The Auditor-General

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Performance Audit

DASFLEET SALE

Australian National Audit Office

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Canberra ACT
18 December 1998

Dear Madam President
Dear Mr Speaker

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

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

Yours sincerely

P. J. Barrett
Auditor-General

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

AUDITING FOR AUSTRALIA

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Abbreviations/Glossary

ACT	Australian Capital Territory
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulatory Authority
CMVR	Commonwealth Motor Vehicle Registry
CPA	Commonwealth Public Account
DAS	Former Department of Administrative Services
DASFLEET	Former DAS Business Unit
DOF	Former Department of Finance
DOFA	Department of Finance and Administration
NPV	Net Present Value
OASITO	Office of Asset Sales and IT Outsourcing
PSCC	Protective Security Coordination Centre
RBA	Reserve Bank of Australia
RWOG	Relative Whole of Government

Summary and Recommendations

Summary

Background

1. The Government announced in the August 1996 Budget its intention to realise the Commonwealth's investment in the vehicles then managed by DASFLEET, either by a trade sale of the whole business or by external refinancing of the vehicles. OASITO and its Business Adviser conducted the sale and refinancing tender processes in tandem. The Minister for Finance[1] and the then Minister for Administrative Services announced on 1 July 1997 that DASFLEET was to be sold to Macquarie Fleet Leasing Pty Ltd, a wholly owned subsidiary of Macquarie Bank Limited.

2. On 17 July 1997, a sale agreement was signed between the Commonwealth and Macquarie Fleet Leasing Pty Ltd for the sale of DASFLEET for $407.9 million but final proceeds will not be able to be determined until a dispute between the Commonwealth and the purchaser of DASFLEET about the completion accounts for the transaction is settled. On 1 September 1997, a five year Tied Contract for vehicle leasing and fleet management services was signed between the parties.

3. The sale was preceded by a 1996 Department of Finance review of DASFLEET's financing and operations which found that the best financial outcome for the Commonwealth would be either a refinancing of the fleet, or privatisation of the business with a five year tied customer contract.

4. Overall responsibility for the management and completion of the sale was assigned to the Office of Asset Sales and IT Outsourcing (OASITO).[2] OASITO was assisted in the DASFLEET sale by a Business Adviser and Legal Adviser. The Business Adviser was primarily responsible for conducting a scoping study and implementing the approved sale strategy. The Legal Adviser assisted with the scoping study and sale process including due diligence activities and preparation of sale documentation.

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1 The Minister for Finance and Administration is referred to by his title at the time of the sale - the Minister for Finance.

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

5. The sale of DASFLEET was selected for audit because of the materiality of the sale and the five year tied contract awarded to the winning bidder. ANAO also audited the sale of Works Australia and the sale of DAS Interiors Australia. Separate audit reports have also been produced on overall sale management, the Works Australia sale, and the DAS Interiors Australia sale.

Audit conclusions

6. OASITO and its advisers succeeded in negotiating the sale of DASFLEET and a five year Tied Contract for vehicle fleet services broadly within the indicative sales timetable. The business was effectively maintained through the sales process and no residual business parts remained with the Commonwealth following the sale.

Tender process

7. The Information Memorandum that was issued on 1 April 1997 requested tenderers to supply a preliminary non-binding cash price and supporting corporate material sufficient to convince the Commonwealth that the prospective purchaser was fit to be short-listed. This was to assume *that vehicle leasing arrangements post sale will be conducted on an operating lease basis.* A transaction using operating leases would result in the purchaser of DASFLEET effectively retaining substantially all the risks and benefits incidental to ownership of the vehicles. This contrasts with a transaction using finance leases where the leases would effectively transfer from the purchaser to the Commonwealth substantially all the risks and benefits incidental to ownership of the vehicles. A subsequent letter to all prospective tenderers (18 April 1997) advised that the residual value risk was to reside with the purchaser who would be required to keep an open book so that the Commonwealth could assess that adequate risk management processes were in place (see also para 16).

8. In assessing the financial aspects of bids a relative whole of government (RWOG) approach was adopted which involved the Business Adviser undertaking a discounted cash flow analysis based on estimating net present value (NPV)[3] for six and ten years. These time horizons were chosen to represent the duration of the tied contract period (five years plus one year average vehicle lease run-off) and the term under which a refinancing proposal would be more financially viable, namely ten years. The Business Adviser in its 9 June 1997 advice to OASITO, which was then provided by OASITO to the Minister for Finance, assessed the Macquarie

[3] NPV outcomes reported were the midpoint of 8 per cent and 10 per cent discount rates.

Bank bid as generating a NPV (Budget impact) of $116 million over six years and, over ten years, a NPV of minus $10 million. The next highest bidder was assessed as generating a NPV of $110 million for six years and minus $13 million for a ten year NPV. The Macquarie Bank bid had the largest up front payment and the lowest cost of funds for the vehicles leased but it had a higher fleet management rate than that proposed by the second ranked bidder.

9. The Minister for Finance agreed to OASITO's 9 June 1997 recommendation that DASFLEET be sold with final negotiations to be undertaken with one party, Macquarie Bank. The two highest bidders for DASFLEET were close in financial terms having regard both to the up front lump sum offered and the ongoing charges proposed. In evaluating bids in such a competitive process, ANAO considers that negotiations should be continued until one bid is identified as clearly presenting a superior outcome in terms of overall risk and return. However, despite the closeness of the two highest bidders, there were no further negotiations with the second ranked bidder after mid June 1997.

10. On 30 June 1997, the Business Adviser re-analysed the bids and confirmed that Macquarie Bank's offer was superior and recommended that the Commonwealth accept Macquarie Bank's binding offer for DASFLEET. The sale process was completed on time with the announcement of the successful bidder on 1 July 1997 and the signing of the Sale Agreement on 17 July 1997.

Financial risk

11. The different mechanisms for sharing risk offered by the bidders were reflected in their differing margins over the benchmark leasing rate cost of funds. The margin rate offered by Macquarie Bank in its May 1997 binding offer was one fifth of that offered by the next highest bidder in the first year of the transaction. In the case of the Macquarie Bank bid for DASFLEET, there was a direct linkage between the interest rate payable by the Commonwealth as customer on the leasing of the fleet and the regulatory risk weight determined by the Reserve Bank of Australia (RBA) for the transaction.[4] This situation did not apply to the other bidders' offers.

12. Effective administrative actions were not taken to identify and specifically quantify the financial risks in the five year Tied Contract associated with the Commonwealth accepting exposure to the variations

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[4] Macquarie Bank Limited is an entity licensed as a bank under the *Banking Act 1959.* At the time of the sale, RBA supervised banks by a range of mechanisms including that banks' risk adjusted capital ratios remain at acceptable levels. Since 1 July 1998, this function has been carried out by the Australian Prudential Regulatory Authority.

in the RBA assessment of the required risk weighting for capital adequacy purposes. The financial analysis undertaken by the Business Adviser for the selection of the winning bidder did include a sensitivity analysis of the change in the NPV of each bid as a result of changes in key assumptions one of which was interest rates.

13. However, the analysis did not explicitly identify how the cost of funds could have increased with any increase in the risk weighting required by the RBA for the transaction as compared to the 10 per cent risk weighting assumed by Macquarie Bank in its offer. This risk weighting is assigned to transactions representing a claim on Commonwealth or State Governments. A risk weighting of 100 per cent could have resulted in the Commonwealth incurring additional costs under the Tied Contract of up to some $25.7 million (nominal dollars) over the term of the contract.

14. The potential equivalent, on a NPV basis, of these additional costs has been calculated by the Business Adviser. The Business Adviser advised ANAO in November 1998 that applying its valuation models, after increasing the cost of funds by 150 basis points (taking account of the expected diminution in the size of the CPA fleet over the period of the Tied Contract; the tax effects; and the time value of money) to reflect a 100 per cent risk weighting, resulted in projected increased costs over the Tied Contract of $7.3 million on a NPV basis.

15. OASITO has advised ANAO that Schedule 10 of the Tied Contract was specifically developed to address the Commonwealth's exposure to the potential that the RBA might impose a different capital adequacy requirement on the transaction to the assumed 10 per cent. Schedule 10 provides that, whenever an adjustment event occurs and the Purchaser notifies the Commonwealth of an increase in margin, the parties must meet and negotiate and use their best endeavours for a period of not more than 30 days to restructure the Tied Contract and funding arrangements so that the same, or substantially the same, intended economic effect can be achieved. If the Commonwealth gives notice to the Purchaser that it does not accept the increase in the margin, the Purchaser may terminate the Tied Contract, with considerable potential adverse financial implications for the Commonwealth.

16. The RBA indicated to Macquarie Bank soon after the sale that it would treat the transaction as being weighted not at 10 per cent but rather at 100 per cent. The RBA agreed in June 1998, some twelve months after the selection of Macquarie Bank, to classify leases entered into under the Tied Contract as finance leases, enjoying a 10 per cent risk weighting, if they are due to expire before the Tied Contract matures on 1 September 2002. Vehicle leases which expire beyond that date will be treated by the

RBA on the basis of 100 per cent risk weighting which will be reflected in higher lease financing costs for Commonwealth agencies under the Tied Contract.

Contractual risk

17. Volatility in the price of second hand vehicles has a major impact on the financial returns of fleet owners. The second highest priced tenderer proposed to assume the full residual risk of the vehicle fleet. The winning tenderer proposed to manage the profit and losses on individual vehicles over the term of the Tied Contract by means of a residual risk fee included in the lease rate for each vehicle which would be paid into a Reserve Account with the intention that its balance would approach zero over the term of the Tied Contract. A consultant appointed by the Department of Finance and Administration (DOFA) advised in January 1998 that the Reserve Account balance would be in deficit in the early years but would target on average a balance of $10.8 million by October 2001. Legal advice received by the Commonwealth indicates that, under the Tied Contract, ambiguities exist which could potentially impact on the proposed arrangements for access to the Reserve Account by the respective parties.

18. The financial implications of the five year Tied Contract are such that the Commonwealth is exposed to a range of commercial risks including increased leasing charges to agencies and potential responsibility for the cost of terminating the contract. ANAO considers that the commercial implications for the Commonwealth of the residual risk fee and the Reserve Account along with expiry of the Tied Contract warrant a comprehensive review of the Commonwealth's financial exposures. DOFA has advised ANAO that it has initiated a comprehensive assessment of the Tied Contract which is scheduled for completion in late December 1998.

Administrative practices

19. ANAO considers that, for future trade sales, administrative practices could be strengthened in the following areas:

- ***Fee arrangements:*** Clearly identifying and evaluating the quantum and calculation of any completion and success fees as <u>part</u> of the selection process for advisers would assist OASITO maximise value for money in its outsourcing arrangements. After the Business Adviser commenced work on the sale process, OASITO negotiated a percentage success fee for the Business Adviser which applied to the excess of proceeds over those that could have been expected for the sale of the vehicles alone plus $50 million. In total, the completion and success fees are estimated to comprise more than 60 per cent of total fees to be paid to the Business Adviser.

