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Performance Audit

Sale of SA Rail, Tasrail and Pax Rail

Australian National Audit Office

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Australian National
Audit Office

Canberra ACT
21 December 1998

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit of the sale of the intrastate freight and interstate passenger rail businesses of the Australian Railways Commission 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 *Sale of SA Rail, Tasrail and Pax Rail.*

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

ANAO	Australian National Audit Office
ARTC	Australian Rail Track Corporation
Australian National	Australian National Railways Commission
DoFA	Department of Finance and Administration
DoTRS	Department of Transport and Regional Services.
DFACS	Department of Family and Community Services.
DVA	Department of Veterans' Affairs.
FAC	Federal Airports Corporation
National Rail	National Rail Corporation Ltd, established in the early 1990s to take over all the interstate freight business of Australian National.
OASITO	Office of Asset Sales and IT Outsourcing
Pax Rail	Pax Rail Pty Limited. The assets of Australian National's passenger rail business were vested in this company.
PM&C	Department of Prime Minister and Cabinet
SA	South Australia
SAGC	SA Generation Corporation
SA Rail	SA Rail Pty Limited. The assets of Australian National's South Australian intrastate freight businesses were vested in this company.
Tasrail	Tasrail Pty Limited. The assets of Australian National's Tasmanian freight business were vested in this company.
TPI veterans	Totally and Permanently Incapacitated veterans

Summary and Recommendations

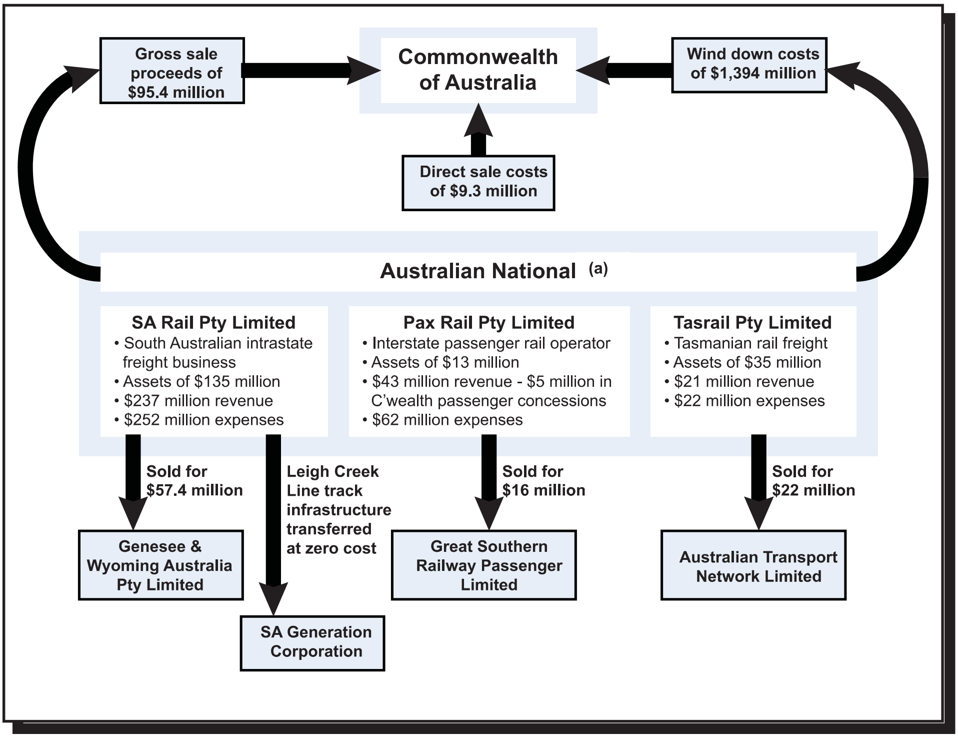
Source: Photograph courtesy of The Exhibition Centre Pty Ltd.

Summary

Background

1. The sale of the intrastate freight and interstate passenger rail businesses of the Australian National Railways Commission (Australian National) was completed in November 1997. The sale was effected by the sale of shares in SA Rail Pty Limited, Tasrail Pty Limited and Pax Rail Pty Limited (see Figure 1). Vested in these companies were the assets of Australian National's intrastate freight and interstate passenger rail businesses.

Figure 1
Australian National Businesses Sale



Note (a): All figures are for 1995-96. Excludes allocation of Australian National corporate overheads and Government grants and supplements.

Source: ANAO analysis based on information provided by OASITO.

2. In April 1996 the then Minister for Transport and Regional Development commissioned a review of Australian National and the National Rail Corporation Ltd (National Rail). The main review finding was that Australian National had no prospect of being commercially viable in its present form. The report recommended the transfer of some functions and assets to the Tasmanian and South Australian Governments; the sale of certain businesses and the sale of the remaining assets; the write-off of debt; and renegotiation of leases and other encumbrances over rolling stock. The report concluded that the likely cost of implementing these recommendations would be recovered within ten years by eliminating the ongoing need to finance Australian National's potential losses of more than $100 million per year.

3. Following the completion of a scoping study of all financial and policy issues in relation to the sale of Australian National and National Rail, the Government announced on 6 March 1997 its intention to sell the assets and businesses of Australian National. The Government's sale objectives were to: enter into an agreement with the successful purchasers by 30 June 1997 or as soon as possible thereafter;[1] provide efficient, competitive, dynamic and reliable transport services; contribute to the establishment of a viable and competitive rail system; promote private sector investment in the rail industry; contribute to regional development; obtain a financial return to the Commonwealth that represents fair and reasonable value; and divest the Commonwealth from ongoing responsibility for the operation of rail in Australia, except for its involvement in track access.

4. Overall responsibility for management and completion of the sale was assigned to the Office of Asset Sales and IT Outsourcing (OASITO).[2] OASITO was assisted by two joint Business Advisers and a Legal Adviser. The Department of Transport and Regional Services (DoTRS) played an important role in the sale being involved in developing the terms of reference for sale advisers and the selection of advisers; due diligence; sales coordination; the tender evaluation process; assisting with the

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1 The Government required that every effort be made to finalise the sales by 30 June 1997. The Request for Tender issued to shortlisted bidders in June 1997 included a revised objective of entering into an agreement with the successful purchasers by 30 June 1997, or as soon as possible thereafter.

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.

negotiation of the new Railways Agreements with South Australia and Tasmania; and developing, in consultation with OASITO, the sale legislation.

Audit approach

5. ANAO's objectives in auditing the sale were to: assess the extent to which the Government's sale objectives were achieved; review the effectiveness of the management of the sale process; and identify principles of sound administrative practice to facilitate improved administrative arrangements for future trade sales. The scope of the audit extended from the initial decision to sell Australian National, to the negotiation of the final sale contracts and all issues associated with management and completion of the sale.

Audit conclusions

6. The sale of Australian National presented OASITO and its advisers with a range of challenges to achieve a successful and timely sale. In particular, the businesses offered for sale did not have a history of profitable operations; sale preparation and the tender process needed to be expedited; and cooperation from the South Australian and Tasmanian Governments was essential to achieving the sale objectives.[3]

7. OASITO's advisers' scoping study found that there was significant market interest in the Commonwealth's rail assets and businesses and that most were likely to be saleable for positive values. In February 1997, the Business Advisers had estimated that proceeds for sales completed by 30 June 1997 would be in the range of $53 million to $100 million and that proceeds for sales completed after 30 June 1997 would be in the range of $110 million to $180 million. The sale of Australian National's intrastate freight and interstate passenger rail businesses raised gross proceeds of $95.4 million which was at the upper end of the estimate for a mid-1997 sale. In addition, it should be noted that the principal financial effect for the Commonwealth was not in the proceeds of sale but in the termination of ongoing revenue supplements and financial losses.

8. The Commonwealth's direct costs of selling the businesses are estimated to be $9.3 million, or 9.7 per cent of gross proceeds. The direct sale costs were 50 per cent higher than the sale budget of $6.2 million developed by OASITO and approved in March 1997. OASITO advised that the approved sale budget was based on initial fee proposals from advisers for completing all sales by the recommended optimal time of

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3 The sale required a renegotiation of the Railways Agreements with each state; transfer of operational railways land including rail corridors to the state concerned and the grant by the states of 50 year leases of the operational land to the purchasers of SA Rail and Tasrail.

December 1997 and before the Government decided on a reduced timeframe. Increased advisory fees were subsequently agreed to by OASITO when additional expertise and resources were required to ensure every effort was made to achieve the earlier completion date.

9. Australian National's financial liabilities totalling $1 393 million, including accrued employee entitlements and debt, have been or are being repaid or assumed by the Commonwealth.

Sale timing

10. Progressing the sales process as quickly as possible was considered important to stem the substantial losses being incurred by Australian National and provide greater certainty to the rail industry. The sale scoping study was completed in late January 1997. In March the Government required every effort be made to complete two aspects of the sale process[4] by 30 June 1997 as follows:

- ***Sale completion:*** Sale agreements were to be signed and purchase prices banked for each of Australian National's independent rail businesses. Due to the complexities of having to restructure the Australian National businesses, difficulties arising out of Australian National management's requirements and bidder anxiety about the timetable, the tender timetable was reviewed by OASITO. The Minister for Finance[5] agreed to an extension to allow receipt of final bids by 25 July 1997. The revised timetable was essentially met with binding offers received for each of the three businesses on 28 July, although final binding offers for all businesses were not received until 19 August. The sale agreements were signed on 28 August and all sales completed by mid-November 1997.
- ***Post-sale management of financial obligations:*** Australian National's debt and lease obligations of some $1 000 million were to be repaid or assumed in conjunction with the sale process. Arrangements for the assumption or repayment of all of Australian National's financial obligations were unable to be finalised by 30 June 1997. Assumption or repayment of the remaining financing transactions is expected to be finalised by March 1999. Major reasons for the delay were the number and complexity of the transactions, and the absence of

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4 OASITO's Business Advisers and Legal Adviser had recommended that the sale preparation and sale process take longer to ensure that a 'fair and reasonable' sale price was achieved. Their scoping study recommendation was that Tasrail, SA Freight (one of the four businesses sold as SA Rail) and Passenger Rail (sold as Pax Rail) be sold by open tender with the sales to be completed between June and December 1997.

5 The Minister for Finance and Administration is referred to by his title at the time of the sale, that is, as the Minister for Finance.

voluntary early termination and transfer rights for some transactions. OASITO advised ANAO that a further significant reason for the delays in settling the remaining debt was the lack of effectiveness of Australian legislation in dealing with off-shore arrangements.

Freight rail tenders

11. Australian National's intrastate freight businesses were sold for a total of $79.4 million comprising $57.4 million for SA Rail and $22.0 million for Tasrail. Tasrail was sold to the highest bidder with the decision to undertake a further bidding round resulting in an increase in the price offered by the successful bidder.

12. The Tender Evaluation Panel reached consensus on the preferred bidder for Tasrail and Pax Rail but not for SA Rail. A majority of the Panel favoured, as preferred tenderer for SA Rail, the bid offering the highest proceeds whereas a minority considered the qualitative aspects of the 'next-in-line' tenderer outweighed the reduced sale price. The Panel's recommendations were incorporated in briefings provided by OASITO and DoTRS to their respective Ministers. Based on these briefings, the Ministers agreed with the Panel's recommendations as to the preferred tenderers for Tasrail and Pax Rail but accepted the Panel minority's recommendation for the preferred tenderer for SA Rail.

Passenger rail tender

13. Australian National's passenger rail business operated three high profile interstate passenger rail services: *The Indian Pacific* (between Sydney and Perth); *The Ghan* (between Adelaide and Alice Springs); and *The Overland* (between Adelaide and Melbourne). The agreement for the sale of Pax Rail to Great Southern Railway Passenger Limited was signed on 28 August 1997 for a purchase price of $16 million. The sale has also removed the need for the Commonwealth to provide ongoing operating supplements, which amounted to $14 million in 1995-96. In addition to the purchase price, the purchaser committed in the Sale Agreement to capital expenditure of $14.3 million by 31 October 2003.

14. The stand alone bid accepted for Pax Rail offered a purchase price of $16 million with the only other final bidder offering a net purchase price of $20 million (after excluding $5 million in concession payments), $4 million or 25 per cent higher than the offer accepted. OASITO advised ANAO that the higher purchase price of the unsuccessful bidder was not sufficient to offset the significantly reduced Commonwealth flexibility in concession reimbursement policy; the reduced commitment to maintain service levels; the $10.5 million lower capital expenditure commitment; and the potentially lower prospects of commercial success.

15. The Pax Rail purchaser determined its purchase price on the basis that reimbursement from the Commonwealth for concessional travel would be discontinued immediately upon sale completion. The purchaser offered to continue concessional travel for some, but not all, existing categories of recipients, without Commonwealth reimbursement.[6] Post-sale arrangements were negotiated with the purchaser after its selection but later had to be amended to ensure concessions would continue to be provided to those who received them before the sale. Depending upon the number of pensioners carried, the purchaser will receive a proportion of the $2.5 million budget allocation from the Commonwealth in concession reimbursement, compared to approximately $5 million per annum reimbursed to Australian National.

16. Passenger concessions are a recognised adjunct to income support arrangements and part of the Government's 'core promise' to maintain the income safety net at existing levels. Not to continue rail pensioner concessions would have been inconsistent with a 1993 Premiers Conference agreement between the Commonwealth and the States. Accordingly, the Department of Family and Community Services and the Department of Veterans' Affairs were of the view that, because the Government had not decided to alter concession entitlements, any new arrangement for concessional travel post-sale should ensure the maintenance of existing arrangements. However, the tender process for Pax Rail was designed to address the issue of passenger concessions only in response to bidders' proposals.

17. The Panel's evaluation report did not quantify bidders' concession proposals in the event the Commonwealth required concessional travel to continue to be provided at existing levels to existing categories of recipients. Balancing the immediate value from the sale (the purchase price) with the ongoing cost to the Commonwealth of passenger concessions would contribute to achieving the sale objectives of a fair return and divesting the Commonwealth from ongoing operational responsibility for rail. ANAO considers that each bidder's purchase price offer and any ongoing Commonwealth funding should be calculated to identify the best overall whole-of-government financial outcome. This is an important aspect of any sale. This would have required modelling a number of scenarios including the continuation, post-sale, of existing Commonwealth policies or possible changes to policies.

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6 The purchaser offered, subject to seat availability, discounts for pensioners, full-time students, children, eligible former Australian National employees, and Parliamentary Gold Pass holders. Discounts were not offered for blind passengers or totally and permanently incapacitated veterans and their carers. The discounts offered were less than those provided by Australian National.

Efficiency, viability and regional development objectives

18. The sale of Australian National, combined with the proposed sale of National Rail, which was announced on 30 June 1997, will confine the Commonwealth's involvement in rail transport to control of the interstate infrastructure. This is consistent with the sale objective of divesting the Commonwealth from ongoing responsibility for the operation of rail. Other Government sale objectives included:

- ***Efficient, competitive, dynamic and reliable rail transport services:*** Each of the businesses was sold to a private sector consortium that included an experienced overseas private sector rail operator. To assist with the introduction of private sector work practices and improve the efficiency of operations, all staff employed by the businesses sold had their positions terminated. This arrangement provided the purchasers with the maximum possible flexibility regarding future employment levels and work practices, although involving a high level of cost in redundancy payments.
- ***Viable and competitive rail system:*** The sale objectives included contributing to a viable and competitive rail industry and the tender evaluation criteria included the financial strength and capacity of bidders. Tender evaluation focused on bidders' commercial experience and their financial ability to complete the sale. The tender evaluation report did not include a clear analysis of bidders' ability to service debt and meet maintenance and development plan requirements; details of operating cashflow forecasts and their sensitivity to changes in key business and financial assumptions; and the funding structure proposed by bidders, including the likely effect of different gearing levels on the financial viability of the businesses. ANAO recognises the cost and time involved in such analysis, but considers it would have contributed significantly to the sale objectives of establishing a viable and competitive rail system, and promoting ongoing regional development. The Pax Rail purchaser was highly geared with a debt to equity ratio of 8.26 : 1, whereas the other final bidder for Pax Rail offered a higher purchase price that was fully funded by equity.
- ***Regional development:*** Each of the businesses sold was important to the economies of South Australia and Tasmania and the sale objectives included contributing to regional development. Consistent with the sale objective of contributing to regional development, OASITO developed effective consultation arrangements with the South Australian and Tasmanian Governments and the importance of regional development issues was reflected in the tender process and tender evaluation. A major outcome from the sale was the contractual

commitments from the three purchasers to a total of $86.6 million in capital expenditure over the next four to six years. In addition, the return of railways land to the State governments enabled the States to require each of the purchasers to commit to the maintenance of minimum services, including the retention of specified lines and frequency of passenger services.

Sale management

19. Asset sales are invariably complex, resource intensive activities undertaken within tight timeframes. In undertaking Commonwealth asset sales, OASITO outsources the services required extensively to the private sector which places considerable focus and emphasis on contract management, including the underlying risks involved.

20. Immediately following the 24 November 1996 sale announcement, OASITO appointed business and legal advisers to conduct and report on a scoping study of all financial and policy issues in relation to the sale of Australian National and National Rail. OASITO conducted a closed tender for its scoping study advisers but, to expedite the then accelerated sale process, did not re-tender the later, more significant advisory contracts as had been foreshadowed. Scoping study fees represented some 6 per cent of final advisory fees. OASITO's tender approach did not identify all suitably qualified candidates for the scoping study with the Business Adviser shortlist supplemented by firms that later sought to be involved, including the two firms eventually selected as joint business advisers. The experience gained by the incumbent Business and Legal Advisers through the scoping study, and the amount of work that had been undertaken before formally appointing the advisers for the sale process, placed OASITO at some disadvantage in negotiating appropriate contractual and fee arrangements for the later contracts.

21. Compared to initial fee proposals from the Business and Legal Advisers for completing all sales by December 1997, OASITO agreed to increased fees when the Government decided it wanted all sales completed by 30 June 1997. The increased fees were agreed to because of the reduced timeframe and the importance of timely completion. However, the sale advisory contracts, which form the foundation of the contractual relationship between OASITO and its advisers, did <u>not</u> link fee payments to the achievement of deadlines or other performance milestones. Commercial risks associated with the outsourcing arrangements were also increased because advisory contracts were not finalised and signed until between four and seven months <u>after</u> the advisers commenced work.

Recommendations

22. ANAO made seven recommendations to improve the future management of Commonwealth trade sales. The Department of Family and Community Services agreed with Recommendation 5. DoTRS agreed with Recommendations 3 and 5. The Department of Veterans' Affairs agreed with qualifications to Recommendations 3 and 5, and agreed with all other recommendations. OASITO agreed to part (b) of Recommendation 2, disagreed with Recommendation 4 and agreed with qualifications to the remaining recommendations.

