business Adviser enabled Finance, at its sole discretion, to extend the term of the contract to cover the sale process. In deciding whether to exercise this discretion, in August 2005 Finance considered:

- the evaluation of Caliburn's capacity to undertake the sale Independent Business Adviser role as part of the earlier open tender process. Specifically, the Tender Evaluation Committee had concluded that Caliburn presented the best understanding of the role of an independent adviser, supported by relevant, recent experience;
- Caliburn's performance during the scoping study, which Finance considered to have been to a very high standard and in a timely manner; and
- the costs to both Finance and the industry of conducting another tender process.

2.22 Finance decided to extend the appointment to cover the sale process. However, as the then Government had not yet made a final sale decision, the August 2005 letter of appointment specifically provided that:

> The provision of the Sale Services by Caliburn Partnership Pty Ltd will be subject to the passage of the legislation necessary to conduct and complete the sale and the Government deciding that conditions are appropriate for achieving its objectives. If that legislation is not passed or the Government decides not to proceed, in addition to its other contractual rights, Finance reserves the right to terminate the Contract immediately, pursuant to clause 13.1 of the Contract.

Fee arrangements

2.23 Tenderers for the Independent Scoping Study Business Adviser were required to include in their scoping study tender the fee they proposed to be paid for their sale role as part of the scoping study tender (should they continue in that role). Two of the three tenderers were assessed by the Tender Evaluation Committee as meeting the fees criterion to a 'good' standard, the other was assessed as 'poor'. The successful tenderer offered the highest fee for the scoping study (a fee of $330 000 including GST compared to fees of

$200 000 and $10 000) but the lowest fee for the sale process (as well as overall).[39]

2.24 The Independent Business Adviser was paid a total fee of $4.24 million (plus GST) and disbursements of $120 060 (plus GST). This comprised:

- $443 453 (plus GST) for the scoping study comprising fees of $390 323 (plus GST)[40] up to 25 August 2005 and travel and accommodation disbursements of $53 130 (plus GST); and
- for the sale process, $4.00 million (plus GST) in fees paid in monthly instalments[41] together with travel and accommodation disbursements of $66 930 (plus GST). Actual payments were reduced by $150 000 (half of the scoping study fee) as the contract required that 'Fifty per cent (50%) of this fixed fee will be immediately rebated back to the Government if the Government decides to exercise its option to extend this Contract to include the Sale Services'.

2.25 The contract also included provision for follow-on work after completion of the scoping study and the sale services and for out of scope work.[42] Follow-on work was to be charged at specified rates, subject to a monthly cap. These rates varied between $400 per hour/$4000 per day (plus GST) for professional staff and up to $1250 per hour/$12 500 per day (plus GST) for senior advisers and above.

2.26 Follow-on work after completion of the scoping study (30 June 2005) was capped at $50 000 per month (plus GST) and work after completion of the sale services (31 December 2006) was capped at $75 000 per month (plus GST). Out of scope work for the period April 2005 to December 2006 would be charged at a rate equal to 40 per cent of hourly and daily rates specified in the

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[39] It offered a fixed fee of $4.4 million including GST and all disbursements except travel and accommodation, with additional monthly fees if the project extended beyond December 2006. The second tenderer ranked as 'good' against the fees criterion also proposed a fixed fee of $4.4 million together with an incentive fee linked to its ability to reduce direct sale costs as a percentage of gross proceeds to below those incurred in Telstra 2. The third candidate proposed a base sale fee of $8 million and up to $12 million in discretionary fees for the sale phase.

[40] This comprised $300 000 (plus GST) for the period to 30 June 2005, $50 000 (plus GST) for July 2005 and $40 323 (plus GST) for the period 1 August to 25 August 2005.

[41] The contract specified that this fee would be payable over a period not exceeding approximately 15 months.

[42] The Telstra 1 and Telstra 2 Business Adviser contracts did not make any provision for out of scope fees. In May 2008, Finance advised ANAO that it included these for Telstra 3 as a risk management measure, to cap any potential fees in advance of contingencies arising at a time when competitive pressure would be very low.

contract. Out of scope work for the period after 31 December 2006 would be charged at a rate equal to 50 per cent of the specified rates. No fees were charged by the Independent Business Adviser for out of scope work.

Project Management Joint Global Coordinators

2.27 Following the then Minister for Finance and Administration's announcement that the then Government would move to the next stage of preparing for a possible Telstra sale, in August 2005 Finance advertised seeking tenders[43] for:

- PMJGC services for the overall project management and logistics of the possible sale and the provision of selling services to retail[44] and institutional investors; and
- the establishment of a panel of firms capable of providing a range of institutional selling services to Australian and international institutional investors.

2.28 By way of background, in Telstra 1, ANAO found that the tenders for, and management of, the Global Coordinator contract in future sales required substantial improvement including through greater emphasis being given to financial issues when tendering for advisers and more competitive pressure being exerted on selling commissions and fees.[45] ANAO's audit of the Telstra 2 sale concluded that the process by which the Global Coordinator contract was tendered and negotiated maximised the Commonwealth's bargaining position and proposed fees and commissions were a strong differentiating factor in the selection process.[46]

2.29 In the Telstra 3 selection process Finance also gave attention to maximising competitive pressure on fees and commissions. In developing its tender approach, Finance obtained advice from its Independent Business Adviser. The Independent Business Adviser recommended a different approach to previous offers for the following reasons:

- the consolidation of the investment banking industry had reduced the number of investment banks available to lead a syndicate;

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43 A single Request for Tender covered both processes.

44 The advertisement for the Request for Tender advised that, should a sale proceed, the appointment of firms other than PMJGCS to retail selling roles would occur at a later stage.

45 ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998, pp. 19 and 22.

46 ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, 30 November 2000, p. 20.

- the scoping study had recommended that Finance maintain as much flexibility as possible for a potential third Telstra sale; and
- the CPGs stipulate minimum timetables for procurement activities and the timing requirements were seen as potentially limiting Finance's flexibility.

2.30 Consistent with the recommendations of the Independent Business Adviser,[47] Finance's tender strategy involved a two-stage approach. PMJGCs would be appointed first. The Request for Tender indicated that Finance was unlikely to appoint more than three firms to the PMJGC role. Tenderers were invited to submit an individual fixed fee for project management services based on the appointment of one PMJGC, a separate fee assuming two PMJGCs and a third fee assuming three PMJGCs. As part of the PMJGC tender process, firms were also invited to tender for positions on an institutional selling services panel for possible appointment to a selling role.[48] In the second stage of Finance's tender strategy, final institutional selling fees were set at the time the remainder of the selling syndicate was appointed.

2.31 The approach taken to setting selling commissions also differed from that adopted in Telstra 2 (where they were set at the time the Global Coordinators were engaged). For Telstra 3, tenderers were asked to provide indicative selling fees to be included in the PMJGC contract with the final rates to be set through a refined offer process when all selling syndicate appointments were finalised (including one or more possible additional Joint Global Coordinators, with no project management responsibilities).[49]

2.32 On 23 November 2005, it was decided to appoint three PMJGCs subject to each first agreeing to fees and other contract terms. The Scoping Study Business Adviser was one of the three preferred candidates. The other two firms were Goldman Sachs JB Were and ABN AMRO Rothschild. JB Were (as it then was) and ABN AMRO Rothschild had both been contracted as Global

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47 The Independent Business Adviser advised Finance that, in its view 'the proposed process will provide Finance with better outcomes than under the traditional selection process assumed in the scoping study report. That process would have created competition for project management and selling fees, but the best project managers would have had disproportionate leverage in setting selling fees. The scoping study report was silent on the particular process that might be adopted for a separate procurement for an accelerated offer or an equity-linked offer. In the absence of such a process we believe that the appointed PMJGCs would have had an unacceptable leverage in setting the timing, terms and pricing for those sale options.'

48 These roles were: Additional Joint Global Co-ordinator, Additional Syndicate Members, Equity Linked Offer and Accelerated Offer to Institutions.

49 The PMJGCs were contractually required to provide selling services only if the commissions were set within the range specified in their contract.

Coordinators in Telstra 1 and Telstra 2 (ABN AMRO Rothschild had also undertaken the Telstra 2 pre-planning Business Adviser role). Goldman Sachs (as it then was) had performed the Business Adviser role in the Telstra 2 sale.

2.33 On 24 November 2005, Finance wrote to the three successful firms seeking their acceptance of fees and contract terms. Among other things, Finance proposed:

- a project management fee of $9 million (including GST) to be divided equally among the three PMJGCs. In addition, 50 per cent of the fee would be paid between December 2005 and December 2006 in equal monthly instalments with the remaining 50 per cent available for reallocation between the PMJGCs where Finance assessed any underperformance or failures by one or more of the PMJGCs (where the underperformance or failure was not serious enough to provide a sound basis for breach of contract but nevertheless was assessed as giving rise to significant project or other risks);
- a disbursements cap of $3.3 million (including GST) with the PMJGCs to determine between themselves the level of disbursements that could be claimed by each PMJGC;
- the range for institutional selling commissions would be between 0.3 per cent and 0.45 per cent; and
- the first instalment settlement underwriting fee range for the international offer would be between 0.025 per cent and 0.045 per cent.

2.34 Each of the firms agreed to Finance's proposals and the contract was signed on 24 November 2005. The contract provided that:

- a project management fee of $9 million (including GST) would be shared equally between the three PMJGCs in the manner proposed by Finance (see paragraph 2.33); and
- reimbursement of up to $3 million (plus GST) in disbursements for travel, legal and counsel fees, roadshow travel and accommodation, office space in Sydney and Melbourne for Finance personnel, communications costs, accommodation, catering for sale related meetings, bulk photocopying, costs associated with the production of briefing materials and travel/accommodation for briefing brokers and financial planners, professional fees/salary for the independent chair of the Joint Project Secretariat (JPS) and costs associated with employee relocation.

2.35 The PMJGCs were paid the full $9 million (GST inclusive) project management fee (with no reallocation between the three PMJGCs) and were reimbursed $2.79 million (plus GST) under the disbursements cap. The PMJGCs were also reimbursed a further $116 014 (plus GST) for the cost of the institutional bookbuild supplier.

Domestic legal adviser

2.36 On 17 December 2004 Finance sought expressions of interest for the role of its Domestic Legal Adviser for the scoping study with the right reserved to extend this appointment for the sale (should it proceed). The role of the Domestic Legal Adviser was to provide input and assistance in the preparation of the scoping study for all facets of the sale, including legislation, offer structure, due diligence, corporate governance, regulatory, taxation, financing, marketing, logistics and any employee share ownership scheme.

2.37 Expressions of interest were received from five firms. All five firms were invited to submit a tender but one firm decided not to participate in the tender.

2.38 In its Expression of Interest, the firm that acted as the Telstra 1 and Telstra 2 Domestic Legal Adviser advised Finance that it could add value instantly, providing efficiencies which would translate into cost savings for Finance. This firm (Freehills, which eventually won the contract) proposed a capped fee of $250 000 (plus GST and excluding permissible disbursements) for the scoping study and a capped fee of $4.9 million (plus GST and excluding permissible disbursements) for the sale. Following review of tenders, both in written form and at interview, the Tender Evaluation Committee[50] concluded that the Freehills tender:

> presented minimal risk and demonstrated clear and significant technical superiority to other tenders and that the degree of superiority would be very difficult for other tenderers to bridge.

2.39 However, the tender evaluation report noted that the Tender Evaluation Committee was concerned that it could not be clearly established that the preferred tenderer offered the best value for money.[51] Finance has advised ANAO that the Tender Evaluation Committee was concerned to have

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[50] The Tender Evaluation Committee was chaired by Finance and included another Finance official as well as two independent business representatives.

[51] The sale fees of the other tenderers were $2.07 million (plus GST), $2.91 million (plus GST) and $3.50 million (plus GST).

greater clarity of the assumptions and exclusions with respect to the basis of the preferred tenderer's proposed fees. On 28 March 2005, the preferred tenderer revised its fee cap to $4.4 million (plus GST). On 29 March 2005, Finance contacted the firm regarding the fee cap and the fee was reduced to $4.18 million (plus GST).

