

The Auditor-General

Audit Report No.48 1998–99
Performance Audit

Phase 2 of the Sales of the Federal Airports

Australian National Audit Office

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Canberra ACT
21 June 1999

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a general performance audit 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 *Phase 2 of the Sales of the Federal Airports*.

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

AA	Airservices Australia
ABC	Airport Building Controller
ACCC	Australian Competition and Consumer Commission
AEO	Airport Environment Officer
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
BZW	BZW Australia Limited
CASA	Civil Aviation Safety Authority
DoD	Department of Defence
DoFA	Department of Finance and Administration
DoTRS	Department of Transport and Regional Services
EBDIT	Earnings Before Depreciation Interest and Tax
FAC	Federal Airports Corporation
MUIT	Multi-User Integrated Terminal
OASITO	Office of Asset Sales and IT Outsourcing
RAAF	Royal Australian Air Force
RFP	Request for Proposals

Summary and Recommendations

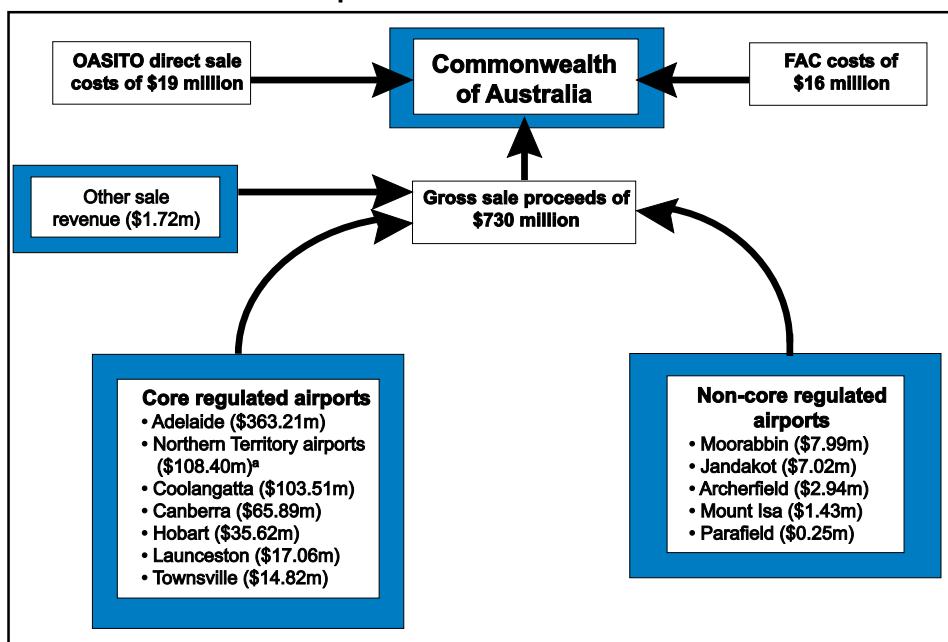
Summary

Background

1. The 1998 sale of 14 airport leases in Phase 2 of the Government's airports privatisation program raised Commonwealth proceeds of \$730 million (see Figure 1), primarily composed of aggregate purchase prices of \$681 million and reimbursed FAC capital expenditure of \$46 million. Phase 2 comprised eight major, or core regulated, airports and seven non-core regulated airports.¹

Figure 1

Phase 2 Sale of Federal Airport Leases



Notes:

^a The Northern Territory airports comprises the core regulated airports at Darwin and Alice Springs as well as Tennant Creek airport, which is a non-core regulated airport.

Source: ANAO analysis

2. The airports privatisation program began in April 1994 when the then Government announced its in-principle decision to sell the 22 airports owned and operated by the Federal Airports Corporation (FAC). The sale of leasehold interests in the FAC Phase 1 airports was completed in

¹ The core regulated airports comprised: Townsville, Canberra, Coolangatta, Adelaide, Hobart, Launceston, Darwin and Alice Springs. The non-core regulated airports comprised: Archerfield, Moorabbin, Essendon, Parafield, Jandakot, Mount Isa and Tennant Creek.

July 1997 with the sale of separate long-term leasehold interests in Brisbane, Melbourne and Perth airports generating gross proceeds of \$3.31 billion. In total, the airports privatisation program has raised to date some \$4.04 billion for the Commonwealth.

3. The Government had a number of specific sales and ongoing privatisation objectives in relation to the Phase 2 airports. The ongoing privatisation objectives addressed diversity of ownership; access by aircraft operators; responsive and effective development of the airport and airport services; and pricing policy at the airports. The sale objectives were to:

- optimise sale proceeds within the context of broader sales and policy objectives;
- ensure that the new airport operators have the necessary financial strength and managerial capabilities to operate and develop the Phase 2 airports;
- minimise the Commonwealth's exposure to residual risks and liabilities associated with the Phase 2 airports;
- ensure fair and equitable treatment of FAC employees, including preservation of accrued entitlements;
- ensure that the airports regulated under the Airports Act meet the Australian ownership requirements of the Airports Act; and
- encourage local participation from the community in which the airport is located, particularly in the case of the airports located outside mainland capital cities.

4. Between 10 and 30 June 1998, 50 year leases (with the option of a further 49 years) were granted under the *Airports (Transitional) Act 1996* over 14 of the Phase 2 airports to nine different consortia, raising \$730 million for the Commonwealth. The only airports that remain under Commonwealth stewardship are the four Sydney basin airports (Sydney, Bankstown, Hoxton Park and Camden) and Essendon airport. Essendon was included in Phase 2 but was withdrawn from sale in April 1998 because it was concluded that the tenders submitted for this airport did not adequately address the Government's sales and ongoing privatisation objectives.

5. Overall responsibility for the sale process was assigned to the Office of Asset Sales and IT Outsourcing (OASITO). Project management was outsourced by OASITO to a Business Adviser, BZW Australia Limited², and OASITO appointed the Office of the Australian Government

² On 1 April 1998, ABN AMRO Australia Limited completed the purchase of the Australian and New Zealand operations of Barclays Plc.

Solicitor (AGS) as its Legal Adviser. The Department of Transport and Regional Services (DoTRS) participated in the tender evaluation process. The Department also developed and will oversight the regulatory regime for the Phase 2 airports.

Audit approach

6. ANAO's objectives for the audit were to review the efficiency and effectiveness of the conduct of the Phase 2 airports sales process with regard to the extent to which the sale objectives were achieved; review the effectiveness of the management of the sale process to ensure the Commonwealth received fair value; determine whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing risk; and identify principles of sound administrative practice to facilitate improved administrative arrangements for future trade sales. The audit also examined steps taken to address the Government's ongoing privatisation objectives for the sale.

7. An aspect of ANAO's approach to auditing the sale of the leasehold interests in the Phase 2 Federal airports was to examine action taken in response to ANAO recommendations made in Audit Report No. 38, *Sale of Brisbane, Melbourne and Perth Airports*, which examined the Phase 1 sale of Federal airport leases. The ANAO made 11 recommendations³ in the 1998 report, all of which were agreed or agreed with qualification by the relevant agencies with the exception of part of a recommendation concerning capping of sub-contractor fees and expenses with which OASITO disagreed.⁴

8. The audit scope extended from the June 1997 decision to sell the Phase 2 airports through the negotiation of the final sale agreements and leases to the completion of the sales. The approach taken was to review data relating to the sales held by OASITO and its advisers, the Civil Aviation Safety Authority (CASA), the Australian Competition and Consumer Commission (ACCC), and DoTRS. In addition, key stakeholders including State Governments, Airservices Australia, and a selection of bidders (both successful and unsuccessful) were consulted. ANAO's fieldwork and consultations were undertaken between July 1998 and March 1999.

³ The 11 recommendations made in the 1998 report together with abbreviated agency responses are set out at Appendix 1.

⁴ Part (b) Recommendation No. 4, Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*.

Audit conclusion

9. The sale of leases for 14 Phase 2 Federal airports was completed by 30 June 1998, in accordance with the Government's timetable. This represented a significant achievement given that, with 15 individual trade sale processes run concurrently on a coordinated basis, it constituted the largest completed airport trade sales program in the world to date⁵ and achieved the Government's sales objectives.

Sale objectives

10. In terms of the sale objectives, ANAO found the following:

- Optimise sale proceeds objective: The simultaneous trade sale of 14 of the 15 Phase 2 Federal airports raised Commonwealth proceeds of \$730 million, bringing total proceeds to date from the airports privatisation program to \$4.04 billion. ANAO considers that the Phase 2 sale aggregate proceeds represent fair value for the Commonwealth. Although there was only limited bidding interest for the non-core regulated airports with very few tenders lodged for these airports, at least two bids were received for each airport and only Essendon airport was not sold. The Phase 2 proceeds compare favourably with current market values of previously privatised major European airports, the value multiples achieved in Phase 1 of the airports privatisation program and the Business Adviser's Phase 2 proceeds estimates. In addition, the aggregate purchase prices for the 14 airport leases compares favourably to the book value of the assets transferred to the airport lessees.

The total direct sale costs to the Commonwealth are estimated to be \$35.4 million, or 4.8 per cent of gross proceeds. This compares to \$153 million or 4.6 per cent of gross proceeds for the Phase 1 sales. The Phase 1 costs included \$94.4 million in ex gratia payments to State governments in lieu of stamp duty on the airport leases (bidders were required to be responsible for stamp duty payments in Phase 2). For comparative purposes, excluding these costs, the Phase 1 costs were \$39.1 million, or 1.2 per cent of gross proceeds. Excluding costs associated with the closure of the Federal Airports Corporation, total OASITO costs for the Phase 2 sale were \$18.7 million or 2.6 per cent of gross proceeds. It should also be recognised that Phase 2 included 15 airports as opposed to three airports included in Phase 1.

- Financial strength/management capability objective: To assess financial capability and commitment to operate and develop the airports,

⁵ OASITO advice to ANAO 22 April 1999.

detailed assessments were undertaken of each bidder's acquisition funding and financial projections for the operation of the airport. The analysis included comparisons with objective benchmarks and sensitivity analysis of the projections. The Tender Evaluation Committee concluded that the management quality of the successful bidders for the regular public transport airports⁶ was high. This was because of the retention of former FAC employees supplemented by expertise from various domestic and international airport operators. Management quality of the general aviation airports was considered by the Tender Evaluation Committee to be of an appropriate standard, given the role of these airports.

- *Risk minimisation objective:* The tender approach for the Phase 2 sales process addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability to the Commonwealth was assessed as part of the tender evaluation process. Overall, it was concluded that the successful tenders involved minimal residual sales risk for the Commonwealth. Remaining post-sale liability issues were addressed with each bidder prior to execution of the Sale Agreements. Joint User Deeds were executed between the Department of Defence and the purchasers of Townsville and Darwin which are aimed at protecting the Commonwealth's interest as well as providing a platform for the new operators to develop and manage successful commercial operations at the airport sites. The Department of Defence has not retained ownership of the base at Fairbairn but entered into a five year sublease. The sub-lease is designed to facilitate the gradual cessation of Royal Australian Air Force operations at the Fairbairn site.
- *Fair and equitable treatment of FAC employees objective:* OASITO effectively addressed the fair and equitable treatment of FAC employees at the sale airports including preservation of their accrued entitlements. Employee terms and conditions have been preserved for a minimum 12 month period following completion of the sales.
- *Airports Act Australian ownership requirements objective:* The Tender Evaluation Committee considered all elements of each of the individual bids and possible permutations of the combination bids, looking not only at direct ownership, but also extending their review to the possible influence which might be exerted on each of the bidders by

⁶ Comprises the core regulated airports plus Tennant Creek and Mount Isa.

related parties, such as those with management contracts. The bid evaluation reports contain discussion on each of the bids including any elements of concern in relation to foreign ownership. There were a number of issues that were referred to DoTRS for policy consideration. The Tender Evaluation Committee agreed to rely on the expertise of DoTRS to make determinations in relation to these issues. All the successful bidders were assessed as adequately addressing the foreign ownership requirements under the *Airports Act 1996*.

- *Local participation objective*: The Tender Evaluation Committee considered the amount of locally contributed equity associated with each bid; the level of local board and management representation; and the level of local consultation. All successful bidders were assessed by the Tender Evaluation Committee as incorporating a reasonable level of local participation.

Ongoing privatisation objectives

11. ANAO found that the Government's ongoing privatisation objectives for the Phase 2 sale were satisfactorily addressed as follows:

- *Diversity of ownership objective*: Diversity of ownership was achieved with nine different consortia acquiring leases for 14 Phase 2 airports. Two of these consortia had been successful in the Phase 1 sales: the purchaser of Melbourne Airport acquired Launceston; and the purchaser of Perth Airport acquired the Northern Territory airports.⁷ In addition to ownership diversity, all bids received for the Phase 2 airports were consistent with the Government's policy of cross-ownership restrictions between Brisbane and Coolangatta; Hobart and Launceston; and Melbourne and Adelaide.
- *Access by aircraft operators objective*: The objective of ensuring airport access on reasonable commercial terms to aircraft owners was addressed by insertion into the leases of core-regulated airports of a requirement that the lessee provide for access to the airport by intrastate, interstate and international air transport. Lessees of the non-core regulated airports are required to provide for access to the airport by intrastate and interstate air transport.
- *Responsive and effective development objective*: DoTRS is undertaking the development of appropriate administrative procedures to monitor the ongoing development of the leased Federal airports, including

⁷ A member of the consortia that acquired Perth airport and the Northern Territory airports was also involved in the consortia that acquired Hobart Airport.

guidance for itself and operators to inform assessments as to whether the airports are being developed to the required standard. The Department has also instituted annual meetings with each of the lessees to assist it to monitor compliance with the Airports Act and the Airport Leases, including development expenditure the lessees have committed themselves to (in the case of core-regulated airports) or planned (in the case of non core regulated airports) over the initial ten years of their lease.

- Pricing policy objective: The Australian Consumer and Competition Commission has effectively implemented the post sale economic regulation framework which applies to the core regulated airports. Scope exists under the current arrangements for the detail of the framework to be adjusted in light of experience and the Commission is to undertake a review of pricing oversight arrangements as a basis for recommending to the Government the arrangements to operate after the first five years.

Tender process

12. A staged tender approach was adopted for the sale of the 15 Phase 2 airports, closely modelled on that used for the leasehold sale of Brisbane, Melbourne and Perth Airports but extended to cater for the greater scope for multiple and combined bids. A total of 24 individual and 34 combination bids were received for the Phase 2 airports. The tender process was completed by the target date of 30 June 1998 with sale agreements signed and leases executed for 14 of the Phase 2 airports. The only airport not sold was Essendon Airport, which was withdrawn from sale because it was concluded that neither of the two tenders submitted for the airport adequately addressed the Government's sales and ongoing privatisation objectives.

13. The tender evaluation process was planned and conducted to provide a clear and transparent approach to assessing the relative merits of each individual and combination bid in order to identify the best overall result for the Commonwealth. Consistent with ANAO recommendations made following the performance audit of the Phase 1 sales, OASITO established a Tender Evaluation Committee for the Phase 2 sales and assigned priorities for evaluation criteria.

14. The Tender Evaluation Committee assessed the net sale proceeds offered by each bid with the successful bids maximising Commonwealth sales proceeds. A feature of the Phase 2 tender process was the large number of combination bids. The Committee compared combination and individual bids to assess which approach would achieve maximum return for the Commonwealth. Combination bids that offered a premium over

the highest stand-alone bids were successful for Adelaide, Parafield and Coolangatta; Townsville and Mount Isa; and the Northern Territory airports. The highest individual offers were accepted for the remaining airport leases.

Administrative issues

15. Agencies implemented all 11 recommendations made in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. ANAO considers that the improved processes resulting from implementation of the audit's recommendations supported an effective overall outcome for the Phase 2 sales process.

16. ANAO considers that for future Commonwealth trade sales administrative procedures could be strengthened in the following areas:

- *Enforcement of Sale Agreement terms*: An element of the strategy for managing completion risk for the sales of Adelaide and Coolangatta Airports was acceptance of a proposal from the successful bidder that it deposit \$197.4 million in two joint bank accounts with this amount to be paid to the Commonwealth upon completion of the sales. These arrangements (known as Equity Deposits) were proposed by the successful bidder to provide security to the Commonwealth for the payment of the balance of the purchase price in lieu of the parent entity guarantees sought by OASITO and provided by all other purchasers. However, ANAO found that these Equity Deposits were not placed in joint bank accounts as required by the Sale Agreements and that insufficient funds were maintained in the nominated bank accounts to fund the Equity Deposit obligations. ANAO notes that the sales of Adelaide and Coolangatta airports proceeded to completion on time.
- *The written contract*: The Adelaide and Coolangatta Sale Agreements signed on 23 March 1998 provided that interest on the Equity Deposits would be paid to the Commonwealth. In October 1998, ANAO drew to OASITO's attention that the Commonwealth had not received any interest on the Equity Deposits, estimated to amount to some \$1.78 million. OASITO and its Business Adviser advised ANAO in November 1998 that the Sale Agreements were in error and that the Commonwealth had agreed, prior to the execution of the Sale Agreements, that interest on the Equity Deposits was to be retained by the purchaser. AGS advised ANAO that a review of its files indicated that it did not appear to have been specifically advised by either OASITO and/or its Business Adviser, prior to execution of the Sales Agreements, of any agreement reached with the purchaser to amend the Sale Agreements to remove the requirement for interest on the Equity Deposits to be paid to the Commonwealth.

OASITO subsequently advised ANAO in February 1999 that, following an exchange of correspondence with the purchaser, OASITO and the purchaser had agreed to amend the Sale Agreements so that interest on the Equity Deposits is retained by the purchaser.

- *Open and effective competition:* OASITO initially sought to negotiate Phase 2 contracts with the Phase 1 Business Adviser and the one of the two Phase 1 Legal Advisers. However, it was later decided to put out to competitive tender the assignments, consistent with the principle of open and effective competition. In the case of the Legal Adviser role, this decision significantly improved the value for money obtained by OASITO. OASITO had negotiated fees of \$10.5 million with the firm it had directly approached. The successful proposal received from AGS in the competitive tender process involved capped fees of \$3.15 million, \$7.3 million less than those negotiated by OASITO.

The initial negotiations with the incumbent Business Adviser reduced the quantum of fees sought but also reduced the time available for other possible candidates to develop a credible and competitive proposal. A request for proposals was issued on 27 June 1997 to nine firms, requiring a response by 8 July 1997. The incumbent Business Adviser was the only firm to submit a proposal. It sought fees capped at \$12.2 million for the period up to 30 June 1998. OASITO paid the Business Adviser a total fee of \$11.72 million, the fee being less because Essendon airport was not sold.

- *Value for money in outsourced project management:* With OASITO's consent, the Business Adviser entered into 14 sub-contracts with an aggregate contract value of \$3.28 million. As part of its project management responsibilities for these sub-contracts, the Business Adviser was required to efficiently and effectively administer payments to the sub-contractors and seek reimbursement of its costs from OASITO. In its administration of the reimbursement, OASITO initially declined to reimburse \$209 134 already paid by the Business Adviser to sub-contractors because of deficiencies in the supporting documentation submitted by the Business Adviser. The Business Adviser was paid its full project management fee, in accordance with the contract, before all of the issues had been resolved relating to the reimbursement of expenses. OASITO's investigations were concluded in December 1998 and it agreed to reimburse all but \$11 632 of the amounts that were initially withheld. ANAO considers that the cost-effectiveness of future project management contracts could be enhanced by linking a component of the project management fee to the project

manager's performance in administering sub-contractor payments and properly rendering the documentation for the reimbursement of sub-contractor fees by the Commonwealth.

Recommendations

Set out below are the ANAO's recommendations with OASITO's abbreviated responses. More detailed responses are shown in the body of the report together with the findings. The ANAO considers that OASITO should give priority to Recommendations 2 and 3.

Recommendation No.1
Para. 2.27 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance open and effective competition for advisory roles in future asset sales by developing tender strategies that, subject to the Government's sale timing objectives, ensure that potential advisers have sufficient opportunity to develop credible and competitive proposals to maximise the likelihood of a successful outcome.

OASITO: Agreed with qualification

Recommendation No.2
Para. 2.42 ANAO *recommends* that, in future asset sales, the Office of Asset Sales and IT Outsourcing consider including appropriate financial incentives within the project management contract to assist in ensuring that its project managers:

- a) implement internal control systems that enable them to establish that the sub-contractor has delivered the contracted services and/or products to the required standard in a timely and responsive manner; and
- b) adopt an appropriate risk based approach to examining sub-contractor invoices to ensure they are correct as to amount, including verifying that the correct rates and calculations have been applied.

OASITO: Agreed with qualification

Recommendation No.3
Para. 3.41 ANAO *recommends* that, as part of a systematic risk management framework for future trade sales, the Office of Asset Sales and IT Outsourcing ensure appropriate systems are in place to fully identify and properly administer the Commonwealth's rights and obligations under the sale documentation, within the identified risk regime.

OASITO: Agreed with qualification

Recommendation No.4
Para. 3.53 ANAO *recommends* that for future trade sales, the Office of Asset Sales and IT Outsourcing:

- a) require written advice from its business adviser on the financial and commercial merits of bidders' proposals for material amendment to the Commonwealth's preferred terms of sale; and
- b) protect the Commonwealth's legal position in future sale contracts by taking steps to ensure that the written contract constitutes the entire agreement between the parties, thereby reducing the risk of contractual uncertainties which may effect the validity and enforceability of the contract.

OASITO: Agreed with qualification

Audit Findings and Conclusions

1. Introduction

This chapter outlines the background to the 1998 sale of leasehold interests in 14 Federal airports, the sale objectives, audit approach and report outline.