- ***Early identification of major sale issues:*** Detailed consideration of the management of the Commonwealth protective services vehicle fleet did not occur until after final bids closed in late May 1997. OASITO then took action to consult with the relevant Commonwealth agencies regarding the disposition of the Commonwealth protective services vehicle fleet. The decision was taken to include the protective services vehicle fleet in the DASFLEET sale and to provide in the sale documentation special arrangements to deal with the security issues involved.
- ***Prioritisation of evaluation criteria:*** ANAO did not find evidence of the application of any specified weightings or priorities to the various criteria in the tender evaluation process. Sound administrative practice suggests that the relative importance attaching to each tender evaluation criterion should be incorporated in the tender evaluation methodology used.
- ***Tender evaluation committees:*** For future asset sales involving long term contracts, ANAO considers that the adoption of an evaluation structure using a tender evaluation committee would improve the transparency and accountability of the tender process. The complexity of the DASFLEET transaction, coupled with the scale and nature of the financial analysis used to judge the relative merits of the bids, required that OASITO be in a position to ensure that the ultimate decision maker can rely on the information about each tender contained in the evaluation report.
- ***Risk assessment:*** ANAO considers the Commonwealth's interests in future trade sales would be enhanced by ensuring all relevant Commonwealth agencies are formally approached and written sign-offs obtained on commercial and administrative issues affecting the financial outcome of the sale. The Macquarie Bank bid of May 1997 indicated, amongst other things, that its transaction funding rate margin was premised on the RBA assessing the transaction for capital adequacy purposes at the rate of 10 per cent. There was a direct linkage between the interest rate payable by the Commonwealth, as customer, on the leasing of the fleet and the regulatory risk weight determined by RBA for the transaction. ANAO was unable to find substantive evidence that any action was taken by OASITO or its Business Adviser to obtain formal confirmation from the RBA of how the transaction would be treated for risk weighting purposes prior to advising the Minister for Finance on 9 June 1997.

Recommendations

20. ANAO made six recommendations to improve the management of future trade sales, particularly those involving the simultaneous letting of a long term contract for services. The Attorney-General's Department agreed with Recommendation No. 2 and DOFA agreed with Recommendation No. 6. OASITO agreed with Recommendation No. 5 and agreed with qualifications to all other relevant recommendations.

Recommendations

Set out below are ANAO's recommendations arising from this report, with report paragraph references and abbreviated responses from agencies. More detailed responses are shown in the body of the report together with the findings.

Recommendation No.1 Para 2.7

ANAO *recommends* that where any completion or success fees are to be part of advisers' remuneration, in future trade sales, the basis for calculation of these fees be clearly identified and evaluated as <u>part</u> of the selection process.

OASITO: Agreed with qualifications.

Recommendation No.2 Para 2.20

ANAO *recommends* that, for future trade sales, relevant Commonwealth agencies ensure that in scoping the sale all significant issues requiring consultations with other agencies and/or decisions by Ministers are identified and dealt with in advance of issuing Information Memoranda and closing bids.

Attorney-General's Department: Agreed.

OASITO: Agreed with qualifications.

Recommendation No.3 Para 2.29

ANAO *recommends* that, where appropriate for future trade sales, the Office of Asset Sales and IT Outsourcing enhances transparency and accountability of decision making in the tender process by developing and assigning appropriate priorities which set out the relative importance of each tender evaluation criterion.

OASITO: Agreed with qualifications.

Recommendation No.4 Para 3.12

ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in future trade sales of major assets involving material long term Commonwealth contracts, improve transparency and accountability in the sale process by the establishment of an appropriately structured tender evaluation committee.

OASITO: Agreed with qualifications.

Recommendation No.5 Para 3.37	ANAO recommends that where possible, in future asset sales, the Office of Asset Sales and IT Outsourcing ensures that all relevant Commonwealth bodies are formally approached and written sign-offs are obtained from appropriate officials on commercial and administrative issues affecting the financial outcome of the sale. ***OASITO:*** Agreed.
Recommendation No.6 Para 3.44	ANAO recommends that the Department of Finance and Administration, in consultation with relevant Commonwealth agencies, undertakes a comprehensive commercial risk assessment of the Commonwealth's exposure under the five year Tied Contract. ***DOFA:*** Agreed.

Audit Findings and Conclusions

Introduction

This chapter outlines the background to the sale of DASFLEET and the audit approach taken.

Background

1.1 The Government announced in the August 1996 Budget its intention to realise the Commonwealth's investment in the vehicles then managed by DASFLEET, either by a trade sale of the whole business or by external refinancing of the vehicles.[5] The Minister for Finance and the then Minister for Administrative Services announced on 1 July 1997 that DASFLEET was to be sold to Macquarie Fleet Leasing Pty Ltd, a wholly owned subsidiary of Macquarie Bank Limited.

1.2 On 17 July 1997, a sale agreement was signed between the Commonwealth and Macquarie Fleet Leasing Pty Ltd for the sale of DASFLEET for $407.9 million but final proceeds will not be able to be determined until a dispute between the Commonwealth and the purchaser of DASFLEET about the completion accounts for the transaction is settled. On 1 September 1997, a five year Tied Contract for vehicle leasing and fleet management services was signed between the parties.[6]

1.3 DASFLEET supplied passenger and commercial vehicles to the majority of Commonwealth bodies. The total active fleet managed by DASFLEET was over 16 000 vehicles[7] with a work force of some 370 staff. Of the total fleet, approximately 9 500 carried Z-plates issued through the

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5 If DASFLEET were to be retained, the Ministers were to consider ceasing to service non-Commonwealth Public Account (CPA) clients, withdrawing from rental activities and market testing the workshop operations.

6 DASFLEET Information Memorandum pp.44 - 46: *DASFLEET is to be sold with a commitment by the Commonwealth to tie to the business those departments and agencies which operate on the Commonwealth Public Account (except for the Office of Governor-General and the Australian Defence Force). The tie will extend for five years from the date of sale and will apply for vehicle purchase orders lodged by CPA customers during the five year period. The purpose of tying the CPA customers is to deliver a single access, comprehensive national vehicle provisioning service which maximises the economies of scale available to the Commonwealth. Individual vehicle leases under this agreement will expire after the termination of the tie in accordance with their individual terms. The Tied Contract will be an annexure to the Sale Contract. The individual Service Agreements between each CPA customer and DASFLEET will be an annexure to the Tied Contract. They will be umbrella agreements for individual vehicle leases.*

7 DASFLEET Information Memorandum p. 7: *The total active fleet managed by DASFLEET was 16,343 vehicles. DASFLEET owns all of those vehicles except for 737 vehicles which were privately financed or managed by DASFLEET for other parties. DASFLEET acquired over 7,000 new vehicles every year in accordance with the Commonwealth's practice of buying Australian made or assembled vehicles with purchasing advantages with the major Australian vehicle manufacturers.*

Commonwealth Motor Vehicle Registry (CMVR), administered by DASFLEET. Under Commonwealth legislation, Z-plate vehicles are not subject to State and Territory registration charges, compulsory third party insurance or stamp duty.

1.4 The value of the fleet was $376 million as at 31 January 1997.[8] DASFLEET was the most profitable of the DAS Business Units, returning a net operating profit of just over $23 million in 1996-97. DASFLEET had three main business areas:

- ***Vehicle leasing:*** (approximately 15 000 vehicles in total) provided under operating leases to tied Commonwealth Public Account (CPA) clients (some 12 000 vehicles) and untied customers (some 3 000 vehicles) such as State Government agencies and other public sector and federally-funded organisations throughout Australia;
- ***Vehicle rental:*** (approximately 1 800 vehicles) short-term services largely to customers from the Australian Public Service and Australian Defence Force through a network of capital city and major regional locations including rental desks at major Australian airports; and
- ***Fleet management and maintenance:*** workshops, technical services, fuel management, fleet information and reporting services were combined within this business area.

1.5 To preserve the benefits of the Commonwealth cars[9] and the position of private plated cars in the event of DASFLEET change of ownership, and to exempt the sale/refinancing from State and Territory stamp duty, the Government passed two bills[10] - the *Commonwealth Motor Vehicles (Liability)*

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8 31 January 1997 was the date of the 'Asset and Liability Statements' and from which the purchase price was determined. As at the date of Completion there was to be a set of 'Completion Asset & Liability Statements' providing for an adjustment by way of payment for a change in the net asset position, after deducting additional depreciation and amortisation between the date of the Asset and Liability statement and completion of the sale.

9 Prior to the sale of DASFLEET, Commonwealth vehicles (either owned by or used exclusively by the Commonwealth or a Commonwealth authority) were registered by the CMVR and issued with "Z-plate" registration. The *Commonwealth Motor Registry (Liability) Act 1959* presumed that such cars were being used for Commonwealth purposes and therefore the cars did not fall subject to State registration charges, compulsory third party insurance and stamp duty. There were a number of cars which were used by the Commonwealth but registered under State or Territory laws and bearing State or Territory number plates. These cars were referred to as " private plated cars". Such cars were not subject to stamp duty payable on registration as they were owned by the Commonwealth but were subject to registration fees and compulsory insurance.

10 The first Bill amended the corresponding Act by extending the provisions under which *the Commonwealth bears its own liability for third-party claims arising out of the use of uninsured motor vehicles owned by the Commonwealth or a Commonwealth authority* to the cars leased to the Commonwealth (or a Commonwealth authority) and not registered in a State or Territory. The second Bill amended the corresponding Act by establishing a Register of Commonwealth motor vehicles, which included cars owned or leased by the Commonwealth (or a Commonwealth authority) and exempting the vehicles on it *from the need to be registered under a law of a State or Territory or to have third party insurance.* Such cars would continue to use Commonwealth number plates. In addition, the Bill exempted the sale of the DASFLEET assets (and the subsequent leasing arrangements) from State and Territory taxes.

Amendment Act 1997 and the *Commonwealth Vehicles (Registration and Exemption from Taxation) Act 1997* which were assented to on 7 July 1997. As both Bills were assented to after 30 June 1997 when the sale agreement was signed, put and call options were developed to enable the transfer of DASFLEET to be exempted from State taxes.[11]

1.6 A Monitoring Body, located within the Department of Finance and Administration (DOFA)[12], was established under the Tied Contract to monitor the compliance of the purchaser with the terms and conditions of the Tied Contract taking into account the interests of CPA customers. The role of the Monitoring Body includes monitoring future pricing and service levels; considering changes to the funding commitments, components and methodologies used in setting the leasing rates; assessing the purchaser's management of the residual risk to ensure no abnormal profit is made on vehicle disposal over the contract period; convening a customer forum; and notifying the purchaser of a non-conforming lease (upon becoming aware of one).

State and Territory Governments

1.7 In recent years, State and Territory Governments have also sought to improve their overall position through sale and lease back of government fleets. In addition to advantages such as the freeing up of capital to reduce debt or provide other services, the chief benefit the States and Territory Governments seek through replacing an arrangement where those Governments own the vehicles with an arrangement of vehicles being owned by the private sector and leased to government is in the utilisation of the tax advantages available to private financiers which can flow back in part or full to those Governments. Private financiers, considered for income tax purposes to be the owners of leased vehicles, can use depreciation benefits available under the Income Tax Assessment Act to pass on cheaper finance than State and Territory Governments can obtain through direct borrowing. The sale agreement for DASFLEET specifically precludes the purchaser from using any taxation depreciation options otherwise available to it thus maintaining the integrity of the tax revenue involved to the Commonwealth Government.

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11 The put option enabled the Commonwealth to bind the purchaser to purchase DASFLEET before the Bill was passed but to exercise this option after the Bill was assented to. The call option enabled Macquarie Bank to require the Commonwealth to sell DASFLEET to Macquarie Bank after the Bill was assented to.

12 The Department of Administrative Services (DAS) and Department of Finance (DOF) were reorganised in October 1997 to form the Department of Finance and Administration (DOFA). In this report the Department of Administrative Services and the Department of Finance will be referred to by their former names and acronyms.

1.8 The Australian Capital Territory (ACT) Government sold some 1300 vehicles to Macquarie Bank Limited on 28 June 1996 and leased them back under a 10 year facility. The ACT Government has accounted for this facility as an 'operating' lease. The ACT Auditor-General reported in September 1997 that the sale and leaseback of the ACT fleet is predominantly a financing arrangement and since the Territory has all the substantial risks incidental to ownership and the lessor is protected from significant risks, the facility is effectively a 'finance lease'. [13]

1.9 The Western Australia Government has also used an outsourcing arrangement for its government fleet since 1 July 1996. In May 1998, the Western Australia Auditor-General tabled a report[14] which examined the implementation and initial operation of the financing and leasing agreement. The report noted that the funding agreement provides up to $250 million for the sale and lease back of passenger and light commercial vehicles.[15] The agreement operates on a ten-year rolling term with an annual option to extend the contract for another year. It is a complex agreement, involving a number of parties, and containing detailed specification of the events it covers.[16] The agreement is primarily about the cost of money. It has introduced a monopoly on public sector fleet leases in exchange for a lower interest rate. The key feature of the funding model is the acceptance by the Australian Tax Office that the investors are the vehicle owners and therefore entitled to such taxation benefits as depreciation.