Recommendations

Set out below are ANAO's recommendations arising from this report, with report paragraph references and abbreviated responses from the agencies. More detailed responses are shown in the body of the report together with the findings. Recommendations 1, 3, 4, 5 and 6 have the highest priority.

Recommendation No.1
Para. 2.11

ANAO *recommends* that the Office of Asset Sales and IT Outsourcing seek to enhance value for money and transparency in future asset sales by developing a comprehensive outsourcing strategy for each sale, including planning for a possible staged procurement approach to major advisory contracts.

DVA: Agreed.

OASITO: Agreed with qualifications.

Recommendation No.2
Para. 2.23

ANAO *recommends* that the Office of Asset Sales and IT Outsourcing seek to manage effectively commercial risks associated with the outsourcing of sale management, where practical, by:

(a) ensuring each major advisory contract directly links fee payment to contract deliverables and/or performance milestones; and

(b) finalising and signing advisory contracts promptly.

DVA: Agreed.

OASITO: Agreed with qualifications (a) and agreed (b).

Recommendation No.3
Para. 3.16

ANAO *recommends* that the Office of Asset Sales and IT Outsourcing improve the effectiveness of Tender Evaluation Panels in future trade sales by:

(a) structuring the membership of Evaluation Panels so that relevant Commonwealth agencies are able to satisfy themselves that tender evaluation is properly conducted and identifies the best possible offer for each business; and

(b) extending the oversight scope of the Panel to comprise all aspects of the tender evaluation process, including shortlisting parties that submit Expressions of Interest.

DoTRS: Agreed.

DVA: Agreed with qualifications.

OASITO: Agreed with qualifications.

Recommendation No.4
Para. 3.24

ANAO *recommends* that the Office of Asset Sales and IT Outsourcing develop a corporate policy on success fees that ensures tender evaluators do not have a pecuniary interest in the outcome of the tender process, as part of its ongoing risk management strategy which should guide decision-makers in particular sales.

DVA: Agreed.

OASITO: Disagreed.

Recommendation No.5
Para. 5.11

ANAO *recommends* that relevant Commonwealth agencies maximise the overall interests of the Commonwealth in future trade sales by implementing arrangements that seek to ensure early resolution of the Government's position on future service requirements, and on any ongoing subsidies the Commonwealth is prepared to provide.

DFACS: Agreed.

DoTRS: Agreed.

DVA: Agreed with qualifications.

OASITO: Agreed with qualifications.

Recommendation No.6
Para. 5.24

ANAO *recommends* that, in future trade sales, the Office of Asset Sales and IT Outsourcing optimise overall Commonwealth financial returns by developing and applying a tender evaluation strategy that requires a credible assessment of the net financial benefits of all tenders.

DVA: Agreed.

OASITO: Agreed with qualifications.

Recommendation No.7
Para. 5.39

ANAO *recommends* that, in future trade sales which include a sale objective relating to the future financial viability of the business being sold, the Office of Asset Sales and IT Outsourcing include in the tender evaluation report a credible assessment of the prospective financial strength of shortlisted bidders, including explicit consideration of gearing levels and their impact on the prospective financial viability of the businesses being sold.

DVA: Agreed.

OASITO: Agreed with qualifications.

Audit Findings and Conclusions

Photographs courtesy of the Department of Transport and Regional Services

1. Introduction

This chapter outlines the background to the sale of the Australian National Railways Commission's intrastate freight and interstate passenger rail businesses, the Government's sale objectives and the audit approach.

Background

1.1 On 28 August 1997, agreements were signed for the sale of shares in SA Rail Pty Limited to the Genesee & Wyoming Inc consortium; Tasrail Pty Limited to the Australian Transport Network Limited; and Pax Rail Pty Limited to the Great Southern Railway consortium. Vested in the companies were assets of the intrastate freight and interstate passenger rail businesses of the Australian National Railways Commission (Australian National) as follows:

- SA Rail: a vertically integrated rail operator which managed all of South Australia's intrastate freight over three networks.[7] The sale included 17 narrow and 71 standard and broad gauge locomotives, rolling stock, track infrastructure, maintenance equipment, some workshops, and specified freight contracts. Freehold property, including rail corridors, was not sold but transferred to the South Australian Government with the purchaser granted a 50 year lease for the use of the land.
- Tasrail: a vertically integrated rail operator which provided bulk and containerised freight haulage services in Tasmania. The sale included 32 operational locomotives, rolling stock, track infrastructure, workshops and terminals, plant and equipment, and specified freight contracts. Operational railways land was excluded from the sale and transferred to the Tasmanian Government with the purchaser granted a 50 year lease for the use of the land and existing facilities.
- Pax Rail: operator of *The Indian Pacific* (between Sydney and Perth), *The Ghan* (between Adelaide and Alice Springs) and *The Overland* (between Adelaide and Melbourne). The sale included rolling stock, the Alice Springs passenger terminal and a rolling stock maintenance

[7] SA Rail incorporated four Australian National businesses: SA Freight, which provided linehaul freight services and managed all intrastate rail freight; PowerFleet, which supplied the operational expertise to run train services, provided train crews, and provided and maintained locomotives and wagons; Infrastructure Services, which constructed, modified and maintained the rail infrastructure; and Railmec which provided specialist rail and heavy engineering services including manufacturing and maintaining locomotives, wagons and passenger carriages.

depot. The South Australian Government granted the purchaser a 50 year lease of the Keswick passenger terminal.

1.2 The sale raised gross proceeds of $95.4 million (see Figure 1.1). In addition to the purchase prices, the purchasers committed, in the respective sale agreements, to spend a total of $86.6 million in capital expenditure over the next four to six years.

Figure 1.1

Sale Proceeds, Direct Sale Costs and Wind Down Costs as at July 1998

	$m	$m
• **Sale Proceeds**		
SA Rail Pty Limited	57.40	
Tasrail Pty Limited	22.00	
Pax Rail Pty Limited	16.00	
Total purchase prices		95.40
Interest on purchase price deposits		0.01
Gross Proceeds		**95.41**
• **Direct Sale Costs**		
Business Advisers [a]	5.04	
Legal Adviser [a]	3.07	
Accounting Adviser	0.40	
OASITO Running Costs	0.35	
Other	0.42	
Total Direct Sale Costs		**9.28**
• **Net Sale Proceeds**		**86.13**
• **Australian National Wind Down Costs**		
Debt retained	840.02	
Lease facilities	159.70	
Outstanding Contracts	152.40	
Redundancies	100.10	
Unfunded provisions	60.60	
Environmental remediation	52.00	
Regional Assistance package	20.00	
Commonwealth debt	9.10	
Australian National's Costs		**1 393.92**

Notes:

[a] Comprises fees and expenses reimbursed by OASITO. Includes cost of original scoping study of Australian National and National Rail and the costs of the sale of Australian National's intrastate freight and interstate passenger rail businesses but excludes $594 000 paid for the later, more detailed, scoping study of National Rail.

Source: ANAO, based on information provided by DoFA, OASITO, DoTRS and Australian National.

1.3 The Commonwealth's direct costs of selling the businesses are estimated to be $9.3 million, or 9.7 per cent of gross proceeds.[8] This is $3.1 million, or 50 per cent, more than the sale budget of $6.2 million approved in March 1997. The $6.2 million budget was prepared on the basis of the scoping study findings and recommendations, prior to the Government's decision to complete the sale before 30 June 1997.[9] OASITO advised ANAO that the approved sale budget was based on initial fee proposals from advisers for completing all sales by the recommended optimal time of December 1997 and before the Government decided on a reduced timeframe. Increased advisory fees were subsequently agreed to by OASITO when additional expertise and resources were required to ensure every effort was made to achieve the earlier completion date.

1.4 Provisions inserted into the *Australian National Railways Commission Act 1983* by the *Australian National Railways Commission Sale Act 1997* provide for the winding down of Australian National's operations prior to its abolition. The major components of this wind down were the repayment or assumption of Australian National's debt and lease obligations ($1 000 million), finalisation of outstanding contractual payments ($152 million) and redundancies ($100 million).

Sale decision

1.5 Australian National was formed in 1975 with the merger of the Commonwealth Railways, the Tasmanian Railways and the non-urban rail operations of the South Australian Railways. It commenced operations in 1978. Figure 1.2 summarises Australian National's recent financial performance. Australian National has been an unprofitable business for a number of years and would not have declared an operating profit for over ten years but for Commonwealth grants and supplements.[10] In the ten years to 30 June 1997, the Commonwealth paid some $600 million in grants and subsidies to Australian National, including supplements and grants of $31 million in 1996-97. In the three years to 30 June 1997, Australian National accumulated losses of $530 million.

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8 OASITO's budgeting was based on expected sale costs of between 2.1 per cent and 2.8 per cent of expected sale proceeds.

9 Following the completion of the January 1997 scoping study, OASITO sought and was granted a sale budget of $10.5 million to plan, prepare and sell Australian National and National Rail. Of this amount, $6.2 million was for the initial combined scoping study of Australian National and National Rail, and the sale of Australian National. The remaining $4.3 million was for the further scoping study and sale of National Rail. The entire Australian National and National Rail sale budget was largely expended on the sale of Australian National. As a result, insufficient funds remained to undertake the sale of National Rail. In December 1997, the Government provided OASITO with a revised budget to complete the sale of National Rail.

10 Audit Report No. 2 1997-98, *Government Business Enterprise Monitoring Practices*, p.10.

Figure 1.2

Financial Performance of Australian National: 1992-93 to 1996-97

	1992-93 $m	1993-94 $m	1994-95 $m	1995-96 $m	1996-97 $m
Total Assets	1052.1	1094.7	1148.5	908.4	902.6
Total Liabilities	967.4	846.7	949.9	920.3	1172.3
Shareholders Equity	84.8	248.0	198.6	(11.9)	(269.7)
Operating Revenue	416.9	410.0	382.3	358.1	328.5
Operating Expenses	392.0	400.4	430.8	426.8	385.5
Operating Loss	24.9	9.6	(48.5)	(68.7)	(57.0)
Abnormal Items	(22.9)	(6.8)	(12.9)	(141.8)	(200.8)
Profit/(Loss)	2.0	2.8	(61.4)	(210.5)	(257.8)[a]

Note:

[a] The financial statements for the year ended 30 June 1997 disclose a profit of $501.3 million. In calculating this profit, Australian National wrote off, as abnormal, $733.6 million of borrowings, swap transactions and prepaid interest to be paid out directly by the Commonwealth Government. Australian National also wrote off, as abnormal, a $25.5 million provision for workers compensation claims as Australian National had been informed by the Commonwealth Government that Comcare would assume responsibility for the payment of all claims. The financial statements were qualified by ANAO because the legal assumption of these liabilities had not taken place as at 30 June 1997. If the liabilities for the borrowings and workers compensation had not been written off, the financial statements would have presented a loss, including abnormals, of $257.8 million.

Source: ANAO based on Australian National Railway Commission annual reports 1992-93 to 1996-97.

1.6 Following a 1991 agreement between the Commonwealth and the mainland states (the National Rail Shareholders Agreement), the National Rail Corporation Ltd (National Rail) was established to take over all the interstate freight business of Australian National.[11] Under the Shareholders' Agreement, the Commonwealth transferred to National Rail Australian National's interstate freight business, including its rolling stock. National Rail did not take over the debt associated with these functions or pay any consideration to Australian National for the assets transferred.[12]

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11 Queensland, South Australia and Western Australia decided not to participate in the ownership of National Rail.

12 In relation to an earlier audit, Australian National advised ANAO that *Australian National's 1995-96 Annual Report clearly highlights the Government's decision to form National Rail and the Government's inaction on Australian National's growing debt burden as major factors* [in Australian National's liabilities exceeding its assets]. Source: Audit Report No. 2 1997-98, *Government Business Enterprise Monitoring Practices*, p.10.

1.7 In April 1996, the then Minister for Transport and Regional Development initiated a review of Australian National and National Rail.[13] The main review[14] finding was that Australian National had no prospect of being commercially viable in its present form. Losses for 1995-96 were expected to be between $135 million and $148 million; debts and liabilities exceeded $1 billion; and 60 per cent of Australian National's workforce had been shed in the previous six years, with only a minor impact on costs and revenue. The report recommended the transfer of some functions and assets to the Tasmanian and South Australian Governments; the sale of certain businesses and the sale of the remaining assets; the write-off of debt; and renegotiation of leases and other encumbrances over rolling stock. The report concluded that the likely cost of implementing these recommendations would be recovered within ten years by eliminating the ongoing need to finance Australian National's potential losses of more than $100 million per year.

1.8 After considering the findings of the review, the then Minister for Transport and Regional Development announced on 24 November 1996 a reform package for Australian rail services. An important element of the package was the sale of Australian National by 30 June 1997. Australian National was to be sold unencumbered with the Commonwealth taking over its debts and liabilities. An authority would be established to manage access to the interstate rail network.

Scoping study

1.9 Immediately following the sale announcement on 24 November 1996, OASITO appointed business and legal advisers to conduct and report on a scoping study of all financial and policy issues in relation to the sale of Australian National and National Rail. The scoping study was completed on time on 31 January 1997. The scoping study advisers concluded that Australian National's financial position was poor and had deteriorated over the previous three years. The scoping study advisers reported that Australian National's 1995-96 financial statements showed it to be technically insolvent and that it was reliant upon Commonwealth guarantees to continue operations.

1.10 The scoping study advisers found that there was significant market interest in the Commonwealth's rail assets and businesses and that most were likely to be saleable for positive values. The advisers recommended that Tasrail, SA Freight (one of the four businesses sold as

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[13] Hon. John Sharp MP, Minister for Transport and Regional Development, Media Statement TR19/96, 18 April 1996.

[14] Mr J.R. Brew, *Review of Australian National Railways Commission and National Rail Corporation*, 19 June 1996.

SA Rail) and Passenger Rail (sold as Pax Rail) be sold by open tender with the sales to be completed between June and December 1997. In February 1997, the Business Advisers estimated that proceeds for sales to be completed by 30 June 1997 would be in the range of $53 million to $100 million and that proceeds for sales completed after 30 June 1997 would be in the range of $110 million to $180 million.

1.11 Following the completion of the scoping study, the Government announced on 6 March 1997 its intention to sell the assets and businesses of Australian National.[15] Excluded from the sale were certain assets of Australian National, including cash and specified heritage and historical items. The sale also did not include the Track Access Unit of Australian National (which manages access to the Commonwealth owned sections of the interstate network)[16] and those assets nominated by National Rail.[17] In commenting on this audit report, OASITO's Legal Adviser noted that:

> *Less than four months was originally allowed for completion of the sale, from its announcement on 6 March 1997 to completion by 30 June 1997. This timetable (later extended to allow for final bids to be received by 25 July 1997) was considerably shorter than that recommended in the scoping study. It required sale preparation and the tender process to be expedited. An abbreviated timetable which is set for sound reasons (in this case, the need to stem losses and provide certainty—see paragraph 3.1) inevitably puts pressure on complete adherence to what the report regards as sound administrative procedures. In the case of the Australian National sale, many of the findings in this [ANAO] report, including the desirability of re-tendering consultancy contracts, development of contracts with major customers, and the need to develop Commonwealth policy on passenger concessions post-sale, were impacted by the time constraints bearing on the sale.*

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15 Hon John Fahey MP, Minister for Finance and Hon. John Sharp MP, Minister for Transport and Regional Development, Media Statement 7/97, 6 March 1997.

16 The Track Access Unit was included in the Australian Rail Track Corporation (ARTC) which was incorporated under South Australia's Corporations Law on 25 February 1998 and began operations as a government business enterprise on 1 July 1998. The ARTC is to manage access to the standard gauge interstate rail network on a commercial basis for all operators. It has assumed control of Australian National's Track Access Unit, including management of access to all sections of the Commonwealth owned interstate track and access arrangements previously managed by the Track Access Unit. Source: House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform, *Tracking Australia: An inquiry into the role of rail in the national transport network*, July 1998, p.96.

17 National Rail commenced operations in February 1993. All functions of interstate rail freight business operated by the Commonwealth and State rail authorities, where nominated by National Rail, were to be transferred within a three year 'transition period' commencing on this date. The National Rail shareholders also agreed to contribute assets and equity funding, plus pay transition subsidies, during the five year 'establishment period'.

1.12 It was decided not to proceed with the sale of National Rail following completion of the January 1997 scoping study report because the New South Wales Government had not given its approval for the release of commercially sensitive information to OASITO's advisers.[18] The sale of Australian National's intrastate freight and interstate passenger rail businesses, combined with the proposed sale of National Rail, will confine the Commonwealth's future involvement in rail transport to control of portions of the interstate infrastructure.

1.13 The Australian National Railways Commission Sale Act received Royal Assent on 30 June 1997. The Sale Act gave effect to the Government's decision to sell the non-interstate mainline track rail assets of Australian National in whole or part. The Sale Act provided a flexible framework to facilitate authority and mechanisms for the sale, including authority to repeal, replace or amend rail agreements with the South Australian and Tasmanian Governments following their agreement to sale arrangements. The Sale Act also provided for the reduction of Australian National to an entity charged with dealing with any residual functions and the balance of assets and liabilities not included in the sale, or not able to be resolved in the short term, and resolving outstanding litigation and disputes prior to abolition.

Commonwealth sale objectives

1.14 The sale objectives were set out in the Invitation to Register an Expression of Interest published in national and international newspapers in March 1997 (see Figure1.3) and the Request for Tender issued to shortlisted bidders. The Commonwealth's sales objectives were to:

- enter into an agreement with the successful purchasers by 30 June 1997 or as soon as possible thereafter;[19]
- provide efficient, competitive, dynamic and reliable transport services;
- contribute to the establishment of a viable and competitive rail system;
- promote private sector investment in the rail industry;
- contribute to regional development;

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[18] The first step in the process to sell the Commonwealth's interest in National Rail (a study on the options for selling the Commonwealth's National Rail shares) was announced on 30 June 1997.

[19] The Invitation to Register an Expression of Interest published on 19 March 1997 included as an objective completing the sale by 30 June 1997. This objective was revised in the Request for Tender issued in June 1997.

Figure 1.3

Invitation to Register an Expression of Interest Advertisement

AUSTRALIA

Commonwealth of Australia

SALE OF

Australian National Railways Commission

The Commonwealth of Australia ("the Commonwealth") is seeking expressions of interest for the purchase, in whole or in part, of the passenger and intrastate freight business of Australian National Railways Commission ("Australian National"). This includes:

- **Tasrail—**a vertically integrated rail operator which provides freight haulage services in Tasmania. Assets include track infrastructure, rolling stock, terminals and a workshop;
- **Passenger Rail**—a passenger rail service which operates the Indian Pacific (between Sydney and Perth), the Ghan (between Adelaide and Alice Springs) and The Overland (between Adelaide and Melbourne); and
- **SA Rail**—a vertically integrated rail operator which manages all of South Australia's intrastate freight task over three networks. The assets offered for sale will include rolling stock, workshops, terminals arid infrastructure maintenance services.