2.40 Given this firm had worked on both of the previous Telstra share offers, the Tender Evaluation Committee considered its claims to be 'superior'. The Committee concluded that, although the fees were higher than all the other firms, this was more than offset by the superior understanding of the assignment and demonstrated ability to deliver. The advisory contract was signed on 5 April 2005. Total scoping study payments were $268 193, comprising fees of $250 000 (plus GST) and disbursements of $18 193 (plus GST).

Re-appointment for sale process

2.41 The contract with the Domestic Legal Adviser permitted Finance, at its sole discretion, to extend the term of the contract to cover the sale process. On 19 August 2005, following the 17 August 2005 announcement that the then Government was moving to the next stage of preparing for a possible Telstra sale, Finance decided to exercise the option to appoint this firm for the sale on the basis that:

- a selection process, including a two phase open approach to the market, for sale related legal advisory services, had recently been completed by Finance resulting in Freehills being selected as the best value for money;
- Finance considered that Freehills had performed the scoping study services to a very high standard and in a timely manner; and
- there would be costs to both Finance and the industry of conducting another tender process.

2.42 On 24 August 2005, Finance advised the Domestic Legal Adviser that it would be extending its appointment for the sale, provided it received confirmation that contact with the scoping study international legal adviser (engaged by the Domestic Legal Adviser for the scoping study) ceased.

2.43 The extended contract for the sale involved a fee cap of $4.18 million (plus GST). This fee cap was reached by 30 September 2006, some three months before the end of the contract period (31 December 2006). In addition to fees, the Domestic Legal Adviser was paid $171 187 (plus GST) for out-of-scope work and work undertaken after 31 December 2006.

Communications consultant

2.44 A communications consultant was appointed for the third tranche sale of the Commonwealth Bank of Australia (CBA3) as well as for each of the Telstra sales. Burson-Marsteller undertook this role in CBA3 and Telstra 1. Gavin Anderson & Company was the contracted firm in Telstra 2 and Telstra 3 (as well as for the trade sale of Sydney (Kingsford Smith) Airport).[52]

Selection process

2.45 The Telstra 3 Communications Consultant was selected at an earlier stage in the sale preparation than previously and was engaged over a longer contract duration. Finance advised ANAO that the Telstra 3 Communications Consultant appointment occurred prior to the appointment of the PMJGCs in order that communications advice could be included in the scoping study report and due to the significant media interest in the financial adviser and other appointments.

2.46 The selection process was broadly similar to that used in the first two Telstra sales, with the then Ministerial Committee on Government Communications (MCGC) selecting the Communications Consultant, after considering the report of the Tender Evaluation Committee and receiving presentations from the shortlisted firms. However, fewer firms were invited to participate in the selection process than in the first two sales. Specifically, five firms were invited to tender for the Telstra 3 role,[53] significantly fewer than Telstra 1 (12 firms) and Telstra 2 (10 firms). Three tenders were received (one of the invited tenderers participated as a sub-contractor to the firm that was appointed to the role), fewer than in Telstra 1 (11 submissions received) and Telstra 2 (five submissions were received including one joint submission from two firms). Finance has advised ANAO that:

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[52] ANAO Audit Report No.43 2002–03, *The Sale of Sydney (Kingsford Smith) Airport*, 8 May 2003, p. 32.

[53] An addendum to the Request for Tender, issued on 13 January 2005, stated that 'Tenderers should be aware that the RFT for Communications Consultants is not an open tender to the market and has only been issued by Finance to a select small number of Tenderers based on advice from the Government Communications Unit.'

Finance sought proposals from the maximum number of firms permitted under the Government policy, with the highest degree of competition possible.[54]

2.47 There was a distinct difference in the assessment of the two tenderers that were shortlisted. The firm that had undertaken the role in Telstra 2 was ranked more highly in terms of its demonstrated understanding of the assignment and demonstrated ability to conduct the assignment to a high professional standard and deliver services in a timely manner. However, the fees tendered by this firm were more than double (137 per cent higher) those of the second shortlisted tenderer (which had offered a heavily discounted fee). The Tender Evaluation Committee concluded that either shortlisted tenderer could offer overall value for money, but:

- one tenderer was assessed to present a potentially higher risk resulting from the strategy and approach it proposed to the management of issues during the scoping study, and offered a lower quality team with less relevant experience; and
- the other tenderer was assessed as needing to significantly reduce its fee through negotiation.

2.48 The MCGC selected Gavin Anderson & Company as the preferred tenderer but, consistent with the recommendations of the Tender Evaluation Committee, requested that Finance and the GCU seek a significant reduction in the fees proposed prior to engaging the firm. Negotiations resulted in the price being reduced by 19 per cent from $3.63 million (plus GST) to $2.95 million (plus GST). The reduction was achieved by a different approach to resourcing some aspects of role (a reduction of $587 845 (plus GST) or 16 per cent) and

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54 Finance further advised ANAO that:

> The Telstra 3 selection process was conducted in accordance with the then Government policy on Government communications and the MCGC process. Where the campaign fell within the MCGC jurisdiction, the communications strategy, briefs and lists of agencies (prepared in consultation by the department and the Government Communications Unit—GCU) were required to be approved by the MCGC.
>
> In accordance with the policy in relation to procurement of communications activities, in Telstra 3 the list of 5 agencies was supplied by the GCU to Finance prior to approval of the list by the then Minister for Finance and subsequently by the MCGC. The GCU proposed adding an additional firm on the list which was provided to Finance and subsequently to the MCGC for approval. The MCGC did not agree to the inclusion of an additional firm and approved the list of 5 agencies to be provided the RFT.
>
> Finance understands that the list of 5 agencies provided by the GCU and approved by the MCGC was derived from a register of communications consultants established by the MCGC following an open Expression of Interest and judged by the MCGC as being capable of performing the role.

reduced rates for two of the nominated individuals (a reduction of $90 909 (plus GST) or 3 per cent). The contract was signed on 8 March 2005.

2.49 Notwithstanding the fee reduction that was negotiated, the cost of the Telstra 3 Communications Consultant contract remained significantly above that for Telstra 1 and Telstra 2, and 93 per cent higher than the other shortlisted tenderer. There were two key factors in the significantly higher cost of the Communications Consultant contract between Telstra 2 and Telstra 3:

- the Telstra 3 Communications Consultant was engaged for a significantly longer period than for Telstra 2. For Telstra 2, the Consultant was not engaged for the pre-planning study but in Telstra 3 the Consultant was engaged for the scoping study. In addition, Telstra 3 sale preparation occurred over a longer timeframe than was the case for Telstra 2; and
- hourly rates paid for nominated personnel for Telstra 3 were higher than those paid in Telstra 2, although Finance has advised ANAO that the rates for professional services firms had increased since Telstra 2 in 1999 and that the increase in the hourly rate was equal or less than the increase in the Consumer Price Index over that period.

Invoicing and payment

2.50 The contract with the Communications Consultant divided the assignment into three parts with fees payable as follows:

- a capped fee of $711 785 (plus GST) for the scoping study including the development of a communications strategy for the scoping study, a media protocol, a communications campaign and communications timetable;
- a capped fee of $2 080 010 (plus GST) for the sale process including any required revisions to the media protocol, communications strategy and communications campaign; the development of a retail marketing plan, and development of a media management strategy for the sale phase; and
- a capped fee of $162 750 (plus GST) for communication advisory services in support of the final instalment collection process.

2.51 At the time of ANAO audit fieldwork, the Communications Consultant had undertaken and completed the roles in relation to the scoping study and sale. In this respect, between April 2005 and January 2007, the

Communications Consultant invoiced Finance and was paid a total of \$3 million (plus GST) for its professional consultancy fees and disbursements. This comprised \$2.69 million (plus GST) for professional fees and a total of \$315 242 (plus GST) in disbursements.

Probity and accountability processes

2.52 In the Telstra 1 sale, to address probity and accountability in the first Commonwealth offer involving outsourced project management, a Process Review Committee was formed.[55] Its role was to ensure the work undertaken by committees involved in the offer met the Commonwealth's accountability, integrity and probity requirements.[56] A Process Review Committee also operated in both the Telstra 2[57] and Telstra 3 sales.

2.53 An additional step taken in Telstra 3 compared to Telstra 2 involved the appointment of a Process Adviser. This approach had first been taken in the 2002 sale of Sydney (Kingsford Smith) Airport.[58] In Telstra 3, Finance conducted a tender for the appointment of a Process Adviser for the scoping study, with the option of extending the engagement to include the sale (should it proceed).

2.54 For the scoping study, the contract with the successful tenderer (Sparke Helmore)[59] specified a capped fee of \$100 600 (plus GST). For the scoping study, the Process Adviser was required to, among other things:

- draft, implement and monitor compliance with a comprehensive process plan;
- review and provide process/probity sign off on the tender, contractual and evaluation documentation for the engagement by Finance of all other scoping study advisers including the Business Advisers, Domestic Legal Advisers, Communications Consultant and Market Research Adviser as well as process reviews for sub-contractor appointments;

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55 ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998, p. 32.

56 ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998, p. 32.

57 ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, 30 November 2000, p. 35.

58 ANAO Audit Report No.43 2002–03, *The Sale of Sydney (Kingsford Smith) Airport*, 8 May 2003, p. 38.

59 The successful tenderer had also performed the Process Adviser role in the Sydney (Kingsford Smith) Airport transaction. Four tenders were received for the Telstra 3 role.

- advise, identify and provide guidance to Finance on how any potential risks or unforseen process issues could be resolved; and
- review any actual or potential conflicts of interest and assist Finance in the management of those conflicts.

2.55 In August 2005, Finance assessed the performance of the Process Adviser against its contractual obligations for the scoping study. With the support of Finance's in-house legal counsel, Finance decided that, in the event of a Government decision to proceed with the Telstra 3 sale, it would exercise the option to extend the term of the Process Adviser's contract to cover the sale process. The services to be provided during the sale process were similar to those required during the scoping study. A capped fee of $425 800 (plus GST) applied to the extended contract. The sale fee was the same as that included in the Sparke Helmore's tender that led to it being selected for the role.

2.56 In its Post Completion Report, the Process Review Committee identified a number of areas where consideration could be given to changing arrangements for future equity capital market offerings be considered. These comprised:

- clarifying the roles of the Process Review Committee and the Process Adviser to ensure there is no overlap and a proper linkage;[60]
- appointing an independent chair of the Process Review Committee;
- combining the Process Review Committee and the JPS; and
- combining the role of Finance's in-house counsel with the Process Adviser role.

Joint Project Secretariat

2.57 A new initiative in Telstra 2 was the establishment of a JPS to, amongst other things, provide an administrative support and coordination office for the offer.[61] A JPS was also established for Telstra 3. In its Telstra 3 scoping study, Finance's Scoping Study Business Adviser had recommended that, given the

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[60] The report of the scoping study noted that: 'There is a question as to how this new role fits within the governance and committee structure. There is a balance between efficiency and ensuring that the Process Adviser has an opportunity to comprehensively review all processes involved in a further sale of Telstra. It is proposed that the appropriate balance involves making the Process Adviser an informal member of the Steering Committee (to attend where process and probity issues are considered or otherwise at the discretion of the Process Adviser) a member of the Process Review Committee and also allowing the Process Adviser to observe any other meetings at the Process Adviser's discretion.'

[61] ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, 30 November 2000, p. 35.

complexity of a further Telstra sale, the JPS function be enhanced with more senior representation. In Telstra 3, the JPS was responsible for:

- maintaining the consolidated timetable for the sale and monitoring progress against this plan;
- overseeing the subcontracting process in conjunction with various sale operating committees;
- arranging for payment of subcontractors; and
- developing and maintaining a risk management plan and a fraud control plan.

2.58 Similar to Telstra 2, the Telstra 3 JPS was staffed and supported by the PMJGCs and reported to them, as well as to Finance on sale performance matters. In addition, at a cost of $286 692 (plus GST) that Finance reimbursed to the PMJGCs, an independent chair was appointed to the JPS to facilitate its independence and integrity, together with an administrative assistant. In addition, at no additional cost to Finance, an internal auditor to the JPS was appointed to review the structure and operation of the JPS and to undertake compliance and risk management activities relating to the appointment and performance of the various subcontractors engaged by the PMJGCs.