1.10 **Finding:** A key difference in the Commonwealth's position to that of the State and Territory Governments is the absence of the use of the tax shield of depreciation as an incentive for sale and lease back of the government's fleet. The sale agreement for DASFLEET specifically precludes the purchaser from using any taxation depreciation options otherwise available to it thus maintaining the integrity of the tax revenue involved to the Commonwealth Government.

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13 ACT Auditor-General's Report No. 9 1997, *Fleet Leasing Arrangements*, p.14.

14 Western Australia Auditor-General, *Selecting the Right Gear - The Funding Facility for the Western Australian Government's Light Vehicle Fleet*, Report No 2 May 1998.

15 Ibid, pp.12-13.

16 The Western Australia Auditor-General concluded that, although the West Australian Government has transferred ownership of the fleet, numerous indemnities to the investors and others mean that the Government continues to bear most of the operating risks associated with the motor vehicles and that it is unlikely that the agreement could have been put in place without the underpinning of these indemnities. Ibid., p.13

Sale management

1.11 Overall responsibility for the management and completion of the sale was assigned to the Office of Asset Sales and IT Outsourcing (OASITO). OASITO was assisted in the sale by Baring Brothers Burrows & Co., Limited (referred to as Barings) as Business Adviser and Deacons Graham and James as Legal Adviser. The Business Adviser was primarily responsible for conducting a scoping study and implementing the approved sale strategy. The Legal Adviser assisted with the scoping study and sale process including due diligence activities and preparation of sale documentation.

1.12 Formal objectives for the DAS Business Unit sales were not developed, although draft objectives were provided by OASITO to its Business and Legal Advisers at a planning forum in November 1996. OASITO has advised ANAO that the draft sales objectives provided to its advisers are an appropriate reference point for assessing the sale outcomes. The draft objectives were to:

- obtain a fair price for the businesses while considering the Government's social, industry, competition and fiscal / revenue policy objectives;
- take into account the impact on Australian industry;
- minimise the potential risk exposure to the Commonwealth, both as former owners of the businesses and as a future purchaser of services;
- take into account the Government's community and public interest obligations;
- take into account the impact on current employees of the DAS businesses;
- complete the sales in a timely manner;
- identify the key pitfalls early in the sales process;
- complete the sales with no residual businesses or business parts; and
- maintain the buoyancy of the businesses during the sales process.

1.13 A Steering Committee, chaired by OASITO, was established to oversee the sales. Legal, Business and Communications Advisers and senior staff from DAS were represented on the Committee.[17] The Business Advisers, Legal Adviser and DAS were required to provide the Committee with regular progress reports on sale preparation. Meetings were held from

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17 The Committee's terms of reference included: identifying, reviewing and resolving relevant policy decisions; ensuring the information memoranda and data packs contained no material omissions or false or misleading statements; and ensuring the information memoranda included all information purchasers and their professional advisers would reasonably require and reasonably expect to find to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the business units.

December 1996 to provide updates on the progress of the planning and execution of the sales, including due diligence, and to assist in prompt decision making in relation to the due diligence process and preparation of the information memoranda.

Audit approach

1.14 The objectives for the audit were to review the efficiency and effectiveness of the conduct of the sales process for DASFLEET in relation to:

- the extent to which the Government's sales objectives were achieved;
- the effectiveness of the management of the sales process; and
- facilitating improved administrative practices for future trade sales.

1.15 The approach taken in the audit was to review data relating to the sales held by OASITO, its advisers, and DOFA. Accordingly, ANAO conducted field work at OASITO and its Business and Legal Advisers, and DOFA. Fieldwork and consultations were undertaken between October 1997 and September 1998.

1.16 ANAO developed criteria which addressed whether the Government's sales objectives were achieved; the management of the sales process including planning and preparation, coordination, contracting process and management; the tendering and tender evaluation process; and any ongoing issues post-settlement. ANAO was assisted by advice from the Australian Government Solicitor (AGS) on contractual issues and Monash University's Centre for Policy Studies on financial modelling. The audit was conducted in accordance with ANAO Auditing Standards at a cost to ANAO of $211 000.

1.17 The sale of DASFLEET was selected for audit because of the materiality of the sale and the five year Tied Contract awarded to the successful bidder. ANAO also audited the sale of Works Australia and the sale of DAS Interiors Australia. Separate audit reports have also been produced on overall sale management; the Works Australia sale; and the DAS Interiors Australia sale.

2. Sale process

This chapter discusses the management of the DASFLEET sale including the bid evaluation methodology and bid assessment.

Background

2.1 In March 1996, Barings (the Business Adviser for the DASFLEET sale) was engaged by the then Department of Finance to undertake a detailed review of the financing and operations of DASFLEET. The review discussed a range of sale options from refinancing to outright sale. The findings were presented in June 1996 and found the best financial outcomes to be either a refinancing of the fleet or privatisation of the business as a whole with a five year CPA tied customer contract.

2.2 Following a competitive tender process, Barings was appointed as Business Adviser in November 1996 to conduct and report on a scoping study in relation to the proposed sale or refinancing of DASFLEET. The final Scoping Study report of February 1997 outlined a range of advantages of the provision of a five year tied customer arrangement in relation to the sale of DASFLEET:

- a purchaser would be assured of retaining its position as sole supplier of the vehicle leasing needs of CPA customers for a period of 5 years beyond the end of each lease prevailing at the date of sale;
- the purchaser could become familiar with the business and develop a relationship with its customers so as to be more confident of retaining this business in the ensuing transition to an untied arrangement when some customer loss is anticipated;
- it would assist the purchaser to quarantine its CPA customers from competitors' approaches;
- the guaranteed business during the tied contract would provide a base enabling the private sector purchaser to expand its activities in other areas to counter a decline in CPA business; and
- the focus of the purchaser would be on the initial five years or so of the business following acquisition, which would underpin its valuation of DASFLEET.

Success fees

2.3 At the conclusion of the scoping study (Phase 1), OASITO sought from Barings a fee quote for the sale or refinancing of DASFLEET (Phase 2).[18] The June 1997 Phase 2 Business Adviser contract for the DASFLEET sale involved a monthly retainer of $75 000; a completion fee of $500 000 payable on completion of the sale or refinancing; and a further success fee of 1.5 per cent of the excess of gross proceeds[19] over the fleet valuation plus $50 million. Total DASFLEET sale fees were capped at $2 million. OASITO advised ANAO that it *believes success fees can be a useful mechanism to provide an incentive to advisers to meet the goals of the project and shift part of the risk of failure to the advisers*.

2.4 Many of the parties that submitted proposals for Phase 1, including the DASFLEET Business Adviser, indicated they would seek success fees. However, the level and method of calculation of the various proposed success fees were not comprehensively evaluated during the selection process. The success fee arrangements were not included in the Phase 1 contract but were prominent in negotiations for Phase 2 of the consultancy.

2.5 The Business Adviser for DASFLEET advised OASITO that it had charged for the Phase 1 work on the expectation of receiving a success fee for Phase 2. It initially sought a success fee which OASITO estimated was likely to cost in the vicinity of $2 million, calculated as a percentage of the excess of proceeds over net tangible assets. OASITO negotiated a percentage success fee which applied to the excess of proceeds over those that could have been expected for the sale of the vehicles alone plus $50 million.[20] In total, the completion and success fees are estimated to comprise more than 60 per cent of total fees to be paid to the DASFLEET Business Adviser. OASITO advised ANAO that:

> *OASITO notes that performance related fee arrangements are inherently complex and need to be settled on a case-by-case basis, having regard to all relevant considerations, and often need to be settled in advance of full knowledge of all relevant parameters. The essential cost-effectiveness judgements should - as it was in this case - be far more concerned with maximising the net outcome rather than with minimising expected cost.*

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18 This approach was consistent with the request for proposals which had informed potential scoping study advisers that, subject to satisfactory performance and Commonwealth discretion, the Business Adviser would implement the sales strategy.

19 Gross proceeds were to be calculated as the purchase price, plus any additional consideration for the Rentals business, less early termination costs under vehicle finance leases, plus cash retained by the Commonwealth less payments to DASFLEET staff under the clean break of $15 million.

20 OASITO has estimated that this fee will be approximately $700 000.

2.6 **Finding:** After the Business Adviser commenced work on the sale process, OASITO negotiated a percentage success fee for the Business Adviser which applied to the excess of proceeds over those that could have been expected for the sale of the vehicles alone plus $50 million. In total, the completion and success fees are estimated to comprise more than 60 per cent of total fees to be paid to the Business Adviser. ANAO considers success fees should only be considered by OASITO where it judges that they will improve value for money in sale outcomes. ANAO also considers that any completion and success fee arrangements should be clearly identified and evaluated as part of the selection process for advisers.

Recommendation No. 1

2.7 ANAO *recommends* that where any completion or success fees are to be part of advisers' remuneration, in future trade sales, the basis for calculation of these fees be clearly identified and evaluated as part of the selection process.

OASITO response

2.8 OASITO's response was that it ***agreed with qualifications*** to the recommendation. OASITO agrees this should be done, but only where it is possible at the time of engaging the adviser to provide the potential advisers with a clear comprehensive statement of requirements. In other cases, a better substantive overall outcome might be obtainable by direct negotiation following either selection or identification of the clear comprehensive statement of requirements (whichever is later). This could even include offering the adviser a success fee as part of a fee restructuring compared to the adviser's own proposed fee in order to secure an improved outcome for all parties. OASITO notes that the objective is the success of the sale, not merely the minimisation of advisers' fees.

Tender process

2.9 The sale of DASFLEET involved a series of stages which the OASITO and its Business Adviser managed. Figure 2.1 outlines the major stages and timing of the process.[21] The sale and refinancing tender processes were conducted in tandem.

