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Performance Audit

Commonwealth Foreign Exchange Risk Management Practices

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Australian National
Audit Office

Canberra ACT
31 May 2000

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken an across agency 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 *Commonwealth Foreign Exchange Risk Management Practices.*

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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The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone (02) 6203 7505
Fax (02) 6203 7798
Email webmaster@anao.gov.au

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Audit Team

Brian Boyd
Suzanne Hinchcliffe
Colin Cronin

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Summary

Overview

1. The Commonwealth has significant foreign exchange risk exposures arising from purchases and sales of foreign currency by agencies. In 1998–99, Commonwealth agencies undertook $A8.4 billion of foreign currency transactions with the Reserve Bank of Australia (Reserve Bank) comprising $A7.0 billion in purchases from the Bank and $A1.4 billion in sales to the Bank.[1] Payment exposures also exist where contract terms generate or increase foreign exchange risk and where Australian dollar denominated transactions can be increased or decreased in line with exchange rate movements. ANAO audited four agencies that have substantial foreign currency payment exposures, namely: the Department of Defence (Defence); the Australian Agency for International Development (AusAID); the Department of Foreign Affairs and Trade (DFAT); and the Department of Finance and Administration (DoFA).

2. The size of the Commonwealth's foreign exchange exposure emphasises the importance of effective and prudent risk management at the whole of government level as well as by individual agencies. ANAO's legal advice confirms the responsibilities of officials in each agency to manage such risks, particularly under the provisions of the *Financial Management and Accountability Act 1997* and accompanying Regulations. However, there is no centrally issued overarching Commonwealth position statement on foreign exchange risk management. Very recently, DoFA issued a Finance Circular titled *Budget Framework for the Management of Foreign Exchange Exposure* that notified agencies that come within the scope of the Financial Management and Accountability Act of their responsibilities and opportunities for managing foreign exchange exposures. It seems as if some of the impacts of inadequate Commonwealth management of such exposures is due to a long period of self-insuring at the whole-of-government level and budget funding of exchange rate risk for particular agencies.

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[1] All Commonwealth agencies subject to the *Financial Management and Accountability Act 1997* are required to undertake foreign exchange transactions with the Reserve Bank, unless the Bank agrees that some or all low value transactions may be conducted through an agency's transactional banker.

3. The Commonwealth's current approach to assessing and managing such risks is set out in Figure 1. This devolved and decentralised approach to managing foreign exchange risk solely at the agency level is in marked contrast to normal commercial practice in managing specialised and highly material financial risks. In comparison, many major corporations and the Australian State Governments[2] centralise the implementation of exposure management strategies as a means of achieving economies of scale in obtaining commercial cover for exposures and ensuring an appropriate internal control framework for exposure management. Any move by the Commonwealth to adopt a centralised risk management model and dealing activities would not absolve individual agencies from their responsibility for managing the underlying business transactions and associated risks. As with other centralised treasury operations, agencies would remain primarily responsible and accountable for developing risk management policies, identifying exposures, deciding when to cover exposures and for monitoring the implementation and effectiveness of their risk management strategies. This dichotomy has to be recognised by agencies covered by the Financial Management and Accountability Act.

Figure 1

Framework for Non-Public Debt Foreign Exchange Risk Management

Better practice principles	*Commonwealth approach*
Exposures are identified and quantified over an appropriate timeframe.	The size of exposures and their effect is not identified and quantified.
Select an appropriate objective to optimise risk/return trade-offs.	No overriding exposure management objective. There is also no central agency guidance to agencies on appropriate objectives, with markedly different and inconsistent approaches adopted by agencies.
Limits set on the maximum allowable exposure.	No limit is set on the level of acceptable risk. Agencies are not aware of the impact risk exposures are having on financial performance.
Responsibility for exposure management decisions is clearly identified.	Four agencies receive budget supplementation for exchange rate variations, a process that transfers foreign exchange risk from the individual agencies to the Commonwealth Budget as a whole. All agencies, including those that receive supplementation, are required to manage their exposures.

[2] Each Australian State has its own treasury unit. The State treasury units usually have an overview role for the management of the State's balance sheet. This role includes acting as a vehicle for covering major currency exposures for state entities that do not have the corporate treasury facilities required to manage the exposures themselves. The treasury units also provide specialist financial advice to client agencies.

Better practice principles	*Commonwealth approach*
Specification of authorised risk management instruments and permissible providers of exposure management services.	Foreign exchange exposure management services are to be provided by the Reserve Bank but there are no guidelines on the permissible instruments.
Systems exist for reporting of exposures and the results of action taken to manage risk.	Absence of management reporting systems at both agency and whole-of-government levels.
Centralised provision of risk management advice and dealing activities.	No central agency guidance, risk management advice or coordination of dealing activities.

Source: ANAO analysis.

Audit objectives

4. The Australian/New Zealand Standard on Risk Management recognises that exchange rate exposures are a potential source of risk that organisations should identify and manage.[3] Similarly, the Management Advisory Board's 1996 *Guidelines for Managing Risk in the Australian Public Service* recognise financial and market risks as an issue that requires management attention from Commonwealth agencies. The audit objectives were to:

- identify the Commonwealth's foreign exchange risks in selected agencies;
- assess the efficiency and cost-effectiveness of the management of foreign exchange risk; and
- identify opportunities to improve the management of foreign exchange risk, including any associated potential financial savings that could accrue to the Commonwealth.

[3] Standards Australia and Standards New Zealand, *AS/NZS 4360:1999 Risk Management*, April 1999, pp. 24 and 30.

Commonwealth exposure management

5. This audit report draws a distinction between agency responsibility for managing foreign exchange risk and budget funding of exchange rate movements. Each of the agencies included in the audit has significant foreign exchange risk exposures that have to be managed (see Figure 2). The Commonwealth's devolved approach, with no central agency guidance until very recently, has been reflected in the audited agencies adopting markedly different approaches to their foreign exchange risk exposures. Furthermore, these agencies did not have any stated policies in relation to foreign exchange risk management or consistent management practices.

Figure 2

Audited Agencies' Foreign Exchange Risk Policies and Management Approaches

Agency	*Exposure*	*Stated Policy*	*Management Approach*
Defence capital procurement	$A1.4 billion in overseas capital expenditure in 1998–99. Substantial exposures exist in individual contracts.	None	Significant **open** positions. Risk **transferred** to Commonwealth budget by budget supplementation arrangements. Up to April 1999, budgets for projects in progress had increased by $A2.98 billion due to exchange rate movements.
AusAID:			
• Bilateral aid	$A195 million in foreign currency payments in 1998–99. Significant exposure exists in reimbursing contractors for overseas procurements.	None	**Variable**. In some circumstances, AusAID considers it appropriate to **transfer** risk to the contractor. Otherwise, there is an **open** position.
• Multilateral aid	Expenditure of $A320 million in 1998–99. Significant exposures exist because underlying obligations are specified in a foreign currency.	None	Aims to **minimise** risk. Where the exposure is not managed through agreements with donors, **open** positions have been maintained.

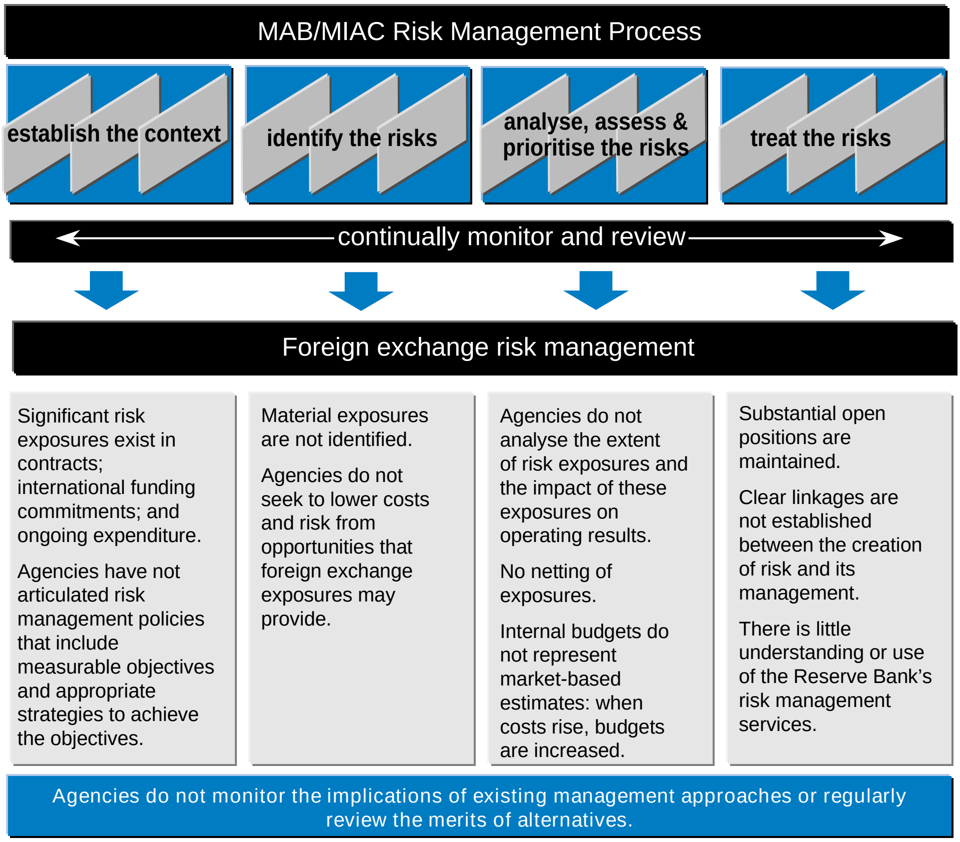
Agency	*Exposure*	*Stated Policy*	*Management Approach*
DFAT:			
• Overseas running costs	Foreign currency expenditure of $A209 million in 1998–99.	None	Negotiated with DoFA to extend budget supplementation so as to continue to **transfer** foreign exchange risk to the Commonwealth budget. The stated purpose of the supplementation arrangements was to remove the incentive for managers to hedge against adverse currency fluctuations. As a result, **open** positions have been maintained on the basis that DFAT considers central agencies are best placed to make exposure management decisions.
• Payments to international organisations	Payments are denominated in various foreign currencies at a cost of $A82 million in 1998–99.	None	**Open** foreign exchange positions.
DoFA overseas property development	30 June 1999 property valuation of $A1.3 billion. Construction, refurbishment and fitout projects invariably give rise to significant foreign exchange exposures.	None	**Inconsistent**. Usually maintains **open** foreign exchange positions. On occasions has sought to **avoid** risk or **covered** some exposures.

Source: ANAO analysis.

6. ANAO concluded that foreign exchange risk was not effectively and prudently managed by the audited agencies because they did not have systems and procedures to: identify their exposures; analyse the extent of these exposures; assess their impact; and take steps to cost-effectively manage the resultant risks (see Figure 3). Furthermore, agencies have not made a proper assessment of foreign exchange risk and the measures available to manage it as part of procurement and expenditure approval processes. In this context, DFAT advised ANAO that it is of the view that it took all steps available to it within the terms of its resource agreement with DoFA to address and manage its foreign exchange risks.

Figure 3

Management of Foreign Exchange Risk by Selected Agencies



Source: ANAO analysis applying the *Guidelines for Managing Risk in the Australian Public Service*, published by the Management Advisory Board and its Management Improvement Advisory Committee in October 1996.

7. Of note, is that agencies do not seek to address value for money considerations in relation to payments involving an actual or potential exposure to exchange rate fluctuations. Minimal attention is given by agencies to managing any potentially negative impacts of exchange rate risk with none of the audited agencies seeking to take advantage of any opportunities that foreign exchange exposures can provide, as the following illustrates:

- Defence and DFAT have relied upon budget supplementation as their management response to foreign exchange risk. Budget supplementation does not obviate the legislative requirement for agencies to assess foreign exchange risk and manage it as part of procurement and expenditure approval processes. However, as budget supplementation substantially reduces the incentive, Defence[4] and DFAT[5] do not identify or manage their foreign currency exposures and no central agency has been allocated responsibility for managing these risk exposures.

- AusAID has not had adequate procedures in place to identify and consider the most cost-effective way to achieve its goal of minimising foreign currency risk exposures in its contributions to multilateral aid agencies.[6] In addition, AusAID has not examined the merits of exercising risk-free currency options which could allow it to significantly reduce the cost of its multilateral aid contributions, without increasing foreign exchange risk. AusAID also faces significant foreign exchange exposures in its bilateral aid program but has not explicitly quantified the extent of its foreign exchange risk exposures or identified the degree to which this exposure has increased cost volatility and reduced or increased contract costs. AusAID's usual approach where projects involve foreign exchange exposures is to accept the exposure rather than manage it.
- DoFA is aware of the potential for adverse exchange rate movements to significantly increase project costs above budget but has not developed and articulated an exposure management policy for its management of overseas property development projects. DoFA's approach to foreign exchange risk has been inconsistent, with instances noted where open positions have unnecessarily increased costs to the Commonwealth, with no offsetting benefits obtained.

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[4] The budget supplementation arrangements have had a pervasive influence in the multi-billion dollar Defence capital equipment program:

- project budgets and tender processes do not identify the degree to which expenditure is subject to foreign exchange risk so as to inform decisions about whether and how foreign exchange risk should be managed;
- project budgets are periodically updated by the Department to match movements in spot exchange rates. This approach lessens financial incentives to effectively manage risk and reduces Defence accountability for its preparation of project budgets and management of foreign exchange risk; and
- Defence's practice of remaining exposed to foreign exchange risk has significantly increased project costs.

[5] DFAT advised ANAO that it considers the agreement with DoFA to continue budget supplementation represents an informed risk management strategy from the Department's perspective. DFAT advised ANAO that, by negotiating to extend the agreement for budget supplementation, it took an informed decision which recognised that DoFA and the Reserve Bank rather than individual agencies were best placed to make exposure management decisions in the Commonwealth's wider interests.

[6] AusAID has been solely reliant on fixing exchange rates with donors as part of the replenishment agreement process. Where this has not been possible, AusAID has not considered other approaches such as covering exposures through the Reserve Bank. In one such instance, AusAID's open foreign exchange position led to the cost of the foreign currency payments exceeding AusAID's budget for this program by 16 per cent.

Improvement opportunities

8. Better practice in financial risk management is to centralise risk management and dealing activities as this can: minimise the exposure management task; deliver economies of scale in obtaining commercial cover for exposures; and ensure an appropriate internal control framework for exposure management. On a whole-of-government basis, there is therefore merit in Commonwealth central agencies investigating and advising the Government as to whether centralised provision of treasury functions for foreign exchange could improve management of the Commonwealth's substantial foreign exchange risks.

9. Under a centralised risk management model, the role of a central treasury unit would be to provide guidance and advice to agencies and to manage residual risks on behalf of the Commonwealth (see Figure 4). This approach recognises that agency managers are best placed to identify risk exposures and take management decisions about those exposures. This is also consistent with agencies' financial management responsibilities under the Financial Management and Accountability Act and its accompanying Regulations.

Figure 4

Better Practice in Foreign Exchange Risk Management

Individual agency functions	Risk Management Process	Central Commonwealth treasury functions
Establish agency risk management policy including measurable objectives	Establishing context	• Establish Commonwealth policy. • Advise agencies on suitable objectives, appropriate strategies and instruments.
• Risk audits of contracts • Estimate cash flows and internal offsets • Determine time horizon of exposures	Risk identification	Identify strategic exposures, such as those resulting from budget supplementation arrangements.
Sensitivity analysis including quantifying the effect of exchange rate changes and comparing the exposure to tolerances.	Analysis	• Analyse net Commonwealth position • Advise/assist with agency analysis.
Make management decisions including whether to accept, restructure or manage exposures	Implement management programs	• Net offsetting exposures • Arrange hedging transactions with the Reserve Bank
• Monitor exposures against objectives • Review effectiveness of management strategies and consider alternatives	Monitor and review	Monitor and report on the overall Commonwealth exposure position.

Source: ANAO analysis.

Audit recommendations

10. The audit recommendations recognise that prudent management of foreign exchange exposures can increase the Commonwealth's purchasing power as well as limit their negative effects. They are aimed at improving the long-run risk-adjusted returns to the Commonwealth of funds involving an actual or potential exposure to exchange rate fluctuations, as the following examples demonstrate:

- For AusAID's most recent contributions to the two largest recipients of multilateral aid, taking advantage of currency options at the time of entering into the commitment would have realised cost savings of around $A23.2 million.[7] As a result of this performance audit, AusAID has begun to investigate the merits of exercising these options in future replenishments and has already applied these principles in the most recent replenishment of one fund.
- Agencies tendering and expenditure approval processes are deficient with respect to the treatment of foreign exchange risk. This can adversely affect the achievement of intended outcomes. For example, to bring the project to acquire helicopters for the ANZAC Ships within budget, Defence reduced helicopter numbers from 14 to 11 and deferred the acquisition of missiles to a separate project. In addition, the approach taken to foreign exchange risk materially understated the likely cost of this long-term acquisition which gave decision makers the mistaken impression that a contract could be signed within the envelope of the approved project budget.
- Managing contracted foreign exchange risk exposures in the Defence capital equipment procurement environment would increase certainty in relation to final costs and, potentially, lead to cost savings. For example, in the project to acquire additional Chinook helicopters, had the Department chosen to manage the contracted exposures, contract costs could have been maintained at $A56.0 million, a saving to the Commonwealth of $A15.2 million and within the original budget of $A61.7 million (which now stands at $A74.3 million). ANAO noted that by not managing exposures in a number of other contracts that were examined, the Department has also experienced significantly increased contract costs.[8]

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7 The same principles can be applied to DFAT's administration of payments to certain international organisations where the audit also noted that cost savings were available.

8 In the project to acquire helicopters for the ANZAC Ships, as of July 1999 the open exposure to foreign exchange risk had increased costs by $A42 million. The budget for the acquisition of new Lead-In Fighter aircraft has increased by $A98 million (12 per cent) because of adverse exchange rate movements.

- In the only known instance where Defence managed its contracted foreign exchange risk exposures, the Department did not obtain competitive, on-market forward foreign exchange rates. Although managing exposures in this case reduced contract costs by $A630 000, even greater savings were available had the Department covered the exposures using wholesale market forward exchange rates through the Reserve Bank rather than retail market spot exchange rates through its contractor.
- DoFA's inconsistent approach to foreign exchange risk in its overseas property developments has meant that the Commonwealth has been exposed to significant foreign exchange risk in this area. In one project examined by ANAO, the budget had to be increased by 14 per cent due to adverse exchange rate movements. In another project, the private financing arrangements included an arrangement whereby the Commonwealth paid a financier to make a payment to DoFA. This complex arrangement, for which there appears to be inadequate justification, significantly increased the Commonwealth's exposure to currency movements. Although DoFA covered payment exposures on the project, it did not cover the exposures on the foreign currency loan receipts.

11. Fundamental to achieving these potential benefits is the need for a substantial improvement in the Commonwealth's management of foreign exchange risk. ANAO made 16 recommendations to address the whole-of-government and agency-specific issues identified by the audit. The audit recommendations were developed to encourage agencies to improve foreign exchange risk management in their business activities, as follows:

- Strategic and operational advice on the cost-effective management of foreign exchange risk should be sought and, where transactions are hedged, dealing activities should similarly be centralised to obtain economies of scale and ensure effective internal controls are in place. The Australian Office of Financial Management (AOFM) and the Reserve Bank have both indicated that, appropriately resourced, they would be prepared to provide these services to agencies.
- Consideration should be given to the use of market based forward exchange rates in Commonwealth budgeting processes. The use of forward exchange rates is particularly important for long-term capital expenditure projects as the use of forward exchange rates would encourage a greater focus on exposure management in order to reduce the risk of costs exceeding the original project budget.
- Tender assessments and expenditure approval processes should involve a proper assessment of foreign exchange risk and of the measures

that are available to manage this risk consistent with regulations 8 and 9 of the Financial Management and Accountability Regulations.

- Agencies should seek to identify opportunities to benefit from favourable currency movements, where appropriate, as well as controlling or eliminating adverse movements (including evaluating the merits of exercising any currency options provided by the terms of contractual arrangements).
- Financial administration processes should be designed to protect the Commonwealth's financial interests by:
  - obtaining wholesale market exchange rates for spot transactions that are equivalent to those available from the Reserve Bank;
  - establishing an audit trail that minimises the risk of receiving off-market and uncompetitive rates for hedging transactions;
  - ensuring that payments are made and received promptly; and
  - requiring contractors to bear any foreign exchange-related costs that result from contractor-caused delays.

12. The audit also identified an apparent gap in the Commonwealth's financial management legislation as it relates to raising funds on the public credit of the Commonwealth. Private financing arrangements for DoFA's property developments have resulted in more than $328 million in Promissory Notes being issued. Unlike the Commonwealth's major debt instruments, there are no specific legislative requirements governing the issue by agencies of Promissory Notes and other debt-like instruments.

Agency responses

13. In the main, agencies either agreed or agreed with qualifications to the recommendations. The one exception was Recommendation No. 4 concerning the use of market based forward exchange rates for Commonwealth budgeting in order to encourage a greater focus on exposure management by Commonwealth agencies. DoFA disagreed with this recommendation whereas all other respondents agreed or agreed with qualifications. DoFA's view is that forward exchange rates do not take into account future events or even all current data that may affect future exchange rates and that it has seen no empirical evidence to indicate that the current exchange rate forecasting methodology is less reliable than market forward exhange rates. In comparison, the Department of the Treasury (Treasury), which calculates the average historic spot rates that are currently used for Commonwealth budgeting (as well as economic forecasting, which is a different issue), stated that a clear case has been made for the use of forward exchange rates in budget estimating.

14. On a more general note, Treasury commented that it considers ANAO's report to be important and well-prepared. Treasury commented that it is likely that the apparent widespread disregard of risk management principles in the exchange rate area can only be explained by the longstanding practice of self-insuring on a whole-of-government basis and the related attitude of agencies that the exchange rate is a sensitive matter, not to be meddled in. Treasury noted that the Financial Management and Accountability Act had changed this but, perhaps because of inadequate central agency guidance, agency hesitation to manage exposures remains. Treasury considered there is a clear need to spread the message that ignoring exchange rate risk leads to improper pricing of outputs, suboptimal choice of suppliers and suboptimal allocation of resources between outputs. In this respect, Treasury considered the audit recommendations make an important contribution.

Recommendations

Set out below are ANAO's recommendations. ANAO considers that the highest priority should be given to implementing Recommendations 1 and 2 as the outcome of the response to these recommendations will influence the implementation of many of the recommendations directed at individual agencies.

Recommendation No.1
Para. 2.14

ANAO *recommends* that DoFA:

(a) in consultation with relevant agencies and, as appropriate, the Government, determine and promulgate an overarching Commonwealth position statement on foreign exchange risk management to all agencies subject to the Financial Management and Accountability Act; and

(b) as the agency responsible for administration of the Financial Management and Accountability Regulations, ensure that, within whatever approach is decided in relation to (a), agencies fully understand and take appropriate action under Regulation 8 requiring a proper assessment of foreign exchange risk as part of their procurement processes and under Regulation 9 requiring consideration of this risk and the measures available to manage it as part of the expenditure approval process.

