

The Auditor-General
Audit Report No.3 2008–09
Performance Audit

Establishment and Management of the Communications Fund

**Department of Broadband, Communications
and the Digital Economy**

Department of Finance and Deregulation

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of Australia 2008

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Canberra ACT
23 September 2008

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Broadband, Communications and the Digital Economy and 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 *Establishment and Management of the Communications Fund*.

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



Steve Chapman
Acting/Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

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

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Abbreviations and Glossary

AGS	The Office of the Australian Government Solicitor
Amending Regulations	The <i>Telecommunications (Consumer Protection and Service Standards)(Communications Fund) Amendment Regulations 2006 (No. 1)</i>
AOFM	The Australian Office of Financial Management
Communications Fund Regulations	The <i>Telecommunications (Consumer Protection and Service Standards)(Communications Fund) Regulations 2005</i>
Consumer Protection Act	The <i>Telecommunications (Consumer Protection and Service Standards) Act 1999</i>
CPGs	The Commonwealth Procurement Guidelines
DBCDE	The Department of Broadband, Communications and the Digital Economy
DCITA	The former Department of Communications, Information Technology and the Arts
Finance	The Department of Finance and Deregulation, formerly the Department of Finance and Administration
FMA Act	The <i>Financial Management and Accountability Act 1997</i>
FMA Regulations	The <i>Financial Management and Accountability Regulations 1997</i>
FMOs	The Finance Minister's Orders
Future Proofing Act	The <i>Telecommunications Legislation Amendment (Future Proofing and Other Measures) Act 2005</i> , which amended the Consumer Protection Act to establish the Communications Fund.

HEEF	The Higher Education Endowment Fund
Initial Authorisation	The <i>Communications Fund Account Investment Authorisation (No. 1 of 2005)</i> , executed by Ministers on 23 September 2005
Investment Guidelines	The long-term investment strategy for the Communications Fund
Nation Building Funds	Three new 'infrastructure Funds' announced in the 2008–09 Federal Budget. Initial funding of \$41 billion is expected to be provided for the three Funds, which are to be established by 1 January 2009 and managed by the Future Fund Board of Guardians.
New Authorisation	The <i>Communications Fund Special Account Investment Authorisation (No. 1 of 2007)</i> , which replaced the Initial Authorisation with effect from 22 January 2007.
OPC	The Office of Parliamentary Counsel
PM&C	The Department of the Prime Minister and Cabinet
Protecting Services Act	The <i>Telecommunications Legislation Amendment (Protecting Services for Rural and Regional Australia into the Future) Act 2007</i>
RBA	The Reserve Bank of Australia
RTIRC	The Regional Telecommunications Independent Review Committee
Telstra Sale Act	The <i>Telstra (Transition to Full Private Ownership) Act 2005</i>
Treasury	The Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. The \$2 billion Communications Fund was established by the previous Government as part of a \$3.1 billion package aimed at 'future proofing' telecommunications in regional Australia (that is, ensuring that people in rural, regional and remote parts of Australia share equitably in the benefits and future advances in technology).¹ It was the then Government's policy² that the Fund exist in perpetuity, thereby ensuring that a source of revenue would always be available to implement responses to reviews of the adequacy of telecommunications in regional, rural and remote areas of Australia.

2. The Communications Fund was established on 23 September 2005, with \$2 billion credited to the Fund three days later. The legislation to establish the Communications Fund was developed in a compressed three week period, to fit in with the timetable for the Telstra sale process. It was necessary for the Telstra sale legislation to be passed as soon as practicable before the end of 2005 in order for the sale of the Commonwealth's remaining Telstra shares to occur by the end of 2006. Amongst other things, this put pressure on the time available for developing the legislation to establish the Communications Fund.

3. The broad legislative approach for the Communications Fund was developed by the then Department of Communications, Information Technology and the Arts (DCITA)³, with some consultation with the Department of the Treasury (Treasury), where a joint Treasury/ Department of

¹ Senator the Hon. Helen Coonan, Minister for Communications, Information Technology and the Arts, *Government Guarantees \$2 billion cash for fund*, Media Release, 11 September 2005.

² Up until September 2007, the \$2 billion principal of the Fund was not protected by specific legislation. However, there were a number of public references made prior to the legislative change in 2007 about the perpetual nature of the Communications Fund. For example, the second reading speech for the legislation that established the Communications Fund referred to the creation of a 'dedicated and perpetual' Fund and the terms of reference for the Senate Environment, Communications, Information Technology and the Arts Committee Inquiry into the provisions of the relevant Bill was to consider 'the establishment of a perpetual \$2 billion Communications Fund'.

³ Prior to the change of Government following the 2007 Federal election and the issuing of a new Administrative Arrangements Order, the Department of Communications, Information Technology and the Arts (DCITA) was primarily responsible for the administration of the Communications Fund. DCITA was abolished following the change of Government, and the new Department of Broadband, Communications and the Digital Economy (DBCDE) is now primarily responsible for the administration of the Communications Fund.

Finance and Deregulation (Finance)⁴ taskforce on establishing the Future Fund was located.⁵ Drafts of the proposed legislation were also provided to Finance.

4. The legislation provides that the Minister for Broadband, Communications and the Digital Economy and the Minister for Finance and Deregulation (Finance Minister) are the responsible Ministers for the Fund.⁶ However, Finance's ongoing involvement with the Fund, following finalisation of the investment arrangements, has been limited to receiving monthly updates of the balance of the Fund's investments, with DBCDE having primary responsibility for the ongoing administration of the Fund. This is consistent with Finance advice to ANAO that the then Minister for Communications, Information Technology and the Arts was assigned the main responsibility for the Fund. DBCDE has advised ANAO that the Ministers, and consequently their departments, have had a joint role in progressing the development of the longer-term investment strategy and governance framework for the Fund, and that only after the strategy and framework were in place did DCITA, on behalf of their Minister, take primary responsibility for the day-to-day administration of the Fund and its monitoring and reporting arrangements.

5. In September 2005, the responsible Ministers authorised the Australian Office of Financial Management (AOFM) to place the \$2 billion fund capital in a term deposit with the Reserve Bank of Australia (RBA). A working group comprising officials from DCITA, Finance and Treasury was then established to develop the longer-term investment strategy and governance arrangements for the Fund, to inform the development of the Investment Authorisation (to be signed by the two responsible Ministers) and the subsidiary Investment Guidelines (issued by DCITA to the AOFM). Treasury has advised ANAO that it was invited to provide input to the group given its experience with the Future Fund.

6. The AOFM was subsequently appointed to manage the investments of the Communications Fund on a long-term basis under the approved

⁴ Prior to the change of Government following the 2007 Federal election and the issuing of a new Administrative Arrangements Order, the Department of Finance and Deregulation was known as the Department of Finance and Administration. The Department is referred to as Finance throughout this report.

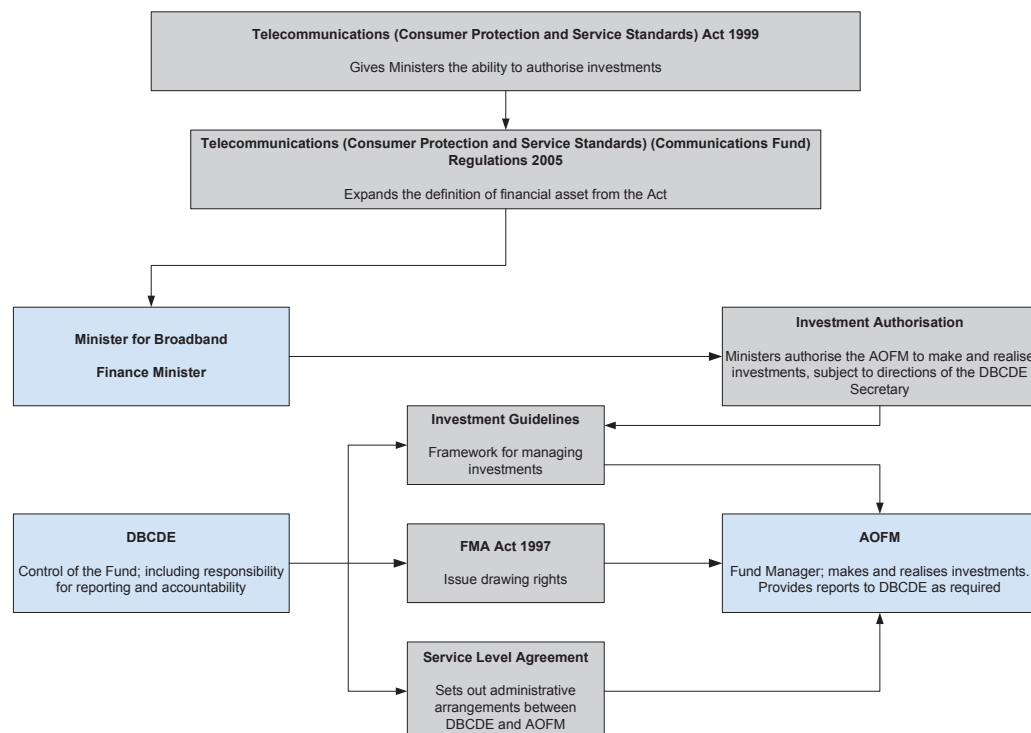
⁵ The drafting instructions for the establishment of the Communications Fund and its investment powers were based on similar provisions contained in an early draft version of the Future Fund Bill 2005. However, the Future Fund Bill was subsequently refined and enhanced.

⁶ Prior to the change of Government following the 2007 Federal election, the responsible Ministers were the Minister for Communications, Information Technology and the Arts, and the Minister for Finance and Administration.

investment strategy (the Investment Guidelines). Figure 1 illustrates the governance arrangements for the Communications Fund.

Figure 1

Communications Fund governance structure



Source: ANAO analysis of DBCDE records.

7. DBCDE's 2007–08 financial statements report the balance of the investments of the Communications Fund as at 30 June 2008 to be \$2.36 billion.

8. In the 2008–09 Federal Budget, it was announced that the Communications Fund would be abolished, with funds being transferred to the Building Australia Fund, which is one of three new 'Nation Building Funds' (or infrastructure Funds) that are set to be established by

1 January 2009.⁷ Initial funding of \$41 billion is expected to be provided by the Government for the three new Funds.

Audit scope and objective

9. The objective of the audit was to assess the effectiveness of the management and administration of the Communications Fund, including an assessment of:

- the development and implementation of appropriate investment strategies; and
- the robustness of the governance structures and controls relating to investment activities.

10. Audit fieldwork was conducted in DBCDE and the AOFM, as well as Finance, Treasury and the Department of the Prime Minister and Cabinet (PM&C).⁸ In addition, ANAO consulted with and examined relevant records held by the consultant engaged by DCITA to advise on financial products and an earning rate benchmark for the Communications Fund. ANAO engaged Applied Financial Diagnostics to assist in assessing agencies' approach to managing and investing the Communications Fund, including the development and implementation of investment strategies for the Fund.

Audit conclusions

11. The then Government's policy of having the Communications Fund exist in perpetuity meant that the policy intent was to maintain the Fund's nominal \$2 billion value, with all earnings on the Fund to be available for expenditure on regional telecommunications. This policy intent was recognised by the Senate Environment, Communications, Information Technology and the Arts Committee in its recommendation (agreed to by the then Government) that the Fund be established with cash, not Telstra shares, as well as by agencies in establishing the arrangements for the

⁷ It was announced that the new Funds would be managed by the Future Fund Board of Guardians (the Board), whose primary role is to set the strategic direction of the investment activities of the Funds under its management (currently the Future Fund and Higher Education Endowment Fund) consistent with the Investment Mandate for each Fund. The Board is supported in its functions by the Future Fund Management Agency (FFMA), an FMA agency in the Finance and Deregulation portfolio. The FFMA is responsible for the development of recommendations to the Board on the most appropriate investment strategy for each fund and for the implementation of these strategies. All administrative and operational functions associated with the management of the Funds are undertaken by the FFMA. Source: <www.futurefund.gov.au> [accessed on 10 June 2008].

⁸ PM&C provided advice to the former Prime Minister on the extent of the investment powers for the Communications Fund and the appointment of the AOFM as the fund manager.

Communications Fund.⁹ However, DBCDE advised ANAO that, in the compressed time that was available to establish the enabling legislation for the Communications Fund, it was not possible to obtain expert advice on how the Fund should be best invested to meet the policy intent of a perpetual fund with the purpose of providing an ongoing funding stream for expenditure on regional telecommunications. In addition, Finance has advised ANAO that, at that time, special expertise in managing financial asset funds was being established within Finance.

12. Against this background, DCITA advised the then Minister for Communications, Information Technology and the Arts that the legislation should enable a broad range of instruments to be purchased, rather than being limited to fixed interest and like products, in order to retain flexibility so as not to limit the future investment strategy for the Fund. The proposed broad range of investments represented a significant departure from the categories of conservative investments authorised by the *Financial Management and Accountability Act 1997* (FMA Act). Treasury raised issues about the breadth of the proposed categories of investments, but these issues were not addressed by DCITA.¹⁰

13. After the legislation was passed, a firm was engaged by DCITA, with the assistance of Finance and Treasury,¹¹ for three weeks to provide investment strategy advice. However, the approach taken was not consistent with the earlier decision that broad legislative investment powers were necessary to enable wide consideration of investment options. Specifically:

- the consultant was required to provide advice on investments to be included in a fixed interest portfolio; and
- the consultant was advised that the Fund was to invest only in low risk assets and to be able to realise investments within three months.

14. The three agencies represented on the working group have each advised ANAO that a key consideration for the working group was the then Minister for Communications, Information Technology and the Arts' public statement that the Fund would earn, from day one, a rate not less than the cash

⁹ Up until September 2007, the perpetual nature of the Fund was not recognised in the establishing legislation.

¹⁰ See further at paragraph 19.

¹¹ The evaluation panel comprised a representative from each of DCITA, Finance and Treasury. The decision on which firm to appoint was made by DCITA, with the contract signed by DCITA on behalf of the Australian Government.

rate.¹² Agencies have further advised that these investment parameters focused the working group on designing an investment mandate that ensured a high level of certainty in achieving at least the cash rate, and limiting the probability of realising a negative return in the period leading up to the first telecommunications review. As a result, the working group pursued an investment strategy comprising conservative and low-risk assets, rather than examining the merits of investing in the full range of assets permitted by the legislation.

15. Subsequently, through the Investment Authorisation, signed by the two responsible Ministers, and the Investment Guidelines issued by DCITA, the Communications Fund has been restricted to investing in a portfolio of low risk, highly liquid, fixed interest assets. This approach closely aligns with the approach adopted for entities investing under the FMA Act and is also more consistent with the policy that the Fund be perpetual in nature. This outcome, which reflects a prudent approach, emphasises the importance of agencies having greater regard to the principles that underlie the existing financial framework before proposing significant departures from it. In this context, Treasury has advised ANAO that its concerns about the legislation were subsequently addressed through the administrative arrangements put in place for the Fund.

16. In the 2008–09 Federal Budget, the Government announced that the new infrastructure Funds are to reside in the Finance and Deregulation portfolio, where experience has been gained from the establishment of the Future Fund and Higher Education Endowment Fund (HEEF). In addition, the timeframe for the establishment of the new infrastructure Funds is considerably longer than was available for the Communications Fund. These different circumstances should be of value in delivering more robust and timely investment arrangements for the infrastructure Funds that reflect the policy intent for the Funds.

¹² At the same time, the then Minister for Communications, Information Technology and the Arts had stated that an investment mandate would be developed and that this mandate and the investments would ensure that the amount earned on the \$2 billion would grow and be available for investment and use in response to the recommendations of regional telecommunications inquiries.

Key findings by chapter

Chapter 2—Development of the Legislative Framework

17. The legislation establishing the Communications Fund stated that the provisions of the FMA Act that typically govern the investment of public funds do not apply to the Communications Fund. As noted in ANAO Audit Report No.22 of 2004–05, *Investment of Public Funds*, during the development of the FMA Act, the Joint Committee of Public Accounts and Audit re-assessed the types of investments it considered appropriate for the different nature of Commonwealth entities and concluded that, with the exception of Government Business Enterprises and Statutory Marketing Authorities, entities should be required to invest funds conservatively.

18. By way of comparison to the FMA framework, the legislation establishing the Communications Fund broadly defines a financial asset. Specifically, in addition to the types of investments permitted under the FMA Act, the legislation permits the Communications Fund to be invested in:

- debentures or stocks issued by a government;
- shares in, or debentures of, other bodies;¹³
- an interest in a managed investment scheme; and
- a derivative (either to protect or enhance the value of, or return on, an investment).