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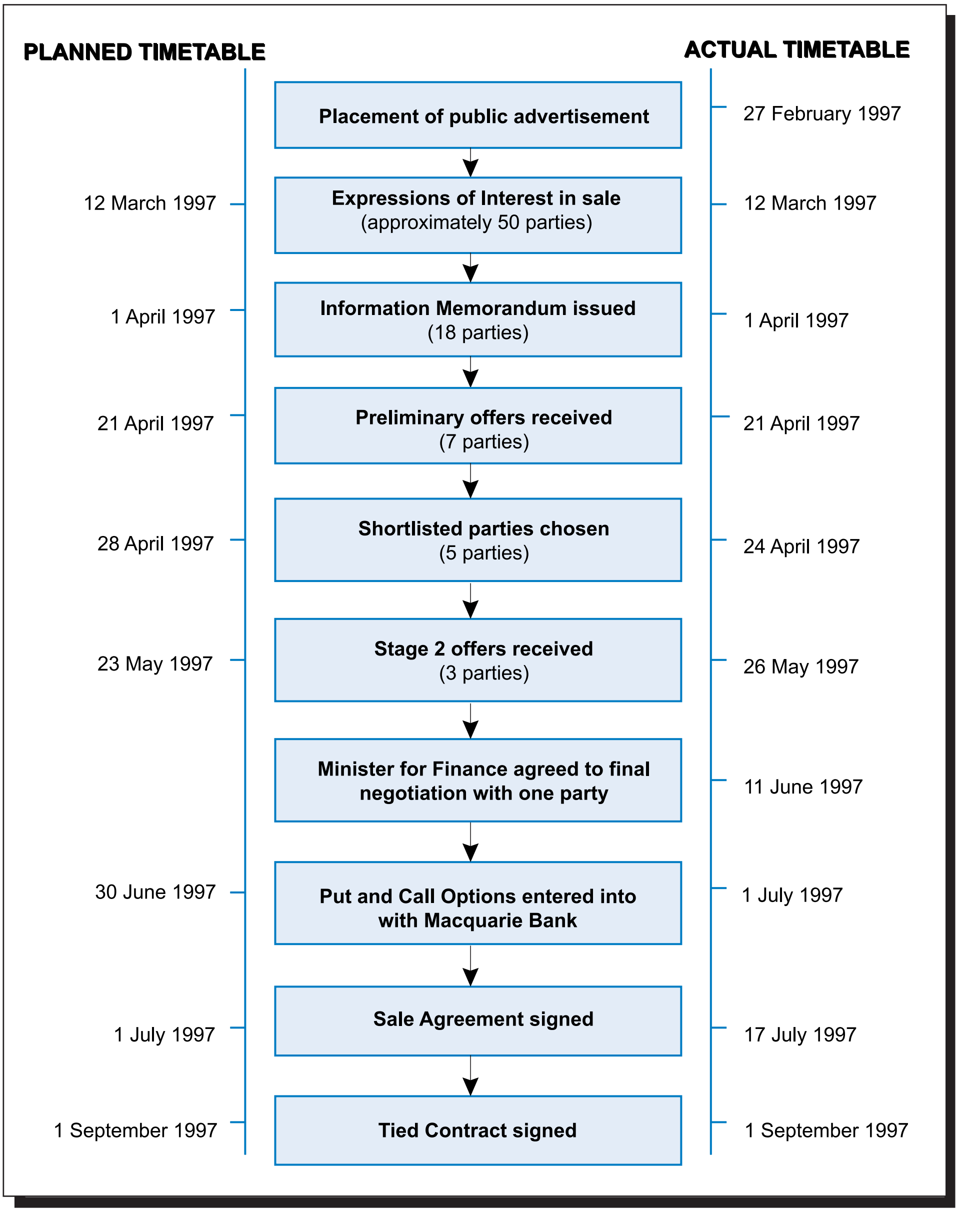
[21] The sale process was conducted in two phases with phase one comprising the submission of preliminary non-binding offers for DASFLEET based solely on the information contained in the Information Memorandum. Phase two comprised the disclosure of further information by way of due diligence investigation. Management presentations were also made to shortlisted parties.

Figure 2.1
Tender process for the sale option



Source: ANAO analysis of information provided by OASITO.

2.10 An Invitation to Tender for the funding of DASFLEET motor vehicles (the refinancing option) was issued on 11 April 1997 inviting tenders by 29 April 1997 for a sale and lease back[22] on an operating lease basis, a sale and buy back[23] on an instalment purchase basis or a combined operating lease and sale and buy back basis. For the purposes of submitting a tender each tenderer was asked to assume a value of $350 million[24] for the vehicle fleet which could vary up or down by 10 per cent.

2.11 In response to the Information Memorandum issued to 18 prospective purchasers on 1 April 1997, seven parties lodged complying non-binding preliminary offers for the purchase of DASFLEET on 21 April 1997. The Information Memorandum requested tenderers to supply a preliminary non-binding cash price and supporting corporate material sufficient to convince the Commonwealth that the prospective purchaser was fit to be short-listed. This was to assume *that vehicle leasing arrangements post sale will be conducted on an operating lease basis.*[25]

2.12 A transaction using operating leases would result in the purchaser of DASFLEET effectively retaining substantially all the risks and benefits incidental to ownership of the vehicles. This contrasts with a transaction using finance leases where the leases would effectively transfer from the purchaser to the Commonwealth substantially all the risks and benefits incidental to ownership of the vehicles.[26] A subsequent letter to all prospective tenderers (18 April 1997) advised that the residual value risk was to reside with the purchaser who would be required to keep an open book so that the Commonwealth could assess that adequate risk management processes were in place.

2.13 On 30 April 1997, shortlisted parties were advised of their selection to proceed to Stage 2 of the sale process. This involved access to further information on DASFLEET, principally by way of CD ROM data disk; meetings with DASFLEET management; site visits to a number of DASFLEET's major locations; negotiation of the tied contract for CPA customers; and negotiation of the sale contract. Initially, this required submission of a final binding offer by 23 May 1997.

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22 The Commonwealth would sell the existing fleet, other than vehicles which were currently subject to finance leases or externally managed for another owner, to the Financier and receive immediate payment with the Financier then leasing the fleet back to the Commonwealth.

23 The Commonwealth would sell the existing fleet to a Financier and receive immediate payment and the Financier would then sell the Commonwealth fleet back to the Commonwealth which would then make instalment purchase payments to the Financier.

24 The Invitation to Tender advised that actual figures and proportions would only be available on settlement of the proposed refinancing.

25 DASFLEET Information Memorandum, March 1997, p.5.

26 Australian Accounting Standard AAS17, *Accounting for Leases*.

2.14 Bidders were advised on 16 May 1997 of the guidelines for lodgment of a final binding offer by 23 May 1997. The document advised that, in making a decision, the Commonwealth would consider the criteria advised to bidders in the Information Memorandum[27] and other additional factors it wished to consider including, but not limited to, the proposed method of managing the transition risk in the sale process for the Commonwealth; any proposed amendments to the terms and conditions in the draft contracts; the risk of non-completion of the sale; any conflicts of interest (real or perceived); and the results of inquiries made by the Commonwealth in order to verify the reputation and standing of each prospective purchaser.

2.15 On 20 May 1997, one of the tenderers sought an extension of the closing date, on the basis that they were provided with information critical to their bid very late in the process and required more time to conduct due diligence. An extension was granted and all bidders were advised about the extension on 23 May 1997.[28] Following the lodgment of three final bids on 26 May 1997, a series of further negotiations were held with all the potential purchasers regarding the conditions specified in their respective offers.

Commonwealth Protective Services Vehicle Fleet

2.16 An issue which received little attention until late in the sale process for DASFLEET was the protective services vehicle fleet. One week after bids closed on 26 May 1997, DASFLEET wrote to OASITO raising the issue of arrangements for the Commonwealth protective services vehicle fleet. OASITO sent a facsimile in early June 1997 to the Protective Security Coordination Centre (PSCC) in the Attorney-General's Department, which coordinates Commonwealth policy regarding these cars, seeking to discuss the options for the future disposition, storage, security, maintenance and acquisition of replacement vehicles for the protective services fleet. OASITO advised the PSCC that the issue needed to be resolved urgently, and the final provisions treating the issue included in contracts, by no later than 16 June 1997.

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[27] These were the capacity and commitment to service the customer base similar to that of DASFLEET; strategies for the continued development of DASFLEET; the financial capability of the prospective purchaser to complete the sale and to provide the business with adequate financial resources over the period of the tied contract; the reputation and standing of the prospective purchaser; and the extent to which the proposal as whole met the Commonwealth's overall objectives. For Stage 1 an additional criterion was included, the preliminary non-binding offer price.

[28] The letter also requested information on the amount in the binding price allocated to the rental business, their intentions for that business and any properties not required under the proposed leasing arrangements.

2.17 The sale of DASFLEET involved the transfer to a new private owner of vehicles requiring specialist expertise then within the Commonwealth for the purchase, service, maintenance, storage and disposal of protective vehicles. At this late stage, it would have been difficult to find another Commonwealth agency with the necessary expertise and capacity to take on the management of these vehicles. Accordingly, the decision was taken to include the protective services vehicle fleet in the DASFLEET sale and to provide in the sale documentation special arrangements to deal with the security issues involved.

2.18 These arrangements are included in the Tied Contract which is to run for five years from 1 September 1997, unless terminated earlier. The vehicles were sold at nil or $1 value reflecting the continuing control of the Commonwealth over disposal options. The Tied Contract provides that protective services vehicles are exclusively available for Commonwealth use; may only be dealt with in accordance with directions issued by the PSCC; and may not be sold by the purchaser.

2.19 **Finding:** Detailed consideration of the management of the Commonwealth protective services vehicle fleet did not occur until after final bids closed in late May 1997. OASITO then took action to consult with the relevant Commonwealth agencies regarding the disposition of the Commonwealth protective services vehicle fleet. The decision was taken to include the protective services vehicle fleet in the DASFLEET sale and to provide in the sale documentation special arrangements to deal with the security issues involved.

Recommendation No. 2

2.20 ANAO *recommends* that, for future trade sales, relevant Commonwealth agencies ensure that in scoping the sale all significant issues requiring consultations with other agencies and/or decisions by Ministers are identified and dealt with in advance of issuing Information Memoranda and closing bids.

Attorney-General's Department response

2.21 The Attorney-General's Department's response was it ***agreed*** with the recommendation.

OASITO response

2.22 OASITO's response was that it ***agreed with qualifications*** to the recommendation. OASITO noted that, while this is a desirable aim, it can be the case that issues that appear to be minor at the scoping study stage - or which are simply overlooked through inadvertence - will arise for consideration later in the process. OASITO seeks to maintain a process that minimises such occurrences, but which does not assume they will not occur and so maintains the flexibility to deal with them if and when they do.

Evaluation methodology

2.23 ANAO considers that effective tendering practice involves determining the basis on which the winning tender will be selected before the tender documentation is issued and devising evaluation criteria which will provide a methodology for distinguishing between tenders on that basis. The basis for selection and the criteria to be used should also be communicated to potential tenderers through the tender documentation so they have an informed basis on which to decide whether to prepare a tender. Such communication also makes the process more transparent. ANAO did not locate any advice to tenderers indicating the relative importance attached to each criterion.

2.24 The guidelines issued to bidders on 16 May 1997 stated that the weight to be given to each criterion would be determined at the discretion of the Commonwealth and that there was no obligation on the Commonwealth or its advisers to accept any offer, whether or not such an offer represented the highest effective purchase price for DASFLEET. The guidelines also stated that the Commonwealth and its advisers reserved the right to discuss with any of the prospective purchasers at any time the terms of the final offer by them for the purpose of clarifying the terms of those offers in any respect. In addition, the Commonwealth expressly reserved the right, without giving reasons, at any time and in any respect, to amend or terminate any of the terms or procedures advised to bidders; to terminate discussions with any of all of the prospective purchasers; and to reject any or all of the offers put forward or to negotiate with any party with respect to a transaction involving the sale of DASFLEET.

2.25 Advice from the Business Adviser to OASITO on 9 June 1997 was that prospective purchasers had provided sufficient information to assess the proposals in terms of offer price; ongoing tied contract leasing and fleet management rates; and the key operational, financial and completion risks. ANAO did not find evidence of the application of any weightings or priorities by the Business Adviser to the various criteria used in the bid evaluation process.

2.26 The Commonwealth Procurement Guidelines indicate that evaluation criteria[29] should clearly identify the relative importance of all

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29 *Commonwealth Procurement Guidelines*, Guideline 1 *Getting Value for Money*, Section 4, September 1989.

relevant factors and provide a sound basis for a decision on a tender. OASITO advised ANAO that it notes that the Commonwealth Procurement Guidelines are not designed for, nor are applicable to, asset sales.[30]

2.27 Nevertheless, ANAO considers that it is sound administrative practice to prepare a sale tender evaluation plan detailing the overall objectives of the tender; explaining how the outcomes are to be achieved; and providing an outline of the tender evaluation methodology to be employed. The relative importance attached to each criterion should be included in the tender evaluation methodology. This provides for transparent and accountable decision-making.

2.28 **Finding:** ANAO did not find evidence of the application of any specified weightings or priorities to the various criteria in the tender evaluation process. Sound administrative practice suggests that the relative importance attaching to each tender evaluation criterion should be incorporated into the tender evaluation methodology used.

Recommendation No. 3

2.29 ANAO *recommends* that, where appropriate for future trade sales, the Office of Asset Sales and IT Outsourcing enhances transparency and accountability of decision making in the tender process by developing and assigning appropriate priorities which set out the relative importance of each tender evaluation criterion.

OASITO response

2.30 OASITO's response was that it ***agreed with qualifications*** to the recommendation. OASITO considers that it will usually be appropriate for a degree of flexibility to be maintained in respect of the balance of priorities among selection criteria, and that in many cases the relative importance of the criteria may depend on the nature of the commercial proposal that is offered.