Background

1.1. On 12 June 1997, the Government announced the commencement of Phase 2 of the Commonwealth's airports privatisation program. The airports privatisation program began in April 1994 when the then Government announced its in-principle decision to sell the 22 airports owned and operated by the Federal Airports Corporation (FAC). The sale of leasehold interests in the FAC Phase 1 airports was completed on 1 July 1997 with the sale of separate long-term leases over Brisbane, Melbourne and Perth airports.⁸ Phase 2 comprised eight major, or core regulated, airports and seven non-core regulated airports (see Figure 1.1).⁹

1.2. In 1996–97, the Phase 2 airports handled traffic of 11.5 million passengers, 1.9 million aircraft movements and 5.2 million tonnes of freight.¹⁰ Total revenue for the year was \$82 million, earnings before depreciation, interest and tax (EBDIT) totalled \$43.6 million and net assets were valued at \$447 million.¹¹ Commercial advice provided to the Commonwealth in May 1997 was that the Phase 2 airports were significantly less valuable assets than the Phase 1 airports. The Phase 1 airports were more attractive assets because of their relative size and strategic importance. They also all benefited from substantial investment in upgrading and modernisation prior to privatisation. In addition, the Phase 1 airports offered a substantial and growing base of international passengers, this group of passengers offering the greatest commercial profit potential.

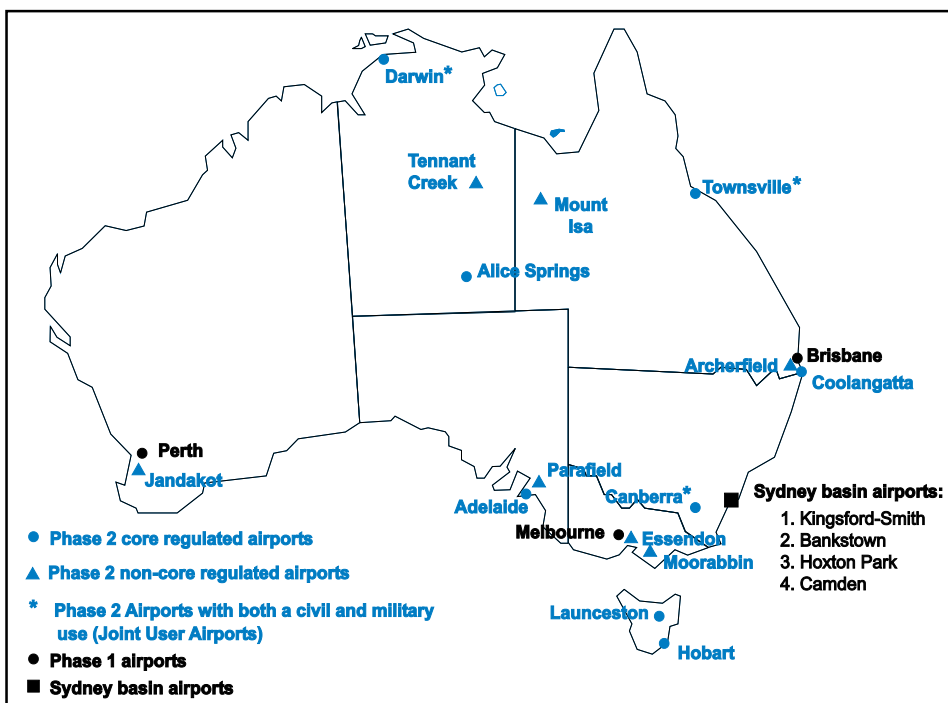
⁸ These sales are reported on in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. Phase 1 initially comprised Sydney and the proposed Sydney-West, Melbourne, Brisbane and Perth. Sydney Airport and the proposed Sydney West Airport were removed following the March 1996 Federal election. Adelaide was included in Phase 1 for a time but later removed to allow time for resolution of issues related to the extension of the runway.

⁹ The *Airports Act 1996* established the regulatory regime for the major Federal airports, defined in the Act as core-regulated airports. The Airports Act also allows for the regulatory regime, or parts of it, to apply to the non-core regulated airports. Key provisions in the Airports Act include: a Commonwealth-owned airport can only be leased to an airport lessee company whose sole business will be to run the airport; foreign ownership, airline ownership and cross ownership restrictions; the requirement for an airport master plan, major development plans, and environment strategies; quality of service monitoring and reporting; access regimes; and the ability for the Minister for Transport and Regional Services to formulate demand management schemes at the airports. The Act also sets out a number of requirements in relation to the content of airport leases.

¹⁰ FAC 1997 Annual Report, pp. 58–59.

¹¹ November 1997 Phase 2 Information Memoranda provided to shortlisted bidders.

Figure 1.1
The airports privatisation program



Source: ANAO analysis.

Commonwealth sale objectives

1.3. The Government had a number of specific sales and ongoing privatisation objectives in relation to the Phase 2 airports.¹² The ongoing privatisation objectives addressed: diversity of ownership; access by aircraft operators; responsive and effective development of the airport and airport services; and pricing policy at the airports. The sale objectives were to:

- optimise sale proceeds within the context of broader sales and policy objectives;
- ensure that the new airport operators have the necessary financial strength and managerial capabilities to operate and develop the Phase 2 airports;
- minimise the Commonwealth's exposure to residual risks and liabilities associated with the Phase 2 airports;
- ensure fair and equitable treatment of FAC employees, including preservation of accrued entitlements;

¹² These objectives were included in the October 1997 Invitation to Register an Expression of Interest and the November 1997 Request for Proposals issued to shortlisted bidders.

- ensure that the airports regulated under the Airports Act meet the Australian ownership requirements of the Airports Act;¹³ and
- encourage local participation from the community in which the airport is located, particularly in the case of the airports located outside mainland capital cities.¹⁴

1.4. The sale process was oversighted by the Office of Asset Sales and IT Outsourcing (OASITO). Project management was outsourced by OASITO to a Business Adviser, BZW Australia Limited¹⁵. OASITO appointed the Office of the Australian Government Solicitor (AGS) as its Legal Adviser for the sale. The Department of Transport and Regional Services (DoTRS)¹⁶ participated in the tender evaluation process. The Department also developed and will oversight the regulatory regime for the Phase 2 airports.

1.5. The Government announced that it was prepared to sell the non-core regulated airports included in Phase 2 on a freehold rather than leasehold basis¹⁷, subject to ensuring that they would continue to be operated as airports. However, DoTRS established that not all of the relevant State, Territory and local governments would be in a position to provide the necessary legislative and policy support required for freehold sale of these airports within the required time-frame. In this circumstance, the Government decided to proceed with a leasehold sale of all the Phase 2 airports. Accordingly, DoTRS developed an approach to regulating the non-core regulated airports under the leasehold framework of the Airports Act.¹⁸

¹³ This objective was modified from the Phase 1 sale objective, established prior to the passage of the *Airports Act 1996*, which was to *ensure that the Phase 1 airports remained majority Australian owned and controlled*.

¹⁴ This objective was included in Phase 2 to recognise the more local airports compared to Phase 1.

¹⁵ ABN AMRO Australia Limited announced on 22 December 1997 that it had signed a sale agreement to purchase the Australian and New Zealand operations of BZW from Barclays Plc. The sale was completed on 1 April 1998.

¹⁶ The Department of Transport and Regional Development (DoTRD) at the time of the sale. With effect from 21 October 1998, DoTRD became the Department of Transport and Regional Services (DoTRS), and is referred to in this report by its current name and acronym.

¹⁷ The non-core regulated airports occupied some 2 670 hectares of the 8 574 hectares of land occupied by all Phase 2 airports.

¹⁸ The regulatory approach adopted for the different airports in Phase 2 varies in recognition of the range of airports involved. The core regulated airports are subject to the full range of regulation under the *Airports Act 1996* including: land use, planning and building; environmental management; financial and other reporting obligations; quality of service monitoring by the ACCC; and regulation of on-airport activities including retail trading and the sale of alcohol. In contrast, Tennant Creek and Mount Isa airports are subject to those parts of the Airports Act relating to leasing but are not subject to the economic regulation regime or the land use, planning, building and environmental management aspects. Rather they are to subject State/Territory planning and environmental laws.

Figure 1.2**Phase 2 Federal Airport Sale Proceeds as at August 1998**

Airport	Lessee	Proceeds (\$m)
Adelaide, Parafield & Coolangatta ^a	Adelaide Airport Ltd, Parafield Airport Ltd & Queensland Airports Ltd	466.96
Darwin, Alice Springs & Tennant Creek ^a	Darwin International Airport Pty Ltd, Alice Springs Airport Pty Ltd & Tennant Creek Airport Pty Ltd	108.40
Canberra	Canberra International Airport Pty Ltd	65.89
Hobart	Hobart International Airport Pty Ltd	35.62
Launceston	Australian Pacific Airports (Launceston) Pty Ltd	17.06
Townsville & Mount Isa ^a	Australian Airports (Townsville) Pty Ltd & Australian Airports (Mount Isa) Pty Ltd	16.25
Moorabbin	Moorabbin Airport Corporation Pty Ltd	7.99
Jandakot	Jandakot Airport Holdings Pty Ltd	7.02
Archerfield	Archerfield Airport Corporation Pty Ltd	2.93
		728.12 ^b
Other sale revenue ^c		1.72
Sale proceeds		729.84
Notes:		
^a Combination bids were accepted for these airport combinations, although the Airports Act requires a separate airport lessee company to be established for each airport. Combination bids involve submitting an offer for two or more businesses on a combined basis. They often involve a price premium over individual offers.		
^b Comprises: the purchase prices paid for the grant of the airport lease and transfer of the relevant FAC assets, contractual rights and obligations, liabilities and employees (\$680.66 million); reimbursement to the Commonwealth for designated capital expenditure made by the FAC at the airports in the period between 1 July 1997 and three days prior to sale completion (\$46.46 million); and adjustments to the purchase prices to reflect movements, above set thresholds, in a sub-set of balance sheet items between 30 June 1997 and one day prior to sale completion (\$995 000).		
^c Comprises initial payments to DoTRS for the Airport Environmental Officers (\$685 000) and Airport Building Controllers (\$389 750); interest on purchase price deposits (\$629 970) and revenue from the sale of marketing materials to potential bidders (\$17 010).		

Source: ANAO analysis of information from DoTRS, OASITO and OASITO's Business and Legal Advisers.

1.6. Between 10 June 1998 and 30 June 1998, long-term¹⁹ leases were granted under the *Airports (Transitional) Act 1996*²⁰ over 14 of the Phase 2 airports. The leases were granted to nine different consortia (see Figure 1.2) raising proceeds of \$730 million for the Commonwealth. The only airports that remain under Commonwealth stewardship are the four Sydney basin airports (Sydney Kingsford-Smith, Bankstown, Hoxton Park and Camden) and Essendon airport. Essendon was included in Phase 2 but was withdrawn from sale in April 1998 because it was concluded that the tenders submitted for this airport did not adequately address the Government's sales and ongoing privatisation objectives.

Audit approach

1.7. ANAO's objectives for the audit were to:

- review the efficiency and effectiveness of the conduct of the Phase 2 airports sales process with regard to the extent to which the sale objectives were achieved;
- review the effectiveness of the management of the sale process to ensure the Commonwealth received fair value²¹;
- determine whether the sale arrangements adequately protected the Commonwealth's interests, including minimising ongoing risk; and
- identify principles of sound administration practice to facilitate improved administrative arrangements for future trade sales.²²

1.8. The audit also examined steps taken to address the Government's ongoing privatisation objectives for the sale. In addition, the audit reviewed action taken in response to the 11 ANAO recommendations made in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, which examined the Phase 1 sale of Federal airport leases.

¹⁹ The leases are for an initial term of 50 years with the option of a further 49 years.

²⁰ This Act was developed during the Phase 1 sale process and provides for the leasing of certain Federal airports. It allows for the reversion of the land and operating assets and liabilities (other than debt) of the Federal airports in the Commonwealth; a flexible disposal strategy for the airports; protection of the rights of existing FAC staff who wish to remain employed at the airports; and the assumption or repayment of the FAC's debt.

²¹ Fair Value is defined in Statement of Accounting Standard AAS21 *Accounting for the Acquisition of Assets (including Business Entities)* as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. In Commonwealth trade sales, fair value can be achieved through an open, competitive tender process that enables a market value for the assets or business to be established.

²² The audit criteria considered the achievement of the sale objectives; the management of the sale, including sale planning and preparation, sale coordination, contracting and contract management, and the tender process; and the Commonwealth's exposure as a result of the sale documentation, and indemnities.

1.9. The audit scope extended from the June 1997 decision to sell the Phase 2 airports, to the negotiation of the final sale agreements and leases, and completion of the sales. The approach taken was to review data relating to the sales held by OASITO and its advisers, the Civil Aviation Safety Authority (CASA), the Australian Competition and Consumer Commission (ACCC), and DoTRS. In addition, ANAO consulted key stakeholders including State Governments, Airservices Australia (AA), and a selection of bidders, both successful and unsuccessful. ANAO undertook fieldwork and consultations between July 1998 and March 1999.

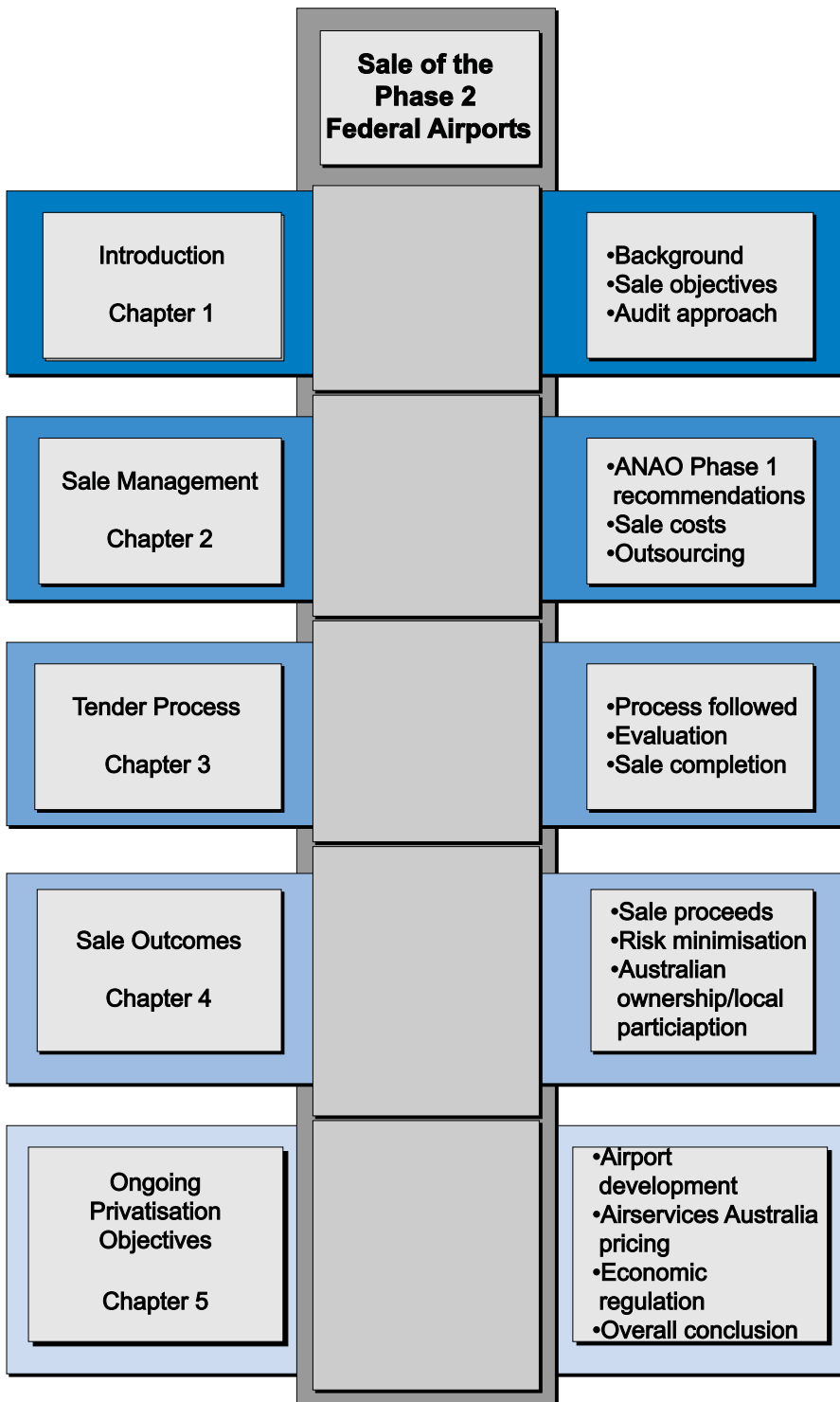
1.10. ANAO engaged Deacons Graham & James to provide legal advice in relation to the rights of the vendor under the Request for Proposals issued to shortlisted bidders in November 1997.

1.11. The audit was conducted in accordance with ANAO Auditing Standards. The cost of the audit to the ANAO at the time of tabling of this report was \$295 000.

Report outline

1.12. Figure 1.3 sets out the scope of the audit report and its structure. The second chapter of the report discusses sale management including the implementation of ANAO's recommendations in the 1998 report; sale costs; issues relating to the appointment of the legal and business advisers for the sale; and outsourced project management. Chapter 3 reviews the tender process, evaluation methodology and completion of the sales and Chapter 4 discusses the major outcomes from the sale. The final chapter outlines the steps taken to address the Government's ongoing privatisation objectives for the Phase 2 sale.

Figure 1.3
Report Scope and Structure



2. Sale Management

This chapter discusses implementation of ANAO recommendations arising from the 1997–98 audit of the sale of Brisbane, Melbourne and Perth airports and the consequent improvements in the management of the sale process for the Phase 2 sale; the cost of the sale; and opportunities for further improvements in the management of future Commonwealth asset sales.

Implementation of ANAO recommendations

2.1. An aspect of ANAO’s approach to auditing the sale of the leasehold interests in the Phase 2 Federal airports was to examine action taken in response to the 11 ANAO recommendations made in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. Appendix 1 to this report contains the full text of the 11 recommendations made in the 1998 report, together with abbreviated agency responses.²³

2.2. The ANAO recommendations made in the 1997–1998 audit²⁴ related to potential improvements in administrative procedures for future airport trade sales in the following areas:

- **Bidder facilitation**: Documents needed for bidder due diligence should be available in a manner which does not exacerbate the costs and time pressures incurred by bidders;
- **Tender documentation**: Although security procedures were in place during the bid evaluation process, improvements could be made to procedures for the receipt, opening, registering, handling and filing of offer documents.
- **Sale documentation**: The leases for the Phase 1 airports will be in operation for up to 99 years; the tripartite deeds could be operative for up to twenty years; and the sales agreements for at least ten years. To manage the Commonwealth’s ongoing risks under the sale documentation, it is important that arrangements be made for the ongoing storage and safe custody of these important legal documents.

²³ The Parliamentary Joint Committee on Public Accounts and Audit (JCPAA) reviewed Audit Report No.38 in its third quarter 1997–98 review of Auditor-General Reports. The Committee conducted a public hearing and its report is included in JCPAA Report 367, March 1999. The JCPAA reported that it supported the general direction taken by the ANAO audit, and endorsed the recommendations that it has made to ensure that, in future, Government sales processes are followed and improvements are made in the management of sales. See JCPAA Report 367, March 1999 p.63.

²⁴ ANAO commenced providing agencies with draft findings and recommendations in relation of the audit of the Phase 1 sale of Federal airport leases in September 1997.

- *Commonwealth Procurement Guidelines*: To ensure value for money and open and effective competition when contracting for services in future asset sales, advisers who are authorised to let contracts on behalf of the Commonwealth should be required to comply with the Commonwealth Procurement Guidelines.
- *Tender evaluation committees*: The establishment of a formal tender evaluation committee comprising OASITO, relevant portfolio departments, major advisers and, possibly, independent members would assist in ensuring transparency and accountability in future trade sales. It may also lead to administrative savings by enhancing coordination and consolidation of the evaluation process including production of reports for Ministers.

2.3. Agencies agreed or agreed with qualification to all of the 11 recommendations made in the 1997–1998 audit report except for part of a recommendation concerning capping of contracts with which OASITO disagreed (part (b) Recommendation No. 4). Figure 2.1 sets out in summary the action taken by agencies in implementing these recommendations.

Figure 2.1

Phase 2 Response to Phase 1 ANAO Audit Report Recommendations

<i>Recommendation</i>	<i>Implemented?</i>	<i>ANAO Comment</i>
1. More flexible data access arrangements for potential buyers.	Yes	Most bidder due diligence information was provided electronically except where it was not practical, cost effective or did not represent a timely distribution of information.
2. Procedures for receipt, opening, registering, handling and filing of offer documents .	Yes	Appropriate procedures were developed and implemented. Originals of all bids have been retained by the Commonwealth.
3. Improved planning for major contracts ; competitively tendering contracts wherever possible; and including performance monitoring arrangements in contracts.	Yes	All consultancy contracts were identified early in the Phase 2 sales process and competitively tendered. A timetable was put in place highlighting key output milestones and contractors were kept to this timetable.
4. Enhanced sub-contracting arrangements to require compliance with Procurement Guidelines and improved management of the commercial risk of cost overruns.	Yes	Commonwealth Procurement Guidelines were complied with for all contracts let by the Business Adviser and OASITO monitored the Business Adviser's tendering processes in this regard. Contracts let by the Business Adviser were, wherever possible, fixed price contracts. There were no sub-contract cost overruns.