Agree: DoFA; Treasury; AOFM; Defence; DFAT; and AusAID

Recommendation No.2
Para. 2.26

ANAO *recommends* that Treasury, in consultation with DoFA and other relevant agencies, investigate the merits of centralising provision of strategic and operational advice to agencies on the cost-effective management of foreign exchange risk.

Agree: Treasury; DoFA; AOFM; Defence; DFAT; and AusAID

Recommendation No.3 **Para. 2.45**	ANAO *recommends* that, where appropriate, agencies proposing to outsource some or all of their foreign currency spot transaction services as part of the agency banking arrangements, manage the tender process so as to ensure that the outcome complies with Commonwealth policy and delivers value for money. ***Agree:*** DoFA; Treasury; DFAT; and AusAID ***Agree with qualifications:*** Defence
Recommendation No.4 **Para. 2.54**	ANAO *recommends* that, to encourage a greater focus on exposure management by Commonwealth agencies, DoFA, in consultation with Treasury, consider the merits of using market based forward exchange rates to prepare the Commonwealth Budget and constituent agency budgets. ***Agree:*** Treasury ***Agree with qualifications:*** Defence and DFAT ***Disagree:*** DoFA
Recommendation No.5 **Para. 2.68**	ANAO *recommends* that DoFA, in consultation with relevant agencies, re-examine the budget supplementation arrangements for foreign exchange risk to encourage more effective management of foreign exchange risk on a whole of government as well as an agency basis. ***Agree:*** Treasury ***Agree with qualifications:*** DoFA; Defence and DFAT

Recommendation No.6
Para. 3.23

ANAO *recommends* that Defence address foreign exchange risk in capital procurement project budgeting by:

(a) using forward exchange rates with cash flow forecasts to develop market based estimates of likely project costs;

(b) including in project budget proposals considered advice on the level of acceptable foreign exchange risk and how to best manage that risk; and

(c) revising the budget delegations process to ensure prudent limits are placed on foreign exchange related variations for major projects.

Agree: Treasury

Agree with qualifications: Defence

Recommendation No.7
Para. 3.33

ANAO *recommends* that Defence provide decision makers with a rigorous estimate of the likely Australian dollar cost and encourage cost-effective management of risk exposures by using current, wholesale market forward exchange rates rather than retail spot exchange rates to undertake financial evaluations of future foreign currency cash flows proposed by tenderers.

Agree: Treasury

Agree with qualifications: Defence

Recommendation No.8
Para. 3.52

ANAO *recommends* that Defence include provisions in future contracts where appropriate that ensure the contractor bears the cost of any foreign exchange losses that result from contractor delays or significantly inaccurate forecasts, with any currency gains to be retained by the Commonwealth.

Agree: Treasury

Agree with qualifications: Defence

Recommendation No.9
Para. 4.21

ANAO *recommends* that AusAID develop an appropriate foreign exchange risk management strategy for the multilateral aid program that:

(a) identifies all material exposures and existing currency options in multilateral aid contribution agreements;

(b) analyses and quantifies cost savings that can be achieved from different approaches to managing foreign exchange risk, including savings from exercising currency options; and

(c) includes a payment plan for each multilateral aid contribution agreement that will enable AusAID to take advantage of currency options in order to minimise the Australian dollar cost of meeting the Commonwealth's financial obligations.

Agree: Treasury

Agree with qualifications: AusAID

Recommendation No.10
Para. 4.38

ANAO *recommends* that AusAID develop and document a considered and consistent policy on foreign exchange risk in the bilateral aid program, that is informed by appropriate specialist advice.

Agree: AusAID and Treasury.

Recommendation No.11
Para. 4.46

ANAO *recommends* that AusAID, in consultation with relevant agencies, significantly upgrade all facets of its financial management of foreign currency payments in the bilateral aid program to ensure value for money by obtaining wholesale market exchange rates for its foreign currency transactions and conversions.

Agree: AusAID and Treasury.

Recommendation No.12 Para. 4.60

ANAO *recommends* that, where the signed written contract requires the contractor to bear foreign exchange risk, AusAID implement procedures that require:

(a) a rigorous and documented examination of all claims by contractors for foreign exchange losses; and

(b) where payment for foreign exchange losses is proposed, sign-off to be obtained that the payment may properly be made, in accordance with relevant Commonwealth policies governing the expenditure of public moneys.

Agree: AusAID and Treasury.

Recommendation No.13 Para. 5.25

ANAO *recommends* that DFAT develop an explicit foreign exchange risk management strategy for administered contributions to international organisations that:

(a) identifies all material exposures and existing currency options;

(b) analyses and quantifies cost savings that can be achieved from different approaches to managing foreign exchange risk, including savings from exercising currency options; and

(c) includes a payment plan for contributions to each international organisation that will enable DFAT to cost-effectively administer Australia's payment obligations for an acceptable level of risk exposure.

Agree: Treasury

Agree with qualifications: DFAT

Recommendation No.14
Para. 6.15

ANAO *recommends* that DoFA develop a considered foreign exchange risk management policy with explicit consideration given to:

(a) revising project budgeting processes to develop market-based estimates of likely project costs by using forward exchange rates; and

(b) the level of acceptable foreign exchange risk and how to manage this risk.

Agree: DoFA and Treasury

Recommendation No.15
Para. 6.54

ANAO *recommends* that, where foreign exchange risks arise in future development projects, DoFA:

(a) adopt a consistent approach to cost-effectively managing financial risks;

(b) improve its financial administration practices to ensure that payments are made and received promptly in order to protect the Commonwealth's financial interests; and

(c) appropriately account for the receipt and disbursement of Commonwealth financial resources.

Agree: DoFA and Treasury

Recommendation No.16
Para. 6.68

ANAO *recommends* that DoFA:

(a) in consultation with Treasury, review the current governance arrangements for the issue of debt and like instruments such as Promissory Notes on the public credit of the Commonwealth in order to ensure a consistent approach is adopted that promotes effective stewardship of Commonwealth resources and appropriate public accountability; and

(b) develop and implement administrative procedures for the issuance, collection and safe custody of its financial instruments including: individual identification of instruments; the establishment of a register of instruments and their status; retention of a copy of all instruments on issue; appropriate cancellation procedures; and safe custody arrangements for instrument stationery.

Agree: DoFA and AOFM

Agree with qualifications: Treasury

Audit Findings and Conclusions

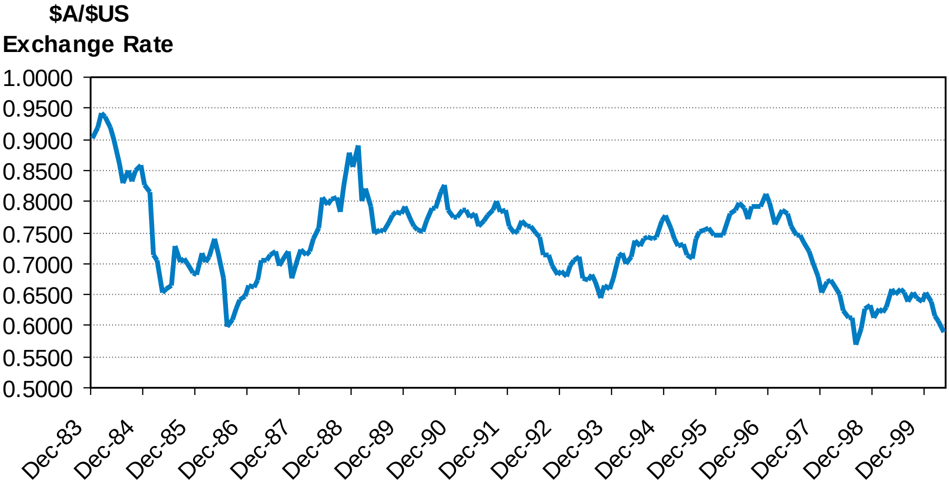
1. Introduction

Background

1.1 An exchange rate is the price of one currency expressed in terms of another. Exchange rates are highly volatile. In December 1983, Australia adopted a floating exchange rate which means that the price of the Australian dollar ($A) with respect to other currencies is set by market forces of supply and demand.[9] Figure 1.1 outlines movements in the Australian dollar against the United States dollar ($US) since the December 1983 float. The Reserve Bank of Australia (Reserve Bank) has noted increased speculative trading in the Australian dollar and a tendency for Australia to be viewed as a proxy for Asian markets and markets of other commodity exporting countries, in which normal market activity had broken down. The Bank considered this added both to exchange rate volatility and foreign exchange market turnover of the Australian dollar.

Figure 1.1

Australian Dollar Spot Exchange Rate: December 1983 (float) to April 2000



Source: Data from Reserve Bank of Australia Bulletins.

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[9] The Reserve Bank intervenes in the foreign exchange markets to stabilise significant movements in the exchange rate. The Bank considers that, in the long run, it is the effective operation of monetary policy that determines the level of the exchange rate, and that it would be futile to pursue a particular level for the exchange rate. Source: Reserve Bank of Australia, *1998 Report and Financial Statements*, p. 37.

1.2 Foreign exchange risk exposure can be defined as the extent to which the future cash flows of an entity are susceptible to variations in exchange rates.[10] Foreign exchange 'risk' embodies the potential for gain as well as the potential for loss. The purpose of foreign exchange risk management is to maximise the long-run return on funds that involve an actual or potential exposure to exchange rate fluctuations. This recognises that currency markets can be used to increase purchasing power as well as to limit negative effects.[11]

1.3 The Commonwealth has significant foreign exchange risk exposures arising from purchases and sales of foreign currency by agencies. In 1998–99, Commonwealth agencies undertook $A8.4 billion of foreign currency transactions with the Reserve Bank of Australia[12] (Reserve Bank) comprising $A7.0 billion in purchases from the Bank and $A1.4 billion in sales to the Bank.[13] Payment exposures also exist where contract terms generate or increase foreign exchange risk and where Australian dollar denominated transactions can be increased or decreased in line with exchange rate movements. The major currencies purchased and sold by Commonwealth agencies through the Reserve Bank were United States Dollars, Great Britain Pounds Sterling and Euros.[14]

1.4 The Australian Financial Markets Association has noted that large corporates are increasingly employing sophisticated risk management systems to record their financial risk exposures and the transactions that are put in place to hedge these exposures.[15] It is equally important that Commonwealth agencies identify their financial risk exposures and explicitly evaluate potential options for the efficient management of exchange rate risk, as part of agencies' overall risk management strategy.

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10 Adapted from the International Federation of Accountants' Financial and Management Accounting Committee, International Management Accounting Practice Statement, *Currency Exposure and Risk Management*, February 1996, para. 24.

11 For example, if interest rates are higher in the foreign country than Australia, it is advantageous to be invoiced in the foreign currency and immediately cover this exposure in the forward foreign exchange markets. The Australian dollar amount is thereby reduced, with no speculation on exchange rate movements.

12 All Commonwealth agencies subject to the *Financial Management and Accountability Act 1997* are required to undertake foreign exchange transactions with the Reserve Bank, unless the Bank agrees that some or all low value transactions may be conducted through an agency's transactional banker.

13 Source: Reserve Bank of Australia, *1999 Report and Financial Statements*, p. 16.

14 The conversion rates between the Euro and the currencies of the 11 Member States adopting the Euro were irrevocably fixed on 31 December 1998 with 1 Euro equivalent to: 40.3399 Belgian francs; 1.95583 German marks; 166.386 Spanish pesetas; 6.55957 French francs; 0.787564 Irish pounds; 1 936.27 Italian lire; 40.3399 Luxembourg francs; 2.20371 Dutch guilders; 13.7603 Austrian schillings; 200.482 Portugese escudos; and 5.94573 Finnish marks.

15 Australian Financial Markets Association, *AFMAdata – Essential New Tool for Financial Risk Management*, AFMA Minutes & Issues, No.5 June 1997. Source: *http://www.afma.com.au*

Audit rationale and approach

1.5 In a number of recent performance audits,[16] ANAO observed that there were opportunities for Commonwealth agencies to improve the identification, analysis and management of financial risk exposures. Accordingly, ANAO considered a performance audit of foreign exchange risk management practices by Commonwealth agencies would inform the Parliament about the management of this particular financial risk and assist agencies improve their financial risk management practices.

1.6 The specific audit objectives were to:

- identify the Commonwealth's foreign exchange risks in selected agencies;
- assess the efficiency and cost-effectiveness of the management of foreign exchange risk; and
- identify opportunities to improve the management of foreign exchange risk, including any associated potential financial savings that could accrue to the Commonwealth.

1.7 The audit methodology involved identifying the most significant exposures within each selected agency and then examining these exposures to evaluate how foreign exchange risk is identified, assessed and managed. The audit drew upon expert consultancy assistance to assist ANAO examine foreign exchange risk exposures and identify opportunities for improvements to existing management approaches. Banking and finance specialists from Blake Dawson Waldron assisted the audit by advising on legal issues associated with foreign exchange exposures in contracts. Legal advice was also sought from the Australian Government Solicitor in relation to legal requirements for the management of foreign exchange risk and from Minter Ellison in relation to Commonwealth agencies issuing Promissory Notes to raise funds.[17] In addition, a competitive tender was conducted to select financial advisers to assist the audit with the following results:

- Dr Richard Allan (ANAO's Strategic Adviser) was contracted to advise on appropriate risk management frameworks for the identification, quantification and management of foreign exchange risks; and

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16 Namely: Audit Report No.10 1997-98 *Sale of One-third of Telstra;* Audit Report No.34 1997-98 *New Submarine Project*; and Audit Report No.20 1996-97 *Selected Commonwealth Property Sales*.

17 The three law firms were selected from ANAO's legal adviser panel.

- Oakvale Capital Limited (ANAO's Financial Adviser), a treasury and financial risk management advisory company, was contracted to: provide advice to assist ANAO analyse and quantify particular foreign exchange risk exposures; assess the extent to which these exposures are presently being managed; and identify possible alternative management approaches and associated potential benefits.

Audit scope

1.8 Many Commonwealth agencies face foreign exchange risk in their operations. The agencies selected for inclusion in this audit were targeted to provide sufficient coverage of the range of likely Commonwealth exposures and alternative risk management approaches as well as to maximise the impact of the audit in encouraging the adoption of better practice in managing financial risk exposures. The audited agencies comprised:[18]

- the Department of Defence (Defence) which had total expenditure overseas of $A2.1 billion in 1998–99, primarily comprised of $A1.4 billion in capital expenditure by the Defence Acquisition Organisation (see Chapter 3);
- the Australian Agency for International Development (AusAID) which plans and implements Australia's overseas aid program (see Chapter 4);
- the Department of Foreign Affairs and Trade (DFAT), which is the largest overseas operating agency in the Australian Public Service (see Chapter 5); and
- the Department of Finance and Administration (DoFA), which manages the Commonwealth's overseas property portfolio which had a value of $A1.3 billion as of 30 June 1999 (see Chapter 6) and has central agency responsibility for implementing the accrual reforms and agency banking arrangements.

1.9 The audit scope was based on foreign currency payments. The audit specifically excluded foreign currency exposures on the Commonwealth's portfolio of Commonwealth Government Securities. This exposure, and its management, were examined in ANAO Audit Report No.14 1999–2000, *Commonwealth Debt Management*. Net purchases of foreign currency related to the Commonwealth's debt portfolio comprised $2.8 billion in 1998–99, or one-half of the $5.6 billion in net purchases undertaken by the Reserve Bank on behalf of Commonwealth agencies.

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[18] The audit also included examining the role of the Reserve Bank and the Australian Office of Financial Management (AOFM).

1.10 The audit was conducted in accordance with the ANAO Auditing Standards at an estimated cost to the ANAO of $347 000. The majority of audit fieldwork was conducted between July 1999 and December 1999.

2. Commonwealth Exposure Management

Introduction

2.1 According to the Australian/New Zealand Standard on Risk Management, risk management is a logical and systematic method of identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process in a way that enables the organisation to minimise losses and maximise opportunities.[19] The Standard recognises that exchange rate exposures are a potential source of risk that organisations should identify and manage.[20]

2.2 Commonwealth agencies, like private sector corporations, may have an underlying transaction or business activity that requires them to purchase or sell a foreign currency. Foreign exchange risk also arises where the value of Australian dollar denominated transactions changes in line with movements in the foreign exchange rate. In addition, legal drafting of contract terms can generate, increase or mitigate foreign exchange risk. Considered decisions on whether to accept, reduce or eliminate such risks requires agencies to properly identify and assess their foreign exchange exposures.

2.3 At the Commonwealth level, a key aspect of more business-like approaches to public administration is the adoption of risk management. Risk management was one of the principles underpinning the Financial Management Improvement Program philosophy of 'letting the managers manage'.[21] In this respect, in 1996 the Management Advisory Board issued guidelines on managing risk in the Australian Public Service (APS).[22] These guidelines recognise the effective management of risk as an integral part of the APS reform program and recommend that risk management be central to agencies' business planning and incorporated as part of

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19 Standards Australia and Standards New Zealand, *op cit*, p. 1.

20 *Ibid*, pp. 24 and 30.

21 Report of the House of Representatives Standing Committee on Finance and Public Administration, *Not Dollars Alone … Review of the Financial Management Improvement Program*, September 1990, p.10.

22 Management Advisory Board and its Management Improvement Advisory Committee, *Guidelines for Managing Risk in the Australian Public Service*, 1996.

agencies' management policies. The Guidelines state that financial and market risks are one element of the risk profile of each agency that needs to be addressed in the planning and management of programs.

2.4 There are also legal requirements under section 44 of the *Financial Management and Accountability Act 1997* for the efficient and effective management of Commonwealth financial resources. More specifically, the Australian Government Solicitor (AGS) advised ANAO that the assessment of cost-effectiveness that is required by the *Financial Management and Accountability Regulations 1997*[23] as part of procurement processes necessarily involves a proper assessment of foreign exchange risk and the measures available to manage this risk. Furthermore, where the amount to be expended is affected by foreign exchange risk, Regulation 9 requires the expenditure approval process to include consideration of foreign exchange risk and the measures that are available to manage this risk. AGS further advised that the fact that some agencies receive budget supplementation for exchange rate movements <u>does not affect the operation of these duties</u> under the Regulations; all agencies are required to assess and, where possible, manage foreign exchange risk.[24]

Elements of a risk management framework

2.5 The Australian/New Zealand Standard on Risk Management states that it is the responsibility of management to define and document its risk management framework and to ensure that risk management strategies are understood and implemented at all levels of the organisation.[25] The overall management framework for an organisation with a risk management orientation has four main elements:

- a philosophical approach that establishes appropriate objectives and the broad strategic principles that will govern the way in which these objectives are pursued by the agency as a whole as well as its constituent parts;

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[23] Regulation 8.

[24] Similar obligations existed prior to the introduction of the Financial Management and Accountability Act. For example, the 1989 Commonwealth Procurement Guidelines, which officials undertaking procurement activities were required to have regard to, stated that foreign exchange risk could impact on assessments of value for money. These Guidelines noted that exchange rate variations can increase procurement costs and that hedging of such exposures was one possible way to deal with them. Similarly, in 1997 the then Department of Administrative Services issued a publication titled *Applying Risk Management Techniques to Complex Procurement* to provide guidance to agencies on managing risk under the 1997 version of the Commonwealth Procurement Guidelines. This publication cited exchange rate variations as a potential source of risk in the procurement process and advocated management of this risk, for example by hedging exposures or agreeing with the contractor on exchange rate variation formulae.

[25] Standards Australia and Standards New Zealand, *AS/NZS 4360:1999 Risk Management*, April 1999, p. 5.

- an operating framework that establishes the policies and practices to implement the philosophy;
- a measurement framework that governs how risk is measured and monitored and how managerial performance is measured against the objectives; and
- an organisational structure that ensures the resource, management and skill base is appropriate for the philosophy and sufficient to implement the policies and procedures.

Risk management objectives

2.6 The choice of an appropriate and clearly enunciated Commonwealth-wide philosophical approach to foreign exchange risk is important as it helps individual agencies establish appropriate objectives and strategic principles to contribute to improving operating results and the Commonwealth's overall net asset position. Encouraging individual agencies to develop separate approaches to foreign exchange management without central agency guidance on the Commonwealth's overall risk philosophy can lead to significant differences in approaches which may not be in the overall best interests of the Commonwealth.

2.7 The Commonwealth's approach involves four agencies receiving budget supplementation for exchange rate variations but, in effect, there is no management of this currency risk, which has been transferred from these four agencies to the Commonwealth Budget as a whole. All agencies, including those that receive supplementation, are required to manage their exposures and are permitted to use financial derivatives for this purpose. However, there is at present no central agency guidance on appropriate management approaches. Nevertheless, DoFA advised ANAO on 13 March 2000 that:

> *The Department would suggest that a broadly philosophical approach does exist across the Commonwealth. It has not been clearly enunciated and promulgated as a formal policy or pronouncement,*[26] *and therefore is not immediately identifiable, but such an approach to foreign exchange risk is in place. Such a position must necessarily recognise the effective management of risk as an integral part of business planning and management policies at an agency level.*

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26 For example, DFAT advised ANAO on 14 March 2000 that there had been very little advice, discussion or guidance from DoFA on foreign exchange risk management.

2.8 The lack of a clearly enunciated and promulgated Commonwealth-wide approach to foreign exchange risk can be contrasted with the introduction from 1 July 1998 of a managed fund policy (known as *Comcover*) for all of the Commonwealth's normal insurable risks.[27] This approach was introduced to provide an incentive for agencies to manage their insurable risks as it had been found that the previous non-insurance policy was outdated as it offered little incentive for agencies to manage their risk effectively.[28] As a result, risk exposures of agencies were not generally identified, loss experience was not recorded and agencies were generally not required to pay any significant losses. The establishment of the Comcover risk managed fund is a form of self-insurance that collects contributions from participating members, accumulates reserves, and meets future losses from those reserves. Although the Comcover arrangements necessitate additional reporting and oversight of the Fund's arrangements, they are expected to provide risk management benefits to the Commonwealth by:

- helping to protect programs and the Budget against unexpected insurable losses over time;
- achieving transparency and greater accountability in the management of the Commonwealth's insurable risks;
- requiring the full identification of risk exposures by each agency;
- enabling the Commonwealth to centrally accumulate risk knowledge and expertise;
- reducing costs by pooling and spreading of risk; and
- providing incentives for better risk management with the application of a claims sensitive premium.

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27 Audit Report No. 47 1997–98, *Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, pp. 37–39.

28 Minister for Finance and Administration, *Comcover—Responsible Risk Management for the Commonwealth Government*, Media Release 60/98, 30 June 1998.

Commonwealth agencies

2.9 An important step in any risk management program is goal specification. Many commercial organisations aim to reduce volatility of cash flows, earnings and/or market value through management of foreign exchange exposures.[29] This is reflected in objectives of not taking speculative positions, eliminating foreign exchange transactional risk, minimising hedge costs[30] and taking advantage of the structure of spot, forward swaps, options and futures markets to increase returns or reduce costs.