19. On two occasions during the development of the legislation, Treasury raised with DCITA issues relating to the proposed breadth of the permissible investments when the Fund's purpose was to produce an income stream to be spent on regional telecommunications. Treasury's concerns were not addressed by DCITA in the drafting of the legislation. DBCDE has advised ANAO that:

- it was not apparent to DCITA that the first Treasury correspondence was raising concerns. The Treasury correspondence had advised DCITA that, from the perspective that sections of the proposed legislation relating to the Communications Fund had been largely

¹³ It is noteworthy that the then Government's initial proposal to constitute the Fund with Telstra shares was not supported during the passage of the legislation because of concerns that the value of the Fund would have fluctuated as the Telstra share price moved. The Bill to establish the Communications Fund was subsequently amended to require \$2 billion in cash to be credited to the Fund but the list of authorised investments continued to permit the purchase of shares.

copied from the draft Future Fund Bill, Treasury had no concerns with the content, noting that the Communications Fund legislation would allow the Fund to be invested in a broad range of financial assets.¹⁴ The correspondence also asked DCITA for advice on the process, timing and means for addressing the investment objective, the extent of the capital contribution and how the perpetual nature of the Fund would be preserved, as these issues had not been addressed in the draft Bill and Treasury assumed that many of these issues would be raised when the Bill was introduced. However, there is no record of DCITA responding to Treasury; and

- there was insufficient time to address the concerns raised in the second Treasury correspondence, as within hours of the time Treasury's comments were received, the then Minister for Communications, Information Technology and the Arts had requested policy approval from the then Prime Minister, Treasurer and Minister for Finance and Administration. The second Treasury correspondence reiterated that Treasury had concerns with the broad range of powers in relation to the Fund being put up for Parliamentary approval without a framework about how the investment of the Fund would operate, and that there was no mechanism to ensure the perpetual nature of the Fund.

20. DBCDE has also advised ANAO that it was not possible, in the time available to develop the legislation, for it to seek expert external advice on the investment powers. Finance was not heavily involved in the development of the legislation and, in any event, has advised ANAO that special expertise in managing financial asset funds was being established in Finance at that time. Treasury has advised ANAO that its concerns were subsequently addressed through the administrative arrangements put in place for the Fund.

Chapter 3—Development of the Investment Strategy

21. A sound investment strategy for a fund like the Communications Fund should be underpinned by a solid understanding of the purposes for which the

¹⁴ The Communications Fund Bill was based on an early draft of the proposed Future Fund legislation. The Future Fund Bill was introduced in the Parliament three months after the Communications Fund legislation was passed. The Future Fund legislation has a more constrained approach to the use of derivatives than was initially proposed for the Future Fund and used in the Communications Fund legislation.

Fund's earnings are to be used and the amount of, and timeframes for, future drawdowns of these earnings.

22. As a result of amendments to the proposed Communications Fund legislation requiring the Fund to be established immediately after the passage of that legislation and Telstra sale legislation, rather than following the completion of the Telstra sale (as had originally been proposed), there was no investment strategy in place for the Fund at the time of its inception. As an interim measure, Ministers authorised the AOFM to invest the \$2 billion principal of the Fund in a six-month term deposit with the Reserve Bank of Australia (RBA). This was intended to provide sufficient time for longer term investment arrangements to be developed for the Fund.

23. Against the background of DCITA being unable to obtain expert advice when the legislation was being developed due to time constraints, the working group (comprising officials from DCITA, Finance and Treasury) concluded that, in developing a long term investment strategy for the Fund, independent expert advice would be sought. DCITA engaged an asset consultant, with the assistance of Finance and Treasury, but the value of the contract was limited (a \$10 000 fee for advising on an investment strategy for a \$2 billion perpetual fund).

24. Ministers had decided that the legislation should be drafted so as to not limit the authorised investments to fixed interest or like products, with the various alternatives possible under the legislation to be investigated after its passage. However, the consultant was restricted to considering a portfolio of low risk, highly liquid, fixed interest assets.¹⁵ As noted at paragraph 14, the three agencies represented on the working group have each advised ANAO that a key consideration for the working group was the then Minister for Communications, Information Technology and the Arts' public statement that the Fund would earn, from day one, a rate not less than the cash rate.

25. Implementation of the longer term investment strategy for the Communications Fund required a new authorisation instrument to be made by Ministers. DCITA and Finance first advised Ministers in March 2006 that a new instrument would be required to be executed. However, it took more than nine months for the new instrument to be prepared by agencies for Ministers

¹⁵ DCITA also did not provide the consultant with an expected drawdown profile for the fund, further complicating the consultant's task. For example, Ministers had been advised that no drawdowns were expected to be required before 2009, but this information was not provided to the consultant.

to sign.¹⁶ In addition, there were significant delays in establishing the long term investment strategy for the Fund (referred to as the Investment Guidelines). The Investment Guidelines were not finalised until June 2007, 15 months after the initial six month term deposit had matured. Although its Minister is one of the two responsible Ministers, Finance is not a party to the Investment Guidelines and has not been involved in overseeing the ongoing investment activities of the Fund.

26. In addition, the Investment Guidelines issued by DCITA restrict the investment of the Communications Fund further below the limits authorised by Ministers (in terms of credit risk¹⁷ and tenor¹⁸ limits). They also do not reflect the intended perpetual nature of the Fund (with the Guidelines requiring both the principal and interest of the Fund to be able to be liquidated within three months). These approaches have potentially limiting effects on the investment returns able to be achieved by the Fund. However, the potential impacts of these approaches on Fund returns was not analysed in developing the investment strategy.

Chapter 4—Investment Activities of the Fund

27. The AOFM is required by the Investment Guidelines to focus on maximising investment returns for the Fund within the parameters set. The working group's views on the import of statements made by Ministers¹⁹ led to tight parameters surrounding the investment of the Communications Fund.

28. There were also a number of aspects of the approach being taken in investing the Communications Fund which, within the conservative investment approach adopted for the Fund, have potentially further restricted investment returns. In particular, authorisation instruments and investment instructions to the AOFM were not updated in a timely manner in light of revised mandates set by Ministers. As a result, the Communications Fund was restricted to investing in RBA term deposits for an extended period, although Ministerial mandates and authorisations permitted investment in a broader

¹⁶ DBCDE has advised ANAO that changes to the Regulations needed to be made during this period, as well as the then Ministers obtaining the then Prime Minister's approval for their chosen course of action.

¹⁷ Credit risk is the risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction.

¹⁸ The tenor of an investment is its time to maturity, or the investment term.

¹⁹ See paragraph 24.

range of instruments which could have been expected to provide higher returns.²⁰

Agency responses

29. DBCDE's full response to the audit is included at Appendix 1. In addition, each of DBCDE, the AOFM, Finance and Treasury provided summary responses to the audit, as follows.

DBCDE

30. The Department of Broadband, Communications and the Digital Economy notes that the ANAO has concluded that the investment approach taken for the Communications Fund (the Fund) closely aligns to the approach adopted for entities investing under the *Financial Management and Accountability Act 1997*, is more consistent with the policy that the Fund be perpetual in nature, and reflects a prudent approach.

31. The Department of Communications, Information Technology and the Arts consulted with the Department of Finance and Administration and Treasury in the development of the Fund legislation which occurred in a compressed timeframe and worked jointly with them in the development and implementation of investment arrangements. The investment approach was developed having regard to commitments made by the Government during Parliamentary debate and was progressed in a careful and considered manner given the significant funds involved and the complex processes required.

32. As the first significant fund of its type, each of the agencies was required to build a base of expertise and carefully develop relevant legislative and Ministerial instruments while managing the Fund which had been established 17 months earlier than reflected in the originally introduced bill. The process has resulted in a soundly managed Fund that has consistently met or exceeded its investment targets.

AOFM

33. The AOFM has no general comments on the report.

²⁰ By way of comparison, agencies investing amounts standing to the credit of special accounts under the provisions of Section 39 of the FMA Act and FMA Regulation 22 are able to invest in a broader range of conservative financial instruments than just term deposits. All of these instruments are permitted for the Communications Fund under the relevant legislation and regulations, but were not authorised by Ministers until January 2007.

Finance

34. Finance notes the report's review and findings. Finance agrees with both recommendations, noting that the approach to the Communications Fund, and its timing, was in the context of the Telstra sale legislation. Consequently, the Communications Fund's governance structure and investment arrangements are different to other funds since established, such as the Future Fund.

35. The existing framework that supports the Future Fund and the Higher Education Endowment Fund will assist with establishing the Government's policy for the Nation Building funds.

Treasury

36. The Treasury welcomes the work undertaken by the ANAO to assess the effectiveness of management and administrative arrangements relating to the Communications Fund.

37. Regarding the investment arrangements for the Communications Fund, Treasury notes that a key consideration for the working group was the Government's public statement that the Fund would be invested in low-risk assets and would earn, from day one, a rate not less than the cash rate. These investment parameters focused the working group on designing an investment mandate that ensured a high level of certainty in achieving at least the cash rate, and limiting the probability of realising a negative return in the period leading up to the first RTIRC meeting. As a result, the working group pursued an investment strategy comprising conservative and low-risk assets, rather than examining the possible investment returns that could have been achieved by investing in the full range of assets that are permissible under the *Telecommunications (Consumer Protection and Service Standards) Act 1999*.

Recommendations

Set out below are ANAO's recommendations and agencies' abbreviated responses. More detailed responses are shown in the body of the report immediately after each recommendation.

Recommendation No. 1

Paragraph 2.21

ANAO *recommends* that, in future circumstances where it is proposed to seek legislative authority for the purchase of investments with higher risk than those permitted under the Financial Management and Accountability Act framework, agencies:

- (a) assess the benefits and risks of the proposed approach so as to provide well-informed advice to the Government; and
- (b) consult with the Department of the Treasury and the Department of Finance and Deregulation.

Agency responses: *Agreed.*

Recommendation No. 2

Paragraph 3.29

ANAO *recommends* that, in future circumstances where agencies are seeking investment advice for asset funds, they provide:

- (a) the selected advisor with a clear statement as to the parameters within which the funds are to be invested and accessed; and
- (b) Ministers with advice that addresses the merits of possible investment approaches.

Agency responses: *Agreed.*

Audit Findings and Conclusions

1. Introduction

This chapter sets out the background to the establishment of the \$2 billion Communications Fund and the audit objective and approach.

Background

1.1 In accordance with the Coalition's election commitments from the 1998 and 2001 Federal elections to not take further steps towards the sale of Telstra Corporation Ltd until it was satisfied that services in regional, rural and remote Australia were adequate, the former Government established two inquiries into the adequacy of telecommunications services in Australia.²¹ The reports from each inquiry (released in September 2000 and November 2002) found that there remained areas where services were not adequate or where improvements needed to be made. In response to each inquiry report, the then Government announced funding packages to implement the reports' recommendations and improve telecommunications services in regional, rural and remote Australia.

1.2 In August 2005, the then Government announced its intention for the final sale of Telstra to proceed. However, to ensure that the legislation enabling the sale was passed, the ongoing concerns expressed by the National Party relating to the adequacy of telecommunications in regional Australia needed to be addressed. One of the then Government's responses to those concerns was the establishment of a multi-billion dollar trust fund to pay for improvements to telecommunications services in the bush.²²

1.3 In this context, on 17 August 2005, the then Government announced a \$3.1 billion communications program aimed at 'future proofing' telecommunications in regional Australia (that is, ensuring that people in regional, rural and remote Australia share equitably in the benefits and future advances in technology). This program comprised:

²¹ The establishment of the Telecommunications Service Inquiry was announced on 19 March 2000. The establishment of the Regional Telecommunications Inquiry was announced on 16 August 2002.

²² *Joyce maintains tough T3 stand*, 10 August 2005, <<http://www.theage.com.au>>, [accessed on 5 November 2007].

- the \$1.1 billion ‘Connect Australia’ package, for the roll-out of broadband, new regional clever networks, mobile services and Indigenous telecommunications;²³ and
- a perpetual \$2 billion ‘Communications Fund’, the earnings from which would be used to provide new communications services for rural Australia, tied to legislated independent reviews of rural, regional and remote telecommunications services.²⁴

1.4 In early September 2005, five related Bills were introduced to the Parliament relating to the final sale of Telstra. On 6 September 2005, the Senate resolved that the Bills, or provisions of the Bills, be referred to the Environment, Communications, Information Technology and the Arts Committee,²⁵ for inquiry and report by 12 September 2005. Included in the Bills referred to the Committee were the Telstra (Transition to Full Private Ownership) Bill 2005 and the Telecommunications Legislation Amendment (Future Proofing and Other Measures) Bill 2005 (Future Proofing Bill). In presenting the latter to the Parliament,²⁶ the then Government stated that the creation of a dedicated and perpetual fund of \$2 billion from the proceeds of the final sale of Telstra would provide an ongoing income stream to fund government responses to any recommendations proposed as a result of regular reviews into the adequacy of regional telecommunications.²⁷

1.5 In examining the five Bills (or provisions of the Bills), the Committee was only to consider four issues—one of which was ‘the establishment of a perpetual \$2 billion Communications Fund’. In its report, the Committee made two recommendations:

²³ Stage 1 of the Broadband Connect Program, which was the major component of the Connect Australia package, was examined in ANAO Audit Report No.36 of 2006-07, *Management of the Higher Bandwidth Incentive Scheme and Broadband Connect Stage 1*. ANAO also undertook a preliminary review of the Broadband Connect Infrastructure Program (BCIP) in July 2007 in response to concerns raised by the then Shadow Minister for Communications and Information Technology about the probity of information provided to applicants under the program. Funding for the BCIP was rescinded in the 2008–09 Budget.

²⁴ Senator the Hon. Helen Coonan, Minister for Communications, Information Technology and the Arts, *Connect Australia: A Plan to Future Proof Telecommunications*, Media Release, 17 August 2005.

²⁵ The Bills were to be referred to the Committee at ‘whatever stage the Bills have reached at the end of the time available for the consideration of government business on 8 September 2005’.

²⁶ Mr Peter McGauran, ‘Second reading speech: Telecommunications Legislation Amendment (Future Proofing and Other Measures) Bill 2005, House of Representatives, 7 September 2005.

²⁷ Similar provisions relating to regular reviews of regional telecommunications services had been included in the Telecommunications Legislation Amendment (Regular Reviews and Other Measures) Bill 2005, which was superseded by the Future Proofing Bill. That earlier Bill was passed by the Senate with amendments on 24 June 2005, but those amendments had not been considered at the time the Future Proofing Bill was introduced.

- that the Future Proofing Bill be amended to specifically require that \$2 billion in cash be transferred to the Communications Fund; and
- subject to the first recommendation, that the Bills be agreed to.

1.6 The Committee's first recommendation was significant, as there had been a number of concerns raised that the Bill as presented to the Parliament provided for the \$2 billion Communications Fund to be composed of various financial assets, including Telstra shares. The value of the Fund would therefore have fluctuated with the price of the shares held by the Fund. The Committee's first recommendation was accepted, and the Future Proofing Bill was amended accordingly.²⁸

1.7 A further amendment was made to the Future Proofing Bill making it a requirement for the \$2 billion in cash to be credited to the Communications Fund on the first business day after the later of the *Telecommunications Legislation Amendment (Future Proofing and Other Measures) Act 2005* (Future Proofing Act) and the *Telstra (Transition to Full Private Ownership) Act 2005* (Telstra Sale Act) received Royal Assent. This amendment had the effect that the transfer of the \$2 billion to the Communications Fund was not dependent on the timing of the sale of Telstra, as had been originally proposed by the then Government, but would occur once legislation enabling the sale was in place.²⁹

1.8 Each of the five Bills was passed by the Parliament within a week of being introduced. The Future Proofing Act and the Telstra Sale Act were each assented to on 23 September 2005.

The Communications Fund

1.9 The Communications Fund was established under Section 158ZG of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* (Consumer Protection Act), as amended by the Future Proofing Act. Section 158ZG provides that the Fund consists of:

- the Communications Fund Special Account (established under Section 158ZH of the Act); and
- the investments of the Fund (which are held outside the Special Account).

²⁸ A number of other amendments were also made to the Future Proofing Bill.

²⁹ DBCDE has advised ANAO that this timing change effectively removed what would have been a 17 month period for the investment strategy and associated instruments to be developed.

1.10 A Special Account is a mechanism used to record amounts in the Consolidated Revenue Fund that are set aside for specified purposes. The *Financial Management and Accountability Act 1997* (FMA Act) provides an appropriation for the purposes of each Special Account, up to the balance of the Special Account for the time being.³⁰ The purposes of the Communications Fund Special Account are outlined in Section 158ZI of the Consumer Protection Act as follows:

- implementing the Commonwealth Government's response to any of the recommendations set out in a report under Section 158Q (being a report of the Regional Telecommunications Independent Review Committee (RTIRC)),³¹ so long as the response relates to telecommunications services in regional, rural or remote parts of Australia;
- a purpose incidental or ancillary to the above purpose; and
- the making of grants of financial assistance for either of the above purposes.

1.11 As noted above, \$2 billion in cash was required by legislation to be credited to the Special Account. This occurred on 26 September 2005, being the first business day after the Future Proofing Act and the Telstra Sale Act were assented to.

1.12 On 24 September 2007, the *Telecommunications Legislation Amendment (Protecting Services for Rural and Regional Australia into the Future) Act 2007* (Protecting Services Act) received Royal Assent. This Act amended the Consumer Protection Act to provide that the Minister for Broadband, Communications and the Digital Economy must take all reasonable steps to ensure that the sum of the amounts standing to the credit of the Special Account and the value of the investments of the Communications Fund does not fall below \$2 billion. The Explanatory Memorandum to the Bill for the Protecting Services Act stated that it was the then Government's intention that the Communications Fund be a perpetual fund with the principal of the fund maintaining at least its nominal value of \$2 billion, and that the introduction of

³⁰ See also ANAO Audit Report No.24 2003–04, *Agency Management of Special Accounts*, Canberra, 30 January 2004.