2.59 An initiative adopted in Telstra 3 to maintain the security of electronic communication and comply with the requirements of the Protective Security Manual as well as assist in the maintenance of an adequate audit trail for the sale process was the appointment of a supplier to provide an electronic platform for members of the sale team to communicate, manage documentation and maintain an effective audit trail of sale process meetings, decisions, papers and other processes. In addition to this platform (referred to as 'T-Central'), a similar platform (referred to as 'T-Extra') was established to disseminate information to Telstra and Telstra's advisers. The JPS acted as the administrator for both sites. The $384 806 (plus GST) cost of these sites was reimbursed to the PMJGCs by Finance.

Internal auditors

2.60 A feature of the management of the Telstra 3 sale was the extent to which auditors were engaged to provide assurance over controls and the management of the sale.

Auditor to the JPS

2.61 As noted, the PMJGC contract required the engagement of an internal auditor to the JPS. Following a tender process, a contract for an internal auditor to the JPS was signed on 18 January 2006. The contract involved a maximum capped aggregate fee of $265 000 (plus GST) with the internal auditor to provide services that included:

- acting as probity and process adviser in respect to aspects of the subcontractor selection and appointment process;
- advising the PMJGCs on the conduct of the sale as it relates to the management of logistical, subcontractor and probity risks;
- assisting the JPS to establish a system for the verification and payment of subcontractor invoices (including verification of invoices to agreed performance hurdles and key performance indicators); and
- signing-off to the PMJGCs on the subcontractor procurement process including subcontractor tender documentation and certification requirements.

2.62 The reviews undertaken by the internal auditor did not identify any significant issues. In relation to sub-contractor payments, the certification provided by the internal auditor (and relied upon by Finance) was that:

> I, the Joint Project Secretarial Internal Auditor, confirm that invoices and supporting documentation are available and, where applicable, attached to this form to substantiate the payment amount. These invoices and the supporting documentation have been reviewed and verified by the Joint Project Secretariat Internal Auditor in accordance with the agreed procedures stated in the Subcontractor's Payment Process Manual.

Finance's internal auditor

2.63 Following a tender, Finance engaged its own internal auditor. For a capped fee of up to $365 000 (plus GST), this firm was to provide independent assurance over certain contract compliance and systems risk matters for the sale. This included reviewing:

- Finance's oversight of PMJGC contract performance and key performance indicator measurement;
- the assessment of risks by the PMJGCs and their sale auditor relating to application processing risks as well as system and processing risks for the sale web environment;

- control measures and subcontractor management and payment systems implemented by the PMJGCs;
- PMJGC claims for reimbursement of their direct expenses;
- broker firm allocations, retail commission payments and bookbuild pricing; and
- settlement arrangements and accounting for sale proceeds.

Roadshow

2.64 An institutional and retail roadshow was conducted as part of the marketing effort. Total expenditure on the retail and institutional roadshow by Finance was $1.7 million (plus GST).[62] Finance has advised ANAO that the conduct of a global institutional roadshow assumed a higher level of importance than was the case during Telstra 2 due to a substantial reduction in the level of interaction by the company with institutional investors compared to that in the lead-up to and following Telstra 2 combined with substantial changes to the Telstra Board and to senior management.

2.65 Telstra management availability affected the duration and cost of the roadshow. The PMJGCs originally planned a three week, multi-region roadshow with two teams, incorporating the equivalent of 30 days of meetings, starting on 26 October 2006. However, Telstra management was unable to commit to the schedule or a subsequent revised proposal presented by the PMJGCs. The final agreed itinerary extended for 32 days, commencing on 9 October 2006 and concluding on 9 November 2006, with 22 days of meeting for the institutional roadshow. The retail roadshow extended for five days. The revised itinerary increased the cost of the roadshow. The original estimated cost of the institutional roadshow provided in the Global Roadshow Coordinator's tender was $1.09 million. The revised estimated cost of the institutional roadshow as of 4 October 2006 was $1.72 million.[63]

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[62] Finance advised ANAO in March 2008 that the PMJGCs met the cost of the Global Roadshow Coordinator's project management fee and professional services fees (totalling $166 526) from their fixed project management fee of $9 million.

[63] This re-costing was used as the basis for fees in the Global Roadshow Coordinator contract. In this re-costing, the Global Roadshow Coordinator advised the PMJGCs that the increase in the length, the routing and number of group presentations for the T3 roadshow had a 'dramatic' effect on the overall estimated costs in the following ways: an increase in flight and accommodation costs; an increase in the number and size of group meetings from 3 set shows and 1 monitor show to 6 set shows and 10 monitor shows; an increase in the number of days the Global Roadshow Coordinator team would be travelling; an increase in the executive team's use of First Class Travel; and additional use of private jet charter in Europe, the US and Asia.

2.66 The cost of accommodation booked for participants in the roadshow was also affected by Telstra management requirements.[64] Finance advised ANAO in March 2008 that:

> While the protocol provided a guideline for containing accommodation expenses, Telstra's policy on senior management team accommodation needed to be taken into consideration. In this regard, Finance was always aware of the scrutiny which attaches to such expenditure and the need to contain costs and maintain a degree of consistency with similar expenditures elsewhere. However, it was also conscious that attempting to impose specific accommodation arrangements on Telstra management in particular locations was unlikely to generate willing participation in the roadshow and had the potential to jeopardise meeting sale objectives. The Joint Project Secretariat advises that prior to the Global Roadshow Coordinator taking charge of all bookings, accommodation for senior Telstra management had been booked at the St Regis in New York and the Berkeley in London. These bookings were made by Telstra. This standard of accommodation was required by senior Telstra management on several occasions.[65]

Substantiation of expenditure by PMJGCs

2.67 In Telstra 1, ANAO found that payments reimbursed to the Global Coordinators for the Roadshow Coordinator ($3.02 million) were not independently verified by the Global Coordinators through appropriate supporting documentation and an effective audit trail was not maintained of this Commonwealth expenditure.[66] In this context, ANAO considers it is good administrative practice for those administering contracts to obtain copies of the underlying receipts supporting expenditure by contractors. Where there are a large number of expenditure items of relatively small value, the cost-effectiveness of the substantiation process can be aided by setting a threshold above which receipts are to be provided. Consistent with these principles, in Telstra 2, steps were taken to address the Telstra 1 shortcoming through

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64 A roadshow protocol set out the standard of accommodation for the roadshow. The protocol stated that accommodation for Finance, Telstra, PMJGCs and the Global Roadshow Coordinator representatives would be at the host venue of the relevant presentation where practicable. In addition, it stated that the standard of accommodation should be selected to reflect a degree of equality with the accommodation typically provided for public servants and should reflect the Commonwealth's objectives of professionalism and value for money. Further, the protocol stated that in the event senior Telstra management wished to stay in a preferred hotel and it was impractical for logistics purposes to separate the travelling roadshow team, the entire team would be permitted to also stay in this hotel.

65 In this context, for two cities (New York and London) the average cost for the executive party (consisting of Telstra representatives, a PMJGC representative, and a Finance official) was in excess of $1300 AUD each per night.

66 ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998, pp. 57–58.

improved contract management procedures, greater cost consciousness and a more appropriate allocation of costs.

2.68 The Telstra 3 Global Roadshow Coordinator provided the JPS, who administered their contract, with detailed spreadsheets as well as invoices to support their expenditure claims. Finance advised ANAO in May 2008 that the primary expenditure control (as provided for in the Global Roadshow Coordinator contract) on the Global Roadshow Coordinator was a detailed spreadsheet of all claims for reimbursement. When ANAO conducted its Telstra 3 audit fieldwork, the JPS did not hold a complete set of invoices relating to expenditure on the roadshow managed by the Global Roadshow Coordinator. The JPS held invoices in relation to: venue hire; accommodation for the production team, advance logistics party and executive party; and private jet invoices for the institutional roadshow.[67] However, for a significant amount of expenditure, ANAO found that invoices had not been obtained by the JPS to support expenditure. For example, no invoices were obtained with respect to $97 221 charged for Executive Party cars, $25 399 in transportation, documentation and insurance, $32 392 in video projection systems and $33 496 in sound and lighting. Some incomplete information was provided in relation to a range of other costs.[68]

2.69 In March 2008, Finance advised ANAO that the volume of invoices provided was sufficient to allow the JPS to do an 'adequate' level of testing and verification to confirm that the majority of roadshow expenses were properly accounted for, with Finance noting that 60 per cent of total institutional roadshow expenditure was tested back to hardcopy invoices in addition to other controls and tests. Finance further advised ANAO that, following the release of ANAO Issues Papers raising concerns in this area, invoices had been obtained for other expense items nominated by the ANAO and that 'no significant exceptions' had been identified.

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[67] Finance advised ANAO in March 2008 that the list of invoices held by the JPS should also include flights which were a significant roadshow expense. ANAO noted that flight invoices were held by the JPS but did not examine whether these were a complete and accurate record of airfare costs.

[68] In its review of supporting documentation of the roadshow, ANAO also found there was no documented acquittal of $17 083 in expenditure through 'cash floats'. Finance advised ANAO in March 2008 that the JPS had subsequently obtained reconciliations from the Global Roadshow Coordinator for all expenditure from the cash floats, and that the expenditure consisted of food, beverage, taxi and other incidental expenses. Finance further advised that the JPS had since reviewed the expenditure and had not identified any 'material variations' from the protocol.

Verification of expenditure

2.70 Certification by the PMJGCs that expenses were incurred in support of the Telstra 3 share offer was an important part of the payment verification process. In May 2008, Finance advised ANAO that:

> The PMJGCs incurred a large volume of often minor expenses on sale activities which it would not be cost-effective for Finance to review on an individual basis. The contract accordingly required the PMJGCs to certify all such expense reimbursements, including the roadshow reimbursements, were incurred for the purposes of the Telstra 3 sale. In doing so, the PMJGCs are signing off to Finance that they have undertaken such expense verification as is required.
>
> However, certification is superfluous where expense claims are fully substantiated by the PMJGCs providing the relevant supporting documentation to Finance. There is no requirement for certificates to be provided (that is, Finance may waive the contractual requirement).

2.71 Certification was provided by the PMJGCs in relation to $1 103 639 (plus GST)[69] in expenditure made to the Global Roadshow Coordinator. These payments constituted the majority of expenditure on the roadshow. However, for a portion of this amount ($531 524 plus GST)[70] the certifications that were provided in relation to the payments made to the Global Roadshow Coordinator did not align with the amounts actually paid out by Finance. In June 2008, Finance advised ANAO that, whilst the relevant payment figures do not align with the actual amount certified by the JPS, the differences can be reconciled.[71] ANAO considers that, in future, certifications should be obtained that align with the actual amounts to be paid and, where certification is not required, a record should be kept of which payments were separately verified by the department.

2.72 In relation to air travel, where no certification was provided, Finance advised ANAO in March 2008 that:

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69 Finance advised ANAO in May 2008 that an amount of $17 873 (plus GST) paid under the PMJGC disbursements cap was also included in the Global Roadshow Coordinator's final invoice and was appropriately certified by the PMJGCs as Telstra 3 expenses.

70 This does not include the amount of $17 873 (plus GST) which Finance advised was paid under the PMJGC disbursements cap and appropriately certified by the PMJGCs as Telstra 3 expenses.

71 Finance further advised in June 2008 that the variance was due to adjustment of invoices for the Global Roadshow Coordinator's project management and consultancy fees which were to the account of the PMJGCs and the difference could be reconciled.

> …it was agreed that the PMJGCs would book and pay for the airfares and jet charters on their own account and then seek prompt reimbursement from Finance….To facilitate prompt reimbursement, it was agreed that these airfare and jet charter reimbursements would be fully substantiated by providing copies of the original supplier invoices with the PMJGC reimbursement claim. In these circumstances, certification could have provided no additional assurance but would have served only to delay the reimbursements to the PMJGCs and as a result it was agreed that none would be required.

2.73 Finance further advised ANAO in May 2008 that the actual verification process for the airfare reimbursements was detailed and comprehensive. Specifically, Finance noted that the JPS undertook an internal verification process (including verification of flight itinerary for name, date and travel route against the roadshow itinerary approved by the Institutional Marketing Committee) as well as providing Finance with a copy of all flight invoices, flight itinerary and roadshow itinerary.

Recommendation No.1

2.74 ANAO *recommends* that, having regard to the particular risks involved, the Department of Finance and Deregulation further improve probity and accountability processes for marketing roadshows in future public share offers by establishing a threshold above which its contracted project managers are required to obtain receipts for roadshow expenditure (including the acquittal of any cash floats) prior to providing certification of roadshow costs.