Neither the Track Access Unit of Australian National, which manages access to the Commonwealth owned sections of the interstate network, nor the interstate freight components of Australian National. will be included in this sale process.

The Commonwealth's objectives in respect of the sale of Australian National are:

- to complete the sale by 30 June 1997;
- to provide efficient, competitive, dynamic and reliable transport services;
- to contribute to the establishment of a viable and competitive rail system;
- to promote private sector investment in the rail industry;
- to contribute to regional development; and
- to obtain a financial return to the Commonwealth that represents fair and reasonable value.

Australian or international parties who wish to consider acquiring part or all of Australian National, as described, are invited formally to express their interest.

Expressions of interest, from principals only, should outline, as a minimum, the legal status of the interested party, including ownership structure, copies of the party's most recent annual reports, together with details concerning the nature and extent of its interest and its experience in the rail sector. In determining the short list, consideration will be given to a number of factors including:

- the financial strength and capacity of the interested party;
- the party's experience and expertise in the rail sector;
- the interested party's objectives and proposed future strategy in acquiring Australian National:
- the benefits (including business and rail development and enhancement, and future employment) which the interested party could provide to the rail and transport sector, both regionally and nationally;
- the party's interest in acquiring Australian National as a whole or in part (if relevant, specify which businesses or assets are of interest);
- the party's demonstrated record of respect for environmental and heritage issues; and
- the interested party's perceived ability to meet the Commonwealth's sale objectives.

The Commonwealth reserves the right to shortlist any party at its sole discretion.

Shortlisted parties will be provided with a detailed Information Memorandum before the end of April 1997, subject to the execution of a Confidentiality Agreement. Shortlisted parties will be expected to commence due diligence in May 1997 and final offers will be expected to be lodged in early June 1997. As stated above, it is the objective of the Commonwealth to complete a sale by 30 June 1997.

The sale will be handled by the Commonwealth's Office of Asset Sales, in conjunction with its business advisers, Deutsche Morgan Grenfell Australia Limited.

Expressions of interest are required to be lodged by no later than 6.00 pm Australian Eastern Standard Time Thursday, 10 April 1997 with:

Deutsche Morgan Grenfell
Level 20, Grosvenor Place
225 George St
Sydney NSW 2000 Australia
Fax: +61 2 9258 1124

Source: Australian Financial Review, 19 March 1997.

- obtain a financial return to the Commonwealth that represents fair and reasonable value; and
- divest the Commonwealth from ongoing responsibility for the operation of rail in Australia, except for its involvement in track access.[20]

1.15 Overall responsibility for the management and completion of the sale of Australian National was assigned to the Office of Asset Sales and IT Outsourcing (OASITO). OASITO was established in October 1996 to replace the former Asset Sales Task Forces within the then Department of Finance.[21] OASITO is responsible for the project management and monitoring of asset sales and relies less on in-house resources with the sales largely executed by private sector advisers and consultants contracted to OASITO.

1.16 The Department of Transport and Regional Services (DoTRS)[22] also played an important role in the sale being involved in developing the terms of reference for sale advisers and the selection of advisers; the Due Diligence and Sale Steering committees; the tender evaluation process; assisting with the negotiation of the new Railways Agreements with South Australia and Tasmania; and developing, in consultation with OASITO, the sale legislation. The Departments of Family and Community Services (DFACS),[23] Veterans Affairs (DVA), Prime Minister and Cabinet (PM&C), and Finance and Administration (DoFA) were also consulted on the passenger concessions clause to be included in the Pax Rail sale agreement and the consideration of policy in respect of the post-sale concession arrangements.

Audit approach

1.17 The objectives for the audit were to: assess the extent to which the Government's sale objectives were achieved; review the effectiveness of the management of the sale process; and identify principles of sound administration practice to facilitate improved administrative arrangements for future trade sales.

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20 This objective was not included in the Invitation to Register an Expression of Interest published on 19 March 1997.

21 The Department of Finance (DoF) and Department of Administrative Services were reorganised in October 1997 to form the Department of Finance and Administration (DoFA). In this report the Department of Finance will be referred to by its current name and acronym.

22 With effect from 21 October 1998, the Department of Transport and Regional Development became the Department of Transport and Regional Services. In this report, DoTRS is referred to by its current name and acronym.

23 With effect from 21 October 1998, the Department of Social Security became the Department of Family and Community Services. In this report, DFACS is referred to by its current name and acronym.

1.18 The audit scope extended from the initial decision to sell Australian National to the negotiation of the final sale contracts and all issues associated with management and completion of the sale. The audit approach involved reviewing data relating to the sales held by OASITO and its advisers, DoTRS, DVA and DFACS.[24] Fieldwork was undertaken between December 1997 and August 1998. The audit was conducted in accordance with the ANAO Auditing Standards at a cost of $223 000.

Report outline

1.19 The next chapter of the report discusses the major elements in the management of the sale including OASITO's outsourcing arrangements and the sale costs. Chapter 3 reviews the tender process and methodology applied to evaluating the tenders received. The major sale outcomes in relation to the sale of the South Australian and Tasmanian freight businesses are outlined in Chapter 4. The final chapter reviews the major sale outcomes in relation to the sale of the passenger rail business, including the continued provision of concessional travel and reimbursement of concessions by the Commonwealth.

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[24] ANAO developed criteria which addressed the extent to which the Government's sale objectives were achieved; the management of the sale process including sale planning and preparation, sale coordination, contracting processes and contract management; and the bidding process.

2. Sale Management

This chapter discusses the management of the sale including appointment and management of OASITO's advisers, the sale costs, and the assumption and/or repayment of Australian National's financial obligations.

Outsourcing arrangements

2.1 OASITO outsources sale project management to private sector advisers but retains responsibility for top level project management and oversight of the sale process.[26] The sale of Australian National presented OASITO and its advisers with a range of challenges to achieve a successful and timely sale. In particular, the businesses offered for sale did not have a history of profitable operations; sale preparation and the tender process needed to be expedited; and cooperation from the Governments of South Australia and Tasmania was essential to achieving the sale objectives.

2.2 Figure 2.1 outlines the fees paid for the various stages of the advisory assignments associated with the sale of Australian National. Deutsche Morgan Grenfell and The L|E|K Partnership were initially appointed as Business Advisers to conduct the scoping study of Australian National and National Rail and subsequently re-appointed to plan and manage the sale of Australian National. Blake Dawson Waldron was initially appointed as Legal Adviser to provide legal advice and assistance on all issues associated with the scoping study of Australian National and National Rail[27] and was subsequently re-appointed for the sale of Australian National and the discharge of Australian National's financial obligations. The Business Advisers and Legal Adviser also conducted a further scoping study for the sale of National Rail.

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[26] A Steering Committee was established by OASITO to coordinate sale planning and preparation. The Steering Committee was chaired by OASITO and included representatives from DoTRS and OASITO's Business and Legal Advisers. The Steering Committee met on a weekly basis, reviewed progress against the sale timetable and allocated responsibility for tasks to Committee members.

[27] For the scoping study, the Legal Adviser contract included personnel from the Office of the Australian Government Solicitor.

Figure 2.1
Adviser contract stages

	Stage 1: Initial Scoping Study	Stage 2: Sale of Australian National	Stage 3: National Rail Scoping Study	Total Fees
Business Adviser Fees	$0.23m	$4.14m	$0.27m	**$4.64m**
Legal Adviser Fees	$0.25m	$2.43m	$0.26m [a]	**$2.94m**
Total Fees	**$0.48m**	**$6.57m**	**$0.53m**	**$7.58m**

Note:

[a] Comprises fixed fee of $150 000 for National Rail scoping study plus costs associated with negotiations with National Rail shareholders ($44 000) and further legal advice between 25 November 1997 and 26 February 1998 ($66 000).

Source: ANAO analysis based on information provided by OASITO and DoFA.

2.3 An important element of successful competitive tendering and contracting is choosing the best approach to the market. Competitive pre-qualification arrangements limiting the field of tenderers, such as establishing a panel of pre-qualified suppliers, can be a valuable means of ensuring a cost-effective, timely and competitive tender process.[28] Pre-qualification can reduce the time taken to conduct the tender. However, it is important that the pre-qualification process encourage effective competition by ensuring there is reasonable opportunity for interested candidates to demonstrate they satisfy the pre-qualification requirements. OASITO advised ANAO that:

> *A 'pre-qualification stage' may be useful in cases where a stream of homogenous assets are being sold, where a timetable of the proposed sales is available and the skills and experience of the consultants are in ready supply but in the case of the Australian National sale (a unique and one-off sale as are most other sales of this Office) we are often limited to a handful of consultancy firms with the relevant expertise.*

2.4 ANAO notes that the scoping study of Australian National and National Rail was to be the precursor of at least two rail sales, although there was a possibility that the sales might occur concurrently or with significant overlap.[29] In these circumstances, a staged procurement approach involving a planned and structured series of selection processes

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[28] *Commonwealth Procurement Guidelines*, September 1989, Guideline 1—Getting Value for Money and *Commonwealth Procurement Guidelines*, July 1997, p.43.

[29] Indeed, the scoping study advisers recommended Australian National be sold in a number of stages and that the sale of National Rail proceed at a later date.

could have been useful.[30] The pre-qualification stage could, for example, have involved approaching firms registered on OASITO's consultancy register to confirm whether they possessed rail or infrastructure experience and expertise. The other aspects of 'unique and one-off sales' is the absence of past experience and knowledge; which has to be effectively risk managed by OASITO.

2.5 OASITO maintains a register of consultants which is updated from time to time by seeking expressions of interest for entry onto the register through advertising in the national press.[31] It is from this register that OASITO identified ten firms to extend an invitation to submit a proposal for each scoping study role.[32] OASITO limited the firms initially invited to tender for the business adviser role to those whose December 1995 registrations of interest indicated relevant rail or infrastructure experience and would not have a conflict of interest. The initial list was supplemented by firms who later sought to be included, including the two firms eventually selected as joint business advisers. Four firms responded to the request for proposals and, because of the small number of respondents, all were interviewed. The panel recommended acceptance of the joint proposal submitted by The L|E|K Partnership and Deutsche Morgan Grenfell involving fees of $230 000.[33] The panel preferred this proposal because it had demonstrated the best expertise, resources and capacity to handle the project, and the team offered immediate availability and competitive fees.

2.6 Two firms responded to the request for proposals to act as scoping study legal adviser. Given the small number of respondents, the selection panel decided to interview both firms. The successful proposal was submitted by Blake Dawson Waldron in conjunction with the Attorney-

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30 *Commonwealth Procurement Guidelines*, September 1989, Guideline 5—Using Staged Procurement and *Commonwealth Procurement Guidelines*, July 1997, pp. 126-127.

31 OASITO advised ANAO that it: *considers that its register provides an opportunity for firms to prequalify in respect of their capabilities. It would not be cost effective to undertake prequalification for each explicit assignment when the cost effectiveness of a particular firm for any assignment will depend greatly on its specific assignment team and concepts and the field of suitable and interested contenders is often small. …OASITO considers that its register of interest and its knowledge of the market obviate the need for any formal project based pre-qualification process.*

32 OASITO advised ANAO that the: *selection process relied on a central register, last updated in December 1995. Also, DoTRS and DoFA were consulted. …*[the] *onus is on potential consultants to ensure they are on the publicly advertised OASITO register and their qualifications appropriately identified.*

33 Total payments were $358 000 comprising $230 000 in professional fees and $128 000 in out of pocket expenses.

General's Legal Practice.[34] The panel considered this proposal offered the best value for money because: the team approach would blend the different expertise of the two firms; the team was available immediately; and the other candidate did not offer a fixed fee. The contract involved a fixed fee of $250 000, out of pocket expenses capped at $10 000 and travel expenses capped at $22 000.

2.7 Candidates for the scoping study contracts were advised, in the request for proposals, that the assignment was limited to the scoping study and that proposals were not then being sought for business and legal advisers to manage any subsequent sales. Candidates were also advised a decision not to tender would not adversely affect their ability to tender for a sale role. OASITO advised ANAO that, at that time, they expected that the period between scoping study completion and sale commencement would allow for a further competition for advisers. However, following the Government's March 1997 decision to require every effort to achieve sale completion by 30 June 1997,[35] OASITO appointed the scoping study Business Advisers for the sale process and for the scoping study of National Rail, without re-tendering.[36]

2.8 OASITO considered the pressing sale timetable required re-appointment because of the time and cost associated with a further selection process and potentially with new firms having to acquire the relevant knowledge and experience. Nevertheless, there were some significant differences between the personnel contractually required to be involved in the scoping study and the sale. For the Business Advisers, the experience and expertise of some of the personnel specified in the scoping study contract, but not in the sale contract, had been a significant factor in the joint Business Adviser's initial appointment.[37] For the Legal Adviser, personnel from the Attorney-General's Legal Practice were no longer involved in advising on the sale.

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34 The contract nominated Blake Dawson Waldron as OASITO's Legal Adviser although personnel from the Attorney-General's Legal Practice were included in the specified contract personnel.

35 OASITO advised ANAO that its intention to continue the engagement of the advisers was advised to Cabinet.

36 This is in contrast to the approach taken in the DAS Business Units sale where scoping study candidates were advised that, subject to satisfactory performance and Commonwealth discretion, the business adviser would execute the sale strategy developed during the scoping study. Candidates for the DAS Business Units sale were required to include an indicative non-binding price for the sale contract in their scoping study proposal. Source: Audit Report No.24 1998-99, *DAS Business Unit Sales Management.*

37 The Business Adviser contract required the Advisers to make available specified personnel to undertake the consultancy services and, subject to any written approval from the Commonwealth, the Advisers were required to ensure that the consultancy services were performed by the specified personnel. Advice from The L|E|K Partnership was that personnel specified in the scoping study contract but not in the sale contract were, in fact, involved in the sale process.

2.9 The decision to re-appoint the scoping study advisers meant that further fees were negotiated by OASITO without the benefit of a competitive tender.[38] In these circumstances, ANAO considers that it is particularly important that OASITO provide its incumbent advisers with a comprehensive statement of its requirements for the sales process. This did not occur and contributed to the need for OASITO to seek a number of proposals from both its Business and Legal Advisers before the scope of the work and fees were finalised in signed contracts in July and August 1997 respectively. The final total cost of the advisory contracts was $8.7 million including fees of $7.6 million.[39] OASITO advised ANAO that:

> *it considers that, in order to secure an optimal outcome that drew on the expertise of the advisers in the context of its outsourcing approach, settlement of the scope of the work required interaction with the advisers rather than the unilateral ex ante specification by OASITO that ANAO advocates. This approach also enabled the sale strategy to be restructured from that envisaged in the scoping study in view of Ministers' position on the 30 June target completion date. OASITO considers that the final fee that was negotiated represented an acceptably competitive fee for the effort required in the context of the investment banking industry and the nature of this transaction. It notes in any case that the selection of sale advisers is not a matter of buying a closely specified service for the minimum price, but is a matter of maximising the expected cost effectiveness of the outcome in terms of sale results.*

2.10 **Finding:** OASITO conducted a closed tender for its scoping study advisers but, to expedite the then accelerated sale process, did not re-tender the later, more significant advisory contracts as had been foreshadowed. Scoping study fees represented some 6 per cent of final advisory fees. OASITO's tender approach did not identify all suitably qualified candidates for the scoping study with the Business Adviser shortlist supplemented by firms that later sought to be involved, including the two firms eventually selected as joint business advisers. The experience gained by the incumbent Business and Legal Advisers through the scoping study, and the amount of work that had been undertaken before formally appointing the advisers for the sale process, placed OASITO at some disadvantage in negotiating appropriate contractual and fee arrangements for the later contracts.

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38 The L|E|K Partnership has noted that: *scoping studies have historically cost advisers (particularly commercial rather than financial advisers) two or three times the fees that they recover. This investment is recovered in the sale process. It is not unreasonable that advisers make a fair and reasonable economic return for their work, in fact it is essential for the ongoing provision of quality advice. On that basis, any new process is likely to require realistic budgets for each phase of work.*

39 Comprises fees and disbursements for the original scoping study of Australian National and National Rail, the sale of Australian National and the later more detailed scoping study of National Rail.

Recommendation No.1

2.11 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing seek to enhance value for money and transparency in future asset sales by developing a comprehensive outsourcing strategy for each sale, including planning for a possible staged procurement approach to major advisory contracts.

DVA response

2.12 DVA ***agreed*** with the recommendation.

OASITO response

2.13 OASITO ***agreed with qualifications*** with the recommendation. OASITO commented that it has reservations about the practicality and merits of staged procurement for its major advisory assignments. In many cases time constraints, limited availability of competitors and the time required for a replacement adviser to acquire the relevant knowledge precludes this approach. We consider that, especially in a trade sale, transparency and value for money can usually be better optimised by a single procurement stage with appropriate commercial arrangements for settling fees for second and later stages where the scope of work may not be able to be settled until the earlier stages are completed. Nonetheless, OASITO accepts that its procurement approach in this case could, with hindsight, have been handled better.

Contract management

2.14 OASITO has adopted a range of methodologies to manage financial risks in its adviser contracts. Its standard consultancy contracts include a range of clauses to address the standard of service required of its advisers; indemnities and warranties; and termination provisions. OASITO has also been flexible in the way it has sought to develop payment schedules that provide appropriate incentives and penalties to advisers. In some sales it has included fixed price fees or fee caps.[40] In others, fee payment has been linked to the completion of clearly identified milestones.[41]

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[40] OASITO advised the Legal Adviser on 2 May 1997 that: *The OASITO requires that all consultants working on asset sale processes provide a fixed or capped fee. I note that in all projects where the appointment has been the result of a competitive tendering process, a fee cap, or fixed price, has been obtained. The recent appointment of advisers in relation to the sale of Telstra serves as an example.* The Legal Adviser informed OASITO on 5 May 1997 that: *If this is so, it is a very material term and one which was not communicated to us when we were asked to continue working after the completion of the scoping study.* The Legal Adviser further advised OASITO that it was difficult to quote a fixed fee because, unlike the scoping study assignment, there were not clear written Terms of Reference for the sale process.

[41] This was the case in the 1997 sale of eight commercial business units of the former Department of Administrative Services. Audit Report No.24 1998-99, *DAS Business Unit Sales Management.*

2.15 The Business and Legal Adviser scoping study contracts involved fixed fees payable upon completion of the scoping study. Payments were made by OASITO after the advisers achieved the milestone of completing the scoping study by 31 January 1997.