³¹ The RTIRC was established under Section 158R of the Consumer Protection Act (as amended by the Future Proofing Act). The primary function of the RTIRC is to conduct reviews of the adequacy of telecommunications services in rural, regional and remote parts of Australia. The first RTIRC review commenced on 14 August 2007, and the committee is expected to develop a comprehensive report for the Australian Government to consider in late 2008.

the new provision into the Consumer Protection Act would ensure that the only money available to be spent for the purposes of the Special Account would be income or interest earned on investments of the Fund.

1.13 Following the 2007 Federal election, the new Government introduced legislation on 13 February 2008 to access the Communications Fund, including the capital, for the National Broadband Network.³² The Government subsequently announced in the 2008–09 Federal Budget that the Communications Fund would be abolished. It was announced that the balance of the Fund would be subsumed into the Building Australia Fund, which is one of three new ‘Nation Building Funds’ (or infrastructure Funds) set to be established by 1 January 2009. It was also announced that initial funding of \$41 billion is expected to be provided for the three Funds.³³

Investments of the Communications Fund

1.14 As noted, the Communications Fund consists of two separate parts—the Special Account, and the investments of the Fund. Section 39 of the FMA Act, which usually governs the investment of amounts standing to the credit of a Special Account, does not apply to the Communications Fund. Instead, the Consumer Protection Act provides the authority for the investment of the Fund and sets out the types of investments that are permitted to be made, on authorisation by the responsible Ministers.³⁴ The *Telecommunications (Consumer Protection and Service Standards)(Communications Fund) Regulations 2005* (Communications Fund Regulations) set out further financial assets in which the responsible Ministers may authorise the Fund to invest. Since the Communications Fund was established, there have been two Ministerial investment authorisations made for the Fund. The investment mandate is discussed in Chapter 3.

1.15 In its 2006–07 Annual Report, the then Department of Communications, Information Technology and the Arts (DCITA) reported the balance of the investments of the Communications Fund as at 30 June 2007 to be \$2.22 billion, reflecting the receipt of reported interest earnings of \$84.5 million in 2005–06

³² The then Opposition had announced in March 2007 that this was its policy intent for the Fund.

³³ It was also announced in the 2008–09 Budget that up to \$400 million in funding for the Government’s response to the first review of the RTIRC would be expected to be made available from the Building Australia Fund.

³⁴ The Consumer Protection Act sets out three separate special appropriations for the investment of the Communications Fund. This is an uncommon practice, as Section 39 of the FMA Act usually provides the appropriation authority for the investment of the balance of a Special Account, where this power has been delegated by the Finance Minister. This is discussed in more detail in later chapters.

and \$131.5 million in 2006–07 from the investments of the Fund. DBCDE’s 2007–08 financial statements report the balance of the investments of the Communications Fund as at 30 June 2008 to be \$2.36 billion.

Agency responsibility for the Communications Fund

1.16 Under the Consumer Protection Act, there are two Ministers responsible for the Communications Fund. These are:

- the Minister administering the FMA Act (currently the Minister for Finance and Deregulation (Finance Minister)); and
- the Minister administering the Consumer Protection Act (currently the Minister for Broadband, Communications and the Digital Economy (Minister for Broadband)).³⁵

1.17 The Minister for Broadband administers the legislation governing the operations of the Communications Fund. Accordingly, the Department of Broadband, Communications and the Digital Economy (DBCDE)³⁶ is the Australian Government department with primary responsibility for the day-to-day administration of the Communications Fund. In June 2008, the Department of Finance and Deregulation (Finance)³⁷ advised ANAO that:

Expertise [*in managing financial asset funds*] was being established within Finance at [the time the Communications Fund was being established]. The Future Fund policy unit in Finance was not established until after the creation of the Communications Fund. ...the broad legislative approach was developed by DBCDE in consultation with the Treasury, where a joint Treasury/Finance taskforce on establishing the Future Fund was located at that time.

1.18 To progress the development of the longer-term investment strategy and governance arrangements for the Communications Fund, a working group was established to examine the investment and management options for the

³⁵ At the time the legislation was made, the responsible Ministers were the Minister for Finance and Administration and the Minister for Communications, Information Technology and the Arts.

³⁶ Prior to the change of Government following the 2007 Federal election and the issuing of a new Administrative Arrangements Order, the Department of Communications, Information Technology and the Arts (DCITA) was responsible for the Communications Fund. DCITA was abolished following the change of Government.

³⁷ Prior to the change of Government following the 2007 Federal election and the issuing of a new Administrative Arrangements Order, the Department of Finance and Deregulation was known as the Department of Finance and Administration. The Department is referred to as Finance throughout this report.

Fund, comprising officials from DCITA, Finance and the Department of the Treasury (Treasury).³⁸

1.19 The Australian Office of Financial Management (AOFM) was commissioned to undertake an operational role to implement the initial interim investment strategy for the Communications Fund.³⁹ The AOFM was not involved as part of the working group in developing a longer term investment strategy for the Communications Fund, but was requested by the working group to develop a paper regarding the AOFM's ability to manage the Fund's investments in the longer term. Subsequently, the AOFM was authorised by the responsible Ministers to manage the investments of the Communications Fund under the approved investment strategy.⁴⁰

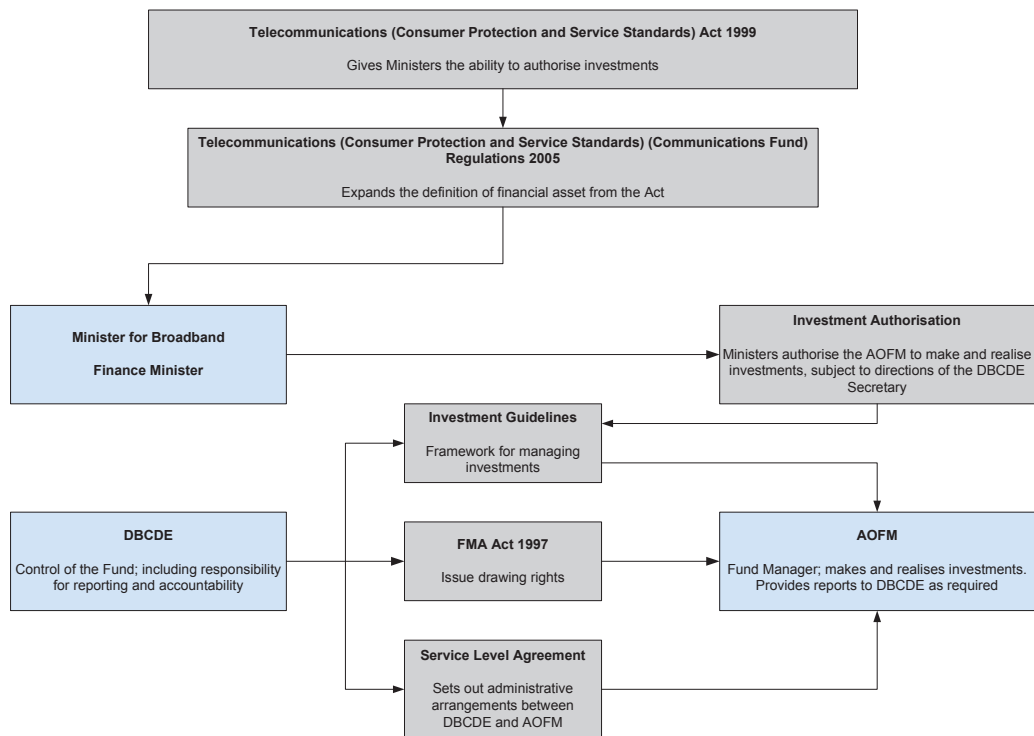
1.20 Figure 1.1 shows the broad governance structure for the Communications Fund. As illustrated by Figure 1.1, although there are two responsible Ministers, Finance has had no substantive ongoing involvement in the investment activities of the Fund under the Service Level Agreement between DCITA/DBCDE and the AOFM.

³⁸ Treasury advised ANAO in May 2008 that it was invited to provide input to the group given its experience with the Future Fund.

³⁹ Upon the crediting of the \$2 billion to the Communications Fund Special Account, the AOFM was authorised by the responsible Ministers to invest the \$2 billion in a term deposit with the Reserve Bank of Australia (RBA).

⁴⁰ Australian Office of Financial Management, Annual Report 2006–07, p. 29.

Figure 1.1
Communications Fund governance structure



Source: ANAO analysis of DBCDE records.

Audit objective and approach

1.21 The objective of the audit was to assess the effectiveness of the management and administration of the Communications Fund, including an assessment of:

- the development and implementation of appropriate investment strategies; and
- the robustness of the governance structures and controls relating to investment activities.

1.22 Fieldwork for the audit was conducted between January and April 2008. The audit examined the establishment of the Communications Fund, the management of the Fund’s investments, and the governance structures and controls in place for the ongoing management of the fund and its investments. Audit fieldwork was conducted in DBCDE and the AOFM, as well as Finance, Treasury, and the Department of the Prime Minister and

Cabinet (PM&C).⁴¹ In addition, ANAO consulted with and examined relevant records held by the consultant that was engaged by DCITA to advise on financial products and an earning rate benchmark for the Communications Fund. ANAO engaged Applied Financial Diagnostics to assist in assessing agencies' approach to managing and investing the Communications Fund, including the development and implementation of investment strategies for the Fund.

1.23 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of \$395 000.

⁴¹ PM&C provided advice to the former Prime Minister on the investment powers for the Communications Fund and the appointment of the AOFM as the fund manager.

2. Development of the Legislative Framework

This chapter examines the development of the legislative framework for the establishment of the Communications Fund and its investments.

Development and passage of governing legislation

2.1 On 17 August 2005, the then Government announced its intention to establish the \$2 billion Communications Fund. Drafting instructions for the legislative establishment of the Fund and the provision of a legislative authority to invest the \$2 billion were provided to the Office of Parliamentary Counsel (OPC) by DCITA on 19 August 2005, two days after the then Government's announcement.⁴²

2.2 Following receipt of the first draft of the Future Proofing Bill, further drafting instructions (to amend the draft Bill) were provided by DCITA to OPC on 28 August 2005. A series of revised drafts and associated amending drafting instructions were exchanged between DCITA and OPC between 29 August 2005 and 4 September 2005. The final version of the Bill was sent to the then Minister for Communications, Information Technology and the Arts for her approval on 5 September 2005.

2.3 The Future Proofing Bill was introduced into the House of Representatives on 7 September 2005, three weeks after the original drafting instructions were issued. As noted in Chapter 1, the Future Proofing Bill underwent a number of amendments during its passage through the Parliament, including giving effect to the Committee recommendation that the Communications Fund be comprised of \$2 billion in cash, and not shares.

2.4 The Bill was passed by the Parliament on 14 September 2005, a week after its introduction. It received Royal Assent on 23 September 2005.

Legislative authority to invest

2.5 The establishment of the Communications Fund was intended to provide a perpetual mechanism to fund the Australian Government's response

⁴² The drafting instructions indicated that the establishment of the Communications Fund was to be included as part of the Telstra (Transition to Full Private Ownership) Bill 2005. However, as it eventuated, a separate but related Bill, the Telecommunications Legislation Amendment (Future Proofing and Other Measures) Bill 2005 (Future Proofing Bill), was drafted to implement the then Government's decision to establish the Communications Fund.

to any recommendations to the Government contained in a report of an RTIRC review of the adequacy of telecommunications services in regional, rural and remote parts of Australia.⁴³ Accordingly, investment of the \$2 billion principal of the Fund was important, in order to create an income stream for future telecommunications infrastructure expenditure.

2.6 As noted in Chapter 1, the Communications Fund is composed of two parts:

- the Communications Fund Special Account, from which funds are to be paid in line with the purposes of the Account; and
- the investments of the Fund, which are held outside the Special Account.

2.7 Ordinarily, the authority for amounts standing to the credit of a Special Account to be invested derives from Section 39 of the FMA Act. However, in respect of the investment of amounts standing to the credit of the Communications Fund, Section 39 of the FMA Act, with its conservative limits on the types of investments permitted to be made, does not apply. The non-application of Section 39 of the FMA Act to the Communications Fund was a specific directive contained in the drafting instructions from DCITA for the establishment of the Communications Fund.

2.8 Instead, the Consumer Protection Act provides for the responsible Ministers to authorise the investment of money standing to the credit of the Communications Fund Special Account in any financial asset. A 'financial asset', as defined in the Consumer Protection Act, means:

- (a) a debenture, stock or bond issued by a government; or
 - (b) a share in, or debenture of, a body; or
 - (c) an interest in a managed investment scheme; or
 - (d) a unit of a debenture, share or interest covered by paragraph (a), (b) or (c);
- and includes:
- (e) a derivative; and
 - (f) an asset (other than tangible property) specified in the regulations.⁴⁴

⁴³ Mr Peter McGauran, 'Second reading speech: Telecommunications Legislation Amendment (Future Proofing and Other Measures) Bill 2005, House of Representatives, 7 September 2005.

⁴⁴ There are a number of other allowable financial assets specified in the regulations. This is discussed in a later chapter.

2.9 This definition provides the Communications Fund with a broader and less conservative framework within which the \$2 billion principal of the Fund may be invested than would otherwise be available using the provisions of Section 39 of the FMA Act. Of particular note is the inclusion of a derivative in the types of investments authorised for the Communications Fund.⁴⁵

2.10 Section 158ZQ of the Consumer Protection Act provides that the responsible Ministers may authorise the acquisition of a derivative for the purposes of enhancing or protecting the value of, or return on, an investment of the Communications Fund. This provision allows for the purchase of a derivative not only to protect an existing investment (through hedging), but also to create new exposures, which carries with it an inherently higher level of risk than might otherwise be considered acceptable for a Commonwealth entity. In this respect, Finance advised ANAO in June 2008 that the Future Fund and HEEF legislation have a more constrained approach to the use of derivatives.

2.11 The drafting instructions for the elements of the Future Proofing Act relating to the establishment of the Communications Fund and its investment powers were based on similar provisions contained in a draft version of the Future Fund Bill 2005. Of note is that the definition of a 'financial asset' in respect of the Communications Fund investments replicated the definition proposed at that time for the investments of the Future Fund.⁴⁶ The explanatory memorandum to the Future Fund Bill (which was introduced three months after the Communications Fund legislation was passed) contained a specific statement of the intent of the investment powers bestowed upon the Future Fund:⁴⁷

The [Future Fund Board of Guardians] has the power to invest the Fund in a broad range of financial assets, including overseas financial assets. The intention of the Board's investment powers is to ensure that the Fund can be invested in a wide range of financial assets to maximise the benefits of diversification.

⁴⁵ A derivative's value is derived from the value of one or more underlying reference assets, rates or indices. Although originally developed as a risk management tool, the use of derivatives also involves risks that need to be managed, and significant unanticipated financial losses in relation to derivatives can occur as a result of unfavourable movements in interest and exchange rates. See also ANAO Audit Report No.14 1999–2000, *Commonwealth Debt Management*, 12 October 1999.

⁴⁶ The Future Fund Bill was subsequently refined and enhanced.

⁴⁷ Explanatory Memorandum to the Future Fund Bill 2005, circulated by the authority of the Minister for Finance and Administration, Senator the Hon Nick Minchin, 7 December 2005.

2.12 By way of comparison, there is no legislative statement of intent in relation to the provision of such broad investment powers for the Communications Fund. In this context, on 23 August 2005 Treasury advised DCITA that:

In relation to the section [of the proposed Bill] on the Communications Fund, I note that sections of the bill relating to establishment of a fund and investment powers have been largely copied from the draft Future Fund Bill. From this perspective, there are no issues with the content, noting that the legislation would allow the Fund to be invested in a broad range of financial assets.

However, the threshold issue seems to be that the bill makes no reference to how the fund will be invested (ie. investment objective), the extent of the capital contribution to the Fund (ie. \$2bn) and how the perpetual nature of the fund will be preserved (ie. how to guarantee that there is always \$2bn capital and that only the earnings are being used to fund future proofing projects).

I would assume that many of these questions will be raised when the bill is introduced, so I was wondering if you could elaborate on the process for getting agreement to these issues, the timing and the means by which they will be reflected (ie. separate legislation)?

2.13 There is no record of DCITA responding to Treasury. In August 2008, DBCDE advised ANAO that DCITA did not consider that the Treasury correspondence represented an expression of concern about matters that should be resolved in the Bill.⁴⁸

2.14 At the time the legislation establishing the Communications Fund was being considered by the Parliament, consideration was given to removing the broad nature of authorised investments originally proposed in the Future Proofing Bill. Specifically, on 10 September 2005, the then Prime Minister requested that the investments of the Communications Fund be restricted to 'fixed interest or like products'.⁴⁹ However, on 12 September 2005 the then Acting Prime Minister agreed to a request from the then Minister for Communications, Information Technology and the Arts that, in order to retain flexibility so as not to limit the future investment strategy for the Fund, the legislation should not limit the authorised investments to fixed interest or like products.