<i>Recommendation</i>	<i>Implemented?</i>	<i>ANAO Comment</i>
5. Early engagement of logistics consultants to allow formal, written contracts to be signed; appropriate planning; and efficient and effective management of sale costs.	Yes	The Business Adviser prepared the transaction timetable and was responsible for process logistics. The timetable was adhered to and even accelerated in places. Contracts were signed in all instances and sub-contractors delivered on-time and within budget.
6. Developing appropriate priorities which set out the relative importance of the evaluation criteria .	Yes	After satisfying certain mandatory criteria, priority was attached to maximising net sales proceeds on a risk adjusted basis whilst achieving optimal outcomes in relation to the other criteria.
7. Considering structures such as a tender evaluation committee to enhance transparency and accountability.	Yes	A Tender Evaluation Committee was established to settle the evaluation methodology; monitor and supervise the evaluation process; and make recommendations on the selection or rejection of bidders. OASITO chaired the Committee with two representatives from each of OASITO, DoTRS, the Business Adviser and Legal Adviser.
8. Development of a comprehensive framework and procedures to monitor and ensure lessee compliance with the Airport Leases.	Yes	DoTRS has identified all compliance areas and has established annual lease review meetings with each of the Airport Lessee Company's where they will be required to report on their compliance. Other less significant areas of lessee compliance are to be monitored through correspondence with the Airport Lessee Company's.
9. Effective arrangements for the ongoing storage and safe custody of original signed sale documentation .	Yes	Copies of the Phase 2 sale documentation were placed in the records of OASITO and DoTRS. The originals of the signed sale documentation for Phases 1 and 2 will be retained by AGS for safe custody within the Commonwealth.
10. Comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the Airports Act and Airport Leases.	Yes	DoTRS has identified all areas requiring monitoring under the Airports Act and the airport leases. Annual review meetings have been established with each of the Airport Lessee Company's.
11. Adequate disclosure to bidders of all costs connected with the purchase of Commonwealth assets.	Yes	Full disclosure was provided to bidders although the exact amount of increases in Airservices Australia charges were only finalised and able to be made available after the sale agreements had been signed and deposits taken. However, indicative increases, as a result of location specific pricing, were advised to bidders.

Source: *Transaction Summary Report for Phase 2—Report to the Office of Asset Sales & Information Technology, ABN AMRO, 27 July 1998 and ANAO analysis of information provided by OASITO, DoTRS, the Business Adviser and the Legal Adviser.*

2.4. Finding: Agencies implemented all 11 recommendations made in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. ANAO considers that the improved processes resulting from implementation of the audit's recommendations supported an effective overall outcome for the Phase 2 sales process.

Sale costs

2.5. ANAO estimates that the direct sale costs for Phase 2 were \$35.4 million, or 4.8 per cent of gross proceeds (see Figure 2.2). This compares with \$153 million or 4.6 per cent of gross proceeds for the Phase 1 sales. The Phase 1 costs included \$94.4 million in ex gratia payments to State governments in lieu of stamp duty on the airport leases. In Phase 2, bidders were responsible for stamp duty payments. For comparative purposes, excluding the cost of the ex gratia payments to the State governments, the Phase 1 costs were \$39.1 million, or 1.2 per cent of gross proceeds.

2.6. Excluding costs associated with the closure of the Federal Airports Corporation, total OASITO costs for the sale were \$18.7 million or 2.6 per cent of gross proceeds. It should also be recognised that Phase 2 included 15 airports as opposed to three airports included in Phase 1.

2.7. Compared to the Phase 1 sale, costs were significantly reduced in Phase 2 for two items, the Legal Adviser contract (a reduction of \$7.0 million or 69 per cent) and the design, typesetting and printing of the tender and marketing documentation (a reduction of \$570 000 or 58 per cent). The absolute value of payments to the Business Adviser also decreased in Phase 2 (by \$4.1 million or 26 per cent). The Business Adviser's Phase 2 contract was for a shorter duration than the Phase 1 contract and it involved the concurrent trade sale of 15 airports while fees in the Phase 1 contract were based on the sale of three airports.

2.8. The major component of the Phase 2 sale costs were payments to OASITO's Business and Legal Advisers. These payments totalled \$14.89 million, or 78 per cent of OASITO's total sale costs. To date, the airports privatisation program has extended over more than four years. The payments to advisers have been significant and involved contracts for the initial scoping study (\$1.46 million); the sale of Brisbane, Melbourne and Perth airports (\$25.96 million); and the Phase 2 sale effort for a further 15 Federal Airports (\$14.89 million).²⁵ In light of this, in order for the Commonwealth to maximise value for money, it was important that

²⁵ The Business Adviser was also contracted by DoTRS in 1997 to undertake the Second Sydney Airport Financial Feasibility Study.

OASITO developed a cost-effective approach for its outsourcing arrangements at each stage of the privatisation program.

Figure 2.2

Phase 2 Federal Airports Sale Costs as at March 1999

	\$ m	\$ m
OASITO		
Business Adviser	11.72	
Legal Adviser	3.17	
Investigating Accountant ^a	1.81	
OASITO Running Costs	0.71	
Advertising, marketing and bidder due diligence	0.65	
Design, typesetting and printing	0.40	
Other	0.51	
Total OASITO Costs		18.97
Federal Airports Corporation		
Due diligence and stand-alone costs	6.20	
Redundancy and corporate closure costs	10.20	
Total Federal Airports Corporation		16.40
Direct Sale Costs		35.37

Source: ANAO analysis of information from OASITO and the Federal Airports Corporation's 1997–98 Annual Report.

Legal Adviser

2.9. OASITO employed two Legal Advisers for the Phase 1 sales process. These were the Office of the Australian Government Solicitor (AGS) and Clayton Utz. Legal Adviser fees paid for the Phase 1 sales process totalled \$9.6 million. AGS received \$6.8 million and Clayton Utz \$2.8 million.

2.10. AGS was initially engaged in August 1995 to advise on Commonwealth interests in the Phase 1 sales process. Following a competitive tender process, in December 1995 AGS was appointed as lead Legal Adviser for the Phase 1 sales. Clayton Utz was sub-contracted by AGS to assist with bidder negotiation, restructuring of the FAC and preparation of sale documentation. AGS and Clayton Utz submitted separate tenders for the Phase 1 Legal Adviser role. The sub-contracting arrangement was proposed by OASITO.

2.11. In December 1996, the agreement with Clayton Utz was renegotiated such that the firm was directly contracted to OASITO from 1 January 1997 to 30 June 1997. Clayton Utz was paid revised fees during this period to reflect the greater resource commitment required by OASITO. AGS' contract was also extended to 30 June 1997 but it was paid reduced fees for services similar to those required under its initial contract.

Phase 2 airport sales contract

2.12. In June 1997, OASITO sought from Clayton Utz a proposal to act as Legal Adviser for the Phase 2 sales.²⁶ OASITO did not seek such a proposal from AGS, the lead Legal Adviser in the Phase 1 sales, for it to act as Legal Adviser for the Phase 2 sales. Four proposals were provided by Clayton Utz to OASITO between 4 June 1997 and 24 June 1997. Clayton Utz's proposed fees were negotiated down from an initial submission of \$12.2 million to \$10.5 million.²⁷ A draft contract with Clayton Utz was prepared on 24 June 1997. However, on 23 June 1997 the Minister for Finance and Administration expressed a view to OASITO that the Phase 2 Business Adviser contract should be competitively tendered. Having regard to the Minister's view, OASITO subsequently decided to competitively tender all Phase 2 adviser contracts.

2.13. On 27 June 1997 OASITO invited 10 firms to submit a proposal, by 8 July 1997, to act as Phase 2 Legal Adviser. The invitations were issued to legal advisers known to OASITO as likely to have Australian and international aviation experience and links. OASITO received proposals from three firms, including AGS and Clayton Utz. The Selection Panel comprised the Chief Executive of OASITO, another senior OASITO officer, a senior officer from DoTRS and two external private sector members nominated by the Minister for Finance and Administration. Following a review of proposals and interviews, each firm was asked to reassess certain elements of their proposals including components relating to the fee structure. The Selection Panel assessed each proposal against the requirements of the invitation letter with particular attention paid to: the level of understanding of the assignment; relevant experience and expertise in the sale of major business enterprises; specific knowledge of the FAC's business, and the airports industry generally; and the quality, depth and commitment of resources available to undertake the task.

2.14. The Selection Panel recommended AGS be appointed as Phase 2 Legal Adviser for a capped fee of \$3.15 million. This capped fee included an allocation of \$250 000 for information technology support for the provision of due diligence information to bidders in an electronic format. Payments were made to AGS in accordance with the contract, comprising fees of \$2.9 million and reimbursed disbursements of \$270 409.

²⁶ Also in June 1997, OASITO sought a proposal from AGS for legal advice between 1 July 1997 and 30 October 1997 in relation to: regulatory and legislative issues; Commonwealth due diligence; the domestic terminal leases; development and management of the confidentiality deed process; and management of any archives agreements required. AGS proposed a fee of \$500 000 for this work.

²⁷ Clayton Utz advised that its pricing would not be different in a competitive tender situation.

2.15. Finding: The decision to competitively tender the Phase 2 Legal Adviser contract significantly improved the value for money obtained by OASITO. OASITO initially proposed to contract one of its Phase 1 Legal Advisers with fees of \$10.5 million negotiated. However, on 23 June 1997, the Minister for Finance and Administration expressed a view to OASITO that the Phase 2 Business Adviser contract should be competitively tendered. Having regard to the Minister's view, OASITO subsequently decided to competitively tender all Phase 2 adviser contracts. Three Legal Adviser proposals were received with the successful proposal involving capped fees of \$3.15 million, \$7.3 million less than those initially negotiated by OASITO.

2.16. In response to the 3 May 1999 proposed audit report issued under section 19 of the *Auditor-General Act 1997*²⁸, OASITO advised ANAO that:

It was important to move ahead quickly with the Phase 2 airport sales to maintain the momentum of the privatisation programme, retain investor interest from Phase 1, take advantage of existing market conditions and to minimise the public debt interest cost arising from any avoidable delays. OASITO, therefore, sought proposals to act in relation to the Phase 2 airport sales from the business and legal advisers to Phase 1—albeit proposing a more reduced role for one of the legal advisers for the reasons set out below. The tender process for the Phase 1 consultancies provided for (but did not require) the advisers to be engaged for Phase 2 without further competition.

OASITO did not then seek a proposal from AGS for it to act as principal legal adviser for the Phase 2 sales, although AGS had been the lead legal adviser for the Phase 1 sales because announced senior staff changes meant that the requisite staff would not have been available to Phase 2. During the course of the selection exercise, after a decision was taken to go out to tender for the legal adviser role, the AGS team leader from the Phase 1 sales process re-engaged with AGS, thereby considerably strengthening their team, and claim for the role. AGS was subsequently appointed as legal adviser to the Phase 2 sales.

Had this officer been available when we first contemplated engagements for Phase 2 we would not have approached Clayton Utz on the basis we did. But had we sought competitive proposals at that time, the AGS team would have been unable to muster the required skills.

²⁸ Section 19 of the *Auditor-General Act 1997* provides that the Auditor-General may give a copy of the proposed report of an audit conducted under section 18 of the Act to any person who, in the Auditor-General's opinion, has a special interest in the report. The section further provides that the Auditor-General is required to consider the comments of a person provided with a copy of the proposed report providing that the comments are given to the Auditor-General within 28 days of the person receiving the proposed report.

2.17. ANAO comment: The core principles and policies of Commonwealth procurement include open and effective competition rather than sole sourcing without a competitive process. ANAO notes OASITO's advice that announced senior staff changes at AGS meant that the Phase 1 AGS team leader originally would not have been available for Phase 2, but also notes that all remaining key personnel specified in AGS' Phase 1 contract were available to OASITO and each of these officers possessed considerable experience in privatisation projects. Furthermore, Clayton Utz's team for Phase 2 was not settled at the time proposals were sought. In addition, OASITO proposed to have Clayton Utz take responsibility for significant aspects of work AGS had handled in Phase 1 which potentially involved significant cost implications. The proposed legal fees of \$10.5 million negotiated by OASITO through its direct approach to Clayton Utz were greater than the total paid to both of the Phase 1 legal advisers. ANAO notes that the fees negotiated by OASITO with Clayton Utz were more than double those bid by either of the two other candidates who responded to the subsequent tender.

Business Adviser

2.18. Following a competitive tender, BZW was engaged in June 1994 to assist with the scoping study for the sale of the Federal airports. The total value of this contract was \$1.26 million. After a further competitive tender, BZW was reappointed in August 1995 to assist the Commonwealth with the sale of the Phase 1 airports.²⁹ Total payments under this contract were \$15.80 million.

2.19. At OASITO's request, on 30 May 1997, BZW provided OASITO with a proposal for it to act as lead adviser and project manager for the disposal of the Phase 2 airports. The proposal had been requested following the successful conclusion of the Phase 1 sales and in light of the need to move quickly to Phase 2 in order to meet the proposed timetable of completing Phase 2 by 30 June 1998.³⁰

2.20. The Business Adviser's Phase 2 proposal was discussed during June 1998 with negotiations focused on the quantum and structure of proposed fees. Negotiations between OASITO and the Business Adviser resulted in the Business Adviser's fee proposal being modified with

²⁹ Further details on these selection processes are provided in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, pp. 21, 25 and 26.

³⁰ Candidates for the Phase 1 Business Adviser role had been advised in the June 1995 request for proposals that *the Commonwealth reserves the right to engage the adviser for the second phase of the sales process should performance on the initial phase prove satisfactory and subject to agreement on terms and conditions.*

maximum fees reduced to \$12.2 million.³¹ A draft contract was then prepared on 19 June 1997. However, as mentioned above, on 23 June 1997 the Minister for Finance and Administration expressed a view to OASITO that the Phase 2 Business Adviser Contract should be competitively tendered. Having regard to the Minister's view, OASITO subsequently decided to competitively tender all Phase 2 advisory contracts.³² Accordingly, a request for proposals was issued on 27 June 1997 to nine firms, requiring a response by 8 July 1997 (7 business days).

2.21. The incumbent Business Adviser was the only firm to submit a proposal for the Phase 2 task. OASITO advised ANAO that this was despite OASITO's attempts to generate interest in tendering for the role for which many saw the incumbent Business Adviser as having the inside running. OASITO further advised that it considers that the limited interest may also have arisen due to most well qualified firms having already obtained mandates to act for prospective purchasers—some as continuations of Phase 1 advisory roles.

2.22. The Business Adviser's proposal included fees identical to the final position negotiated with OASITO in June 1998. This proposal included a success fee which had initially been requested by OASITO in order to link some part of the Business Adviser's remuneration to successful outcomes for the Commonwealth. Following further negotiations, the Business Adviser removed the proposed success fee because of the Selection Panel's³³ concern with the quantum of the fee and the nature of the incentive being linked to the airport valuations prepared by the Business Adviser.³⁴ While still of the view that the fees were on the high side,³⁵ the Selection Panel agreed to recommend BZW's reappointment on the basis that the fee was capped,³⁶ it reflected BZW's demonstrated capabilities and the re-engagement would result in value returns for the Commonwealth.

³¹ The 30 May 1997 proposal included two alternative fee structures. The first structure involved a total fee of \$13.75 million (base fee of \$11.25 million and \$2.5 million completion fee). The second structure comprised a base fee of \$8.75 million plus one per cent of total sale consideration received by the Commonwealth. Based on the actual sale proceeds of \$730 million, the success fee would have resulted in total Business Adviser fees of \$16 million.

³² On 4 June 1997, OASITO had advised the Minister for Finance and Administration that it proposed to commence discussions with BZW, AGS, Clayton Utz and KPMG with a view to their appointment as business, legal and accounting advisers for Phase 2.

³³ The same selection panel was used for the Business and Legal Advisers and the Investigating Accountant. The panel was chaired by the OASITO Chief Executive and included a further OASITO representative, a DoTRS representative and two representatives of the Minister for Finance and Administration.

³⁴ The proposal involved a success fee of two per cent of sale proceeds in excess of the Business Adviser's base valuation. The success fee was to be capped at \$3.2 million.

³⁵ The fees were capped at \$12.2 million and comprised a base fee of \$8 million; a completion fee of \$3.9 million apportioned between the 15 airports; and a completion fee of \$300 000 payable on completion of the sale or other disposal of all 15 of the Phase 2 airports.

³⁶ The contract signed provided for a capped fee of \$12.2 million up to 30 June 1998 but the fee would increase by \$250 000 per month thereafter.

2.23. After advising the Minister, OASITO negotiated with BZW over the terms and conditions of a contract and the Business Adviser contract was signed on 31 July 1997. The contract required the Business Adviser to project manage the sale process; manage an effective and efficient marketing campaign; oversight and assist the due diligence process; advise on, coordinate and undertake the design, packaging, printing and distribution of all tender documentation; evaluate and analyse the financial and commercial aspects of all tenders and coordinate the preparation of bid evaluation reports; and advise on the airport sale and lease documents and airport business restructuring. The contract also required the Business Adviser to ensure that the sale process was conducted to the highest standards of probity and integrity required of public authorities under Commonwealth accountability legislation.

2.24. In consideration for the performance of the nominated consultancy services, the contract required OASITO to pay the Business Adviser a fee of \$12.2 million.³⁷ The fee comprised:

- a Base Fee of \$8 million. The Base Fee was payable as follows: \$4 million on 31 December 1997; \$2 million on 31 March 1998 and \$2 million on 30 June 1998³⁸; and
- a Completion Fee of up to \$4.2 million. The Completion Fee comprised a fixed component of \$3.9 million apportioned across the 15 airports and a fee of \$300 000 for the sale of all 15 of the Phase 2 airports.

2.25. The Business Adviser was paid a total fee of \$11.72 million made up of the Base Fee of \$8 million and \$3.72 million in Completion Fees. The Completion Fees were reduced by \$480 000³⁹ as Essendon airport was not sold because the bids received did not satisfy, to the level required, a number of the Government's sale objectives.

2.26. Finding: OASITO initially sought to negotiate directly a Phase 2 contract with the Phase 1 Business Adviser. However, it was later decided to competitively tender the assignment, consistent with the principle of open and effective competition. The initial negotiations with the

³⁷ The fee included all disbursements with the exception of travel and accommodation expenses associated with any international marketing of the sale; costs of any sub-contractors; external printing, design and packaging costs associated with the tender and marketing documentation; and external costs associated with the transfer, copying and assembly of information to be provided to bidders.

³⁸ A monthly retainer of \$250 000 was paid from the commencement of the contract. The monthly retainer was fully rebateable against the instalments of the Base Fee otherwise payable in the period up to 30 June 1998. Thereafter, the monthly retainer was not rebateable.

³⁹ Comprising the \$180 000 fixed completion fees for Essendon and the \$300 000 fee for completing the sale of all 15 airports.

incumbent Business Adviser reduced the quantum of fees sought but also reduced the time available for other possible candidates to develop a credible and competitive proposal. The incumbent Business Adviser was the only firm to submit a proposal. It sought fees capped at \$12.2 million for the period up to 30 June 1998. OASITO paid the Business Adviser a total fee of \$11.72 million, the fee being less because Essendon Airport was not sold.

2.27. Recommendation No.1 ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance open and effective competition for advisory roles in future asset sales by developing tender strategies that, subject to the Government's sale timing objectives, ensure that potential advisers have sufficient opportunity to develop credible and competitive proposals to maximise the likelihood of a successful outcome.

2.28. OASITO's response to the recommendation was that it ***agreed with qualification***. OASITO advised that it considered that the time allowed in the case of the Phase 2 airports sales was adequate because most competing well-credentialed firms had sound knowledge of the process from their involvement in Phase 1 representing bidders, and no firm objected to the timetable. Only one firm sought an extension of time and that was because the letter got lost within their firm. OASITO notes that in light of the widely acknowledged success of Phase 1, it was likely that competing firms would not be willing to commit time and resources to submit competing bids when the issue was largely one of seeking fee reductions below levels that were already competitive by industry standards.

2.29. ANAO comment: ANAO considers that OASITO's decision to competitively tender all Phase 2 sales adviser contracts recognised that advantages can accrue from competitively tendering major contracts. However, calling tenders may not guarantee effective competition where, for example, existing contractors possess incumbency advantages over potential competitors which impair the ability to switch contractors. In these circumstances, it is important that tender specifications do not unduly favour the existing contractor and that potential competitors be given sufficient information and adequate opportunity to develop credible and competitive proposals. In this instance, OASITO had been discussing the scope and approach to the Phase 2 sales process with the incumbent Business Adviser since January 1997 but only provided potential competitors with seven business days to develop a proposal. It may be that more time would not have succeeded in eliciting proposals from additional Business Adviser candidates for the reasons cited by OASITO, but negotiating with the incumbent Business Adviser before approaching the market is unlikely to have fostered effective competition.

Outsourced Project Management

2.30. OASITO's Phase 2 Business Adviser was contracted to undertake day-to-day management (in consultation with OASITO) of the leasehold sale of the 15 Phase 2 Federal Airports, including management of all other consultants and advisers with the exception of the Legal Adviser, AGS. The contract permitted the Business Adviser, with OASITO's agreement, to engage sub-contractors to perform any of its obligations or functions. Nevertheless, contractually the Business Adviser would remain fully responsible for the performance of all its contractual obligations.

2.31. OASITO consented to 14 sub-contracts with an aggregate contract value of \$3.28 million. To assist in achieving value for money, OASITO required the Business Adviser to conduct a competitive tender for each sub-contract.

Sub-contractor payments

2.32. The cost of claims processing can be high and it is not always efficient or cost-effective to strive for absolute verification of the accuracy of a claim for payment. The process of certifying amounts for payment is the mechanism through which the Commonwealth obtains assurance that it has paid only what it was supposed to pay. For this reason, the act of certifying a claim for payment is an important part of the process of safeguarding public money. It is a fundamental internal control for ensuring the efficient, effective and ethical use of Commonwealth resources, as required by Section 44 of the *Financial Management and Accountability Act 1997*.⁴⁰

2.33. OASITO agreed to reimburse the Business Adviser for the costs of all approved sub-contractors. As part of its project management responsibilities for these sub-contracts, the Business Adviser was required by its contract to pay the sub-contractor in accordance with correctly rendered invoices. The contract required that, on a quarterly basis, the Business Adviser forward to OASITO proof of payment to the sub-contractor together with a certificate which stated that the sub-contractor had complied with all of the conditions of the sub-contract and that it

⁴⁰ Prior to the Financial Management and Accountability Act, Section 34 of the *Audit Act 1901* required that, before a payment may properly be made, a Certifying Officer ensure the claim is correct as to amount, is for expenditure that had been duly approved; is made out in the name of a person or authority to whom payment may be made; has not been previously paid; identifies the correct head of expenditure; and complies with any contractual requirements. Certain prescribed classes of payments (for example, claims made by one Department on another Department or claims for an amount not exceeding \$1,000) only required the Certifying Officer to ensure the expenditure has been duly approved and the claim identifies the correct head of expenditure before certifying payment, provided the Certifying Officer has no reason to believe payment should not be made.

was proper for the payment to be made. The Business Adviser was to be liable for any reimbursement wrongly made by OASITO as a result of a wrongly issued certificate by the Business Adviser.⁴¹

2.34. The proper monitoring of contractors' performance is an element of OASITO's accountability for the delivery of services by its contractors. Importantly, OASITO remains accountable for the proper expenditure of Commonwealth funds, notwithstanding its outsourcing of project management for individual sales. To discharge this responsibility cost-effectively, and given the substantial sums of money that are paid to OASITO's project managers, it is necessary for OASITO to employ a contractual and administrative framework that enables it to place reliance on certificates issued by its project managers. In recognition of its accountabilities, OASITO instituted a diligent review of payments made to subcontractors by its advisers and the documentation associated with these payments.