Agency response

2.75 Finance agreed to the recommendation and commented as follows:

> Finance agrees with the Recommendation that a threshold be set, above which project managers are required to obtain underlying receipts of roadshow expenditure prior to certifying that expenditure. This approach will provide clarity to all participants in relation to their obligations, noting that in setting the threshold the costs involved need to be commensurate with the risks being managed.

3. Financial Returns

This chapter examines the pricing for the sale and includes analysis of both the sale financial returns and sale costs.

Introduction

3.1 One of the Government's key objectives for the Telstra 3 sale process was that taxpayers achieve an 'appropriate' financial return. This objective varied from the comparable objective for each of Telstra 1 and Telstra 2, which involved achieving an 'optimum' financial return. While a range of similar factors required consideration, Finance advised ANAO that achievement of an appropriate return for Telstra 3 required closer attention to be paid to the alternative use of the proceeds, particularly following the introduction of the Future Fund, and the trade-off between the quantity of shares sold and the price achieved. In relation to achieving an optimum financial return, the ANAO concluded that the Telstra 1 offer was not fully priced and that the Telstra 2 offer was fully priced.

3.2 Prior to the Telstra 3 sale, the Commonwealth held over 6.4 billion shares in Telstra. To complete the privatisation of Telstra in a single tranche with an appropriate financial return, this level of share ownership presented challenges to the sale team in relation to the balancing of demand and supply for Telstra 3 shares. The scoping study concluded that divestment of the Government's entire shareholding was achievable by the end of 2006 subject to a number of conditions. These conditions were:

- the Government providing regulatory certainty to Telstra and the investment community;
- no Telstra corporate structure or business plan changes which affect investor support;
- Telstra undertaking a significant buyback of the Government's shares;
- the Government completing a fully marketed retail and institutional offer in October/November 2006 while retaining full flexibility to pursue other offer structure elements;
- the Government taking appropriate preparatory steps to enable completion of a fully marketed offer in October/November 2006;

- passage of Telstra sale legislation as soon as practicable before the end of calendar year 2005; and
- there being no material adverse change in general market conditions or Telstra's investment case and attractiveness to retail and institutional investors.

3.3 Finance advised ANAO in May 2008 that, as circumstances developed, many of these conditions were not able to be met. Nevertheless, a full divestment was completed at an appropriate return.

3.4 In this context, the scoping study advised that the ability to maximise proceeds in a further sale of Telstra would be determined by the ability to change the size of an offer (via structural mechanisms) and maximise demand. This latter aspect would in turn depend to some extent on the ability of Telstra to increase the attractiveness of its investment case.

3.5 In terms of net financial returns, the scoping study:

- estimated aggregate proceeds to vary between $26 billion and $32 billion comprising receipts from a proposed company buy-back of shares and the sale of shares through an equity offering; and
- included an estimate of costs under various sale scenarios so that the cost implications of various structural recommendations could be considered. The high level costings that were prepared suggested that sale costs would be in the order of $210 million to $290 million (plus GST) and before any contingency (risk) factors, or $260 million to $340 million (plus GST) after contingency factors.

3.6 Under various demand and allocation scenarios[72], the scoping study estimated total sale costs as a percentage of gross proceeds to be in the range of 0.8 per cent to 1.1 per cent.[73] A key finding of the scoping study was that there

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[72] Cost estimates were produced for the three demand and allocation scenarios (worst-case demand with a share buy-back, mid-case demand with a share buy-back and high-case demand with a share buy-back) together with a worst-case cost scenario which assumed a low buy-back amount with a large equity offer and high proportion of institutional allocations (which attract higher selling fees than retail allocations). Under all four scenarios, overall gross proceeds were $32 million, with different amounts for the amount (if any) of shares retained by the Australian Government, the value of the equity sell-down and the combined size of the Future Fund allocation and a share buy back by the company.

[73] In May 2008, Finance advised ANAO that on the basis of the equity sell-down component in the scenarios the cost range was 1.3 per cent to 1.5 per cent. In this respect, in May 2008, Finance's domestic legal adviser advised ANAO that increased legal costs were, in part, as a result of, amongst other things, the Future Fund transfers and investigation of various structural options, including different kinds of buy-backs.

was scope to achieve cost savings under most scenarios and that this was expected to result in costs being less than 1.0 per cent of gross proceeds (compared to 1.1 per cent in Telstra 2).

3.7 Telstra 3 resulted in 4.23 billion shares being sold with a further 93.5 million shares transferred to the Telstra Sale Company Limited to be held as Bonus Loyalty Shares.[74] The Commonwealth's remaining 2.13 billion shares were transferred to the Future Fund Board of Guardians.

3.8 The gross offer proceeds were $15.4 billion, with sale costs of $204 million, or 1.3 per cent of proceeds. The proceeds arose solely from the share offer as a share buy-back did not occur (see Table 3.1).

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[74] Bonus loyalty shares were additional shares received if retail investors purchased instalment receipts under the Australian retail offer at the retail investor price, held them in the same registered name until 15 May 2008 and paid the final instalment on or by 29 May 2008. The entitlement to bonus loyalty shares was based on 1 bonus loyalty share for every 25 applicable instalment receipts held. Any bonus loyalty shares not allocated to retail investors in 2008 are expected to be transferred to the Future Fund. In this regard, Finance advised ANAO in December 2007 that there was not a formal decision on this matter at that time.

Table 3.1

Telstra 3 sale proceeds and costs as at April 2008

	$m	$m
SALE PROCEEDS		
Retail offer	9 263.40	
Institutional offer	6 753.35	
Total value of shares sold		**16 016.75**
Less proceeds foregone by:		
Instalment discounts	242.28	
Loyalty shares	336.60	
Total proceeds foregone		**578.88**
Gross offer proceeds		**15 437.87**
SALE COSTS		
Retail selling commissions	61.70	
Institutional selling commissions	24.29	
Subtotal		*85. 99*
Advertising and marketing	24.71	
Logistics	22.89	
Costs incurred by Telstra Corporation Limited and reimbursed by the Commonwealth	21.88	
Project management advisory costs	11.01	
Estimated costs associated with collection of final instalment	11.00	
Finance running costs	10.16	
Legal advisers	7.34	
Sale independent business adviser	3.92	
Scoping study	2.45	
Other advice	2.37	
Total offer costs		**203.72**
NET SALE PROCEEDS		**15 234.15**

Note: Sale proceeds and costs are GST exclusive.

Source: ANAO analysis of Finance documentation.

Offer structure and demand for shares

3.9 The PMJGCs initially recommended a pre-registration process be used for Telstra 3 on the basis that: it was an effective way to build early offer momentum amongst retail investors and their advisers; the development of the pre-registration database was useful in streamlining later logistical processes; and it was an effective means of attracting new investors to large-scale offers.[75] Planning continued for the proposed pre-registration process up until June 2006, when a decision was made to proceed without a pre-registration phase. Finance's June 2006 decision not to proceed with pre-registration was based on the PMJGC's June advice that:

- launching pre-registration prior to Telstra's regulatory position being finalised would necessitate weaker pre-registration marketing messages. As of June 2006, there was ongoing regulatory uncertainty in relation to the 'fibre to the node' proposal, and it was unclear whether this uncertainty would be resolved by the proposed launch date for pre-registration (20 August 2006);
- low pre-registration participation would lead to negative media coverage and adversely impact sale momentum before the offer had been formally launched. Market research conducted indicated that the number of potential investors likely to pre-register was likely to be significantly lower than in Telstra 2; and
- a significant proportion of pre-registration costs would still be incurred if pre-registration was required to be cancelled immediately before the launch date.

3.10 In the context of a base offer size of 2.15 billion shares, an array of offer structure mechanisms were developed to tighten the demand for shares. These included an upsizing mechanism, the size of the broker firm offer and Japanese public offer without listing (POWL); and the institutional entitlement offer.

Broker demand and Public offer without listing (POWL)

3.11 Firm allocations were advised to brokers and financial planners prior to the opening of the retail offer, with broker firms and financial planners

75 Since the QANTAS Share Offer in 1995, every Commonwealth Government privatisation via listing has included a pre-registration component. In both Telstra 1 and Telstra 2, pre-registrants were a significant source of retail applications. For example, in Telstra 2, of the 1.64 million retail applications received, 1.56 million were received from shareholders and pre-registrants.

required to underwrite their bids. As a result, the total amount of broker firm demand, and the subsequent amount allocated to this component were important signals of overall retail demand.

3.12 The broker firm allocation to brokers and financial planners was announced on 22 October 2006, prior to the opening of the retail offer. In total, 1.654 billion shares were bid for, with 1.1 billion shares allocated.[76] This represented 51 per cent of the total base offer size, excluding the Greenshoe.[77] This was significantly larger as a percentage of the total offer than the Telstra 1 and Telstra 2 precedents, at 15 per cent and 21 per cent respectively. In this context, Finance advised ANAO that a different prudential environment operated for brokers in Telstra 3 than Telstra 1 and Telstra 2, and the implications of this were addressed in advice by the PMJGCs and Independent Business Adviser and a lower level of scaleback[78] was expected because of these changes.

3.13 One of the factors underlying the increase in total broker firm allocation relative to previous Telstra share offers was the consideration that the high net worth individual segment, which is generally channelled through brokers, would be an important source of demand for the offer. Another factor was that interest from general retail investors, measured through requests for a prospectus, was considerably lower at that point than anticipated. In this context, both the PMJGCs and the Independent Business Adviser advised Finance that, if the market perceived that the broker firm offer had been strongly supported and received a substantial allocation, this would assist in building offer momentum for both the public and institutional offers.

3.14 The POWL was used in conjunction with the broker firm offer to assist build offer momentum.[79] A POWL is a type of sale unique to Japan that allows retail investors to buy stock without requiring a separate listing on the stock exchange in Japan. A total of 120 million shares were allocated to the Japanese

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76 Broker firm scaleback in Telstra 3 was 33 per cent. This represented a much lower level of scaleback than the two previous Telstra offers, with Telstra 1 scaleback at 87 per cent and Telstra 2 scaleback at 80 per cent.

77 The Greenshoe over-allotment option gave the PMJGCs the option to over-allocate a fixed percentage of the offer. In the event that the securities traded lower in the aftermarket, they were able to cover their short position by purchasing securities on-market. In the event that the securities traded higher, the PMJGCs were able to exercise their option to acquire the securities from the offeror at the issue price.

78 Scaleback refers to the practice of providing less shares to investors than they have requested.

79 A Japanese POWL was also used in Telstra 2.

POWL.[80] As a result of the POWL and Broker Firm offer, 57 per cent of the base offer shares were committed prior to the start of the Australian public offer.

Institutional entitlements

3.15 In the lead up to a major sale, the main reason for the share price fall is supply and demand, as more securities are to come onto the market, price falls in anticipation of the additional supply and a potentially discounted sale clearing price. Some investors may sell in anticipation of these price falls which may be exacerbated by short-selling.[81] As the issue price is often based on the preceding closing price there is no incentive for investors to buy on-market if they believe they will be allocated shares in the offer. In order to combat this tendency, the PMJGCs recommended the use of an institutional entitlement offer.

3.16 The institutional entitlement offer gave institutions the right to acquire one share for every two Telstra shares held by the institution as at the close of the bookbuild, on 17 November 2006. This was a much higher institutional entitlement ratio than was used for Telstra 2 (one share for every ten Telstra shares held). In conjunction with the limiting of supply of shares through the broker firm offer and POWL, it was believed that this would provide a strong disincentive for the selling of Telstra shares by institutions prior to the close of the bookbuild. Specifically, institutions who wanted to guarantee receiving stock would need to hold their shares or purchase shares on market. In addition, it was hoped that the institutional entitlement offer would minimise stock lending (for example, for stock borrowers seeking to short-sell), as lenders would lose their entitlements if they did not get their stock back prior to the close of the bookbuild. Finance advised ANAO in May 2008 that this

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[80] Unlike in previous Telstra offers, the minimum allocation for the POWL (being 120 million shares) was underwritten, with $100 800 ultimately paid in settlement underwriting fees. As well as selling and underwriting fees, Finance also agreed to pay an additional capped fee to cover the cost of translation of the offer document into Japanese; any accounting/auditing requirements, if required; and the design, production and distribution of all POWL offer documents. Tenderers were to provide in their tender response their proposed capped fee for each these tasks. However, the Tender Evaluation Report did not assess the tenderers against each of these fees, and included one activity in its assessment which it did not include in its tender ('Issuer's Japanese Legal Counsel'). Finance advised ANAO in May 2008 that as the two tenders included this cost in their capped fee proposals it was taken into account in the Tender Evaluation Report, however the tender outcome was based on more substantive issues such as commissions payable and relevant experience. In total, $213 320 was reimbursed to the POWL manager in respect of these costs.