2.10 In June 1998, DoFA advised ANAO that the Commonwealth does not have an explicit policy that prohibits or endorses effective management of foreign exchange risk.[31] DoFA stated that financial and market risks are recognised as an element of the risk profile of individual agencies that needs a consistent approach and that this should be addressed in the planning and management of programs. DoFA noted that: *it is appropriate to stress the need for the articulation of a policy approach to exchange rate management (eg the possible desirability of locking-in a rate which meets business objectives) rather than on the likelihood and possible direction of possible exchange rate movements. Once articulated, it is important that the policy be consistently applied.*

2.11 The audit found that individual agencies have already adopted some very different approaches to foreign exchange risk and that there is also considerable inconsistency within and between agencies (see Figure 2.1). Of note is that agencies do not seek to maximise the long-run return to the Commonwealth of funds involving an actual or potential exposure to exchange rate fluctuations. Minimal attention is given to managing any potentially negative impacts of exchange rate risk and no agency seeks to take advantage of any opportunities (without engaging in speculative behaviour) that foreign exchange exposures can provide.[32]

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[29] *Implementing a Risk Management Program*, Charles W. Smithson, CIBC World Markets, School of Financial Products in *Managing Financial Risk—A Guide to Derivative Products, Financial Engineering, and Value Maximisation*.

[30] Greenwich Treasury Advisors LLC, *The Group of 31 Report: Core Principles for Managing Multinational FX Risk*, July 1999, p. 4.

[31] Audit Report No 10 1999–99, *Sale of One-third of Telstra*, p. 44.

[32] Exchange rates are relative (not absolute) prices and there is always one quote that is preferable to the alternative. For example, as of December 1999, forward exchange rate differentials favoured payments being made in United States dollars and immediately covering the exposure in the forward markets in order to make financial savings, rather than paying directly in Australian dollars. In neither case is there any foreign exchange exposures. However, different cash flows result.

Figure 2.1

Audited Agencies' Foreign Exchange Risk Exposures

Agency	*Foreign Exchange Risks*	*Management Approach*
Defence	Defence had total expenditure overseas of $A2.1 billion in 1998–99, primarily comprised of $A1.4 billion in capital expenditure by the Defence Acquisition Organisation. Defence's policy of negotiating contract payments in source currency means that, in the absence of effective hedging arrangements, there are often substantial exposures in individual procurement contracts.	Budget supplementation arrangements substantially reduces any incentive for Defence to identify or manage the foreign currency exposures in its capital equipment procurement contracts because the exposures are transferred to the Commonwealth Budget as a whole. Defence has adopted a policy of contracting wherever possible in foreign currencies (so as to increase supplementation of its budget) and gives little or no consideration to the resulting risk exposures with potentially serious adverse implications for the Commonwealth.
AusAID	By its nature, the overseas aid program exposes AusAID to foreign currency risk. This risk is most apparent in the $A195 million in foreign exchange payments made by AusAID in 1998–99. In addition, there are significant exposures that arise from AusAID's policy of denominating contracts and contributions to multilateral aid agencies in Australian dollars. This arises because, while AusAID may pay in Australian dollars, in many instances the invoice or contribution is actually a foreign currency amount that the contractor or multilateral agency has converted into an Australian dollar equivalent.	In the ***bilateral aid*** program, AusAID faces significant foreign exchange risk in reimbursing contractors for the foreign exchange costs of some project components such as equipment procured overseas. Where this occurs, AusAID's usual approach is to remain exposed rather than manage the exposure. As a result, AusAID's costs rise and fall with exchange rate movements. In comparison, AusAID seeks to minimise foreign currency risk exposures in its contributions to ***multilateral aid*** agencies by seeking to specify as many contributions as possible in Australian dollars.
DFAT	DFAT is the largest overseas operating agency in the Australian Public Service. Approximately one-third of DFAT's operating costs are spent overseas, with foreign currency expenditure of some $A209 million in 1998–99. In addition, DFAT administers ongoing payments to international organisations that are denominated in various foreign currencies.	DFAT negotiated with DoFA to extend budget supplementation for operating costs so as to continue to **transfer** foreign exchange risk to the Commonwealth budget. The stated purpose of the supplementation arrangements was to remove the incentive for managers to hedge against adverse currency fluctuations. As a result, **open** positions have been maintained on the basis that DFAT considers central agencies are best placed to make exposure management decisions. DFAT maintains significant open foreign exchange positions in relation to administered payments to international organisations and seeks additional funds where exchange rates increase costs above those budgeted. *continued next page*

Agency	Foreign Exchange Risks	Management Approach
DoFA	DoFA's Property Group funds and manages overseas construction, refurbishment and fitout projects. Overseas construction, refurbishment and fitout projects invariably give rise to significant foreign exchange exposures because of the need to procure materials locally and engage local contractors and consultants. In addition, further foreign exchange exposures have arisen in relation to certain privately financed overseas property developments.	An inconsistent approach to addressing foreign exchange risk has been adopted. DoFA often maintains significant open foreign exchange positions, although DoFA is aware of the potential for adverse exchange rate movements to significantly increase project costs above budget. On other occasions DoFA has sought to avoid exposures. In one instance, DoFA hedged its contracted payments but retained an open position on contract receipts with no explanation provided for the different approaches adopted.

Source: ANAO analysis.

2.12 ANAO considers that the protection and promotion of the Commonwealth's financial interests as a whole is an overriding consideration rather than just individual agency performance. Emphasising group performance requires a balance between empowering individual agencies and managers and providing structures and incentives to motivate behaviour that is in the interests of the Commonwealth as a whole. Accordingly, the absence of central agency guidance to agencies on appropriate risk management objectives and management approaches does not encourage promotion of a whole-of-government approach.

2.13 **Finding:** Individual agencies are legislatively responsible for managing their foreign exchange risk exposures but because of the lack of a clearly enunciated Commonwealth approach, inadequate risk management and (in some cases) provision of budget supplementation for exchange rate losses, there has been insufficient agency attention given to managing these risks. ANAO considers that DoFA has an important central agency role to play in promulgating appropriate guidance to agencies on the financial management framework that should be applied to foreign exchange risk. This would assist individual agencies to establish appropriate objectives and strategic principles to contribute to improving operating results and the Commonwealth's overall net asset position.

Recommendation No.1

2.14 ANAO *recommends* that DoFA:

(a) in consultation with relevant agencies and, as appropriate, the Government, determine and promulgate an overarching Commonwealth position statement on foreign exchange risk management to all agencies subject to the Financial Management and Accountability Act; and

(b) as the agency responsible for administration of the Financial Management and Accountability Regulations, ensure that, within whatever approach is decided in relation to (a), agencies fully understand and take appropriate action under Regulation 8 requiring a proper assessment of foreign exchange risk as part of their procurement processes and under Regulation 9 requiring consideration of this risk and the measures available to manage it as part of the expenditure approval process.

Agencies responded to the recommendation as follows:

2.15 ***Agree:*** DoFA; Treasury; AOFM; Defence; DFAT; AusAID. In addition, the Reserve Bank commented that it was in agreement with the main theme of the audit report, namely that the Commonwealth should have an explicit policy in relation to foreign exchange risk management.

2.16 Specific comments by agencies are set out below:

- **DFAT** stated that a carefully constructed and logically sound position that provides adequate guidance and assistance to agencies on foreign exchange risk management would be useful.
- **DoFA** suggested a broadly philosophical approach to foreign exchange risk does exist across the Commonwealth. DoFA considered this approach has not been clearly enunciated and promulgated as a formal policy or pronouncement, and therefore it has not been immediately identifiable, but such an approach is in place. DoFA considered such a position must necessarily recognise the effective management of risk as an integral part of business planning and management policies at an agency level. DoFA's view was that any policy approach to exposure management needs to focus on the needs of the business being conducted. Providing there is a sound risk assessment underpinned by clear risk management policy objectives in each case, DoFA considers inconsistency may be appropriate.

Nevertheless, in relation to part (a) of the recommendation, DoFA advised ANAO on 9 May 2000 that it had issued Finance Circular 2000/3 *Budget Framework for the Management of Foreign Exchange (FOREX) Exposure* to provide guidance to agencies covered by the Financial Management and Accountability Act on the budgetary framework for management of foreign exchange risk and avenues for the hedging of foreign currency payments and receipts. In relation to part (b), DoFA noted that this Finance Circular stipulates that *agencies have responsibility for managing FOREX risk within the constraints of their annual budget appropriations*. Attached to this responsibility is the requirement to adhere to Commonwealth Procurement Guidelines which recommend purchasing functions be undertaken after full assessment of all relevant costs. DoFA reiterated that responsibility for ensuring that expenditure approvals consider foreign exchange risks rests with approvers at the agency level.

ANAO comment

2.17 ANAO acknowledges the release of Finance Circular 2000/3 (see Appendix 1 to this audit report) as a positive development but considers that further action will be necessary to fully address the recommendation, as indicated by the responses from the Reserve Bank and DFAT. In particular, Finance Circular 2000/3 does not include an overarching Commonwealth position statement on foreign exchange risk management and no guidance is provided to agencies on issues they might need to address as part of their particular responsibilities for managing their foreign exchange exposures. In addition, the Finance Circular focuses on hedging of exposures whereas prudent foreign exchange risk management requires management action at all stages of the expenditure cycle. ANAO considers that exposure management that starts with hedging of contracted exposures risks missing the opportunities that exist to set or influence contractual conditions, which can be a more cost-effective way to manage the risk.

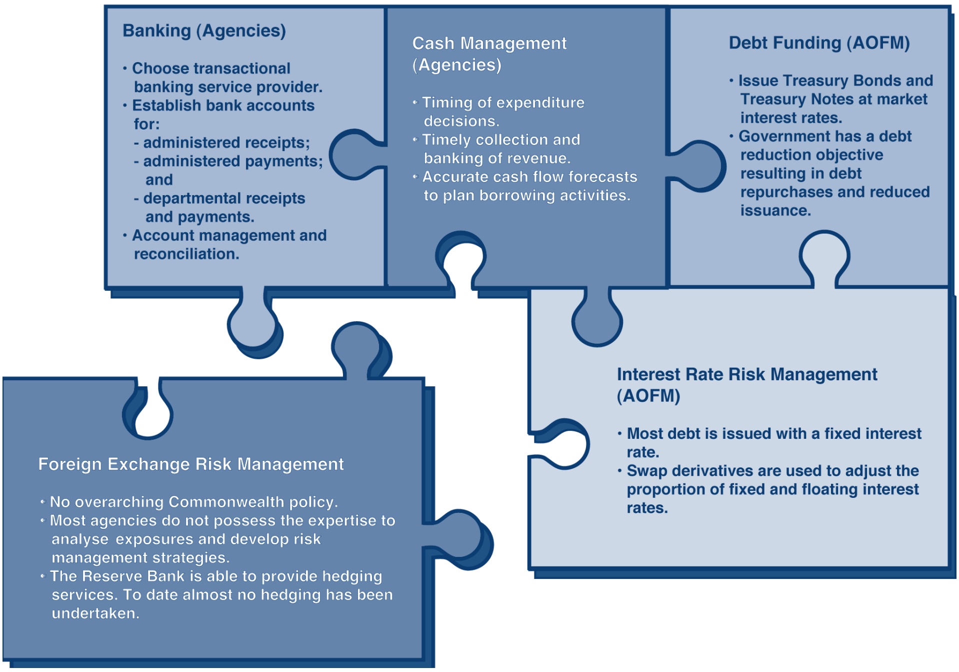
Risk management framework

2.18 The treasury management function is a core part of any business operation as its management has a significant impact on the financial and operating performance of the entity. This role includes procuring the finances needed to fund the operations of the organisation and managing funds to meet working capital requirements and prevent liquidity or solvency crises.

2.19 The Commonwealth's treasury function involves centralised responsibility for certain aspects such as borrowing and devolved responsibility for banking and cash management (see Figure 2.2).[33] The Commonwealth also has a devolved and decentralised approach to managing foreign exchange risk. There was until very recently no central agency guidance on foreign exchange risk management and no attempt has been made, for example, to aggregate exposures to take advantage of netting opportunities and diversification benefits which can reduce the exposure management task. The Commonwealth's devolved and fully decentralised approach is in marked contrast to normal commercial practice in managing specialised and highly material financial risks.

Figure 2.2

The Commonwealth's Treasury Function: Financial Management and Accountability Act Agencies



Source: ANAO analysis.

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33 Figure 2.3 does not address the Commonwealth's approach to other financial risk such as commodity price exposures (such as the purchase of fuel) or credit exposures.

2.20 Although managers are generally in the best position to identify and manage risk exposures, a central treasury can play a key role in cost-effective risk management. This is because a central treasury can provide expert advice to managers; offset individual manager's risk positions to minimise the exposure management task; deliver economies of scale in obtaining commercial cover for exposures that are to be managed; and establish an appropriate internal control framework for financial derivatives. In comparison, decentralised management of foreign exchange risks, with minimal central oversight, has the potential to increase Commonwealth risk exposures, particularly where financial derivatives are used to hedge exposures. Decentralisation is also likely to be less cost-effective because of the reduced capacity for netting exposures, increased transaction costs through the loss of economies of scale and duplication of systems and activities.

2.21 Many major corporations and the Australian State Governments centralise the implementation of exposure management strategies as a means of achieving economies of scale in obtaining commercial cover for exposures and ensuring an appropriate internal control framework for exposure management. Centralising risk management advice and dealing activities does not absolve individual agencies from their responsibility for managing the underlying business transactions and associated risks. Agencies remain primarily responsible and accountable for developing risk management policies, identifying exposures, deciding when to cover exposures and monitoring the implementation and effectiveness of risk management strategies. Under a centralised model, the role of central agencies is to provide guidance and advice to agencies and to manage residual risks on behalf of the Commonwealth. This approach recognises that agency managers are best placed to identify risk exposures and make exposure management decisions and contributes to the establishment of clear links between the creation of risk and its effective management.

2.22 ANAO notes that, appropriately resourced, the newly formed Australian Office of Financial Management (AOFM)[34] and/or the Reserve Bank may be able to play a key role in providing specialist advice to agencies on the development and implementation of considered approaches to managing their foreign exchange exposures. The AOFM

34 The AOFM is a prescribed agency under the *Financial Management and Accountability Act 1997*. From 1 July 1999 the AOFM assumed responsibility for the Commonwealth's existing debt management activities, including use of financial derivatives to manage the cost and risk associated with the Commonwealth debt portfolio. The funding for the AOFM allows for staffing and resources additional to those of Treasury's Debt Management Office which the AOFM replaces.

and/or the Reserve Bank could assist agencies identify and analyse foreign exchange exposures, both to manage negative risks and to take advantage of opportunities to increase value. It may also be possible to outsource such a function, but this could have implications for the Reserve Bank's exchange rate management activities. In addition, centralisation within the Commonwealth offers an advantage in terms of the level of independence of any advice and dealing services provided to agencies. Such matters would require careful consideration by central agencies in their advice to the Government if a centralised model were to be adopted.

2.23 Whilst risk management advice and dealing activities could be centralised, agencies would need to retain responsibility for the development of risk management policies, identification of exposures and monitoring the implementation and effectiveness of risk management strategies. This would contribute to the establishment of clear links between the creation of risk and its management. In this respect:

- DFAT advised ANAO that centralised management would enable benefits to be achieved by aggregating the Commonwealth's foreign currency exposure and it would facilitate proper management of the specialist expertise required to achieve optimal results. In the absence of centralised management, the Department was concerned that there would be a need for individual agencies to source and retain expertise not normally available in the public sector and that, whilst this might be the subject of outsourcing, agencies would still need to retain expertise adequate for managing the outsourced contract(s). In either case, the Department stated that it would expect aggregate costs across the Commonwealth to be significant and that these costs may well exceed the costs of a centralised approach.
- Defence advised ANAO that it supported the use of the AOFM for expert advice on the management of foreign exchange risk and to assist in arranging commercial cover for exposures through the Reserve Bank. Defence commented that this would obviate the need for agencies to acquire highly specialised skills and knowledge required for exposure management.

2.24 Although some agencies support greater centralisation of foreign exchange risk management activities, it is important that agencies retain responsibility for the identification of their foreign exchange exposures, as an integral element of their management of programs. This recognises that the potential benefits of managing exposures to foreign exchange risk can only be properly identified in a timely manner by individual agencies and that exposure management decisions are best made in the context of the management of programs. Although central agencies can provide valuable assistance with expert analysis and guidance, and accepted sound practice is to centralise dealing activities, individual agencies remain accountable for the efficient, effective and ethical use of Commonwealth resources under their stewardship.

2.25 **Finding:** The development and implementation of foreign exchange risk management programs is a specialist activity that requires appropriate knowledge and expertise in financial markets, robust systems and rigorous internal controls. Although managers are generally in the best position to identify and manage risk exposures, a centralised treasury function can play a key role in cost-effective risk management. This is because a central treasury can provide expert advice to managers; offset individual managers' risk positions to minimise the exposure management task; deliver economies of scale in obtaining commercial cover for exposures that are to be managed; and establishing an appropriate internal control framework for financial derivatives. In comparison, decentralised management of foreign exchange risks, with minimal central oversight, has the potential to increase Commonwealth risk exposures particularly where financial derivatives are used to hedge exposures.

Recommendation No.2

2.26 ANAO *recommends* that Treasury, in consultation with DoFA and other relevant agencies, investigate the merits of centralising provision of strategic and operational advice to agencies on the cost-effective management of foreign exchange risk.

Agencies responded to the recommendation as follows:

2.27 ***Agree:*** Treasury; DoFA; AOFM; Defence; DFAT; and AusAID.

2.28 Specific comments by agencies are set out below:

- **Treasury** considered that centralised provision of advice will need to be tested against competitive neutrality principles.
- **DFAT** commented that the design of a Commonwealth-wide, centralised, efficient, and cost-effective model for foreign exchange risk management would provide benefits across all agencies. In addition, DFAT stated that it remains firmly of the view that foreign exchange risk should be managed centrally. This view is based on the highly specialised nature of foreign exchange risk management, the relatively small number and amounts of overseas transactions of many agencies, the high costs of expertise required to manage exposures in-house, and the benefits that would flow from economies of scale

from centralised management. The Department considered that the complex and specialist nature of foreign exchange risk management, together with the potentially high costs involved, dictates that management of this risk be undertaken by a single agency. Client agencies could provide regular profiles of future foreign exchange requirements, from which the central body could consolidated demand, identify appropriate currencies for payment, and utilise appropriate instruments.

- **DoFA** stated that, in conjunction with Treasury, it is willing to consider the option of the AOFM providing a central source of strategic and operational advice to agencies on the management of foreign exchange risk.
- **AOFM** noted that the approach at the State level has been one of centralising the risk management execution function. Centralisation of the provision of strategic and operational advice provides a service to agency heads and assists them to identify risks consistent with the policy framework established by the central monitoring agency. In addition, a centralised approach is also adopted by the States for the 'market execution' function in order to ensure that risk is managed within a prudential control framework and any associated monitoring and administrative efficiency gains can be delivered. With the appropriate resource allocation, the AOFM would be available to assist agencies to develop appropriate risk management strategies, consistent with the policy framework prescribed by DoFA. However, it is essential that the lines of responsibility and accountability be clearly defined and transparent. In particular, it is important to make clear to Departments/Agencies that ultimate accountability for any hedging undertaken resides with the relevant agency.
- The **Reserve Bank** commented that it would be happy to be part of a review of the merits of centralising the provision of strategic and operational risk management advice to agencies. If that review were to decide there were merits in a centralised approach, the Bank stated that it would be willing to provide this service to agencies if the Commonwealth wanted it to do so. Irrespective of who provides the strategic advice to agencies, the Bank stated that hedging transactions should be channelled through the Bank in order to gain cost efficiencies for the Commonwealth and to ensure that these hedging activities do not undermine the Bank's exchange rate management activities.

Financial derivatives

2.29 Where foreign exchange risk exposures can have a significant effect on the core business of an entity these exposures should be managed so that operational effectiveness is not adversely affected. Whilst gains can be made from hedging activities, these gains offset underlying transaction exposure losses. From the Commonwealth's perspective, it would be inappropriate for agencies to seek to profit from speculative foreign currency trading.[35] Equally, for entities such as Commonwealth agencies whose core business does not involve trading in financial risks, having any significant open exposure to exchange rate fluctuations could also be inappropriate.

2.30 Hedging refers to the process of managing risk by eliminating, or at least reducing, the underlying exposure. A hedge is effected by offsetting in part or whole the existing risk exposure associated with an underlying transaction. 'Natural' hedges are also possible, where exposure to payments/liabilities in one currency are offset by receipts/ assets denominated in the same currency. Cost-effective foreign exchange risk management also includes identifying opportunities to increase value by advantage of any opportunities (without speculating or forecasting) that foreign exchange exposures can provide.

2.31 The development and implementation of foreign exchange risk management programs is a specialist activity that requires appropriate knowledge and expertise in financial markets, strong systems and rigorous internal controls. In 1998, General Motors Corporation in the United States sponsored a foreign exchange risk management benchmarking study to develop an authoritative list of foreign exchange risk principles appropriate for multinational corporations. The study identified 12 risk management principles that are expected to reinforce each other to promote: measurable hedging objectives; accurate and timely information on performance against the objectives; minimisation of transaction costs; rigorous error and compliance checking; and appropriate senior management oversight (see Figure 2.3).[36]

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35 It is important to contrast hedging (risk management) with speculators and arbitrageurs. Speculating is attempting to profit on predicted exchange rate movements by taking a currency position. For example, if it is expected that the Australian dollar will appreciate, a speculator might not hedge foreign currency payments in the hope of making a gain. Arbitrageurs attempt to take advantage of price discrepancies that may exist within a market or between related markets. Whereas speculators can make a profit or loss, arbitrageurs seek to lock in a profit with no risk.

36 Greenwich Treasury Advisors LLC, *The Group of 31 Report: Core Principles for Managing Multinational FX Risk*, July 1999.

Figure 2.3

Better Practice for Managing Foreign Exchange Risk by Multinationals

1. Document Foreign Exchange Policy. The policy should be approved by senior management or the Board of Directors. It should address: hedging objectives; hedgeable exposures; hedging time horizon; authorised derivatives; compensation for trader performance; and hedging performance measures. Although the treasury should be involved in the developing the policy, it is a senior management responsibility to define when and how the foreign exchange risks of the corporation should be managed.

2. Well-Qualified, Experienced Personnel. The aim is to ensure there are a sufficient number of qualified, experienced personnel to properly execute the policy. The principle recognises that prudent hedging requires a significant investment in policy and procedures, systems, support from other company units and departments and qualified people to manage the process.

3. Centralise Trading. Centralising trading with the Parent Treasury, which may be assisted by foreign hedging centres reporting to the Parent Treasury, is advocated as centralisation allows for economies of scale in sophisticated trading systems and analytics, better internal controls, more professional trading and enhanced netting opportunities.

4. Adopt Uniform Accounting Procedures. Accounting should provide an independent check over hedging activities. This is achieved by requiring uniform foreign exchange accounting procedures, uniform exchange rates for book purposes, multi-currency general ledgers for all foreign exchange transactions and regular reconciliations of hedging results to the consolidated foreign exchange accounting results.

5. Manage Forecast Error. Where anticipated risk exposures are being hedged, steps should be taken to manage and minimise the forecast error. This is because there is no point in hedging unreliable forecasts.