2.35. The Business Adviser submitted three invoices to OASITO for reimbursement of sub-contractor expenses. The first invoice was submitted on 20 October 1997 for \$475 402. The Business Adviser certified that it had paid the sub-contractors in accordance with correctly rendered invoices; it had provided to the Commonwealth valid invoices; the sub-contractors had complied with the terms of their contractual arrangements; and that no disputes were outstanding between the Business Adviser and the sub-contractors. OASITO reimbursed \$475 215 to the Business Adviser for the first invoice. The reimbursement was \$187 less than the amount claimed in the invoice because the Business Adviser had sought reimbursement in excess of the fixed price OASITO had agreed to for one sub-contract.

2.36. The second invoice for sub-contractor cost reimbursement was submitted to OASITO on 19 December 1997 for \$977 596. The Business Adviser provided an identical certification to that provided with the first invoice. OASITO initially withheld \$40 599 from the second reimbursement because the documentation provided by the Business Adviser indicated that one sub-contractor had not invoiced in accordance with the rates specified in its sub-contract. After investigation, on 3 December 1998 OASITO agreed to reimburse the Business Adviser \$40 445 of the amount initially withheld on the basis that this represented the correct amount in accordance with the rates specified in the sub-contract.

⁴¹ These provisions were similar to those adopted in the 1997 Sale of One-third of Telstra. See further in Audit Report No.10 1998–99, *Sale of One-third of Telstra*, pp. 33–44 and 54–65.

2.37. The Business Adviser submitted the third invoice for reimbursement of the cost of sub-contractors to OASITO on 7 August 1998 for \$1 274 192, with an identical certification to the first two invoices. Although the Business Adviser advised OASITO that supporting documentation for the invoice would be provided on 10 August 1998, this documentation was not provided to OASITO until 14 October 1998, after OASITO had requested it in writing on four occasions and verbally on a number of other occasions. By this time, the Business Adviser had been paid its full fee in accordance with the contract, although it had not yet, as required as part of its project management responsibilities, properly rendered invoices to enable it to be reimbursed for all sub-contractor expenditures.

2.38. OASITO's review of the supporting documentation for the third invoice identified a number of matters that needed to be resolved before it could fully reimburse the Business Adviser. Accordingly, OASITO reimbursed the Business Adviser \$168 348 less than had been sought. The difference related to over-invoicing identified by OASITO (\$8941) and items that were not clear or not fully substantiated (\$159 407). At the time audit fieldwork was completed in March 1999, most of OASITO's concerns had been addressed and OASITO had agreed to reimburse \$157 057 of the amount initially withheld.

2.39. Finding: One challenge for OASITO in outsourcing project management is to develop administrative and contractual arrangements that reduce the need for it to engage in double-checking of all expenditure incurred by its project manager. With OASITO's consent, the Business Adviser entered into 14 sub-contracts with an aggregate contract value of \$3.28 million. As part of its project management responsibilities for these sub-contracts, the Business Adviser was required to efficiently and effectively administer payments to the sub-contractors and seek reimbursement of its costs from OASITO.

2.40. As a Commonwealth agency, OASITO cannot outsource accountability for the expenditure of Commonwealth funds. Accordingly, it implemented effective administrative safeguards to make sure that Commonwealth funds reimbursed to the Business Adviser were properly expended. As a result of its detailed review of the Business Adviser's reimbursement claims, OASITO initially declined to reimburse \$209 134 already paid by the Business Adviser to sub-contractors. OASITO's investigations were concluded in December 1998 and OASITO agreed to reimburse all but \$11 632 of the amounts that were initially withheld.

2.41. OASITO delayed reimbursement of sub-contractor expenses which provided the Business Adviser with some financial incentive to complete

its work. However, the Business Adviser was paid its full project management fee, in accordance with the contract, before its sub-contracting project management responsibilities had been fully discharged. ANAO considers that the cost-effectiveness of future project management contracts could be enhanced by linking a component of the project management fee to the project manager's performance in administering sub-contractor payments.

2.42. Recommendation No.2 ANAO *recommends* that, in future asset sales, the Office of Asset Sales and IT Outsourcing consider including appropriate financial incentives within the project management contract to assist in ensuring that its project managers:

- a) implement internal control systems that enable them to establish that the sub-contractor has delivered the contracted services and/or products to the required standard in a timely and responsive manner; and
- b) adopt an appropriate risk based approach to examining sub-contractor invoices to ensure they are correct as to amount, including verifying that the correct rates and calculations have been applied.

2.43. OASITO's response to the recommendation was that it **agreed with qualification**. OASITO noted that the arrangements in place already provided a \$280 000 incentive to the business adviser to complete its work because this was the amount of unreimbursed expenditure carried by the Business Adviser pending satisfactory resolution and documentation of expenditure. However, for future appointments, OASITO will consider whether, as an additional sanction, a portion of the final project management fee should also be withheld pending timely finalisation of sub-consultant arrangements.

3. Tender process

This chapter outlines the tender process and the evaluation methodology and outcome.

Tender process

3.1. Following the appointment of OASITO's advisers, preparation for the sales commenced in June 1997. This included the conduct of vendor due diligence and the preparation of information to be disclosed to shortlisted bidders. The tender process was closely modelled on that used for the leasehold sale of Brisbane, Melbourne and Perth airports. The tender process commenced in August 1997 with the issue of a marketing brochure.⁴² Then in September 1997 potential bidders were provided with preliminary airport site tours. The formal bidding process commenced in October 1997 (see Figure 3.1) with interested parties invited to lodge an Expression of Interest (Stage 1) by 27 October 1997.

3.2. The Expressions of Interest stage was undertaken to focus the bidding stage on parties considered to have the capability and commitment to lodge a competitive and comprehensive tender. The Business Adviser coordinated the evaluation of Expressions of Interest. OASITO reviewed all Expressions of Interest and provided its views to the Business Adviser for inclusion in the overall assessment. DoTRS and AGS also reviewed the Expressions of Interest. AGS focused on issues concerning ownership and control, probity and security, legal issues and confidentiality deeds. DoTRS focused on candidates' airport management capability, environment management and local participation.

3.3. Expressions of Interest were ranked against each of the shortlisting criteria⁴³ to assist in developing an overall assessment. Consideration was also given, where there was a deficiency in a specific attribute, to the extent to which the consortium would be capable of rectifying the deficiency during the full bidding stage. To further enhance

⁴² The marketing brochure was sent to approximately 800 interested parties providing details about the sales process, the regulatory environment, each individual airport and an overview of Australia. Potential bidders were advised in the brochure that it was the Government's intention that the sales be completed by 30 June 1998.

⁴³ The criteria applied related to financial strength and commitment; management capability and commitment; the level and credibility of resources committed to the tender process; local participation; and compliance with the ownership requirements of the Airports Act. Information was not sought on price, approach to risk, development proposals or business plans. Each of the criteria were treated equally by the Business Adviser in developing its shortlisting recommendations.

the level of competition for individual airports, the Business Adviser recommended shortlisting marginal candidates who otherwise may not have proceeded based on strict application of the shortlisting criteria.⁴⁴

3.4. In November 1997, Stage 2 of the bidding process commenced with shortlisted bidders issued with a Request for Proposals. The Request for Proposals outlined the terms and procedures governing the tender process; the requirements for the preparation and lodgement of binding offers; and the evaluation criteria. ANAO sought legal advice as to whether or not, under the terms of the Request for Proposals, the Commonwealth was prevented from considering and selecting a bid which was not compliant with all of these terms prior to the closing date for proposals. Legal advice obtained by ANAO was that the Commonwealth was entitled to select a bidder whose bid was not compliant with all requirements of the Request for Proposals, given that in the Request for Proposals the Commonwealth reserved significant discretions to vary the content and application of certain aspects of the tender process, and to select a non-conforming bid.

3.5. The principal purpose of Stage 2 was to obtain high quality, legally binding offers which satisfied the requirements of the Request for Proposals and were capable of immediate acceptance by the Commonwealth.⁴⁵ The Request for Proposals noted the Government's intention to complete all 15 Phase 2 airport sales prior to 30 June 1998.

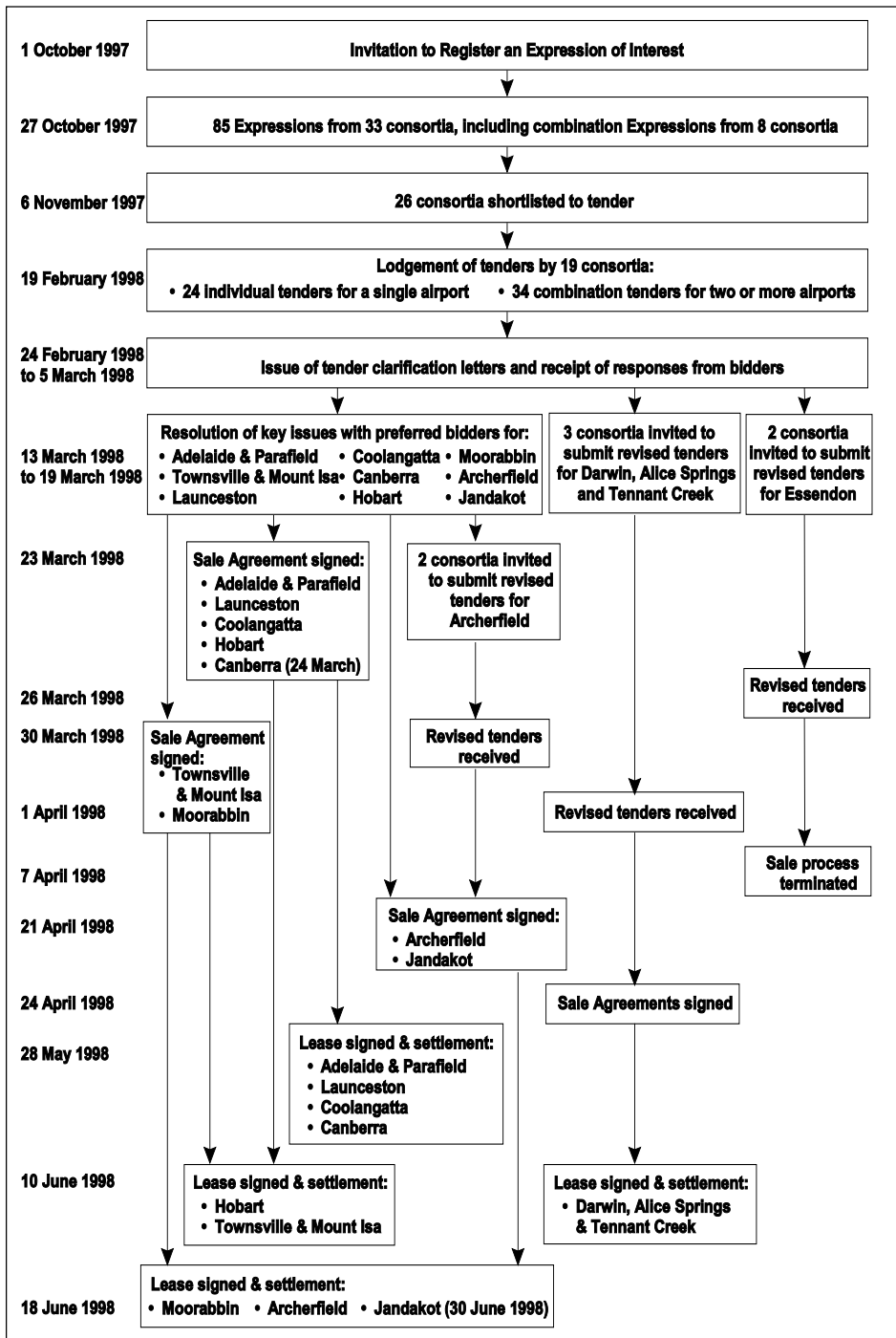
3.6. On 19 February 1997, 24 individual and 34 combination bids were received for the Phase 2 airports.⁴⁶ At least two individual bids were received for each Phase 2 airport with the exception of Canberra and Tennant Creek (one individual bid each) and Alice Springs and Mount Isa, for which no individual bids were received. Based on the Stage 2 bids and clarification of certain aspects of these bids, preferred purchasers were identified for 11 airports. Sale Agreements for 10 of these airports were signed between 23 March 1998 and 21 April 1998.

⁴⁴ Consideration was also given to prequalify additional parties or invite parties to submit Expressions of Interest for airports for which they had not nominated an interest. Initial legal advice indicated that there could be difficulties with either approach. OASITO advises that subsequent Counsel advice was the approach eventually adopted was defensible in accordance with the tender documentation.

⁴⁵ A 'short bid' stage was contemplated before the binding bid stage should there have been a need to further cull parties proceeding past the Expressions of Interest stage. This did not prove necessary.

⁴⁶ One individual bid for Mount Isa airport was subsequently withdrawn.

Figure 3.1
Sale bidding process



Source: ANAO analysis of information from OASITO, DoTRS, Business Adviser and Legal Adviser.

3.7. A preferred purchaser was identified at the end of Stage 2 for Archerfield airport. However, this was subject to confirmation of this bidder's ability to fund the bid; a condition which was not satisfied. As a result, the two Archerfield bidders were invited to re-bid (Stage 3). A limited re-bid was also conducted for the Northern Territory airports (Darwin, Alice Springs and Tennant Creek) and Essendon airport because preferred purchasers were not able to be identified from Stage 2 bids for these airports. With one exception, all parties invited to re-bid submitted a Stage 3 bid. Preferred purchasers were identified for Archerfield airport and the Northern Territory airports from the Stage 3 bids. Sale Agreements were signed on 21 April 1998 and 24 April 1998 respectively.

3.8. Finding: The sale of leases on 14 Phase 2 FAC airports was completed by 30 June 1998, in accordance with the Government's timetable. This represented a significant achievement given that, with 15 individual trade sale processes run concurrently on a coordinated basis, it constituted the largest completed airport trade sales program in the world to date.⁴⁷

Essendon airport

3.9. The Tender Evaluation Committee concluded that Stage 2 bids for Essendon airport were not acceptable on the grounds of quality, conditionality, certainty of funding and providing 'fair value' to the Commonwealth. The Minister for Finance and Administration and the then Minister for Transport and Regional Development accepted the Committee's recommendation that a limited re-bid (Stage 3) be undertaken. Both of the consortia that submitted a Stage 2 bid proceeded to submit a Stage 3 bid.

3.10. The Committee concluded that both of the Stage 3 Essendon airport bids raised significant issues about the commitment of the parties to the long term aeronautical use of the site.⁴⁸ The Committee recommended the acceptance of the highest bid providing certain bid conditions were

⁴⁷ OASITO advice to ANAO 22 April 1999.

⁴⁸ The Bid Evaluation Committee's Stage 3 report noted that: *The sale process has confirmed that Essendon airport is a complex asset, with several unique features compared to other Commonwealth owned airports. Its operations as an airport are restricted by regulation of aircraft weight and noise, etc. This has a significant impact on its commercial performance as an airport. Its non-aero business has also been limited and the airport itself has a history of underdevelopment arising from uncertainty about its future. Its capital stock has been run down since Melbourne airport was opened.*

removed and other issues addressed.⁴⁹ If the highest priced bidder was not selected as preferred purchaser for Essendon, the Committee recommended consideration be given to either, withholding Essendon airport from sale and establishing appropriate administrative arrangements for its retention in the public sector, or designating the lower priced bidder as preferred candidate subject to certain conditions being met by the bidder.

3.11. After considering the Committee's report, the Minister for Finance and Administration and the then Minister for Transport and Regional Development concluded that neither tender adequately addressed the Government's sales and ongoing privatisation objectives. Given that the bidders for Essendon had been given clear instructions on the Commonwealth's requirements, it was decided not to provide the bidders with a further opportunity to address the areas of concern. Accordingly, the Ministers decided on 7 April 1998 to withdraw Essendon Airport from the sale⁵⁰ and the two bidders for Essendon Airport were advised of this decision on 8 April 1998. A lease over Essendon Airport was granted on 30 June 1997 to Essendon Airport Limited, a wholly Commonwealth owned company.⁵¹

3.12. Finding: A staged tender approach was adopted for the sale of the 15 Phase 2 airports, closely modelled on that used for the leasehold sale of Brisbane, Melbourne and Perth airports but extended to cater for the greater scope for multiple and combined bids. A total of 24 individual and 34 combination bids were received for the Phase 2 airports. The tender process was completed by the target date of 30 June 1998 with sale agreements signed and leases executed for 14 of the Phase 2 airports. The only airport not sold was Essendon Airport, which was withdrawn from sale because it was concluded that neither of the two tenders submitted for the airport adequately addressed the Government's sales and ongoing privatisation objectives.

⁴⁹ The Bid Evaluation Committee's Stage 3 report noted that: *Both bids are based on business plans heavily reliant on post-lease freeholding of airport land and its use for non-aeronautical development, including residential development. Both proposals involve freeholding more than one third of the leasehold site. Should freeholding such a large parcel of the airport not be subsequently agreed, it is not possible for DoTRS to conclude that an alternative effective business strategy is in place.*

⁵⁰ DoTRS has noted that this decision was made on the basis that: one bidder's tender was non-compliant and conditional despite the clear advice that the Commonwealth was seeking clean, clear and fully funded bids; and the second bidder's purchase price offer was at the low end of what was considered a fair return to the Commonwealth and there were also significant concerns about the consortium's business plan and its capacity to support a long term commitment to the airport.

⁵¹ In consideration for the grant of the lease and transfer of the relevant assets, contractual rights and obligations, liabilities and employees, Essendon Airport Limited issued to the Commonwealth 10 million shares at an agreed value of \$15 million.

Evaluation methodology

3.13. Consistent with a recommendation made in ANAO's audit report on the Phase 1 sales, a Tender Evaluation Committee was established by OASITO for the Phase 2 sales.⁵² The Committee was formally established on 18 February 1998. Its responsibilities were to settle the evaluation methodology; monitor and supervise the evaluation process to ensure conformity with the methodology and adherence to the sale timetable; and make recommendations to OASITO on the selection or rejection of bidders, or the need to seek revised bids. The Committee was accountable to OASITO, which retained ongoing executive management responsibility for the sale process.⁵³ It was chaired by one of the two OASITO representatives, and included two members from DoTRS and two members from each of OASITO's Business and Legal Advisers.⁵⁴

3.14. ANAO considers that it is sound administrative practice for the tender evaluation methodology to identify the relative importance attaching to each evaluation criterion.⁵⁵ The Request for Proposals issued to shortlisted bidders in November 1997 outlined 14 evaluation criteria. Shortlisted bidders were advised that the Commonwealth was seeking to maximise net sales proceeds on a risk-adjusted basis whilst achieving optimal outcomes in relation to the other criteria. To achieve this outcome, the evaluation criteria were prioritised as follows:

- tenders were required to conform to certain mandatory criteria.⁵⁶ Tenders that were non-compliant with the mandatory criteria and which the Committee considered had no prospect of compliance would not be considered further;

⁵² Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, Recommendation No.7, p.55.

⁵³ OASITO's Business Adviser undertook day to day management of the bid evaluation process including liaising with each of the parties responsible for undertaking the evaluation to ensure the process was correctly followed and the timetable adhered to. The Business Adviser also provided the Secretary to the Committee and collated individual evaluation reports and the overall summary and recommendation reports.

⁵⁴ Based on a recommendation from its Business Adviser, OASITO decided not to include an independent party on the Committee because of the lack of inherent conflicts of interest in the proposed Committee structure; the importance of strict confidentiality; and the breadth and balance of skills and experience amongst the proposed Committee covering legal, commercial, transport policy and sales policy issues.

⁵⁵ Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, Recommendation No.6, p.37.

⁵⁶ The mandatory criteria comprised prospective compliance with the Airports Act and other applicable legislation; satisfaction of the Commonwealth's security and probity requirements; compliance with cross-ownership restrictions; and bidders' financial and management capacity and commitment to operate and develop the airport.

- tenders that complied with the mandatory criteria would then be ranked in decreasing order of risk-adjusted sales proceeds;⁵⁷ and
- the relative ranking of tenders would only be adjusted where assessment against non-sales proceeds criteria clearly warranted a departure from the risk-adjusted sales proceeds ranking.⁵⁸

3.15. A tender evaluation plan was prepared by the Tender Evaluation Committee addressing the approach to, and organisation of, bid evaluation and specifying some of the more detailed aspects of the evaluation process. The plan was designed to assist the Committee rank all bids against the published evaluation criteria⁵⁹. Also, in accordance with the agreed methodology, the Committee was to identify any major issues requiring resolution or further clarification with bidders; outline selection recommendations and the basis for the recommendations; and establish a clear and properly documented basis for the selection and rejection of bids. The plan also identified which Committee member was primarily responsible for evaluations against each criterion,⁶⁰ although the evaluation as a whole was reviewed and endorsed by all members of the Committee.

3.16. The Committee adopted a three step process to bid evaluation. The best individual stand-alone bid was identified for each airport by ranking individual bids for each airport in decreasing order of risk-adjusted net sale proceeds. Any trade-off between risk-adjusted sale proceeds and other evaluation criteria was then assessed. The best combination bid for each particular combination of airports was identified and compared to the combination of the best individual bids for these airports. Finally, the best combination and individual bids were assessed across all possible ownership permutations to determine the best overall result for the Commonwealth.