Relative Whole of Government analysis

2.31 The bids were assessed by the Business Adviser on the basis of a Relative Whole of Government (RWOG) approach which took into account, amongst other things, the initial lump sum offer price and the future vehicle lease and fleet management rates. The future vehicle lease rates are

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30 OASITO further advised ANAO that: *formally, the Purchasing Guidelines do not apply to divestments. Many of the former Guidelines are cast in terms of acquisitions with tightly defined specifications. There are substantial differences in sales of businesses from acquiring goods and services. To apply the rigidity of these acquisition processes to asset sales would be increasing the risk that they would fail because such processes would not be sufficiently flexible to cope with complexities of asset sales.*

primarily determined by the estimated residual values of the vehicles and the cost of funds; the latter comprises the benchmark leasing rate and a lender's margin. In assessing the bids, the Business Adviser used a 6.2 per cent benchmark cost of funds to which was added the bidders' various margins. By far the largest component of the cost of funds arises from the benchmark rate as opposed to the lenders' margin rate.

2.32 The aim of a RWOG analysis was to ensure that the sale outcome generated the most favourable net present value (NPV) return to the Commonwealth. The Macquarie Bank bid was considered by the Business Adviser in their 9 June 1997 advice to OASITO, which was then provided by OASITO to the Minister for Finance, to generate the highest NPV to the Commonwealth based on all inputs to its RWOG analysis. The Macquarie Bank bid had the largest up front payment and the lowest cost of funds for the vehicles leased but it had a higher fleet management rate than that proposed by the second ranked bidder.

2.33 The RWOG approach involved the Business Adviser undertaking a discounted cash flow analysis based on estimating NPV[31] for six and ten years. These time horizons were chosen to represent the duration of the Tied Contract period (five years plus one year average vehicle lease run-off) and the term under which a refinancing proposal would be more financially viable, namely ten years. The Macquarie Bank bid was assessed as generating a NPV (Budget impact) of $116 million over six years and, over ten years, a NPV of minus $10 million. The next highest bidder was assessed as generating a NPV of $110 million for six years and minus $13 million for a ten year NPV. In comparing final bids the Business Adviser gave greater weight to the six year NPV outcomes on the basis it was more representative of the financial transaction to which the Commonwealth was a party.

2.34 The Business Adviser's advice to OASITO included reference to advice it had obtained from an independent financial consultant. OASITO advised ANAO that the independent consultant review included *a review of inputs; a review of RWOG model methodology; a review of certain calculations; comments on particular assumptions; and a review of taxation treatment of particular issues in Barings' model (including a further reference to its taxation division).*

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[31] NPV outcomes reported were the midpoint of 8 per cent and 10 per cent discount rates.

2.35 The Business Adviser assumed an average marginal tax rate[32] of 36 per cent for their RWOG analysis which was synthesised from a scenario of investors' tax profiles.[33] ANAO was advised by Barings that *this approach of applying the tax rate to revenue rather than profit and the synthesised tax rate were reviewed and confirmed by an independent taxation adviser*. The Business Adviser applied this assumption to revenue (rather than to profits) with the result that, for every $100 paid in lease and fleet management costs by Commonwealth agencies, $64 was effectively taken into account in the RWOG calculations because of the 36 per cent tax shield. In this circumstance, the payment of a higher up front lump sum for the business may subsequently be able to be partially off-set through higher lease and fleet management rates but this may not be adversely affected in the RWOG analysis compared to a lower up front lump sum combined with lower recurrent charges.

2.36 **Finding:** An RWOG approach was adopted which involved the Business Adviser undertaking a discounted cash flow analysis based on estimating NPV for six and ten years. These time horizons were chosen to represent the duration of the Tied Contract period (five years plus one year average vehicle lease run-off) and the term under which a refinancing proposal would be more financially viable, namely ten years. The Business Adviser in its 9 June 1997 advice to OASITO, which was then provided by OASITO to the Minister for Finance, assessed the Macquarie Bank bid as generating a NPV (Budget impact) of $116 million over six years and, over ten years, a NPV of minus $10 million. The next highest bidder was assessed as generating a NPV of $110 million for six years and minus $13 million for a ten year NPV. The Macquarie Bank bid had the largest up front payment and the lowest cost of funds for the vehicles leased but it had a higher fleet management rate than that proposed by the second ranked bidder.

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32 The Business Adviser advised OASITO on 4 August 1998 that *it is neither possible nor appropriate to attempt to forecast the actual tax rate that may apply to payments generated by the tied contract. Such analysis would involve making a number of highly subjective forecast assumptions, which in our view would not provide a reliable basis from which to draw any conclusion. Furthermore forecasting specific tax rates for investors is contrary to RWOG analysis of the offers for DASFLEET. Specifically, Commonwealth tax receipts in our RWOG analysis reflected the dynamic nature of cash flows in the economy, where one entity's expenses (including interest) is another entity's revenue. On this basis, it is inappropriate to assess the specific forecast tax rates of investors in* [the two highest bidders] *in the RWOG analysis.*

33 The average marginal tax rate assumed by the Business Adviser equals the corporate tax rate of 36 per cent.

Vehicle residual values

2.37 Volatility in the price of second hand vehicles has a major impact on the financial returns of fleet owners. The risk management approaches proposed by the two highest priced bidders differed markedly in the sharing of the residual value risk between the purchaser and vendor. The second highest priced tenderer proposed to assume the full residual risk of the vehicle fleet. The winning tenderer proposed to manage the profit and losses on individual vehicles over the term of the Tied Contract by means of a residual risk fee[34] included in the lease rate for each vehicle which would be paid into a Reserve Account with the intention that its balance would approach zero over the term of the Tied Contract.

2.38 The treatment of the residual value of vehicles expressed as a percentage of the purchase price differed between the bidders.[35] Taking the vehicle category Upper Medium Sedan as an example,[36] the residual value in the winning bid was 99.9 per cent whereas in the next highest bid the residual value was 99 per cent. This means the winning bidder was assumed to achieve higher resale values which resulted in lower lease costs giving a finance charge advantage. For example, the implications for the financial analysis tendered to the OASITO from standardising residual values and removing the residual risk fee from the Business Adviser's calculations are as follows:

- 9 June 1997 advice: the $6 million NPV advantage to Macquarie Bank, based on a $1 residual risk fee for a six year analysis, reduces to an advantage of $2.5 million and, on a ten year analysis, the second ranked bidder would have a marginal NPV advantage; and

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[34] Macquarie Bank wrote to the then Minister for Administrative Services on 1 July 1997 and advised that: *The fundamental concept behind the Purchaser's approach is that profits and losses on individual vehicles are managed over a longer term facility (ie: 5 or 10 years) so that exposure to volatility in second hand car values is substantially reduced, and reduced volatility may result in lower rentals. A residual risk fee is payable for each vehicle (as part of the rentals), which is a charge to reflect the volatility referred to above. The fee is credited to the Reserve Account with the intention that the balance in the account trends to zero over the term of the Tied Contract. Our residual value risk strategies are based on our objective to break even on the Residual Values over the period of the Tied Contract. Consequently, the effect of any profit or loss experience will be smoothed over the term of the Tied Contract.*

[35] Barings advised ANAO that the treatment of the residual values of vehicles expressed as a percentage of the purchase price differed between the bidders *reflecting the fact that the winning bidder committed to higher residual values for the period 1 July to 30 September 1997 than those to which the second bidder committed for a similar period.*

[36] DASFLEET Information Memorandum p. 14: The category Upper Medium Sedan comprised by far the largest grouping within DASFLEET, being 56.2 per cent of the passenger vehicle fleet and 47.7 per cent of the total active fleet as of 31 January 1997.

- 30 June 1997 advice: the $5 million NPV advantage to Macquarie Bank, based on a $20 residual risk fee for a six year analysis, increases by $0.4 million and, on a ten year analysis, the Macquarie Bank bid continues to have a superior NPV.

2.39 The Business Adviser and its independent adviser did not consider that the second highest bidder would take the residual risk on every vehicle. The Business Adviser advised ANAO that:

> *This approach was not considered to be commercially sustainable over the term of the tied contract (particularly if a market downturn were to eventuate), unless residual values were set very conservatively through the period of the tied contract to take account of this risk. In these circumstances, it was likely that the Commonwealth would have incurred higher monthly lease rates under* [the second highest bidder's] *offer, ceteris paribus, compared to Macquarie's offer. Furthermore* [the second highest bidder's] *residual management process was not transparent from its offer.*

2.40 The winning tenderer's May 1997 bid initially priced the residual risk fee at $1 per month per vehicle. At the time of signing the Tied Contract the residual risk fee had increased to $20 per month per vehicle. The increased residual risk fee was taken into account in the Business Adviser's 30 June 1997 advice to OASITO.

2.41 The Business Adviser engaged a consultant[37] to review the Macquarie Bank residual risk fee proposal. The expected residual risk fee is calculated on the basis of a complex mathematical formula which relates all the components of the past residual value experience to the expected variance in future values. The formula is premised on generating an outcome that results in 99 out of every 100 transactions producing a positive balance in the Reserve Account. A consultant appointed by DOFA advised in January 1998 that the Reserve Account balance would be in deficit in the early years but would target, on average, a balance of $10.8 million by October 2001. Legal advice received by the Commonwealth indicates that, under the Tied Contract, ambiguities exist which could potentially impact on the proposed arrangements for access to the Reserve Account by the respective parties.

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37 The consultant advised the Business Adviser on 30 June 1997 that g*iven the complex stochastic nature of residual fee and residual value setting mechanisms a full review of this process would need to include an extensive simulation of the formula's reaction to assumed residual value scenarios. This review would take an estimated 5 man days to perform. As agreed, we have therefore reviewed these formulae from a general statistical reasoning and process intent perspective, which means this advice only deals with the broad concepts behind the formulae and does not address any of the detail of them including whether all the terms in the formulae are appropriate for the underlying statistical model formulation; and whether, given that formulation, every element of the formulae is mathematically precise as stated.*

2.42 Under a full termination, the balance of the Reserve Account (if positive)[38] shall be paid by the purchaser to the Commonwealth, less any amounts reasonably determined by the purchaser as payable by the Commonwealth including leasing rates,[39] break costs,[40] and any other amounts then outstanding under the contract.

2.43 **Finding:** Volatility in the price of second hand vehicles has a major impact on the financial returns of fleet owners. The winning tenderer proposed to manage the profit and loss on individual vehicles over the term of the Tied Contract by means of a mathematical formula which would derive a residual risk fee to be included in the lease rate for each vehicle. The residual risk fee amount was to be paid into a Reserve Account with the intention that the balance would approach zero over the term of the Tied Contract. A consultant appointed by DOFA advised in January 1998 that the Reserve Account balance would be in deficit in the early years but would target on average a balance of $10.8 million by October 2001. Legal advice received by the Commonwealth indicates that, under the Tied Contract, ambiguities exist which could potentially impact on the proposed arrangements for access to the Reserve Account by the respective parties.

Tender negotiation

2.44 The Minister for Finance agreed to OASITO's 9 June 1997 recommendation that DASFLEET be sold with final negotiations to be undertaken with one party, Macquarie Bank. The Business Adviser's advice to OASITO of the same date was that Macquarie Bank's bid provided for:

- a trade sale which provided a Net Present Value (NPV) outcome over a 10 year period $95 million better than the best refinancing option;[41]
- sale proceeds of $408 million including a goodwill premium of $35 million over net assets;

38 If the Reserve Account is negative, the Tied Contract provides for the Commonwealth to pay the purchaser an amount calculated by the Purchaser equivalent to any negative balance of the Reserve Account.

39 The Tied Contract requires the Commonwealth to pay to the Purchaser that amount determined by the Purchaser as being the aggregate for all Vehicles then leased and in relation to each Vehicle the amount which is the sum of: all Leasing Rates then accrued on a day to day basis that are unpaid; and the Vehicle Principal Outstanding as at the Full Termination Effective Date for each Vehicle. The purchaser is required to transfer title in the Vehicles to the Commonwealth or its nominees in exchange for the payment.