⁴⁸ See also paragraph 2.16.

⁴⁹ The restriction of the Communications Fund's investments to these types of financial assets would have been more in keeping with the provisions of Section 39 of the FMA Act and the conservative nature of investments allowed for other Special Accounts under that provision.

2.15 As a result, the legislation governing the investments of the Communications Fund provides a breadth of permissible investments that is uncommon in respect of public money (as defined by the FMA Act). In this respect, Finance advised ANAO in April 2008 that:

The Communications Fund legislation was passed by the Parliament in September 2005. The Communications Fund was the first financial asset fund established by the then Government and, to meet timing required by Government, the relevant legislation was prepared within a compressed timeframe.

Whilst Finance was involved in the framing of the legislation from the perspective of advice relating to the interaction of the financial framework with the proposed legislation (e.g. FMA Act issues, including Special Accounts and investments provisions), it was not directly responsible for the drafting or consideration of investment options potentially made available within the legislation. This matter was primarily attended to by DCITA, with input from Treasury.⁵⁰

2.16 In respect of Treasury's input, in addition to the 23 August 2005 correspondence noted in paragraph 2.12, on 1 September 2005, shortly prior to the introduction of the Future Proofing Bill into the Parliament, Treasury advised DCITA and Finance that:

...we still have some concerns that a broad range of powers in relation to the Fund are being put up for Parliamentary approval without a framework about how the investment of the Fund (and broader financial flows) will operate. This may lead someone to ask why the Fund is being given the ability to use complex (and risky) financial management arrangements such as derivatives, when the purpose of the Fund is simply to produce an income stream to be spent on regional telecommunications activities. In contrast to the Future Fund, where there will be an independent board established to manage investments using fund managers, custodian, etc, it is not clear in relation to the Communications Fund who will make the equivalent decisions and how the investment management will be undertaken.

2.17 However, Treasury's concerns were not addressed by DCITA in drafting the legislation.⁵¹ In this respect, DBCDE advised ANAO in August 2008 that:

⁵⁰ Treasury advised ANAO in May 2008 that it provided advice for DCITA to consider, but had no direct input in regards to the drafting of the legislation.

⁵¹ Treasury advised ANAO in May 2008 that it considered that the concerns raised were subsequently addressed in the administrative arrangements that were put in place for the Communications Fund.

It should be noted that within hours of the time Treasury's comments were received, the [then] Communications Minister had already requested policy approval from the [then] Prime Minister, Treasurer and Minister for Finance and Administration.

2.18 There were also no steps taken to obtain expert investment advice as an input to developing the legislation, due to the limited time that was available. DBCDE advised ANAO in May 2008 that:

the Future Proofing Bill which amended the *Telecommunications (Consumer Protection and Service Standards) Act 1999* (T(CPSS) Act) to establish the Communications Fund, was developed very quickly. As it was being drafted at the same time as the Future Fund Bill this Department sought to learn from the work already undertaken by the then Department of Finance and Administration (Finance) in developing the Future Fund and the Bill to establish it. However, given the Future Proofing Bill was introduced into the Parliament three months before the Future Fund Bill, it was not able to benefit from the further consideration and subsequent refinements made to the latter.

...

The requirement for the Future Proofing Bill to set aside section 39 of the *Financial Management and Accountability Act 1997* (FMA Act) was agreed after discussion with the drafter of the Bill, to avoid limiting the types of investments that the responsible Ministers could authorise. The definition of 'financial asset' in what is now section 158ZF of the T(CPSS) Act was drafted in broad terms to allow flexibility in the investments that the responsible Ministers could authorise under what is now section 158ZO of that Act. ...

It was not possible in the time available to seek expert advice during the development of the legislation. ...

2.19 Finance further advised ANAO in June 2008 that:

The decision to establish the Communications Fund was done in a unique set of circumstances prior to the establishment of the Future Fund. The approach to the fund, and its timing, was driven by the need to introduce the Telstra sale legislation. It was originally drafted to be included in the Telstra sale legislation, but later placed in a separate Bill due to the technical appropriation requirements of the proposed Communications Fund and the expected approach to the passage of the Telstra sale legislation.

In this environment, with the link to the Telstra sale, there was considerable sensitivity regarding the approaches to the Fund. This is reflected in opposition within Parliament to the transfer of Telstra shares to the Fund. It also explains the [then] Government's view, after the legislation was

introduced, of an intolerance to the risk of loss in value. The same features suggested a need for flexibility in potential drawdowns.

This background not only explains DCITA's main role, but also gives context to the approaches to legislation and the investment authorisation and investment guidelines by DCITA. We understand that there was little time, for example, to redraft the Bill because of the urgency status assigned to the Bill for its introduction into the Parliament.

2.20 As outlined in the following chapter, through the administrative arrangements subsequently put in place for the operation of the Communications Fund, the Fund has been restricted to investing in a portfolio of low risk, highly liquid, fixed interest assets—an approach which more closely aligns with the conservative framework adopted for agencies investing under the FMA Act.

Recommendation No.1

2.21 ANAO *recommends* that, in future circumstances where it is proposed to seek legislative authority for the purchase of investments with higher risk than those permitted under the Financial Management and Accountability Act framework, agencies:

- (a) assess the benefits and risks of the proposed approach so as to provide well-informed advice to the Government; and
- (b) consult with the Department of the Treasury and the Department of Finance and Deregulation.

Agency responses

2.22 All responding agencies agreed to the recommendation.

2.23 DBCDE commented that it agreed with the recommendation, noting that Treasury and the Department of Finance and Administration were consulted on the development of the Communications Fund legislation.

Appropriation arrangements

2.24 Section 21 of the FMA Act provides a special appropriation for amounts to be debited from a Special Account created through legislation (such as the Communications Fund) for the purposes of that Special Account. Where amounts standing to the credit of a Special Account are to be invested, and the investment of the amounts is not specified as a purpose of the Special Account (as is often the case), Section 39 of the FMA Act provides a special

appropriation for the purchase of investments to be undertaken and for the expenses of the investments (for example, management fees) to be debited from the Special Account.

2.25 Although the legislation provides for the investment of the Communications Fund Special Account, this is not included as a purpose of the Special Account and, as such, cannot be supported by the Section 21 appropriation authority. In addition, as Section 39 of the FMA Act does not apply to the Communications Fund, it was necessary for the establishing legislation to provide a separate appropriation authority for the investments to be undertaken. Accordingly, the Consumer Protection Act contains the following special appropriations in respect of the investment of the Communications Fund:

- subsection 158ZO(4)—authorising the investment of money standing to the credit of the Special Account in any financial asset except a derivative;
- subsection 158ZP(7)—authorising the expenses of an investment of the Communications Fund to be debited from the Special Account; and
- subsection 158ZQ(5)—authorising the cost of the acquisition of a derivative to be debited from the Special Account.

2.26 As noted in Chapter 1, the Government announced in the 2008–09 Budget that it will close the Communications Fund and transfer its balance to a new Building Australia Fund. In May 2008, Finance advised ANAO that it:

continues to take an interest in simplifying appropriation provisions, but also recognises the need to have funding arrangements in place so as to implement government policy objectives. When an opportunity subsequently arises to revisit arrangements, as in this case, Finance does seek to explore options for less complex provisions which are easier to understand and operate.

... Finance will monitor developments to determine the most appropriate course of action, depending on whether the current legislation is repealed or amended.

3. Development of the Investment Strategy

This chapter examines the initial investment arrangements put in place for the \$2 billion Communications Fund; the development of the Ministerial Investment Authorisation for the longer term investment of the Fund, including the advice sought on developing an investment strategy; and the development of the long-term investment strategy for the Fund, known as the Investment Guidelines.

Interim investment arrangements

3.1 When the then Government initially announced its intention to establish the \$2 billion Communications Fund, it was intended that the Fund would be established with cash and shares, following the final sale of Telstra. The Bill to establish the Fund was therefore introduced to the Parliament on this basis. However, amendments were later made to the Future Proofing Bill to ensure that the Fund would be constituted of \$2 billion in cash, not shares, and that the \$2 billion would be credited to the Fund immediately following the commencement of the Telstra sale legislation, rather than following the completion of the Telstra sale.

3.2 The changes to the legislation meant that the Communications Fund would be established much earlier than the then Government had originally planned. This in turn meant that agencies needed to implement investment arrangements for the \$2 billion principal of the Fund quickly, in order that interest could be earned on the funds from the first day it was credited to the Special Account. This was reflected in a briefing provided by DCITA to the then Minister for Communications, Information Technology and the Arts, which stated:

As the money will now go into the Communications Fund much earlier than expected, there has not been the time to develop an investment strategy to invest the money in the kind of financial assets specified in the Future Proofing Bill. The Acting Prime Minister has agreed that in the short term the \$2 billion will be invested in a term deposit with the Reserve Bank of Australia (RBA) while machinery is put in place to manage broader and longer term investments.

3.3 A term deposit was not included in the proposed legislative definition of an authorised 'financial asset' for the Communications Fund. In this respect,

Regulations needed to be made to allow this type of investment.⁵² Accordingly, on 13 September 2005, DCITA issued drafting instructions for the ‘urgent preparation’ of Regulations to be made under the Consumer Protection Act. The drafting instructions stated:

We propose that the regulations should specify the investments set out in paragraph (a) of the definition of ‘authorised investment’ in subsection 39(10) of the *Financial Management and Accountability Act 1997* (FMA Act). This covers deposits with a bank as well as other conventional investments.

3.4 Accordingly, the *Telecommunications (Consumer Protection and Service Standards)(Communications Fund) Regulations 2005* (Communications Fund Regulations) include, for the purposes of the definition of a financial asset in the Consumer Protection Act, each of the investment types set out in subsection 39(10) of the FMA Act and FMA Regulation 22 (as they then were).⁵³

3.5 On 23 September 2005, Ministers executed the *Communications Fund Account Investment Authorisation (No.1 of 2005)* (Initial Authorisation). The Initial Authorisation provided for the Chief Executive of the AOFM (or a person authorised by the Chief Executive of the AOFM) to invest money standing to the credit of the Communications Fund Special Account only in term deposits with the RBA.

3.6 DCITA wrote to the AOFM on 26 September 2005 concerning the arrangements for the management of the RBA term deposit by the AOFM,⁵⁴ and, upon the \$2 billion being credited to the Special Account that day, the AOFM effected the transfer of the funds to a term deposit with the RBA for a period of six months.

⁵² Had Section 39 of the FMA Act been applicable to the Fund, placing the \$2 billion principal of the Fund in a term deposit with the RBA would have been permissible by virtue of that Section. However, as noted in Chapter 2, the legislation was drafted such that Section 39 of the FMA Act explicitly does not apply to the Communications Fund.

⁵³ Amendments have subsequently been made to the types of investments authorised under Section 39 of the FMA Act and FMA Regulation 22. Amendments have also since been made to the Communications Fund Regulations specifying additional classes of financial assets that are permissible for the Communications Fund. This is discussed later in the chapter.

⁵⁴ DCITA had engaged in discussions with the AOFM prior to this time concerning its capacity to assist in managing the investment of the \$2 billion in a term deposit with the RBA.

Expert advice

3.7 After the interim investment arrangements for the Communications Fund were settled, a working group comprising officials from DCITA, Finance and Treasury⁵⁵ was established to examine the investment and management options for the Fund. The working group concluded that, in developing a long term investment strategy for the Fund, independent expert advice would be sought.

3.8 DCITA initially proposed a \$60 000 consultancy, for the provision of expert advice on investment options for the Fund. Under this proposal, DCITA planned to require the successful consultant to take into account:

- the purpose of the Communications Fund (being to provide an ongoing income stream for regional telecommunications expenditure);
- the timing of the first RTIRC review and Government response (which meant that the earliest earnings from the Fund were required to be drawn upon was in 2009); and
- a series of alternative possible spending scenarios or drawdown patterns.

3.9 However, the working group subsequently concluded that the Fund was restricted by Government policy statements to investment in a low risk, fixed interest portfolio.⁵⁶ In this respect, the working group decided to instead seek options from the AOFM in the first instance, rather than immediately seeking independent expert advice. The AOFM subsequently provided a paper on possible options for the investment of the Communications Fund. The paper indicated that the AOFM could facilitate the transfer of the Fund's investments from term deposits to a portfolio of bank bills, but that it was not intended to pre-empt the outcome of a possible asset consultancy, or limit the advice DCITA may seek from a consultant on an appropriate investment strategy.

⁵⁵ Treasury advised ANAO in June 2008 that it had an advisory role in the working group, having been invited to provide input in light of its experience with the Future Fund, and that its level of involvement was consistent with the fact that there was no formal role for the Treasurer in relation to the governance of the Communications Fund.

⁵⁶ See also paragraph 3.11.

Cost of advice

3.10 The working group considered that expert advice should still be sought, but on a more limited scale than originally proposed by DCITA. In this respect, DCITA undertook a select tender for a consultancy, inviting quotations from the three selected firms that had been shortlisted by Treasury through the Future Fund tender process.⁵⁷

3.11 On 20 February 2006, DCITA engaged an asset consultant under a \$10 000 contract.⁵⁸ As noted above in paragraph 3.8, initially a \$60 000 consultancy was considered by DCITA, to report on a wide range of investment options and provide clear and detailed information on the levels of risk and likely returns for each option. This proposed approach was consistent with the earlier Ministerial decision not to narrow the types of investments permitted by the legislation, so as not to limit flexibility in an investment strategy. However, the working group's conclusion that the Fund was restricted to investment in a low-risk fixed interest portfolio⁵⁹ narrowed the scope of advice so that the reduced value was estimated as being up to \$10 000. This amount was for advice on financial products that might appropriately be considered for inclusion in a fixed interest portfolio and for advice on the appropriate benchmark to use in measuring the performance of the portfolio over time.⁶⁰

3.12 In this respect, ANAO notes that the consultancies engaged for investment advice for the Future Fund and the HEEF were valued at \$220 000

⁵⁷ Treasury provided DCITA with the names of five firms that had participated in the Future Fund tender process. DBCDE's records do not provide any documented rationale for the inclusion of only three of these potential suppliers in the select tender process. Treasury advised ANAO in June 2008 that, while the selection of a procurement approach was an issue for DCITA, Treasury considered that the scope and complexity of the work, low expected value for the consultancy, and recent experience with the Future Fund were sufficient grounds on which to consider a select tender approach.

⁵⁸ The evaluation panel comprised a representative from each of DCITA, Finance and Treasury. The decision on which firm to appoint was made by DCITA, with the contract signed by DCITA on behalf of the Australian Government.

⁵⁹ Each of the three agencies represented on the working group has advised ANAO that a key consideration for the working group was the then Minister for Communications, Information Technology and the Arts' public statement that the Fund would earn, from day one, a rate not less than the cash rate.

⁶⁰ The consultant engaged by DCITA advised ANAO that it ordinarily would not accept that type of work for such a low value contract sum, but that it had submitted a proposal for the work in this instance given the importance of the Fund's investment strategy being well considered and in the hope of securing further work in regards to the development of the investment strategy for the Fund or the management of the Fund's investments. The firm further advised ANAO that the work that was ultimately undertaken by it in providing the advice cost the firm well in excess of the \$10 000 which it had quoted for the work.

and \$55 000⁶¹ respectively. Both Finance and Treasury have advised ANAO that they consider that the work expected under the consultancies for the Future Fund and the HEEF was more complex than under the Communications Fund consultancy.

The Nation Building Funds

3.13 In respect of the new Nation Building Funds, the Government announced that each of the Funds would be invested in line with a mandate provided by the Government.⁶² ANAO notes that, while the existing contract in place for the HEEF provides for other services to be conducted in respect of new asset funds, the nature of the new Nation Building Funds (with principal and interest available to be drawn upon) together with the significant quantum of the initial funding involved (\$41 billion), may warrant further consideration in respect of the appropriate investment to be made in obtaining expert advice for the Funds, including the possibility of conducting a further approach to the market.⁶³ However, Finance advised ANAO in June 2008 that:

The current contract was the result of an open market process and forward consideration of the possibility of further work being needed in the area of Investment Mandates and Maximum Grant Rules for existing or new financial asset funds.

Whilst there may be variations in the specifics of advice sought between the different Funds, this was considered in the preparation of the Request for Tender and subsequent Contract and is not grounds to abandon an existing contract through which these services could be expertly delivered.

All additional services under this contract are subject to receipt and acceptance of a written proposal for the delivery of the additional services. If such proposal/s are not considered to best fulfil the requirements of the requested service, nor represent value for money, then Finance would take a decision to approach other companies in the market for the requested service.

Investment parameters advised to consultant

3.14 A sound investment strategy for a fund like the Communications Fund should be underpinned by a solid understanding of the purposes for which the

⁶¹ The consultancy contract for the HEEF is valued at \$250 000. This comprises \$55 000 for the delivery of the investment mandate for the HEEF, with a possible further \$195 000 available under the three year contract period (two years with an option of a further year) for advice on other financial asset funds, which could include the new infrastructure Funds.