6. Measure Hedging Performance. Performance benchmarks need to be chosen carefully because they often drive hedging results to cluster around them. Historic hedging performance should be fully evaluated using several performance measures. Current hedging performance should be measured by frequently marking to market both the outstanding hedges and the underlying exposures.

7. Segregate the Back Office Function. Segregating back office functions such as confirmations and settlements from trading activities is a fundamental internal control to reduce the risk of losses being deferred or hidden. Many of the worst derivative debacles of the last decade have been traced to a simple failure to properly segregate duties.

8. Manage Counterparty Risk. Credit rating standards need to be developed and applied and counterparty risk regularly evaluated against these standards. Credit exposure should be measured using market valuations against assigned credit limits and appropriate legal documentation adopted.

9. Buy Derivatives Competitively. Seeking quotes from a number of potential counterparties with appropriate trading controls ensures that value for money is achieved from hedging transactions.

10. Use Pricing Model and Systems. Investing in systems to help measure and managed foreign exchange risks assists entities to track, manage and value the derivatives traded and the underlying business exposures being hedged.

11. Measure Foreign Exchange Risk. The full nature of the risks being managed should be understood using a combination of risk measures such as Value-at-Risk, sensitivity analysis and stress testing.

12. Oversee Treasury's Risk Management. A Risk Committee should independently oversee the treasury's risk management activities and strategies, exposure and counterparty credit limits, and exceptions to corporate policy. A dedicated function should review treasury's compliance with approved risk management policies and procedures.

Source: Greenwich Treasury Advisors LLC, *The Group of 31 Report: Core Principles for Managing Multinational FX Risk*

2.32 To protect against adverse movements in exchange rates creating budget uncertainty, agencies are permitted to arrange hedging transactions for their foreign currency payments and receipts. In July 1999, the Government decided that, as an extension of the foreign currency spot transaction services that are provided to Commonwealth agencies, foreign exchange exposure management transaction services are to be provided by the Reserve Bank. The Bank is to execute transactions at market prices and undertake offsetting transactions with the market when market conditions permit.

2.33 Where financial derivatives are to be used to manage foreign exchange risk, it is important that operating rules approved by senior management define the instruments that may be used, the purpose of their use and any transaction limits. As part of the decision to allocate responsibility for hedging services to the Bank, Ministers decided that hedging processes and guidelines would be developed by DoFA and the Bank, in consultation with Treasury, Defence and DFAT. When finalised, DoFA was to distribute the guidelines to all Commonwealth agencies.

2.34 In July 1999, the Reserve Bank provided DoFA with a first draft of the proposed hedging guidelines. These draft guidelines state that the purpose of any hedging transactions is to protect against adverse movements in exchange rates creating budget uncertainty. This allows agencies the flexibility to enter into hedging transactions (such as currency options) that permit them to benefit from favourable exchange rate movements but protect against adverse movements. The Reserve Bank's July 1999 draft included general guidelines for the commencement of hedging operations using basic forward foreign exchange contracts. More exotic hedging products (such as options) may be considered in the future.

2.35 The Reserve Bank provides forward foreign exchange contracts to hedge agencies' payments and receipts on the following basis:

- where settlement dates and foreign currency amounts are known to agencies, the Bank can provide transaction by transaction cover to fix the exact Australian dollar amount and timing of foreign currency receipts/payments;[37] and/or
- general cover for a total amount of foreign currency over a period against which individual payments/receipts can be made with only a

[37] The Bank's envisages that agencies would be able to set up hedging transactions for an individual underlying payment/receipt once during any fiscal year. In the event that commitments or timing of payments/receipts change during the year, the Bank can adjust forward contracts to meet the changes but reductions in hedges would need to be closed out at the then current market rate; this could result in a cost or benefit to the agency depending on exchange rate movements over the intervening period. The Bank does not envisage permitting agencies to trade into and out of hedging transactions for particular commitments.

marginal change to the Australian dollar amounts involved. In this way, general cover could be established for a full year's payments/receipts. This is akin to a portfolio approach to managing risk exposures.

2.36 There is no fee involved for forward foreign exchange contracts undertaken by Commonwealth agencies through the Reserve Bank.

2.37 As of December 1999, DoFA had not responded to the Bank's initial draft.[38] As the absence of a documented foreign exchange hedging policy was considered likely to perpetuate continuing uncertainty among Commonwealth agencies as to the Commonwealth's hedging policy and processes,[39] ANAO sought DoFA advice on the reasons for the significant delay in promulgating guidance to agencies. On 13 March 2000, DoFA advised ANAO that the Reserve Bank and Treasury *have provided advice in relation to updated guidelines on foreign exchange risk management to apply to entities in the General Government Sector. DoFA will provide these Guidelines to agencies through normal channels of advice relating to financial management.* This occurred in May 2000 with the issue of Finance Circular 2000/3.

2.38 Depending on the nature and value of an agency's hedging transactions, the Reserve Bank may selectively allow hedging contracts to be sought directly from the market. As a provider of hedging services to Commonwealth agencies, the Reserve Bank is able to offer attractive commercial rates, stemming from its holdings of foreign currencies in the reserve assets portfolio. Accordingly, any proposal to enter into derivative transactions other than with the Reserve Bank needs to include rigorous analysis that demonstrates the financial merits of an alternative approach.[40] Where the Bank permits certain exposures to be hedged with other counterparties, it is important to ensure value for money by implementing appropriate trading controls including seeking quotes from a number of potential counterparties.

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38 Defence advised ANAO on 17 February 2000 that it is yet to be consulted by DoFA on the development of hedging guidelines and that the 2000–01 Defence Budget is being developed, in consultation with DoFA, on the basis of continued supplementation for foreign exchange risk.

39 The AOFM is an exception, making extensive use of financial derivatives (cross-currency swaps) to exchange its Australian dollar payment obligations for foreign currency (principally United States dollar) payment obligations. These swaps are undertaken to increase its exposure to foreign currency risk above the level necessary to fund expenditure. Increased foreign currency exposures is sought as part of an explicit strategy intended to reduce long-term debt costs for an acceptable level of risk. Source: Audit Report No. 14 1999-2000, *Commonwealth Debt Management*, pp. 52—60.

40 For example, a departure from the general policy of transacting with the Reserve Bank may be justified where the Bank is unable to deal in the currencies or volumes required or a commercial bank is able to offer a more attractive rate than is available in the market. This could occur where a market participant has an open position it wishes to close by entering into a hedge contract with the Commonwealth

2.39 Finding: The development and implementation of foreign exchange risk management programs is a specialist activity that requires appropriate knowledge and expertise in financial markets, strong systems and rigorous internal controls. Commonwealth policy is that foreign exchange exposure management transaction services are to be provided by the Reserve Bank, unless the Bank agrees otherwise. After a significant delay, DoFA has very recently provided agencies with guidance on the foreign exchange risk management services that are available from the Reserve Bank.

Agency banking arrangements

2.40 Under the new agency banking arrangements that came into force on 1 July 1999, subject to agreement with the Reserve Bank, agencies are able to arrange for the delivery of some or all low value transactions through their transactional banker rather than the Reserve Bank. The previous position was that all foreign currency transactions should be undertaken through the Reserve Bank.

2.41 The Reserve Bank is charged with exercising its monetary and banking policy powers in a way that contributes to the stability of the Australian currency.[41] To ensure consistency with the Reserve Bank's exchange management objectives, all Commonwealth agencies subject to the Financial Management and Accountability Act are required to undertake foreign exchange transactions with the Reserve Bank, which the Bank passes through to counterparties in the financial market at times of its own choosing. This is to ensure that the Bank's interventions at times of pressure on the currency are not undermined by foreign exchange purchases and sales by Commonwealth agencies and to ensure that agencies receive wholesale, not retail, exchange rates.[42]

2.42 The Reserve Bank undertakes foreign exchange transactions with Commonwealth agencies in the wholesale market. The 'spreads'[43] on

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41 *Reserve Bank Act 1959*, section 10 (2) (a).

42 The Bank noted in its 1999 Annual Report and Financial Statements (p. 16) that its transactions with the Commonwealth are passed more or less directly through to the market so that they do not act as a drain on (or a source of augmentation for) foreign currency reserves. However, at times when the exchange rate is under downward pressure and well below its long-run average, such as in 1998 and in recent months, the Bank will usually refrain from passing the transactions through to the market in order to avoid exacerbating market pressures. Instead, these transactions are initially met from the Bank's holdings of foreign exchange and put through the market at a later time, when the exchange rate is more favourable.

43 The 'spread' is the difference between a price maker's (usually a financial institution) bid and offer (or buy and sell) rates and represents the price maker's profit on undertaking both sides (or 'legs') of a foreign exchange transaction. The wider the spread, the greater the profit made by the price maker on its foreign exchange transactions. These profits will be made at the expense of price takers (such as Commonwealth agencies) who should be seeking to minimise the spread on their transactions.

foreign currency deals in the wholesale market are generally narrower than retail market spreads because of the lower value of retail transactions and the minimum costs necessary to undertake foreign exchange transactions regardless of the transaction value. Commonwealth agencies can, on average, realise significant financial benefits by undertaking their foreign exchange spot transactions in the wholesale market with the Reserve Bank.

2.43 The financial benefits of dealing with the Reserve Bank mean that Commonwealth agencies that propose to undertake foreign currency spot transaction other than with the Reserve Bank need to carefully evaluate the financial merits of obtaining these services from another financial institution. In particular, ANAO considers:

- the transactional banker tender would need to address the currencies in which each candidate is prepared to deal and whether spot or wholesale exchange rates are to be used; and
- procedures would be required whereby the agency could periodically satisfy itself that the rates it is receiving are competitive with those that would have been available from the Reserve Bank.

2.44 **Finding:** All Commonwealth agencies subject to the Financial Management and Accountability Act are required to undertake foreign exchange transactions with the Reserve Bank, unless the Reserve Bank agrees that some or all low value transactions may be conducted through their transactional banker. To obtain value for money in these circumstances, ANAO considers that agencies would need to manage the tender for transactional banking services and the resulting contract in a way that ensured competitive, market based exchange rates were being received from the transactional banker.

Recommendation No.3

2.45 ANAO *recommends* that, where appropriate, agencies proposing to outsource some or all of their foreign currency spot transaction services as part of the agency banking arrangements, manage the tender process so as to ensure that the outcome complies with Commonwealth policy and delivers value for money.

Agencies responded to the recommendation as follows:

2.46 *Agree:* DoFA; Treasury; DFAT; and AusAID

Agree with qualifications: Defence

2.47 Specific comments by agencies are set out below:

- **Defence** agreed subject to successful implementation of Recommendation No.1 (promulgation of an overarching Commonwealth position statement) and Recommendation No.2 (centralised provision of strategic and operational advice to agencies) and resolution of Recommendation No.5 with regard to the outcome of the current review of Defence's global funding arrangements, including foreign currency supplementation.
- **DoFA** commented that, from 1 July 1999, the transactional banking services provided by the Reserve Bank were opened to competition with the private sector. DoFA stated that, within this framework, the delivery and settlement of foreign exchange payments is contestable. DoFA advised that the competitive arrangements also operate with respect to forward contracts for the purchase of foreign exchange such as may be entered into by agencies for hedging purposes. DoFA stated that these hedging contracts may be authorised by Ministers in accordance with their inherent executive powers under the Constitution.

  DoFA supported the principle of agencies ensuring value for money in their purchase of foreign exchange services under the post 1 July 1999 competitive arrangements. DoFA stated that, to assist agencies in market-testing transactional banking services, a template contract and panel of banks capable of delivering services to government agencies are being developed. These tools are to incorporate an overarching requirement to ensure value for money.

Commonwealth budgeting

2.48 In April 1997, as part of its public service reform agenda, the Commonwealth Government decided to implement an accrual-based, outcome and output-focused resource management framework for the Commonwealth. The first accrual budget was produced in May 1999 for the 1999–2000 Budget. The accrual reforms are intended to improve the linkages between plans and reported performance by providing greater transparency of the Government's financial position and a more accurate assessment of what it costs to undertake Government activities and services.[44]

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[44] Audit Report No. 38 1998–99, *Management of Commonwealth Budgetary Processes*, pp. 37–38.

2.49 The Commonwealth Budget and constituent agency budgets are prepared on the basis of economic parameters developed by Treasury, including exchange rate parameters. These economic parameters are prepared to forecast growth and other economic factors. The economic parameters are not prepared specifically for Commonwealth budgeting purposes but are adopted by DoFA for the annual Commonwealth Budget and by some individual agencies for project budgeting purposes.

2.50 The Treasury exchange rates are average historic spot rates for a single month. For example, for a May budget, Treasury uses average spot exchange rates for the preceding March as the basis for developing exchange rate assumptions that underpin preparation of the Commonwealth budget for the following financial year. Using average historic spot exchange rates for one month for budget estimating purposes may be considered to offer advantages of being simple, easily calculated and not able to be manipulated. An alternative to average historic spot rates would be to use forward exchange rates.[45]

2.51 The use of historic average spot exchange rates for Commonwealth budgeting has significant adverse implications on the recognition and management of foreign exchange risk by agencies. For example, the average historic spot exchange rates are also used by agencies such as Defence and DFAT to prepare capital expenditure budgets, which often involve expenditure extending many years into the future. ANAO's analysis of these capital expenditure projects found that the average historic spot exchange rates developed by Treasury and adopted by DoFA for budget preparation have not been a good indicator of exchange rates over the course of such projects, which in some cases has led to substantial cost increases compared to the original project budget. ANAO's Strategic Adviser observed that, as the Budget exchange rates are an average spot rate for a period prior to the Budget, they are inappropriate to use for project budgeting because:

- forward exchange rates are a better indicator of exchange rates that are likely to apply over the course of the contract, without recourse to forecasting which is often unreliable and can involve unsatisfactory policy signalling implications; and
- spot rates are unlikely to be achievable over the course of the project. In comparison, entities are able to lock-in forward rates in order to provide greater certainty that the project will be completed in accordance with the budget.

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45 Forward exchange rates are a combination of a spot price and a foreign exchange swap price. They can be calculated by reference to the spot price and the two interest rates involved.

2.52 A major advantage of using forward exchange rates for budgeting is that, if a Commonwealth agency wished to remove its exposure to exchange rates in order to achieve greater budget certainty, it could lock in the forward rate. The continued use of average historic spot exchange rates for budgeting does not promote management of foreign exchange risk as it is not possible for agencies to lock in average historic spot exchange rates. For agencies that receive budget supplementation, significant departures of actual exchange rates from the Budget rate does not have a significant impact on their ability to deliver outputs within budget. However, agencies that do not receive budget supplementation are at a disadvantage because their ability to deliver outputs within the budget can be adversely affected by exchange rate variations.

2.53 **Finding:** The use of average historic spot exchange rates for one month as the basis for Commonwealth budgeting has significant exposure management implications for agencies. ANAO's analysis of a number of Defence and DoFA projects found that the average historic spot exchange rates developed by Treasury have not been a good indicator of exchange rates over the course of such projects, which in some cases has led to substantial cost increases compared to the original project budget.

Recommendation No.4

2.54 ANAO *recommends* that, to encourage a greater focus on exposure management by Commonwealth agencies, DoFA, in consultation with Treasury, consider the merits of using market based forward exchange rates to prepare the Commonwealth Budget and constituent agency budgets.

Agencies responded to the recommendation as follows:

2.55 ***Agree:*** Treasury

Agree with qualifications: Defence and DFAT

Disagree: DoFA

2.56 Specific comments by agencies are set out below:

- **Defence** agreed subject to successful implementation of Recommendation No.1 (promulgation of an overarching Commonwealth position statement) and Recommendation No.2 (centralised provision of strategic and operational advice to agencies) and resolution of Recommendation No.5 with regard to the outcome of the current review of Defence's global funding arrangements, including foreign currency supplementation.

- **DFAT** supported, in principle, the recommendation but considered that full consultation between DoFA and all relevant agencies on the details of the proposed arrangements would be necessary.
- **DoFA** stated that it considers forward exchange rates represent the market's estimation of future exchange rates based on currently available data. DoFA's view is that forward exchange rates do not take into account future events or even all current data that may affect future exchange rates. Furthermore, DoFA stated that it has seen no empirical evidence to indicate that the current exchange rate forecasting methodology is less reliable than market forward exhange rates. DoFA also commented that this recommendation may result in other potential difficulties, such as raising the prospect of speculation by overseas suppliers against the quoted forward rate for budgeting purposes.
- **Treasury** stated that it could see a clear case for the use of forward rates in budget estimates. Treasury considers that, for economic purposes (which is a different issue) the existing approach of average historic spot rates is superior to the use of forward rates in that context.

Budget supplementation

2.57 Agencies with significant foreign exchange exposures face an increased risk of cashflow volatility which can affect their ability to achieve budgeted results. Failure to recognise foreign exchange exposures or ineffective risk management can have substantial adverse implications for cash flows and, ultimately, the financial performance of individual programs. Consequently, under the accrual budgeting framework, this could have unfavourable impacts on agencies' ability to deliver their outputs within the funding provided. Accordingly, agencies may seek additional funding or reduce the quality or quantity of budgeted outputs.

2.58 Sound practice in risk management is to link the ability to create foreign currency exposures and accountability for the management of these exposures. This can be achieved by ensuring that the entity that creates the exposures has the responsibility either to manage them directly or to pass them to another entity that has a mandate for exposure management. Conversely, the immunisation of a business unit or agency from foreign exchange risk affects attitudes to risk and whether risk is managed. In this respect, budget supplementation arrangements in place for Defence and DFAT[46] transfer foreign currency exposures from these

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46 Treasury advised ANAO that Austrade and the Department of Immigration and Multicultural Affairs also receive budget supplementation.

agencies to the Commonwealth Budget as a whole, which substantially reduces incentives for Defence and DFAT to identify, assess or manage foreign exchange risk exposures.[47] No agency has been allocated responsibility for managing the risk exposures transferred from Defence and DFAT to the Commonwealth Budget.

2.59 The budgets of Defence and DFAT are supplemented for differences between the actual exchange rate on individual transactions and the exchange rate used to prepare that year's Commonwealth Budget.[48] In comparison, the sourcing of domestic supplied goods that include foreign sourced goods are not shielded from the pricing impact of exchange rate movements. Accordingly, there can be a substantial financial incentive to source goods from overseas suppliers as opposed to domestic suppliers for budget supplemented agencies as the exchange rate risks are borne by the Commonwealth Budget.

2.60 Under the supplementation arrangements, foreign exchange losses result in an increase to the following year's Defence/DFAT budget whilst gains are fully refunded through a reduction to the following year's Defence/DFAT budget, as follows:

- over the last four years, supplementation has resulted in a net aggregate increase of $89 million to the Defence budget, including an increase of $A120 million to the 1999–2000 budget[49] for exchange rate variations from the Budget rates for 1998–99 expenditure;[50] and

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47 For example, as a result of supplementation, Defence has adopted a policy of contracting wherever possible in foreign currencies (so as to increase supplementation) and generally ignores the resulting risk exposures.

48 DoFA advised ANAO that: *We have made inquires as to the original policy reasons for supplemenation for foreign exchange losses, but due to the length of time elapsed since the original decision was made, we are unable to provide any answers. Our own thoughts on this matter are that the Government sought to maintain the purchasing power, and service levels, of agencies that undertook foreign exchange risk as part of their operations. However, this position changed over time to relate only to those agencies that undertook considerable foreign exchange risk as part of their everyday operations, namely DFAT and Defence.*

49 The 1998–99 Defence Budget was increased by $177.525 million for the change between the average actual exchange rate achieved in 1996–97 (as 1997–98 figures were not available at the time the Budget was finalised in May 1998) and the exchange rate used to prepare the 1998–99 Budget. At the end of the 1998–99 year, actual foreign currency expenditure for 1998–99 at the actual exchange rates ($1.955 billion) is compared to actual foreign currency expenditure at the budget exchange rates ($1.835 billion). This comparison revealed that exchange rate movements compared to the budget rate had increased Defence expenditure by $119.977 million. This amount was less than the $177.525 million added to the 1998–99 Defence budget and, accordingly, the difference of $57.548 million will be subtracted from the 1999–00 Defence budget during the Additional Estimates process.

50 The 1997–98 budget was increased by some $A29 million for variations from the exchange rates used to prepare the 1996–97 Commonwealth Budget whereas reductions of $A28 million and $A32 million were made in 1996–97 and 1995–96 due to favourable exchange rate movements in 1995–96 and 1994–95 respectively.

- over the last two years, supplementation has resulted in a net aggregate increase of $A27.7 million[51] to the DFAT budget, including an increase of $A13.5 million to the 1999–2000 budget for transactional exchange rate variations from the Budget rates for 1998–99 expenditure. This represented a seven per cent increase on $A194.2 million in foreign currency expenditure at the 1998–99 Budget rates.

2.61 Supplementation reflects a cash-based account of the additional costs in the prior year of open foreign exchange positions. Accordingly, the amount of annual budget supplementation does not reflect the full cost to the Commonwealth of the substantial open foreign exchange positions in Defence and DFAT.

2.62 ANAO considers that the full effect of exchange rate variations is best assessed by market based measures which account not only for cash flows that have occurred but also market based estimates of the Australian dollar cost of future foreign currency cash flows. At present, such market based estimates are not produced by Defence, DFAT or DoFA.

2.63 Budget supplementation plays a role in meeting the Government's commitment to maintain Defence funding in real terms.[52] It also maintains DFAT's purchasing power.[53] However, the budget supplementation arrangements contribute to maintaining funding in real terms by transferring foreign currency exposures from Defence and DFAT to the Commonwealth Budget as a whole, which substantially reduces incentives for Defence and DFAT to identify, assess or manage foreign exchange risk exposures. These exposures continue to exist, but management of them is not presently addressed either by Defence and DFAT or by DoFA. In this respect, DFAT advised ANAO that:

> *Historically, the Commonwealth has carried its own risks, including for foreign exchange exposure. In line with this overarching approach, we note that DFAT's Resource Agreement, as agreed with DoFA, details the methodology by which DFAT's Running Cost Budget is rebased each year to reflect foreign currency movements. The Agreement effectively transfers the exposure from DFAT to the Federal Budget, and, as stipulated in the current resource agreement, removes the incentive for program managers to hedge against adverse currency fluctuations.*

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51 Adopting forward foreign exchange rates to develop DFAT's annual budget would provide a more realistic estimate of the likely Australian dollar cost of DFAT's overseas operations. This would also be likely to reduce supplementation of DFAT's budgets.

52 The Hon. John Moore, MP, Minister for Defence, *Budget Demonstrates Government's Commitment to a Stronger, Better Prepared Defence Force*, Media Release MIN130/99, 11 May 1999, p. 1.

53 The other part involves annual re-basing of DFAT's Australian dollar budget for anticipated salaries and administrative expenditure in each foreign currency. This is achieved by adjusting for the change in DoFA Budget exchange rates for each foreign currency. In the last four budgets, the effect of the re-basing adjustment has been a net increase of $A4.4 million to the DFAT budget.