2.16 The advisers' scoping study recommendation had been to complete the sale of Australian National's intrastate freight and passenger businesses between June and December 1997. Their initial fee proposals for the sale process reflected this timetable. On 10 February 1997 the Legal Adviser provided OASITO with estimated fees of $670 000 to $760 000 for the sale of Tasrail and SA Freight (one of four Australian National business units sold as SA Rail). This estimate excluded fees for the sale of Pax Rail and the other three business units sold as SA Rail and fees for the assumption or repayment of Australian National's financial obligations. The Business Adviser's first proposal was submitted on 3 March 1997 and included a fee estimate of $3.5 million for a sale completed by December 1997.

2.17 Following the Government's decision to expedite the sales process with the objective of completing all sales by 30 June 1997, OASITO sought revised fee proposals. The Business Advisers submitted a revised proposal on 18 March 1997 reflecting the objective of sale completion by 30 June 1997 and included a fee estimate of $3.5 million. A further revised proposal was submitted on 4 June 1997 with estimated fees of $4.5 million.[42] The Legal Adviser's proposal of 7 April 1997 estimated fees of $1.03 million for the sale of Tasrail, SA Rail and Pax Rail, the repayment of Australian National's debt and lease liabilities and general sale oversight.[43]

2.18 In recognition of the reduced timeframe and the importance of timely completion, OASITO agreed to the revised fee proposals for a sale by 30 June 1997 although they were significantly higher than those initially proposed by the advisers for a more extended sale process. In these circumstances, ANAO considers linking contract payments to clear indicators of contractor performance, such as the achievement of deadlines, should be accepted elements of good contract management practice.[44] OASITO has advised ANAO that:

> *while it generally agrees with this view where the outsourcing is of a*

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42 This proposal formed the basis of the fee arrangements included in the contract signed on 4 July 1997. Fee payments to the Business Advisers for the sale process totalled $4.14 million (see Figure 2.1).

43 Fee payments for the sale process were $2.43 million (see Figure 2.1), more than double the estimate.

44 For example, see *Competitive Tendering and Contracting: Guidance for Managers*, Department of Finance and Administration, March 1998, p.18.

particular defined service, where the relationship is more one of "agent" than "contractor"—as in this case—there are practical limits to such linkages. OASITO contends that commercial risk was at all times limited by close contract supervision to fees payable for inputs provided. OASITO accepts that it was not good practice to have sale contract signature delayed, but notes that given the difficulties in agreeing contract terms related to liability it was still preferable to press on to pursue the Government's timetable rather than to suspend work pending resolution on the minor contractual details, given that Cabinet had directed that "every effort" be made to complete the sales by the target date.

2.19 In contrast to the scoping study arrangements, the Business Adviser sale advisory fees were not linked to performance milestones although OASITO agreed to increased fees because of the reduced timeframe and importance of timely completion. Different fee arrangements were specified for the two Business Advisers:

- Deutsche Morgan Grenfell was paid a fixed fee of $1.4 million to 30 June 1997. Between 30 June 1997 and 30 August 1997 a specified daily fee was paid with a cap of $560 000. In addition, a fixed fee of $55 000 was payable for a review of Australian National's leases; a success fee of $250 000 if sale proceeds were $100 million or greater; and a fee of $59 000 for the completion of the National Rail scoping study.
- The L|E|K Partnership was paid a fixed fee of $40 000 for developing a logical and efficient sales structure and a fixed fee of $1.224 million for developing business plans for all Australian National's business units included in the sale. A further fee of up to $880 000 was payable. From this provision, The L|E|K Partnership advised ANAO that it was paid $550 000 for taking a primary role in the vendor due diligence process; and $330 000 for analytical support for the accounting vendor due diligence team, the development of management presentations to bidders and attendance at all bidder presentations, and providing detailed answers to a large number of bidder questions throughout the bidder due diligence process. The fee for the National Rail scoping study was fixed at $171 000.

2.20 The Legal Adviser's sale advisory contract involved a capped fee of $1.35 million up to 30 June 1997 for its work on the sale of the intrastate components of Australian National and repayment of debt and lease liabilities. After 30 June 1997, monthly fee caps were to be agreed in advance with fees calculated using the hourly rates specified in the contract. For most months, fee caps were not agreed in advance. In any case, the capping arrangements were unlikely to constrain costs as, where caps were agreed, they were significantly in excess of the Legal Adviser's estimate of monthly fees. The contract also included a fixed fee of $150 000 for the scoping study of National Rail.

2.21 Draft contracts were provided to the Business and Legal Advisers at the outset of both the scoping study and the sale process. However, contracts were not finalised and signed until after the advisers had commenced, and in some cases had completed, the contracted work:

- The first draft scoping study Business Adviser contract was provided to the Business Advisers on 13 December 1996. The scoping study contract was not finalised and signed until 16 June 1997, over four months after the scoping study had been completed. The sale contract was signed on 4 July 1997, after the original completion deadline of 30 June 1997 and some four months after the Business Advisers commenced working on the tender process.
- The Legal Adviser scoping study contract was signed on 7 April 1997, some four months after the Legal Advisers commenced work on the scoping study and some two months after the scoping study was completed. The sale contract was signed on 4 September 1997, after the tender process had been completed and some seven months after the Legal Adviser commenced working on the tender process.

2.22 **Finding:** Compared to initial fee proposals from the Business and Legal Advisers for completing all sales by December 1997, OASITO agreed to increased fees when the Government decided it wanted all sales completed by 30 June 1997 because of the reduced timeframe and the importance of timely completion. However, the sale advisory contracts, which form the foundation of the contractual relationship between OASITO and its advisers, did not link fee payments to the achievement of deadlines or other performance milestones. Commercial risks associated with the outsourcing arrangements were also increased because advisory contracts were not finalised and signed until between four and seven months after the advisers commenced work.

Recommendation No.2

2.23 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing seek to manage effectively commercial risks associated with the outsourcing of sale management, where practical, by:

(a) ensuring each major advisory contract directly links fee payment to contract deliverables and/or performance milestones; and

(b) finalising and signing advisory contracts promptly.

DVA response

2.24 DVA ***agreed*** with the recommendation.

OASITO response

2.25 OASITO ***agreed with qualifications with part (a)*** of the recommendation and ***agreed with part (b)***. In relation to part (a), OASITO noted that the engagement of professional advisers is a different procurement and contracting exercise from the purchasing of closely defined goods or services. The scope of work in the various stages of some asset sales is not capable of ex ante ascertainment sufficient to define a commercially viable fee package based only on outputs and milestones. In these circumstances, unless OASITO is prepared to award and manage some contracts that are resource based, it is likely that the commercial fees payable for some assignments will be unduly high as advisers seek to protect themselves commercially against unknown workloads that only emerge as the process unfolds. Where OASITO considers that value for money can be achieved through incorporating penalties and rewards or performance milestones in its management of a contract, this has been done. OASITO standard form contracts explicitly provide for fee reductions in the event of inadequate performance. OASITO considers that the approach adopted in the Australian National sale, given the circumstances, produced an efficient outcome for that sale.

ANAO comment

2.26 In undertaking Commonwealth asset sales, OASITO outsources the services required extensively to the private sector which places considerable focus and emphasis on contract management, including the underlying risks involved. The Government decided in March 1997 that it wanted every effort to be made to finalise the Australian National sales by 30 June 1997. This decision required a shorter sale process than that recommended by OASITO's advisers and OASITO subsequently agreed to pay increased fees to its advisers in recognition of the reduced timeframe and the importance of timely completion. In these circumstances, ANAO considers linking payment of fees to achievement of the 30 June 1997 sale objective would have provided a direct financial incentive for the advisers to make every effort to complete all sales by this date, consistent with the Government's direction.

Financial obligations

2.27 In order to fund working capital requirements and acquire or lease assets such as locomotives, rolling stock and motor vehicles, Australian National had entered into various financing arrangements including bond issues, loan facilities[45] and associated interest rate and currency swap agreements, and lease facilities. The Government decided to sell Australian National unencumbered with all its debt and other financing transactions to be taken over directly by the Commonwealth or retired.

2.28 The repayment and assumption of Australian National's financial obligations comprised a major component of the liabilities realised from the winding down of Australian National. The liabilities associated with repaying or assuming Australian National's debt totalled $840 million with the costs of discharging Australian National's lease facilities amounting to $160 million (see Figure 1.1).

2.29 To achieve a timely sale and effectively manage the Commonwealth's ongoing financial exposure, the Government wanted the repayment or assumption of Australian National's existing debt, inscribed stock and bond liabilities, and the discharge of finance and operating lease liabilities finalised by 30 June 1997. OASITO undertook this process with its Legal Adviser providing detailed advice on each of the financing transactions including outlining the available options. Deutsche Morgan Grenfell was required to provide it with advice on the financial implications of each option. Consistent with its overall role in managing the Commonwealth's debt, the Department of the Treasury was approached to assist OASITO develop proposals for managing the assumption or repayment of Australian National's commercial debt and associated derivative transactions. OASITO advised ANAO that:

> *its 1997 estimates for sale costs had been prepared, inter alia, on the basis that the Commonwealth's resumption of Australian National's liabilities would be effected by legislation as foreshadowed in the 18 November 1996 Cabinet decision, and managed largely by others. OASITO did not then contemplate the level of involvement in the actual mechanics of resumption that it later needed to assume.*[46]

2.30 Consistent with the objective of completing the sale of Australian National's passenger and intrastate rail businesses by 30 June 1997 or as soon as possible thereafter, priority was given to gaining title to the leased assets considered important to the sale of these businesses. This meant that the assumption or repayment of some of Australian National's

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45 The bond and loan financings were guaranteed by the Commonwealth.

46 ANAO notes that there were important links between management of the sale process and the repayment or assumption of Australian National's financial obligations. For example, the sale would lead to a default event for a number of the transactions which could have adversely affected the sale process. Furthermore, for the 1997 sale of Brisbane, Melbourne and Perth airports, OASITO developed and implemented a detailed plan and timetable to manage the assumption of the Federal Airports Corporation's domestic bonds and Eurobonds.

financial obligations did not commence until after 30 June 1997. OASITO advised ANAO that all financing transactions essential to the completion of the sale of the Australian National businesses were completed before the date of sale completion. However, the complexity of some transactions, the impediments in transaction documentation to early termination or ready transfer to the Commonwealth, and the extra cost of termination or novation, were a source of concern to OASITO.

2.31 OASITO's approach to each financing transaction sought to balance timeliness with minimising the economic cost to the Commonwealth. Assumption of certain overseas loans proved more complex than originally anticipated, requiring a time consuming and complicated negotiation process. For example, some leases did not provide the Commonwealth with early termination rights requiring OASITO and its adviser to negotiate with the lessors. OASITO advised ANAO that a further significant reason for the delays in settling the remaining debt was the lack of effectiveness of Australian legislation in dealing with off-shore arrangements. However, based on its experiences in late 1996 and early 1997 in relation to the airports sale, ANAO considers OASITO should have been aware that Commonwealth legislation may not be able to be used to assume debt instruments which are subject to foreign laws and taken appropriate advice and action to minimise the problem.

2.32 In March 1998, OASITO informed its Legal Adviser that it did not believe it had sufficient funds available for the Legal Adviser to complete the work anticipated. OASITO instructed the Legal Adviser to suspend all work being performed on the non-lease debt and sought from the Legal Adviser capped estimates and an estimated time to complete all outstanding financing transactions. The Legal Adviser estimated its fees would be at least $148 500. OASITO estimated fees (excluding disbursements) from overseas legal advisers to be at least $237 000.

2.33 In April 1998, overall responsibility for developing post-sale arrangements for Australian National's financial obligations was transferred from OASITO to DoTRS. DoTRS required Australian National to take responsibility for finalising outstanding transactions and Australian National contracted OASITO's Legal Adviser and Deutsche Morgan Grenfell to continue providing advice. Australian National advised ANAO in July 1998 that it expects the assumption or repayment of all financing transactions to be finalised by March 1999.

2.34 **Finding:** Australian National's debt and lease obligations of some $1 000 million were to be repaid or assumed in conjunction with the sale process. Arrangements for the assumption or repayment of all of Australian National's financial obligations were unable to be finalised by 30 June 1997. Assumption or repayment of the remaining financing transactions is expected to be finalised by March 1999. Major reasons for the delay were the number and complexity of the transactions, and the absence of voluntary early termination and transfer rights for some transactions. OASITO advised ANAO that a further significant reason for the delays in settling the remaining debt was the lack of effectiveness of Australian legislation in dealing with off-shore arrangements.

3. Tender Process

This chapter outlines the tender process and evaluation methodology.

Tender timetable

3.1 Progressing the sales process as quickly as possible was considered important to stem the substantial losses being incurred by Australian National[47] and provide certainty to the rail industry. The Government required that every effort be made to finalise the sales by 30 June 1997. The Request for Tender issued to shortlisted bidders in June 1997 included a revised objective of entering into an agreement with the successful purchasers by 30 June 1997 or as soon as possible thereafter.

3.2 Marketing activities were constrained by the tight tender timetable with the sale being formally announced on 6 March 1997 with the objective of completion by 30 June 1997. For this reason, marketing was limited to placing advertisements in major Australian and international newspapers with Deutsche Morgan Grenfell contacting approximately 120 Australian and international parties (including all three purchasers) regarding the sale. Information flyers were sent to most of these parties. In addition, during the scoping study Deutsche Morgan Grenfell contacted potential investors through its international network of offices to gauge interest in the sale. The South Australian Department of Industry and Trade also made an unsolicited contribution to marketing activities with a trade delegation to Canada and the United States in late 1996 contacting rail operators to inform them about the pending investment opportunities in South Australia.[48]

3.3 The tight sale timeframe emphasised the importance of minimising the time taken to prepare the businesses for sale. Cooperation between OASITO and its advisers, DoTRS and Australian National was important to achieving this outcome, as was effective management of relationships with the Tasmanian and South Australian Governments.[49]

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[47] OASITO's Business Advisers advised it in February 1997 that Australian National was losing $1.75 million per month.

[48] One of the purchasers advised ANAO that it became aware of the sale as a result of this trade delegation.

[49] The sale required a renegotiation of the Railways Agreements with each state; transfer of the rail corridors to the state concerned and the grant by the state of a 50 year lease of the operational land to the purchasers of SA Rail and Tasrail. Cooperation of the respective state governments was also important on a range of issues including environmental remediation, regional development, and residual rights over railways land.

3.4 OASITO advised ANAO that it reviewed the tender timetable due to the complexities of having to restructure the Australian National businesses, difficulties arising out of Australian National management's requirements and bidder anxiety about the timetable. The Minister for Finance agreed to an extension in the timetable to allow receipt of final bids by 25 July 1997. This timing was intended to balance the objective of a timely sale with the need for bidders to have sufficient opportunity to review in detail the businesses offered for sale, consider the Commonwealth's draft sale agreements and receive necessary Board approvals.[50] Figure 3.1 outlines the major tender stages, the shortlisting of bidders and time taken.

3.5 The revised timetable was essentially met with binding offers received for each of the three businesses on 28 July 1997, although final binding offers for all businesses were not received until 19 August 1997. The Tender Evaluation Panel finalised its recommendations on preferred bidders on 23 August 1997. Sale Agreements were signed on 28 August 1997 with the payment of 10 per cent purchase price deposits. The sales were completed on 31 October 1997 (Pax Rail), 7 November 1997 (SA Rail) and 14 November 1997 (Tasrail) with the transfer of shares and payment of the balance of the purchase prices.[51]

3.6 **Finding:** The Government required that every effort be made to finalise the sales by 30 June 1997. Due to the complexities of having to restructure the Australian National businesses, difficulties arising out of Australian National management's requirements and bidder anxiety about the timetable, the tender timetable was reviewed by OASITO. The Minister for Finance agreed to an extension to receive final bids by 25 July 1997. The revised timetable was essentially met with binding offers received for each of the three businesses on 28 July, although final binding offers for all businesses were not received until 19 August. The sale agreements were signed on 28 August and all sales completed by mid-November 1997.

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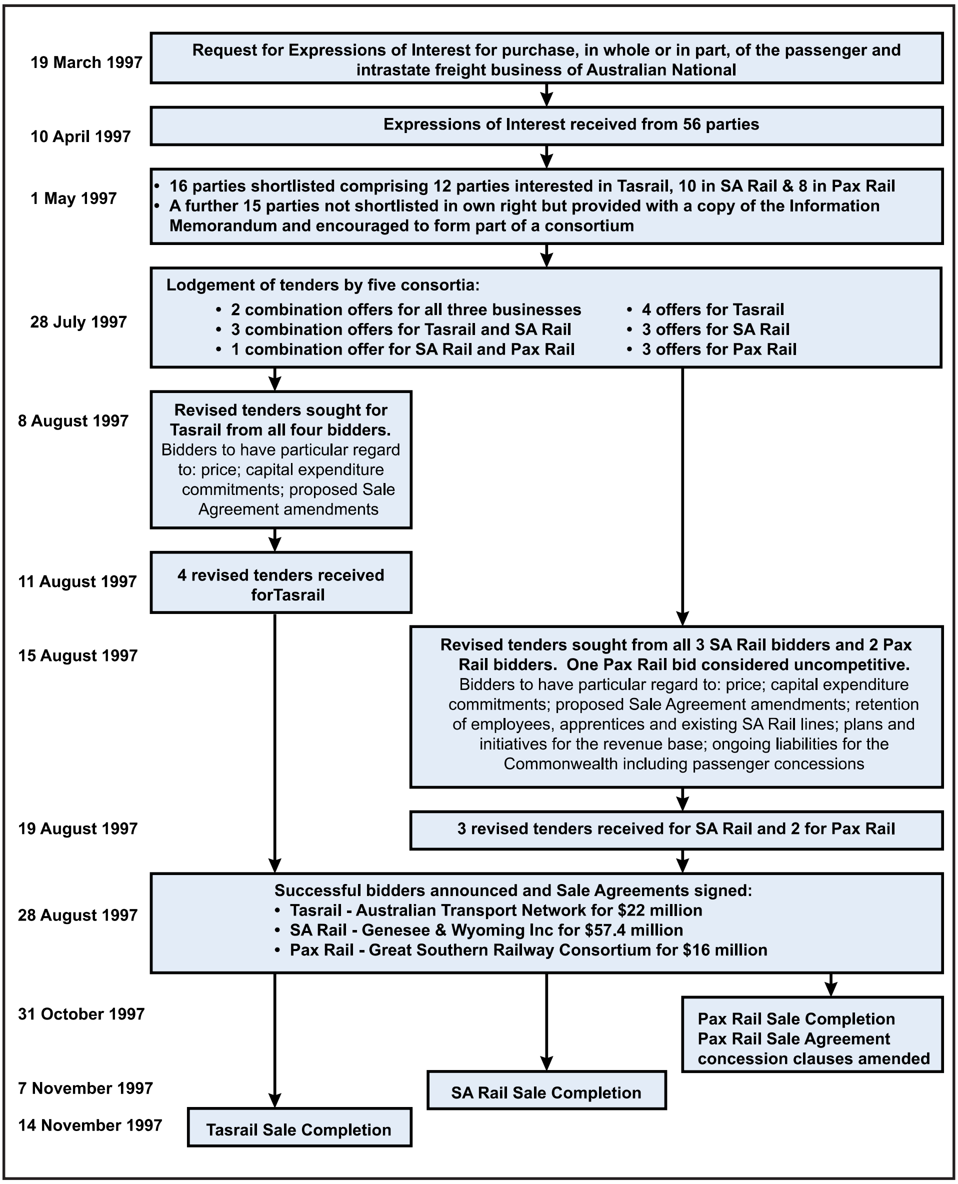
50 The Business Advisers considered reducing the time available to bidders would lead to a number of parties not proceeding, thus reducing the competitiveness and integrity of the sales process.