⁵⁷ Risk adjusted proceeds was determined by considering the purchase price offered by each bidder; the approach bidders took to reimbursing capital expenditure at the airports between 1 July 1997 and completion; potential adjustments for stamp duty, interest rate movements, any elements of the bid considered to have a quantifiable and material negative cost to future Commonwealth taxation revenue; the extent to which any adjustments were proposed to the draft transaction documentation issued to bidders on a broadly non-negotiable basis; and the extent to which acceptance of the offer would result in any increased risk allocation, cost or liability to the Commonwealth.

⁵⁸ These criteria related to certainty, clarity and conditionality of the offer; local participation from the community in which the airport is located; commitment to development and maintenance of the airport; fair and equitable treatment of FAC employees; optimising the Government's ongoing privatisation objectives; responsiveness of the bidders approach to development and operation of the airport to environmental considerations; and diversity of ownership.

⁵⁹ For example, sub-criteria were established to assist in the assessment of the main evaluation criteria. The overall assessment of a given evaluation criterion reflected the aggregate assessment of the specified sub-criteria.

⁶⁰ A separate review was undertaken by the Accounting Adviser on accounting, tax and superannuation matters in respect to the Phase 2 Airports. The Accounting Adviser's report was used as an input by the Committee.

3.17. To ensure a consistent approach to the evaluation of all bids, blank templates for the bid evaluation reports were produced in advance by the Committee. The blank templates were supported by detailed guidance notes to indicate how bids were to be evaluated and the information to be taken into account. Separate evaluation reports were prepared on the individual bids for each airport as well as a separate evaluation report for each combination bid permutation. This provided a clear and transparent approach to assessing the relative merits of each individual and combination bid.

3.18. Finding: The evaluation process was planned and conducted to provide a clear and transparent approach to assessing the relative merits of each individual and combination bid in order to identify the best overall result for the Commonwealth. Consistent with ANAO recommendations made following the performance audit of the Phase 1 sale of airport leases, OASITO established a Tender Evaluation Committee and assigned priorities to the evaluation criteria.

Price criterion

3.19. The Request for Proposals noted that the Commonwealth aimed to maximise net sales proceeds on a risk-adjusted basis whilst achieving optimal outcomes in relation to the other criteria. Each bid was required to state the purchase price offered for the grant of the Airport Lease, and transfer of the assets, contractual rights and obligations, liabilities and employees of the FAC relevant to the operation of the airport. In addition, bidders were advised that the purchasers would be required to reimburse the Commonwealth for designated capital expenditure made by the FAC in the period between 1 July 1997 and three days prior to sale completion.⁶¹

3.20. The Tender Evaluation Committee assessed the net sale proceeds offered by each bid, comprising the purchase price and capital expenditure reimbursement. The Request for Proposals reserved the Commonwealth's right to assess the tax implications of offers, particularly elements which the Commonwealth considered would result in a quantifiable and material negative cost to future Commonwealth tax revenue. KPMG Chartered Accountants were engaged to review the bids to identify any items of an accounting, tax or superannuation nature that could impact on bid assessment. Their report concluded that none of the financing, ownership or other structures of any bid gave rise to any material Australian taxation

⁶¹ Estimates of the likely capital expenditure that would be required to be reimbursed were provided to bidders to assist them develop their proposals.

implication which might result in a quantifiable and material negative cost to future Commonwealth tax revenue for comparative bid evaluation purposes.

3.21. A feature of the Phase 2 tender process was the large number of combination bids received.⁶² Six bidding consortia submitted a total of 34 combination bids for the Phase 2 airports. The Request for Proposals permitted bidders to lodge combination offers providing the bidder also lodged a separate bid for each Phase 2 airport included in the combination offer; and the total purchase price for the combination offer was greater than the sum of the purchase prices for those airports on a stand-alone basis.⁶³ Due to cross-ownership restrictions, a combination offer could not be made for Hobart and Launceston airports.

3.22. All combination bids were evaluated and a permutation analysis undertaken comparing combination bids and individual bids to assess which approach would achieve the maximum return for the Commonwealth. The Tender Evaluation Committee concluded that, with few exceptions, the combination bids were not competitive in price, on a risk-adjusted basis, with the stand-alone bids. Accordingly, the highest individual offers were accepted for six airports (Canberra, Hobart, Launceston, Moorabbin, Jandakot and Archerfield). Combination bids that offered a premium over the highest stand-alone bids (and other combination bids) were accepted for Adelaide, Parafield and Coolangatta; Townsville and Mount Isa; and the Northern Territory airports.⁶⁴

3.23. Finding: The Tender Evaluation Committee assessed the net sale proceeds offered by each bid with the successful bids maximising Commonwealth sale proceeds. A feature of the Phase 2 tender process was the large number of combination bids. The Committee compared combination bids and individual bids to assess which approach would achieve the maximum return for the Commonwealth. Combination bids that offered a premium over the highest stand-alone bids were successful for Adelaide, Parafield and Coolangatta; Townsville and Mount Isa; and the Northern Territory airports. The highest individual airport offers were accepted for the remaining airports sold.

⁶² The Business Adviser informed OASITO in its Evaluation of Expressions of Interest that combination offers for the Phase 2 airports reflected the smaller scale of the Phase 2 airports compared to that of the Phase 1 airports, the desire of bidders to obtain a reasonable size of investment, and the desire to diversify risk.

⁶³ The Request for Proposals reserved the Commonwealth's right to consider and accept a combination offer which did not satisfy the requirements specified in the Request for Proposals.

⁶⁴ Combination bids also enabled the Commonwealth to sell Mount Isa airport, for which no individual bid was submitted.

Interest rate risk

3.24. Bidders were required to hold their Stage 2 bids open until 30 April 1998. The high component of debt funding in most bids meant they were sensitive to interest rate movements. This sensitivity, together with the lengthy acceptance period, led to six bidders including conditions in their Stage 2 bids entitling them to review or adjust their bid price in the event of an adverse movement in interest rates. ANAO considers the significance of this risk required OASITO and its advisers to assess carefully the timing of sale completion and any decisions to seek revised bids.⁶⁵

3.25. Based on the interest rate futures market and the term structure of interest rates, the Business Adviser assessed that it was likely that interest rates would increase by 13 basis points⁶⁶ between March 1998 and May 1998. For those bidders that included an interest rate condition, the Business Adviser quantified the estimated price adjustments from a range of interest rate variations. The Business Adviser recommended that, for those airports where preferred bidders were able to be identified from Stage 2 bids, interest rate risk be managed by negotiating out these conditions prior to final confirmation of their status as preferred bidder.

3.26. It was not possible to avoid interest rate risk for those airports where revised bids were sought. To manage risk in these circumstances, bidders proceeding to Stage 3 were specifically asked to review the inclusion of an interest rate condition. The risk to the Commonwealth was further addressed by minimising the duration of Stage 3 and requiring bidders to remove their interest rate conditions prior to final confirmation of their status. No purchase price offers were adjusted because of movements in interest rates.

3.27. Finding: Effective steps were taken during the tender process to identify, assess and manage interest rate risk to the Commonwealth. In accordance with sound risk management practices, the Business Adviser assessed the likelihood of an increase in interest rates and quantified the potential impact of interest rate movements on purchase prices. Steps were taken to effectively manage the risk to the Commonwealth of bidders adjusting their purchase price offers in the event of an adverse interest rate movement.

⁶⁵ See further in Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, paragraph 3.21, p.41.

⁶⁶ One basis point equals one-hundredth of one per cent.

Financial strength and managerial capabilities

3.28. The sale objectives included ensuring that the new airport operators possess the necessary financial strength and managerial capabilities to operate and develop the Phase 2 airports. Financial strength and managerial capabilities of bidders were explicitly addressed in the tender process. Bidders were required to provide bid financing details (including terms and conditions) and submit a 10 year business and development plan addressing: proposed business strategies to enhance the performance and value of the airport and maintain its operating integrity; development and maintenance of aeronautical infrastructure; environmental planning and management; and financial projections and the underlying assumptions for the operation of each airport. The Tender Evaluation Committee of OASITO, DoTRS and OASITO's Business and Legal Adviser's concluded that as follows:

- **Management quality** of the successful bidders for the regular public transport airports⁶⁷ was high through the retention of FAC employees supplemented by expertise from various domestic and international airport operators. Management quality of the general aviation airports⁶⁸ was considered to be of an appropriate standard, given the role of these airports.
- The successful proposals were **financially strong** with firm commitments and appropriate financial structures. With few exceptions, the major airports were highly geared.⁶⁹ The smaller airports were generally less geared and the panel considered that they should remain viable if appropriately managed and operated.

Financial viability

3.29. Bidders were required to provide details of how they proposed to finance the acquisition of the airport(s) and related working capital and capital expenditure requirements. This was to include details of the types and levels of debt, equity and hybrid financing. Together with the 10 year business plans and financial projections, this information was to be used to assess each bidder's financial capability and commitment to operate and develop the airport.

3.30. The methodology applied to assess bidder's financial capability and commitment was similar to that applied in the Phase 1 sales process.

⁶⁷ Comprises the core regulated airports plus Tennant Creek and Mount Isa.

⁶⁸ Archerfield, Jandakot, Moorabbin and Parafield.

⁶⁹ Gearing refers to the relationship between equity and debt funding of assets.

The Business Adviser⁷⁰ analysed acquisition funding (the quality and commitment of equity and debt providers; conditions on the provision of equity; and maturity, covenants and other conditions pertaining to debt financing) and financial projections for the operation of the airport (serviceability of debt; ability to meet maintenance and development plans; and availability of additional funding). To assist with the evaluation, bidders' projections were compared with objective benchmarks for traffic growth, revenue, operating costs, capital and maintenance expenditure and debt serviceability. In addition, sensitivity analysis of bidders' financial projections was carried out to reflect the possible impact of: reduced traffic growth; non-achievement of forecast operating efficiency gains; and continuation of the FAC's existing maintenance and development plans.

3.31. An important element in any financial viability analysis is identifying the obligations of the business and the cashflows available to meet these obligations. In evaluating bids, the Business Adviser adopted a consistent methodology on the treatment of funding that was subordinated to senior debt. The key considerations adopted in assessing whether to classify facilities as equity rather than debt were: the facilities should rank after ordinary creditors; interest is only payable to the extent to which there is sufficient cash flow to support the payment with interest not able to be accrued; principal is only repayable to the extent there is sufficient cash available; debt could not be repaid without the repayment of equity. As a result, there were instances where subordinated debt was classified as debt for the purposes of financial viability analysis.⁷¹

3.32. Finding: To assess financial capability and commitment to operate and develop the airports, detailed assessments were undertaken of each bidder's acquisition funding and financial projections for the operation of the airport. The analysis included comparisons with objective benchmarks and sensitivity analysis of the projections.

⁷⁰ The Business Adviser was allocated primary responsibility for reviewing the financial projections and business plans of bidders to determine whether they could service their liabilities as they fall due and whether they would have funds to meet maintenance and development plans.

⁷¹ For example, funding for the acquisition of Adelaide airport comprised 53 per cent of term debt; 3 per cent of subordinated loans; 43 per cent of airport notes; and 0.4 per cent of equity. Equity investors in the airport acquired a stapled security consisting of debt instruments (airport notes) stapled to shares in the ratio of 99:1. The airport notes were unsecured. Revenues earned from the operation of the airport are to be allocated in a priority such that interest under the airport notes would be paid before tax and equity distributions but after payments to all other creditors. As the airport notes satisfied the Business Adviser's criteria, they were classified as equity for the purposes of financial viability analysis. The subordinated loans were classified as debt because they were not subordinated to ordinary creditors, there were circumstances under which the loans would be paid interest but the airport notes would not, and repayment of the subordinated loans was envisaged without equity being repaid.

Sale completion

3.33. Sale Agreements for 14 of the Phase 2 airports were signed between 23 March 1998 and 24 April 1998. The Sale Agreement was the core transaction document in which the Commonwealth agreed to grant the Airport Lease, and transfer all of the relevant assets, contractual rights and obligations, liabilities and employees of the FAC to the successful bidder's. To spread the administrative workload during the period between signing of the Sale Agreements and completion, the 14 Phase 2 airports sold were divided into three groups with sale completion staggered: five sales were completed on 28 May 1998, six on 10 June 1998 and two on 18 June 1998 (see Figure 3.1).

3.34. Completion of the sale of Jandakot Airport was originally scheduled to occur on 18 June 1998. On 16 June 1998, the purchaser advised OASITO that financing had been withdrawn and that the consortium would not be able to complete on the scheduled completion date. OASITO granted an extension until 30 June 1998 to allow the purchaser to finalise its financing arrangements. Alternate financing was obtained which enabled completion to occur on 30 June 1998. OASITO and its advisers have noted that the amendment to the purchaser's financing arrangements and delay in completion did not materially affect the evaluation of the purchaser's bid.

Management of financial settlement

3.35. There is a risk that, after signing of the Sale Agreement, a bidder may not complete the sale. OASITO took a number of steps to manage this risk. The successful bidder's were required to execute a Deposit Deed⁷² and pay a 10 per cent purchase price deposit within 48 hours of being nominated as the preferred purchaser. This deposit would be forfeited in the event the successful bidder did not complete the transaction.⁷³ In addition, shortlisted bidders were asked to nominate substantial parties associated with the offer who would guarantee the purchase price; and warrant the capacity of the substantial entity to enter into and carry out its obligations under the Sale Agreement and the substantial entity's solvency.

3.36. The successful bidder for Adelaide and Coolangatta airports proposed, in lieu of the guarantees and warranties from substantial parties associated with the offer, to secure payment of the remainder of

⁷² The Deposit Deeds covered the period between notification of preferred bidder status and execution of the Sale Agreement and bound the preferred bidder to proceed to complete the sale with the risk of losing their deposit if they failed to do so.

⁷³ Purchase price deposits totalling \$68.1 million were paid to the Commonwealth.

the purchase price by depositing the balance of the equity component of each bid (the 'Equity Deposit') in a bank account controlled by the bidder and the Commonwealth. OASITO and its advisers agreed to the bidder's proposal. The Sale Agreements for Adelaide and Coolangatta reflected this agreement with \$197.4 million⁷⁴ required to be deposited into two accounts in joint names over which the bidder would have security. The Equity Deposits were to vest in the Commonwealth upon completion of the sale.

3.37. In recognition of the changed security arrangements for Adelaide and Coolangatta, ANAO considers that it was important that OASITO and its advisers develop and implement appropriate administrative procedures to manage financial completion risk for these two sales. However, OASITO did not require the successful bidder to provide it with evidence of a Commonwealth bank account being established in joint names or of the Equity Deposits being placed in this account as required by the Adelaide and Coolangatta Sale Agreements. For example, OASITO could have required the bidder to provide it with bank statements as this would have reflected the Commonwealth's stakeholder interest in these accounts.

3.38. As a result of ANAO's enquires, OASITO's Business Adviser obtained from the purchaser documentary evidence concerning the establishment and administration of the Equity Deposit bank accounts. ANAO's analysis of this documentation indicates that the two accounts mentioned in para 3.36 established to hold the Equity Deposits were not joint accounts as required by the respective Sale Agreements. In addition, the documentation indicates that insufficient funds were maintained in the nominated bank accounts to fund the Equity Deposit obligations. For Adelaide airport, \$148 766 600 was required to be maintained in the account between 23 March 1998 and 28 May 1998. However, the bank statements provided to ANAO indicate that during the period the balance was as little as \$13 343.

3.39. The Coolangatta Airport sale agreement required \$48 642 400 to be maintained in the account between 23 March 1998 and 28 May 1998. ANAO's analysis of the bank statements indicated that the balance in the account varied between nil and \$30 862 during this period.⁷⁵ This would mean that the Equity Deposit arrangements did not meet the

⁷⁴ Comprising \$148.8 million for Adelaide and \$48.6 million for Coolangatta.

⁷⁵ In response to ANAO's analysis, OASITO advised ANAO on 23 April 1999 that it had written to Adelaide Airport Limited and Queensland Airports Limited on 22 April 1999 seeking further advice and documentary evidence from the companies in relation to the establishment of the accounts for the Equity Deposits and the placement and maintenance of funds on deposit in the accounts.

objective of providing security to the Commonwealth for the payment of the balance of the purchase price. ANAO notes that the sales of Adelaide and Coolangatta airports were completed, as scheduled, on 28 May 1998.

3.40. Finding: OASITO and its advisers generally developed effective mechanisms to manage the risk of the successful bidders' defaulting on their obligations under the respective Sale Agreements. An element of the strategy for managing completion risk for the sales of Adelaide and Coolangatta airports was acceptance of a proposal from the successful bidder that it deposit \$197.4 million in two joint bank accounts with this amount to be paid to the Commonwealth upon completion of the sales. These arrangements were proposed by the successful bidder to provide security to the Commonwealth for the payment of the balance of the purchase price in lieu of the parent entity guarantees and warranties sought by OASITO and provided by all other purchasers. However, ANAO found that the Equity Deposits were not placed in joint Commonwealth bank accounts as required by the Sale Agreements and that insufficient funds were maintained in the nominated bank accounts to fund the Equity Deposit obligations. ANAO notes that the sales of Adelaide and Coolangatta airports proceeded to completion on time.

3.41. Recommendation No.3: ANAO *recommends* that, as part of a systematic risk management framework for future trade sales, the Office of Asset Sales and IT Outsourcing ensure appropriate systems are in place to fully identify and properly administer the Commonwealth's rights and obligations under the sale documentation, within the identified risk regime.

3.42. OASITO's response to the recommendation was that it ***agreed with qualification***. OASITO noted that the Equity Deposit arrangements that appear to underpin this recommendation were seen as further comfort of sale completion, over and above the non-refundable 10 per cent (\$42 million) deposits already paid in respect of Adelaide and Coolangatta airports and the inherent financial strengths of the purchaser. Nevertheless, OASITO will in future more explicitly task the Legal Adviser with responsibility for ensuring that the completion checklist explicitly includes all pre and post-completion obligations of any party included in executed sale documentation.

3.43. ANAO comment: ANAO notes that the parent entity guarantee mechanism was developed during the Phase 1 airports sales. In these sales, it was initially envisaged that there would only be a very short period of time (as little as three days) between signing of the Sale Agreement and financial completion. As the transaction unfolded, it

became clear that the large number of transitional issues involved in transferring operation of the airports would require a period of six to eight weeks between signing of the Sale Agreements and financial completion. The 10 per cent purchase price deposit was one safeguard developed to manage the increased risk (because of the longer transitional period) of purchaser's defaulting on their obligation to complete the transaction. The other safeguard developed was the parent entity guarantee.

3.44. In light of the commitments given by the parent entities of other purchasers, and the significant amount of sale proceeds involved (\$425 million), ANAO considers it was not unreasonable for OASITO to have required the purchaser of Adelaide and Coolangatta airports to provide security for payment of the balance of the transfer price, over and above the deposit already paid. In this context, OASITO agreed to a proposal from the purchaser to vary the terms of the Sale Agreement and forego any parent entity guarantee. Instead, the purchaser was to deposit a total of \$197.4 million (comprising \$148.77 million for Adelaide Airport and \$48.64 million for Coolangatta Airport) in two bank accounts for the duration of the period from when the Sale Agreements were signed until final settlement. However, this did not occur with the result that only minimal funds were maintained in the bank accounts. For example, for Adelaide Airport, the bank statements provided to ANAO indicate that the balance varied during the period to final settlement from the contractual requirement of \$148.77 million to a low of \$13 343.

3.45. In the event that the purchaser had defaulted on final settlement, the Commonwealth would have been entitled to retain the Equity Deposits. Despite the importance of the risk addressed by this clause, OASITO (as the agency responsible for administering this aspect of the Sale Agreements) did not take effective steps to ensure the purchaser deposited the required funds in the appropriate bank accounts and only became aware of the purchaser's non-compliance as a result of ANAO's audit enquiries.

Interest on Equity Deposits

3.46. In the case of Commonwealth Government trade sales, a tender is usually conducted in which the Commonwealth issues a request for proposals that specifies the form tenders are to take, the matters to be covered by tenders and standard terms of contract to be agreed to by the tenderers.⁷⁶ After accepting a tender, the terms of the sale are generally formalised in a written contract which is intended to constitute

⁷⁶ The November 1997 Request for Proposals for the Phase 2 Airports sale advised tenderers that the Commonwealth regarded its draft Sale Agreement to be broadly non-negotiable and that any proposed amendments would be taken into account when assessing tenders.

the entire agreement between the parties and supersede all communications, negotiations, arrangements and agreements, either oral or written, between the parties. This is not to say that an inadvertent mistake cannot find its way into a contract.

3.47. The Adelaide and Coolangatta Sale Agreements signed on 23 March 1998⁷⁷ provided that the Airport Leases would be granted and associated transfers would be effected on the terms and conditions set out in the Sale Agreements.⁷⁸ One term of the Sale Agreements was that interest on the Equity Deposits would be paid to the Commonwealth.⁷⁹ ANAO estimates interest on the Equity Deposits would amount to some \$1.78 million.

3.48. The relevant Sale Agreement clauses were initially drafted by the purchaser and proposed interest be paid to the Commonwealth. The purchaser provided a revision of the relevant clauses the next day (after the deadline for bidders' proposed changes to sale documentation) which provided that interest would not be paid to the Commonwealth. In response to ANAO's enquires, the Business Adviser has advised OASITO that, although it could not locate any written advice on the issue, its recollection is that it advised OASITO that it would be reasonable for OASITO to agree the bidder not paying interest in relation to the Equity Deposit given that the Equity Deposits were offered in lieu of a guarantee and were designed simply as security for the payment of the balance of the purchase price.⁸⁰ OASITO advised ANAO on 26 May 1999 that:

A process was in place through which all members of the Sales Team were copied in on the incoming correspondence. Further, the matter was discussed by members of the Sales Team and it was thought that the revised clause under which interest on the Equity Deposit would be retained by the

⁷⁷ The Sale Agreements were signed by the Minister for Finance and Administration on behalf of the Commonwealth and, on behalf of the purchaser, by the attorneys of Adelaide Airport Limited and Queensland Airports Limited, and the attorneys of the parent entities of the purchasers.