2.64 Budget supplementation reduces the incentives (but not the legal requirement) for rigorous examination of contract terms and consequently leaves the Commonwealth open to increased costs. DoFA has also noted that the budget supplementation arrangements could be providing Defence with the wrong incentives and that alternative arrangements of seeking cover for foreign exchange exposures on a contract by contract basis could be an improvement.

2.65 Defence advised ANAO that, while it agrees that foreign exchange risk management needs improvement and that this should be implemented on a whole-of-government approach, consideration has to be given to the Government's commitment to maintain zero percentage growth in 2000–01 and the Forward Estimates period. Defence stated that it would be concerned if any movement away from the present approach that involves budget supplementation was undertaken without consultation between DoFA, Treasury and Defence. Defence considers that such consultation would need to be framed in the context of a broader review of Defence global funding arrangements.

2.66 It is in the Commonwealth's overall best interests that, where cost-effective, foreign exchange risk in Defence and DFAT be cost-effectively managed so as to minimise the need for budget supplementation.[54] This would achieve the goal of maintaining funding in real terms whilst reducing financial risks and therefore the potential for significant increases in agency budgets and overall Commonwealth expenditure. Nevertheless, there may remain individual exposures that cannot be managed. In addition, DFAT advised ANAO that the Department's need to manage its cash flows has a direct bearing on the extent to which it might better manage foreign exchange risk.

2.67 **Finding:** The budget supplementation arrangements have a pervasive influence on foreign exchange risk in the multi-billion dollar Defence capital equipment program and in DFAT's overseas operations. Budget supplementation involves the expenditure of additional money in so far as costs have increased; it does not obviate the legal requirement for agencies to assess foreign exchange risk and manage it as part of procurement and expenditure approval processes. However, as budget supplementation substantially reduces the incentive, Defence and DFAT do not identify or manage their foreign currency exposures and no central agency has been allocated responsibility for managing these risk

[54] ANAO's Strategic Adviser noted that one way of hedging which involves no premium payments is to take out a collar or zero cost hedge. This means that the Commonwealth can do no worse than a specified rate but at a cost of doing no better than another pre-specified rate. This is constructed by the Commonwealth buying an option on downside risk and selling an option on upside benefits.

exposures. This means that there is no effective link between the ability to create foreign currency exposures and the management of these exposures.

Recommendation No.5

2.68 ANAO *recommends* that DoFA, in consultation with relevant agencies, re-examine the budget supplementation arrangements for foreign exchange risk to encourage more effective management of foreign exchange risk on a whole of government as well as an agency basis.

Agencies responded to the recommendation as follows:

2.69 ***Agree:*** Treasury.

Agree with qualifications: DoFA; Defence and DFAT.

2.70 Specific comments by agencies are set out below:

- **DoFA** stated that it is developing transitional arrangements so that, in consultation with Defence and DFAT, these agencies will move away from the supplementation guarantees to arrangements that apply to other agencies.
- **Defence** stated that it supports better foreign exchange exposure management and would seek to be actively involved in its implementation. A review of Defence's global funding arrangements, including supplementation for foreign exchange movements, is underway and expected to be finalised in July 2000. Following the successful implementation of Recommendations 1 and 2 and the resolution of the budget supplementation issue, Defence stated that it would be in a better position to evaluate and introduce appropriate foreign exchange risk management practices.
- **DFAT** supported the continuation of current budget arrangements for both administered and departmental items which, appropriately managed centrally, is considered by DFAT to provide maximum benefit to the Commonwealth's whole of government interests. DFAT viewed retention of the current resource agreement arrangements for budget supplementation, coupled with centralised management of foreign exchange hedging activity, as the most appropriate way forward.

3. Defence Capital Procurement

Introduction

3.1 The Defence mission is *to prevent or defeat the use of armed force against our country or its interests*.[55] Defence's prime business during peacetime is developing and maintaining the capability needed to achieve this mission. Accordingly, its goals include a greater combat-ready capability and stronger future capability.[56]

3.2 The Defence Acquisition Organisation (DAO) makes a significant contribution to the Defence mission by managing the acquisition of new or enhanced military capabilities. Approximately one-quarter of the Defence budget is spent on capital equipment acquisitions.[57] The 1997 Defence Efficiency Review report noted that: *the acquisition strategy is disproportionately important in Defence, not merely because it spends the largest single discretionary sum of money, but also because what it buys forms the backbone of the Australian Defence Force and determines its military capability for decades.*[58] As of May 1999, the Major Capital Equipment Sub-group of the DAO was managing over 200 major projects with a total estimated cost of some $A43 billion, of which $A26 billion was to have been spent by June 1999 with $A2.8 billion planned to be spent in 1999–2000.[59]

3.3 Australia's defence industry is relatively small and this means that a significant proportion of Defence capital expenditure involves foreign suppliers and/or foreign sourced equipment. As a consequence, DAO spent some $A17.8 billion overseas between 1985–86 and 1997–98.[60] In 1998–99, Defence made $A2.08 billion in foreign currency payments, $A1.43 billion or 70 per cent of which related to the acquisition of capital equipment and systems by the DAO. Defence capital acquisition foreign currency exposures are typically dominated by substantial payments in United States dollars and Pounds Sterling (see Figure 3.1).

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55 Audit Report No.13 1999–2000, *Management of Major Equipment Acquisition Projects*, para 1, p. 13.

56 *Portfolio Budget Statements 1999–2000—Defence Portfolio*, Budget Related Paper No. 1.4A, p. 2.

57 Audit Report No.13 1999–2000, *Management of Major Equipment Acquisition Projects*, para 4.1, p. 70.

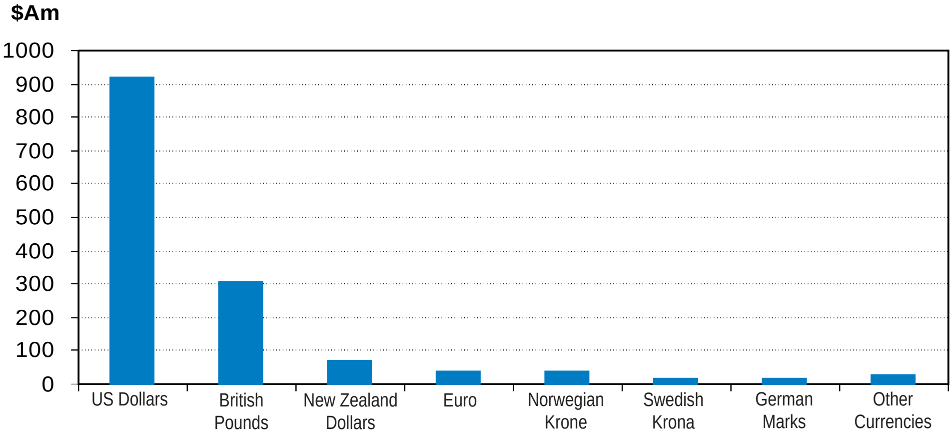
58 *Future Directions for the Management of Australia's Defence*, Report of the Defence Efficiency Review, 10 March 1997, p. 25.

59 *Portfolio Budget Statements 1999–2000—Defence Portfolio*, *op cit*, p. 153.

60 *Defence Annual Report 1997–98*, p. 151.

Figure 3.1

Defence Acquisition Organisation: Foreign Currency Payments 1998–99



Source: ANAO analysis of Defence data.

Audit methodology

3.4 Foreign exchange exposures in the capital equipment procurement program are primarily the result of significant foreign currency payment streams in procurement contracts. Accordingly, as well as examining Departmental policy and documented procedures, ANAO examined foreign exchange exposures in a sample of seven projects, namely:

- Project AIR 130: Chinook Helicopters;
- Project AIR 5367: Lead-In Fighter Aircraft;
- Project AIR 5400: Air to Air Missiles;
- Project LAND 53: NINOX (night fighting equipment and ground based surveillance equipment);
- Project SEA 1411: ANZAC Ship Helicopters;
- Project SEA 1414: ANZAC Ship Helicopter Missiles; and
- Project SEA 1555: Minehunter Coastal.

Capital acquisition process

3.5 The Defence acquisition process commences with the development for Government approval of new capability proposals by the Australian Defence Headquarters.[61] Once approved, DAO manages the acquisition of the new or enhanced capabilities. When acquired, the capabilities are operated by the three Services (Navy, Army and Air Force) during trials and evaluations and after their acceptance into service. Support Command Australia provides in-service logistics support for all new and existing weapon systems and equipment platforms.

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[61] Audit Report No.13 1999–2000, *Management of Major Equipment Acquisition Projects*, para. 3, p. 13. This report includes a fuller description of the Defence acquisition process.

3.6 A staged procurement approach is typically adopted by the DAO. At the start of the tender phase, the project office may commission a Project Definition Study or seek Expressions of Interest to collect further relevant information. A Request for Tender document will then be prepared requesting information, including prices, to permit the Commonwealth to obtain and evaluate tender responses. A Tender Evaluation Board will be tasked with assessing all aspects of the tenders on the basis of agreed evaluation criteria and value-for-money considerations. Once a preferred tenderer is chosen (source selection), contract negotiations commence culminating in contract signature.[62]

3.7 The procurement process can take a considerable period of time with the nature of any foreign exchange exposures evolving as the procurement process progresses (see Figure 3.2). The uncertainty over foreign currency exposures prior to contract signing, and the variable length of time between project approval and contract signature affects the nature of any foreign exchange risk management activities. Prior to selecting the preferred tenderer, foreign exchange risk can be addressed by including a foreign exchange rate contingency reserve in the budget or by purchasing option-based protection in one of a number of forms including options that may be included in the terms of the procurement contract (known as embedded options).

3.8 Once the preferred tenderer has been selected, the foreign exchange exposures become more 'firm' which increases the range of feasible risk management approaches. For example, where the objective is to retain the opportunity to benefit from favourable exchange rate movements but protect against adverse movements, currency options can be used. Options are a form of risk insurance as they give an importer such as Defence the right but not the obligation to purchase foreign currencies at a predetermined rate. To obtain this right, the option holder must pay a premium to the option seller.

3.9 The exposure profile of procurement contracts is confirmed when the contract is signed. Prudent hedging of contract exposures at this stage can increase certainty in relation to final project costs.

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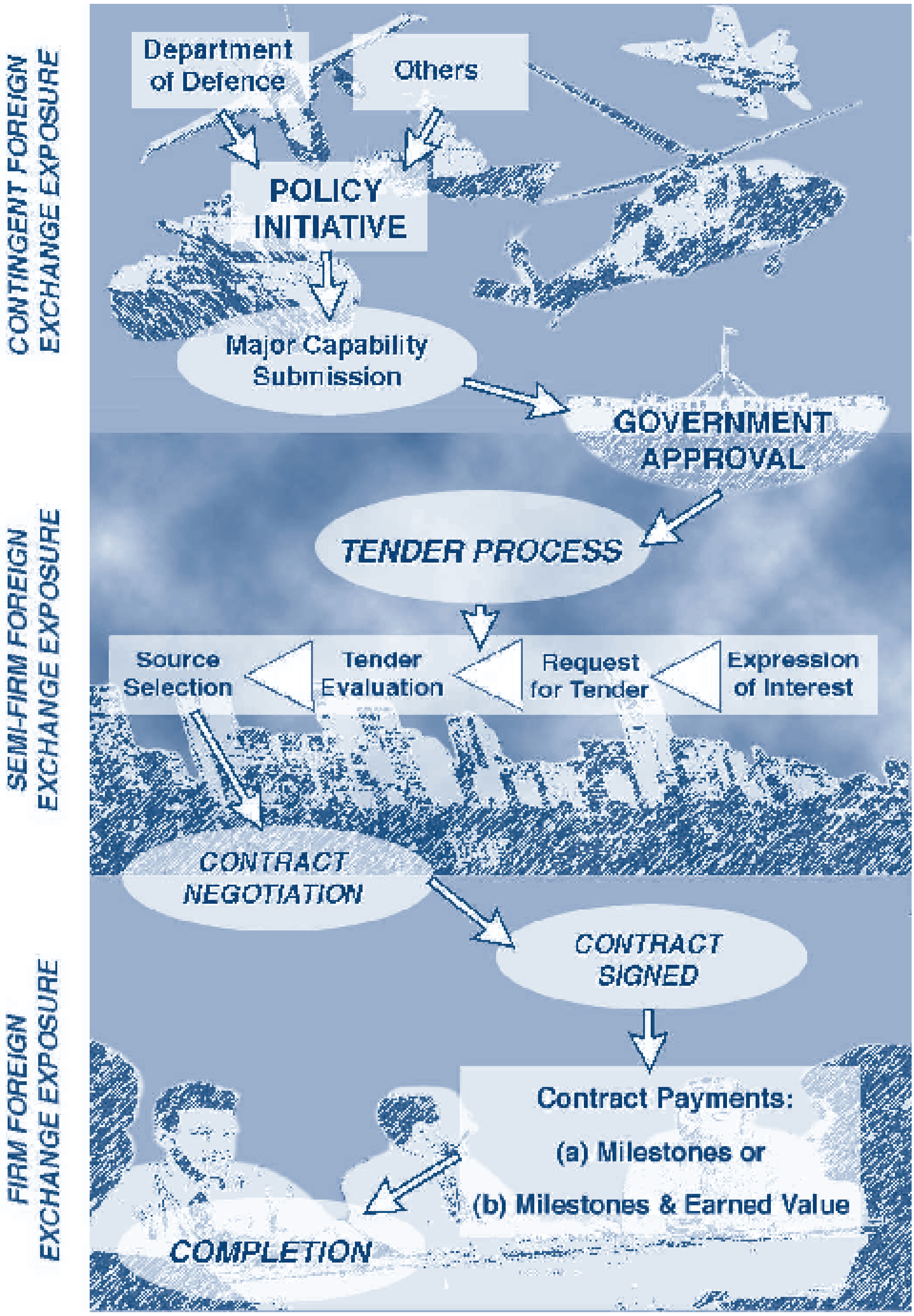
62 Audit Report No. 43 1997–98, *Life-cycle Costing in the Department of Defence*, para 4.2.

Figure 3.2
Foreign Exchange Risk Exposures in Defence Capital Procurement Projects



Source: ANAO with advice from Oakvale Capital.

Project budgeting

3.10 The purpose of project cost estimates and budgets is to provide decision makers with a credible and reliable basis for evaluating and approving projects. Cost estimating involves calculating the probable cost of a project when the values of some or all of the cost actions are incomplete, unknown or uncertain.[63] Because of the unique nature of projects and potential contractors, project costing generally involves a series of evaluations of alternative ways of managing or removing an exposure.

3.11 As part of the decision-making process for major Defence capital acquisitions, the Department prepares for Government consideration a budget of the estimated project costs. Defence's policy of negotiating contract payments in source currency means that, in the absence of effective hedging arrangements, there is no fixed Australian dollar cost for contracts that include foreign currency payments. It is the foreign currency amounts and any Australian dollar <u>component</u> that is fixed. Project approval involves the formal endorsement by Government of the planned scope of procurement activities, project objectives and budget.

3.12 Budgets presented to Government are required to aid the decision making process of Government. To do this, a range of information needs to be provided to properly inform decisions on projects that have significant foreign exchange risk exposures, namely: the party that is expected to accept the risk; the expected cost of the project if exposures are not hedged; and the expected cost (including hedging benefits or costs) if exposures are fully or partially hedged. However, Defence does not formally advise the Government on ways to reduce or eliminate any significant foreign exchange risk in its projects.

3.13 Although the potential for foreign exchange risk to affect the Defence capital equipment budget has been recognised by the Parliament,[64] Defence's capital acquisition project budgets are presented to Government as a fixed Australian dollar estimated cost with no explicit recognition of foreign exchange risks. In many instances, the Australian dollar cost presented for approval actually represents an estimated cost of a contract that may involve a significant foreign currency component,

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63 Defence Capital Equipment Procurement Manual, Part 3, Chapter 5, para. 505.

64 In 1986, the then Joint Committee of Public Accounts noted that pressure on the Department's capital equipment budget had arisen from five sources including *serious price impacts arising from exchange rate changes.* Source: Joint Committee of Public Accounts, Report 243, *Review of Defence Project Management: Volume 1—Report*, 10 February 1986, p. 50.

but this is not fully explained in the budget submission. Instead, the foreign currency components are converted at the current year's Commonwealth Budget spot exchange rate and the budget presented as a fixed Australian dollar amount.

3.14 Exchange rates are volatile and it is unrealistic to assume on long-term contracts that there will not be significant foreign exchange gains or losses. However, in preparing its project budgets, Defence does not estimate the possible effect of exchange rate changes on the project cost, although a number of techniques are available including statistical analyses such as Value at Risk (VaR).[65] Failure to include the economic cost of exchange rate risk by Defence misrepresents the true cost of foreign sourced goods compared to domestic produced goods. Where Defence's approach understates the likely cost of foreign sourced equipment, it can compromise Defence's Australian Industry Involvement objective of enhancing Australian industry's contribution to Defence self reliance.[66]

Exchange rates for project budgeting

3.15 Defence's project budgets use the Commonwealth Budget spot exchange rates which are an average of past spot exchange rates and therefore provide a poor basis for long term forward budgeting. Project budgets originally approved[67] by the Government are varied by the Department in annual budget updates that are intended to ensure that project approvals are maintained in current prices.[68] The annual project budget update process also involves adjustments for price variations and changes in the nature or scope of the original proposal (called 'real' variations).

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65 VaR is the 'worst-case' loss expected over a given period of time (the holding period) expressed in terms of a specified degree of certainty (the confidence interval). The worst-case loss is based on applying historical volatility measures to the quantity of risk identified. Larger losses are possible, but the probability of this is 100 per cent minus the confidence interval. For example, according to VaR analysis based on historical monthly movements in the Australian dollar exchange rate, at a 95 per cent confidence level, the worst-case movement in any one year in the $A/$US is 13.2 per cent.

66 Capital Equipment Procurement Manual, Part 2, Chapter 2, para 201.

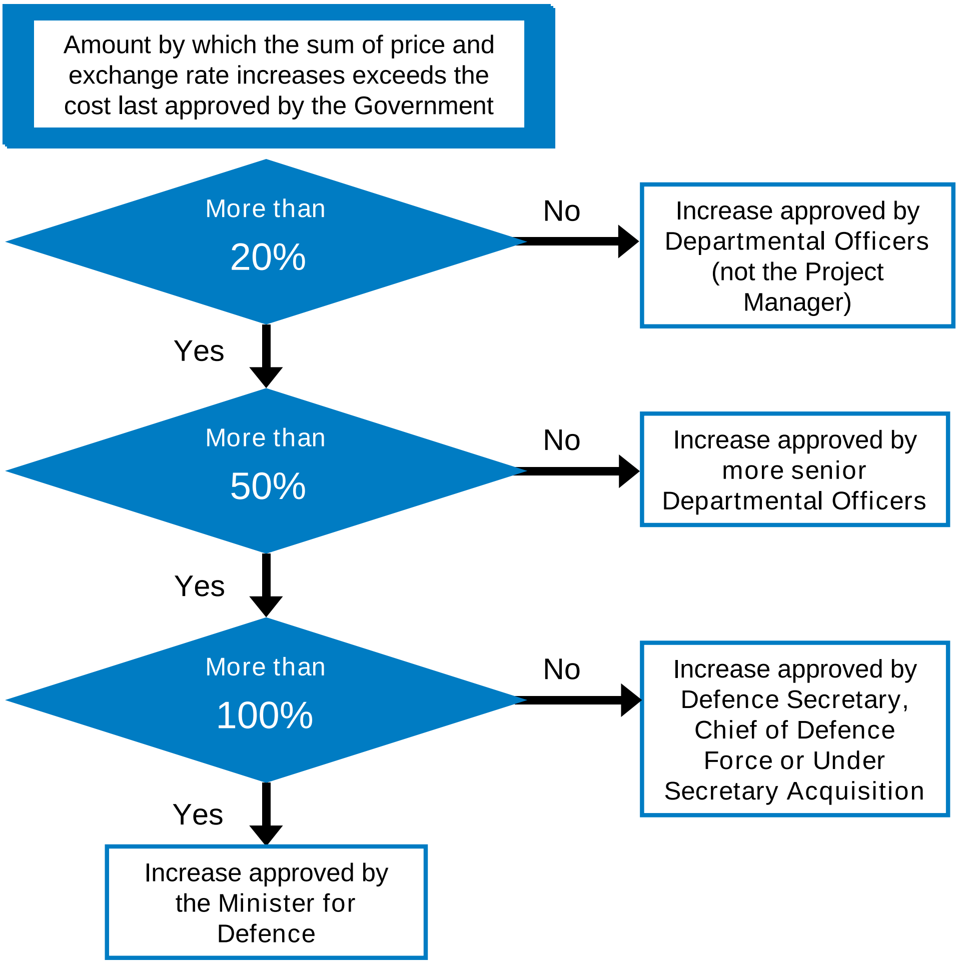
67 The authority for this process is the Department's Capital Equipment Procurement Manual, which is jointly authorised by the Secretary and the Chief of the Defence Force for use within the Department of Defence and the Australian Defence Force. This Manual is Defence's prime reference document for the procurement of capital equipment and systems.

68 Capital Equipment Procurement Manual, Part 3, Chapter 7, para 733.

3.16 In relation to exchange rate adjustments, project budgets are updated from the previous year's Budget spot exchange rates to the current Budget year's spot exchange rates. Departmental officers are able to approve price and exchange rate variations, without recourse to the original decision making authority, as long as variations do not exceed 100 per cent of the project cost originally approved by the Government either through Cabinet, the Minister for Defence with the concurrence of the Minister for Finance and Administration or the Minister for Defence (see Figure 3.3). ANAO considers that this approach reflects a gap in financial accountability for capital procurement project budgets as it does not place prudent limits on foreign exchange related variations for major projects.

Figure 3.3

Project Budget Updates: Delegations for Exchange Rate Adjustments



Source: ANAO analysis of Defence Capital Equipment Procurement Manual.

3.17 Up to April 1999, for projects still in progress at this time, there had been more than 2500 adjustments attributed to exchange rate movements in relation to some 220 Defence capital acquisition project budgets. Adjustments that increased budgets totalled $A4.13 billion and adjustments that decreased budgets totalled $A1.15 billion, resulting in an aggregate overall increase to project budgets of $A2.98 billion for changes in the Budget exchange rates. Periodic updating of project budgets to match movements in spot exchange rates lessens financial incentives to effectively manage this risk in order to maintain costs within the envelope of the original Government approved budget.

3.18 An outline of the effect of exchange rate adjustments on the budget for one of the projects examined by ANAO and how a changed approach to project budgeting would provide more realistic estimates of project costs is demonstrated by the project for the acquisition of additional Chinook helicopters (see Case Study No. 1).

Case Study No.1

Acquisition of Additional Chinook Helicopters

Introduction

Project Air 130 – Chinook Helicopter Acquisition seeks to provide the Australian Defence Force with an additional two Chinook helicopters to expand the fleet to six aircraft. In August 1995, the Boeing Company submitted an unsolicited proposal for sale of two basic aircraft to the Commonwealth at a price of $US40.2 million. Project Air 130 is a 'fast track' project to accept this offer in order to make maximum use of the funds made available under the Government's 1996 Defence Policy Initiatives on the redirection of Defence expenditure towards combat capabilities. The sole source acquisition strategy was approved on 24 October 1996 and a contract was signed on 19 June 1998. The contract payments are largely specified in United States dollars ($US44.74 million).