51 The January 1997 scoping study had recommended that the three businesses be sold by open tender with the sales to be completed between June and December 1997. The scoping study concluded that the sales could not be completed earlier due to commercial, legal and restructuring issues which needed to be addressed.

Figure 3.1

Sale Bidding Process



Source: ANAO analysis based on information provided by OASITO, Business Advisers and Legal Adviser.

Evaluation methodology

3.7 Expressions of Interest were lodged by 56 parties with 16 of these shortlisted to bid for the businesses offered for sale. A further 15 parties were not shortlisted in their own right but were provided with a copy of the Information Memorandum and encouraged to form part of a consortium.

3.8 Deutsche Morgan Grenfell was tasked with shortlisting Expressions of Interest against the selection criteria and shortlisting guidelines.[52] This Business Adviser's recommendations were endorsed by OASITO and approved by the Minister for Finance.

Tender evaluation

3.9 Good administrative practice in tendering includes the development and application of a tender evaluation plan. One of the major advantages of a tender evaluation plan is that it can be used to guide the evaluation process, and then used as the basis of the tender evaluation report, which is prepared as a record of how the evaluation was conducted. Where the ultimate decision maker is not one of the evaluators, the tender evaluation report serves to explain to the decision maker why the evaluators are recommending the selection of a particular tenderer.

3.10 Responsibility for advising the Minister for Finance and the then Minister for Transport and Regional Development on the tender process and outcome rested with OASITO and DoTRS. In preparing advice to their respective Ministers, OASITO and DoTRS needed to satisfy themselves that the tender evaluation was properly conducted and identified the best possible offer for each business. Tender Evaluation Procedures were developed by the Sale Steering Committee[53] to guide the receipt, evaluation and clarification of offers. The Procedures stated that tender evaluation would be conducted by a Tender Evaluation Panel.

3.11 ANAO considers that, appropriately structured, a tender evaluation panel can provide a focused, efficient, transparent and accountable approach to tender evaluation. The Panel consisted of an OASITO contractor; two representatives from Deutsche Morgan Grenfell; one representative from the Legal Adviser;[54] and one Commonwealth officer from DoTRS. One of the Deutsche Morgan Grenfell representatives chaired the Panel.

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52 The advertisement for expressions of interest stated that shortlisting would consider:
- the financial strength and capacity of the interested party;
- the party's experience and expertise in the rail sector;
- the party's objectives and proposed future strategy in acquiring Australian National;
- the benefits (including business and rail development and enhancement, and future employment) which the party could provide to the rail and transport sector, both regionally and nationally;
- the party's interest in acquiring Australian National as a whole or in part;
- the party's demonstrated track record of respect for environmental and heritage issues; and
- the party's perceived ability to meet the Commonwealth's sale objectives.

53 The Steering Committee was chaired by OASITO and included DOTRS, OASITO's two Business Advisers and OASITO's Legal Adviser.

54 Whilst there was a Legal Adviser representative on the Panel, this was done expressly on the basis that any legal advice required by the Panel would be provided by another partner of the Legal Adviser's firm. This arrangement was implemented to separate the Legal Adviser's responsibilities as a Panel member from the provision of legal advice on tender issues.

3.12 The Tender Evaluation Procedures required the Panel to conduct the evaluation of tenders in accordance with the Request for Tender. The Panel was to provide the Minister for Finance with a copy of the tenders; a summary of its evaluation; and a recommendation of the preferred tenderers and next-in-line tenderers for each business or combination of businesses. The Procedures stated that the Minister for Finance would consider the tenders and the Panel's report, bearing in mind the published evaluation criteria, and make the final decision as to the preferred tenderers.

3.13 The Tender Evaluation Procedures outlined the methodology to be employed by the Tender Evaluation Panel to undertake a comparative assessment of each offer against the evaluation criteria. The criteria comprised:

- the financial strength and capacity of the bidder;
- the bidder's experience and expertise in the rail sector;
- the bidder's objectives and proposed future strategy;
- the benefits (including business and rail development enhancement, and future employment) which the bidder could provide to the rail and transport sector, both regionally and nationally;
- the bidder's interest in acquiring the business;
- the bidder's demonstrated record of respect for environmental and heritage issues; and
- the bidder's perceived ability to meet the Commonwealth's sales objectives.

3.14 OASITO decided to attach no specific priority or weighting to the criteria. ANAO considers the development of appropriate priorities which set out the relative importance attaching to each criterion can enhance transparency and accountability of decision making and help ensure the Government's key policy priorities are achieved.[55] This approach has also been advocated by the Productivity Commission,[56] used in other major Commonwealth tenders,[57] and adopted in two recent trade sales reviewed by ANAO, including some of the DAS Business Units sales conducted by OASITO.

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55 Audit Report No. 38 1997-98, *Sale of Brisbane, Melbourne and Perth Airports*, p.37.

56 In its Report No. 48 *Competitive Tendering and Contracting by Public Sector Agencies* published on 24 January 1996, the Industry Commission (now Productivity Commission) recommended agencies *specify and rank relevant evaluation criteria in tender documentation. However, agencies should be free to determine whether tenderers will be informed of any precise weightings to be applied to these criteria.*

57 For example, the Employment Services Request for Tender issued by the then Department of Employment, Education, Training and Youth Affairs in August 1997 set out the relative importance of the criteria for selection of service providers. See Audit Report No.7 1998-99, *Management of the Implementation of the New Employment Services Market*, p.65.

3.15 **Finding:** Appropriately structured, a tender evaluation panel can provide a focused, efficient, transparent and accountable approach to tender evaluation. It is basically an exercise in risk management and should be used where those with adequate knowledge of the risks and their implications can contribute to better sales outcomes. OASITO formed a Tender Evaluation Panel of five members of which four were contracted to OASITO with only one Commonwealth officer on the Panel. The Tender Evaluation Procedures required the Panel to conduct the evaluation of tenders in accordance with the Request for Tender and to provide the Minister for Finance with a copy of the tenders; a summary of its evaluation; and a recommendation of the preferred tenderers and next-in-line tenderers for each business or combination of businesses. The Panel's role did not encompass the initial phase of the tender process, that is, shortlisting of Expressions of Interest.

Recommendation No.3

3.16 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing improve the effectiveness of Tender Evaluation Panels in future trade sales by:

(a) structuring the membership of Evaluation Panels so that relevant Commonwealth agencies are able to satisfy themselves that tender evaluation is properly conducted and identifies the best possible offer for each business; and

(b) extending the oversight scope of the Panel to comprise all aspects of the tender evaluation process, including shortlisting parties that submit Expressions of Interest.

DoTRS response

3.17 DoTRS ***agreed*** with the recommendation. DoTRS commented that the Recommendation 3(b) proposal for extension of the role of Tender Evaluation Panels is a matter for OASITO to consider. The Australian National sale Panel included appropriate representation from this Department to ensure that the interests of this Portfolio were considered. The composition of the remainder of the Panel is a matter for which OASITO is responsible. Nevertheless, it is important not to overstate the significance of the Panel's role in protecting the Commonwealth's position. While the Panel performed an important task, there was a further process to select successful bidders. The Panel's recommendations were incorporated into briefing provided by Senior Executive officers of OASITO and this Department to the respective Ministers. It was this subsequent briefing that Ministers based their decisions on. Reflecting this process, Ministers decided on an outcome at variance with the Panel's preferred tenderers.

DVA response

3.18 DVA ***agreed with qualifications*** to the recommendation. DVA commented that, where OASITO is selling Commonwealth assets or tendering for the outsourcing of services, DVA and DFACS should be consulted to gauge potential impact on current social policy and the delivery of that policy. Where there is an impact, DFACS and DVA should have input and any Tender Evaluation Panel should consider the current position of DVA and DFACS prior to sale or award of contract.

OASITO response

3.19 OASITO ***agreed with qualifications*** with the recommendation. OASITO commented that it considers that the formality and inflexibility of a tender evaluation committee or panel is often not cost effective and therefore prefers to target such processes at only those tasks that require them. OASITO considers that an effective tender evaluation process was in place in this case. Where appropriate, OASITO draws on the expertise and experience of Commonwealth agencies in evaluating bids (including shortlisting), especially in respect of those sales objectives and selection criteria reflecting the Commonwealth's relevant industry policy and micro-economic reform agenda. In respect of the commercial evaluation of bids, OASITO relies on the skills and expertise it contracts through the appointment of commercial advisers.

Success fees

3.20 The Business Adviser contract provided for a success fee of $250 000 to be paid to Deutsche Morgan Grenfell in the event that sale proceeds were $100 million or greater.[58] The success fee was intended to encourage this Business Adviser to maximise sale proceeds to be received by the Commonwealth.[59] ANAO considers that such an arrangement has to be well managed as it has the potential to encourage advisers to view maximising sale proceeds as the most important sale objective and evaluation criterion. In situations where there may not be clear formal guidance from the Commonwealth on the relative importance of its sale objectives, such a view could result in less than satisfactory outcomes.[60]

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58 The minutes of the first Tender Evaluation Panel Meeting record that this Business Adviser declared that part of its remuneration from the Commonwealth included a success fee which is payable should proceeds from the sale meet a certain threshold.

59 The sale of Brisbane, Melbourne and Perth airports indicated that success fees calculated by reference to sale proceeds are not necessary to motivate business advisers to maximise Commonwealth sale proceeds. No proceeds-related success fee was paid to OASITO's Business Adviser in this sale, but the sale proceeds were significantly in excess of book values, the Business Adviser's 1995 scoping study estimates of minimum likely proceeds, and estimated Budget receipts. They also compare favourably with current market values of previous privatisations of major European airports.

60 For example, the January 1997 scoping study report noted that establishing a viable, competitive rail system was not necessarily mutually consistent with maximising the financial proceeds from the sale.

OASITO advised ANAO that it rejects any suggestion that there was an absence of guidance from the Commonwealth on the relative importance of the sale objectives.

3.21 Sound administrative practice also suggests that the members of the Tender Evaluation Panel should have no pecuniary interest in the outcome of the tender process. There is a risk to the Commonwealth that paying success fees to advisers who either inform or participate in the decision to recommend preferred bidders could be seen to give the adviser a pecuniary interest in the tender outcome. Consistent with this principle, DoTRS advised ANAO that it agreed that members of tender evaluation panels should not have a direct personal interest in the outcome of the process.

3.22 At the conclusion of the sale Deutsche Morgan Grenfell sought payment of the success fee although the sale proceeds of $95.4 million were less than the $100 million threshold. Deutsche Morgan Grenfell argued that it *has a reasonable claim for the payment of this amount due to the fact that the Commonwealth did have before it an offer for the assets which was capable of acceptance, and which if accepted would have resulted in the sales proceeds being in excess of $100 million*. OASITO rejected the request for payment, advising Deutsche Morgan Grenfell that it was only free to make payments that conform with contracts.

3.23 **Finding:** ANAO considers that, in the absence of guidance from the Commonwealth on the relative importance of the sale objectives and evaluation criteria, there is a risk that success fees can encourage the pursuit of higher sale proceeds at the expense of other, possibly more important, sale objectives. There is also a risk that paying success fees to advisers who either inform or participate in the decision to recommend preferred bidders could be seen to give the adviser a pecuniary interest in the tender outcome.

Recommendation No.4

3.24 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing develop a corporate policy on success fees that ensures tender evaluators do not have a pecuniary interest in the outcome of the tender process, as part of its ongoing risk management strategy which should guide decision-makers in particular sales.

DVA response

3.25 DVA ***agreed*** with the recommendation.

OASITO response

3.26 OASITO ***disagreed*** with the recommendation. OASITO advised that it will address this issue on a case-by-case basis by close management and supervision, including managing those issues that affect its advisers' success or completion fees. Private sector specialist advisers' input to tender evaluation is always required, even where the outcome may affect their fees. This is a situation that must be managed and which cannot be dealt with simplistically by excluding those specialists who are engaged to undertake the necessary work. The nature of any success fees needs to be tailored to the specifics of commercial proposals and the transaction rather than risk being constrained by general ex ante corporate policies. This is because such policies may inadvertently preclude innovative proposals that may have merit but were not contemplated in the framing of the policies.

ANAO comment

3.27 Tender evaluation is an important aspect of every trade sale and ANAO fully supports the cost-effectiveness of obtaining expert input from advisers into the evaluation process. The success of a sale is measured by the extent to which all objectives are met in concert and adviser's fee arrangements play an important role in motivating advisers to act in the best overall interests of the Commonwealth. For this reason, ANAO considers there is merit in OASITO developing a corporate policy on success fees that recognises the importance of encouraging advisers to provide advice that is, and can be seen to be, reflective of the full range and relative importance of the sale objectives. It is therefore important that those objectives are clear or further clarification is sought where they are not.

Tender outcome

3.28 After initial evaluation of bids, a number of approaches for additional information and/or clarification[61] were made to bidders. In addition, revised bids were sought for each of the businesses. This approach was permitted by the Request for Tender. Bidders for Tasrail were asked to re-bid because the Panel was unable to identify a preferred bidder as most were close on both price and commitment to future capital expenditure. Revised tenders were later sought from bidders for SA Rail and Pax Rail with emphasis on State issues such as retention of lines and workshops, planned employment levels and retention of apprentices.

3.29 The Tender Evaluation Panel finalised its report and recommendations on preferred bidders on 22 August 1997. The Panel reached consensus on the preferred bidder for Tasrail and Passenger

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[61] The Tender Evaluation Procedures stated that: *Clarifications on any part of a Tender that are not clear to the Tender Evaluation Panel may be sought. Such clarifications will be sought in writing by the Tender Evaluation Panel. Any required clarifications will be sought by the Tender Evaluation Panel from interested parties as soon as practicable after receipt of the Tenders.*

Rail but not SA Rail. The majority of the Panel recommended as preferred tenderer the bidder that maximised sale proceeds whereas the minority considered the qualitative aspects, particularly commitment to regional development, of the 'next-in-line' tenderer outweighed the reduced purchase price. The minority also held concerns about the highest bidder's medium to longer term financial capacity and concerns of the South Australian Government and major rail users. OASITO's Legal Adviser advised it that either decision was capable of being reached within the rules of the tender process.[62]

3.30 OASITO provided a brief to the Minister for Finance on 23 August 1997. DoTRS provided the then Minister for Transport and Regional Development with a brief on 25 August 1997. DoTRS advised ANAO that:

> *The Panel was not responsible for recommending preferred bidders to the Minister for Finance and Administration and the Minister for Transport and Regional Development. The Panel's recommendations were incorporated in briefing provided by Senior Executive Service officers of the OASITO and this Department to the respective Ministers. It was this subsequent briefing that Ministers based their decisions on. Reflecting this process, Ministers decided on an outcome at variance with the Panel's preferred tenderers.*

3.31 Successful bidders were announced on 28 August 1997. The bid accepted for Tasrail offered the highest purchase price of the individual offers for this business and the highest capital expenditure commitment. The bid accepted for SA Rail was the second highest bidder, with the Minister's endorsing the greater priority given to regional development issues and financial capacity by a minority of the Panel.

3.32 The bid accepted for Pax Rail was the lower of the two final bids; the higher purchase price being netted off against the requirement by that bidder for the Commonwealth to continue concession reimbursement for one year (this was estimated by the Panel to cost the Commonwealth $5 million). Overall, the successful bidder ranked more highly on the qualitative criteria. When combined with the Panel majority's recommendation for the preferred tenderer for SA Rail, the bid accepted for Pax Rail would have maximised sale proceeds for Pax Rail because of the significant premium offered by the combination tender over the individual tenders.

3.33 The Tender Evaluation Panel concluded that each of the successful bidders would introduce new operators to the Australian rail industry,

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62 The Request for Tender reserved the Commonwealth's right to accept or reject any tender, including the tender with the highest purchase price and decisions on preferred bidder's were to be made after considering all selection criteria.

thereby increasing competition as they seek to establish themselves as viable players. The Panel noted that each consortium included a rail operator from either the United States or Europe with a proven track record in running efficient, competitive businesses. The successful bidders were also considered to have submitted credible plans for the businesses including forecast gains in efficiency[63] and expansion of the transport services offered.

3.34 **Finding:** The Tender Evaluation Panel reached consensus on the preferred bidder for Tasrail and Passenger Rail but not for SA Rail. A majority of the Panel favoured as, preferred tenderer for SA Rail, the bid offering the highest proceeds whereas a minority considered the qualitative aspects of the 'next-in-line' tenderer outweighed the reduced sale price. The Panel's recommendations were incorporated in briefings provided by OASITO and DoTRS to their respective Ministers. Based on these briefings, the Ministers accepted the Panel minority's recommendation for the preferred tenderer for SA Rail.

Regional development

3.35 The sale objectives included contributing to regional development. It was therefore important that OASITO develop effective consultation arrangements with the Tasmanian and South Australian Governments and other stakeholders. The states were consulted by OASITO in the development of the evaluation criteria; contact between the bidders and the Tasmanian and South Australian Governments was facilitated; and state government officials were briefed on each bidder's financial capacity, business intentions, investment plans and proposed contribution to regional development opportunities.

3.36 The tender evaluation criteria addressed each bidder's experience and expertise in the rail industry; the development and employment benefits likely to be provided; interest in acquiring the business; and objectives and proposed future strategy. In addition to information provided by bidders in their tenders, OASITO informed the Panel of the views of the States and major rail users for consideration as part of the evaluation process. The States were also provided with a briefing that summarised certain aspects of the bids received and they advised OASITO of their preferred bidders.

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63 To assist the introduction of private sector work practices and improve the efficiency of operations, all staff employed by the businesses sold were terminated and redundancy payments paid with accrued entitlements paid out. The sale agreements did not include any clauses for transfer of employees or for the maintenance of existing pay and conditions for staff that may be subsequently offered a job by the purchasers. This approach was intended to provide maximum flexibility to the purchasers regarding future employment levels and work practices whilst treating employees fairly and equitably.