[81] Short selling involves 'short-sellers' borrowing a security and then selling it, expecting it will decrease in value so they can buy it back at a lower price and profit from the difference.

was backed up by extensive registry analytics to verify holdings at the time of allocation.

3.17 The institutional entitlement take up rate in Telstra 2 was 18 per cent. In Telstra 3, the institutional entitlement take up rate was 72 per cent. There were some price fluctuations during the period from the announcement of the offer launch on 9 October 2006 to the end of the bookbuild on 17 November 2006. However, overall the Telstra price rose one cent over the period, indicating the entitlement incentives assisted in preventing the share price falling. By way of comparison, in Telstra 2, the share price fell 28 cents from the offer launch to the end of the bookbuild.

Upsizing Mechanism

3.18 The upsizing mechanism provided the flexibility to increase the offer size if demand conditions indicated this was required. However, this would only occur if the number of shares required to satisfy allocations for the retail offer, the POWL minimum guarantee[82] and institutional investors' initial allocation benefit[83] exceeded the base offer size (of 2.15 billion shares). This meant that offer size could only be increased in response to committed demand (that is, from retail demand where bids were prepaid, the POWL which was underwritten or institutional entitlements where the Commonwealth held binding bids for entitlement shares at the final sale price).

3.19 Overall, the various components of the offer structure were successful in achieving a high level of demand for shares, such that the upsizing option was employed. The base offer size was increased from 2.15 billion shares (plus a Greenshoe) to 4.25 billion shares including the Greenshoe (see Figure 3.1), leading to a significant increase in cash proceeds.

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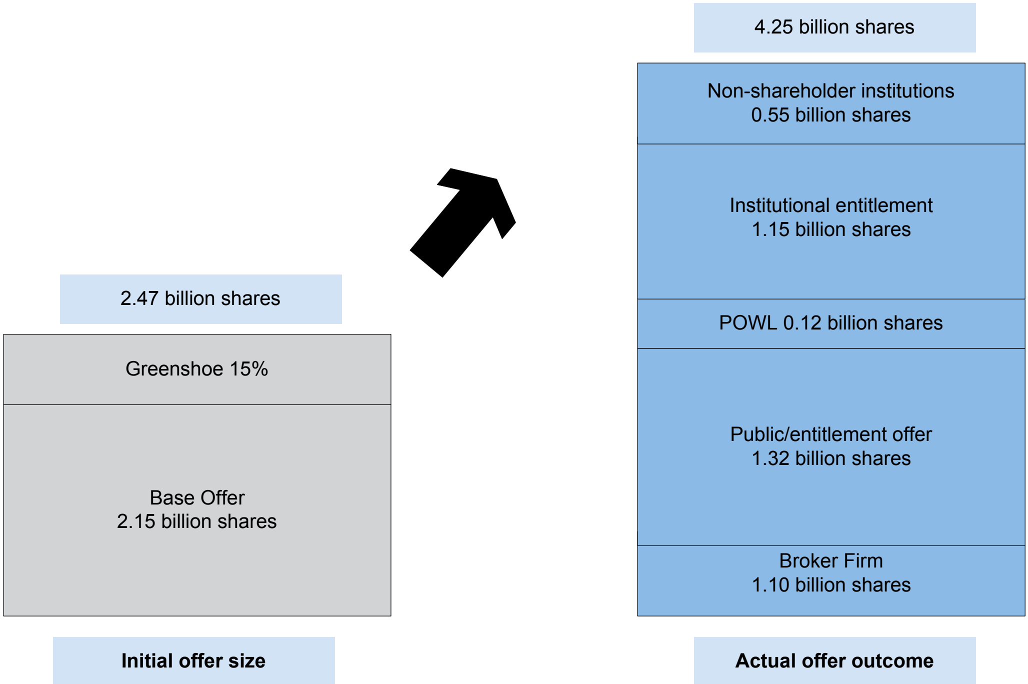
82 A minimum total number of shares that could be reserved for Japanese investors subscribing under the POWL in Japan.

83 That is, the allocation for institutional investors who were Telstra shareholders at the close of the institutional offer, based on the number of shares held as of the close of the institutional offer.

Figure 3.1

Final allocation outcome and upsize



Note: Public/entitlement offer includes 30 million buffer stock shares. Figures do not add due to rounding.

Source: PMJGC Offer Structure Committee Sale Completion Report, p. 18.

3.20 Retail demand figures for Telstra 3 shares provided by the PMJGCs to Finance on 15 November 2006 (excluding the broker firm offer and New Zealand retail demand) totalled 1.313 billion shares. Of this overall demand, approximately 324 million shares represented 'scaleable demand' (that is, demand in excess of guaranteed shareholder entitlements and the general public and broker client offer guaranteed allocation of 2000 shares per application). The PMJGCs recommended that given the relatively low amount of scaleable demand in the context of the overall Telstra 3 share offer size and the ability for the Government to upscale the offer, allocating retail investors an average of 95 per cent of their application amount would be appropriate. This resulted in an allocation policy whereby:

- all shareholders who applied under the shareholder entitlement offer for their entitlement or less would be allocated their entitlement in full up to 200 000 shares;

- retail shareholders who applied under the shareholder entitlement offer for more than their entitlement would receive allocations as follows:
  - applicants who applied for up to 10 000 shares would receive the number of shares they applied for; and
  - for applicants who applied for more than 10 000 shares, if the entitlement was less than or equal to 10 000 shares, 10 000 shares plus 75 per cent of any additional shares applied for above 10 000 shares, up to a maximum allocation of 100 000 shares. If the entitlement was greater than 10 000 shares but less than 100 000 shares, they were to receive their entitlement plus 75 per cent of any additional shares applied for above their entitlement, up to a maximum allocation of 100 000 shares. And, if the entitlement was greater than or equal to 100 000 shares, their entitlement, up to a maximum allocation of 200 000 shares;
- general public offer applicants who applied for up to 5000 shares received the number of shares they applied for; and
- general public offer applicants who applied for more than 5000 shares received 5000 shares plus 75 per cent of any additional shares applied for above 5000 shares, up to a maximum allocation of 100 000 shares.

Offer pricing

3.21 In line with the Government's formal sale objectives of promoting orderly market trading in Telstra shares, achieving an appropriate financial return and removing the Government's conflict of interest, when setting a price for Telstra 3 shares, the Government needed to set the price at a level designed to generate a stable after-market whilst optimising pricing based on the demand received. In December 2007, Finance advised ANAO that a further factor in this regard was the sale of sufficient shares to resolve the Government's conflict of interest.

3.22 Ensuring adequate minimum bid coverage of the shares on offer is important in achieving an orderly aftermarket by leaving some remaining demand in the market for shares and reflects upon whether the offer is fully priced. In Telstra 2, institutional demand exceeded allocation by 1.9 times compared to 6.2 times in Telstra 1 and 3.1 times in the 1996 CBA 3 offer.

3.23 For Telstra 3, in August 2006, the PMJGCs recommended that the targeted minimum offer size should be such that there was a strong degree of confidence that institutional demand of 1.2 times the number of shares available was achievable. They noted that a coverage level below this level makes it difficult to only allocate to high quality investors and also achieve a reasonable level of scaleback.

3.24 The Telstra 3 bookbuild period was three days, commencing at 9am on 15 November 2006 and concluding at 6pm on 17 November 2006. Overall, 277 valid institutional bids were received, resulting in total demand for shares of 2688.9 million shares. Demand was strongest from the Australia region. Overseas demand was strongest from the UK/Europe region, followed by the North American region (see Table 3.2).[84]

Table 3.2

Institutional demand and allocation by region

Region	Demand (shares m)	% Total Demand	Allocation (shares m)	% Total Allocation	Allocation as % of Demand
Australia	1 653.9	62	1 198.2	70	72
UK/Europe	549.5	20	269.8	16	49
USA/Canada	270.4	10	158.9	9	59
Asia/Rest of World	215.1	8	78.3	5	36
TOTAL	**2 688.9**	**100**	**1 705.2**	**100**	**63**

Source: Institutional Marketing Committee Sale Completion Report, 18 January 2007.

3.25 The PMJGCs recommended to Finance on 18 November 2006 that the price be set at $3.70 rather than $3.75. The PMJGC's believed that pricing the offer at $3.75 would increase the risk that the instalment receipts would trade poorly in the aftermarket. This was based on a number of factors, including the PMJGCs view that the current market price was, to an extent, artificially high due to the short squeeze that eventuated as a result of the offer structure, and

[84] Institutional demand at the final price of $3.70 was at the high end of the institutional demand estimates of $7.1 to $9.9 billion produced by the Institutional Marketing Committee in September 2006, with total demand of $9.9 billion.

their view that at a price of $3.75, the quality of demand for the '15 per cent component'[85] was materially poorer than that at $3.70 per share.

3.26 On 18 November 2006, Finance's Independent Business Adviser also provided advice on the final price recommendation. It advised that although the sale could be priced at either $3.70 or $3.75, on balance it recommended the sale price be set at $3.75.

3.27 Partially underlying the differences in advice were conflicting views on the effect of the sale on the Government's total assets. The PMJGCs calculated that an increase in share price from $3.70 to $3.75 would result in a reduction in overall sale proceeds of $327.5 million, due to fewer shares being sold, assuming the Greenshoe was not triggered. However, the Independent Business Adviser took the view that this did not represent a loss to the Government, as the Government still held those shares.

3.28 In advising the then Minister, Finance noted that, while acknowledging the Independent Business Adviser's view that the increased risk at $3.75 per share was on balance minimal, it considered that the PMJGCs concern over the residual elements of the 15 per cent component warranted pricing at $3.70 per share. On this basis, on 18 November 2006, a final strike price of $3.70 was recommended to, and agreed by, the then Minister for Finance and Administration. In December 2007, Finance advised ANAO that:

> While the coverage ratio for institutional shares at $3.70 was 1.58 times, above that recommended by the PMJGCs, the original recommendation was made prior to the development of the final offer structure, with its mechanism for increasing offer size. Overall, institutional demand fell by 16 per cent as the possible strike price increased from $3.70 to $3.75. More specifically, demand for the initial allocation benefit fell by 11 per cent, whilst other institutional demand fell by 20 per cent. With respect to the 15 per cent component, total demand fell by 20 per when the possible strike price increased from $3.70 to $3.75. Under the adopted structure, the PMJGCs advised that allocations to the 15 per cent component were of greater concern in considering the impact on aftermarket trading. They advised that pricing at $3.75 would necessitate allocating top ranking investors a large proportion of the shares they bid for as

[85] A minimum of 15 per cent of the offer size before any over-allocations was reserved for certain investors in the institutional offer ('Certain Institutional Investors'), including: Telstra shareholders who placed bids for amounts in excess of their institutional entitlement; other institutional investors who were not Telstra shareholders at the close of the institutional offer; investors subscribing under the Japanese POWL in excess of any POWL Minimum Guarantee; and Australian and New Zealand retail investors who participated in the institutional offer via broker sponsored bids for amounts in excess of their shareholder entitlements (if any).

well as higher than desirable allocations to lower quality investors, raising significant concerns over the likely effect of aftermarket buying. They also pointed to an expectation of a lower volume of retail flow-back in the early days of trading post listing. Under these circumstances they were not confident there was sufficient follow-up demand at $3.75 to balance flows from these channels.

3.29 The listing of Telstra 3 Instalment Receipts occurred on Monday, 20 November 2006 on a conditional and deferred settlement basis. They traded on a normal settlement basis from Friday, 1 December 2006.