Project budget

The budget approved in December 1996 was $A61.67 million, which was developed using the 1996–97 Budget spot exchange rate for United States dollars. The chart below demonstrates the significant extent to which exchange rates have moved over the course of this project.

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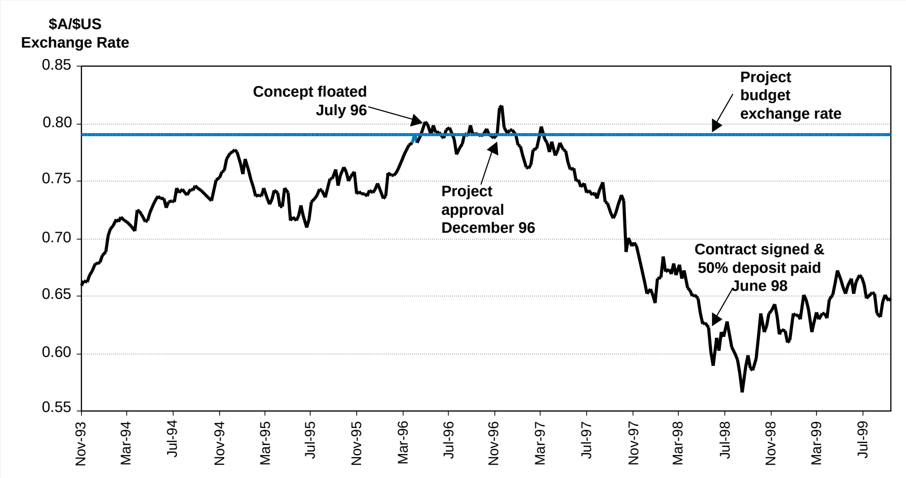

ANAO's Financial Adviser advised that, at a 95 per cent confidence interval using Value at Risk analysis on the budgeted $US exposure, the contract costs had the potential to increase by $A8.1 million ($US6.43 million) due to exchange rate movements if the exposure remained unhedged over one year. This represents a significant risk to the project but this was not reflected in the budget (for example, through a contingency for currency movements which would have increased the estimated cost to some $A70 million) or mitigated through hedging activities.

On 26 March 1998, a Defence officer approved a project budget increase of $A0.77 million to reflect the deterioration in the Australian dollar exchange rate between the 1996–97 and 1997–98 Budgets. On 16 May 1998, due to a further weakening in the Australian dollar, the same officer approved increasing the project budget by a further $A9.86 million making the project budget $A74.68 million. This was before the contract was signed on 19 June 1998. In aggregate, exchange rate variations over the 18 month period that the contract was negotiated increased the budget by 17 per cent. In comparison, variations in the price of labour and materials and changes in project scope ('real' increases) increased the project budget by less than 4 per cent ($A2.38 million).

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A possible hedging program

ANAO's Financial Adviser observed that until the contract was signed in June 1998 the Commonwealth carried a contingent foreign exchange risk. Once the contract was signed, the foreign exchange became committed. Due to the different nature of these exposures, different hedging instruments are recommended for the different stages of the project lifecycle:

- To hedge the contingent $US exposure during the negotiation stage of the contract, a currency option could have been purchased. The negotiation phase lasted for 18 months and the cost of an appropriate option with this duration was estimated by ANAO's Financial Adviser to be $A1.22 million. As the exchange rate at contract signature was significantly lower than that available under the option, the option would have been exercised with a gain of $A17.69 million to the Commonwealth.
- When the contract was signed on 19 June 1998, the firm foreign currency exposure was $US44.74 million (the contract price). This firm exposure could have been managed by entering into forward foreign exchange contracts with maturities that matched the contracted payment milestones. The following table outlines the overall benefit that would have been achieved from this hedging program.

Contract	***Maturity***	***$US Exposure***	***Rate***	***$A Equivalent***
Buy $US/Sell $A	19 June 1998	22.490 million	0.6139	36.63 million
Buy $US/Sell $A	19 August 1998	0.899 million	0.61421	1.46 million
Buy $US/Sell $A	19 November 1998	0.732 million	0.61385	1.19 million
Buy $US/Sell $A	19 July 1999	4.498 million	0.6178	7.28 million
Buy $US/Sell $A	19 November 1999	1.349 million	0.6219	2.17 million
Buy $US/Sell $A	19 December 1999	4.457 million	0.6222	7.16 million
Buy $US/Sell $A	19 March 1999	10.315 million	0.6229	16.56 million
Total		44.740 million		72.47 million
Add: Option cost				1.22 million
Less: Option gain				17.69 million
Total hedged $A cost (effective rate of 0.7991)				***55.99 million***
September 1999 estimate of likely contract cost				71.22 million
Estimated opportunity cost from not hedging risk exposures				***15.23 million***

Source: ANAO analysis of Defence data with specialist advice from Oakvale Capital. Figures may not add due to rounding.

3.19 **Finding:** As part of the decision making process for major Defence capital acquisitions, the Department of Defence prepares for Government consideration a budget of the estimated project costs. These budgets are presented as a fixed Australian dollar estimated cost, with foreign currency components converted at that year's Federal Budget spot exchange rate. ANAO considers that using forward exchange rates for project budgeting would provide a more realistic estimate of the project cost.

3.20 Defence does not clearly identify to decision makers the degree to which a project budget is subject to foreign exchange risk or estimate the possible effect of exchange rate changes on the project cost to inform decisions about whether and how foreign exchange risk should be managed. Instead, budgets are annually updated by the Department (generally without recourse to the original approving authority) for exchange rate variations. ANAO considers that this approach substantially reduces Defence's financial accountability for its project budgets and management of foreign exchange risk in its capital procurement projects.

3.21 Up to April 1999, for projects still in progress at this time, there had been more than 2500 adjustments attributed to exchange rate movements in relation to some 220 Defence capital acquisition project budgets resulting in an aggregate overall increase to project budgets of $A2.98 billion for changes in the Budget exchange rates. Periodic updating of project budgets to match movements in spot exchange rates lessens financial incentives to effectively manage this risk in order to maintain costs within the envelope of the original Government approved budget.

3.22 The project to acquire additional Chinook helicopters exemplifies the structural deficiencies in Defence project budgeting for foreign exchange risk. In this project, by the time the $US45 million contract was signed, the Department had already approved project budget increases of $A10.6 million (17 per cent). These budget increases were necessary because the original budget prepared for Government approval ignored foreign exchange risk and Defence took no steps to manage these exposures. Had there been a decision to manage the contracted exposures, contract costs could have been maintained at $A56.0 million, a saving to the Commonwealth of $A15.2 million and well within the original budget of $A61.7 million (which now stands at $A74.3 million).

Recommendation No.6

3.23 ANAO *recommends* that Defence address foreign exchange risk in capital procurement project budgeting by:

(a) using forward exchange rates with cash flow forecasts to develop market based estimates of likely project costs;

(b) including in project budget proposals considered advice on the level of acceptable foreign exchange risk and how to best manage that risk; and

(c) revising the budget delegations process to ensure prudent limits are placed on foreign exchange related variations for major projects.

Agencies responded to the recommendation as follows:

3.24 ***Agree:*** Treasury.

Agree with qualifications: Defence.

3.25 Specific comments by Defence are set out below:

- **Defence's** agreement was subject to successful implementation of Recommendation No.1 (promulgation of an overarching Commonwealth position statement) and Recommendation No.2 (centralised provision of strategic and operational advice to agencies) and resolution of Recommendation No.5 with regard to the outcome of the current review of Defence's global funding arrangements, including foreign currency supplementation.

Tender processes

3.26 Defence policy is for its Requests for Tender to seek prices in foreign currency so as to inform a decision on whether contracts should be written in source currencies, Australian dollars or a combination of both.[69]

3.27 Defence's Capital Equipment Procurement Manual requires tender evaluators to evaluate the potential exchange rate exposure as part of the value for money considerations in comparing Australian and overseas tenderers and to justify the recommended price and exchange basis in their report.[70] Factors to be considered are whether the foreign currency payments are significant, the Commonwealth's potential exposure to fluctuations in the relevant currency, the volatility of the currency and the duration of the foreign currency payment schedule, administrative costs of foreign currency payments and the availability of benefits such

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69 Capital Equipment Procurement Manual, Part 3, Chapter 12, para 1210.

70 Capital Equipment Procurement Manual, Part 3, Chapter 12, para 1212.

as discounts for contracting in a particular currency.[71] ANAO analysed the evaluation reports for each of the seven projects examined as part of the audit and found that the reports did not evidence that these issues were being considered.

3.28 Defence requires tenderers to provide extensive detail on financial aspects of their proposals, including a schedule of proposed payments by currency and details of proposed milestones and how the proposed milestone payments relate to anticipated work progress and cash flow. These schedules are used by Defence to derive a common basis for price comparison and evaluate competing tenderers. This is done through present value analysis and modelling of proposed cash flows against the Department's budget.

3.29 The detailed financial data obtained from tenderers could also be used by Defence to estimate the likely Australian dollar cost of each tender by applying forward foreign exchange rates to each tenderer's proposed future stream of foreign currency payments. However, despite being required to undertake its foreign exchange transactions with the Reserve Bank at wholesale exchange rates, Defence uses retail spot rates quoted by a commercial bank to estimate the Australian dollar cost of making the foreign currency payments proposed by each tenderer. ANAO notes that retail spot rates are focused on retail customers and contain wide spreads to allow for intra-day volatility and the small volumes requested by retail customers. As such, these rates are not applicable to commercial transactions of the type entered into by Defence.

3.30 In addition, ANAO considers that spot rates are inappropriate for tender evaluation as that they do not provide a market based estimate of the likely Australian dollar cost of a future stream of foreign currency payments, which in Defence's case can extend many years into the future (see Case Study No. 2). As a result, current tender evaluation procedures fail to provide a market based future funding cost estimate of tenders because Defence uses retail spot exchange rates rather than wholesale forward exchange rates. ANAO notes that the foreign exchange rate used can have a material effect on the outcome of the tender process and may also effect the underlying viability of the project. Accordingly, ANAO considers that Defence should use current, wholesale market forward exchange rates from the Reserve Bank to undertake financial evaluations of proposed future foreign currency cash flows in order to provide decision makers with a rigorous estimate of the likely Australian dollar value and encourage the consideration of cost-effective exposure management.

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71 Capital Equipment Procurement Manual, Part 3, Chapter 12, paras. 1210 and 1211.

Case Study No.2

Acquisition of Helicopters for the ANZAC Ships

Project SEA 1411 involves the acquisition of helicopters equipped with anti-ship missiles for the 8 ANZAC Ships being constructed for Australia. The project was approved in the 1995–96 Commonwealth Budget with a project budget of $A763 million. As of September 1999, the budget had risen to $A897 million, $A95 million or 71 per cent of the increase attributed to exchange rate variations.

Tender evaluation

The Request for Tender was issued in October 1995 and two tenders were received in March 1996. The Request for Tender sought prices in source country currencies. One tenderer's cash flows were predominantly in $US over a six year period, the other's were predominantly in United Kingdom Pounds Sterling over an eight year period.

The Tender Evaluation Board applied February 1996 spot exchange rates from a commercial bank to forecasted cash flows specified in various currencies by the two tenderers. On this basis, the Tender Evaluation Board concluded that there was a significant difference between the approved budget and the prices submitted by the two tenderers: the baseline price of the preferred tender was assessed to exceed the project budget by $A189 million. ANAO's analysis indicates that Defence understated the likely costs of both tenders as a result of its use of spot exchange rates rather than forward exchange rates for tender evaluation.

To tailor the project within budget, helicopter numbers were reduced from 14 to 11, the acquisition of the missiles was deferred to a separate project and the project budget contingency provision was reduced. The Tender Evaluation Board also investigated other areas that it considered offered the potential for a significant overall cost reduction, without impacting on operational capability. One of these was exchange rate adjustments. Evaluation of tender prices was conducted using exchange rates fixed at the 20 February 1996 spot rate of $A/$US 0.7485. At the time of its deliberations (October 1996), the Tender Evaluation Board considered that using the October 1996 spot rate ($A/$US 0.7900) would have reduced the Australian dollar value of the price of the preferred tenderer by $A36 million, helping to keep the project within the approved budget.

However, the Department did not examine the forward exchange rates to assess whether any savings were likely to be achieved. ANAO notes that the October 1996 forward exchange rates indicate that the costs of the preferred tender were likely to be significantly <u>greater</u> than the approved project budget. In addition, if Defence was concerned that exchange rate variations could result in costs exceeding the project budget, it would have been prudent to use forward exchange rates because it is possible to lock-in these exchange rates over the duration of the contract. On this point, ANAO's Financial Adviser noted that:

> *the 'savings' generated by the use of revised spot rate in October 1996 is actually no more than a revaluation of outstanding, unhedged currency exposures. The opportunistic use of a favourable revision of a spot rate for project specification purposes, and the absence of any subsequent revisions which would have proved unfavourable, is an excellent example of the structural weaknesses in the existing framework for the management of foreign exchange exposures.*

Costs of the foreign currency exposure

On 26 June 1997, a contract was signed with the majority of payments specified in United States dollars. The payments are partly based on milestones and partly earned value.

ANAO's Financial Adviser noted that standard financial market risk estimation techniques suggest that currency variations could have added $A112.9 million to the cost of the project if exposures remained unhedged over one year. This represented a significant exchange rate risk for the Commonwealth which had the potential to cause substantial over-runs on the final project cost compared to the originally approved budget.

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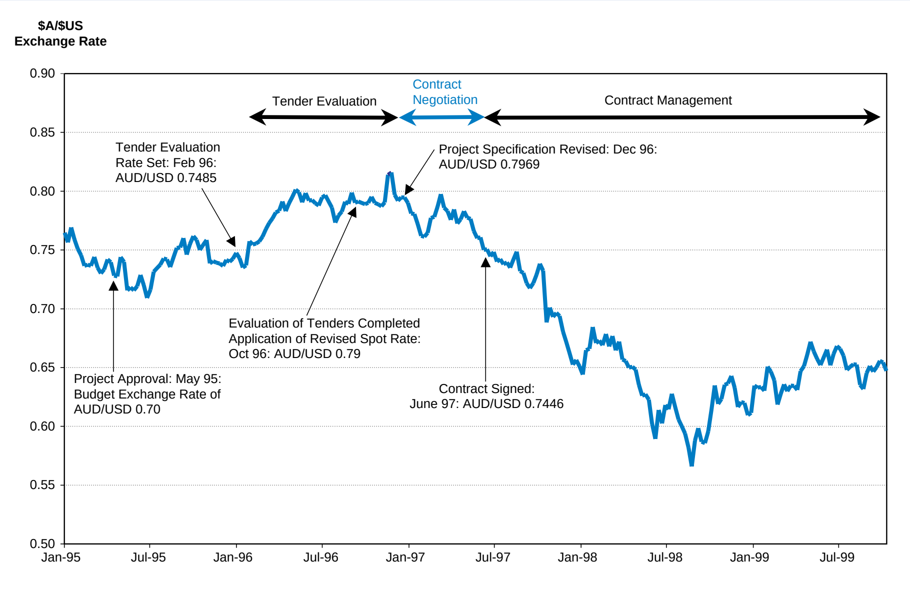
The foreign exchange risk has been realised with ex-post analysis indicating that not hedging exposures at the time of contract signing has added $A42 million to the cost of project made to the end of July 1999. This cost primarily reflects the decline in the $A/$US exchange rate over the period since the contract was signed (see the following chart). The cost of retaining an open foreign exchange position is likely to increase further as some 40 per cent of foreign currency contract payments are due to be paid after July 1999.



Later contract for Air to Surface Missiles

In its October 1996 report, the Tender Evaluation Board recommended that the Air to Surface missile component of the project, which involved significant Norwegian Kroner payments, be deferred in order to reduce initial acquisition costs by $A91 million. The Board noted that, without the missiles, the helicopters would not be able to wholly perform one of their primary roles. Accordingly, the Board recommended deferral of a limited duration until a separate budget for missile procurement could be submitted in 1997–98. A separate budget of $A90 million for the missiles was approved in December 1997.

The Board's report stated that deferring the purchase of missiles did not introduce any additional risk to the project. However, deferral with no hedging in place involved a substantial open foreign exchange position for the Commonwealth. In this respect, ANAO's Financial Adviser noted that financial market risk estimation techniques suggest that currency variations could have added $A16.5 million to the cost of the project if exposures remained unhedged over one year. Furthermore, had Defence examined exchange rates in the forward market at the time of its decision to defer, it would have realised that it was likely that the cost of the missile procurement would exceed Defence's estimate of procurement costs.

In the light of Defence's commitment to procure the missiles, reflected in the December 1997 approval of a project budget of $A90 million, there were reasons for Defence to consider it had a relatively firm exposure to the Norwegian Kroner payments for the missiles. Arguably, this was the case at the time of the December 1996 selection of the preferred tenderer for the helicopters (the missiles were a key component of the helicopter tender) and was even more so when the helicopter contract was signed in June 1997.

ANAO's Financial Adviser noted that analysis of movements in exchange rates over the life of the project suggests that not hedging the foreign currency exposure on the missile component has not, to date, added to the cost of the project and may actually have reduced costs. However, this possible benefit has been achieved without any deliberate risk management strategy being in place. Several preferable approaches are possible, including:

- putting a 'floor' on the risk, allowing gains from favourable exchange rate movements to be realised whilst limiting losses;
- limiting the upside and downside by purchasing a 'collar'. These can be entered into with no cash outlay. Potential benefits from subsequent currency movements are offset by potential costs being limited to a specified level; or
- identifying a tolerance to currency variation and purchasing what amounts to disaster insurance. This is known as an 'out of the money option'. They are a relatively inexpensive way of protecting the agency from unacceptable cost increases.

Source: ANAO analysis of Defence data with specialist advice from Oakvale Capital.

3.31 **Finding:** Defence policy is for its Requests for Tender to seek prices in foreign currency so as to inform a decision on whether contracts should be written in source currencies, Australian dollars or a combination of both. This approach, together with the extensive financial information tenderers are required to include in their tenders, places Defence in a strong position to estimate the likely Australian dollar cost of each tender. However, current tender evaluation procedures fail to provide a rigorous estimate of the likely Australian dollar cost of tenders because Defence uses retail spot exchange rates provided by a commercial bank rather than wholesale forward exchange rates from the Reserve Bank. ANAO notes that the foreign exchange rate used can determine the outcome of the tender process and can also affect the underlying viability of the project.

3.32 The project to acquire helicopters for the ANZAC Ships illustrates how Defence's tendering processes do not properly address foreign exchange risk. In this instance, to tailor the project within budget, helicopter numbers were reduced from 14 to 11, the acquisition of the missiles was deferred to a separate project and the project budget contingency provision was reduced. Also to bring the project within budget, the Department opportunistically revalued currency exposures which gave decision makers the impression that a contract could be signed that was within the envelope of the approved project budget. However, by using spot exchange rates for tender evaluation, Defence's calculations materially understated the likely cost of both tenders. Furthermore, Defence did not manage the substantial foreign exchange exposures in the contract which, as of July 1999, had increased contract costs by $A42 million.

Recommendation No.7

3.33 ANAO *recommends* that Defence provide decision makers with a rigorous estimate of the likely Australian dollar cost and encourage cost-effective management of risk exposures by using current, wholesale market forward exchange rates rather than retail spot exchange rates to undertake financial evaluations of future foreign currency cash flows proposed by tenderers.

Agencies responded to the recommendation as follows:

3.34 ***Agree:*** Treasury.

Agree with qualifications: Defence.

3.35 Specific comments by Defence are set out below:

- **Defence's** agreement was subject to successful implementation of Recommendation No.1 (promulgation of an overarching Commonwealth position statement) and Recommendation No.2 (centralised provision of strategic and operational advice to agencies) and resolution of Recommendation No.5 with regard to the outcome of the current review of Defence's global funding arrangements, including foreign currency supplementation.

Exposure management

3.36 Defence policy on foreign exchange risk in procurement contracts is that where *the cost of the overseas component of a planned acquisition is expected to be significant, the Department's risk of loss from exchange variations should be avoided by negotiating contracts in the currency of the country or countries where the work will be performed. This may result in several currencies being used within the same contract but it will ensure that the total Defence portfolio guidance will be adjusted* [through the budget supplementation arrangements] *to provide for actual exchange variations against contract payments.*[72] This policy represents a risk-averse approach to foreign exchange risk from the viewpoint of Defence, which usually requires hedging of exposures.

3.37 The New Zealand Ministry of Defence also has a risk-averse approach to foreign exchange risk, consistent with the New Zealand Government's aversion to risk.[73] However, there are no supplementation arrangements to immunise the Ministry from foreign exchange risk. Instead, the Ministry's policy requires it to minimise foreign exchange risk by identifying and covering transaction exposures in a timely manner. The policy also requires the New Zealand Ministry of Defence to ensure that contracts facilitate the arrangement of appropriate cover, outlines the covering instruments that are permitted and, for transactions that involve complicated or unusual cash flows, the Ministry is able to approach the New Zealand Debt Management Office for advice and assistance.[74] Where the Ministry considers exposures cannot be covered, the policy requires the contract approving authority to be advised of this fact with a contingency reserve added to the estimated cost of the contract.

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72 Capital Equipment Procurement Manual, Part 3, Chapter 8, para 833.

73 Information on the New Zealand Government's approach was provided to ANAO by the New Zealand Ministry of Defence.

74 Other features of the policy are: clear allocation of responsibility for the identification, measurement and management of transaction exposures; a system for reporting uncovered exposures; segregation of duties and other controls over hedging activities; and exposure limits for each approved hedging counterparty.

3.38 In Australia, the budget supplementation arrangements substantially reduces the incentive for Defence to identify and manage foreign currency exposures in its contracts.[75] As a result, Case Study No. 3 is the only instance identified by ANAO where Defence has sought to manage foreign exchange risk in a contract. However, Defence did not adopt a consistent approach to foreign exchange risk as foreign exchange risk was not hedged on contract options with the result that subsequent exchange rate movements have significantly increased contract costs.[76] In addition, Defence accepted the contractor's proposal that the contractor rather than Defence manage exchange rate risk. Defence accepted the contractor's offer to convert the foreign currency payments at the prevailing spot exchange rate quoted by the contractor's bank. However, at the time the contract was signed, it was cheaper to purchase Pounds Sterling in the forward markets than the spot market. As a result, the contractor has made a hedging gain when this gain could have been made by the Commonwealth had Defence hedged the exposures through the Reserve Bank.

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75 In one project, the terms of the proposed contract would have precluded Defence from receiving budget supplementation for exchange rate movements. Defence did not to examine ways of managing this risk. Instead, departmental approval of the proposed contract was withheld by the relevant delegate on the grounds that Defence does not take unnecessary commercial risks by being exposed to the effects of exchange rate variations when the budget supplementation arrangements can immunise the department. As a result, the contract was renegotiated by the project office so as to ensure Defence would receive budget supplementation.