3.37 The importance of regional development issues was reflected in the tender process with each bidder addressing regional development issues in its tender. The different commitments offered by bidders were considered in tender evaluation, particularly those relating to minimum service levels, capital expenditure and employment. The return of railways land to the State governments enabled the States to require each of the purchasers to commit in their leases with the respective State Governments to the maintenance of minimum services including the retention of specified lines and frequency of passenger services. The capital expenditure commitments of the successful bidders are contained in the sale agreements.

3.38 **Finding:** Consistent with the sale objective of contributing to regional development, OASITO developed effective consultation arrangements with the South Australian and Tasmanian Governments. The importance of regional development issues was also reflected in the tender process and tender evaluation.

Financial strength criterion

3.39 Most of Australian National's businesses were loss making enterprises after taking into account debt servicing obligations and this was reflected in the ongoing provision of financial support by the Commonwealth. Sale of the businesses to companies of operational and financial substance that could develop them in the long term was important to the sale objectives of establishing a viable and competitive rail system, and promoting ongoing regional development.

3.40 The Request for Tender required bidders to provide details of their ability to finance the acquisition and related working capital and capital expenditure requirements; the extent and details of any third party financing; and the extent to which the financing was to be secured on assets. The Request for Tender also required bidders to provide details of their proposed future strategy including plans to upgrade equipment and track assets, their business development strategy and pricing strategy. Bidders were informed that tenders which included business plans with specific data on business intentions, investment expenditures and standard financial indicators would be favoured in evaluation. However, these plans were not required to be provided and, while some bidders provided detailed plans, others did not.

3.41 In comparison, the 1997 sales of Brisbane, Melbourne and Perth airports required bidders to include in their tenders a detailed business plan, including financial forecasts, that complied with a specified format.[64]

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64 The sale of Australian National and the sales of Brisbane, Melbourne and Perth airports included similar objectives and evaluation criteria relating to financial viability.

Key assumptions were extracted from each bidder's business plan and tested using a financial strength model; bidders' forecasts were compared; and the total debt burden, maturity profile and refinancing risks, principal and interest serviceability, sensitivity to reduced cash flows and access to additional capital were analysed to assess the financial strength and ongoing viability of each bidder. OASITO advised ANAO that:

> *the comparison with the airports privatisation is inappropriate because of the different circumstances. In this case, the primary issue at stake was the capacity to complete the transaction. The likelihood of financial stability in operation was arguably of declining importance over time to the Commonwealth following the sale because, unlike the airports, there was no provision for the Commonwealth to step into the business in the event of failure. OASITO considers that the analysis was adequate for its purpose and raised no additional issues that required to be drawn to Ministers' attention as material to the decision that needed to be made. OASITO is of the view that the nature of these businesses would have made any attempt to distinguish among bidders on the basis of financial modelling of ex ante proposals misleading as a guide to likely commercial prospects.*

3.42 The tender process for the Australian National sale was significantly shorter than for the sale of Brisbane, Melbourne and Perth airports.[65] Nevertheless, a number of bidders stated in their tenders that they had prepared detailed business plans for the businesses. One bidder included a detailed business plan, including financial projections, in its tenders. Furthermore, some debt providers required this type of information as a precondition to credit approval.

3.43 The Tender Evaluation Panel examined the capitalisation and asset backing of the equity participants in each consortium; each bidders' ability to finance the acquisition and related working capital and capital expenditure requirements; and guarantor arrangements. However, the Panel's evaluation report did not draw attention to the varying guarantees offered by each bidder, although certain guarantees were identified in the tender evaluation report.[66] Furthermore, although the Panel's evaluation report included data on the equity contributions and debt

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65 Deutsche Morgan Grenfell advised ANAO that: *To contrast the Australian National sale process with the Airports sale process is neither fair nor reasonable given that the Airports sale process took more than 2 years to complete, whereas the Australian National sale (of 3 businesses) was undertaken in a period of approximately eight months.*

66 Although each sale agreement included a guarantee from the bidder's parent entities, the guarantee arrangements varied markedly. In relation to Tasrail, each of the consortium members separately and severally guaranteed all of the purchaser's obligations under the sale agreement. The parent company of the purchaser of SA Rail guaranteed payment of the purchase price. One member of the consortium that purchased Pax Rail guaranteed 82 per cent of the capital expenditure commitment specified in the sale agreement.

financing for each bidder, the report did not analyse the likely effect of bidders' different gearing levels on the prospective financial viability of the businesses. Other important elements of financial viability not addressed in the evaluation report include: bidders' ability to service debt and meet maintenance and development plan requirements; operating cashflow forecasts and their sensitivity to changes in key business and financial assumptions; and the funding structure proposed by bidders', including the likely effect of different gearing levels on the financial viability of the businesses.

3.44 **Finding:** The tender evaluation report did not include clear and comprehensive analysis of bidders' ability to service debt and meet maintenance and development plan requirements; details of operating cashflow forecasts and their sensitivity to changes in key business and financial assumptions; and the funding structure proposed by bidders, including the likely effect of different gearing levels on the financial viability of the businesses. ANAO recognises the cost and time involved in such analysis, but considers it would have contributed significantly to the sale objectives of establishing a viable and competitive rail system, and promoting ongoing regional development.

4. Freight Rail Sales

This chapter outlines the major sale outcomes in relation to the sale of Australian National's South Australian and Tasmanian freight businesses.

Background

4.1 Australian National operated intrastate rail freight businesses in Tasmania (sold as Tasrail) and South Australia (sold as SA Rail). These businesses were important to the transport of commodities such as coal, cement, newsprint and pulp in Tasmania and coal, gypsum and grain in South Australia.

4.2 Tasrail[67] is a vertically integrated rail operator with approximately 750 kilometres of narrow gauge track, some 500 kilometres of which was in use at the time of the sale. As part of a major upgrade of Tasrail's permanent way, a major sleeper replacement program had been undertaken over the ten years prior to sale. The majority of the freight task was concentrated in the carriage of containers, pulp and paper products, and bulk cement and coal. Tasrail also maintains track and associated infrastructure, locomotives and wagons.

4.3 SA Rail is a vertically integrated rail business which comprised four business units of Australian National as follows:

- SA Freight, which provided linehaul freight services and managed all intrastate rail freight. Its major product groups included coal, gypsum, grain, marble, limestone products and overseas containers. It was marketed as having a proven track record with a well established customer base with the opportunity of entering into long term contracts with customers.
- PowerFleet, which supplied train crews and the operational expertise to run train services as well as providing and maintaining locomotives and wagons. PowerFleet was marketed as having a fleet of 72 operational locomotives which were used for its major external customers and Australian National's passenger rail business. It also owned maintenance facilities and workshops.

[67] The Tasmanian railway system was established in 1871. It was run by the State Government until its transfer to the Commonwealth in the mid 1970s. Since then, Tasrail has been part of Australian National but remained a largely stand-alone rail operation.

- Infrastructure Services, which was responsible for constructing, modifying and maintaining most of SA Freight's rail infrastructure as well as the Commonwealth owned section of the main interstate track network.
- Railmec, which provided specialist rail and heavy engineering services including manufacturing and maintaining locomotives, wagons and passenger carriages. It operated out of sites in Port Augusta and Adelaide.

Tasrail sale

4.4 The Business Advisers advised OASITO that there were good prospects of selling Tasrail prior to 30 June 1997, subject to the resolution of some important legal and commercial issues. Compared to SA Rail and Pax Rail, Tasrail was considered to be a stand-alone business unit, with fewer stakeholder interests and involving potentially less complex legal and commercial issues. In addition, it was considered that the Tasmanian Government was likely to support an early sale, subject to negotiation of residual rights over land should rail operations cease.

4.5 Tasrail operated with positive earnings before interest, tax, depreciation and amortisation in the two years prior to sale (see Figure 4.1). Information provided to shortlisted bidders for Tasrail projected this to continue, with earnings before interest, tax, depreciation and amortisation of $1.8 million and $6.1 million forecast for 1996-97 and 1997-98 respectively. Total assets were $34.5 million as of 30 June 1996.

Sale Outcome

4.6 The agreement for the sale of Tasrail to the Australian Transport Network Limited was signed on 28 August 1997 with a ten per cent purchase price deposit of $2.2 million paid to the Commonwealth. The sale included 32 operational locomotives, rolling stock, track infrastructure, workshops and terminals, plant and equipment, and freight contracts. Operational railways land was excluded from the sale and transferred to the Tasmania Government with the purchaser granted a 50 year lease for the use of the land and existing facilities.

4.7 The sale was completed on 14 November 1997 with the transfer of the Commonwealth's shares in Tasrail to the purchaser in return for payment of the purchase price balance of $19.8 million. In addition to the purchase price, the purchaser committed in the Sale Agreement to capital expenditure of $20 million by 14 November 2001 including expenditure on the refurbishment of old locomotives and wagons,

Figure 4.1

Tasrail Financial Performance: 1994-95 and 1995-96

	1994-95 $m	1995-96 $m
• **Freight revenue:**		
Coal	5.2	5.1
Containerised	4.2	4.4
Cement	3.8	4.2
Woodchips, logs, newsprint & pulp	3.3	4.4
Other revenue	3.8	3.3
Total revenue	20.3	21.4
• **Operational expenses:**		
Train operations	12.2	13.8
Train maintenance	5.8	6.6
Infrastructure & other	0.3	1.8
Total operational expenses	18.3	22.2
• **Operational Earnings:**	**2.0**	**-0.8**
• **Non-Operational Items:**	**1.6**	**1.6**
• **Earnings Before Interest, Tax, Depreciation and Amortisation:** [a]	**3.6**	**0.8**

Note:

[a] Excludes allocation of Australian National corporate overhead and Government grants and supplements.

Source: ANAO analysis based on information provided by OASITO.

refurbishment or replacement of track infrastructure, and purchase of new locomotives, rolling stock, buildings, terminals and workshop plant and equipment.[68]

4.8 The $22 million bid accepted for Tasrail was the highest offer with the decision to undertake a further bidding round extracting a significant increase in the purchase price offered by the successful bidder. This increase, and the comparatively smaller increases from other shortlisted bidders, assisted the Panel to distinguish sufficiently between bidders' purchase price and capital expenditure commitments.[69] The increase was fully funded by additional equity.

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68 This commitment, and those included in the SA Rail and Pax Rail sale agreements, is to be monitored by DoTRS.

69 Tasrail bidders had been asked to re-bid because the Panel were unable to identify a preferred bidder as most were close on both price and commitment to future capital expenditure.

4.9 Finding: The agreement for the sale of Tasrail to Australian Transport Network Limited for $22 million was signed on 28 August 1997 and the sale was completed on 14 November 1997. The business was sold to the highest bidder with the decision to undertake a further bidding round resulting in an increase in the price offered by the successful bidder. In addition to the purchase price, the purchaser committed in the Sale Agreement to capital expenditure of $20 million over a four year period.

SA Rail sale

4.10 Compared to Pax Rail and Tasrail, SA Rail earned the most revenue and had the largest asset base (see Figure 4.2). Although overall it was not profitable at the time of the sale, shortlisted bidders were advised that the business units had implemented or were implementing steps to improve operational efficiencies and that these initiatives, together with the introduction of private sector investment and attendant work practices and marketing expertise could lead to significant improvements in SA Rail's future financial and operating performance.

Figure 4.2
SA Rail Financial Performance: 1995-96

	SA Freight $m	Power-Fleet $m	Infrastructure Services $m	Railmec $m	Total $m
Revenue	55.0	145.1	68.2	47.9	237.2[a]
Expenses	50.1	165.4	65.6	50.3	252.4[a]
Earnings before Interest, Tax, Depreciation and Amortisation[b]	4.9	-20.3	2.6	-2.4	-15.2
Capital Expenditure	5.1	1.2	1.3	0.3	7.9
Total Assets	63.6	36.7	20.9	14.0	135.2

Note:

[a] Consolidated figures for SA Rail exclude inter-divisional transactions.

[b] Excludes allocation of Australian National corporate overhead and $10 million in Government grants and supplements.

Source: ANAO analysis based on information provided by OASITO.

Sale Outcome

4.11 The agreement for the sale of SA Rail to Genesee & Wyoming Australia Pty Limited[70] was signed on 28 August 1997 with a 10 per cent purchase price deposit of $5.74 million paid to the Commonwealth. Completion was effected on 7 November 1997 with the transfer of the Commonwealth's shares in SA Rail to the purchaser in return for payment of the purchase price balance of $51.66 million.

4.12 In addition to paying the purchase price, the purchaser has committed in the Sale Agreement to $52.3 million in capital expenditure by 31 December 2002. The expenditure is to involve the acquisition or major overhaul of locomotives and wagons, upgrading of track infrastructure, and other items of a capital nature. Maintenance or refurbishment of locomotives and wagons is to be carried out in South Australia. Capital expenditure can be deferred where the purchaser considers it is unable to comply with its obligations as a result of factors substantially beyond its control.

4.13 Vested in SA Rail were the assets of Australian National's South Australian intrastate freight businesses including 17 narrow and 71 standard and broad gauge locomotives, rolling stock, track infrastructure, maintenance equipment, some workshops, and freight contracts. Freehold property, including rail corridors, was not sold but transferred to the South Australian Government with the purchaser granted a 50 year lease for the use of the land.

4.14 The SA Rail sale did not include contracts[71] with some major users. The South Australian Rail Users Group, which represents some of SA Rail's major customers,[72] has advised ANAO that it would have preferred to negotiate pro-forma contracts with each of the bidders for SA Rail during the tender process. It believes this approach would have provided both their businesses and bidders with greater certainty.

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70 On 29 October 1997, Genesee & Wyoming Australia Pty Limited changed its name to Australia Southern Railroad Pty Limited.

71 Deutsche Morgan Grenfell advised ANAO that: *The issue of putting contracts in place with major customers was identified and discussed during Steering Committee and Due Diligence Committee meetings. At the Due Diligence Meeting on 4 April 1997, the Legal Adviser tabled a document entitled 'Material Contracts to be Put in Place and their Priority'. While negotiations were held with most of Australian National's major customers, many customers did not want to enter into pro-forma contracts during the tender process since they perceived the sale as an opportunity to negotiate lower freight rates with the new owner of SA Rail. Furthermore, the putting in place of agreements by the Commonwealth and its advisers may have overridden the Commonwealth's sale objective of 'to provide an efficient, competitive, dynamic and reliable transport service'.*

72 The Group comprises the Australian Wheat Board, Australian Barley Board, South Australian Co-operative Bulk Handling Limited, Penrice Soda Products Pty Ltd, and Gypsum Resources Australia.

4.15 The purchase price of $57.4 million was the second highest of the three final tenders submitted for SA Rail. The purchaser was ranked more highly on qualitative criteria with the Ministers endorsing the greater priority given to regional development issues and financial capacity by a minority of the Tender Evaluation Panel.

4.16 **Finding:** The agreement for the sale of SA Rail to Genesee & Wyoming Australia (now known as Australia Southern Railroad) for $57.4 million was signed on 28 August 1997 and the sale was completed on 7 November 1997. The successful bidder was ranked more highly on qualitative criteria than the bidder who offered the highest purchase price. In addition to the purchase price, the purchaser committed in the Sale Agreement to capital expenditure of $52.3 million over a four year period.

Leigh Creek Line business

4.17 The rail line in South Australia between Leigh Creek and Port Augusta provides the essential service link for the cartage of coal from the SA Generation Corporation's (SAGC) coal field at Leigh Creek to the Northern Power Station at Port Augusta, a distance of 247 kilometres. The Northern Power Station provides around 40 per cent of the base load electricity generating capacity of the SAGC.

4.18 At the time of the sale, Australian National transported coal for the SAGC using approximately 140 coal wagons and a compressor wagon on a single train, hauled by three locomotives. The Leigh Creek Line business has traditionally been highly profitable for Australian National with 1995-96 revenue of $20.1 million.[73] However, Australian National and the SAGC have been in dispute for several years over haulage prices on the Line.

4.19 The Leigh Creek Line business, including the track infrastructure, was to be included in the sale of SA Rail although OASITO's Business Advisers considered the business could be offered and sold separately through a targeted sale process involving the SAGC and a limited number of other potential bidders. They considered excluding the Leigh Creek Line business from the sale of SA Rail would dampen buyer interest and negatively impact on the sale price for SA Rail. OASITO has advised ANAO that later advice was that exclusion of the track infrastructure alone was unlikely to significantly affect the appeal of the SA Rail business to bidders.

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[73] The SA Freight Business Plan prepared by OASITO's Business Advisers noted that: *SA Freight's potential for profitability will largely be determined by its success in protecting the existing margins in the coal and gypsum traffic, rationalising the grain operation and achieving further improvements in operating costs.*

4.20 The Business Advisers initially estimated that the Leigh Creek Line business was likely to generate sale proceeds of between $20 million and $40 million, including components for the freight task specific rolling stock and the track infrastructure, if sold as a separate stand alone business. They advised OASITO that the optimal approach was to include the Leigh Creek Line business in the SA Rail sales process but allow bids for individual components of SA Rail as well as the whole.

4.21 The SAGC lodged a complying Expression of Interest on 9 April 1997 for the Leigh Creek Line, associated facilities and the coal wagons used to haul coal from Leigh Creek to Port Augusta. The Business Adviser recommended against shortlisting the SAGC's Expression of Interest because it had no expertise as a rail operator; was a State Government enterprise; and was interested in the Leigh Creek Line business only.