⁷⁸ OASITO commented on, and accepted, sign-offs from its Legal and Business Advisers on the sale documents. According to these sign-offs, the Sale Agreements were prepared in accordance with the instructions received from OASITO and DoTRS and they contained appropriate commercial terms and conditions having regard to the nature of the transaction and the Commonwealth's sale objectives.

⁷⁹ Except where the Sale Agreements were terminated for any reason other than default by the bidder. In these circumstances, the Equity Deposits were to be refunded to the bidder with all interest paid to the bidder.

⁸⁰ Following ANAO's enquires, the purchaser of Adelaide and Coolangatta airports advised OASITO on 13 November 1998 that, because of the diversity of shareholders, it was deemed too difficult to try to organise a guarantee of equity contributions. Accordingly, as an alternative, the purchaser had proposed to raise all equity funds at the time of execution of the Sale Agreements and to place the equity funds on deposit until financial close. The equity providers were only prepared to do this on the basis that, if the sale did not proceed (for whatever reason), any interest on the equity deposits would be paid to the equity providers.

purchaser would be reflected in the Sale Agreements for Adelaide and Coolangatta airports. That this did not occur was an unusual error, which could have been expected to be picked up by the Government Sales Team, or for that matter, by the prospective purchaser adversely affected. We accept that this demonstrates a need to ensure that any such instructions are clear and documented at the time of being given.

3.49. As Legal Adviser to OASITO for the sale, AGS was responsible for the drafting of the Sale Agreements. AGS advised ANAO on 15 April 1999 that a review of its files indicated that AGS did not appear to have been specifically advised by either OASITO and/or its Business Adviser of the agreement reached with the purchaser to amend the sale agreements for Adelaide and Coolangatta Airports prior to their execution. AGS further advised that *in this regard, we note that representatives of both the Business Adviser and OASITO attended at our Offices for the purposes of contract execution for these Airports. Accordingly, [ANAO] should make it clear that any inaccuracies which arose in the drafting of the sale agreements were inaccuracies which could not be attributed to the work undertaken by AGS itself.*

3.50. Following an exchange of correspondence with the purchaser of Adelaide and Coolangatta airports after ANAO raised this issue, OASITO concluded that the Adelaide and Coolangatta Sale Agreements inaccurately described the security deposit arrangements because both parties had agreed that interest on the Equity Deposits should have been retained by the purchaser.⁸¹ Accordingly, OASITO proposed to formally amend the Adelaide and Coolangatta Sale Agreements so that all interest on the Equity Deposits be payable to the purchaser in all circumstances. OASITO has advised ANAO that the purchaser has agreed to the proposed amendment.⁸²

3.51. Finding: The Adelaide and Coolangatta Sale Agreements signed on 23 March 1998 provided that interest on the Equity Deposits would be paid to the Commonwealth. In October 1998, ANAO drew to OASITO's attention that the Commonwealth had not received any interest on the Equity Deposits, estimated to amount to some \$1.78 million. OASITO and its Business Adviser advised ANAO in November 1998 that the Sale Agreements were in error and that the Commonwealth had agreed, prior to the execution of the Sale Agreements, that interest on

⁸¹ The Business Adviser advised ANAO that the retention of interest on the Equity Deposit by the purchaser of Adelaide and Coolangatta airports was fully consistent with the approach taken in general with all other airports where guarantees rather than equity deposits were provided.

⁸² The amendment was to be formalised by an exchange of letters between the Chief Executive Office of OASITO and Macquarie Bank Limited, one of the parent entities of the purchaser.

the Equity Deposits was to be retained by the purchaser. AGS advised ANAO that a review of its files indicated that it did not appear to have been specifically advised by either OASITO and/or its Business Adviser, prior to execution of the Sales Agreements, of any agreement reached with the purchaser to amend the Sale Agreements to remove the requirement for interest on the Equity Deposits to be paid to the Commonwealth.

3.52. OASITO advised ANAO in February 1999 that following an exchange of correspondence with the purchaser, OASITO and the purchaser have agreed to amend the Sale Agreements so that interest on the Equity Deposits is to be retained by the purchaser.

3.53. Recommendation No.4: ANAO *recommends* that for future trade sales, the Office of Asset Sales and IT Outsourcing:

- (a) require written advice from its business adviser on the financial and commercial merits of bidders' proposals for material amendment to the Commonwealth's preferred terms of sale; and
- (b) protect the Commonwealth's legal position in future sale contracts by taking steps to ensure that the written contract constitutes the entire agreement between the parties, thereby reducing the risk of contractual uncertainties which may effect the validity and enforceability of the contract.

3.54. OASITO's response to the recommendation was that it ***agreed with qualification***. OASITO noted that despite best endeavours, it is not always possible to prepare written contracts that achieve the aim of constituting the entire agreement, and therefore scope needs to be maintained to deal ethically and fairly on a commercial basis with any situation that arises as a result of unforeseen eventualities or inadvertent error. To proceed on the assumption that the laudable objective of an entire agreement had been achieved may itself be an unwarranted risk.

3.55. ANAO comment: ANAO recognises that, after the execution of a contract, parties may subsequently agree to vary the terms of the contract for a variety of commercial reasons. However, there is a substantial risk that, in circumstances where a material error disadvantages the Commonwealth, it may be difficult to obtain the other party's agreement to an amendment of the contract. This highlights the importance of Commonwealth agencies ensuring that the written contract accurately reflects the agreed financial terms of the transaction.

4. Sale outcomes

This chapter discusses the major outcomes from the sale against the Government's sale objectives.

Sale proceeds

4.1. Recommendations on the structure of Phase 2 of the airports privatisation program were provided by the Business Adviser in May 1997. The Business Adviser recommended that Phase 2 comprise 15 of the remaining FAC airports and exclude the four Sydney basin airports and the proposed Sydney-West Airport. These recommendations were endorsed by OASITO and accepted by the Government. Achieving the sale of all 15 Phase 2 airports was an important element of the sales objectives of maximising proceeds and minimising the Commonwealth's exposure to residual risks and liabilities associated with the Phase 2 airports. For this reason, it was important that appropriate marketing⁸³ and tender strategies be implemented to develop and maintain bidder interest in all airports.⁸⁴ Compared to Phase 1, less time was allowed for marketing the Phase 2 airports to potential bidders, partly because of the interest generated through the Phase 1 sales and media attention already given to the Phase 2 sales. Investor interest in Phase 2 was further developed through the issue of pre-tender marketing material, the Business Adviser meeting with prospective investors and the availability of preliminary airport site tours and management presentations.

4.2. In May 1997, the Business Adviser estimated that sale of the 15 Phase 2 airports could realise between \$420 million and \$620 million, excluding Essendon Airport, which was not sold. The Business Adviser's estimates were for proceeds of between \$410 million and \$605 million. The Business Adviser noted in its estimates that there was considerable 'hidden' value potential that could be extracted by the Commonwealth. To extract full value, sale preparation and marketing activities highlighted

⁸³ The principal marketing messages included: some of Australia's largest and most attractive airports were being offered for sale together with several smaller regional airports; each of the Phase 2 airports had potential for commercial improvement and some had a very attractive growth outlook; foreign investment in Australia is actively encouraged with minimal restrictions on airport acquisitions; and the post-sale regulatory environment would not be onerous.

⁸⁴ Consistent with this principle, the Business Adviser contract provided for a fixed completion fee capped at \$3.9 million, allocated across the 15 airports, and a lump sum completion fee of \$0.3 million payable on completion of the disposal of all 15 airports. Because the Essendon sale was not completed, the fixed completion fee for this airport (\$0.18 million) and the lump sum completion fee were not paid.

the investment opportunity presented by each airport and the tender strategies were designed to maximise competitive pressure in the bidding process. Actual proceeds exceeded the upper end of the estimate, primarily due to the proceeds from Adelaide airport significantly exceeding the upper estimate for that airport. Proceeds exceeded the upper estimate for all airports with the exception of Launceston, Moorabbin and Parafield (which was sold in combination with Adelaide and Coolangatta).

4.3. Airports are generally valued on the basis of their current and expected revenues, earnings and cashflow.⁸⁵ Phase 1 of the airports privatisation comprised Brisbane, Melbourne and Perth airports which were highly profitable and have been found to be highly cost-efficient compared to other major international airports.⁸⁶ After Sydney, the Phase 1 airports were the FAC's most profitable airports, with earnings before depreciation, interest and tax of some \$199 million in 1996–97 (the year prior to their sale).⁸⁷

4.4. The 15 Phase 2 airports were offered for sale with earnings of \$43.6 million in 1996–97 (see Figure 4.1). The eight major (or core regulated) Phase 2 airports contributed some 94 per cent of these earnings. The seven non-core regulated Phase 2 airports were not highly profitable at the time they were offered for sale and the value of their assets lower than the core regulated airports. In addition, passenger and traffic volumes were smaller and, whereas passenger growth for the core regulated airports was forecasted to increase by up to 8.8 per cent between 1996–97 and 2001–02, forecasts were not able to be developed for the non-core regulated airports.

4.5. It was apparent at the Expressions of Interest stage that the Commonwealth may have some difficulty selling the seven non-core regulated airports, particularly on a stand alone basis.⁸⁸ This was reflected in the bidding process with very few tenders lodged for the non-core regulated airports. Of note was that none of the consortia that had successfully bid for Brisbane, Melbourne or Perth airports lodged a tender for the nearby non-core regulated (General Aviation) airports, while the

⁸⁵ Salomon Brothers, *European Airports—Destination Private Sector: Cleared for Take-off*, October 1996, p.44.

⁸⁶ Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, p.57, para 4.4.

⁸⁷ Federal Airports Corporation, 1996–97 Annual Report, pp.58–59.

⁸⁸ Following the December 1997 mid-term review meetings with shortlisted bidders, the Business Adviser advised OASITO that there was weak bidding interest for the non-core regulated airports and that bidding interest in Mount Isa was conditional on acquisition of Townsville; bidding interest in Parafield was conditional on acquisition of Adelaide; and any sale of Tennant Creek was likely to be conditional on acquisition of Alice Springs.

sales of the non-core regulated airports located close to Australia's other major international airports at Adelaide and Darwin were effected through joint sales with the relevant international airport. This highlights the apparent focus of the larger bidders on acquisition of the major international airports.⁸⁹ Nevertheless, the only Phase 2 airport not sold was Essendon airport, which was withdrawn from sale because it was concluded that the tenders submitted for this airport did not adequately address the Government's sales and ongoing privatisation objectives (see Chapter 3).

Figure 4.1

Phase 2 Federal Airports' Financial Position and Growth Outlook: 1996–97

<i>Airport</i>	<i>Total Assets (\$'000)</i>	<i>Earnings^a (\$'000)</i>	<i>Forecast Passenger Domestic & Regional</i>	<i>Growth to 2001/02 International</i>
Adelaide	138,700	17,000	2.4% to 4.5%	1.2% to 4.5%
Alice Springs	28,064	2,019	0.3% to 2.6%	Not applicable
Canberra	24,128	4,306	2.9% to 4.9%	Not applicable
Coolangatta	21,133	6,184	3.4% to 5.2%	Not applicable
Darwin	73,768	4,379	3.7% to 5.9%	5.3% to 8.8%
Hobart	14,399	3,167	2.6% to 4.8%	Not applicable
Launceston	16,777	2,327	2.3% to 4.5%	Not applicable
Townsville	27,307	1,572	2.6% to 5.6%	Not applicable
Total Core Regulated	344,276	40,954		
Archerfield	14,707	72	Not provided	Not applicable
Essendon	30,045	1,287	Not provided	Not applicable
Jandakot	13,689	(280)	Not provided	Not applicable
Moorabbin	20,394	675	Not provided	Not applicable
Mount Isa	11,611	84	Not provided	Not applicable
Parafield	23,854	856	Not provided	Not applicable
Tennant Creek	473	(44)	Not provided	Not applicable
Total Non Core Regulated	114,773	2,650		
Total Phase 2I	459,049	43,604		

Notes:

^a Calculated as Earnings Before Depreciation, Interest and Tax (EBDIT).

Source: ANAO analysis of Information Memoranda provided to shortlisted bidders.

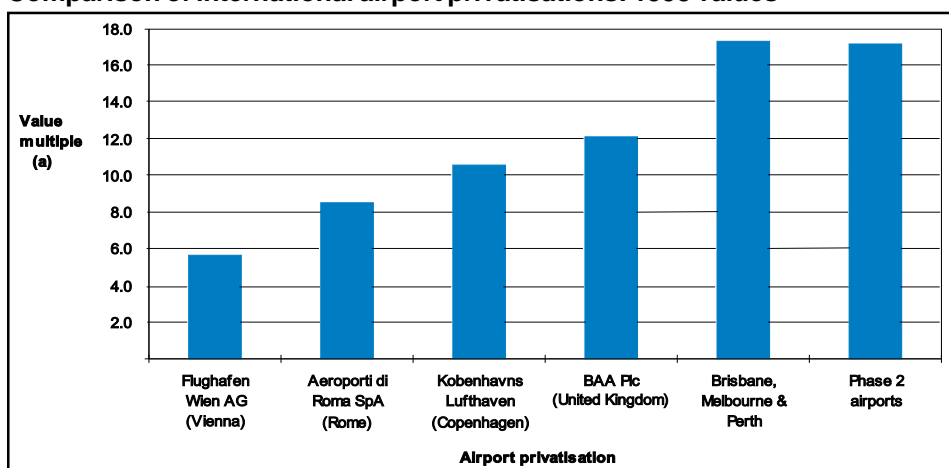
4.6. Phase 2 of the airports privatisation program raised Commonwealth proceeds of \$730 million, primarily comprised of

⁸⁹ Indeed, in its recommendations on the structure of the Phase 2 sales, the Business Adviser recommended that the non-core regulated airports at Bankstown, Hoxton Park and Camden be excluded from sale until the privatisation of Sydney Kingsford-Smith and the proposed Sydney-West airport.

aggregate purchase prices of \$681 million and reimbursed FAC capital expenditure of \$46 million (see Figure 1.2). As illustrated by Figure 4.2, the proceeds compare favourably with current market values of previous privatisations of major European airports and proceeds achieved in Phase 1 of the airports privatisation program. In total, the airports privatisation program has raised to date some \$4.04 billion for the Commonwealth.

Figure 4.2

Comparison of international airport privatisations: 1998 values



Note:

(a) Value multiple is calculated for the privatised European airports as Enterprise Value (market capitalisation plus net debt (short term and long term debt less cash equivalents) divided by Earnings Before Depreciation, Interest and Tax (EBDIT)). For the privatised Australian airports, value multiple is calculated as the weighted average of the total consideration for the airports included in each phase divided by EBDIT figures for the year ended 30 June 1996 (Brisbane, Melbourne and Perth airports) and 30 June 1997 (Phase 2 airports).

Source: ANAO analysis and Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, p.4.

4.7. Shortlisted bidders were required to state in their tender the purchase price they offered for the grant of the Airport Lease, and transfer of the assets, contractual rights and obligations, liabilities and employees of the FAC relevant to the operation of the airport. Shortlisted bidders were informed that the Commonwealth intended to maximise net sales proceeds on a risk-adjusted basis whilst achieving optimal outcomes in relation to the other evaluation criteria. Although there was only limited bidding interest for the non-core regulated airports, at least two bids were received for each airport. The successful bids maximised Commonwealth proceeds as the highest bid was accepted for each airport sold.

4.8. The purchase prices offered by the successful bidders also compares favourably to the value of the net assets transferred to the

Airport Lessee's. The aggregate purchase prices paid for the seven core regulated airports was \$613.3 million. In return, the Commonwealth transferred to the Airport Lessees' net assets valued in aggregate at \$334.5 million as at 30 June 1997. The purchase prices paid for the seven non-core regulated airports sold totalled \$41.4 million, compared to the net assets transferred to the Airport Lessees' which were valued in aggregate at \$82.8 million as at 30 June 1997.

4.9. Finding: The simultaneous trade sale of 14 of the 15 Phase 2 Federal airports raised Commonwealth proceeds of \$730 million, bringing total proceeds to date from the airports privatisation program to \$4.04 billion. ANAO considers that the Phase 2 aggregate sale proceeds represent fair value for the Commonwealth. Although there was only limited bidding interest for the non-core regulated airports with very few tenders lodged for these airports, at least two bids were received for each airport and only Essendon airport was not sold. Furthermore, the Phase 2 proceeds compare favourably with current market values of previous privatisations of major European airports, value multiples achieved in Phase 1 of the airports privatisation program and the Business Adviser's Phase 2 proceeds estimates. In addition, the aggregate purchase prices paid for the 14 airports sold compares favourably to the value of the net assets transferred to the Airport Lessees.

Risk minimisation

4.10. Residual Commonwealth risks and liabilities can arise primarily through the tender process and the terms and conditions of the sale documentation. The tender approach for the Phase 2 sales process addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability to the Commonwealth was assessed as part of the tender evaluation process. Overall, it was concluded that the successful tenders were relatively clean with minimal residual sales risk for the Commonwealth. Outstanding post-sale liability issues were addressed with each bidder prior to execution of the Sale Agreements.

4.11. The Phase 2 sale documentation was modelled on that developed over a twelve month period during the Phase 1 sales. OASITO's Legal Adviser was primarily responsible for preparation of the sale documentation, with input from OASITO, DoTRS, the Business Adviser and Investigating Accountant. The Legal Adviser advised OASITO that the major sale documents represent an acceptable outcome for the

Commonwealth having regard to the nature of the transaction and the level of risk assumed. The major documents comprised:

- **Sale Agreements**, the parties to which were the Commonwealth, the Airport Lessee Company and its parent entities. The Sale Agreements were in a substantially similar form for each Phase 2 airport and contained measures designed to minimise the Commonwealth's post-sale risks and liabilities, including: capping the Commonwealth's maximum liability; and providing limited Commonwealth warranties with the warranties provided subject to a number of qualifications. The major differences between the Phase 2 and Phase 1 Sale Agreements were: the absence of mandatory development commitments for the non-core regulated Phase 2 airports; provisions for dealing with the General Aviation Infrastructure Tariff (GAIT)⁹⁰ were included for the non-core regulated airports; the Adelaide Agreement included a specific obligation to complete the runway extension and also contractual arrangements relating to a proposed Multi User Integrated Terminal⁹¹; and the Canberra Agreement requires the purchaser to negotiate in good faith access arrangements for the proposed very fast train.
- **Airport Leases**, which were granted under section 22 of the *Airports (Transitional) Act 1996* for each airport for a period of 50 years with a 49 year option.⁹² The Leases were drafted to contain only those terms which were considered essential to protect the Commonwealth's interests as landlord; the intention being to grant the lessee rights

⁹⁰ The FAC imposed a GAIT in relation to aircraft weighing 10 000 kilograms or less. Qualifying aircraft displaying a GAIT label are able to be parked for any length of time per day and/or conduct any number of landings, take-offs and circuits at, on or from the airport site for the period indicated on the label. The Sale Agreements for the non-core regulated airports required the lessees to allow any aircraft displaying a validly issued GAIT label to use the airport site in accordance with the terms on which the GAIT label was issued. The new owners are able to introduce new charges for aircraft not covered by GAIT or for aircraft where the GAIT period expires.

⁹¹ A concept design for a Multi-User Integrated Terminal (MUIT) was completed in September 1997. It was costed at a budget of \$200 million and had the design capacity to the year 2025 based on passenger growth forecasts. It proposed that funding for the MUIT would be supported by cashflows from a Passenger Facility Charge on all departing and arriving passenger tickets. The lessee is required to use all reasonable endeavours to obtain all requisite planning and regulatory approvals; negotiate terminal and access arrangements with the domestic airlines; finalise the proposed MUIT design; and finalise construction costings. However, the lessee is not required to accept any conditions or requirements imposed by other entities that would render the MUIT uneconomic having regard to the lessee's cost of capital and MUIT usage projections.

⁹² The lessees will not be eligible to exercise the option if there is a default under the Lease which has not been remedied at the time the option is to be exercised. This is subject to the statutory rights of the lessee to seek relief against forfeiture.

which as far as possible equate with freehold.⁹³ The Lease for each of the airports is identical in all essential terms except there is no obligation in relation to the payment of environmental officer costs for Tennant Creek and Mount Isa as the environmental provisions of the Airports Act do not apply to these airports.

- **Tripartite Security Deeds** were introduced in Phase 1⁹⁴ in response to the concerns of lenders that lease termination would mean that their borrowers' main asset and, thus, a substantial part of the lenders' security value could be lost without the lenders having an opportunity to rectify the problem prior to termination.⁹⁵ DoTRS decided that Tripartite Deeds would only be made available for the core regulated airports, in a similar form to that adopted for the Phase 1 sales. No Tripartite Deed was offered for the non-core regulated airports given their relative size, the nature of their operations, and DoTRS' policy which would not be to step in if a default occurred.

Joint User Airports

4.12. The General Information Memorandum advised bidders that Canberra, Townsville and Darwin airports are joint user airports. Prior to the Phase 2 airports sales, the Royal Australian Air Force owned and maintained joint user facilities, which comprise runways and taxiways, at each of these airports. In addition, at each of these airports the Australian Defence Force operates various activities separate from civil operations, these activities vary from airport to airport.

4.13. The Department of Defence (DoD) determined that Darwin and Townsville airports are both of continuing strategic significance. Accordingly, joint user arrangements, which had been in place between DoD and the FAC for these airports, were formalised in a joint user agreement between the new operators and the Department. These agreements are focused on ensuring that the military presence and the commercial activities of the private operators coexist in a manner which is mutually beneficial. The joint user agreements provide that the runways at the joint user airports at Darwin and Townsville will continue to be

⁹³ Given that the Commonwealth's role as regulator is different from its role as landlord, provisions for regulation and administration of the airport sites are largely contained in the Airports Act and various regulations.

⁹⁴ Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, pp. 64–66.