40 Break Costs is defined in the Tied Contract as the amount determined by the Purchaser which is sufficient to compensate the Purchaser for any loss or damage suffered by the Purchaser.

41 The NPV outcome over a six year period for a trade sale was $78 million better than the best refinancing option.

- an estimated overall financial outcome of a NPV over 6 years of $116 million, $6 million better than the bid from the next highest tenderer;
- a potential gain of up to a further $4 million if the rentals business is sold;
- an agreement to supply leased vehicles to Commonwealth Public Account customers for five years at commercial rates[42]; and
- further potential gains in fleet management costs[43] which were to be passed on to the Commonwealth.

2.45 In view of the closeness of the two highest bidders, OASITO and its advisers needed to ensure that there was a substantive basis for the selection of only one of these bidders with which to continue negotiations. OASTIO advised ANAO that the advice to the Minister of 9 June 1997 consisted of:

> *a three page brief and a 45 page advice from Barings Brothers Burrows (including detailed analysis of bids and sensitivity analysis (reviewed by Coopers and Lybrand); recommendations; final offer summary; overview and assessment of process; background information on prospective purchasers; legal issues outstanding on all three bids prepared by Deacons Graham & James; and an overview of the process.*
>
> *In addition, the Minister for Finance and the Minister for Administrative Services received a face-to-face briefing from Baring Brothers Burrows on the bids. The 9 June advice from Barings Brothers Burrows was the culmination of a series of discussions and briefings including the personal Ministerial briefing.*

2.46 Barings advised ANAO that:

> *the Commonwealth and its advisers had more than sufficient grounds on which to make the decision to continue negotiations with the winning bidder. These factors were also set out in our letter of 9 June 1997.*

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42 DOFA has advised ANAO that the DASFLEET rate for a typical Z-plated Upper Medium Sedan (the Holden Commodore Acclaim VS2 Auto 3.8litre with ‘full service’) before commencement of the Tied Contract was $489 per month and $380 in September 1997. The Tied Contract which commenced on 1 September 1997 indicates a rate of $300 per month comprising $165.54 per month lease rate (Schedule 2) and $135.90 per month fleet management rate (Schedule 3). The Tied Contract provides for a review of fleet management charges and lease vehicle charges to be conducted in March 1998 and a report from DASFLEET to the Monitoring Body on 1 June 1998 (with all information concerning the Tied Contract including pricing, residual values and the Reserve Account).

43 The Tied Contract provides a mechanism for savings in both lease and fleet management rates to be reflected in the rates to apply to new leases any year after 1998-99 if more than 7500 vehicles are being provided fleet management services in that year.

2.47 There are risks for the Commonwealth in accepting a qualified or conditional bid too early. A preferred bidder may be announced on the basis of the price offered. In such circumstances, the other bidders cease to have any involvement in the sale process but further negotiations with the preferred bidder are required to bring the transaction to finality. The preferred bidder may seek, during these negotiations, to reduce the margin by which they won the bid through reducing their effective price by modifying the risk allocation between themselves and the Commonwealth.

2.48 One method by which the Commonwealth can seek to minimise the scope for the conditionality of bids to affect the final value received for an asset, if the initial bids received are considered too conditional, is to proceed to a second bidding round with a smaller group of bidders. In this circumstance, competitive tension between quality bidders is maintained while the Commonwealth continues to negotiate on price and conditions. An alternative, where relatively few parties are involved in a tender process, is to continue negotiating with all parties seeking to improve offers in terms of conditionality, conformity with the tender requirements and, potentially, price. This can impose considerable costs on the bidders which requires that a balance be struck taking into account the size of the transaction and the closeness of the bids. In such circumstances, the winning bidder is selected only when the final outcome for the Commonwealth is demonstrably clear and certain.[44] The Business Adviser advised OASITO in September 1998 that [a second bidding round was not possible because of] *the fact that the winning and second bidder's offers were: markedly different in substance and were incapable of being standardised or made more comparable after their lodgement; and already of a sufficiently 'final' nature.*

2.49 ANAO considers that the whole purpose of the tender evaluation is to select the tender which offers the Commonwealth the best outcome against the Government's sale objectives. Therefore, it is important that the evaluation methodology employed is capable of standardising the various bids so that an informed judgement may be made as to which tenderer is selected to undertake final negotiations with. The two highest bidders for DASFLEET were close in financial terms having regard both to the up front lump sum offered and the ongoing charges proposed. In evaluating bids in such a competitive process, ANAO considers that negotiations should be continued until one bid is identified as clearly presenting a superior outcome in terms of overall risk and return. However, despite the closeness of the two highest bidders, there were no further negotiations with the second ranked bidder after mid June 1997.

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[44] See *Sale of Brisbane, Melbourne and Perth Airports,* Audit Report No. 38 1997-98, p.18.

2.50 On the basis of the Business Adviser's advice *in terms of financial return and other key completion and operational risk factors*, OASITO recommended to the Minister for Finance that final negotiations be confined to Macquarie Bank. OASITO advised ANAO that:

At the point at which the 9 June recommendation was made, OASITO was confident that Macquarie offered the best outcome. Some features of that offer were unattractive. The recommendation was to retain flexibility by not nominating a preferred purchaser so as to maintain competitive tension. Second bidding rounds are appropriate in some circumstances - for instance where a further shortlisting occurs or where the contracts for sale are reasonably uniform between buyers (see Airports Phase 1 and 2). In circumstances, where one bid clearly offers potentially the best outcome and there is a reasonable prospect of achieving that outcome, it is both commercially advantageous and defensible to seek to conclude satisfactory contractual arrangements with that party, whilst retaining the alternative bidder in the wings as contingency in the event that a satisfactory deal cannot be struck with the preferred party.

2.51 OASITO also advised ANAO that:

The recommendation was specifically not to nominate Macquarie Bank as preferred purchaser. This enabled maintenance of competitive tension and the option of further negotiations with the second placed bidder.

2.52 Barings advised ANAO that:

The Macquarie Bank bid was superior to the second ranked bidder by $6 million in NPV financial terms and offered considerably greater potential future revenue and cost savings benefits not factored into the financial analysis. Whilst the second ranked bidder was marginally superior in terms of certain key completion and operational risk factors, the intention was to deal with these issues as part of the negotiations with Macquarie Bank.

2.53 The Minister agreed to OASITO's recommendation and negotiation with other bidders effectively ceased from mid June 1997, since no further communication was made with the second ranked bidder prior to the announcement of the successful bidder on 1 July 1997.

2.54 **Finding:** The Minister for Finance agreed to OASITO's 9 June 1997 recommendation that DASFLEET be sold with final negotiations to be undertaken with one party, Macquarie Bank. The two highest bidders for DASFLEET were close in financial terms having regard both to the up front lump sum offered and the ongoing charges proposed. In evaluating bids in such a competitive process, ANAO considers that negotiations should be continued until one bid is identified as clearly presenting a superior outcome in terms of overall risk and return. However, despite the closeness of the two highest bidders, there were no further negotiations with the second ranked bidder after mid June 1997.

3. Evaluation and Outcome

This chapter outlines the selection of the successful bidder and some of the ongoing financial and contractual risks.

Final selection

3.1 Responsibility for advising the Minister for Finance on the outcomes of the evaluation process resided with OASITO. In preparing its advice to the Minister, OASITO needed to satisfy itself that the bid evaluation process had identified the best offer for DASFLEET. The Business Adviser's provision of advice to OASITO, and OASITO's conveyance of its advice to the Minister both occurred on 9 June 1997.

3.2 OASITO has advised ANAO that:

> *OASITO engaged the business adviser to provide expertise and a recommendation on the best available outcome. That advice was independently reviewed. The advisers were advisers to the Commonwealth. It is not OASITO's role to second guess the advisers. OASITO transmits that advice to the Minister together with a consideration of factors which OASITO believes the advisers may have overlooked. The Minister's decision was informed by OASITO and the advisers.*
>
> *OASITO does not accept the implicit ANAO view that it stands in a reporting line between the Minister and advisers. It is explicit in the OASITO management process that the advice of experts should be provided direct to Ministers and not filtered through official processes. OASITO only augments, summarises or amends its advisers views where there is some value to be added.*

3.3 The approach adopted by OASITO is one of a number of methods which have been used across the Commonwealth in evaluating tenders. An alternative approach would have been to use a tender evaluation committee as has been successfully done in the context of other asset sales. OASITO advised ANAO that:

> *OASITO has utilised a tender evaluation committee in some recent sales. OASITO does not believe that the establishment of such a committee necessarily enhances the outcome and does not intend to utilise such committees as a matter of course. The OASITO sales team and the advisers constitute a full time evaluation team. An evaluation committee can be an enhancement where there are conflicting and diverse objectives and a group of part-time officials. The formality of a committee of itself offers no advantage to achieve the required outcomes.*

3.4 The sale of DASFLEET involved the sale of an asset and a long term contract. Similarly, the Department of Veterans' Affairs sales of repatriation hospitals[45] also involved the sale of assets together with ten year service contracts. In the Department of Veteran's Affairs' sales, a tender evaluation committee together with a dedicated sales team was used to oversight the tendering, evaluation, selection and contracting processes associated with the sales. In undertaking major asset sales such as the sale of DASFLEET, ANAO considers the use of a tender evaluation committee comprising OASITO, its Business Adviser and, preferably, members drawn from relevant Commonwealth agencies could markedly assist in ensuring enhanced transparency and accountability in the bid evaluation process.

3.5 ANAO also considers that sound administrative practice requires the tender evaluation report to adequately explain to the ultimate decision maker the rationale for the evaluators' recommendations concerning the selection of a particular tenderer. When deciding the basis on which the evaluators will recommend the winning tenderer, a number of criteria may be relevant. It is sound administrative practice for the evaluators to decide how the criteria will be applied before they consider the tenders.

Post-tender negotiation

3.6 Further negotiation over outstanding contractual issues continued with Macquarie Bank until 30 June 1997. The up front price was not subject to further negotiation but legal and lease rate issues continued to be subject to negotiation. Macquarie Bank increased its funding margin over the floating benchmark rate[46] by 10 basis points[47] as a partial compensation for

45 ANAO reviewed these sales in Audit Report No.20 1996-97, *Selected Commonwealth Property Sales*.

46 The Floating Benchmark Rate is the rate of discount expressed as a yield per centum per annum which is the average of the bid rates as calculated by the Australian Financial Markets Association and currently shown on the page numbered 'BBSY' on the Reuters Monitor System at or about 10.15am (Sydney time) on that date, for a bank accepted bill having a tenor of 30 days.

47 The additional funding margin reduced the result of Macquarie Bank's offer by approximately $0.5 million over 6 years.

several conditions withdrawn after 9 June 1997.[48] For example, Macquarie Bank agreed to pass on to the Commonwealth the net proceeds from the sale of the rental business (if sold within six months). On 23 July 1997, Macquarie Bank advised OASITO that its intention was to retain long term ownership of the rental business and this decision was communicated to the Minister on 15 August 1997. However, shortly after the six month cut-off date Macquarie Bank sold the rental business.