4.22 Following the exclusion of the SAGC from the bidding process, the South Australian Government sought the transfer of the Leigh Creek Line track infrastructure[74] to the SAGC as a condition of it facilitating the sale and agreeing to the transfer of railway land to the State. The Commonwealth agreed to transfer the track infrastructure on the Leigh Creek Line to the SAGC, which would be responsible for the condition of the track, its maintenance and upgrading.[75] The agreement did not address resolution of the ongoing dispute between Australian National and SAGC concerning haulage prices.[76] In this respect, DoTRS advised ANAO that:

> *At the time of negotiations between the Commonwealth and South Australia, Australian National was a commercial operating business and the responsible management was strongly of the view that Australian National could achieve a better result through normal commercial and legal processes.*

4.23 OASITO's Legal Adviser recommended that the track infrastructure on the Leigh Creek Line should not be transferred without, at the same time, attempting to resolve all outstanding issues, particularly

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74 The May 1997 Information Memorandum provided by OASITO to shortlisted SA Rail bidders advised (p.91) that: *It is intended that the track infrastructure on the railways land will be severed from the land and separately vested by the Commonwealth in SA Rail. For this purpose, the track infrastructure comprises both the permanent way and all other improvements on the land. South Australia will have rights to acquire these assets on termination of the lease (or early termination in the event of closure of any line). If South Australia exercises this option, assets taken over at the date of transfer would be transferred at no cost, and post sale improvements would be sold at independent valuation conducted on the basis of continued railway use of the assets.*

75 The agreement was signed on 7 November 1997.

76 Australian National advised ANAO in July 1998 that $14.8 million had been invoiced to the SAGC but not paid. Australian National further advised that it proposes to take legal action to recover these monies.

the dispute over haulage prices, given the Commonwealth's leverage on this point and the large amount in dispute. OASITO advised ANAO that its decision was to leave resolution of the dispute to the appropriate arbitrator, given the large amount in dispute and Australian National's confidence of a better financial outcome for the Commonwealth if resolution was left to an independent arbitrator. OASITO also advised that:

> *it disagreed with its Legal Adviser's view on 'leverage' in the context of the South Australian Government making the transfer a condition of it accepting the South Australian Railways Agreement that was necessary to enable the sale to proceed. The issue was then no longer commercial, but a matter of Commonwealth - State relations.*

4.24 Shortlisted bidders for SA Rail were advised by the South Australian Government that the SAGC would negotiate a haulage contract for the Leigh Creek business and would offer a maintenance contract. OASITO recognised that the transfer of the track infrastructure on the Leigh Creek Line to the SAGC may have led to a loss of some proceeds[77] for the Commonwealth because SA Rail bidders could not be certain of being awarded the haulage and/or maintenance contracts or the profitability of any contracts.[78] Deutsche Morgan Grenfell advised ANAO that:

> *Australia Southern Railroad obtained the freight task specific rollingstock associated with the Leigh Creek Line, but did not acquire the track. The loss in sale proceeds (if any) as a result of Australia Southern Railroad not acquiring the track is, in our view, likely to be minimal. A major reason for this is that ownership of the freight specific rollingstock placed Australia Southern Railroad in an extremely strong position when tendering for this business immediately upon completion of the sale.*

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77 DoTRS advised the then Minister for Transport and Regional Development on 26 June 1997 that: *The OASITO has confirmed its business consultant's advice that the transfer of the Line to SAGC is unlikely to significantly effect the appeal of the SA Rail business to bidders and hence the expected sales proceeds because the operator will not be required to maintain the track and because of the foreshadowed introduction of a State access regime. The monopoly profits extracted by Australian National from this Line in the past will be very difficult to achieve under such a regime.*

78 The Australian Financial Review reported on 16 November 1998 (p. 8) that Australian Southern Railroad had not been shortlisted in the tender for a 'lucrative' 10-year contract to operate the Leigh Creek line from February 1999 and that a separate tender was being undertaken to maintain the Leigh Creek line. On 2 December 1998, the NSW Government-owned rail freight carrier FreightCorp announced that Flinders Power, an energy corporation owned by the South Australian Government, had awarded FreightCorp a 2 year contract for coal haulage between the Leigh Creek Coalfield and the Port Augusta Power Station from 1 February 1999 with negotiations continuing for a longer-term contract. FreightCorp's announcement stated that Flinders Power was converting from a rotary dump operation, where wagons are rotated and the coal tipped, to a bottom discharge operation, such as that operating at Port Waratah Coal Services in Newcastle, the main export point for Hunter Valley coal.

4.25 **Finding:** The Leigh Creek to Port Augusta line is used for the cartage of coal for the SA Generation Corporation (SAGC). This business has traditionally been highly profitable for Australian National with OASITO's Business Adviser's initially estimating it to be worth between $20 million and $40 million, including components for the freight task specific rolling stock sold with SA Rail and the track infrastructure, if sold as a stand alone business. Following the exclusion of the SAGC from the bidding process, the South Australian Government required the transfer of the track infrastructure to the SAGC at no cost as a condition of the State Government facilitating the sale through the passing of State legislation.

5. Pax Rail Sale

This chapter outlines the major sale outcomes in relation to the sale of Australian National's passenger rail business.

Background

5.1 Australian National's passenger rail business operated three high profile interstate passenger rail services together with associated catering and motorail services as follows:

- *The Indian Pacific* carried approximately 98 000 passengers in 1996, departing Sydney and Perth twice a week for the 4 352 kilometre journey via Broken Hill and Adelaide.
- *The Ghan* service provides the rail passenger link between Adelaide and Alice Springs making two trips per week in the peak tourist season. Approximately 40 000 passengers were carried by The Ghan in 1996.
- *The Overland* is Australia's longest running interstate service, in 1996 transporting more than 107 000 passengers overnight between Melbourne and Adelaide.[79]

5.2 Australian National's passenger rail business did not have a history of profitable operations. Figure 5.1 provides details of the operating performance of the passenger rail business at the time of the sale. The major sources of revenue in 1995-96 were from ticket sales ($35.3 million) and Commonwealth passenger concessions ($5.1 million) with the Commonwealth providing a further operating supplement of $14 million. Losses before interest, tax, depreciation and amortisation amounted to $18.4 million in 1995-96 and total assets were $13 million as of 30 June 1996.

Sale Outcome

5.3 The January 1997 scoping study concluded that Pax Rail was unlikely to be sold for a positive value unless it could be reconfigured as a tourist-based operator. Accordingly, the business was marketed to bidders as offering the potential for targeting high yielding segments of the inbound tourist market, developing of cross-market partnerships with

[79] The operation of The Overland was shared jointly by Australian National and the Public Transport Corporation of Victoria with certain revenues and costs split proportionally 37.3 per cent (Australian National) and 62.7 per cent (Public Transport Corporation).

Figure 5.1

Passenger Rail Services 1995-96 Financial Performance

		$m	$m
•	**Revenue:**		
	Net ticket sales	35.3	
	Commonwealth concessions	5.1	
	Other revenue [a]	2.9	
	Total revenue		43.3
•	**Expenses:**		
	Operating	32.8	
	Wages & salaries	18.3	
	Overheads	10.6	
	Total expenses		61.7
•	**Earnings Before Interest, Tax, Depreciation and Amortisation** [b]		**-18.4**

Note:

[a] Excludes $14.0 million operating supplement paid by the Commonwealth.

[b] Excludes allocation of Australian National corporate overheads. Corporate overhead allocation represents administrative costs for advertising, promotion and travel expenditure incurred at Australian National's corporate level and then allocated to passenger rail.

Source: ANAO analysis based on information provided by OASITO.

other tourism operators, and improving financial and operating performance through the introduction of private sector investment, work practices and marketing expertise.

5.4 The agreement for the sale of Pax Rail to Great Southern Railway Passenger Limited was signed on 28 August 1997 for a purchase price of $16 million. The sale has removed the need for the Commonwealth to provide ongoing operating supplements, which amounted to $14 million in 1995-96.[80] In addition to the purchase price, the purchaser committed in the Sale Agreement to capital expenditure of $14.3 million by 31 October 2003. Capital expenditure is to be undertaken in South Australia unless the purchaser satisfies the Commonwealth that the commercial benefits resulting from the expenditure would be higher if that expenditure was undertaken elsewhere. One member of the purchasing consortium guaranteed 82 per cent of the capital expenditure commitment.

5.5 The assets of Australian National's passenger rail business were vested in Pax Rail, including rolling stock, the Alice Springs passenger terminal and a rolling stock maintenance depot. In addition, the Sale

[80] No operating supplements were paid in 1996-97.

Agreement provided for continuation of the existing track access agreement with Australian National. The South Australian Government granted the purchaser a 50 year lease of the Keswick passenger terminal.

Financial returns

5.6 A substantial proportion of passengers on Australian National's passenger business travelled on concession tickets[81] with concessional travel historically providing an important source of revenue.[82] At the time of the sale, DoTRS was responsible for reimbursing Australian National for the cost of Commonwealth concessions with some $5.2 million reimbursed to Australian National in 1996-97. The then Department of Social Security (now DFACS) and DVA assumed responsibility for administration of the Commonwealth's policy on passenger rail concessions with effect from 1 July 1998. Figure 5.2 summarises the major passenger concessions provided by Australian National's passenger rail business at the time of the sale.

5.7 The continued provision of concessional travel and reimbursement of concessions by the Commonwealth could be expected to have a marked effect on the patronage and viability of Pax Rail following the sale, and therefore the purchase prices likely to be offered by bidders. Indeed, the January 1997 scoping study found that the continuation of passenger rail services could require ongoing Commonwealth subsidies and that the Commonwealth's preparedness to offer a Commonwealth subsidy needed to be addressed prior to sale.[83]

5.8 Between February 1996 and March 1997, the United Kingdom completed a three stage franchising program[84] in which bidders tendered for the operation of passenger services for a period of between five years

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81 Pensioner discounts were claimed by 30 per cent of all passengers on the three services and by more than 40 per cent of passengers on The Indian Pacific.

82 Australian National received $5.1 million in 1995-96 from the Commonwealth for providing discounted travel to pensioners and totally and permanently incapacitated veterans. The New South Wales, Western Australian and South Australian State governments provided a further $2.4 million for discounted travel by pensioners and the blind. In addition, Australian National granted approximately $1 million of non-reimbursed concessions to students, former Australian National employees, and Australian National and Parliamentary Gold Pass holders.

83 The L|E|K Partnership has noted that: *the importance of concessional travel to the Passenger Rail business was raised in the scoping study and given considerable coverage in both the business plan and Information Memorandum. Furthermore, it was continually a topic of discussion in the vendor due diligence committee meetings. OASITO and its advisers did everything possible to progress the issue of concessions and any slowness to act on this lies squarely with DoTRS and the Department of Finance.*

84 Direct sale of passenger services was not considered desirable because costs generally exceeded revenues.

Figure 5.2

Summary of Major Passenger Concessions: May 1997

Beneficiary	Reimbursing Entity	Concession Overview
Pensioners	Commonwealth, NSW & WA State Governments	Half price of the travel component.
Totally and Permanently Incapacitated (TPI) Veterans	Commonwealth Government	100% on fare component. In addition, 40 veterans and their carers are able to gain a free Sydney to Perth ticket through an annual ballot.
Blind Passengers	State Governments where recipient resides	Individual and companion free in home state and half fare for any other part of the journey.
Student	Not reimbursed	Half fare to holders of Railways of Australia student discount card.
Unemployed	New South Wales only	Half fare from Sydney to Broken Hill, free thereafter.
Former Australian National Employee	Not reimbursed	One free north/south or free east/west trip per annum plus 12 tickets at 75% discount.
Australian National Gold Pass Holders	Not reimbursed	Free first class travel.
Parliamentarian Gold Pass Holders	Not reimbursed Not reimbursed	Free first class travel for self and accompanying spouses.

Source: ANAO analysis based on information provided by OASITO to shortlisted Pax Rail bidders.

and 15 years.[85] The tender process was designed to minimise the ongoing subsidy from Government to passenger rail operators.[86] After assessing shortlisted parties' prospective financial strength, managerial competence and suitability to operate a franchise, shortlisted bidders were asked to attach the highest priority in their tenders to the lowest possible subsidy levels. Subject to committing to an acceptable level of service, bids that required the lowest financial support and committed themselves to a declining profile of payments were generally successful.[87] Preferred

85 United Kingdom National Audit Office, *The Award of the First Three Passenger Rail Franchises*, 16 October 1996 and *Privatisation of the Rolling Stock Leasing Companies*, 5 March 1998.

86 With one exception, all 25 franchises were awarded in return for a United Kingdom Government subsidy. This subsidy either reduces or is replaced by payments to the United Kingdom Government over the franchise period.

87 As an integral part of tender evaluation, advisers were required to estimate the likely level of subsidy bidders would require over the life of the franchise with these estimates used as benchmarks to assess the range of bids.

bidders were not chosen until all key aspects of post-franchise arrangements had been finalised.

5.9 In comparison to the approach taken in the United Kingdom,[88] shortlisted Pax Rail bidders were not asked to tender for the Pax Rail business on the basis of the lowest ongoing economic cost to the Commonwealth. The June 1997 Request for Tender required bidders to offer a purchase price but bidders were not required to specifically address any requirement they would have for the continued provision by the Commonwealth of funding for passenger concessions; and/or identify how they would respond if the Commonwealth required concessional travel to continue to be provided at existing levels to existing recipients.[89] OASITO advised ANAO that, at this stage, the Commonwealth's policy on the continuation of Commonwealth funded passenger rail concessions had not been decided.[90] However, DFACS[91] and DVA were then of the view that, because the Government had not decided to alter concession entitlements, any new arrangement for concessional travel post-sale should ensure the maintenance of existing arrangements.

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88 DoTRS advised ANAO that: *Although both processes involved passenger services there is little else in common. The outcome of the United Kingdom program was a series of franchises requiring ongoing Government subsidy. In comparison, the Australian National passenger sale resulted in the complete cessation of Commonwealth responsibility for this business and the associated significant operating subsidies. There was also a substantial decline in the Commonwealth's concession expenditures which now properly fall within the responsibility of a social welfare portfolio.*

89 Shortlisted Pax Rail bidders were advised in the May 1997 Information Memorandum that the purchaser would be required to continue concessions for which reimbursement was received for as long as services continue to be provided. In the event the Commonwealth decided not to fund these obligations, bidders were told the new owner would not be obliged to offer these concessions.

90 OASITO advised ANAO that: *the sale steering committee decided to seek bids without offering bidders a preferred Commonwealth position on the future of Commonwealth financial assistance, whether by way of specific passenger concessions or general subsidy. At that time, Commonwealth policy on post-sale concessions was that it would be reviewed and settled in the light of commercial proposals from bidders. This approach was consistent with the Government response to the Senate Brew Inquiry* [which stated that any changes to the operation and administration of passenger services would be undertaken after market interest has been gauged through the Australian National sale process]. *It was also a prudent measure to maintain Commonwealth negotiation flexibility in the event that bids sought a continued commitment to general subsidy on the United Kingdom model (as one bid did in fact do).*

91 In June 1997, DFACS advised DoTRS that it believed that: *it should be a requirement that bids from prospective purchasers be submitted on the basis that fare concessions are to continue. Alternatively, the Commonwealth could require that bids be presented inclusive of calculations supporting community service obligations, with and without Commonwealth government supplementation. …any approach failing to recognise a Commonwealth commitment to community service obligations would require the approval of Cabinet after a full consideration of the implications in a change to existing concessional arrangements. Concessions are a recognised adjunct to income support arrangements and are a part of the Government's core promise to maintain the income safety net at existing levels. In addition, the 1993 Premiers Conference Agreement confirmed that both Commonwealth and State Governments jointly recognised transport, along with health, rates and energy, as one of the four major core concessions to be funded.*

5.10 **Finding:** Passenger concessions are a recognised adjunct to income support arrangements and part of the Government's 'core promise' to maintain the income safety net at existing levels. Not to continue rail pensioner concessions would have been inconsistent with a 1993 Premiers Conference agreement between the Commonwealth and the States. Accordingly, the Department of Family and Community Services and the Department of Veterans' Affairs were of the view that, because the Government had not decided to alter concession entitlements, any new arrangement for concessional travel post-sale should ensure the maintenance of existing arrangements. However, the tender process for Pax Rail was designed to address the issue of passenger concessions only in response to bidders' proposals.

Recommendation No.5

5.11 ANAO *recommends* that relevant Commonwealth agencies maximise the overall interests of the Commonwealth in future trade sales by implementing arrangements that seek to ensure early resolution of the Government's position on future service requirements, and on any ongoing subsidies the Commonwealth is prepared to provide.

DFACS response

5.12 DFACS ***agreed*** with the recommendation.

DoTRS response

5.13 DoTRS ***agreed*** with the recommendation. DoTRS noted that early resolution of the Government's policy position on all issues relevant to a sale is not only likely to facilitate a more efficient sale process but is also likely to achieve a more favourable outcome for the Commonwealth.

DVA response

5.14 DVA ***agreed with qualifications*** with the recommendation. DVA commented that a single, consistent coordinator of interests should be appointed. In the sale of Australian National, this role kept shifting between OASITO, DoTRS, DoFA and PM&C making it difficult for DVA to establish continuity in the consultation process. Where there is a proposed shift in Government policy as part of a sale process, OASITO and DoFA should identify such a position with full Ministerial and Cabinet approval as appropriate.

OASITO response

5.15 OASITO ***agreed*** with qualifications with the recommendation. OASITO commented that while the recommendation sets out an ideal approach, it is not always possible to resolve such issues in the preferred timeframe. However, OASITO also considers that, no matter how diligent the ex ante effort to comply with this motherhood recommendation, it would be most unwise to proceed on the basis that all such issues have been identified and resolved early. Sales processes need to retain flexibility and scope to address or re-examine such issues that emerge later or for which the early resolution needs to be revisited later in the process.

ANAO comment

5.16 ANAO considers it important that the agency responsible for managing Commonwealth asset sales implements effective consultative arrangements with a primary focus on achieving early resolution of policy implications and obligations. This provides added certainty to bidders and assists the Commonwealth to achieve an optimal outcome. Essentially it requires the implementation of suitable arrangements to ensure early resolution of the Government's position is sought by relevant agencies. Passenger concessions were an important issue for the Pax Rail sale. Although the January 1997 scoping study found that the continuation of passenger rail services may require ongoing Commonwealth subsidies,[92] this issue was not addressed and resolved sufficiently early in the sale process.

Tender evaluation

5.17 Although the Government had not decided to change the operation and administration of passenger service concessions until after market interest had been gauged through the tender process, financial forecasts provided to Pax Rail bidders excluded any future revenue from Commonwealth concessions. Understating the future revenue stream of a business can reduce the purchase price offered by bidders and / or reduce the number of shortlisted parties who proceed to lodge a binding tender.[93]

5.18 Eight parties were shortlisted to bid for Pax Rail with three conforming tenders received. Two bidders proceeded to the second bidding round, the third being excluded because the Tender Evaluation Panel considered its tender uncompetitive. The Pax Rail purchaser offered a purchase price of $16 million and discount tickets reduced in price by

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[92] Furthermore, DoTRS advised the then Minister for Transport and Regional Development on 16 May 1997 that: *Not to continue rail pensioner concessions would unravel an agreement under which the Commonwealth provided $70m to the states to fund an extension from 1 January 1994 of the 50% concession for pensioners to include recipients of part pensions and to extend it to cover all interstate rail services in Australia whether operated by Australian National or by the State rail systems.*

[93] For example, the Pax Rail purchaser's initial bid offered to increase its purchase price in the event the Commonwealth committed to continue reimbursement for pensioner discounts. Another bidder stated that its purchase price reflected the lack of clarity and certainty in relation to concession fare contributions from the Commonwealth.

at least 25 per cent from the unrestricted adult full fare (other than any food or drink component of such fare and any items purchased on the relevant rail service) to pensioners, full-time students, children and eligible former Australian National employees.[94] The purchaser did not seek the continuance of any Commonwealth concessions, with the exception of Parliamentary Gold Pass Holders.[95] The Panel did not quantify the cost to the Commonwealth of this bidder's discount proposal in the event the Commonwealth required concessional travel to continue to be provided at existing levels to existing categories of recipients. Evaluation against two other criteria also did not reflect the need to negotiate ongoing provision of concessions by the successful bidder.[96]

5.19 The second final bidder offered a purchase price of $25 million but required the Commonwealth to continue to fully fund concessions for the first twelve months following the sale.[97] The Tender Evaluation Panel assessed that this reduced the financial return to the Commonwealth by $5 million leading to a net purchase price offer of $20 million, or 25 per cent higher than the successful bidder. This bidder also offered a 30 per cent fare discount for a period of three years from the first anniversary of sale completion. An analysis was undertaken to compare the two bids and their relative effects on pensioner contributions towards their fares in the event the Commonwealth decided <u>not</u> to continue subsidising concessional travel post-sale. However, the Panel did not quantify the cost to the Commonwealth of this discount proposal in the event the Commonwealth required concessional travel to continue to be provided at existing levels to existing categories of recipients.