⁹⁵ The Airport Leases provide the Commonwealth with limited termination rights. Termination may occur following the suspension or cancellation of the airport license for the breach, other than as a result of *force majeure*, of the obligation to provide access to or to use the airport. In each case, the Leases allow for almost immediate termination upon the occurrence of one of these events although the Commonwealth may prevent or cure any termination event at the cost of the lessee without terminating the Lease.

shared, with the DoD retaining responsibility for maintenance of the runways and the private operator being responsible for proportional reimbursement of maintenance costs to DoD.

4.14. In the case of Canberra airport, DoD was of the view that there was not a continuing strategic requirement for Canberra airport to remain a joint user airport. It plans to cease RAAF operations at the Fairbairn Base over a five year period. The General Information Memorandum advised bidders that the Minister for Defence had approved in principle the inclusion of the joint user areas at Canberra airport in the leasehold sale but that final confirmation on this and the arrangements which might need to be put in place to reflect the transfer of responsibilities for the joint user area from the RAAF to the new operator were to be provided in due course.

4.15. Negotiation between the OASITO, its advisers and the DoD resulted in the Prime Minister advising the Minister for Finance and Administration, on 21 January 1998, that the Fairbairn Base would be included in the airport lease for Canberra airport. To enable continued operation of the Fairbairn Base pending its closure, it was arranged that DoD would enter into a five year sub-lease for the Fairbairn site. The sub-lease is designed to facilitate the gradual cessation RAAF operations at the Fairbairn site. In addition, arrangements have been made to ensure that Canberra Airport continues to provide a permanent home for the Special Purpose Fleet (that is the VIP aircraft used to transport the Prime Minister and other dignitaries).

4.16. The consultation and liaison in relation to the joint user airports consistently included all relevant parties which enabled agreements to be developed which are aimed at protecting the Commonwealth's interests as well as providing a platform for the new operators to manage/develop successful commercial operations at the airport sites.

4.17. Finding: The tender approach for the Phase 2 sales process addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability to the Commonwealth was assessed as part of the tender evaluation process. Overall, it was concluded that the successful tenders involved minimal residual sales risk for the Commonwealth. Remaining post-sale liability issues were addressed with each bidder prior to execution of the Sale Agreements. Joint User Deeds were executed between the Department of Defence and the purchasers of Townsville and Darwin which are aimed at protecting the Commonwealth's interest

as well as providing a platform for the new operators to develop and manage successful commercial operations at the airport sites. The Department of Defence has not retained ownership of the base at Fairbairn but entered into a five year sublease. The sub-lease is designed to facilitate the gradual cessation of Royal Australian Air Force operations at the Fairbairn site.

Employee issues

4.18. One sale objective was to ensure fair and equitable treatment of FAC employees, including preservation of accrued entitlements.⁹⁶ To achieve this, negotiations were undertaken with the five unions representing FAC employees in mid 1995 and a “*Principles Agreement*” was reached on 14 December 1995. This Agreement formed the basis for further negotiations.

4.19. At the beginning of the Phase 2 sales process, the Unions confirmed that it was their understanding that the Agreement would also apply to the Phase 2 airports. All successful bidders for the Phase 2 airports agreed to the Unions’ requirements for all Phase 2 airport staff. Pursuant to Ministerial Transfer Declarations under the *Airports (Transitional) Act 1996*, Award and Non-Award staff at the Phase 2 airports transferred to the new operators. Employee terms and conditions have been preserved for a minimum 12 month period following completion of the sales. The Sale Agreement for each airport contains provisions whereby the lessee has undertaken not to seek to vary or terminate, in the first 12 months of the lease, awards, enterprise or redundancy agreements applicable to the transferring FAC employees. In addition, the lessees have undertaken not to subject any former FAC employee to compulsory redundancy during the first 12 months of the lease or to establish a dual workforce⁹⁷ at the airport.

4.20. Finding: The sale process adequately addressed the fair and equitable treatment of FAC employees at the sale airports including preservation of their accrued entitlements.

⁹⁶ A joint superannuation working party comprising representatives of the then Asset Sales Task Force and its Superannuation Adviser, FAC, FAC Unions and DoFA was established in May 1995 and negotiated the conversion of the FAC Superannuation Fund to a multi-employer fund. Each Phase 2 airport lessee company has undertaken to join the FAC Superannuation Fund as a participating employer and will be required to make contributions to the Fund in respect of the former FAC employees for the first 12 months of the lease.

⁹⁷ That is all employees must be on similar terms and conditions of employment as the specified employees.

Australian ownership and local participation

4.21. Nine different consortia acquired the 14 Phase 2 airport leases. The Government's sale objectives of diversity of ownership and majority Australian ownership were met in the selection of these consortia.

4.22. The Tender Evaluation Committee considered all elements of each individual bid and possible permutations of combination bids, looking not only at direct ownership, but extending their review to the possible influence which may be exerted on each of the bidders by related parties, such as those with management contracts. The bid evaluation reports contain discussion on each of the bids including any elements of concern in relation to foreign ownership. There were a number of issues which were referred to the DoTRS for policy consideration, the Tender Evaluation Committee agreed to rely on the expertise of DoTRS to make determinations in relation to these issues. All the successful bidders were assessed as adequately addressing the foreign ownership requirements under the Airports Act.

4.23. Bidders were also asked to detail the extent of local participation associated with their bids. The Tender Evaluation Committee considered the following elements when looking at local participation: the amount of locally contributed equity associated with bid; the level of local board and management representation; and the level of local consultation. All successful bidders were assessed by the Tender Evaluation Committee as incorporating a reasonable level of local participation.

5. Ongoing Privatisation Objectives

This chapter discusses steps taken to address the Government's ongoing privatisation objectives including regulatory and leasehold arrangements for ongoing management of the airports.

Background

5.1. The Commonwealth's ongoing interests in the operation and management of the leased Federal airports are governed by: the Airports Act and its regulations, the Airport Leases and the Sale Agreements. The Government nominated ongoing privatisation objectives for the Phase 2 airports which were developed from, and are substantially similar to, those adopted for the Phase 1 sales, namely to:

- ensure diversity of ownership, to the degree consistent with achieving the other objectives of sale;
- require that each airport owner or lessee offers access on reasonable commercial terms to aircraft owners, consistent with national competition policy standards and the maximum benefit to the travelling public;
- ensure that each airport owner or lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations;
- ensure each airport owner or lessee, in undertaking the development of the airport, demonstrates an ability commensurate with the region in which the airport is sited, to respond to the interests of airport users and the environment; and
- require that each owner or lessee indicates a willingness to abide by the pricing policy and framework established by the Commonwealth.

5.2. The diversity of ownership objective was explicitly considered by the Tender Evaluation Committee in its recommendations on preferred bidders. Diversity of ownership was achieved with nine different consortia acquiring leases for the 14 Phase 2 airports. Two of these consortia had been successful in the Phase 1 sales: the purchaser of Melbourne airport acquired Launceston; and the purchaser of Perth airport acquired the Northern Territory airports.⁹⁸ In addition to

⁹⁸ A member of the consortia that acquired Perth airport and the Northern Territory airports was also involved in the consortia that acquired Hobart airport.

ownership diversity, all bids received for the Phase 2 airports were consistent with the Government's policy of cross-ownership restrictions between Brisbane and Coolangatta; Hobart and Launceston; and Melbourne and Adelaide.⁹⁹

5.3. The objective of ensuring airport access on reasonable commercial terms to aircraft owners was addressed by insertion into the airport leases on core-regulated airports of a requirement that the lessee provide for access to the airport by intrastate, interstate and international air transport. Lessees of the non-core regulated airports are required to provide for access to the airport by intrastate and interstate air transport.¹⁰⁰ Access can be refused where an aircraft owner or operator has failed to pay to the lessee, within 21 days after the due date, any amount due to the lessee for use of the airport site.¹⁰¹ Access can also be refused in order to comply with a demand management scheme under the Airports Act.

Airport development

5.4. Two ongoing privatisation objectives addressed future airport development. The first required a commitment by lessees to the effective development of airport services, consistent with Australia's international obligations. To fulfil this objective, the lease for each airport contains an obligation on the lessee to develop the airport site to a standard consistent with quality standards reasonably expected of such an airport in Australia and good business practice, having regard to the actual and anticipated future growth in traffic demand.¹⁰²

5.5. The objective of responsive airport development is to be addressed through the requirement under the Airports Act that a master plan for each airport is developed which sets out, among other things, the lessee's development objectives, the lessee's assessment of the future service and facility needs of airport users, and land use and related development

⁹⁹ The Government established its cross-ownership policy in respect to the Phase 2 airports at the beginning of the sale process. The cross-ownership restrictions apply for an initial 2 year period post-sale. Thereafter, cross-ownership between the specified airports is subject to review by the Australian Consumer and Competition Commission (ACCC).

¹⁰⁰ Access to the core-regulated airports by interstate and international air transport, and the non-core regulated airports by interstate air transport, is subject to any *force majeure* events, which are events that are beyond the control of the lessee which prevent the lessee from meeting its commitment. Common examples of *force majeure* events are war, riots and earthquakes.

¹⁰¹ The lessee is required to notify the Commonwealth of its intention to refuse access at least 14 days in advance of the first day on which it intends to refuse access.

¹⁰² The lease provides that if the Commonwealth believes the lessee is not complying with the long term development obligation it has the power to require the lessee to produce a plan to bring the airport up to the required standard within five years. The plan must be produced within 120 days and must contain at least the level of detail required for a major development plan under the Airports Act.

proposals. The Act includes public consultation processes for airport master plans and for the major development plans required for each major development at an airport.¹⁰³

5.6. In addition, the new airport operators are required to develop and implement an environmental strategy for the airport approved by the Minister for Transport and Regional Services. The strategy should set out how the airport will be operated so that its environmental health is maintained or improved. In developing the strategy an operator is required to consult widely. And the strategy is subject to Ministerial approval. The airport operator must then take all reasonable steps to ensure that the strategy is complied with.¹⁰⁴

5.7. DoTRS is responsible for administering these requirements. In response to a previous ANAO recommendation¹⁰⁵, DoTRS has undertaken to develop guidance for the airport operators and itself to inform assessments of whether the airport sites are being developed to the required standard. DoTRS has also instituted annual meetings with each of the lessees to assist it to monitor compliance with the Airports Act and the Airport Leases.

Airport Environmental Officers and Airport Building Controllers

5.8. An important element of the environmental management regime at the leased Federal airports is the Airport Environment Officer (AEO) position. DoTRS has appointed an AEO for each airport subject to the relevant provisions of the Airports Act.¹⁰⁶ The AEO is responsible for the day-to-day administration of environmental issues. The Department oversees the AEOs and retains overall responsibility for enforcement of environmental protection regulations.

5.9. The AEO positions at the airports are substantially funded by airport operators under provisions in the airport leases. Under the leases, the operators are required to pay to the Commonwealth, six monthly and in advance, the Commonwealth's estimate of the costs of the AEO for the next six months less any costs recovered by the AEO from third parties.¹⁰⁷

¹⁰³ Major developments include constructing a new runway; extending the length of a runway; and constructing or extending a passenger terminal, taxiway, railway or rail handling facility.

¹⁰⁴ The strategy should be in place within 12 months of a new operator taking over a leased Federal airport, and is to cover a five year period. After it has been approved, the airport operator must advertise the approved strategy, indicating where copies are available for public perusal or purchase.

¹⁰⁵ Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*, Recommendation No.10, p. 75.

¹⁰⁶ Tennant Creek and Mount Isa Airports are not subject to Part 6 of the Airports Act which deals with environmental management. These airports are subject to State/Territory environmental legislation.

¹⁰⁷ AEO cost estimates range from \$22 250 at Parafield to \$100 000 at Coolangatta and \$177 750 at Adelaide.

5.10. DoTRS has also appointed an Airport Building Controller (ABC) at each airport subject to the Part 5 of the Airports Act regarding land use, planning and building controls.¹⁰⁸ ABC's are responsible for ensuring that activities at the airports meet the appropriate building and engineering standards. The airport operators are also required under the Sale Agreement to fund the ABC position, but are only required to reimburse the Commonwealth to the extent that Building Controller costs incurred by the Commonwealth are not recovered by third parties through fees paid under the *Airports (Building Control) Regulations* and only up to a maximum annual cap. The maximum annual cap on the operators' obligations regarding the ABC positions is different for each of the airports.¹⁰⁹ The Sale Agreements also provide that airport operators obligations regarding the costs of the Building Controllers ends on 30 June 2003, by which time it is anticipated that the positions will be self-funded through the collection of fees for services.

Development commitments

5.11. The airport lessee companies for the eight core-regulated airports committed, with conditions, in the respective sale agreements to undertake a total of \$163 million of capital expenditure at the airport sites over the first 10 year period of the airport leases. The commitments are significant, representing some 22 per cent of sale proceeds compared to \$591 million, or 18 per cent of sale proceeds, for the Phase 1 airports. In addition to the development commitments, additional infrastructure development obligations were included in the sale agreements for Canberra¹¹⁰ and Adelaide airports.¹¹¹

5.12. The development commitment expenditure is required to be made by the airport lessee company on items of an aeronautical nature with

¹⁰⁸ Tennant Creek and Mount Isa Airports are not subject to Part 5 of the Airports Act. These airports are subject to State/Territory land use, planning and building control legislation.

¹⁰⁹ Ranging from \$15 000 for Moorabbin Airport to \$112 000 for Adelaide Airport.

¹¹⁰ The Canberra airport lessee is required to negotiate in good faith concerning access arrangements with the proponents or developers of the Very High Speed Train (VHST) proposal if: construction of the VHST proceeds to completion and operation; and the proponents or developers of the VHST wish to locate the Canberra VHST terminal at the airport site.

¹¹¹ The Adelaide airport lessee is required to complete the extension of the main runway and associated works. A Multi-User Integrated Terminal (MUIT) is proposed for Adelaide Airport. A concept design completed in September 1997 was costed at a budget of \$200 million and had the design capacity to the year 2025 based on passenger growth forecasts. It proposed that funding for the MUIT would be supported by cashflows from a Passenger Facility Charge on all departing and arriving passenger tickets. The lessee is required to use all reasonable endeavours to obtain all requisite planning and regulatory approvals, negotiate terminal and access arrangements with the domestic airlines, finalise the proposed MUIT design, and finalise construction costings. However, the lessee is not required to accept any conditions or requirements imposed by other entities that would render the MUIT uneconomic having regard to the lessee's cost of capital and MUIT usage projections. Currently, the ACCC is considering a proposal from Adelaide Airport Limited regarding the level a Passenger Facility Charge.

the projects on which these amounts must be spent are broadly specified in the sale agreements. The agreements included provisions, to be administered by DoTRS, for monitoring compliance with the development commitments. Unless expenditure is delayed due to economic factors such as reduced passenger numbers and aircraft movements or a *force majeure* event, any shortfall in expenditure is to be paid to the Commonwealth.

Airservices Australia location specific pricing

5.13. The Phase 2 sales process coincided with a major change to how Airservices Australia prices its terminal navigation services¹¹² at airports with Airservices Australia air traffic control towers. Airservices Australia formerly structured its pricing for services on a network basis rather than on the actual cost to provide services at particular airports. In February 1997 the Federal Court ruled that these network charges were potentially invalid.¹¹³ In light of this, and consistent with the Government's general policy objective of eliminating the economic distortion which arises from such an approach to pricing, Airservices Australia commenced discussing with aviation industry representatives in 1996 the need to move to a pricing structure whereby the price better reflected the local demand and costs of operation. This initiative is referred to by Airservices Australia as location specific pricing.

5.14. Airservices Australia developed a staged movement to location specific pricing planned to be implemented over a three year period. From 1 July 1997, location specific pricing was introduced for the provision of rescue and firefighting services by Airservices Australia. Location specific pricing for terminal navigation services commenced from 1 July 1998. The Airservices Australia's pricing reform process is planned to culminate in the disaggregation of a range of specific charges currently included in en route services.

5.15. The development of policy on the introduction of location specific pricing for terminal navigation services occurred concurrently with the Phase 2 sales process. In the end, final binding offers were required from bidders, prior to the Government's announcement in March 1998 of its decision to proceed with the initiative from 1 July 1998, and in the

¹¹² The terminal navigation services provided by Airservices Australia include the provision, maintenance and operation of air traffic control services (including radar) within 55 kilometres of an aerodrome with an operating Airservices Australia control tower and navigational aids used in take-off, approach and landing of aircraft.

¹¹³ See *Monarch Airlines Ltd & Ors v Airservices Australia* [1997] 65 FCA (14 February 1997). In February 1998, the Federal Court upheld the earlier ruling (*Airservices Australia (formerly Civil Aviation Authority) v Monarch Airlines Ltd* [1998] 79 FCA (18 February 1998)).

absence of advice of the specific price effect of the introduction of location specific pricing for terminal navigation services at each of the relevant airports.

5.16. The shift to location specific pricing in relation fire and emergency services had little impact on the area of general aviation as the charging threshold for these services is 2.5 tonnes, effectively eliminating the entire general aviation sector from exposure to rescue and fire fighting charges. The potential impact on general aviation operators of a move to airport specific pricing of terminal navigation services was far greater.

5.17. From the outset of the Phase 2 sales process, DoTRS, OASITO and its advisers were aware that it was not certain that the Government's decision on the initiative to introduce location specific pricing of terminal navigation services would be available prior to the closing date for final binding offers. To address this issue, the General Information Memorandum provided to bidders advised of Airservices Australia's intention to expand location specific pricing to terminal navigation services from 1 July 1998 and referred bidders to a discussion paper released by Airservices Australia in 1996 which identified indicative unit costs by airport location.¹¹⁴

5.18. Bidders for the general aviation airports were offered the opportunity to attend a briefing by DoTRS in January 1998 at which they were advised of the state of play in the development of the location specific pricing¹¹⁵. In February 1998, following the Government's decision to implement reform of Airservices Australia's pricing for terminal navigation services from 1 July 1998, bidders were advised of the decision

¹¹⁴ The General Information Memorandum highlighted that the 1996 Airservices Australia paper showed the potential for significant cost differentials between locations, with many general aviation and small regional airports likely to experience large price increases if cost recovery underpinned the final strategy approved by Government. Conversely, under location specific pricing, costs at the larger airports, such as Brisbane, Sydney, Melbourne, would fall. The General Information Memorandum also advised bidders that, depending on the pricing strategy adopted, implementation of a new pricing regime had the potential to adversely affect demand at those airports used predominantly by general aviation, small public transport and charter operations, as well as by flight training schools, given that demand for services by these operators tended to be more price sensitive.

¹¹⁵ The 8 January 1998 briefing was arranged in response to concerns raised by the bidders for these airports about the location specific pricing for terminal navigation services issue. The successful bidder for Canberra Airport was not invited to the 8 January 1998 briefing, apparently because it was not a bidder for a general aviation airport and because it was not one of the consortia which had previously raised any concerns with the Government Sales Team in relation to this issue.

and that the reforms would involve capping of location specific prices after a transitional process.¹¹⁶

5.19. Funding was approved in the 1998–99 Federal Budget to support transitional arrangements over the two years from 1 July 1998 for transition from the previous pricing model to a location specific pricing regime with prices capped at the locations most severely affected by the new pricing regime.¹¹⁷ The location specific pricing regime, with respect to terminal navigation services, is regulated by a series of contracts with major airlines. These contracts outline the services and fees which are covered by the policy. General aviation users are party to standard terms and conditions which mirror the provisions of the contracts with major airlines.

5.20. The new owners of Canberra, Adelaide and Coolangatta Airports expressed concerns regarding the level of prices for terminal navigation services to apply at their airports from 1 July 1998. Accordingly, they approached the ACCC with their concerns. On 16 June 1998, the ACCC announced that, while it had accepted most of the price changes proposed by Airservices Australia for terminal navigation services, it had reservations about the price increases proposed for Canberra, Adelaide and Coolangatta airports. Airservices Australia had sought an increase from \$5.19 per tonne to \$9.00 per tonne at the three airports. The ACCC decided to initially cap the price at these three airports at \$6.75 per tonne, that is at the same level applying in 1998–99 at the general aviation airports. Following negotiations between Airservices Australia, the aviation industry and the airport operators, Airservices Australia submitted revised terminal navigation charges for Canberra, Adelaide and Coolangatta Airports to the ACCC. The ACCC announced on 26 June 1998 that it had approved the new charges of \$8.18 per tonne at Adelaide, \$8.34 per tonne at Canberra and \$8.61 per tonne at Coolangatta.

¹¹⁶ After the staged phase in over two years, prices for terminal navigation services will be capped at \$10 per tonne, that is Airservices Australia will charge on the basis of the location specific costs of providing the services at a particular airport up to the cap of \$10 per tonne. For the general aviation airports, the initial transitional arrangements provided a subsidy to Airservices Australia to fund a lower cap in each of 1998–99 (\$6.75) and 1999–2000 (\$8.30) before the \$10 cap applies in 2000–01. These transitional arrangements have now been superseded by the pricing changes announced on 2 December 1998.

¹¹⁷ The 1998–99 Budget includes \$11 million for transitional funding to Airservices Australia this year and provides for a further \$2 million in 1999–2000 to facilitate the phasing in of the new pricing structure. In addition, Airservices Australia advised that it will bear costs estimated to amount to some \$8.1 million and the airline sector of the aviation industry will contribute \$8.9 million through a temporary surcharge.

5.21. Since the introduction of the location specific pricing model, in addition to the issues raised with the ACCC by the operators of Canberra, Adelaide and Coolangatta airports, concerns have been expressed by a number aviation industry participants, particularly in general aviation, regarding its impact on their financial viability. Airservices Australia advised ANAO that following the introduction of location specific pricing from 1 July 1998, extensive consultation has been undertaken by Airservices Australia with airport owners, aircraft operators and other interested groups.¹¹⁸

5.22. On 2 December 1998, Airservices Australia announced that it had reviewed its pricing approach to general aviation services, following consultation with the aviation industry. From 1 January 1999, Airservices Australia has introduced refinements including differential pricing for general aviation traffic. All general aviation traffic using any airport, other than Perth, Melbourne, Adelaide, Sydney and Brisbane, will attract the same \$6.75 per tonne charge which applies at general aviation airports.¹¹⁹ In addition, general aviation aircraft using airports for circuits will only be liable for one charge for a session of circuits.