76 Defence contracts often include options for the Commonwealth to purchase additional equipment and/or associated spares under a predetermined pricing arrangement. Where the option is exercised and additional foreign currency payments result, the foreign currency risk profile of the contract is increased. Accordingly, it is important that these options are identified and their likely risk consequences assessed. Judgements then need to be made about the likelihood and timing of any decision to exercise the option in order to develop a cost-effective approach to managing the exposures.

Case Study No.3

Project Ninox Phase 1C – Perimeter Surveillance Equipment

Introduction

Phase 1C of Project Ninox is part of a multi-phase project to acquire a range of night fighting and ground based surveillance capabilities. A contract for the supply of 98 Perimeter Surveillance Equipment (PSE) systems, test equipment, spares, training and manuals was signed on 31 May 1996 with the Australian subsidiary of a United Kingdom manufacturer.

Foreign exchange hedging arrangements

A sole source tender was issued in October 1995 to the supplier of the Army's original PSE. In accordance with Defence policy, the tender sought foreign currency prices for imported supplies, advised the tenderer that the contract would be written in source currencies and that Defence would make contractual payments in both Australian dollars and foreign currencies.

Approximately 82 per cent of the contract content is imported by the Australian subsidiary from its United Kingdom parent. Defence's usual approach would be to pay the contractor in Pounds Sterling for the cost of the Pound Sterling payments to the United Kingdom parent. However, the tenderer offered to provide Defence with a fixed Australian dollar price and assume all exchange rate risk on the foreign currency payments to its parent. Defence accepted this offer, with the Source Evaluation Report noting that the cost of forward exchange cover is included in the contract price, which was fixed at $A10 842 641.

Defence's acceptance of the contractor's offer represented a conscious decision to eliminate foreign currency risk by transferring the risk to the contractor. Compared to Defence's usual approach of accepting but not managing foreign currency risk, ANAO estimates that the approach taken in this contract reduced the contract cost by $A630 000.

Standard practice in most corporate treasuries is to seek quotes from several banks before placing hedging transactions. In this case, Defence did not seek quotes from the Reserve Bank or any other financial institution in order to assess whether the contractor's proposal maximised value for money. Indeed, the rate used by the contractor to convert Pound Sterling payments into Australian dollars was a retail spot exchange rate quoted by the contractor's bank at the time of contract signature. At this time, it was cheaper to purchase goods priced in Pounds Sterling at the forward rate than at the spot rate. As a result, had Defence hedged the exposures through the Reserve Bank rather than its contractor, it would have guaranteed a lower effective price for the contract.

Contract options

ANAO also found that the contract provided Defence with options to procure up to an additional 120 PSE systems. Defence retained foreign exchange risk on the contract options as the price of optional equipment varies with exchange rates.

The option was first exercised on 30 August 1996 when an additional 14 sets of PSE, repair parts and test equipment was purchased for the Royal Australian Air Force at a total cost of $A1 826 048. The price of this equipment increased because the $A/Sterling exchange rate had depreciated since the contract was signed. ANAO is unable to ascertain the precise impact of the exchange rate on the price as Defence records made available to ANAO did not include the necessary data to validate the increased price quoted by the contractor. ANAO estimates exchange rates may have increased costs by as much as $A56 000.

The option was exercised again on 30 September 1998 when an additional 15 PSE systems were purchased at a cost of $A2 459 295, or $A163 953 per system. The contract included an option of purchasing between 11 and 50 new systems at a price of $A116 200 each. According to Defence records, the contracted price of $A116 200 had to be increased by more than 42 per cent due to a 30 per cent depreciation in the $A/Sterling exchange rate.[77] Again, the records made available to ANAO by Defence did not include the necessary data to validate the increased price quoted by the contractor.

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The exchange rate variation clauses in the contract for optional items are deficient. The contract refers to the *'exchange rate prevailing at the time the Commonwealth exercises its option'* but does not specify the source of the exchange rates to be used to vary the price of optional items:

·For the first exercise of the option, the exchange rate used was a forward exchange rate obtained by the contractor from its bank. At this time, the Reserve Bank's spot exchange rate would have been more favourable for the Commonwealth.

·Defence records do not indicate the source of the exchange rate used on the second occasion the option was exercised. The rate used was $A/Stg 0.36, which was more favourable than the Reserve Bank's spot exchange rate. However, the rate used is deficient as it is only quoted to two decimal places whereas the $A/Stg exchange rate is quoted to four decimal places. Rounding exchange rates can have a significant effect on the calculation of the Australian dollar equivalent.[78]

Source: ANAO analysis of Defence data.

3.39 Finding: In the only known instance where Defence hedged its contracted foreign exchange risk exposures (thereby reducing contract costs by $A630 000), the Department accepted the contractor's offer to convert the foreign currency payments at the prevailing spot exchange rate quoted by the contractor's bank. However, at the time the contract was signed, it was cheaper to purchase the relevant foreign currency in the forward markets than the spot market. As a result, had Defence hedged the exposures through the Reserve Bank rather than its contractor, it would have guaranteed a lower effective price for the contract.

3.40 In other instances, Defence's practice of remaining exposed to foreign exchange risk (so as to increase budget supplementation) significantly increased project costs. In the acquisition of new Chinook helicopters, the cost from not hedging risk exposures is estimated to be some $15 million. The cost of payments for the acquisition of helicopters for the ANZAC ships has increased by $42 million. As of April 1999, The budget for the acquisition of new Lead-In Fighter aircraft has increased by $A98 million (12 per cent) because of adverse exchange rate movements.

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77 The contract provides that the price of options exercised more than twelve months after contract signature (as in this case) was to be adjusted for exchange rate variations <u>and</u> changes in labour and material costs. Defence's financial investigators advised the project office that the contractor had not applied for any increases due to the movements in indexes as there were only minor changes.

78 For example, Stg1 million at an exchange rate of 0.3600 costs $A2 777 777 whereas GBP Stg1 million at an exchange rate of 0.3699 costs $A2 703 433—a difference of $A74 343.

Hedging contract payments

3.41 Managing foreign exchange exposures can present Defence with opportunities to reduce costs by reducing the impact of adverse exchange rate movements. Prudent hedging programs can also seek to take advantage of the diversification benefits that exist in Defence contracts where the foreign currency component is denominated in a number of currencies (or in overall Defence expenditure if a portfolio approach to hedging is adopted). This was illustrated in Case Study No.2 where the Australian dollar depreciated against the United States dollar over the term of the contract but appreciated against the Norwegian Kroner. In addition, ANAO's Financial Adviser noted that commercial entities hedge non-committed foreign exchange exposures using 'basket options' to translate diversification benefits into hedging cost savings.

3.42 Defence contracts provide for payment based on earned value and/or a combination of milestones and earned value. Milestone payments provide a high degree of certainty concerning the timing and quantum of contract payments which aids hedging of foreign currency payments. Cost-effective hedging of foreign currency milestone payments requires that Defence contracts contain appropriate and clear time stipulations, the terms of the contract encourage timely achievement of milestones and that Defence take appropriate action where significant breaches occur (including exercising its entitlement to liquidated damages and/or suing for damages).

3.43 Given the difficulty of calculating damages for some kinds of contractual delays, Defence contracts often include a liquidated damages clause that represents a pre-estimate of the costs of delay. However, although the exchange rate and/or additional hedging costs of contractor delays can be calculated, the liquidated damages clauses in Defence contracts do not address this issue and the fixed liquidated damages provisions do not include an amount for exchange rate or additional hedging costs.[79] Conversely, it would be inappropriate for the contractor to receive the benefit of any exchange rate movements that favour the Commonwealth as a result of contractor delay.

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79 Defence advised ANAO of one instance where liquidated damages provisions have been exercised in contracts involving foreign currency payments. Defence advised that the prime contract identified liquidated damages for late delivery of aircraft of USD0.045 million per day. Liquidated damages commenced in December 1997 and ceased in December 1999 with a total of USD28.376 million claimed by Defence. Damages were taken by holding back from payments to the company for work not associated with the delivery of aircraft until these invoices became too small. After this, damages were taken from aircraft delivery payments.

3.44 ANAO's Financial Adviser noted that it is normal commercial practice to include contractual provisions whereby any costs arising to the purchaser (including foreign exchange losses and additional hedging costs) as a result of failure to complete on time are borne by the supplier. However, as illustrated by Case Study No.4, Defence liquidated damages provisions do not provide for exchange rate risks and any additional hedging costs associated with contractor delays. Of note is that, in negotiating this particular contract, the contract provides the contractor with a financial incentive to delay completion.

Case Study No.4

Chinook Helicopter contract

The contract required aircraft to be delivered in December 1999 and accepted by the Commonwealth in March 2000 (a 21 month contract duration). In the event that the contract was not completed by 18 March 2000, Defence is entitled to require the contractor to pay liquidated damages of $A4,700 per day. As of December 1999, when audit fieldwork was completed, there was a strong likelihood that the contract would not be completed on time.

The aircraft offered to the Commonwealth were substantially complete (approximately 70 per cent) and the contractor initially proposed that 75 per cent of the contract price be paid upon contract signature. During contract negotiations, Defence had the initial milestone payment reduced to approximately 50 per cent of the contract price. The significant size of the contract signature milestone payment resulted in substantial up-front additional interest costs for the Commonwealth. In comparison to an initial payment of, say, 10 per cent, the 50 per cent initial payment increased Commonwealth interest costs by $A5.03 million.

Advance payments on contract signature are usually mobilisation payments to provide working capital for the contractor to commence work. The standard Defence contract requires these funds to be held in a bank account until expended and they are only be expended for the purpose for which they were advanced. The Project Office views the contract signature payment in this particular instance as reimbursement for the work already undertaken by the contractor rather than a mobilisation payment. The cost of work undertaken by the contractor to produce substantially complete aircraft was undertaken prior to an offer being made to the Commonwealth or a contract being signed. Indeed, the aircraft were only offered to the Commonwealth because another country had signed a contract to purchase only four of an expected six aircraft. Accordingly, ANAO considers that these costs represent a sunk cost to the contractor[80] and therefore the Commonwealth should not be expected to reimburse the contractor for its prior commercial decision to commence manufacture of aircraft which had not been ordered by the Commonwealth.[81]

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80 Sunk costs refer to past costs. Sunk costs are not incremental cash flows and accordingly should not affect future investment decisions.

81 Defence's Capital Equipment Procurement Manual (Part 3, para 1255) requires analysis of the associated opportunity costs (cost of money) and any negotiated value for money trade-offs such as a reduction in the contract price before the Department agrees to advance payments.

> The 50 per cent contract signature payment on this particular contract conferred a substantial financing benefit on the contractor. ANAO's Financial Adviser estimated that the financing benefit to the contractor could be in the order of $A3.6 million if the project is completed on time (compared to a 10 per cent initial payment). The longer the project is delayed, the greater the financing benefit that accrues to the contractor (if delivery is delayed to June 2001, the benefit was estimated to be some $A6.3 million). This benefit is much greater than the liquidated damages[82] of $A4700 per day payable under the contract for late delivery, should the Department exercise its entitlement to these damages. Accordingly, there could be a significant financial disincentive for the contractor to progress and complete the contract in accordance with the contract schedule.

Source: ANAO analysis of Defence data with specialist advice from Oakvale Capital.

3.45 Earned value payments are based on contractor cost management systems that are intended to ensure that progress payments do not exceed the value of work completed by contractors. Earned value payments increase uncertainty over the timing of contract payments which may mean that any gain/loss on the hedge may not precisely offset the loss/gain on the underlying exposure. Nevertheless, ANAO's Financial Adviser advised that the increased timing uncertainty associated with earned value payments does not eliminate the feasibility of hedging these payments and that significant uncertainty has not proven a barrier to effective management of foreign exchange risk by commercial entities.

3.46 According to Defence, project liability and expenditure forecasts are the cornerstone of major capital equipment planning, reporting and review processes and form the basis of financial management of Defence's Major Capital Equipment sub-Program.[83] Accordingly, the major earned value capital equipment procurement contracts examined by ANAO included provisions which require the contractor to provide, by currency, with each monthly claim for payment:

- a forecast of monthly claims for the period up to 30 June of the next financial year; and
- a forecast of total annual claims based on financial years, until completion of the acquisition phase of the contract.

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82 Liquidated damages apply when the parties to a contract have agreed in advance on the measure of damages to be assessed in the event of delay or default. Liquidated damages are distinguishable from a penalty, which involves punishment rather than a genuine pre-estimate of damages. Source: Bryan A. Garner, *A Dictionary of Modern Legal Usage*, Second Edition, 1995, p. 530.

83 Capital Equipment Procurement Manual, Part 3, Chapter 9, para 904.

3.47 These payment forecasts provide Defence with valuable information that can be used to match forward hedging to expected earned value payment flows. ANAO's Financial Adviser advised that the forecasts could be used to hedge these exposures by employing a 'block' program of forward foreign exchange contracts.[84] This approach involves adjusting each month the composition and timing of the hedges in place as the payment forecasts are revised and as unused cover is rolled forward.

3.48 ANAO analyses indicate that the use of forward exchange rates for project budgeting and tender evaluation together with block hedging of contract payments may assist Defence reduce the risk of cost overruns in earned value contracts and, in some instances, would have reduced contract costs. This is the case, for example, with the June 1997 contract for the acquisition of 33 Lead-In Fighter aircraft and associated support. At the time of signature, the contract price was comprised of two parts: $A39.6 million and £Stg 327.0 million. When the contract was signed it was cheaper to make Pounds Sterling payments at forward exchange rates than at the spot rate. Accordingly, had Defence entered into forward foreign exchange contracts for the foreign currency milestone payments and the forecast foreign currency earned value payments, the contract cost could have been maintained within the original project budget. Instead, with the significant depreciation in the $A/Sterling exchange rate since budget approval and contract signature (see Figure 3.4), the open foreign exchange position has increased the Australian dollar cost of Pound Sterling contract payments resulting in the project budget increasing by $A98 million, or 12 per cent.

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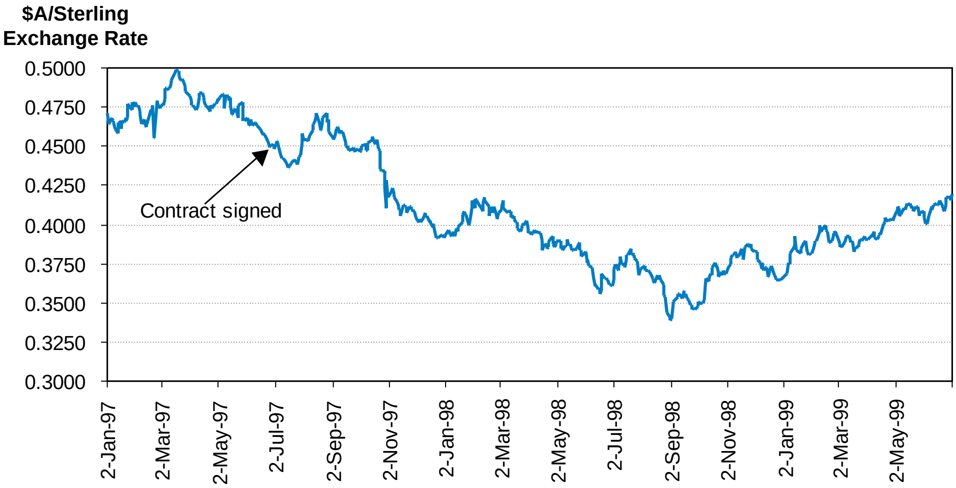
[84] ANAO's Financial Adviser noted that: *uncertainty over the timing of foreign currency receipts and payments is the 'norm' for private sector firms in the corporate sector. Corporate treasurers handle this uncertainty by executing block hedges –that is, executing a 'chunk' of forward cover to a nominal date – say the middle of a calendar month or quarter. Payments are pre-delivered against the block cover, with any residual block cover being rolled to the next 'block' cover date. While this method of hedging imposes some administrative burden and attaches some uncertainty to the final cost of hedging a forward foreign exposure, most risk managers consider these factors to be minor relative to holding an open foreign exchange exposure.*

Figure 3.4
Lead-In Fighter Project: Exchange Rate Movements



Source: ANAO analysis of Defence data with exchange rates provided by the Reserve Bank.

3.49 Given the importance of the payment forecasts to developing cost-effective hedging of earned value payments, Defence contract managers should ensure payment forecasts are provided and that the contract includes provisions that encourage the contractor to provide accurate and reliable forecasts. For example, the prime construction contract for Project SEA 1555 (Coastal Minehunter) includes a Management Performance Incentive Fee of up to $A18.3 million that Defence may pay a proportion of every six months to the prime contractor according to Defence's assessment of its performance in four broad categories, namely: financial, schedule, product and cost administration. ANAO considers that Defence's assessment of the contractor's performance could have regard, at least in part, to the accuracy of the monthly payment forecasts.

3.50 Where payment forecasts prove to be unreliable and/or the achievement of milestones is delayed, the exposure profile changes which requires adjustments to be made to any hedges in place. Even where exposures are not hedged, delays can increase Commonwealth costs if the spot exchange rate depreciates.

3.51 **Finding:** Cost-effective management of foreign exchange risk in Defence capital equipment procurement contracts requires the Department to develop accurate and reliable payment schedules and to minimise contractor delays. Where contractor payment forecasts prove to be unreliable and/or the achievement of milestones is delayed, the exposure profile changes which requires adjustments to be made to any hedges in place. Even where exposures are not hedged, delays can increase Commonwealth costs if the spot exchange rate depreciates. At present, Defence contracts do not ensure that foreign exchange losses and any additional hedging costs arising to the Commonwealth from contractor delay and/or inaccurate payment forecasts are borne by the contractor.

Recommendation No.8

3.52 ANAO *recommends* that Defence include provisions in future contracts where appropriate that ensure the contractor bears the cost of any foreign exchange losses that result from contractor delays or significantly inaccurate forecasts, with any currency gains to be retained by the Commonwealth.

Agencies responded to the recommendation as follows:

3.53 *Agree:* Treasury and AOFM.

Agree with qualifications: Defence.

3.54 Specific comments by agencies are set out below:

- **AOFM** stated that, while it agrees with the general concept of the recommendation, there may be an increased credit risk exposure for the Commonwealth as well as the potential for higher contract costs to the agency, as the contractor builds in the cost of hedging. An alternative solution would be for the agency to hedge any foreign currency exposure direct.
- **Defence's** agreement was subject to successful implementation of Recommendation No.1 (promulgation of an overarching Commonwealth position statement) and Recommendation No.2 (centralised provision of strategic and operational advice to agencies) and resolution of Recommendation No.5 with regard to the outcome of the current review of Defence's global funding arrangements, including foreign currency supplementation.

4. Overseas Aid

Introduction

4.1 The Australian Agency for International Development, known as AusAID, is an administratively autonomous agency within the Foreign Affairs and Trade Portfolio. It is responsible for the management of the Commonwealth's overseas aid program and, accordingly, administers the bulk of Australia's Official Development Assistance (ODA) which is budgeted to be $A1.48 billion in 1999–2000.[85] The Australian aid program focuses on the Asia Pacific with Papua New Guinea, Pacific Island countries and the poorest regions of East Asia being the areas of highest priority.

4.2 AusAID is a prescribed agency under the Financial Management and Accountability Act.[86] Its objective is to *advance Australia's national interest by assisting developing countries to reduce poverty and achieve sustainable devlopment*.[87] Development assistance administered by AusAID plays an important part in Australia's engagement in the Asia-Pacific region and supports broader bilateral efforts such as support of economic recovery and stability in Indonesia and restoring peace in Bougainville.[88] AusAID's major functions involve:[89]

- ensuring programs and projects correspond with Government priorities and are determined in partnership with the people and governments of developing countries;
- ensuring high quality projects and programs through effective identification and design, regular monitoring, evaluation, establishment of lessons-learned databases, and accessing technical expertise and external advice as appropriate; and
- establishing and managing contracts with delivery agents including the private sector, public sector providers, international and regional development organisations and non-government organisations.

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85 *Australia's Overseas Aid Program 1999–2000*, Statement by The Honourable Alexander Downer MP, Minister for Foreign Affairs, 11 May 1999, p. 14.

86 AusAID's Chief Executive is known as the Director-General.

87 *AusAID Corporate Plan 1998–2000*.

88 *Portfolio Budget Statements 1999–2000 Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 111.

89 *Australia's Overseas Aid Program 1999–2000*, *op cit*, p.93.

4.3 The Minister for Foreign Affairs allocates AusAID's aid program funds against country/regional and global programs[90] with a focus on governance, agriculture and rural development, health, infrastructure and education.[91] Aid is provided through bilateral and multilateral programs in a number of forms such as project aid, student scholarships to Australia,[92] food aid, emergency and refugee relief, funding for non-government organisations (NGOs)[93] and contributions to international development agencies.

4.4 By its nature, the overseas aid program exposes AusAID to foreign currency risk. This risk is most apparent in the $A195 million in foreign exchange payments made by AusAID in 1998–99 in relation to the bilateral aid program. In addition, there are significant exposures that arise from AusAID's policy of denominating contracts and contributions to multilateral aid agencies in Australian dollars. This arises because, while AusAID may pay in Australian dollars, in many instances the invoice or contribution is actually a foreign currency amount that the contractor or multilateral agency has converted into an Australian dollar equivalent.

Audit methodology

4.5 ANAO examined foreign exchange risk exposures in the multilateral aid program and the bilateral aid program, which collectively comprise some 92 per cent of annual overseas aid expenditure. Audit examination of the multilateral aid program focused on the administration of Australia's commitments to five multilateral aid agencies. In relation to the bilateral aid program, ANAO examined AusAID's contracting policies and procedures, with a sample of ten contracts examined in detail.

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90 Global programs include emergency and humanitarian assistance, non-government organisation (NGO) projects and expenditure through multilateral agencies such as the World Food Program. Source: *Australia's Aid Program—Memorandum for the DAC Peer Review of Australia 1999*, AusAID, p. 63. http://www.ausaid.gov.au

91 *Australia's Overseas Aid Program 1999–2000*, *op cit*, p.15.

92 See Audit Report No. 15 1999–2000, *Management of Australian Development Scholarship Scheme*.

93 See Audit Report No. 18 1998–99, *Accounting for Aid—The Management of Funding to Non-Government Organisations—Follow-up Audit*.

Multilateral aid contributions

4.6 Multilateral aid expenditure totalled $A319.7 million in 1998–99, or 22 per cent of Official Development Assistance.[94] The majority of this ($A229.3 million or 72 per cent) involved contributions to the concessional lending arms of the World Bank and the Asian Development Bank. Multilateral aid also includes contributions to United Nations development agencies, Commonwealth organisations, and international environmental and health programs.

4.7 Figure 4.1 summarises, at the time of audit fieldwork, the funding arrangements for AusAID's contributions to five of the multilateral aid agencies of which Australia is a contributing member. As outlined in Figure 4.1, each of the contribution and replenishment arrangements include an option to allow payment in a range of currencies. Currency options may be replicated in the forward markets and therefore their value to the holder can be priced.