3.30 One of the methods used for short term market stabilisation in share offerings is a 'Greenshoe overallotment.' A Greenshoe overallotment option was included in both the Telstra 1 and 2 offers. It was also incorporated into the Telstra 3 share offer. Under the Telstra 3 Greenshoe arrangements, 554 093 373 instalment receipts[86] were over allocated. Depending on the state of the aftermarket, the PMJGCs could then elect to purchase instalment receipts on the market or exercise the overallotment option. On 4 December 2006, following a request by the PMJGCs, the then Minister for Finance and Administration agreed to the early full exercise of the over-allotment option.

3.31 Since the listing of Telstra 3 Instalment Receipts, the Telstra share price has experienced a steady increase (see Figure 3.2).

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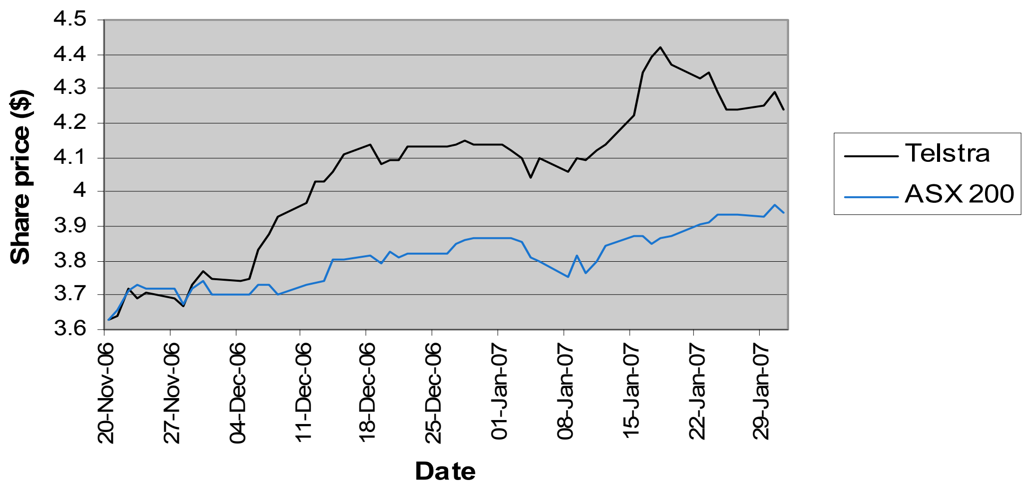
86 In the market stabilisation arrangement letter of 19 November 2006 the three PMJGCs elected to borrow a total of 544 093 373 shares, whilst in the market stabilisation arrangement letter of 4 December 2006 the PMJGCs purchased a total of 554 093 373 shares. Finance advised ANAO in May 2008 that the difference in number of shares borrowed stated is due to a transcribing error in the 19 November 2006 document, and the PMJGCs agreed that the 19 November letter was amended to reflect the correct number.

Figure 3.2

Telstra share price following listing: immediate aftermarket



Source: Analysis of Telstra share price

Settlement

3.32 Settlement of all institutional share allocations occurred on a 'Delivery versus Payment' basis in CHESS[87] via the Australian Securities Exchange. This system provides the Government with same day cleared funds, thus greatly minimising default risk and reducing settlement time frames. In order to facilitate the institutional settlement, the PMJGCs subcontracted the services of a wholly owned subsidiary of one of the PMJGCs to act as the CHESS settlement agent. Portions of the retail offer also used CHESS. The application processing centre, a sub-contractor of the PMJGCs, acted as the Government's CHESS delivery-versus payment settlement agent for the retail firm offer and for any non-firm stamped applications from broker and financial planner clients settled using Delivery versus Payment.

3.33 Under Section 12 of the *Financial Management and Accountability Act 1997* (FMA Act), an official or Minister must not enter into an agreement or

[87] CHESS stands for the Clearing House Electronic Subregister System. CHESS effects the settlement of a trade by transferring the title or legal ownership of the shares while simultaneously facilitating the transfer of money for those shares between participants via their respective banks. This type of settlement is called Delivery versus Payment.

arrangement for the receipt or custody of public money by an outsider[88] unless:

- the Finance Minister has first given a written authorisation for the arrangement; or
- the arrangement is expressly authorised by this Act or by another Act.

3.34 Finance sought advice from AGS in October 2006 in relation to the handling of public money by outsiders. AGS advised that the contractual arrangements then in place between the PMJGCs and the Commonwealth (that is, the PMJGCs' existing contract with the Commonwealth, and the PMJGCs' contract with the application processing centre) did not require a Section 12 authorisation. AGS advised that it would be appropriate for the Commonwealth to enter into a supplementary arrangement with the PMJGCs under which the PMJGCs or subcontractors of the PMJGCs, could receive and have custody of public money on behalf of the Commonwealth. However, prior to entering such a supplementary arrangement, authorisation would need to be obtained either from the Finance Minister or from a delegate of the Finance Minister, pursuant to Section 12.

3.35 Accordingly, on 3 November 2006, the Finance Secretary authorised arrangements for the receipt and custody by the PMJGCs of public money for the Telstra 3 Share Offer via CHESS delivery versus payment processes under Section 12 of the FMA Act.[89] However, ANAO identified one instance where an authorisation under Section 12 was not obtained as required. Specifically, amounts relating to dividends payments for the buffer stock were held in a PMJGC Joint Account. According to the market stabilisation agreement of 9 October 2006, if the PMJGCs or their nominee received any dividends or other benefits as a result of their holding of Buffer Instalment Receipts, they were to hold those dividends or benefits on trust for the Commonwealth. A Section 12 agreement was not provided in relation to this function undertaken by the PMJGCs. In June 2008, Finance commented to ANAO that:

> The purpose of the buffer allocation of instalment receipts (IRs) was for the PMJGCs to transfer those IRs to valid applicants.

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88 For this purpose, outsider means any person other than the Commonwealth, an official or a Minister.

89 On 12 December 2006, the Secretary also authorised arrangements for the receipt and custody of public money via CHESS delivery versus payment processes by the Instalment Receipt Registrar and the Instalment Receipt Trustee under Section 12 of the FMA Act, in relation to prepayments and the final instalment receipts.

Consistent with previous public share offers, in Telstra 3 a pool of IRs was allocated to the PMJGCs to satisfy valid applications by investors which had not been successfully processed at the time of the offer. Guidelines and business rules including correspondence concerning payment of dividends to relevant applicants, were agreed by the PMJGCs and Finance to determine which applications could be valid. Where the business rules were met the PMJGCs transferred the IRs to the applicant, the IRs were allocated as if allocated on 20 November 2006 (under the terms of the offer). Where these transfers took place following the dividend record date the relevant investors were paid the dividend in relation to those IRs.

The legal agreement with the PMJGCs covering the allocation recognised that there could be residual IRs after satisfying all valid applications in which case they were to be returned to the Commonwealth. The agreement was structured on a no cost/no benefit basis. To ensure that the PMJGCs could not access additional benefits such as franking credits the agreement specified that any dividends or other benefits were held on bare trust for the Commonwealth. This arrangement was fully effective in protecting the commercial position of the Commonwealth.

Finance proceeded on the basis that the primary purpose was to hold any dividends on behalf of valid applicants and therefore at that time did not consider it to be public money.

Buffer stock

3.36 Buffer stock is a term used to describe the practice of retaining an unallocated pool of shares following the close of the offer to satisfy investors who, in the issuer's view, have a genuine claim for offer shares but whose application was not processed correctly during the offer. A buffer stock limit of 30 million shares was approved for the retail offer. Finance advised that a buffer stock limit of 6 million shares was approved for the institutional offer, of which 5 867 944 were allocated to eligible investors. [90]

3.37 The application processing centre prepared a report on the processing exceptions following the close of the Telstra 3 share offer period. It identified some 8 620 767 instalment receipts which could potentially result in buffer

[90] Finance further advised ANAO in May 2008 that the remaining 132 056 instalment receipts were sold on market by the PMJGCs at $2.25 per instalment receipt and the proceeds in excess of $2.10 paid to the Commonwealth.

stock allocations. Slightly less than half of these related to broker claims.[91] Of the thirty million buffer instalment receipts approved for the retail offer, 8 138 988 were ultimately used to settle buffer disputes.

3.38 An error occurred during the allocation process for some New Zealand resident retail investors. In regards to this error, Finance advised ANAO in May 2008:

> Under the terms of the offer, New Zealand resident retail investors' first instalment payable was $2.10 per share. However, the instalment receipts allocated in the first buffer stock were allocated at $2.00, including to New Zealand resident retail investors. This resulted in an over-allocation of 16 124 instalment receipts to 76 New Zealand investors. The error was identified in May 2007, following which the application processing centre adjusted the allocations at the correct price which reduced the relevant investors' instalment receipt allocations. Where instalment receipts had been sold the application processing centre returned the equivalent number of instalments receipts to the buffer stock at its own cost. The interim dividend that was paid on 30 March 2007 was based on the over-allocated amount. The application processing centre returned funds equivalent to the amount paid on the over-allocated shares from its own account, including for instalment receipts that had been sold.

Sale proceeds

3.39 In total, the Commonwealth is expected to receive approximately $15.4 billion in sale proceeds from the Telstra 3 Share Offer, of which $8.64 billion was received as payment for the first instalment.

3.40 The final $1.60 instalment was payable on or by 29 May 2008. Instalment receipt holders could prepay the final instalment for some or all of their registered holding on or before 31 March 2008, and received a prepayment discount if they did so.[92] The prepayment discount was calculated by discounting the final instalment amount for the period between the relevant prepayment day (the last day of the month in which payment is received) and

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[91] Finance advised ANAO in May 2008 that Finance paid broker commissions on some of the batches of broker client applications that were included in the first allocation of buffer stock on 29 November 2006, being 3 962 224 instalment receipts allocated to the Australian register and 1 000 188 instalment receipts allocated to the New Zealand register. Finance advised that its decision to pay commission was based on Finance's assessment of the circumstances involved in the Application Processing Centre not being able to include particular batches of broker client applications in the original allocation of 19 November 2006, and if it was clear the broker had caused this situation, then commission was not paid.

[92] Holders with New Zealand registered addresses did not receive the prepayment discount.

the final instalment due date, using the 'reference bond yield'[93] applicable as at the end of the previous month. If applicants under the retail offer elected to prepay the final instalment, they did not receive the bonus loyalty shares on the instalment receipts for which they had prepaid the final instalment. In May 2008, Finance advised ANAO that more than 109 million of the Telstra 3 shares had been paid in full as part of the pre-payment facility.[94]

Future Fund

3.41 It was Government policy that the proceeds of the Telstra Sale be transferred to the Future Fund. The *Future Fund Act 2006* (the Future Fund Act) established the Future Fund. The legislation gives effect to the Government's commitment made during the 2004 federal election to establish a dedicated financial asset fund to meet unfunded superannuation liabilities. According to the Explanatory Memorandum, by accumulating assets to meet liabilities that will become payable at a time when spending pressures associated with an ageing population are likely to hit, the Fund will strengthen the Government's balance sheet and ensure the long-term sustainability of its finances.

3.42 The Future Fund consists of the Future Fund Special Account and investments of the Future Fund. The Future Fund Act grants the Treasurer and the Finance Minister the power to credit cash amounts to the Fund through the Special Account and to transfer financial assets to the Future Fund. In addition, income derived from the investment of the Fund and proceeds upon realisation of an investment are to be credited to the Special Account.

3.43 Amounts can be debited from the Future Fund Special Account in accordance with the purposes of the Account. The major purpose of the Special Account is to discharge unfunded superannuation liabilities from whichever is the earlier of the time when the balance of the Fund is greater than or equal to the target asset level and 1 July 2020. In December 2007, Finance advised ANAO that, as at 30 November 2007, the balance of the fund was $61.5 billion,

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93 The Reference Bond Yield on a particular date means the yield to maturity of the benchmark Commonwealth Government bond 8.75% Coupon, maturing 15 August 2008, published on the Reuters monitor system page 'RBA28' (or any page which replaces that page) at 4.30pm on that day.

94 In one instance, in relation to the February 2007 prepayment it appears that the Reference Bond Yield Rate used was 6.185 per cent rather than the correct figure of 6.180 per cent. This resulted in a reduction in the amount of proceeds received by the Commonwealth of $9 315. Finance advised ANAO in December 2007 that: 'As required by the pre-payment procedures, the Instalment Receipt Registrar advised Finance of the proposed rate which was referred to the Internal Auditor for review. It was necessary to finalise the rate the same day because of the demand for the information from interested shareholders. On subsequent review the variation in the figure became apparent but investors had already been advised.'

including the value of some 2 126 552 392 Telstra shares which have been transferred to the Fund since February 2007.