5.23. Airservices Australia further advised ANAO that it has also raised the subject of alternative suppliers of Air Traffic Control services at all of these airports, although practical progress in this area depends on changes to the legislative framework.¹²⁰

Economic regulation

5.24. One of the Government's objectives in privatising airports was to promote efficient and commercial operation of airports. At the same time, the potential for abuse of market power by the airport operators was recognised. For this reason, the Government established an airports economic regulatory framework covering pricing, quality of service and

¹¹⁸ Airservices Australia further advised ANAO that *formal Consultation Groups have been established at Canberra and Bankstown in Sydney and others are planned for Coolangatta and Adelaide. As well, discussions have been held at all other General Aviation airports (Camden, Archerfield, Parafield, Jandakot and Moorabbin) and at a number of regional airports. These discussions have been aimed at determining stakeholder requirements and explaining Airservices' cost structures and commercial objectives. The ultimate intention is to align customer needs with the services provided at a cost which both sides find acceptable.*

¹¹⁹ At Perth, Adelaide, Melbourne, Sydney and Brisbane Airports a minimum charge of \$20 per landing applies. Such a charge applies to all landings including training flights for each touch and go, stop and go, overshoot, or go around at these airports.

¹²⁰ Facsimile from Airservices Australia to the ANAO dated 17 February 1999.

access issues.¹²¹ This framework applies to the 12 core regulated airports.¹²² One of the Government's ongoing privatisation objectives requires that each owner or lessee indicates a willingness to abide by the pricing policy and framework established by the Commonwealth.

5.25. The ACCC has been given primary responsibility for implementing and administering the arrangements. The regime which is in place for the Phase 2 airports¹²³ is identical to that which exists for Phase 1 airports and is drawn from the Government's Pricing Policy paper which was released in November 1996.¹²⁴ The regulatory regime comprises measures under the *Trade Practices Act 1974*¹²⁵, the *Prices Surveillance Act 1983* and the *Airports Act 1996* which are designed to protect airport users from the potential for abuse of market power by airport operators. The regime also includes a range of measures directed toward ensuring transparency, including quality of service monitoring, financial accounts reporting requirements and monitoring of prices of aeronautically related services.

¹²¹ In addition, the Airports Act requires airport operator companies of core regulated airports to provide the ACCC with accounts and reports specified in the regulations. It is intended the accounting information will supplement that which is required under the Corporations Law. While the Corporations Law allows holding companies to present consolidated accounts for the entire group, the regulations require individual airport operator companies to provide separate accounts to the ACCC covering the operation of the company only. Once lodged, the ACCC has the ability to publish appropriate information about airports.

¹²² Notwithstanding that Sydney Airport remains in Commonwealth ownership, the Government took the decision that Sydney Airport Corporation (the entity formed to assume ownership of Sydney Airport and the Sydney basin general aviation airports following the winding up of the FAC) should be subject to the same requirements under the Airports Act as the lessees of the privatised airports.

¹²³ Sydney Airport, as a core regulated airport, is subject to the economic regulation measures administered by the ACCC including quality of service monitoring and monitoring of prices but is not subject to the price cap for aeronautical services. Non-core regulated airports are not subject to the pricing regime established for core regulated airports.

¹²⁴ The Government's Pricing Policy paper sets out the post-sale pricing policy and was developed by DoTRS in consultation with ACCC and other stakeholders.

¹²⁵ Division 2 of Part 13 of the Airports Act 1996 deals with the application of the access regime in Part IIIA of the Trade Practices Act 1974 to core regulated airports. Currently, the ACCC is dealing with the first request it has received from a user of airport services for a determination that an airport service is a declared service for the purposes of Part IIIA of the Trade Practices Act 1974. The user, an operator of off airport car rental services and short and long term car parking for airport users, provides a shuttle bus service from its business site to the airport. This requires access to the airport to drop off and pick up passengers. So far the company has not been able to agree on terms and conditions of access with the airport. The ACCC has proposed that *landside roads and associated vehicle facilities for dropping off and picking up passengers* at the airport are considered *airport services* under section 192 of the Airports Act 1996. A draft determination to this effect was issued by the Commission on 10 March 1999. In assessing the company's request for determination, the ACCC held public consultations, which included releasing a discussion paper, issuing calls for submissions and conducting a public hearing. Interested parties have been invited to make written submission before a final determination is made. Should a final determination be made, along the lines proposed, the way would be open for the ACCC to arbitrate the dispute between the airport operator and the user. Other users of the facilities for purposes of dropping-off and picking-up facilities would also have a right to arbitration.

Prices Surveillance and Price Cap

5.26. The Government decided to apply a price cap on aeronautical services¹²⁶ at all leased core regulated airports (Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Perth, Melbourne and Townsville Airports) which is administered under the *Prices Surveillance Act 1983*. Under section 20 of the *Prices Surveillance Act 1983*, the Treasurer may give written directions to the Commission to give special consideration to specified matters in exercising its powers and performing its functions under the Act. Certain aeronautical services at leased airports have been declared by the Treasurer under section 21 of the *Prices Surveillance Act 1983* for surveillance. These are the services included in the price cap and the matters to be taken into account in administering the cap have been given to the ACCC in a written direction from the Treasurer.¹²⁷

5.27. The price cap is in the form of a Consumer Price Index minus an X factor formula (CPI-X). For each of the core regulated airports leased in Phase 1 and Phase 2 the Government, upon the advice of the ACCC, has determined a value for the X factor to apply at the airport.¹²⁸ The X factors are based on expected productivity improvements. The Government's intention is that in a given financial year the total price of the basket of declared aeronautical services at each of these airports will not rise by more than the annual CPI minus the X factor for the particular airport. As the X factors for most airports are higher than CPI forecasts, it is expected that at most airports the overall prices for aeronautical services will fall in the first five years post sale.

5.28. Prices oversight under the *Prices Surveillance Act 1983* is based on voluntary restraint. Declaration of services under the Act requires the airport operator to notify the ACCC of a proposal to increase charges for these services. The penalties provided for in the Act relate to a failure to notify price increases. However, they are not penalties for price increases. The General Information Memorandum advised bidders that these

¹²⁶ Aeronautical services for the purposes of the price cap are those which were covered by the definition in the *Federal Airports Act 1986* and include: Aircraft movement areas—grounds, runways, taxiways, aprons; airfield lighting, airside roads/lighting; airside safety; nose-in guidance; aircraft parking areas; and visual navigation aids. Passenger processing areas—forward airline support service areas; aerobridges, airside buses; departure lounges and holding lounges (excluding commercially—important persons lounges); immigration and customs service areas; public address systems, closed circuit surveillance systems, security systems; baggage make-up/handling/reclaim; public areas in terminals, public amenities, lifts/escalators/moving walkways; flight information display systems; and landside road and lighting and covered walkways.

¹²⁷ Direction 13 from the Treasurer to the ACCC sets out details of the price cap formula, the X values and other issues relevant to the ACCC's administration of the cap.

¹²⁸ The Airport X factors for the Phase 2 airports are: Adelaide 4.0; Alice Springs 3.0; Canberra 1.0; Coolangatta 4.5; Darwin 3.0; Hobart 3.0; Launceston 2.5; and Townsville 1.0.

voluntary arrangements for price oversight have operated successfully since 1983, and that no Prices Surveillance Authority/ACCC pricing recommendation has ever been ignored by firms declared under the Act. If an airport operator were to attempt to establish charges above those allowed by the price cap, then measures contained in the *Prices Surveillance Act 1983* could be applied. For example, the ACCC could recommend a public inquiry, during which the charges for declared services could be frozen.

5.29. In this circumstance, operators are required to advise the ACCC of proposed increases in charges for declared services. There is scope for airport operators to rebalance charges within the overall price cap. In addition, some flexibility is included in the price cap regime to allow airport operators to rebalance charges outside the cap. There is scope for the operator to seek charging increases outside the cap, to recoup costs associated with necessary new investment where the price rises are required to fund the new investment and where those users with a significant interest in the new investment support the investment, including associated charges.¹²⁹ Under this approach, operators have room to rebalance charges within the cap, and scope to cover costs and earn a rate of return on new investment.

5.30. Price cap compliance will be calculated on a revenue weighted average price basis. Under this approach, increases in particular charges are weighted by that component's proportion of revenue for the previous period. As the proportion of each component's revenue may change over time, leading to under or over recoveries, the component weighting may need to be adjusted at some time in the future. Such adjustment would occur after actual revenues are known so that the change in average charges remains within the cap when considered over a period of two or three years. The ACCC is to undertake a review of pricing oversight arrangements as a basis for recommending to the Government the arrangements to operate after the first five years of the price cap.

5.31. In addition to its responsibilities for administering the price cap on aeronautical services, the Treasurer directed the ACCC in May 1998 to undertake formal price monitoring under section 27A of the *Prices Surveillance Act 1983* of nominated aeronautical related¹³⁰ services at the

¹²⁹ The ACCC will apply criteria against which airport operator's requests for charging increases outside the cap will be assessed with the aim of ensuring the interests of users remain protected while requiring that the ACCC has regard to factors such as the costs of the investment, the efficiency of the airport's operation and the particular demand characteristics of the airport.

¹³⁰ The aeronautical related services provided by airport operators monitored by the ACCC include aircraft refuelling; aircraft maintenance sites and buildings; freight equipment storage sites; car parks (including public and staff parking but not valet parking); freight facility sites and buildings; ground support equipment sites; and check-in counter and related facilities.

12 airports. The monitoring covers costs, revenues and profits. The rationale for monitoring is that airport operators may exert significant market power in relation to the monitored services at individual airports. Under section 27B of the *Prices Surveillance Act 1983*, the ACCC is required to report to the Treasurer annually on its formal prices monitoring activities and to make the report publicly available.

5.32. In exercising its role, the ACCC may investigate particular pricing issues where users have raised concerns and it appears that the operator has taken advantage of market power.¹³¹ In this regard, the plan by Brisbane and Perth Airports to introduce a fuel throughput levy has been considered in detail by the ACCC and on 11 December 1998 the Commission released a report¹³² on fuel throughput levies at privatised airports. In light of the report's conclusions, the ACCC has recommended that stricter forms of prices oversight should be considered in relation to aircraft refueling services. The report considers what forms the stricter price oversight should take, outlining a number of options and the advantages and disadvantages of each option. It recommends that refuelling services be included within a CPI-X price cap. The report also considers a number of options for implementation of a CPI-X price cap for refuelling services.¹³³ The airports associated with this current proposal have not yet responded to this recommendation.

Quality of Service Monitoring

5.33. Quality of service monitoring is undertaken under Part 8 of the *Airports Act 1996*. The Airports Regulations require airport operators to provide information on a range of performance indicators to the ACCC. For the Phase 1 airports the indicators cover various aspects of the airports service quality performance, the required information is provided by airport operators, Airservices Australia, Australian Customs Service and airlines. DoTRS advised ANAO that performance indicators for quality

¹³¹ In announcing the monitoring direction, the Treasurer made the following comment: *Price monitoring will allow the Commission to collect data where the airport operator may have scope to exercise market power but where coverage of the services under the more formal price cap arrangement was not considered warranted. Any abuses of market power detected through prices monitoring arrangements will be a trigger for consideration of stricter forms of prices oversight.*

¹³² The report concluded that: the introduction of fuel throughput levies at Brisbane and Perth Airports will significantly increase the price of refuelling services; the price increases are not justified in terms of increases in costs or through offsetting reductions to other charges; and there is a strong case that airport operators have market power in the provision of refuelling services. *ACCC Press Release 'ACCC Recommends Stricter Forms of Prices Oversight for Aircraft Refuelling Services'*, 11 December 1998.

¹³³ ACCC 'Fuel Throughput Levies—Report Pursuant to the Commission's Monitoring Functions Under The Prices Surveillance Act 1983', December 1998, p. 9.

of service monitoring for the relevant Phase 2 airports¹³⁴ (and Sydney Airport) have not yet been finalised. The Department sought comments from airport operators on a discussion paper it had prepared on the matter. DoTRS advised ANAO on 26 May 1999 that it has now received these comments and, in consultation with the ACCC, has commenced preparing draft regulations for the relevant Phase 2 airports and Sydney Airport.

5.34. The focus of the ACCC's quality monitoring is on the facilities and services provided by, or which can be influenced by, the airport operator. For the Phase 1 airports these include; airside facilities such as runways, taxiways and aprons; terminal facilities, such as international departure lounges and baggage claim, car parking and taxi and bus pick up and drop off points. Not included are domestic terminals owned and/or operated by airlines. ACCC's quality of service monitoring also recognises that airlines, Airservices Australia and other service providers also contribute to quality outcomes at the airports.¹³⁵

5.35. Quality of service monitoring is intended to complement the prices oversight arrangements. Under price cap regulation there is an incentive to increase profits by reducing costs. In some cases such cost cutting could lead to a lower quality of service. Quality of service monitoring is a means of providing indication of whether this may be occurring over time and for seeking further information from the airport operator.¹³⁶

5.36. The results of monitoring will be compared with future years' monitoring to assess whether quality is improving, remaining static or deteriorating. The first year of monitoring will establish a base for comparison with experience in future years.¹³⁷ In the first year, the ACCC will take into consideration, in respect of deficiencies identified in the

¹³⁴ Under Part 8 of the Airports Act, core regulated airports and leased airports as specified in the regulations are subject to quality of service monitoring by the ACCC.

¹³⁵ The objectives of quality service monitoring are to provide transparency about airport performance; discourage airport operators from providing unsatisfactory standards for services which are associated with significant market power; and assist the ACCC assess airport operator conduct as part of the review of prices oversight arrangements which the ACCC must undertake towards the end of the first five years of the price cap.

¹³⁶ The information sources of quality monitoring comprise customer perception surveys conducted by airport operators, surveys of airlines and data provided on the quality indicators by Australian Customs Service and Airservices Australia. The airport operators also provide data against the quality indicators, as required under the Airports regulations, such as the number of passengers, aerobridges and the size of aprons.

¹³⁷ It is not designed, nor intended, that the results of the surveys be used to compare airports. In making comparisons from year to year, the ACCC has stated that it will take into consideration the variety of factors outside the immediate control of airport operators which have the capacity to influence results (for example, staffing by airlines of check-in facilities and similarly Customs and/or Immigration service provision). Using the range of data sources, the ACCC intends to allow for these in reporting on quality and in its review of oversight arrangements for prices.

monitoring process, that the airport operator may not have had sufficient time to make improvements. For example, there will be a lag between an increase in passenger and flight numbers and an increase in the capacity of terminal infrastructure. The ACCC has acknowledged that there is a cost-quality trade-off and that improvements in quality may not be made where the cost could not be justified in relation to the expected benefits. The results of the first year of monitoring at individual airports will act as a benchmark and be used as a basis for comparison with those of future years for the airport.

Review of Regulatory Arrangements

5.37. Toward the end of the first five years of the airport leases, the ACCC will review the prices and oversight arrangements for airports. The review will be based on the premise that the price cap applied to aeronautical charges during the first five years will no longer operate. The review will aim to develop arrangements targeted at those charges where the airport operator has the most potential to abuse market power. The existing set of aeronautical charges will be examined, on an airport-by-airport basis, with the review assessing whether services should be added or removed from surveillance.

5.38. A key objective of the review will be to ensure that the aviation industry retains appropriate protection. The guidelines also make it clear that the ACCC can recommend stronger forms of prices oversight if operators have a constant track record of abusing their market power. The review will give airport operators the opportunity to suggest alternative forms of oversight, ideally with the backing of their customers. The Government's aim is that airlines and airport operators form close and cooperative working arrangements.

5.39. Beyond the central issue of 'market power', it is not intended that the review place further obligations on airport operators in respect of pricing. As with the initial five year period, the Government will not mandate the use of a single till approach to airport pricing. The outcome of the review will take the form of recommendations from the ACCC for consideration by the Government, allowing decisions to be taken before the end of the initial five year pricing period.

Overall conclusion

5.40. Finding: The 1998 sale of leases on 14 Phase 2 Federal airports achieved the Government's sales objectives. In respect of the actions taken by agencies in addressing the Government's ongoing privatisation objectives the ANAO found that:

- Diversity of ownership objective: Diversity of ownership was achieved with nine different consortia acquiring leases for 14 Phase 2 airports. Two of these consortia had been successful in the Phase 1 sales: the purchaser of Melbourne airport acquired Launceston; and the purchaser of Perth airport acquired the Northern Territory airports. In addition to ownership diversity, all bids received for the Phase 2 airports were consistent with the Government's policy of cross-ownership restrictions between Brisbane and Coolangatta; Hobart and Launceston; and Melbourne and Adelaide.
- Access by aircraft operators objective: The objective of ensuring airport access on reasonable commercial terms to aircraft owners was addressed by insertion into the airport leases on core-regulated airports of a requirement that the lessee provide for access to the airport by intrastate, interstate and international air transport. Lessees of the non-core regulated airports are required to provide for access to the airport by intrastate and interstate air transport.
- Responsive and effective development objective: DoTRS is undertaking the development of appropriate administrative procedures to monitor the ongoing development of the leased Federal airports, including guidance for itself and operators to inform assessments as to whether the airports are being developed to the required standard. The Department has also instituted annual meetings with each of the lessees to assist it to monitor compliance with the Airports Act and the Airport Leases, including development expenditure the lessees have committed themselves to (in the case of core-regulated airports) or planned (in the case of non core regulated airports) over the initial 10 years of their lease.
- Pricing policy objective: The post sale economic regulation framework which applies to the core regulated airports has been effectively implemented by the Australian Consumer and Competition Commission. Scope exists under the current arrangements for the detail of the framework to be adjusted in light of experience and the Commission is to undertake a review of pricing oversight arrangements as a basis for recommending to the Government the arrangements to operate after the first five years of the price cap.



Canberra ACT
21 June 1999

P.J. Barrett
Auditor-General

Appendices

Appendix 1

Recommendations and comments from ANAO Audit Report No. 38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports.*

Recommendation No. 1 The ANAO *recommends* that, where applicable for future trade sales, the Office of Asset Sales and IT Outsourcing, ensure more flexible data access arrangements in order to minimise the costs of buyer due diligence and assist potential buyers develop bids.

Agreed: AGS

Agreed with qualification: OASITO

Recommendation No.2 The ANAO *recommends* that, the Office of Asset Sales and IT Outsourcing institute procedures to improve transparency and accountability in future trade sales by requiring bid documents to be numbered consecutively on opening, recorded in a register of tenders and formally signed-out to officers and/or contractors.

Agreed: AGS.

Agreed with qualification: OASITO

Recommendation No.3 The ANAO *recommends* that, the Office of Asset Sales and IT Outsourcing strengthen its contracting for services by:

- a) improving planning for major contracts by identifying the critical path for the selection and appointment of all major consultants and competitively tendering contracts wherever possible; and
- b) improving its contract management by including performance monitoring arrangements in all major contracts such as reports on progress, resources used and costs.

Agreed with qualification: OASITO

- Recommendation No.4** The ANAO *recommends* that, for future trade sales, the Office of Asset Sales and IT Outsourcing in outsourcing tasks, where applicable, include:
- a) provisions in major adviser contracts that require advisers who are authorised to let contracts on behalf of the Commonwealth to comply with the Commonwealth Procurement Guidelines; and
 - b) caps for sub-contractor fees and expenses in major adviser contracts to ensure that the Commonwealth does not bear the commercial risk of cost overruns.
- Agreed:** AGS and OASITO part (a)
- Disagreed:** OASITO part (b)

- Recommendation No.5** The ANAO *recommends* that, for future asset sales, the Office of Asset Sales and IT Outsourcing ensure that logistics consultants are engaged early in the sale process to allow:
- a) a formal, written contract, including indemnities and confidentiality provisions, to be drafted and signed prior to work commencing;
 - b) expert advice on logistical aspects to influence the tender timetable and procedures;
 - c) appropriate planning of logistical activities; and
 - d) efficient and effective management of sale costs.
- Agreed with qualification:** OASITO

- Recommendation No.6** The ANAO *recommends* that, for future trade sales, the Office of Asset Sales and IT Outsourcing enhance transparency and accountability of decision making in the tender process by evaluating the merits of incorporating, as part of the tender evaluation planning process, the development of appropriate priorities which set out the relative importance attaching to each evaluation criterion.
- Agreed:** AGS
- Agreed with qualification:** OASITO

Recommendation No.7 The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing enhance transparency and accountability in future major trade sales by considering structures such as a tender evaluation committee.

Agreed: AGS

Agreed with qualification: OASITO

Recommendation No. 8 The ANAO *recommends* that the Department of Transport and Regional Development develop a comprehensive framework and procedures to monitor and enforce lessee compliance with the airport leases.

Agreed with qualification: DoTRS

Recommendation No.9 The ANAO *recommends* that the Office of Asset Sales and IT Outsourcing, in consultation with the Department of Transport and Regional Development:

- a) for future airport trade sales, develop an agreed framework for the post-sale disposition of sale documentation including providing for appropriate safe custody arrangements for the original signed sale documentation in an appropriate legal form for the duration of the lease term, and placing, in the records of each agency, a full set of copies of the signed sale documentation; and
- b) establish appropriate safe custody arrangements for the original signed sale documentation relating to the Phase 1 airports sales, in an appropriate legal form, for the duration of the lease term.

Agreed: OASITO; DoTRS; and AGS.

Recommendation No.10 The ANAO *recommends* that the Department of Transport and Regional Development develop and implement comprehensive administrative procedures to monitor ongoing development of the Phase 1 airports as required by the *Airports Act 1996* and airport leases.

Agreed with qualification: DoTRS.

Recommendation No.11 The ANAO *recommends* that, in future trade sales, agencies ensure adequate disclosure of all costs connected with the purchase of Commonwealth assets is made to bidders prior to requiring the submission of binding bids.

Agreed: DoTRS.

Agreed with qualification: OASITO.

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