⁶² Australian Government, *Budget Overview 2008–09*, 13 May 2008, p. 7.

⁶³ There were only two respondents to the Request for Tender issued in respect of the development of the investment mandate for the HEEF.

fund's earnings are to be used and the amount of, and timeframes for, future drawdowns of these earnings. However, unlike with the initial proposal for a \$60 000 consultancy, which proposed that the tendering firms would be required to take into account the purpose of the fund, the timing of the first RTIRC review and a series of possible spending scenarios, none of this information was included in the statement of requirements that was provided by DCITA to the firm engaged for the \$10 000 consultancy. Instead, the consultant was required to provide advice on possible investments to be included in a fixed interest portfolio.

3.15 Although DCITA had advised the consultant that it was unaware of the timeframes in which it would require access to the earnings of the Communications Fund, the timing of the first RTIRC review provided DCITA with a broad time from which it could be anticipated that drawdowns from the Fund would occur. In this respect, as far back as October 2005, when consideration was first given by the working group to engaging a consultant to provide advice on the investment of the Communications Fund, it was recognised by each of the parties involved in the working group that the earnings would not be required to be drawn upon until at least early 2009, following the first recommendations of the RTIRC. Advice from DCITA to its then Minister in March 2006 (after the consultant had reported) also stated that the general policy parameters for the Fund included that all earnings should be available from early 2009, following the first RTIRC recommendations being made, and on an annual basis after that.

3.16 In addition to the requirement for advice on financial instruments to be included in a fixed interest portfolio, the consultant was also advised of other parameters surrounding the investment of the Fund. However, as Table 3.1 shows, these parameters were added to as the drafting progressed, rather than having been provided to the consultant at the commencement of its work.⁶⁴

⁶⁴ DBCDE has advised ANAO that the working group met on 3 March 2006 and again on 9 March 2006 to discuss the draft consultant's report, and that a joint meeting with the consultant was also held on 6 March 2006. However, there is no record of what was discussed or agreed to by the working group in those meetings.

Table 3.1**Investment parameters advised to consultant**

Report version	Date	Investment parameters for Communications Fund
First draft	28 February 2006	Achieve a return greater than the return on cash over any financial year
Second draft	8 March 2006	Achieve a return greater than the return on cash over any financial year
Third draft	9 March 2006	Invest in low risk assets ^A
		Achieve a return that is at least equal to the return on cash over every financial year
Final	10 March 2006	Relatively high level of liquidity (say within 3 months)
		Invest in low risk assets
		Achieve a return that is at least equal to the return on cash over every financial year
Notes: ^A The Request for Quotation issued by DCITA in seeking to engage a consultant foreshadowed that it was intended that the Fund would invest in low risk investments. However, a requirement to consider only low risk assets was not included in the statement of requirements in the contract for the consultancy. The consultant was formally advised of this requirement following completion of the second draft of its report.		

Source: ANAO analysis of DBCDE records.

3.17 Through these constraints, notified to the consultant over time, the consultant was restricted to advising on a portfolio of low risk, highly liquid, short term financial assets. This approach was not consistent with the earlier advice in developing the legislation for the Communications Fund that broad investment powers were necessary so that the future investment strategy for the Fund was not limited. It also meant that consideration was not given by DCITA to the merits of adopting the wider mandate possible under the legislation. This was recognised by the consultant in its tender for the works, which stated:

We note that the terms of the Consultancy Agreement are much more limited than the broad investment powers granted under [the legislation]. We believe a broader investment mandate that exercises the full scope of the investment powers will significantly increase the Fund’s ability to respond to any recommendations made in a report [of the RTIRC].

3.18 In addition, a key parameter advised to the consultant by DCITA for the final version of the consultant’s report (that the Communications Fund was to have a three month liquidity period) did not reflect the perpetual nature of the Fund. This approach was not consistent with the earlier recognition by the

working group that the earnings of the Fund would not be required until at least 2009, following the Government's response to the first RTIRC review. DBCDE has advised ANAO that the addition of this parameter did not result in significant change in the consultant's advice prior to delivering its final report.

Use of consultant's report

3.19 A detailed report was prepared by the consultant that examined a range of possible investment strategies that would have accorded with the legislation. DCITA requested to be provided with an executive summary for the report that more closely reflected the consultancy terms of reference (that is, set out the types of financial instruments that could be included in a fixed interest portfolio, the risk and return associated with each, and a probable benchmark), and a table outlining the composition of a possible portfolio of financial assets. Accordingly, the final version of the consultant's report stated:

Based on the constraints identified we recommend that when developing and implementing an investment strategy the Government should:

1. Invest in a well diversified portfolio of 'Basic' instruments.⁶⁵
2. Benchmark the Funds performance against the UBS Australia Bank Bill Index; and
3. Diversify the portfolio across term, instrument and issuer. (see example overleaf).

We note, however, that portfolios containing some of the more complex instruments discussed above could deliver significantly higher returns over time but with greater variability over shorter periods, possibly including negative returns in some months.

3.20 The table that the consultant included in the final report as an example of a Fund composition is shown in Figure 3.1.

⁶⁵ 'Basic' instruments, as set out in the consultant's report, comprised: high quality short term and call deposits (rated 'A1' or 'A1+' by an approved rating agency); short dated Government and semi-Government bonds; bank bills of exchange; and investment grade corporate promissory notes.

Figure 3.1

Example of investment portfolio construction

PORTFOLIO LIMITS		
Fund Rating (S&P)		AAAf
Duration Limits		Index + 0.5 yrs
	<365 days	100%
	<183 days	At least 50%
Issuer Limits		
Call deposits	Major banks	Max 100%
	Other banks	Max 30%
Government and Semi-government bonds	All issuers	Max 100%
Bank Bills and Promissory Notes	A1+ major banks	Max 100%
	Other banks	Max 30%
	A1+ Commercial paper	Max 20%
	A1 Commercial paper	Max 10%

Source: Consultant's report provided to DCITA, 10 March 2006.

Note to Figure: A Standard and Poor's (S&P) Fund Rating of 'AAAf' means that the Fund's portfolio holdings 'provide extremely strong protection against losses from credit defaults'.

Ministerial investment mandate

3.21 Following receipt of the final consultant's report, a meeting of the Communications Fund working group was held on 14 March 2006. A paper drafted by DCITA for the meeting proposed that it be recommended to Ministers that they:

agree that the AOFM manage a basic investment portfolio, with a view to reviewing the strategy following the first regular review of regional telecommunications when draw-down patterns will be more apparent.

3.22 Accordingly, on 17 March 2006, Ministers were advised that the working group had received expert asset consultant advice,⁶⁶ and their agreement was sought as follows:⁶⁷

⁶⁶ Ministers were provided with a copy of the executive summary from the consultant's report.

⁶⁷ Agreement was given by the then Minister for Communications, Information Technology and the Arts on 22 March 2006 and by the then Finance Minister on 6 April 2006.

- for the Communications Fund to be invested in a portfolio of fixed interest assets within the broad portfolio limits outlined in the consultant's report (see Figure 3.1);⁶⁸
- for the portfolio to be managed by the AOFM;
- for the performance benchmark for the Fund (following the full transition to the new strategy) to be set at two to three basis points below the UBS Australia Bank Bill Index; and
- for changes to be made to the Communications Fund Regulations to allow investment in investment grade corporate promissory notes.⁶⁹

3.23 Ministers were also asked to note that:

- moving to the longer term strategy with the AOFM as manager would involve a transitional period of around six months, during which the Fund would move from being fully invested in term deposits to being invested in a broader fixed interest portfolio; and
- a new investment authorisation would need to be made to allow transition to the longer term strategy.

Clarification from consultant

3.24 In May 2006, the AOFM raised with DCITA, and the working group met to consider, some apparent discrepancies in the consultant's report in respect of the liquidity requirements for the Communications Fund, and in relation to the types of instruments that had been identified in the 'basic' instruments category. Consistent with a suggestion from the AOFM, on 7 June 2006 DCITA sought clarification from the consultant.

3.25 On 28 June 2006, the consultant responded to DCITA reiterating that:

As you are aware, the table on page six of our report was included at DCITA's request as an **example** [*highlighting as per original*] of limits for a AAAF portfolio. It was not our intention that this would be a definitive set of limits for the Communications Fund. To determine limits for the Communications Fund, DCITA needs to determine a list of Authorised Investments, duration limit and whether portfolio management is to be outsourced to professional fund managers or managed by DCITA. ...

⁶⁸ Ministers were not advised that these portfolio limits were provided by the consultant only as an example of portfolio limits. This is discussed in more detail in the following section.

⁶⁹ Corporate promissory notes were included in the 'basic' instruments category identified by the consultant, but existing legislation and regulations did not authorise investment in these instruments.

In respect to term deposits and negotiable certificates of deposit, both are basic instruments, as would be some foreign governments, supranationals, corporates and securitised debt with a maturity less than 12 months.

3.26 Subsequently, the responsible Ministers were each informed that further clarification of the types of basic instruments in which the Communications Fund could invest had been obtained from the consultant. However, Ministers were not advised that the consultant had recommended that DCITA develop a definitive set of limits for the Communications Fund, or that a decision had been taken by DCITA not to undertake this task. In addition, no qualification or advice was provided by either DCITA or Finance to their respective Ministers that the investment mandate that Ministers had now signed off on (as per the consultant's example table) was not in fact based on any specific expert advice in respect of the investments that should be made for the Communications Fund.

3.27 Further, the consultant's March 2006 report itself was clear in providing the portfolio limits as an example (see also paragraph 3.19), with this being reinforced through the consultant's letter of 28 June 2006. In this respect, the advice from DCITA and Finance to their respective Ministers in March 2006 that the consultant had recommended that the Fund be invested within those portfolio limits did not accurately represent the consultant's advice. In this respect, DBCDE advised ANAO in August 2008 that:

It should be noted, however, that the consultant's actual advice (that the table was an example) was included in the executive summary of the consultant's report attached to the Department's briefing to the Minister and that her handwritten annotations indicate that she read this information.

3.28 In September 2006, when finalising the appointment of the AOFM to manage the Fund, DCITA advised its then Minister that it had clarified with the consultant that the portfolio limits table was intended as an example only.

Recommendation No.2

3.29 ANAO *recommends* that, in future circumstances where agencies are seeking investment advice for asset funds, they provide:

- (a) the selected advisor with a clear statement as to the parameters within which the funds are to be invested and accessed; and
- (b) Ministers with advice that addresses the merits of possible investment approaches.

Agency responses

3.30 All responding agencies agreed to the recommendation. DBCDE and Treasury provided comments on the recommendation as follows.

- DBCDE commented that it agreed with the recommendation, noting that information on future requirements by Governments to access funds may not always be clearly established. In cases where this information is not available, agencies will need to take a cautious approach to avoid inappropriately limiting future decisions by Government.
- Treasury commented in respect of part (a) of the recommendation that, while Treasury broadly agreed with this part of the recommendation, it will not always be possible to provide the selected advisor with all of the parameters in which a fund will be operated or accessed. In some cases it may therefore be appropriate to seek advice from the selected advisor on the different outcomes that might be achieved from different portfolio allocations and drawdown profiles.

Amendment of Regulations

3.31 On 21 June 2006, DCITA wrote to the AOFM advising, among other things, that changes to the Communications Fund Regulations were being proposed to permit the Fund to invest in investment grade corporate promissory notes, which were not allowable under the existing Regulations. Changes were also proposed to allow investment in electronic forms of certain financial instruments.

3.32 Drafting instructions for amending Regulations were provided to the Office of Legislative Drafting and Publishing by DCITA on 4 July 2006, following consultation with the AOFM and Finance. The *Telecommunications (Consumer Protection and Service Standards)(Communications Fund) Amendment Regulations 2006 (No. 1)* (the Amending Regulations) were made on 21 September 2006, amending the Communications Fund Regulations with effect from 23 September 2006.

3.33 The Explanatory Statement to the Amending Regulations stated that:

The Australian Government Solicitor has advised that item 5 of Schedule 1 to the Principal Regulations [*a bill of exchange accepted or endorsed only by a bank*] does not cover a bill of exchange accepted or endorsed only by a bank that exists only in electronic form (an electronic bank bill). A bill of exchange, within the meaning of the *Bills of Exchange Act 1909*, refers to a paper

instrument. While the *Electronic Transactions Act 1999* enables transactions for the purposes of Commonwealth law to be done electronically, the regulations made under that Act specifically exempt the Bills of Exchange Act from the operative provisions of that Act...No other item in Schedule 1 to the Principal Regulations is apt to cover electronic bank bills.

The Australian Government Solicitor also doubted whether item 3 of Schedule 1 to the Principal Regulations [*a deposit with a bank, including a deposit evidenced by a certificate of deposit*] would include a deposit evidenced by an electronic certificate of deposit. Whilst deposits without a certificate are permissible investments, the Australian Government Solicitor considered there may be room for an argument that investments in transferable securities issued by banks are limited to securities in paper form.

Having regard to the advice of the Australian Government Solicitor, item 1 of Schedule 1 to the [Amendment] Regulations adds new items 8 and 9 to Schedule 1 to the Principal Regulations to enable investment in electronic equivalents of assets covered by the definition of 'financial asset', if authorised by the responsible Ministers.

3.34 As noted in paragraphs 3.3 and 3.4, the original Communications Fund Regulations were drafted to replicate the investment types set out in subsection 39(10) of the FMA Act and FMA Regulation 22. Although the Australian Government Solicitor (AGS) advice (which was obtained by the AOFM on 11 April 2006) raised concerns about the validity of certain electronic investment transactions under the existing Communications Fund Regulations, resulting in the amendment of those Regulations, no similar amendment was made to the FMA Regulations. This presented a risk that entities authorised by the Finance Minister to invest public money in accordance with Section 39 of the FMA Act may have been in breach of the legislation where they were investing in electronic equivalents of authorised financial instruments, which the AGS advice indicates are not permissible investments.⁷⁰ In this respect, the *Financial Management and Accountability Amendment Regulations 2008 (No. 2)*⁷¹ amended FMA Regulation 22 to permit authorised agencies to invest in electronic equivalents of bank bills and negotiable certificates of deposit.

⁷⁰ It is an agency's responsibility to ensure compliance with the FMA Act. Finance advised ANAO in August 2008 that compliance with section 39 must be reported on by agencies in their current Certificates of Compliance, and that there were no reported instances of non-compliance with subsection 39(10) in 2006–07. Finance further advised that it will continue to monitor this issue in the 2007–08 certificate of compliance process.

⁷¹ This amendment regulation was made on 24 June 2008.

New Ministerial investment authorisation

3.35 As noted, when DCITA and Finance sought their respective Ministers' agreement in March 2006 to the portfolio limits in the example table from the consultant's report, Ministers were also informed that a new authorisation instrument would be required to be made in order to begin investing under the new mandate. However, there was a considerable delay in this being progressed.

3.36 DBCDE has advised ANAO that DCITA, Finance and the AOFM met on 24 August 2006 to develop drafting instructions for a new authorisation instrument. On 12 October 2006, DCITA provided Finance and the AOFM with a draft of the new investment authorisation and sought each agency's comments on the draft. The AOFM provided DCITA with two proposed changes on 18 October 2006. Finance responded to DCITA on 16 November 2006, commenting that:

We have no concern with the way the Investment Authorisation is framed with the exception (as previously discussed) of the provision requiring consultation with the Secretary of Finance regarding the 'directions' of the Secretary of DCITA...This consultation provision should be removed in our view.⁷²

3.37 DCITA subsequently agreed to the AOFM's proposed changes and Finance's request to remove the requirement for the Secretary of Finance to be consulted on directions with which the AOFM would be required to comply. The final version of the new investment authorisation was provided to Ministers by DCITA and Finance on 20 December 2006 and 11 January 2007 respectively, more than nine months after Ministers were first advised that the longer term investment strategy would require a new authorisation instrument. The *Communications Fund Special Account Investment Authorisation (No. 1 of 2007)* (New Authorisation) took effect on 22 January 2007.⁷³

3.38 In respect of the timeframes over which the New Authorisation was developed, DBCDE advised ANAO in June 2008 that:

⁷² In this respect, Finance had indicated to DCITA on several occasions since the establishment of the Communications Fund that it intended to brief its Minister that he seek approval for the legislation to be amended to remove him as a joint Minister responsible for the Fund. At the time of audit, no action had been taken to rescind the joint responsibility for the Fund. Finance advised ANAO in June 2008 that: 'This was a matter of timing and priorities.'

⁷³ The New Authorisation was signed by the then Minister for Communications, Information Technology and the Arts on 4 January 2007, and by the then Finance Minister on 22 January 2007.

The March 2006 advice to Ministers that a new Investment Authorisation would be needed stated that it would need to occur at the same time as the regulations were changed to allow the Communications Fund to invest in corporate promissory notes. The changes to the regulations were made in September 2006. The Investment Authorisation was then drafted in October 2006 but delayed while the Prime Minister's formalisation of the Government's position to have the AOFM continue to act as the Fund Manager was obtained in December 2006. Minister's executed the Investment Authorisation in January 2007.