Table 3.3

Future Fund transfers

Date of transfer	Amount transferred ($)	Ordinary Telstra Shares transferred	Source
5 May 2006	18 000 000 000	N/A	Previously realised surpluses held on deposit with the Reserve Bank of Australia
22 January 2007	10 000 000 000	N/A	2005–06 Budget Surplus
22 January 2007	8 639 000 000	N/A	First instalment of Telstra sale proceeds
16 February 2007	3 638 000 000	N/A	Remainder of the available 2005–06 Budget surplus
28 February 2007	N/A	2 104 657 933	Government's residual Telstra shareholding
22 June 2007	151 000 000	N/A	Telstra 3 sale proceeds including minor residual first instalment receipts, prepayment of second instalment receipts and proceeds from the sale of some residual buffer stock[95]
28 June 2007	N/A	21 894 459	Telstra 1 (33 447 shares) and Telstra 3 buffer stock (21 861 012)
24 August 2007	7 000 000 000	N/A	Part of the realised budget surplus from 2006–07
TOTAL	**47 428 000 000**	**2 126 552 392**	

Notes: The Telstra 1 shares included in the 28 June 2007 transfer were not included in the Telstra 2 share offer in 1998 as Telstra 1 buffer claims were still being dealt with.

Source: ANAO analysis of Finance material including http://www.finance.gov.au/futurefund/transfers.html

3.44 As a result of a direction from the then Finance Minister, subject to certain exceptions, the Future Fund Board of Guardians are not permitted to dispose of any Telstra Shares during the period from and including the date Telstra 3 Instalment Receipts were first listed on the Australian Stock Exchange Limited to and including the date two years after that date (that is until 20 November 2008). The Telstra 3 prospectus stated that a sale or anticipated sale by the Future Fund of Telstra shares could reduce the price of Telstra

[95] Explanatory Statement, Future Fund (Crediting of Additional Amounts) Determination 2007 (No.2).

shares, and could negatively impact the timing and effectiveness of capital raising activities, with an adverse impact on Telstra's cost of capital.

Communications Fund

3.45 Some of the proceeds of the first two Telstra sales were hypothecated for specified purposes.[96] For example, from the proceeds of Telstra 1, $1.1 billion was allocated to establish the Natural Heritage Trust (NHT) with further funding of $250 million allocated to the NHT from the second sale of Telstra shares.[97] The Telstra 2 funding to the NHT was part of $671 million package of 'social bonus' funding that was credited to various special accounts.

3.46 The Telstra 3 scoping study examined the telecommunications regulatory framework. It stated that, given the commitment by the Government to ensure arrangements were in place to guarantee the adequacy of telecommunications services, particularly in rural and regional Australia, it should reiterate its intention to fund any future proofing initiatives for rural and regional areas. It further recommended that the Government should also take steps to ensure that its post-Estens Inquiry policy position of delivering service outcomes through Government funding of programs rather than expansion of the universal service obligation is well understood by stakeholders and investors.

3.47 On 17 August 2005, the then Government announced a $3.1 billion communications program aimed at 'future proofing' telecommunications in regional Australia. This was comprised of the $1.1 billion 'Connect Australia' package (for the roll-out of broadband, new regional clever networks, mobile services and Indigenous telecommunications) and a $2 billion 'Communications Fund' (the earnings from which would be used to provide new communications services for rural Australia, tied to legislated

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96 As noted in Financial Management Guidance No. 7 *Guidelines for the Management of Special Accounts* issued by the then Department of Finance and Administration, Special Accounts provide a useful method for delivering some government activities, particularly where it is desirable to hypothecate funds within the CRF for specified purposes.

97 ANAO examined the financial management of the NHT Special Account in Audit Report No.24 2003–04, *Agency Management of Special Accounts*, Canberra, 30 January 2004. This audit identified significant deficiencies in the financial management of the Account, with the recorded and reported balance of the fund significantly less than the amount that had been credited to the Account. The effectiveness of the administration of the NHT has been examined on a number of occasions, most recently in Audit Report No.21 2007–08, *Regional Delivery Model for the Natural Heritage Trust and the National Action Plan for Salinity and Water Quality*, Canberra, 7 February 2008.

independent reviews of rural, regional and remote telecommunications services).

3.48 The Communications Fund was established by the *Telecommunications (Consumer Protection and Service Standards) Act 1999*, as amended by the *Telecommunications Legislation Amendment (Future Proofing and Other Measures) Act 2005* (Future Proofing Act), which was one of five related bills introduced into the Parliament concerning the final sale of Telstra. This Act required that $2 billion be credited to the Communications Fund on the first business day after the later of:

- the Future Proofing Act receiving the Royal Assent; and
- the *Telstra (Transition to Full Private Ownership) Act 2005* receiving the Royal Assent.

3.49 The Government announced in the 2008–09 Federal Budget that the Communications Fund would be abolished and its funds subsumed into a new Building Australia Fund, which is one of three new infrastructure Funds set to be established by 1 January 2009. The establishment and management of the Communications Fund, including in light of its proposed abolition, is being examined in a separate ANAO performance audit.

Sale costs

3.50 The three Telstra sale transactions were structurally different, spread over a significant timeframe and conducted in substantially different market conditions. In this respect, in March 2008, Finance advised ANAO that:

> Conclusions drawn from comparisons need to reflect these contextual differences. To highlight this important point it should be noted that:
>
> - Telstra 1 was an initial public offering of some 30 per cent of a company which was seen, at the time, to have strong growth prospects.
> - Telstra 2 was a secondary sale of less than 20 per cent in a sector that was a global favourite in the marketplace .
> - Telstra 3 was a change of control disposal of over 30 per cent of a company perceived to be facing significant challenges in generating future growth.

3.51 Nevertheless, the Telstra 3 scoping study used the Telstra 2 sale as the starting point for costing a further sale of Telstra. The scoping study stated that this approach was adopted because:

- costs as a percentage of gross proceeds were significantly reduced in Telstra 2 (1.1 per cent) when compared with Telstra 1 (1.9 per cent) and CBA3 (1.7 per cent);
- as a secondary offering, Telstra 2 was considered a more appropriate benchmark than Telstra 1 for estimating costs for a further Telstra sale; and
- Telstra 2 represented the most recent public share offer the Commonwealth had undertaken and was likely to be viewed as the relevant benchmark by ANAO when comparing costs in a further Telstra sale.

3.52 Based on information obtained by Finance as of April 2008, Telstra 3 sale costs were $204 million (see Table 3.1). These costs were well within the final sale budget of $306.5 million and below the range of sale costs estimated during the scoping study.

3.53 While less than that budgeted, the Telstra 3 sale costs represented a higher percentage of gross sale proceeds (1.3 per cent) than in Telstra 2 (1.1 per cent) but remained lower than in Telstra 1 (1.9 per cent). The costs (as a percentage of gross sale proceeds) were also higher than had been expected at the time of the scoping study (which ranged between 0.8 per cent and 1.1 per cent of gross proceeds). In this latter respect, the increase was, to a large extent, a reflection that actual sale proceeds were significantly less than the figures used in the scoping study.

3.54 The scoping study concluded that, subject to a number of factors including the company undertaking a significant selective buy-back of shares from the Commonwealth, a divestment of the entire remaining Telstra shareholding was possible by the end of calendar 2006. The scoping study estimates of sale costs as a percentage of proceeds were premised on sale proceeds of between $26 billion and $32 billion. However:

- the recommended share buy-back was not undertaken—the scoping study had proposed that Telstra undertake a selective buy-back of part of the Government's remaining shareholding. This was expected to realise gross proceeds of between $5 billion and $12 billion at an estimated fixed cost of $1.9 million; and

- equity offer proceeds at $15.4 billion were below the range of scenarios ($17 billion to $27 billion) on which the scoping study figures were based.[98]

3.55 The reduced sale proceeds from those used by the scoping study were not matched by a similar reduction in aggregate sale costs. A significant reduction was achieved in sale logistics costs, an area that the scoping study saw as offering potential savings, and a number of other costs were maintained at or around the same level as Telstra 2 (including fees and expenses paid to the PMJGC's and the Independent Business Adviser). However, costs increased significantly in relation to:

- the total amount paid for selling commissions and fees. As outlined below, whilst the rates paid for sales to institutional investors were reduced between Telstra 2 and Telstra 3, higher public offer commissions were set as part of a strategy to create demand pressure in the institutional bookbuild through which the offer price was to be set;
- advertising and marketing. In May 2008, Finance advised ANAO that the increased costs of delivering the advertising campaign to achieve the necessary objectives of the Telstra 3 marketing campaign (which comprised the largest element of advertising and marketing costs) reflected increased media rates and changes in media consumption since Telstra 2;
- the overall cost to Finance of legal advice obtained by the department, the PMJGCs and Telstra; and
- reimbursement of costs incurred by Telstra which had increased from no reimbursement in Telstra 1 (costs of $15.3 million) to reimbursement of $6.63 million in Telstra 2 and $21.88 million in Telstra 3. In March 2008, Finance advised ANAO that:

  > In each of the Telstra offers, the level of Australian Government shareholding varied significantly. This, along with other changes to the company's management and operations, fundamentally changed the cost reimbursement equation.
  >
  > …When a shareholder owns 100 per cent of the shares, then no other shareholder interests need to be taken into consideration and no reimbursement of costs is necessary. When the level of majority ownership is

[98] Under the low case demand scenario, gross proceeds included the allocation of the Government's residual shareholding to the Future Fund with an attributed value of $5.00 per share.

> being reduced, but not eliminated, the range of sale cost issues faced by a company is more limited. Where a sale involves a move from majority ownership to a minority or zero position substantial change of control issues arise increasing the range of sale cost pressures faced by the company.

Selling commissions

3.56 Selling commissions and fees typically comprise a significant proportion of sale costs for any share offer. In the Telstra 1 offer, institutional selling commissions and fees were the highest percentage rate paid in any Commonwealth offer, and commissions on broker firm sales were significantly higher than those paid on broker stamped sales to Australian retail investors.[99] In Telstra 2, major reductions were achieved in selling commissions and fees, primarily as a result of the improved tender and contract negotiation procedures implemented as a result of previous ANAO recommendations.[100] In March 2008, Finance advised ANAO that:

> Although tender procedures and contract negotiations are important in determining selling commissions, it should be noted that the marketing environment is another key determinant. The Telstra 2 offer was a smaller offer (in terms of shares on offer) and was conducted amidst a bullish outlook for technology stocks. Because competition for shares was intense, it was more feasible to be able to negotiate lower fees.

Institutional selling fees

3.57 Unlike in the Telstra 2 sale, institutional selling fees were not set at the time of PMJGC appointments. Instead, as part of their tender proposal for the panel[101], tenderers for the PMJGC role, the Additional Joint Global Coordinator (AJGC) role and Additional Syndicate Member roles were required to submit their indicative fees for the provision of global institutional sale and distribution services and a settlement underwriting fee. Having regard to the tendered fees received, Finance then determined a set fee range for institutional sale and distribution services and instalment settlement underwriting. Firms offered a role as a PMJGC were required to execute a contract with the Commonwealth which obliged them to provide the

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99 ANAO Audit Report No.10 1998–99, *Sale of One-third of Telstra*, Canberra, 19 October 1998, p. 110.

100 ANAO Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, Canberra, 30 November 2000, p. 51.

101 Investment banks were invited to participate in a tender process for the establishment of an institutional selling panel, in conjunction with the selection of the PMJGCs.

institutional selling services and first instalment settlement underwriting internationally for a yet to be decided fee within this range.

3.58 Finance set the actual institutional selling fees through a 'refined offer' process in September 2006. Finance requested that all PMJGCS, together with all firms from the institutional selling panel seeking to be appointed to an AJGC role[102], submit a 'refined offer' for selling fees. Based on its evaluation of these submissions, Finance set the institutional selling fees and the first instalment settlement underwriting fee. As indicated in Table 3.4, institutional sales commissions have fallen since the Telstra 1 and Telstra 2 sales.

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[102] Refined offers were requested and received from six firms: Citigroup; Credit Suisse; Deutsche Bank; JP Morgan; Lehman Brothers and Morgan Stanley.