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94 DoTRS's brief to its Minister on the Panel's recommendations recognised that it was likely that *the Commonwealth will need to continue providing concessions to certain groups for some time to preserve their current entitlements. However,* [the purchaser's] *commitment to pensioner discounts of at least 25 per cent of all fare levels (compared to the current 50 per cent of the sit up fare) may prove popular and should hopefully result in a reduction in the share of the concession burden to be carried by the Commonwealth*.

95 Shortlisted bidders had been advised in the May 1997 Information Memorandum that: *Prospective purchasers should note that they will not be required to continue the other* [non-reimbursed] *concessions except for Gold Passes held by former Commonwealth and State Parliamentarians. To the extent that these concessions are used by Gold Pass Holders, the successful purchaser(s) will be entitled to be reimbursed by the Commonwealth*.

96 The successful bidder was rated more highly against: the criterion of divesting the Commonwealth of ongoing responsibility for rail because it was considered to not require any ongoing payments from the Commonwealth; and the criterion of entering into a sale agreement as soon as possible because it would not require negotiation on concessions.

97 Shortlisted bidders were advised in May 1997 that monies had been appropriated to reimburse concession obligations for the year ending 30 June 1998 however a decision had not been made regarding the reimbursement of concessions to the purchaser of Pax Rail.

5.20 Balancing the immediate value from the sale (the purchase price) with the ongoing cost to the Commonwealth of passenger concessions would contribute to achieving the sale objectives of a fair return and divesting the Commonwealth from ongoing operational responsibility for rail. To achieve this outcome, ANAO considers that it was important that tender evaluation seek to identify the most favourable overall net financial return to the Commonwealth in the event the Commonwealth required concessional travel to continue to be provided post-sale at existing levels. This would have required the Tender Evaluation Panel to analyse each bidder's purchase price offer and any ongoing Commonwealth funding.[98]

5.21 The Panel's evaluation report also did not explicitly address whether the higher ranking against the qualitative criteria of the successful bidder's Pax Rail offer was offset by the lower net purchase price the successful bidder offered for Pax Rail alone. OASITO advised ANAO that:

> *it considered that this $4 million apparent benefit was not sufficient to offset the significantly reduced Commonwealth flexibility in concession reimbursement policy, the reduced commitment to maintain service levels, the $10.5 million lower capital expenditure commitment and the potentially lower prospects of commercial success (in part from a slower rate of change in service character and a lower level of capital investment).*

5.22 OASITO advised ANAO that its advice to its Minister examined the relative merits of the bids with respect to their provisions for pensioner concessions. In addition, DoTRS advised ANAO that:

> *It should be noted that the unsuccessful bidder's offer of a 30% discount for the subsequent 3 years was to be calculated on the sit up economy fare component only. In contrast, the successful bidder's offer of a 25% discount was to be calculated on the total fare and berth component, which in the majority of classes results in a superior result for the Commonwealth. Accordingly, as the ongoing Commonwealth subsidy payments would be less under the preferred bidder, the price differential between the two bids would be further reduced over time.*

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98 For example, in the 1997 DASFLEET trade sale (see Audit Report No.25 1998-99, *DASFLEET Sale*), the bids were assessed by OASITO's Business Adviser on the basis of a Relative Whole-of-Government approach which took into account, amongst other things, the initial lump sum offer price and the future vehicle lease and fleet management rates tendered by each bidder. The analysis was dependent on a number of assumptions with the financial return of the different bids compared over both six year and ten year periods.

5.23 Finding: Balancing the immediate value from the sale (the purchase price) with the ongoing cost to the Commonwealth of passenger concessions would contribute to achieving the sale objectives of a fair return and divesting the Commonwealth from ongoing operational responsibility for rail. ANAO considers that this required the Tender Evaluation Panel to analyse each bidder's purchase price offer and any ongoing Commonwealth funding to calculate the best overall whole-of-government financial outcome. This is an important aspect of any sale. The stand alone bid accepted for Pax Rail offered a purchase price of $16 million with the only other final bidder offering a net purchase price of $20 million (after excluding $5 million in concession payments), $4 million or 25 per cent higher than the offer accepted. However, the Panel did not quantify bidders' concession proposals in the event the Commonwealth required concessional travel to continue to be provided at existing levels to existing categories of recipients.

Recommendation No.6

5.24 ANAO *recommends* that, in future trade sales, the Office of Asset Sales and IT Outsourcing optimise overall Commonwealth financial returns by developing and applying a tender evaluation strategy that requires a credible assessment of the net financial benefits of <u>all</u> tenders.

DVA response

5.25 DVA ***agreed*** with the recommendation.

OASITO response

5.26 OASITO ***agreed with qualifications*** with the recommendation. OASITO commented that the role of the Commonwealth Sales Team in the evaluation process is to ensure that sufficient information and advice is available to Ministers to enable them to assess the relative merits of bids and determine the relative trade-off Ministers see as appropriate, given the sales objectives, bids and public policy outcomes the Government is seeking. OASITO considers that the appropriate information and advice was provided to Ministers in respect of enabling them to consider the trade-offs in achieving an optimal financial return to the Commonwealth. In evaluating the Australian National tenders against the Government's sales objective of a financial return to the Commonwealth that represents fair and reasonable value, a credible assessment of the financial benefits of all tenders was undertaken. OASITO sees no merit in extending evaluation to issues that are not relevant to the decisions that Ministers need to make, or that do not provide information that differentiates among bids.

ANAO comment

5.27 A credible assessment of the net financial benefits of all Pax Rail tenders was important not only to the immediate sale returns but also to the sale objectives relating to establishing a viable and competitive rail system and divesting the Commonwealth from ongoing responsibility for the operation of rail in Australia. Passenger concessions are also a recognised adjunct to income support arrangements. The tender evaluation was predicated on there being no continuing requirement for concessional travel to be provided at existing levels to existing categories of recipients, a position that has not eventuated. As a result, there was no comprehensive analysis undertaken of each bidder's concession proposals, such as identifying the implications for the Commonwealth's overall financial outcome. ANAO considers that this should be a part of any sale.

Commonwealth financial assistance

5.28 The successful bidder's 25 per cent discount offer did not apply to a number of existing categories of recipients of concessional or free travel, including: blind passengers; and totally and permanently incapacitated (TPI) veterans and their carers. In addition, discount fares to pensioners were to be subject to seat availability. Clauses addressing the provision of concessions were negotiated with the successful bidder by OASITO and its Legal Adviser after the successful bidder had been selected. The negotiated clauses essentially provided a framework by which further negotiation could be undertaken with the purchaser.

5.29 The negotiated clauses were included in the Sale Agreement signed on 28 August 1997 with the Minister for Finance and Administration and the then Minister for Transport and Regional Development announcing[99] at this time that travel concessions would continue for those who currently receive them. As a result, the passenger concession Sale Agreement clauses were amended on 31 October 1997.

5.30 The amended Sale Agreement provides for the continuation of concessional travel for pensioners, blind pensioners and TPI veterans, with some limitations, under a mix of discounts provided by the Pax Rail purchaser and a top-up concession from the Commonwealth.[100] The Pax

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99 Minister for Finance The Hon John Fahey, MP and the then Minister for Transport and Regional Development The Hon John Sharp, MP, *Joint Media Release—Australian National Sale Success*, 28 August 1997.

100 On 17 November 1997, the House of Representatives Standing Committee on Family and Community Affairs tabled a report titled *Concessions—Who Benefits?* The Committee recommended (Recommendation No.26) that current concessions available to pensioner concession card holders and veterans travelling on Australian National passenger services continue to be partially met by the Commonwealth and that a contract be drafted with the Pax Rail purchaser for the ongoing provision of concessional rail travel.

Rail purchaser stated in its tender that it determined its purchase price on the basis that reimbursement from the Commonwealth for concessional travel would be discontinued immediately upon sale completion. However, under the amended Sale Agreement and based on actual pensioner travel numbers, the Pax Rail purchaser will receive a proportion of the $2.5 million per annum allocated for Commonwealth concession reimbursement, compared to the approximately $5 million per annum previously reimbursed to Australian National.[101]

5.31 **Finding:** The Pax Rail purchaser determined its purchase price on the basis that reimbursement from the Commonwealth for concessional travel would be discontinued immediately upon sale completion. The successful bidder offered to continue concessional travel for some, but not all, existing categories of recipients, without Commonwealth reimbursement. Post-sale arrangements were negotiated with the successful bidder after its selection but later had to be amended to ensure concessions would continue to be provided to those who received them before the sale. Depending upon the number of pensioners carried, the purchaser will receive a proportion of the $2.5 million budget allocation from the Commonwealth in concession reimbursement, compared to approximately $5 million per annum reimbursed to Australian National. The purchaser's initial, but not its final, bid had offered to increase the purchase price in the event the Commonwealth committed to continue reimbursement for pensioner concessions.

Gearing levels

5.32 The Government recognised Australian National's rail operations had been restricted by corporate overheads and the burden of debt.[102] The Government considered this arrangement unsustainable and decided to sell Australian National unencumbered by debt or lease liabilities.[103]

5.33 Some bidders proposed to fully fund the acquisition, working capital requirements and future capital expenditure through equity

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[101] At the time audit fieldwork was completed, DFACS was leading discussions with the Pax Rail purchaser aimed at agreeing an approach to ongoing provision of Commonwealth funded concessional travel. DFACS proposed to enter into a new agreement with the purchaser to provide a clearer definition of terms and requirements and establish an agreed, simple reimbursement formulae between the Commonwealth and the purchaser allowing for appropriate audit and accountability requirements.

[102] The advantage of equity funding to businesses experiencing financial difficulties is that there is a reduced call on the cash flows of the business to finance operations. Equity providers also expect a return on their investment, but this return varies with cash flow variations whereas debt providers often require a fixed return.

[103] *Australian National Railways Commission Sale Act 1997*, 2nd Reading Speech, House of Representatives, 14 May 1997.

contributions from the members of their consortium. However, a number of the tenders involved highly geared financing structures, with a debt to equity ratio as high as 8.26 : 1.[104]

5.34 The purchasers had very different financing structures: the Tasrail purchaser was fully funded by equity; the SA Rail purchaser's debt to equity ratio was 1.95 : 1; and the Pax Rail purchaser's debt to equity ratio was 8.26 : 1. While data on the equity contributions and debt financing for each bidder was included in the Panel's evaluation report, the report did not analyse the likely effect of bidders' different gearing levels on the prospective financial viability of the businesses.[105] For example, whilst the purchaser of Pax Rail funded its offer of $16 million largely with debt, the other final bidder for Pax Rail offered a purchase price of $25 million fully funded by equity. DoTRS, which was represented on the Tender Evaluation Panel, advised ANAO that while it was *not aware of a detailed assessment of the impact of different gearing levels,* [it] *did express concern about high gearing levels particularly if these levels were based upon expensive borrowing sources.*

5.35 Deutsche Morgan Grenfell advised ANAO that:

> *The proportion of acquisition funding provided by way of debt and equity was reviewed. In particular, Great Southern Railway's financing structure was discussed with OASITO and certain aspects of it were set out in a fax dated 22 August 1997 which was sent to OASITO. …Great Southern Railway Passenger Ltd's financing structure included debt, equity and quasi-equity instruments (equity, Rail Notes, subordinated debt and senior debt). The following points should be noted:*
>
> - *Great Southern Railway Passenger's senior debt and subordinated debt was fully underwritten by Great Southern Railway Passenger shareholders. Debt provided by a company's shareholders represents a strong commitment to the business and provides a strong incentive to ensure that the return from the assets is optimised.*
> - *Two of the debt providers were financial institutions. Both these institutions would have required independent credit approval prior to committing to underwrite the debt.*
> - *The Rail Notes and subordinated debt are subordinated to senior lenders and rank above equity only. The subordinated debt was provided by shareholders. Senior lenders generally treat this type of funding as quasi-*

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104 Calculated as the dollar amount of debt for every dollar of equity.

105 The highest geared purchaser included detailed financial forecasts in its tender which predicted 24 per cent of its earnings before interest and tax in the first 5 years would be required to service its debt.

equity for the purposes of analysing debt:equity ratios and therefore more senior debt can be supported.

- *Should the Rail Notes*[106] *(which were unsecured and subordinate to senior debt) and subordinated debt*[107] *be treated as equity rather than debt, the debt to equity ratio was 127 per cent.*

5.36 The need for revised bids for SA Rail and Pax Rail was due, in part, to the need to clarify the financial capacity of bidders to complete the sale. As a result of the decision to seek revised bids, the Pax Rail purchaser's financing structure changed significantly with the senior debt provider named in the initial tender refusing to provide finance and being replaced by more expensive sources of finance. DoTRS advised the then Minister for Transport and Regional Development on 25 August 1997 that OASITO's Business Adviser has *given clear advice that it considers the Great Southern Railway bid to be financially secure, despite the refusal of the* [Senior Debt Provider] *to provide debt finance. While alternative (more expensive) sources of finance have now been secured, this point must warrant some concern, particularly over the medium to longer term.* This tenderer was assessed by the Panel as meeting the Commonwealth's expectation against the financial strength criterion. OASITO advised ANAO that:

> *gearing levels are only one indicator, and it is not always the case that high levels are undesirable. Regard has to be had to the fundamental economic structure of the transaction. The simplistic reporting of gearing levels alone (or even primarily) is not necessarily a helpful guide to the issues at stake—which were the capacity to complete the transaction (of paramount importance in this case) and the likelihood of financial stability in operation (which was arguably of declining importance to the Commonwealth following the sale). In the latter case, a high level of debt within the capital structure, provided it is stable and interest expenses are adequately accommodated, may be more rather than less helpful; debt is a cheaper form of capital than equity, so lowering the hurdle rates of return required for viability; debt interest is tax-deductible in the hands of a commercial entity,*

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106 The bidder's tender stated that: *equity investors in Great Southern Railways will acquire Stapled Securities consisting of debt instruments (Rail Notes) stapled to equity instruments. The issue price of one Stapled Security will be $3.00. The equity component of a $3.00 Stapled Security will be on $1.00 share in Great Southern Railways. The debt component of the $3.00 Stapled Security will be one $2.00 Rail Note.*

107 The subordinated debt comprised subordinated floating interest rate convertible notes. The convertible notes have a term of five years with an interest payable quarterly in arrears at a rate of 10% per annum over the 13 week Commonwealth Treasury note rate. The outstanding amount of principal and interest must be repaid at the end of year five. Available cashflow must be applied to payment of interest on the convertible notes before any payments are made to equity investors or Rail Loan Note holders.

thus increasing its value. The interest of the Commonwealth in the ongoing viability of the businesses was limited by the lack of any obligation on the Commonwealth to act in the event of business failure (compared with the case of the airports privatisations, for example).

5.37 ANAO recognises that there is some risk that conservatively geared bidders could restructure their financing arrangements after the sale. However, bidders' stated plans concerning their future financing structure can provide some assurance about the likelihood of increases in debt levels. For example, the constitution documents of some bidder's precluded further equity injections[108] and some tenders stated the bidder's plan to re-sell the business through a public float and/or trade sale.

5.38 **Finding:** Australian National's debt and lease liabilities were retained by the Commonwealth to improve the future financial viability and competitiveness of the businesses sold. While data on the equity contributions and debt financing for each bidder was included in the Panel's evaluation report, the report did not analyse the likely effect of bidders' different gearing levels on the prospective financial viability of the businesses. The Pax Rail purchaser was highly geared with a debt to equity ratio of 8.26 : 1, whereas the other final bidder for Pax Rail offered a higher purchase price which was fully funded by equity.

Recommendation No.7

5.39 ANAO *recommends* that, in future trade sales which include a sale objective relating to the future financial viability of the business being sold, the Office of Asset Sales and IT Outsourcing include in the tender evaluation report a credible assessment of the prospective financial strength of shortlisted bidders, including explicit consideration of gearing levels and their impact on the prospective financial viability of the businesses being sold.

DVA response

5.40 DVA ***agreed*** with the recommendation.

OASITO response

5.41 OASITO ***agreed*** with qualifications with the recommendation. OASITO commented that it considers that a detailed assessment of the prospective business should only be undertaken where, and to the extent, that it can be done meaningfully, where it enables real differentiation

108 Deutsche Morgan Grenfell advised ANAO that *although the constitution documents may have prevented further equity injections, they did not necessarily prevent re-gearing the business.*

among bidders, or where there is a special Commonwealth interest in the ongoing business. In the case of innovative business plans that necessarily depart radically from a chronic loss-making past (as in this case) no amount of financial modelling is likely to add much value to an assessment that is best based more on the assessed capability of the bidder to execute and/or adapt its plan, rather than on second guessing that plan. As to 'gearing levels', this is simply one partial indicator (sometimes with no implications for financial strength or viability) that is so readily able to be changed commercially after sale that undue focus on it risks being misleading.

5.42 In this case the tender evaluation did consider the equity contributions and debt financing for each bidder. In addition, the ability of bidders to complete the sale was important in order to ensure the quick transfer of the Australian National businesses to private ownership. The prospective financial strength of shortlisted bidders was only one consideration in the evaluation of the contribution of tenders to a viable and competitive rail system and was given appropriate consideration in the evaluation of tenders against this criterion.

ANAO comment

5.43 The sale objectives included contributing to a viable and competitive rail industry and the tender evaluation criteria included the financial strength and capacity of bidders. In these circumstances, ANAO considers there was merit in the tender evaluation report analysing at least the likely effect of bidders' different gearing levels on the prospective financial viability of the businesses.

Canberra ACT
21 December 1998

P. J. Barrettt
Auditor-General

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