Development of Investment Guidelines

3.39 Concurrent with the work being undertaken in finalising the New Authorisation, DCITA, the AOFM and Finance commenced work on developing an investment strategy for the Fund (the Investment Guidelines). The Investment Guidelines had already begun to be drafted prior to the AOFM being advised by DCITA on 21 June 2006 that Ministers had decided upon the longer term arrangements for the Communications Fund. Specifically, the AOFM contacted DCITA on 6 June 2006 and stated:

As discussed yesterday, please find attached [the] draft investment policy for the Communications Fund for your review. We are very happy to walk you through the document if you feel this will provide you additional comfort on the proposed management framework surrounding the Fund. Please note that the investment policy has been prepared on the assumption that the latest proposed changes to the regulations to broaden the allowable investments are achieved.

3.40 In January 2008, ANAO sought advice from the AOFM in respect of aspects of the drafting of the Investment Guidelines. The AOFM advised ANAO that:

DCITA advised AOFM formally on 21 June 2006...that relevant Ministers had agreed to a longer term investment strategy for the Communications Fund and that it be managed by AOFM **within** the portfolio limits attached to the letter. The AOFM was not involved in the formulation of the portfolio limits attached to the letter, which presumably reflected input from DCITA and/or the [working] group drawing on the [consultant's] report.

The letter also indicated that the Investment Policy (which subsequently became known as the **Investment Guidelines**) would be **developed** by the two agencies. The AOFM took the bulk of the workload in developing the Investment Guidelines given its experience in producing similar frameworks for its own operation. However, it was clearly understood that the Investment

Guidelines were **not the responsibility** of AOFM. DCITA had the responsibility for developing Communications Fund policy and had the final say/decision on the nature and form of the Investment Guidelines issued to AOFM. ...

In developing the Investment Guidelines the two agencies tried to ensure that they were clear and unambiguous. In particular, some aspects of the concepts/language used in the [consultant's] report were made more precise or clearer. For example, credit ratings across asset types, moving from duration to tenor limits and limiting the range of acceptable bands. ...

In these and other detailed aspects of the Investment Guidelines, the AOFM's participation was largely in identifying issues and suggesting how they be handled with a particular emphasis on their practical implementation. The decisions on these matters were the responsibility of DCITA.

[Highlighting as per original]

3.41 When Ministers agreed in September 2005 that the initial \$2 billion term deposit with the RBA should be for a period of six months, they were advised by DCITA and Finance that this period should provide sufficient time for the longer term strategy to be finalised.⁷⁴ However, the Investment Guidelines were not completed until June 2007—15 months after the initial six month term deposit had matured.

3.42 The Investment Guidelines commenced operation on 18 June 2007. Although the Finance Minister has joint responsibility for the Communications Fund under the legislation, Finance is not a party to the Investment Guidelines. In this respect, DBCDE records state:

The reason that we have interpreted DCITA as being responsible for day-to-day running of the Fund is because our Minister is responsible for the *Telecommunications (Consumer Protection and Service Standards) Act 1999* which establishes the Communications Fund Special Account. All expenses of the Fund come out of that account and DCITA is responsible for all reporting etc. associated with it. However, having said that, the legislation is silent in terms of agency responsibility... Technically it is possible to have both Secretaries sign the Investment Policy but it would be cumbersome to have both Departments responsible for the day-to-day running of the Fund. Furthermore, the Department of Finance and Administration has indicated that it will strongly resist any such arrangement.

⁷⁴ Ministers agreed that, should it be necessary, at the expiration of the six month term deposit, the Communications Fund could be rolled over into shorter term deposits of up to seven days.

3.43 In the 12 months between the original draft of the Guidelines being provided to DCITA by the AOFM and the final Guidelines commencing operation, a number of amendments were made following input from, and discussions between, DCITA, Finance and the AOFM. The major changes that were made between the first and final versions of the Investment Guidelines are as follows:⁷⁵

- it was clearly stated that the Investment Guidelines represent the ‘instructions from the Secretary of DCITA’, as contemplated by the New Authorisation;
- the existence of a Service Level Agreement between DCITA and the AOFM was acknowledged;
- the timeframe for the operation of the Guidelines was amended, from a maximum of four years, to either four years or until they are replaced by a revised set of Guidelines; and
- changes to the Guidelines approved by the Secretary of DCITA were deemed to apply automatically to the AOFM, rather than the initial approach of being subject to the acceptance of the changes by the Chief Executive of the AOFM.

3.44 Some other minor changes were also made to provide clarification of some roles and responsibilities, and to provide additional detail in respect of some of the policies contained in the Guidelines.

The Nation Building Funds

3.45 Given the experience to date with the Future Fund and the HEEF, it would be reasonable to expect that the development and implementation of investment mandates and related investment policies for the new infrastructure Funds will be undertaken in a more timely manner than occurred in respect of the Communications Fund. In this respect, Finance advised ANAO in June 2008 that:

Since the establishment of the Communications Fund, subsequent financial asset funds have included more structured governance processes for investment mandate changes.

⁷⁵ DBCDE has advised ANAO that some of the changes were made in response to expert advice obtained to ensure the consistency of the Guidelines with the Investment Authorisation.

Investment policies

3.46 The Investment Guidelines state that:

The Investment Guidelines, as agreed between the AOFM and DCITA, provide the framework for the management of the Fund's investments under the Investment Authorisation, including establishing allowable investments, defining risk and return along with credit, tenor and liquidity policies, assigning roles and responsibilities to the respective parties and prescribing reporting requirements. ...

These Investment Guidelines restrict the Fund to investing in Australian dollar denominated debt instruments and bank deposits only. The Fund will have a focus on maximising returns subject to the various constraints outlined in these Investment Guidelines. The Fund will typically be a buy and hold investor and as such the returns generated will primarily be generated from interest receipts. However, the Fund may need to sell an investment for either portfolio management or liquidity reasons.

Credit Policy

3.47 Credit risk is the risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction.⁷⁶ A credit rating gives an indication of how a company is expected to perform in the future and whether it is well placed to repay its debts and meet its overall financial obligations.⁷⁷

3.48 The Credit Policy set out in the Investment Guidelines states:

The AOFM will manage the Fund in line with the credit limits set out in Table 1. Due to market concentration, the Fund will typically have credit exposures to a small number of highly rated counterparties. Where possible, diversification of credit exposures will be sought. It is expected that credit limits may be fully utilised from time to time in view of the objective of maximising return.

3.49 The Credit Policy establishes credit limits for the Communications Fund both by issuer type and by credit rating. In addition, credit limits are specified in terms of the overall exposure of the Fund, and in terms of exposure to a single entity. In this respect, the AOFM advised ANAO in January 2008 that:

⁷⁶ AOFM website, <<http://www.aofm.gov.au/content/glossary.asp>>, [accessed on 8 May 2008].

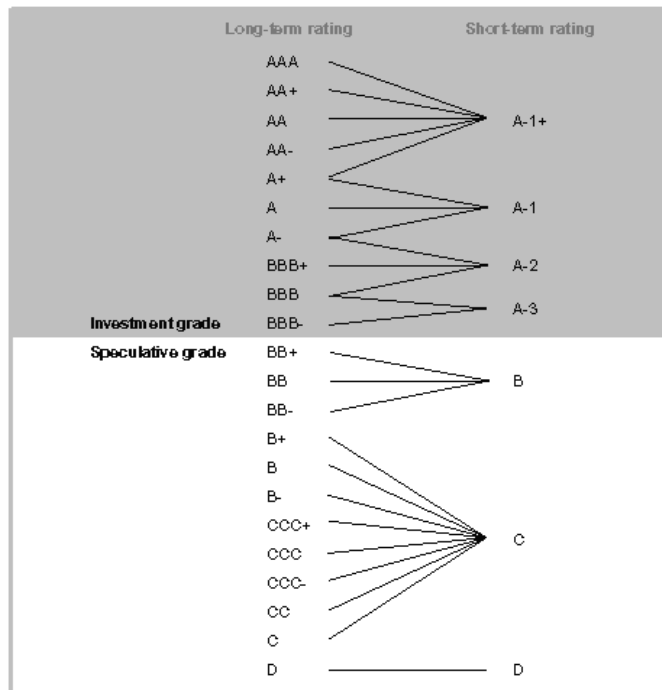
⁷⁷ Australian Securities Exchange, *The importance of credit ratings*, <http://www.asx.com.au/resources/newsletters/investor_update/20050913_credit_ratings.htm>, [accessed on 8 May 2008].

It is worth noting that the [consultant's] report and the limits put to Ministers only dealt with overall fund limits. The Investment Guidelines also established limits at the individual entity level to prevent over-concentration in credit exposures.

3.50 When amendments were made to the Communications Fund Regulations in 2006, a new class of asset, 'Australian dollar denominated debt instruments with an investment grade credit rating', was added to the authorised financial assets for the Communications Fund in order for the AOFM to be able to invest in corporate promissory notes upon commencement of the longer term strategy. A note to the Communications Fund Regulations states that the term 'investment grade credit rating' is well recognised as referring to securities with a Standard and Poor's long term credit rating of at least 'BBB-' or a short term rating of at least 'A3'.⁷⁸ This is shown in Figure 3.2.

Figure 3.2

Investment grade credit ratings



Source: Standard and Poor's.

⁷⁸ Or an equivalent rating from another internationally recognised rating agency.

3.51 Accordingly, the New Authorisation executed by Ministers in 2007 includes as an authorised investment an ‘Australian dollar denominated debt instrument with an investment grade credit rating’. However, in providing a draft of the Investment Guidelines to DCITA and Finance on 9 August 2006, the AOFM stated:

The Policy restricts ‘Investment Grade’ to a minimum short term rating of A1, several notches above the lowest rating in the Investment Grade class.

3.52 In addition to individual counterparty credit rating limits, the Credit Policy in the Investment Guidelines requires the Communications Fund as a whole to maintain a Standard and Poor’s Fund Rating of ‘AAAf’.⁷⁹ The Investment Guidelines set out the methodology to be used in establishing that the Fund is compliant with the AAAf fund rating, as shown in Figure 3.3.

Figure 3.3

Credit Quality Rating Matrix

To calculate a fund’s rating score, multiply the % the held in each bucket by the corresponding factor. Take the sum of these to determine the fund’s overall score. The maximum score allowable to maintain AAAf rating is 7.		
Rating	<=90 days	>90 & <365 days
Long Term Rating		
‘AAA’	0	0
‘AA+’	0	0
‘AA’	0	0
‘AA-’	0	0
‘A+’	0	0
‘A’	20	20
‘A-’	20	20
‘BBB+’	20	50
‘BBB’	50	50
‘BBB-’	50	250
‘BB+’	1000	1000
Short Term Rating		
‘A1+’	0	0
A1’	0	0
Combination Long and Short Term Ratings		
‘A/A2’	20	20
‘A-/A2’	20	20
‘BBB+/A2’	20	50
‘BBB/A2’	50	50
‘BBB/A3’	50	50
‘BBB-/A3’	50	250

Source: Investment Guidelines agreed between DCITA and the AOFM.

⁷⁹ This is defined to mean that the Fund’s portfolio holdings ‘provide extremely strong protection against losses from credit defaults’.

3.53 Using the matrix shown in Figure 3.3, it can be seen that holdings of securities with a long term rating of 'A+' or above and securities with a short term rating of 'A1' or 'A1+' do not accumulate any points towards the overall fund score. At the other end of the 'investment grade' spectrum, a five per cent holding of a short term (less than 90 days) 'BBB-' rated security would result in a score of 2.5 being added to the overall fund score. This is within the seven point limit for the Fund to maintain a 'AAAf' fund rating.

3.54 In respect of the Investment Guidelines limiting the credit ratings of allowable investments to a minimum of 'A1', the AOFM advised ANAO in January 2008 that, had the limits been set more broadly, should a counterparty with a 'BBB-' credit rating incur a credit downgrade, the Fund would become non-compliant with the Ministerial mandate, as the investments held with that counterparty would no longer be considered as having an investment grade credit rating (see Figure 3.2). However, ANAO notes that the Investment Guidelines expressly provide for a situation where a counterparty experiences a credit downgrade, as follows:

Where a passive breach of credit limits arises, either through an increase in market value of the investment portfolio (not arising from a purchase) or due to a credit downgrade of an issuer, the AOFM will monitor relevant investments and notify DCITA within five business days with a recommendation of how it intends to move the portfolio back within limits.

In the event that the Fund breaches the AAAf rating requirement, the AOFM will immediately initiate action to bring the portfolio back within the AAAf rating requirements. Notification of this will be provided to DCITA within five business days with an explanation of actions undertaken to bring the Fund back within the AAAf rating requirements.

3.55 As a general principle, the riskier an investment, the greater is the expected return on the investment. Accordingly, an investment with a short term credit rating of 'A2', for instance, would be expected to generate a higher return than an investment with a short term credit rating of 'A1+'. Although limiting the allowable credit limits for the Communications Fund to below the levels authorised by Ministers represented a conservative approach, there was no documented analysis undertaken by the AOFM or DCITA of the possible effects on potential returns for the Communications Fund by restricting the credit ratings of counterparties to the Fund in this manner.

Liquidity Policy

3.56 Liquidity risk is the risk that arises from the difficulty of selling an asset or buying back a financial liability.⁸⁰ Liquidity risk can stem from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimise a loss. A liquid asset is one that is quickly and easily converted into cash without loss of value.⁸¹

3.57 The Investment Guidelines set out the following as an investment objective of the Fund:

The Fund is to have a relatively high level of liquidity whereby all the principal funding and accumulated earnings are to be available within 3 months with minimal risk of capital loss over that period.

3.58 This investment objective has been translated into the Liquidity Policy in the Investment Guidelines, which states:

DCITA may require access to all of the principal and accumulated earnings of the Fund with three months notice.

3.59 The requirement that both the principal of the Fund and the interest earnings of the Fund are to be available with three months notice did not accord with the stated intention of the then Government that the Communications Fund was to be a perpetual fund⁸² (meaning that the principal of the Fund should remain secured) with only the earnings of the Fund available to be spent from the Communications Fund Special Account. In addition, there was no documented rationale for the inclusion of a requirement that both the principal and the interest earned on the Fund be available with three months notice.

3.60 In January 2008, Applied Financial Diagnostics advised ANAO that it had difficulty in reconciling the legislated investment powers of the Communications Fund, and statements of intent by the previous Government

⁸⁰ AOFM website, <www.aofm.gov.au/content/glossary.asp>, [accessed on 8 May 2008].

⁸¹ Viney, Christopher, *Financial Institutions, Instruments and Markets*, Third Edition, McGraw-Hill, Australia, 2000, p. 681.

⁸² There were a number of public references made prior to the legislative change in September 2007 about the perpetual nature of the Communications Fund. For example, the second reading speech for the Future Proofing Bill referred to the creation of a 'dedicated and perpetual' Fund. In addition, the terms of reference for the Committee Inquiry into the provisions of the Future Proofing Bill was to consider 'the establishment of a perpetual \$2 billion Communications Fund'. There was also continued recognition by the working group that numerous public references to the Fund being 'perpetual' implied that the policy intent was to maintain the Fund's nominal \$2 billion value, with only interest earnings available to be spent.

that the Fund was to exist in perpetuity, with the policies contained in the Investment Guidelines. Specifically, Applied Financial Diagnostics advised:

If the principal of the Fund is not to be used for expenditure on rural and regional communications then it is in the nature of an investment fund rather than a cash or liquidity reserve, with important consequences for the structure of the Fund's assets. ...

These [*the investment powers contained in the Consumer Protection Act*] are not the investments powers required by a cash management fund with a need to liquidate the entire fund within any 3 month period. They are more appropriate to a fund designed to maximise risk-adjusted long-term income streams as well as to the protection of the capital base through risk management rather than risk avoidance.⁸³

3.61 Applied Financial Diagnostics further advised ANAO that:

This [*the reconciliation of liquidity requirements with good investment performance*] is the key issue of portfolio management. At present, 100% of the Fund has to be able to be liquidated within 3 months without suffering capital losses. However, if the base \$2 billion is not to be available for expenditure within any one year, only a small proportion of assets (around 10%) need to be able to be liquidated within 3 months—thereby potentially radically altering the portfolio structure and enhancing risk-adjusted returns. Every 1 basis point...adds \$200,000 in returns per annum on the \$2 billion base.

3.62 In respect of the new infrastructure Funds, the Government announced in the 2008–09 Federal Budget that each of the Nation Building Funds will have its capital and earnings available for drawdown over time, after specific projects have been identified.⁸⁴

Tenor Policy

3.63 The tenor of an investment is its time to maturity, or the investment term. The Tenor Policy in the Investment Guidelines states:

Table 3 below identifies the tenor (investment term) limits for the Fund. The majority of the tenor limits apply to the Fund as an entire portfolio. However, the tenor limits include a requirement that the maximum tenor of any single investment shall be no more than 364 days. The AOFM shall manage the portfolio in accordance with these tenor limits and ensure that the AAAf credit

⁸³ This assessment reinforces ANAO's concerns regarding the broad nature of the investments permitted by the legislation, and the restrictions imposed by DCITA in seeking expert advice on the appropriate investment portfolio composition for the Communications Fund.