3.7 The Business Adviser in conjunction with the Legal Adviser, reviewed the risks associated with the warranties provided by the Commonwealth in the Sale Agreement, concluding that the transaction *reflects an appropriate balance between achieving what is an attractive purchase price for the Commonwealth and mitigating the commercial risks of claims under the contract*.[49]

3.8 On 30 June 1997, the Business Adviser confirmed the 9 June 1997 recommendation that the Commonwealth accept Macquarie Bank's binding offer for DASFLEET, with a five year Tied Contract for the provision of leasing and fleet management services, based upon a debt funding arrangement and on terms which reflect the pricing schedules that are attached to the Tied Contract. On the same day OASITO advised the Minister for Finance that it recommended selling DASFLEET to Macquarie Fleet Leasing[50] for $407 901 000; entering into a Tied Contract with

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48 The major conditions withdrawn by Macquarie Bank were: utilisation fees payable if the Commonwealth utilised less than 90 per cent of the predetermined fleet size commitment limits and there was a negative balance in the reserve account; and losses associated with the non-CPA vehicles acquired at the sale date were to be recovered through lease rates for the CPA customers under the Tied Contract. Other changes to the Sale Agreement and the Tied Contract (as reported by the Business Adviser on 30 June 1997) included:

- the Commonwealth agreed not to unreasonably withhold its consent in relation to possible sell down of Macquarie Bank's financing arrangement;
- Macquarie Bank agreed to pass on a significant proportion of cost savings achieved from the fleet leasing and management and a formula to this effect was included in the Tied Contract;
- the Commonwealth elected the floating benchmark interest rate under the Tied Contract with the option of converting it into a fixed rate;
- the Commonwealth would pay up to $17.4 million as damages if it sought to exempt from the Tied Contract more than 2 per cent of the total CPA fleet;
- the Commonwealth agreed that Macquarie Bank may change its funding margin as a result of possible changes in risk weighting imposed by the Reserve Bank of Australia (an adjustment event) where such changes affected Macquarie Bank's cost of performing the contract with the Commonwealth. If the Commonwealth did not agree to the increase in cost it may terminate the Tied Contract and the provisions regarding early termination would apply; and
- inclusion of voluntary early termination clauses (Schedule 6 of the Tied Contract). Under these provisions the Commonwealth may terminate the contract upon a force majeure event or at its election taking effect 5 years and 10 months after the commencement of the Tied Contract.

49 The Business Adviser to OASITO on 30 June 1997.

50 Macquarie Fleet Leasing, a wholly owned subsidiary of Macquarie Bank, is the entity which now trades as DASFLEET and which signed the Tied Contract.

Macquarie Fleet Leasing for the provision of leasing and fleet management services for five years; and signing the put and call options with Macquarie Fleet Leasing and Macquarie Bank. The sale process was completed on time.

3.9 In a joint media release of 1 July 1997 the Minister for Finance and the then Minister for Administrative Services stated that, after testing the market, the Government's decision to sell reflected the *assessment of a better overall outcome* when compared with refinancing.[51] The Sale Agreement was signed on 17 July 1997 and the Tied Contract was signed on 1 September 1997.

3.10 Macquarie Fleet Leasing entered into a sub-contracting agreement with the Serco Group on 1 September 1997 for the provision of certain Tied Fleet management arrangements for DASFLEET. In August 1998, Macquarie Fleet Leasing announced that Lease Plan Australia would take over responsibility for the operation of the DASFLEET business from the Serco Group.[52] The new arrangement took effect from 21 September 1998.

3.11 **Finding:** On 30 June 1997, the Business Adviser re-analysed the bids and confirmed that Macquarie Bank's offer was superior and recommended that the Commonwealth accept Macquarie Bank's binding offer for DASFLEET. The sale process was completed on time with the announcement of the successful bidder on 1 July 1997 and the signing of the Sale Agreement on 17 July 1997. The complexity of the transaction, coupled with the scale and nature of the financial analysis used to judge the relative merits of the bids, required that OASITO be in a position to ensure that the ultimate decision maker can rely on the information about each tender contained in the evaluation report. For future asset sales involving long term contracts, ANAO considers that the adoption of an evaluation structure using a tender evaluation committee would improve the transparency and accountability of the tender process.

Recommendation No. 4

3.12 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in future trade sales of major assets involving material long term Commonwealth contracts, improve transparency and accountability in the sale process by the establishment of an appropriately structured tender evaluation committee.

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51 The Ministers stated that *under the proposed agreement it is expected that initially the Commonwealth will pay lease rates on new vehicles which are on average below those now charged by DASFLEET. Macquarie has undertaken to share the benefits of any future cost savings with the Commonwealth.*

52 Macquarie Media Statement of 28 August 1998.

OASITO response

3.13 OASITO's response was that it ***agreed with qualifications*** with the recommendation. OASITO stated that it is its experience that a formal tender evaluation process staffed with line officers and advisers is preferable to a tender evaluation committee in the case of asset sales executed by a dedicated unit such as OASITO. A formal committee often adds an unhelpful level of bureaucracy (in its literal meaning) to no good end.

3.14 OASITO accepts that where a long term contract is involved, it is essential to draw on the expertise across relevant agencies. Whether this requires the formality of a committee will depend on the particular circumstances. In the case of the DASFLEET sale, DAS was represented on the Steering Committee and provided officers to review the draft documentation.

ANAO comment

3.15 The value in using a tender evaluation committee lies in the enhanced level of transparency and accountability it affords. ANAO recognises that there are a number of approaches which can be used in the evaluation of tenders but considers that a tender evaluation committee is particularly useful where the proposals to be evaluated include not only the sale of assets but also tenders for a long term contract for the provision of services. Such committees have been successfully adopted in previous Commonwealth asset sales of the Repatriation General Hospitals which involved commitments to 10 year contracts for services. Where a tender evaluation committee is constituted, representatives of the Commonwealth agency with ongoing responsibility for management of the long term contract, may be afforded a structured role in the tender evaluation process not provided under the model outlined by OASITO above. In this way the responsibilities of panel members are kept distinct, but the panel is able to take advantage of the balance of skills of individuals familiar with the sale.

3.16 OASITO has advised ANAO that it does not stand in a reporting line between the Minister and its advisers. In this circumstance, ANAO considers implementation of the recommendation to employ a tender evaluation committee would provide the ultimate decision maker with a higher degree of assurance that a structured assessment of the proposals and of the reports prepared by advisers has been carried out. The resulting evaluation report, including a recommended course of action, is then provided to the Minister ensuring that there is an appropriate transparent framework for the decision.

Financial risk

3.17 In the planning for an asset sale, it is important that all relevant agencies and advisers identify, analyse and evaluate risks to ensure that the Commonwealth's commercial position is adequately protected. As an overarching sound administrative practice, responsibility for the effective management of risk should be allocated to those parties that have the necessary expertise to identify and manage the risk.[53] Effective risk pricing is a key ingredient in the sales process to ensure the most cost effective outcome.

3.18 The margin over the benchmark funding rate offered by Macquarie Bank in its May 1997 binding offer was one fifth of the next highest bidder's rate. The May 1997 bid submitted by Macquarie Bank and the next highest placed bidder differed significantly with regard to the sharing of commercial risk associated with the transaction in terms of the events that would affect the lease financing rates and the costs of residual risk on each vehicle in the fleet. The Business Adviser noted that:

> *none of the bidders would commit to residual values for a period greater than three months and, therefore, it is impossible to conclude that the second highest bidder's lease rates would not have increased (to manage residual value risk) simply because it incorporated a higher margin in its lease rate calculations.*

3.19 The Macquarie Bank bid of May 1997 indicated, amongst other things, that its transaction funding rate margin was premised on the Reserve Bank of Australia (RBA)[54] assessing the transaction for capital adequacy purposes at the rate of 10 per cent. The RBA uses a risk based measurement of the capital adequacy of banks[55] which incorporates balance sheet and off-balance sheet exposures.

3.20 Balance sheet assets and off-balance sheet exposures are weighted according to broad categories of relative risk based in large part on the nature of the counter parties. These range from a zero per cent rating on notes and coins to 10 per cent rating on claims on governments to 100 per cent for claims on Australian public trading enterprises with corporate status. The greater the risk, the greater is the capital backing required by

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53 *Guidelines for Managing Risk in the Australian Public Service, Management Advisory Board/ Management Improvement Advisory Committee Report No. 22*, October 1996, p.31.

54 The Australian Prudential Regulatory Authority (APRA) assumed responsibility for prudential regulation for deposit-taking, life and general insurance and superannuation institutions from 1 July 1998.

55 Macquarie Bank Limited is an entity licensed as a bank under the *Banking Act 1959.* At the time of the sale, the RBA supervised banks by a range of mechanisms including that banks risk adjusted capital ratios remain at acceptable levels. APRA now undertakes this role.

the bank and the higher the cost of funds. ANAO noted that the move from a 10 per cent (that is a government loan transaction) to a 100 per cent (that is a commercial transaction) weighting could increase the winning bidder's cost of funds margin by around four times. This would make the cost of funds comparable between the first and second ranked bidder.

3.21 It would not be normal commercial practice for a bank customer to approach the RBA to determine what is the risk weight applied to a transaction. In the case of the Macquarie Bank bid for DASFLEET there was a direct linkage between the interest rate payable by the Commonwealth as customer on the leasing of the fleet and the regulatory risk weight determined by RBA for the transaction. This situation did not apply to the other bidders' offers.

3.22 **Finding:** The different mechanisms for sharing risk offered by the bidders were reflected in their differing margins over the benchmark leasing rate cost of funds. The margin rate offered by Macquarie Bank in its May 1997 binding offer was one-fifth of that offered by the next highest bidder in the first year of the transaction. In the case of the Macquarie Bank bid for DASFLEET, there was a direct linkage between the interest rate payable by the Commonwealth, as customer, on the leasing of the fleet and the regulatory risk weight determined by the RBA for the transaction. This situation did not apply to the other bidders' offers.

3.23 OASITO advised ANAO that:

> *The approach taken was itself a risk management strategy designed to secure for the Commonwealth the benefits of an expected 10 per cent RBA weighting, while affording Macquarie protection against an adverse outcome that was assessed as unlikely. It is not certain that bidder ranking could have been different at 100 per cent weighting but this outcome was not expected, its prospect was carefully managed and did not eventuate.*
>
> *The capacity of the Commonwealth to negotiate or effectively cancel the transaction in the event that a 10 per cent weighting did not apply was designed to manage the relevant regulatory risk. That is the way any other purchaser of services would need to deal with regulatory uncertainty. OASITO did not seek to place the Commonwealth in a more advantageous position because the RBA happens to be a Commonwealth agency.*

3.24 The Business Adviser asked Macquarie Bank on 29 May 1997 to indicate which of a list of assumptions (including the assumption that the transaction is risk weighted at 10 per cent) in the Bank's final offer were the risks that the Commonwealth would be required to accept. Macquarie

Bank indicated[56] that the risk weighting was a risk to which the Commonwealth would be exposed. The advice prepared by the Business Adviser for the OASITO on 9 June 1997 (and included in the Ministerial Briefing of 9 June 1997) did not identify the financial consequences of the RBA treating this transaction for capital adequacy purposes at a rate different to that assumed by the bidder. A risk weighting of 100 per cent could have resulted in the Commonwealth incurring additional costs under the Tied Contract of up to $25.7 million (nominal dollars) over the contract's life.[57] The potential equivalent, on a NPV basis, of these additional costs has been calculated by the Business Adviser. The Business Adviser, in its 12 November 1998 response to the proposed report issued under section 19 of *Auditor-General Act 1997*, advised ANAO that applying its valuation models, after increasing the cost of funds by 150 basis points (taking account of the expected diminution in the size of the CPA fleet over the period of the Tied Contract; the tax effects; and the time value of money) to reflect a 100 per cent risk weighting, results in increased costs over the Tied Contract of $7.3 million on a NPV basis.