Table 3.4

Comparative commissions and fees

	Telstra IPO (1997)	Telstra 2 (1999)	Telstra 3 (2006)
Transaction Size	$14 241m	$16 045m	$15 400m
Institutional Offer Commissions			
Domestic Institutions	0.8%	0.64%	0.4% and a further 0.04% of the amount of the first instalment for shares sold outside Australia and New Zealand[A]
International Institutions	1.75%[B]	0.84%[C]	
Public Offer Commissions			
Broker stamped	1.10%	0.5%	0.75%[D]
Broker firm	1.45%	0.5%	1.25%[E]
Entitlements	1.10%	Not relevant	See broker stamped
Employee	1.10%[F]	0.00%	Not relevant

Notes:

[A] The 0.4 per cent institutional selling commission was GST inclusive for Australian resident institutions. The 0.04 per cent underwriting fee payable on the first instalment for shares sold outside Australia and New Zealand was GST free. The underwriting fee component did not apply to shares that were the subject of the Over-Allocation Option and associated stock borrowing arrangements.

[B] Comprised a competitive selling commission of 1.05 per cent, management commission of 0.35 per cent and underwriting fee of 0.35 per cent.

[C] Includes 0.08 per cent underwriting fee payable on the first instalment. The underwriting fee component did not apply to shares that were subject to the Greenshoe Over-allotment Option or to the second instalment.

[D] Net of GST but GST-free for New Zealand brokers. Finance advised ANAO in May 2008 that there was no selling commission for entitlements on Telstra 3, but a stamped fee was paid for an entitlement application lodged through a broker.

[E] GST free.

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

Source: Telstra 3 Prospectus, p. 57, Audit Report No.20 2000–01, *Second Tranche Sale of Telstra Shares*, p. 47, Finance documentation and advice.

Retail selling fees

3.59 As for institutional fees, retail fees were not set at the time of the PMJGCs engagement. Finance wrote to a number of brokers and financial planners in May 2006,[103] requesting that the firms provide their views on the level of retail fees that would be appropriate if the Telstra 3 sale went ahead. Following the receipt of these suggestions, and on the assumption that market

[103] Finance also wrote to the three PMJGCs seeking their views.

conditions, the outlook for Telstra and industry attitudes towards the sale of Telstra remained consistent, Finance's Independent Business Adviser recommended in August 2006 that general stamping fees should be 0.75 per cent and broker firm fees should be 1.25 per cent. These recommendations were subsequently agreed by Finance and brokers and financial planners were advised that:

- the 1.25 per cent broker firm fees were not subject to GST; and
- the general stamping fee was subject to GST and brokers/financial planners were to receive a net 0.75 per cent.

3.60 Each of the seven firms who lodged a tender was appointed to the retail selling syndicate. They were expected to provide sales leadership in the areas of marketing to Australian retail advisers and financial planners, bidding for firm shares and encouraging and facilitating the lodgement of retail applications under the entitlement and general public offer streams.

3.61 The commission on broker firm sales was significantly higher than that paid in Telstra 2 (see Table 3.4) but still lower than Telstra 1. This was consistent with the Independent Business Adviser's recommendation that a higher fee level was appropriate in the environment that existed at the time of Telstra 3. In particular, it was believed that a higher fee level would help convince brokers that there was a business case for them to dedicate the necessary resources to analysing and marketing Telstra 3 to their clients, in a difficult market environment. In this context, both the PMJGCs and the Independent Business Adviser advised Finance that, if the market perceived that the broker firm offer had been strongly supported and received a substantial allocation, this would assist in building offer momentum for both the retail and institutional offer.

Broker firm process

3.62 Finance engaged an independent adviser on the broker firm process. The independent adviser was required to advise on and administer firm allocations of Telstra shares to brokers as part of the Australian and New Zealand retail broker firm offers. In particular, they were required to perform the following activities and services:

- provide independent advice on the criteria for allocation of broker firm stock to brokers and financial planners; and
- administer the broker firm allocation process:

- prepare (and sign off on) the broker firm Manuals, in conjunction with the PMJGCs, for both Australia and New Zealand;
- assist in sending out the Manuals and invitations to submit bids;
- collect and process broker firm bids;
- analyse bids and assess them against the agreed allocation criteria;
- make recommendations to Finance on broker firm allocations to brokers and financial planners;
- inform brokers of allocations and deal with inquiries from them; and
- sign off to Finance that the allocation process has been conducted in accordance with agreed criteria and to the highest standards of probity and accountability.

3.63 Under its contract with Finance, Finance's internal auditor was responsible for reviewing the broker firm stock allocations including:

- liaising with the broker firm consultant engaged to advise on the allocation of broker firm stock to brokers and financial planners;
- reviewing the broker firm consultant's allocation criteria and recommendations;
- reviewing broker firm allocations against the allocation criteria for accuracy and consistency with those criteria; and
- reviewing requests from brokers for variations to allocations.

3.64 The Telstra 3 Application Processing Centre first identified that an error may have occurred in the final broker firm allocation process. The broker firm adviser was responsible for sending letters to brokers advising them of their final share allocation, based on a final allocation model. A transcription error with a difference of two million shares appeared to have been made by the broker firm adviser in preparing one of these letters. The error was not identified by Finance's internal auditor in its review of the broker firms stock allocation process.[104] The error resulted in the Commonwealth being obliged to pay a commission rate to the broker on the additional broker firm shares of 1.25 per cent, the highest commission payable in relation to the offer.

3.65 Finance wrote to both the broker firm adviser and Finance's internal auditor advising that the department was seeking to recover the additional amount of commission which it had been obliged to pay to the broker as a result of the error in the broker firm allocations. When writing to the broker firm adviser and Finance's internal auditor, Finance noted that:

> If these shares had not been allocated to *[firm name removed by ANAO]* as part of the broker firm process, they may have either been received as broker stamped applications via *[firm name removed by ANAO]* under the retail offer (in which case a commission rate of 0.75% would be payable), or alternatively (albeit Finance accepts this would be unlikely given the nature of the investors covered by broker firm allocations ie high net worth individuals) being received in the retail offer as "cleanskins" with no commission payable. Based on the above, it seems clear that the error which occurred has at a minimum resulted in the Commonwealth incurring additional broker commission costs of $34 623.

3.66 Finance recovered $34 623 in total from the broker firm adviser and its internal auditor. This was calculated by determining the actual amount paid out in relation to the two million shares, at a commission rate of 1.25 per cent (being $86 558). An amount of $51 935 was then subtracted, being the commission payable on two million shares at a commission rate of 0.75 per cent.

Cost of legal advice

3.67 As noted, Telstra 3 was completed in accordance with the sale timetable, within the overall budget and in a different environment[105] seven years after the previous sale. In June 2008, Finance advised ANAO that the Commonwealth's legal risks in Telstra 3 were substantial given the amount of money, complexities, interests and jurisdictions involved. Finance further

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[104] The internal auditor provided a report on its review of Broker Stock Allocations on 22 October 2006. It stated: '*we have validated: the initial requests were correctly entered in the Master Data Spreadsheet; the Allocation Model was calculating the final allocations correctly; and the confirmation faxes show the correct final allocation.*'

[105] For example, in June 2008 Finance advised ANAO that the introduction of Sarbanes-Oxley in the United States since the Telstra 2 offer in 1999 substantially changed the United States legal requirements and resulted in increased legal compliance costs.

advised that there are a great number of legal compliance matters to be dealt with associated with a large public share offer.

3.68 Against this background, the total cost to Finance of legal advice associated with the Telstra 3 sale was $12.74 million (plus GST) (see Table 3.5), including $3.74 million in legal advice costs reimbursed to Telstra. Excluding these costs, on a comparative basis, the cost paid by Finance for legal advisers to it and the PMJGCs was $9.00 million (plus GST), nearly double the equivalent costs in Telstra 2. The majority of this amount ($8.26 million plus GST) related to professional fees. ANAO notes that professional fees paid for legal advice in the Telstra 3 sale was higher than the project management fee paid to the three PMJGCs ($8.18 million plus GST).

Table 3.5

Telstra 3 legal advice costs paid by Finance

Cost item	$m (plus GST)	$m (plus GST)
Legal advisers to Finance		
In-house counsel	1.15	
Domestic Legal Adviser	4.67	
International Legal Adviser	2.09	
Sub-total		7.91
Legal advisers to the PMJGCs—costs reimbursed by Finance		
Domestic Legal Adviser	0.34	
International Legal Adviser	0.75	
Sub-total		1.09
Legal advisers to Telstra—costs reimbursed by Finance		3.74
Total		**12.74**

Source: ANAO analysis of Finance data

3.69 In Audit Report No.52 2004–05 *Legal Services Arrangements in the Australian Public Service*, ANAO noted that expenditure on legal services had increased by 23 per cent between 1999–2000 and 2003–04. ANAO concluded that growth had predominantly been driven by an increasing volume of legal work performed with periodic increases in the chargeout rates of providers accounting for a smaller proportion of the increase.

3.70 Against this background, the increased cost of legal advice in Telstra 3 compared to Telstra 2 resulted from other factors. Finance paid costs relating to legal work undertaken by nine firms working for the department (three firms including the in-house counsel), the PMJGCs (two firms) and Telstra (four firms).[106] In terms of the amounts paid:

- the cost of legal advice to the PMJGCs reimbursed by Finance remained at a similar level ($1.09 million (plus GST) in Telstra 3 compared to $1.00 million in Telstra 2);[107]
- there were significant increases in the amounts paid by Finance to its Domestic[108] and International Legal Advisers, recognising that Telstra 2 involved a smaller number of shares being offered, over a shorter period of time and in closer proximity to the prior transaction;
- Telstra's legal advisory costs were reimbursed on the same basis as Telstra 2, being that there would be parity with the costs of Finance's domestic and international legal advisers; and
- there were new costs associated with the engagement by Finance of an in-house counsel (an in-house counsel was not engaged for Telstra 2,

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[106] There were four domestic legal advisers paid for by Finance and five international legal advisers. In June 2008, Finance advised ANAO that it differentiates between the in-house counsel role and the three domestic legal advisers to each of the three parties involved in the marketing of Telstra 3 which, as a result of the need for independent advice, required a different firm to be engaged by each party. Finance further advised that the marketing of the offer in jurisdictions other than Australia and the need for independent representation for each of the three parties to fulfil their fiduciary responsibilities could only be achieved through different lawyers being engaged for each party in the key jurisdictions.

[107] In June 2008, Finance advised ANAO that it regards the arrangements in the PMJGC contract for the engagement of legal counsel and the reimbursement of costs under the disbursement caps as an efficient and cost-effective mechanism for resolving a key issue in the engagement of lead managers and limiting the Commonwealth's contingent liabilities arising out of public share offers, notwithstanding that it adds a PMJGC domestic legal adviser and a PMJGC international legal adviser to the legal adviser participant list. Finance further advised that, prior to these arrangements, some prospective lead managers sought indemnities in respect of regulatory and other legal risks, or declined to participate in public offers.

[108] In June 2008, the Domestic Legal Adviser advised ANAO that factors that contributed to the increased costs of domestic legal advice include:

- Telstra 3 was a larger offer in terms of number of shares sold, and at the time the Domestic Legal Adviser tender was undertaken the sale was planned as a potentially even larger offer;
- the extended duration of the engagement, from April 2005 until after November 2006, including some timetable delays during that period;
- additional offer complexity and parallel development of equity-linked and other structured options, Future Fund transfers and capital management options (as well as investigation of various other structural options, including different kinds of buy-back); and
- changes to financial services regulation, licensing and the Corporations Act that occurred in the period between Telstra 2 and Telstra 3 that, among other things, required 're-engineering' of the instalment receipt structure.

although there were costs associated a firm being engaged following a select tender to draft contracts for all advisory engagements[109]).

3.71 In May 2008, the Attorney-General announced[110] the first in a series of reforms to the way the Australian Government purchases legal services, following increases in spending in this area.

Ian McPhee
Auditor-General

Canberra ACT
24 June 2008

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[109] This firm was paid $165 739 for work on contractual matters for the Telstra 1 sale, and $225 460 for Telstra 2.

[110] The Hon Robert McClelland MP, Attorney-General, *First Wave of Reforms to Improve Legal Purchasing*, Media Release, 23 May 2008.

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