⁸⁴ Australian Government, *Budget Overview 2008-09*, 13 May 2008, p. 7.

quality rating is maintained. The tenor limits does not differentiate between issuer types.

The benchmark (UBS ABBI) tenor declines daily until a new investment is undertaken every Tuesday. For the purposes of clarity, the benchmark's tenor is assumed to be steady at 45 days. The tenor of the Fund shall be targeted, within the limits in Table 3, around the benchmark level of 45 days.

3.64 The Tenor Policy limits in the Investment Guidelines are shown in Table 3.2.

Table 3.2

Tenor Policy Limits

Tenor Limits	
	All institutions
Upper limit average weighted tenor of portfolio	95 days
Maximum % of investments with a tenor of >180 days from the date of investment	20%
Maximum tenor for a single investment	364 days

Source: Investment Guidelines agreed between DCITA and the AOFM.

3.65 A paper prepared by the AOFM for a meeting between the AOFM, DCITA and Finance held on 24 August 2006 addressed the preparation of the Investment Guidelines and stated:

With a requirement that all Fund investments may need to be redeemed within 3 months, there is a risk that a capital loss may be incurred. A balance needs to be struck between underperformance (by investing short) and making capital losses (by investing long).

3.66 The conservative tenor limits imposed on the Fund through the Investment Guidelines thus appear to have arisen as a function of the three-month liquidity requirement borne out in the Liquidity Policy. Further, the structure of the tenor limits included in the Tenor Policy in the Investment Guidelines reflects the Ministerial investment mandate, taken from the example table provided in the consultant's report, which provided the following in respect of tenor limits:

- 100 per cent of investments being for less than 365 days; and
- at least 50 per cent of investments being for less than 183 days.

3.67 However, as discussed, the example table in the consultant's report did not amount to a recommendation in respect of the Communications Fund. By

way of comparison, the executive summary to the consultant's report did contain a specific recommendation for the Communications Fund in respect of tenor limits, as follows:

...We recommend that for each instrument, the term to maturity at the time of investing be no greater than 180 days and the maturities be spread evenly out to 180 days.

3.68 Whilst adopting the tenor limits specifically recommended by the consultants report in developing the Investment Guidelines would have been within the limits of the Ministerial mandate, there was no documented consideration given by DCITA to the merits of this approach.⁸⁵ In addition, although the AOFM advised DCITA and Finance that the tenor limits contained in the Investment Guidelines were 'more conservative than the limits recommended by the consultant', there was no analysis of the effect of those conservative tenor limits on the potential returns for the Communications Fund.

Review of Investment Guidelines

3.69 The Investment Guidelines state that:

[These Guidelines] shall remain in operation for four years or until such time as these Investment Guidelines are replaced by any revised Investment Guidelines. DCITA expects to conduct a review of the Fund's arrangements in 2009, which may include a revision of the Investment Guidelines. These Investment Guidelines will remain in force during the review and until such time as these Investment Guidelines are replaced by any revised Investment Guidelines.

3.70 In June 2007, the then Minister for Communications, Information Technology and the Arts sought the agreement of the then Finance Minister to the introduction of legislation protecting the \$2 billion principal of the Communications Fund, giving legislative effect to the then Government's intention that the Fund exist in perpetuity. On 21 June 2007, the then Finance Minister wrote to the then Minister for Communications, Information Technology and the Arts agreeing to the introduction of the amending legislation and stated:

⁸⁵ Indeed, the only documented consideration given to the specific recommendation at all was in relation to DCITA seeking clarification from the consultant in June 2006. In this regard DCITA simply noted the discrepancy between the recommendation in the executive summary to the report and the limits contained in the example table.

I note, however, that the detail of amendments to the Act may affect the investment strategy for the Communications Fund and that the strategy may need to be re-examined in the future.

3.71 However, ANAO found that there was no evidence of consultation between DCITA and Finance in respect of the need to amend the Investment Guidelines or any other action taken to review the investment mandate for the Fund. In this respect, DBCDE advised ANAO in June 2008 that:

The suggestion to re-examine the investment strategy for the Fund after the 2007 amendment to protect the principle was passed was never progressed as the caretaker period for the 2007 Federal election intervened and the [then] Opposition's policy was clearly that it intended to use all of the \$2 billion principal if it was elected. The then Opposition's established policy—to use the \$2 billion for a National Broadband Network—was well known, and re-examining the investment strategy at that time, or following the election of the current Government, was judged not to be a rational use of public resources, in light of the fact that high liquidity would be preferable if the Funds would be moved at short notice.

It should be noted that the new Government introduced legislation in February 2008 to reverse the previous Government's September 2007 amendment.

3.72 Similarly, Finance advised ANAO in August 2008 that:

After the introduction of the amending legislation, Finance considered the appropriate timing to review the investment arrangements and determined that this should be reviewed after the election. The Government's 2008–09 Budget announcement regarding the Nation Building Funds has superseded changes to the Investment Authorisation.

4. Investment Activities

This chapter examines the investment activities of the Communications Fund, including financial and performance reporting.

Appointment of AOFM as investment manager

4.1 As discussed, the AOFM was commissioned in September 2005 to undertake an operational role for the Communications Fund, to facilitate the transfer of the \$2 billion principal of the Fund to a six month term deposit with the RBA. Subsequently, DCITA and Finance recommended to Ministers that the AOFM be appointed as the investment manager for the Communications Fund, and that the AOFM be authorised to implement the longer term investment arrangements for the Fund. However, as noted, there were significant delays in finalising that Ministerial authorisation.

4.2 ANAO's examination of records held by DBCDE and Finance show that these delays were primarily attributable to issues surrounding the basis on which the AOFM was to be appointed as the investment manager. In particular:

- although Ministers had agreed in April 2006, on recommendation from DCITA and Finance, that the AOFM should manage the Fund, there had been no processes undertaken in respect of other potential suppliers for the investment management services. The nature and value of the services to be provided meant that both the Mandatory Procurement Procedures in the Commonwealth Procurement Guidelines (CPGs) and the Government's Competitive Neutrality Policy would ordinarily apply to the arrangement;
- Finance advised DCITA in August 2006 that obtaining the then Prime Minister's confirmation that general government policy required the use of AOFM for the services could mitigate DCITA's risk in going directly to the AOFM rather than approaching the market.⁸⁶ The then Prime Minister agreed in December 2006 that the Communications Fund should be managed by the AOFM as a matter of government policy, provided that responsible Ministers were satisfied that the

⁸⁶ The CPGs exempt a procurement from the Mandatory Procurement Procedures where general government policy requires the use of a government provider. However, agencies are still required to apply the other divisions of the CPGs in undertaking the procurement, including encouraging effective competition.

AOFM's quote for the services reflected a fair market rate. However, in advising Ministers that they considered that the AOFM's quote reflected a fair market rate, DCITA and Finance relied on an estimate of fees contained in the consultant's report which was not provided specifically in relation to the management of the Communications Fund.⁸⁷ No qualification of this fee estimate was provided to Ministers by either department; and

- notwithstanding the then Prime Minister's later approval to appoint the AOFM as investment manager for the Fund as a matter of government policy, at the time the AOFM was advised that Ministers had agreed that this would be the case, there was no requirement for a Government provider to be used, nor was there an established government policy in place to that effect.

4.3 In respect of the continuation of the AOFM as investment manager for the Communications Fund, DBCDE advised ANAO in June 2008 that:

The choice of AOFM provided the security for the Government of having the Fund managed by a body already operating within the framework of public sector controls such as the FMA Act. ...

...The previous Prime Minister and responsible Ministers accepted that the AOFM, a specialised agency within the Treasury portfolio accustomed to operating within the framework of public sector controls, with its responsibility for, amongst other matters, financial and operational risk management of the Australian Government's debt management and cash balance, was well placed to manage the Communications Fund investments.

Service Level Agreement

4.4 As noted in Chapter 3, when DCITA advised the AOFM in June 2006 that Ministers had decided upon the longer term arrangements for the Communications Fund and that the AOFM should manage the investments of the Fund on an ongoing basis, it was foreshadowed that a Service Level Agreement would be developed between the two agencies.

⁸⁷ The consultant's report contained the following statement in respect of potential investment management fees: 'On an individual mandate of say \$0.5 billion, professional investment fees would be expected to be 0.025–0.05%'. In the conclusions of the report it was stated that: 'We believe that by investing in a well diversified portfolio of basic instruments the Government will be able to achieve an after expenses (0.025–0.05% pa) return that is above the RBA Cash Rate over rolling six month periods. However, we would expect the after fees return to be marginally below the return on the UBS Australia Bank Bill Index'. This is the only comparison made by DCITA and Finance to a 'market rate' for investment services.

4.5 The Service Level Agreement commenced on 18 June 2007, the same day as the Investment Guidelines.⁸⁸ The introduction to the Service Level Agreement states:

The purpose of this Service Level Agreement (SLA) is to establish the roles and responsibilities of the AOFM as the investment manager for the Communications Fund and of DCITA as the agency responsible for the Communications Fund Special Account.

4.6 The Service Level Agreement sets out the following in respect of the responsibilities of various parties:⁸⁹

As the investment manager, the AOFM is responsible for providing a range of investment management services, comprising deal selection, authorisation and execution, interest rate risk management, credit risk management, performance reporting, transaction confirmation and settlement, bookkeeping and accounting. Investment management services shall be conducted in accordance with Ministerial Authorisations and the Investment Guidelines approved by DCITA. ...

Control of the Communications Fund, for the purposes of accounting and reporting, remains with DCITA.

The responsible Ministers are responsible for setting the investment parameters within the Investment Authorisation.

DCITA and DoFA are also responsible for reporting to their Ministers in relation to the Communications Fund.

4.7 The importance of separating the role of an investment adviser from investment management is well recognised.⁹⁰ It is also important to recognise that the overall performance of an investment manager depends not only on the investment manager's performance, but also on the strategy that is being pursued. In this respect, in January 2008, Applied Financial Diagnostics advised ANAO in respect of the responsibilities set out in the Service Level Agreement that:

The service level agreement between AOFM and DCITA states that AOFM is responsible for 'a range of investment management services'...

It should also be noted what the AOFM does *not* provide:

⁸⁸ As with the Investment Guidelines, the Department of Finance and Deregulation is not a party to the Service Level Agreement.

⁸⁹ Schedule 1 to the Service Level Agreement sets out in detail the specific responsibilities of both DCITA and the AOFM under the Agreement.

⁹⁰ See also ANAO Audit Report No.22 2004–05, *Investment of Public Funds*, Canberra, 18 January 2005.

*The AOFM is not required by this SLA to provide investment advice, taxation advice or accounting policy advice to DCITA.*⁹¹

Thus if the investment advice is initially inappropriate, no matter how excellently AOFM carry out their operational duties, the overall functioning of the Communications Fund will remain sub-optimal.

The Nation Building Funds

4.8 The Government announced in the 2008–09 Federal Budget that each of the new Nation Building Funds will be managed by the Future Fund Board of Guardians (the Board), and invested in line with a mandate provided by Government.⁹² These are the same governance arrangements currently in place for the Future Fund and the HEEF. Under the current arrangements, which are expected to equally apply to the Nation Building Funds, the Board may not invest fund assets unless it does so through an investment manager appointed by the Board.⁹³ At the time of audit, there were nine entities that had been appointed as external investment managers by the Board.

Reporting

4.9 The Investment Guidelines prescribe reporting requirements for the AOFM in respect of the investment of the Communications Fund, as follows:

The AOFM will provide quarterly reporting of the Fund to DCITA. This reporting will show the Fund's return in absolute and percentage on both a pre- and post-cost basis and compare the percentage returns with the benchmarks (UBS ABBI and UBS ABBI less 2-3 basis points respectively).

The reporting will also show the Fund's portfolio characteristics and compliance with the various limits set out in [the credit and tenor limits tables] in these Investment Guidelines.

4.10 The Service Level Agreement between the AOFM and DCITA sets out additional detail in respect of the AOFM's performance reporting obligations to DCITA. The AOFM is also required to provide DCITA with monthly accounting reports for the Communications Fund and end-of-year accounting information for statutory reporting by DCITA. As Finance is not a party to

⁹¹ The Schedule to the Service Level Agreement similarly states that: 'The AOFM shall not provide investment advice to DCITA on the Communications Fund'.

⁹² Budget overview 2008–09, p. 7.

⁹³ Future Fund Statement of Investment Policies, 22 January 2008, p. 17. However, under subsection 28(2) of the *Future Fund Act 2006*, the responsible Ministers may provide approval, in writing, for investment in a manner other than through investment managers.

either the Investment Guidelines or the Service Level Agreement, Finance does not receive, and has not requested, any performance reporting on the Communications Fund from the AOFM.⁹⁴

Financial reporting

4.11 The financial reporting requirements for Australian Government agencies are contained in the Finance Minister’s Orders (FMOs) made under Section 63 of the FMA Act. The FMOs provide minimum mandatory disclosure and reporting requirements for Australian Government agencies.⁹⁵ The FMOs require agencies to disclose the use of each special appropriation for which they are responsible in a separate table in the notes to the agency’s financial statements. There is also to be separate disclosure of each Special Account, its opening and closing balances and transactions.

4.12 While, under the Service Level Agreement, DCITA/DBCDE is responsible for disclosing the Communications Fund in its annual financial statements, the AOFM has also included some reporting in its annual financial statements for the Communications Fund. Table 4.1 shows the figures reported by each agency for the Communications Fund from 2005–06 to 2007–08.

Table 4.1

Reported Communications Fund balances 2005–06 to 2007–08

	2005–06		2006–07		2007–08	
	DCITA (\$'000)	AOFM (\$'000)	DCITA (\$'000)	AOFM (\$'000)	DBCDE (\$'000)	AOFM (\$'000)
Opening balance	2 000 000	2 000 000	2 084 595	2 084 595	2 215 986	2 215 986
Interest earned	84 598	84 598	131 583	131 583	140 593	140 592
Expenses	3.5	3.5	192	192	159	159
Closing balance of investments	2 084 595	2 084 595	2 217 885	2 215 986	2 356 420	2 356 419

Source: ANAO analysis of DCITA, DBCDE and AOFM financial statements.

⁹⁴ Finance has sought from DCITA on a monthly basis advice on the value of the Communications Fund as at the end of each month.

⁹⁵ ANAO Audit Report No.15 2004-05, *Financial Management of Special Appropriations*, Canberra, 23 November 2004, p. 54.

4.13 As Table 4.1 shows, in 2006–07, although each agency reported identical opening balances, interest earnings and expense payments, the balance of investments reported by DCITA was greater than the balance reported by the AOFM. This is because DCITA reported the market value of the Communications Fund’s investments rather than the settlement (or cash) value of the investments. This approach was taken notwithstanding that Special Accounts are required by the FMOs to be disclosed on a cash basis (as the AOFM’s reporting of the Fund was) and, as such, DCITA’s disclosure of the balance of the investments of the Fund was incorrect.

4.14 In addition to reporting on the Communications Fund Special Account, DCITA/DBCDE is also responsible for disclosing the special appropriations supporting the operation of the Communications Fund in its annual financial statements. As noted in Chapter 2, there are three special appropriations contained in the Consumer Protection Act for the Communications Fund, authorising:

- the purchase of investments (other than derivatives);
- the purchase of derivatives; and
- the payment of the expenses of the Communications Fund (that is, the fees paid to the investment manager).

4.15 Although only two of the three special appropriations are able to be drawn on,⁹⁶ DCITA/DBCDE is required to disclose each special appropriation for which it is responsible, whether or not that appropriation has been used. However, ANAO’s examination of DCITA’s financial statements for the years 2005–06 and 2006–07 has shown that none of the Communications Fund special appropriations have been appropriately disclosed by DCITA in either year. Specifically, while the special appropriations have been identified in aggregate in DCITA’s Special Accounts note in relation to the investment of public funds, the use of each special appropriation has not been separately disclosed in the manner required by the FMOs.

4.16 DBCDE advised ANAO in June 2008 that:

Issues raised by ANAO relating to DBCDE’s reporting will be investigated by the Department and will be addressed through the 2007–08 Annual Financial Statements preparation process, including any required disclosures. Where

⁹⁶ As Ministers have not authorised investment in derivatives for the Communications Fund, the special appropriation in the Consumer Protection Act relating to the purchase of derivatives is currently not being used.

required, consultation will be undertaken between the Department and the AOFM.

4.17 In this respect, in DBCDE's 2007–08 financial statements, the correct cash balance of investments is reported for the Communications Fund, and the use of the special appropriations has been separately disclosed. DBCDE has also disclosed the errors in the information presented in the DCITA 2006–07 financial statements.

Performance reporting

4.18 At the time of audit fieldwork, there had been three quarterly performance reports due from, and provided by, the AOFM. These reports related to the performance of the Communications Fund for the quarters ending 30 September 2007, 31 December 2007 and 31 March 2008.