3.25 The Business Adviser advised OASITO that *the recommendation of 9 June 1997 included a sensitivity analysis on the change in the NPV of each bidder as a result of a change in numerous assumptions, one of these was a change in interest rates (or cost of funds).* The Business Adviser's advice of 9 June 1997 outlined that a plus or minus 50 basis points (that is 0.5 per cent) change in the lease benchmark cost of funds would result in an increase or decrease of $2 million in the NPV for each of the three bids evaluated. In assessing the bids as of 9 June 1997, the Business Adviser used a 6.2 per cent lease benchmark cost of funds to which was added the bidders' various

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56 On 6 June 1997, Macquarie Bank advised the list of assumptions to which a change affecting the Head Lessor would 'constitute a Recalculation Event and require a revision to the Margin Table'. These included replacement vehicles with 5 or 10 year leases, Fleet Administration Expenses are payable in advance and equal to 15% of the funding limit, vehicles are depreciated at 30 per cent per annum diminishing value, lease payments are received monthly in arrears, a 36 per cent corporate tax rate, 30 September as the Head Lessor's tax year end, tax instalment due dates are June, September, December and March, vehicles are acquired at the Government Contract Price (excluding sales or equivalent tax) or lower, no sales tax, capital gains tax, penalty, duty, levy or any other additional tax is payable in respect of the vehicles, Section 59(2A) of the Tax Act can be applied to defer profits on disposal of vehicles, Initial Management Fee payable on 30 June 1997, ongoing Management Fees of 0.25 per cent paid annually in advance commencing 30 June 1997, Lease Payments and Interest Expenses are accounted for on an accrual basis for taxation purposes, the transaction is a rental agreement under the Tax Act, the 'listed' tax deductions are available, the 'listed' Parts of the Tax Act apply to this transaction, a 10 per cent risk weighting applies for capital adequacy purposes, the maximum debt funding of vehicles on commencement of each vehicle lease is 80per cent of the cost, the applicable fixed or floating rate is 7.5 per cent per annum monthly, no amendment to the Tax Act requiring an increased amount of accessible income to be returned or which reduces the deductions claimable, no additional imposts, taxes, or charges of any kind whatsoever which would increase the cost of funds.

57 DOFA advice to OASITO September 1997.

margins. Any increase in the RBA's risk weighting above the 10 per cent assumed by the winning bidder would have increased the winning bidder's cost of funds margin but would not have altered the base lease benchmark cost of funds which was derived from the financial markets.

3.26 The issue of capital risk weighting was discussed between OASITO, the Business Adviser and Macquarie Bank in late May 1997. ANAO was unable to find substantive evidence that any action was taken by OASITO or its Business Adviser to obtain formal confirmation from the RBA of how the transaction would be treated for risk weighting purposes prior to advising the Minister for Finance on 9 June 1997. The Minister was advised on 30 June 1997 that Macquarie Bank may adjust its funding margin provided to the Commonwealth under the Tied Contract if the RBA changes the risk weighting guidelines of the transaction or imposes any form of reserve or special deposit requirement which results in increased or decreased cost of performing Macquarie Bank's obligations under the Tied Contract.

3.27 In the advice provided by the Business Adviser to OASITO on 30 June 1997, there was specific mention made regarding the effect of the RBA adopting any different view on the appropriate risk weighting for this transaction. Advice to OASITO from the Business Adviser was that if the Commonwealth does not agree to an increase in lease costs due to changes in RBA risk weighting, the Commonwealth may terminate the Tied Contract and draw upon the Voluntary Early Termination provisions of the Tied Contract.

3.28 OASITO has advised ANAO that Schedule 10 of the Tied Contract was specifically developed to address the Commonwealth's exposure to the potential that the RBA might impose a different capital adequacy requirement on the transaction to the assumed 10 per cent. Schedule 10 provides that, whenever an adjustment event occurs and the Purchaser notifies the Commonwealth of an increase in margin, the parties must meet and negotiate and use their best endeavours for a period of not more than 30 days to restructure the Tied Contract and funding arrangements so that the same, or substantially the same, intended economic effect may be achieved. If the increased margin is accepted by the Commonwealth, that increased margin applies to all new leases entered into after the date of acceptance by the Commonwealth. If the Commonwealth gives notice to the Purchaser that it does not accept the increase in the margin, the Purchaser may terminate the Tied Contract.

3.29 The financial analysis undertaken by the Business Adviser for the selection of the winning bidder did not capture the higher cost of funds resulting from any change in RBA risk weighting compared to the 10 per cent risk weighting which was the basis of Macquarie Bank's offer. At Schedule 10 of the Tied Contract it is specifically provided that the funding for the vehicles is predicated on the transaction attracting a 10 per cent rate for capital adequacy purposes and if the RBA imposes a different rate then any additional cost can be passed onto the Commonwealth.

3.30 The RBA indicated to Macquarie Bank after the sale that it would treat the transaction as being weighted not at 10 per cent but rather at 100 per cent. A joint submission was made by OASITO and Macquarie Bank on 23 February 1998 to the RBA outlining why the Tied Contract leasing arrangements should be risk weighted at 10 per cent and the reasons why the Macquarie Bank has full recourse to the Commonwealth for the entire lease receiveable.[58]

3.31 In June 1998, the RBA agreed to treat individual leases entered into under the Tied Contract, and which will expire before the Tied Contract matures, as finance leases because of a mechanism established in the Tied Contract which passes substantially all of the risks and rewards relating to the ownership of these lease assets to the Commonwealth. Accordingly, individual leases will attract a 10 per cent risk weighting if they expire before the Tied Contract matures on 1 September 2002. Vehicle leases which expire beyond that date are considered by the RBA to be operating leases, and as such will attract a 100 per cent risk weighting which will be reflected in higher lease financing costs for Commonwealth agencies under the Tied Contract. For example, a two year vehicle lease entered into by an agency in September 2000 and expiring in September 2002 would be fully risk weighted at 100 per cent.

3.32 **Finding**: Effective administrative actions were not taken to identify and specifically quantify the financial risks in the five year Tied Contract associated with the Commonwealth accepting exposure to any variations in the RBA assessment of the required risk weighting for capital adequacy purposes. The financial analysis undertaken by the Business Adviser for the selection of the winning bidder did include a sensitivity analysis of the change in the NPV of each bidder as a result of changes in key assumptions one of which was interest rates.

3.33 However, the analysis did not explicitly identify how the cost of funds could have increased with any increase in the risk weighting required by the RBA for the transaction as compared to the 10 per cent risk weighting assumed by Macquarie Bank in its offer. A risk weighting of 100 per cent could have resulted in the Commonwealth incurring additional costs under the Tied Contract of up to some $25.7 million (nominal dollars) over the

[58] Lease amounts receivable under the Tied Contract were some $309 million.

term of the contract. The potential equivalent, on a NPV basis, of these additional costs has been calculated by the Business Adviser. The Business Adviser has advised ANAO that applying its valuation models, after increasing the cost of funds by 150 basis points (taking account of the expected diminution in the size of the CPA fleet over the period of the Tied Contract; the tax effects; and the time value of money) to reflect a 100 per cent risk weighting, resulted in projected increased costs over the Tied Contract of $7.3 million on a NPV basis.

3.34 OASITO has advised ANAO that Schedule 10 of the Tied Contract was specifically developed to address the Commonwealth's exposure to the potential that the RBA might impose a different capital adequacy requirement on the transaction to the assumed 10 per cent. Schedule 10 provides that whenever an adjustment event occurs and the Purchaser notifies the Commonwealth of an increase in margin, the parties must meet and negotiate and use their best endeavours for a period of not more than 30 days to restructure the Tied Contract and funding arrangements so that the same, or substantially the same, intended economic effect can be achieved If the Commonwealth gives notice to the Purchaser that it does not accept the increase in the margin, the Purchaser may terminate the Tied Contract, with considerable potential adverse financial implications for the Commonwealth.

3.35 ANAO was unable to find substantive evidence that any action was taken by OASITO or its Business Adviser to obtain formal confirmation from the RBA of how the transaction would be treated for risk weighting purposes prior to advising the Minister for Finance on 9 June 1997.

3.36 The RBA indicated to Macquarie Bank soon after the sale that it would treat the transaction as being weighted not at 10 per cent but rather at 100 per cent. The RBA agreed in June 1998, some twelve months after the selection of Macquarie Bank, to classify leases entered into under the Tied Contract as finance leases, enjoying a 10 per cent risk weighting, if they are due to expire before the Tied Contract matures on 1 September 2002. This risk weighting is assigned to transactions representing a claim on Commonwealth or State Governments. Vehicle leases which expire beyond that date will be treated by the RBA on the basis of 100 per cent risk weighting which will be reflected in higher lease financing costs for Commonwealth agencies under the Tied Contract.

Recommendation No. 5

3.37 ANAO *recommends* that where possible, in future asset sales, the Office of Asset Sales and IT Outsourcing ensures that all relevant Commonwealth bodies are formally approached and written sign-offs are obtained from appropriate officials on commercial and administrative issues affecting the financial outcome of the sale.

OASITO response

3.38 OASITO's response was that it ***agreed*** with the recommendation.

Tied Contract

3.39 The financial implications of the Tied Contract are such that the Commonwealth is exposed to a range of commercial risks including increased leasing charges to agencies and a full accounting of the cost of terminating the contract. DOFA received an application from Macquarie Fleet Leasing on 26 September 1997 for an increase in the residual risk fee to over $100 per month per vehicle to cover lower than anticipated resale values for the existing fleet resulting from the fall in second hand car prices. DOFA did not accept the significant variation in the size and value of both residual values and the residual risk fee that Macquarie Fleet Leasing requested.

3.40 It was the intention of both parties that the Tied Contract should run for five years from 1 September 1997 to 1 September 2002 with a wind down period in accordance with the length of the individual leases written before 1 September 2002. Under the Tied Contract, the Commonwealth is committed to enter into leases progressively over the Tied Contract term. As a result, individual leases of some vehicles will expire after the termination date of the Tied Contract in accordance with the individual terms of particular vehicle leases.

3.41 A Voluntary Early Termination Period is defined in Schedule 6 of the Tied Contract which entitles the Commonwealth to terminate the remaining leases under the Tied Contract between 5 years 10 months and six years after commencement of the agreement. In the event of any Full Termination event,[59] prior to the expiration of the last lease, the Reserve Account, less any costs, is to be paid to the Commonwealth.

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[59] ANAO was advised by AGS that: *There are two circumstances under which the Commonwealth may terminate the Tied Contract, upon a Force Majeure Event and upon a Termination Breach. Macquarie Fleet Leasing may terminate the contract upon an Adjustment Event. It should also be noted that the Adjustment Event does not give rise to a Commonwealth right to terminate, but an ability to possibly trigger a termination by objecting to the rate increase.*

3.42 Of particular importance are termination upon a Force Majeure Event and termination upon an Adjustment Event, as under both of these circumstances the Commonwealth is exposed to the residual risk and, while it would access the Reserve Account, it could have to pay leasing and fleet management rates outstanding; the vehicle principal outstanding; the break cost; and any negative balance in the Reserve Account.[60] In the case of no early termination, the Tied Contract provides that:

> *If the Tied Contract expires due to the effluxion of time, and there had been no termination … at the expiration of the term of the last Lease, the Purchaser is entitled to and is responsible for the Reserve Account at that time, irrespective of whether a positive or negative balance exists at that point in time.*

3.43 **Finding:** The financial implications of the five year Tied Contract are such that the Commonwealth is exposed to a range of commercial risks including increased leasing charges to agencies and potential responsibility for the cost of terminating the contract. ANAO considers that the commercial implications for the Commonwealth of the residual risk fee and the Reserve Account along with expiry of the Tied Contract warrant a comprehensive review of the Commonwealth's financial exposures.

Recommendation No. 6

3.44 ANAO *recommends* that the Department of Finance and Administration, in consultation with relevant Commonwealth agencies, undertakes a comprehensive commercial risk assessment of the Commonwealth's exposure under the five year Tied Contract.

DOFA response

3.45 DOFA ***agreed*** with the recommendation. DOFA advised that the Department has been active on issues related to the management of this contract. The Monitoring Body (within DOFA) continually reviews the terms and conditions of the Tied Contract. Further to this the Monitoring Body has already initiated a comprehensive assessment of the Tied

[60] See also paragraph 2.37.

Contract's dynamics and downstream liabilities (if any). This is scheduled for completion in late December 1998. This external review is being performed by Oxley Corporate Finance.

OASITO response

3.46 OASITO noted that this recommendation was a matter for DOFA.

Canberra ACT — P. J. Barrett
18 December 1998 — Auditor-General