4.19 The performance reports prepared by the AOFM are quite detailed, covering each aspect required by the Service Level Agreement and Investment Guidelines, and include narrative summaries of the Fund's operations and diagrammatic representations of the Fund's compliance with relevant limits.⁹⁷ In providing the first quarterly report to DCITA on 12 October 2007, the AOFM stated:

This report provides information on the Australian Office of Financial Management's investment activities for the Communications Fund, its compliance with the Investment Guidelines and performance outcomes of the Communications Fund up to the end of the September Quarter 2007.

This is the first quarterly performance report provided on the activities of the Communications Fund as required under the Service Level Agreement between our agencies signed on 18 June 2007. I intend to use the scope and structure of this report as a basis for future performance reporting and would welcome your feedback on the report.

4.20 However, ANAO found that there were significant delays in DCITA and DBCDE considering and responding to the AOFM's first quarterly report. Specifically, in late November 2007, DCITA requested the AOFM to provide a one-page summary of the quarterly report against the requirements of the Investment Guidelines and Service Level Agreement, to 'help decipher' the report in providing a briefing to the DCITA Secretary. Following further consultation with the AOFM, on 29 January 2008 (more than three months after

⁹⁷ A similar report is prepared internally by the AOFM on a daily basis for the Communications Fund. The daily reports are structured largely the same way as the quarterly performance reports, but contain more detailed information in respect of the operations of the Fund.

the first quarterly performance report had been provided by the AOFM) DBCDE wrote to the AOFM and stated:

The Department has now considered the First Quarterly Performance Report along with the additional comments AOFM kindly provided and concluded that it reports against, and meets all of the requirements of, the Investment Guidelines and the Service Level Agreement.

With regard to your request for feedback on the scope and structure of the report as a model for future performance reporting, it would be helpful if a short summary, specifically referring to each requirement set out in the Investment Guidelines and SLA could be provided with future reports.

4.21 At the time the letter was sent to the AOFM by DBCDE, the second quarterly performance report had already been submitted by the AOFM. Although this second report was received by DBCDE on 8 January 2008, the letter sent to the AOFM in respect of the first quarterly report did not acknowledge receipt of the second report.

4.22 There were also delays in DBCDE responding to the AOFM's second and third quarterly performance reports, with DBCDE formally accepting the reports two months and six weeks respectively after having received them. DBCDE advised ANAO in June 2008 that:

Initial delays with processing AOFM's quarterly performance reports within the Department have resulted from seeking to ensure that the Department completed a comprehensive and careful analysis of the report and that all requirements had been met. In some cases there has also been a need to clarify certain aspects of the reporting. The initial report in particular, since it was the first, required particular attention so that we could ensure robust internal processes into the future. While not yet optimal, the assessment period has improved over the course of the three quarters and the Department has put in place processes to ensure that the assessment of future reports is expedited without compromising the need for careful consideration.

4.23 Given the experience that has already been obtained in the management of the Future Fund and the HEEF, it would be reasonable to expect that the management of the new infrastructure Funds will include more timely action than that which has occurred for the Communications Fund in considering performance reports provided by investment managers.

Investments of the Fund

4.24 ANAO has examined the investment activities of the Communications Fund from its inception on 26 September 2005⁹⁸ through to 31 December 2007. Over time, there have been different parameters and instructions in place in respect of the investment of the Communications Fund. As Table 4.2 shows, the overarching parameters for the investment of the Communications Fund stem from the Ministerial Authorisation in force during the relevant time period, which provides the legal authority for the Fund to be invested. There have also been other Ministerial parameters set at different times, and DCITA has issued instructions to the AOFM in respect of the types of investments that the AOFM is permitted to make for the Fund.

Table 4.2

Investment parameters and instructions advised to the AOFM

Ministerial authorisation	Time period	Ministerial investment parameters	Instructions from DCITA to AOFM
Initial Authorisation – term deposits with RBA only	26 September 2005 to 23 March 2006	6 month term deposit with RBA, provision for 7 day term deposits following maturity	6 month term deposit with RBA, provision for 7 day term deposits following maturity
	24 March 2006 to 20 June 2006		Term deposits with RBA, period or periods up to 7 days
	21 June 2006 to 21 January 2007 ^A	Within portfolio limits from consultant's report	Term deposits with RBA, no 7 day tenor restriction
New Authorisation – broader range of instruments	22 January 2007 to 17 June 2007	Within portfolio limits from consultant's report and in accordance with instructions (if any) from Secretary of DCITA	In accordance with Investment Guidelines
	18 June 2007 onwards		
<p>Note A: Ministers agreed on 22 March 2006 and 6 April 2006 that the Communications Fund should be invested within the broad portfolio limits contained in the consultant's report, and that the AOFM should manage the investments of the Fund. However, the AOFM was not formally advised of the Ministers' decision until 21 June 2006.</p>			

Source: ANAO analysis of DBCDE records.

Investment activity under Initial Authorisation

4.25 As Table 4.2 shows, under the Initial Authorisation the AOFM was permitted to invest the Communications Fund only in term deposits with the

⁹⁸ The Communications Fund was legally established on 23 September 2005 following the passage of the Future Proofing Bill. However, the \$2 billion was not required to be credited to the Special Account until the first business day after the passage of the legislation, which was 26 September 2005.

RBA. Following maturity of the initial six month \$2 billion term deposit, DCITA advised the AOFM that Ministers were in the process of finalising longer term arrangements for the Communications Fund, and that, following the maturity of the initial six month term deposit on 27 March 2006, it should be rolled over into shorter term deposits for a period or periods of up to seven days, until further notice.

4.26 No further advice to the AOFM was provided by DCITA in the following 12 weeks. In this respect, DBCDE advised ANAO in August 2008 that detailed checking of legal and contractual implications was necessary before updating instructions to the AOFM.

4.27 The seven day tenor restriction on term deposit investments was removed by DCITA on 21 June 2006, when DCITA advised the AOFM that Ministers had decided that the AOFM should manage the investments of the Communications Fund within the broad portfolio limits that had been set out in the consultant's report. Although these portfolio limits provided for investment in a broader range of financial instruments, there had been no revision made to the Ministerial authorisation instrument to reflect the revised mandate for the Fund. Accordingly, DCITA advised the AOFM that it should continue to invest the Fund only in term deposits with the RBA until a new authorisation had been given.

4.28 ANAO notes that, while the Initial Authorisation permitted investment only in RBA term deposits, Ministers agreed in April 2006 that the Communications Fund should be invested in line with the broad portfolio limits that were contained in the example table in the consultant's report. This Ministerial mandate provided for investment in a broader range of instruments than just term deposits. However, it took 10 months for a new authorisation instrument to be put in place.

4.29 Accordingly, for the 10 months between Ministers agreeing to the broad mandate and signing the New Authorisation, the AOFM was restricted to investing the Communications Fund only in RBA term deposits. By way of comparison, agencies who have been delegated the authority to invest amounts standing to the credit of a Special Account are able to invest those monies in any of the financial instruments authorised by Section 39 of the FMA Act and FMA Regulation 22. These same instruments are authorised under the Consumer Protection Act and Communications Fund Regulations—but were not permitted by the Initial Authorisation.

Investment activity under New Authorisation

4.30 The New Authorisation took effect on 22 January 2007. The authorisation permits the AOFM to undertake investments for the Communications Fund in a broader range of financial instruments than just RBA term deposits, such as debentures, bank bills, negotiable certificates of deposit and various other debt instruments. However, instructions from DCITA that the AOFM should continue to invest only in term deposits with the RBA until the Investment Guidelines were finalised meant that the AOFM was not able to commence investing the Communications Fund in the broader range of financial instruments until 18 June 2007, five months after the New Authorisation had commenced.

4.31 In this respect, the AOFM had advised DCITA in September 2006 that it did not consider it was appropriate for it to commence establishment processes for the transition to the longer term investment strategy until Ministers had formally approved the AOFM's appointment as the manager of the Communications Fund. This appointment did not occur until 22 January 2007 when the New Authorisation was signed. The AOFM then required time to transition from the existing arrangements to the longer term investment arrangements (including the processes to appoint investment dealing panel members to sell eligible securities to the Commonwealth, which the AOFM commenced on 9 February 2007). The AOFM began the transition out of term deposits to other financial instruments permitted by the New Authorisation from 26 June 2007.

Panel arrangements and tenders for investments

4.32 There are a number of different approaches that entities can adopt to maximise investment returns, for a given level of risk. These can include the following:

- quotes can be sought from a number of institutions;
- in selecting a provider of investment and other financial services, entities can include as part of the selection process explicit consideration of rates and margins that will be offered on products; and/or
- entities can compare quoted rates with published market rates.⁹⁹

⁹⁹ ANAO Audit Report No.22 of 2004–05, *Investment of Public Funds*, Canberra, 18 January 2005, p. 40.

4.33 As part of its new role of investment management for the Communications Fund, the AOFM established an investment dealing panel for the Communications Fund investment facility. Each entity that is appointed to the dealing panel is required to sign a 'Panel Membership Agreement' and abide by the 'Conditions of Panel Participation' (the Panel Conditions). The Panel Conditions set out, among other things, details of the tender and dealing arrangements for the funds under management. At the time of audit fieldwork, Panel Agreements had been signed with 19 counterparties. The AOFM conducts a tender each Tuesday morning, with Panel members being invited to take part in the tenders on a rotation basis.

4.34 ANAO considers that the investment dealing panel arrangements established by the AOFM for conducting the investment transactions of the Communications Fund provide a sound base for maximising investment returns on the instruments sought through each tender. In this respect, in March 2008 Applied Financial Diagnostics advised ANAO that the bank bill and negotiable certificate of deposit investments undertaken for the Communications Fund from 26 June 2007¹⁰⁰ were generally transacted at or above expected market rates.

Replication of benchmark

4.35 The performance benchmark selected for the Communications Fund under the longer term investment strategy was the UBS Australia Bank Bill Index (UBS ABBI).¹⁰¹ The AOFM's approach to managing the Communications Fund's investments was to replicate the benchmark. As a result, the average tenor of the Communications Fund investment portfolio has hovered between 40 and 50 days. The longest tenor of a single investment of the Fund since the completion of the transition out of RBA term deposits has been 93 days, roughly one quarter of the upper tenor limit allowed by the Investment Guidelines.

4.36 In this regard, Applied Financial Diagnostics advised ANAO in March 2008 that:

The Fund is benchmarked against the UBS Australia Bank Bill Index. There is a further worst case benchmark of no less than the RBA Cash Rate.

¹⁰⁰ The AOFM began the transition from term deposits to the broader range of instruments on 26 June 2007, when the first tender was conducted.

¹⁰¹ The UBS ABBI comprises a portfolio of 13 bank bills, with a bank bill maturing every Tuesday. The average tenor of the index's portfolio moves between 43 and 49 days.

A performance benchmark is a powerful communications tool and provides a very strong indicator to the fund manager of the investor's expectations with respect to risk and return.

Given the following circumstances:

- the fund's benchmark is the UBS bank bill index;
- there is a further minimum benchmark in place—the RBA cash rate;
- there is no provision for rewarding the AOFM for exceeding the benchmark under the investment guidelines or SLA; and
- for the AOFM, underperforming the benchmark would probably be much more visible and the censure would probably far outweigh the congratulations for over-performance,

we would consider it reasonable that the AOFM should manage the Communications Fund with the aim of replicating the benchmark.

In our opinion, if a higher return were to be sought by DCITA then a more appropriate benchmark targeting that higher return should be set.

4.37 The AOFM advised ANAO in June 2008 that:

In managing the Fund, the AOFM not only out-performed its mandated benchmark, but did so in the context of unusually difficult credit conditions.

Restriction on investment types

4.38 The Panel Conditions state that the AOFM will only purchase through the tender process those securities that are registered on the Eligible Investment List. In this respect, the AOFM's Investment Committee, which was established in late 2006 to oversee the operational management of the Communications Fund, meets on a monthly basis, and makes recommendations to the Chief Executive of the AOFM in respect of the inclusion of certain issuers or issues on the Eligible Investment List.

4.39 ANAO found that the Eligible Investment List, as at the time of audit, contained only a small subset of the financial instruments authorised by Ministers for the Communications Fund. Specifically, only the following instruments were included:

- bank accepted bills of exchange;
- negotiable certificates of deposit; and
- commercial paper.¹⁰²

¹⁰² Commercial paper was first added to the Eligible Investment List on 16 November 2007.

4.40 The returns achieved for the Communications Fund through the purchase of commercial paper investments have been well in excess of the returns achieved on bank bills and negotiable certificates of deposit. As at 31 December 2007, the AOFM had invested \$40 million in 'A1+' commercial paper. This represented approximately two per cent of the value of the Fund. However, under the Investment Guidelines, up to 20 per cent of the Fund could have been allocated to securities of this nature, or a range of other debt instruments, thereby achieving higher fund returns. In March 2008, Applied Financial Diagnostics advised ANAO that:

Given the risk-averse nature of the Investment Guidelines, and with the benefit of hindsight with respect to recent credit market correction, in our opinion the AOFM could have justified not seeking higher returns.

4.41 In this respect, the AOFM's third quarterly performance report for the Fund stated:

The Communications Fund did not add to its initial investment in asset backed commercial paper purchased in December 2007, which at around 2% was well below the 20% limit for the Fund. The investment was rolled on maturity into A1+ bank paper in early March. In doing so, the AOFM acted conservatively in light of market credit concerns about the monoline insurers of these asset backed vehicles.


Steve Chapman
Acting/Auditor-General

Canberra ACT
23 September 2008

Appendix

Appendix 1: DBCDE Formal Agency Comments

The Department of Broadband, Communications and the Digital Economy (DBCDE) notes that the ANAO has concluded that the investment approach taken for the Communications Fund (the Fund) ‘closely aligns with the approach adopted for entities investing under the [*Financial Management and Accountability Act 1997*] and is also more consistent with the policy that the Fund be perpetual in nature’ and that the outcome ‘reflects a prudent approach’.

Investment parameters

DBCDE notes the report’s conclusion that the broad investment powers established in the Fund’s enabling legislation were made without the merits of such an approach being subject to expert advice.

The Bill creating the Fund was the first of its type to be introduced into the Australian Parliament and was developed over an extremely short timeframe. The legislation was introduced three weeks after the intention to establish the Fund was announced. By way of comparison, the Future Fund legislation was developed over seven months after the detailed plans for the Communications Fund were announced. All agencies involved with the Fund legislation (the Department of Communications, Information Technology and the Arts (DCITA), Finance and Administration and Treasury) had limited expertise to bring to bear at the time and, as the report notes, it was not possible to obtain external expert advice in the short timeframe.

Given these factors, the then draft Future Fund Bill (which both Treasury and Finance had been developing) was used as a base for the Communications Fund legislation. A broad range of investment instruments was enabled, with the requirement that both the portfolio Minister and the Minister for Finance and Administration approve an Investment Authorisation instrument to clarify and, as appropriate, restrict investment instruments once an investment strategy was more clearly defined. This mechanism provides a strong and prudent check to protect against the use of inappropriate investment instruments.

With additional time, a different approach to the legislation may well have been adopted. However, a broad approach provided the Parliament with transparency about the breadth of investments that the Fund could potentially utilise at a time when the scope of such investments had not yet been settled.

Following the passage of the Fund's enabling legislation, a working group (comprising DCITA, Finance and Treasury) was established to develop the longer-term investment strategy and governance arrangements for the Fund. During debate in Parliament about the Fund's legislative arrangements, the then Ministers made a number of statements regarding the planned investment outcomes (positive returns on an annual basis, earnings of at least the cash rate). These were taken into account by the working group in considering the investment strategy. It was agreed by all three agencies that it would be appropriate to limit the Fund's investment to a low-risk portfolio and that expert advice be sought within those parameters. The then Minister was advised by DCITA of this and noted the intended approach, including that it had been adopted having regard to Ministerial statements in Parliament. Following receipt of the expert advice, the Minister was advised that alternative approaches had the potential to provide greater financial returns but noted that the greater risks involved would have required a relaxation of the investment parameters previously outlined by the government.

Timeliness

DBCDE notes the ANAO view that significant delays were experienced in developing the investment strategy and assessing investment reports.

The original Bill provided for the creation of the Fund using the proceeds from the final sale of Telstra, which eventuated on 28 February 2007. This original timing would have allowed for considered planning and analysis. However, the Bill was amended by the Parliament to require an immediate establishment of the Fund, bringing forward its creation by 17 months. This required the Department to immediately manage the Fund while at the same time work with Finance and Treasury to develop the Fund's investment and management arrangements.

Developing and implementing the arrangements was a complex process for the three agencies involved (DCITA, Finance and Treasury) and required careful development, review and implementation of the necessary approval processes on each of the key documents. As the first initiative of its type, involving very significant public funds in respect of which clear Government commitments had been made regarding investment returns, it was important that this development work was consultative, thorough and fully considered so as to ensure there were robust management and comprehensive reporting arrangements for the Fund.

DBCDE holds the view that the responsible agencies (DCITA and Finance), and our partner in the exercise (Treasury), acted appropriately in carefully progressing the processes required to establish an appropriate set of investment structures. The experience developed in implementing this Fund, however, has provided a broader base of expertise on which more recent similar initiatives can build.

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