4.8 Prior to the most recent replenishment agreement for the Montreal Protocol on Substances that Deplete the Ozone Layer, AusAID was unable to denominate its commitment in Australian dollars as it did for other agreements. The replenishment agreement for the period 1996–97 to 1998–99 involved a foreign exchange exposure on the $US8.158 million to be contributed by AusAID. At the time it entered into the commitment, AusAID estimated that, at prevailing spot exchange rates, its foreign currency payments would cost $A10.26 million. AusAID took no steps to manage the risk that the Australian dollar cost of its United States dollar contributions would increase. The exchange rate subsequently depreciated, with the result that the cost of these contributions was $11.95 million, $1.69 million or 16 per cent more than budgeted by AusAID. This indicates that AusAID has not had procedures in place to identify and consider the most cost-effective way to achieve its goal of minimising foreign exchange risk in the multilateral aid program. AusAID has been solely reliant on the ability to fix exchange rates with donors as part of the replenishment agreement process and, where this has not been possible, has not considered other approaches such as hedging exposures through the Reserve Bank.

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[94] *Australia's Aid Program—Memorandum for the DAC Peer Review of Australia 1999*, *op cit*, p. 52.

Figure 4.1

Currency Options in Multilateral Aid Contribution Agreements

Recipient	*Australia's Commitment*	*Currency Options*	*AusAID Election*
World Bank's International Development Association (IDA)	The current replenishment arrangement was finalised in May 1999. Under this arrangement Australia has agreed to contribute Special Drawing Rights (SDR)[95] 129.36 million between 1999 and 2002.	Under the terms of the replenishment arrangement, subject to IDA's agreement, Australia is able to choose to denominate its contribution in Special Drawing Rights, Australian dollars or any convertible currency of another member country. Contributions are converted using predetermined historic rates and will be paid over a six year period.	On 20 May 1999, AusAID elected to denominate the commitment in Australian dollars ($A275.00 million).
Asian Development Fund (ADF)	The current replenishment arrangement covers the period 1997–2000 with Australia agreeing to contribute $US175.230 million/ SDR 119.583 million.	Under the terms of the replenishment arrangement, Australia is able to choose to denominate its contribution in Special Drawing Rights, Australian dollars, or United States dollars. However, the agreement also provides members with an option to pay their contribution in any freely convertible currency, regardless of the currency of commitment denomination, with payments converted to the commitment currency using current exchange rates.	On 18 June 1997, AusAID elected to denominate the commitment in Australian dollars ($A231,588,699).
International Fund for Agricultural Development	The fourth replenishment of IFAD was resolved in February 1997 with Australia's commitment set at $US5.080 million.	Under the terms of the replenishment arrangement Australia is able to choose to denominate its contribution in Special Drawing Rights or in freely convertible currencies. Contributions are converted using predetermined historic rates.	On 18 June 1997, AusAID elected to denominate the commitment in Australian dollars ($A6,426,708).

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95 The value of the Special Drawing Right is calculated by the International Monetary Fund on the basis of a weighted basket of four currencies: the United States dollar; the Euro; the Japanese Yen; and the United Kingdom Pound Sterling.

Recipient	*Australia's Commitment*	*Currency Options*	*AusAID Election*
Global Environment Facility (GEF)	The current replenishment period covers the period 1998–99 to 2001–02 with Australia's commitment set at SDR 23.47 million.	Under the terms of the replenishment arrangements Australia is able to choose to denominate its contribution in SDRs or a freely convertible currency. The calculation of the currency equivalent of SDR commitments is performed using predetermined historic rates.	On 29 August 1998, AusAID elected to denominate the commitment in Australian dollars ($A43.27 million).
The Montreal Protocol on Substances that Deplete the Ozone Layer	At the time of audit fieldwork, the most recent replenishment agreement was for 1996–97 to 1998–99. Contributions were denominated in United States dollars with Australia committing to provide $US8.158 million.	Contributions to the fund can be made in the currency of the contributing country or United States dollars. Where contributions are made in the currency of the contributing country, these contributions are receipted in United States dollar equivalents. This means there is a foreign exchange risk exposure for AusAID: as the Australian dollar appreciates, the Australian dollar cost of meeting this United States dollar commitment increases. No steps were taken to manage this exposure.	Australia's most recent commitment was denominated in United States dollars.

Source: ANAO analysis of AusAID data.

Financial implications

4.9 The multilateral aid contribution arrangements described in Figure 4.1 provide AusAID with currency options in the form of contractual rights[96] to choose the currency in which to denominate commitments and/or make payments to four of the multilateral aid agencies. AusAID denominates its commitment to these agencies in Australian dollars, without examining any benefits that could accrue from exercising the option to denominate commitments in other currencies.

4.10 AusAID's management approach provides the benefit of certainty of the Australian dollar cost of what is, in effect, an underlying foreign currency obligation. However, AusAID's procedures do not recognise that the currency options provide AusAID with a source of potentially significant financial savings.

4.11 A decision whether to exercise a currency option is best made following an assessment of the financial outcome of the various alternatives. The contribution agreements define each country's commitment in terms of Special Drawing Rights (SDRs) and/or $US. Donors are able to specify their commitment and/or payments in SDRs/$US, their own currency or a freely convertible currency of another member country. The value of the commitment/payments in each currency is determined by applying fixed historic exchange rates to the underlying SDR/$US commitment.

4.12 The effect of this is to grant AusAID essentially a <u>risk-less option which it can exercise in hindsight</u> and with a range of currencies to choose from in order to minimise the Australian dollar cost of this commitment. This can be done by denominating commitments in the most favourable currency and fully hedging the foreign exchange exposure. Financial savings arise where exchange rates in the forward markets (which are largely a factor of interest rate differentials between countries) make it cheaper to specify payments in foreign currencies and <u>immediately cover the exposure</u> in the forward market. AusAID will not incur a transaction fee for forward foreign exchange contracts when this function is performed by the Reserve Bank.

4.13 Exchange rates are relative (not absolute) prices and there is always one quote that is preferable to the alternative. On occasions, forward exchange rate differentials in AusAID's replenishment agreements favoured payments being made in foreign currency and immediately covering the exposure in the forward markets in order to make financial savings, rather than paying directly in Australian dollars.

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96 Which, in some instances, are subject to the agreement of the recipient multilateral aid organisation.

4.14 The potential financial savings from this approach are significant. ANAO estimates that aggregating savings of $A12.66 million would have been achieved by denominating the most recent commitment to the International Development Association (IDA) in United States dollars and fully hedging the resulting exposures.[97] Similarly, savings of $A10.51 million would have been achieved by denominating the most recent commitment to the Asian Development Fund (ADF) in German Deutschmark.

4.15 ANAO considers that realising these potential savings in future agreements will require AusAID to seek specialist advice and analytical support at the time it negotiates and enters into funding commitments. In January 2000, AusAID advised ANAO that, as a result of ANAO's analysis, AusAID had sought formal advice from the IDA and ADF regarding the exercise of these options, as well as holding discussions with the Reserve Bank and the AOFM and seeking legal advice on its contributions to IDA and the ADF. In relation to future contribution agreements, AusAID advised ANAO that IDA had confirmed that, other than the Australian dollar, AusAID would be able to denominate contributions in SDRs or, with IDA's agreement, in any freely convertible currency based on predetermined exchange rates. The ADF advised that, other than Australian dollars, AusAID can pledge its contribution to new replenishments in SDRs or the currency of another donor member. Accordingly, in future funding agreements, AusAID would be in a position to realise any savings from the currency options identified by ANAO.

4.16 AusAID advised that any decision to exercise these options would depend on there being a tangible financial benefit for the Commonwealth and that it would not impair Australia's close relationship and influence with the multilateral aid agencies and other donors as well as Australia's international reputation. AusAID further advised ANAO on 15 March 2000 that:

> *ANAO's draft report identifies theoretical opportunities for Australia to obtain potential financial advantage by making pledges to international financial institutions in currencies other than the*

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97 The means by which such savings can be achieved is illustrated by the currency option available to AusAID in the International Development Association's Replenishment Agreement. In this case, AusAID could have elected to pay $A275.00 million, $US 172.998 million or a predetermined amount in any other freely convertible currency. At the time AusAID recommended denominating the commitment as $A275.00 million, it could have recommended denominating the commitment as $US172.998 million and, through forward foreign exchange contracts, fully hedged this exposure. This approach would have fixed the total Australian dollar payments at $A262.34 million, a saving of $A12.66 million compared to denominating the commitment as $A275.00 million. The savings from specifying in some other currencies was even larger because the interest rate differentials for these were greater.

Australian dollar. Leaving aside practical difficulties in realising such gains, which may be significant, AusAID is concerned that the proposal may have significant adverse domestic and foreign policy implications. Consideration needs to be given to how pledging in any foreign currency would be viewed by the Australian public, other nations and the institutions we seek to support. On this latter point, it should be noted that it is not Australia's overarching objective to minimise the cost of its Australian dollar support for international financial institutions. Any proposal that leaves the international financial institutions worse off – either because the real value of the resources transferred is diminished, or because their ability to earn income on funds is curtailed – is, understandably, likely to be opposed. Such opposition will come both from the institutions themselves and from other countries concerned that the work of the international financial institutions may be adversely affected and that they may be called on to make up any resource shortfall. This may damage Australia's international standing.

AusAID believes ANAO should weigh these issues closely before advocating Australia take the unprecedented step of pledging in foreign currencies. It is possible, for example, that this might be seen as an expression of lack of confidence in the Australian currency and economy. Globalisation notwithstanding, Members of Parliament, the public and the media may not be easily persuaded that Australia should make commitments in other currencies, especially in the currencies of nations less prosperous, stable or democratic than Australia. Yet it is quite possible that from time to time the currencies of such nations might be precisely those that offer the greatest opportunity for the short term financial gains postulated in the draft report. All of the above points to the importance of these issued being considered very carefully to ensure that the Report is not seen as ill conceived.

4.17 ANAO notes that Commonwealth agencies made some $A7.0 billion in foreign currency payments in 1998–99. In the absence of an international agency mandating Australian dollar payments, ANAO considers that Commonwealth agencies should aim to obtain value for money in making payments in freely traded international currencies. This is distinct to the issues of domestic and foreign policy which, ultimately, need to be resolved by Ministers.

4.18 On 3 February 2000, AusAID advised ANAO that it was examining possible procedures for applying ANAO's proposed processes to payments under the recently completed replenishment of the Montreal Protocol on

Substances that Deplete the Ozone Layer with Australia pledging $US7.4 million for the period 2000 to 2002. Under the terms of the new replenishment agreement, Australia is able to choose to denominate its contribution in United States dollars or Australian dollars, with contributions converted between currencies using predetermined historic exchange rates. With the Reserve Bank's assistance, AusAID concluded that, on this occasion, it would have been more expensive to denominate payments in United States dollars and cover the exposure than to denominate payments in Australian dollars using the predetermined historic spot exchange rate. Accordingly, AusAID elected to denominate Australia's contribution in Australian dollars ($A11.6 million). This represents the first occasion that AusAID has examined a currency option and made an informed decision about which approach would make the most efficient and effective use of Commonwealth financial resources. As noted earlier, by not examining the merits of exercising options in past replenishment agreements for the IDA and the ADF, the Commonwealth lost an opportunity to realise cost savings of $A23.2 million.

4.19 **Finding:** AusAID aims to minimise foreign currency risk exposures in its contributions to multilateral aid agencies by seeking to specify as many contributions as possible in Australian dollars. However, AusAID has not had procedures in place to identify and consider the most cost-effective way to achieve this goal. AusAID has been solely reliant on the ability to fix exchange rates with donors as part of the replenishment agreement process. Where this has not been possible, AusAID has not considered other approaches such as hedging exposures through the Reserve Bank. In one such instance, AusAID's open foreign exchange position led to the cost of the foreign currency payments exceeding AusAID's budget by $1.69 million or 16 per cent.

4.20 Strategic management of resources involves looking for opportunities as well as informed assessments about the best way to manage risks. However, AusAID has not examined the merits of exercising risk-free currency options which would allow AusAID to significantly reduce the cost of its multilateral aid contributions, without increasing foreign exchange risk. AusAID could do this electing to specify its commitments in a predetermined foreign currency amount and entering into forward cover for the exposure generated. For the most recent contributions to the two largest recipients, taking advantage of these options at the time of entering into the commitment would have realised cost savings of an estimated $A23.2 million. As a result of the ANAO audit, AusAID has begun to investigate the merits of exercising these options.

Recommendation No.9

4.21 ANAO *recommends* that AusAID develop an appropriate foreign exchange risk management strategy for the multilateral aid program that:

(a) identifies all material exposures and existing currency options in multilateral aid contribution agreements;

(b) analyses and quantifies cost savings that can be achieved from different approaches to managing foreign exchange risk, including savings from exercising currency options; and

(c) includes a payment plan for each multilateral aid contribution agreement that will enable AusAID to take advantage of currency options in order to minimise the Australian dollar cost of meeting the Commonwealth's financial obligations.

Agencies responded to the recommendation as follows:

4.22 ***Agree:*** Treasury.

Agree with qualifications: AusAID.

4.23 Specific comments by AusAID are set out below:

- **AusAID's** qualifications were that: any changes to the current approach would be partly dependent on any overarching Commonwealth position developed for the provision of centralised advice to agencies on the cost-effective management of foreign exchange risk; and any decision on adopting foreign exchange risk management approach will need to take into account broader foreign policy and overseas development policy considerations.

Bilateral Aid

4.24 The majority of Australia's bilateral aid (which comprises approximately 70 per cent of all overseas aid) is delivered under the terms of contracts let by AusAID. In 1997–98, AusAID let 1700 contracts worth more than $580 million ranging from short-term consultancies to multi-million dollar five-year project implementation contracts.[98] In 1999, AusAID reported that it was managing 1800 contracts worth about $2 billion.[99] AusAID has reported that it expects expenditure through contractors to increase with the shift from budget support to program aid in the Papua New Guinea Program and with new program activity in Indonesia, Vietnam and Cambodia.[100]

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98 *Australia's Aid Program—Memorandum for the DAC Peer Review of Australia 1999*, AusAID, p. 78. http://www.ausaid.gov.au

99 *Ibid*, p.17.

100 *Ibid*, p.78

4.25 The current preferred form of contract used by AusAID is an outputs-based contract.[101] These contracts see the contractor paid on the basis of performance, for example, the delivery of an output or the achievement of an identifiable milestone. However, AusAID advised ANAO that, despite the discernable shift to outputs-based contracts, many contracts are hybrid contracts involving a fixed price component and a reimbursable component. AusAID noted that the fixed price component typically comprises the provision of consultancy (technical) services which can be clearly identified and priced in advance and is expressed in Australian dollars. AusAID further noted that the reimbursable component of the contract typically reflects the estimated costs of procuring project equipment both in and outside Australia and therefore may include reimbursement of payments made in foreign currencies.

4.26 AusAID advised ANAO that, although it delivers projects overseas, it is almost exclusively contracting with Australian suppliers who need to recover mainly Australian dollar costs. AusAID noted that, by and large, Australian contractors manage their finances in Australian currency and prefer Australian dollar contracts. AusAID advised ANAO that it is the reimbursable component value of contracts (not the whole contract value) for which AusAID usually assumes foreign exchange risk.

4.27 AusAID advised ANAO that the decision as to which form of contract is most appropriate for the project will determine which party bears exchange rate risk. AusAID further advised ANAO that it seeks to minimise risks being taken by the Commonwealth that would more appropriately be taken by the contractor. AusAID considers that foreign exchange risk is but one of many risks that will be allocated or shared, either explicitly or implicitly, through the contracting process. AusAID advised ANAO that it considers it appropriate for the contractor to be allocated risks (including foreign exchange) through an outputs (fixed price) contract only when the tenderer: can clearly identify the outputs required; can reasonably price those outputs; and is able to manage the risk.

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101 Reflecting changes in Commonwealth contracting practices, AusAID is phasing out input contracts where contractors are paid solely on the basis of their inputs to the project.

Risk management policy

4.28 Where foreign exchange risk exposures can have a significant effect on the core business of an entity, these exposures should be managed so that operational effectiveness is not adversely affected. From the Commonwealth's perspective, it would be inappropriate for agencies to seek to profit from speculative foreign currency trading.[102] Equally, for entities such as Commonwealth agencies whose core business does not involve trading in financial risks, having any significant open exposure to exchange rate fluctuations could be inappropriate.

4.29 AusAID advised ANAO that: *It is usual AusAID policy for the foreign exchange risk, or at least most of this risk, to be allocated to the contractor for which they make an allowance in their tender prices. However, AusAID will normally assume the foreign exchange risk for the reimburseable component of projects where typically the costs, quantities and specifications of, for example project equipment, cannot be accurately assessed in advance. Where AusAID assumes this risk, it does not hedge this risk.* AusAID further advised ANAO that it is aware that if it carries the risk and decides not to hedge, then the cost to AusAID's budget will rise and fall with currency movements.

4.30 AusAID advised ANAO that there is not a significant exposure to foreign exchange risk in the bilateral aid program because most of the program is sourced in Australia. However, AusAID has not quantified the extent of its foreign exchange risk exposures and has not identified whether this exposure has added value to the Commonwealth, for example by reducing cost volatility or reducing contract costs. appropriatelyAccordingly, ANAO considers that AusAID should undertake a rigorous analysis to quantify the extent of foreign exchange exposure in the bilateral aid program and monitor its exposure on an ongoing basis in order to inform the development of prudent management policies and risk management strategies.

4.31 Figure 4.2 illustrates how the exchange rates used by one AusAID contractor to convert foreign currency transactions into Australian dollars prior to invoicing AusAID has lead to variations in the Australian dollar cost of this project. In this instance, analysis of the exchange rates that have been applied by the contractor over the life of the project indicates that AusAID's exposure to foreign currency risk has not, to date, added to the Australian dollar cost of the project but instead has reduced costs.

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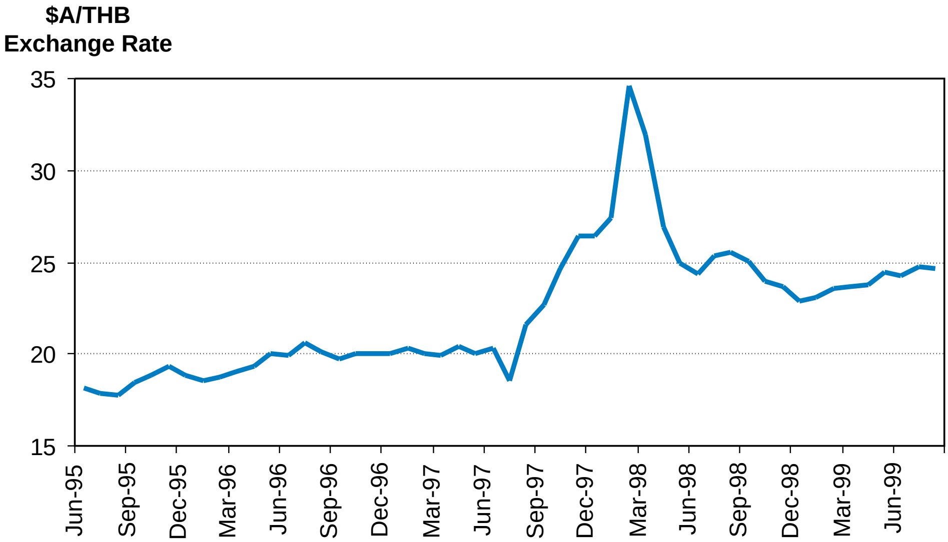
102 It is important to contrast hedging (risk management) with speculators and arbitrageurs. Speculating is attempting to profit on predicted exchange rate movements by taking a currency position. For example, if it is expected that the Australian dollar will appreciate, a speculator might not hedge foreign currency payments in the hope of making a gain. Arbitrageurs attempt to take advantage of price discrepancies that may exist within a market or between related markets. Whereas speculators can make a profit or loss, arbitrageurs seek to lock in a profit with no risk.

Figure 4.2
Thailand Land Titling Project: Exchange Rates Used – June 1995 to August 1999



Source: ANAO analysis of AusAID data.

4.32 AusAID advised ANAO that the gain to the aid budget in this project is a result of the application of its policy of bearing foreign exchange risk rather than hedging. The beneficial exchange rate impact was achieved without AusAID identifying or analysing the foreign exchange risk in this contract. Accordingly, the gain is not as a result of a deliberate policy but is a windfall gain as a result of a failure to properly identify and manage exposures.

4.33 AusAID's present approach does not recognise that active management of foreign exchange exposures, with no forecasting or speculation, can increase AusAID's purchasing power as well as limit negative effects. Instead, AusAID's present approach means that on many occasions AusAID's contract costs will increase because of exchange rate movements. For example, the November 1995 contract for the Cambodia-Australia Agriculture Extension Project requires $US1.877 million of procurement of motor vehicles and other equipment and $US1.017 million in training expenditure. Figure 4.3 indicates that the substantial overall depreciation in the $A/$US exchange rate since the contract was signed has significantly increased the cost to AusAID of these elements of the contract.[103]

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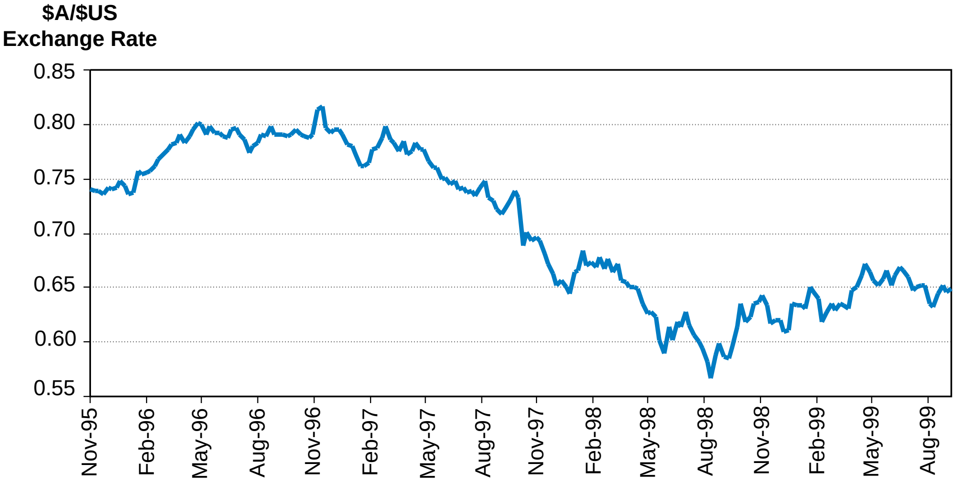
[103] The contract states that the United States dollar costs would be reimbursable at cost with expenditure by the contractor not to exceed the Australian dollar limits specified in the contract without the prior approval in writing from AusAID. However, the Australian dollar limit for in-country procurement was incorrectly calculated in the contract: the $US1.877 million of in-country procurement was converted to $A1.988 million, implying an exchange rate of $A/$US0.9449. However, this rate differs markedly from those available at the time from the financial markets. Using the spot exchange rate at the time of contract signature, the $US1.877 million would have been equivalent to $A2.535 million, an increase of $A546 414.

Figure 4.3

Cambodia-Australia Agriculture Extension Project: Exchange Rates



Source: ANAO analysis of data from Oakvale Capital.

4.34 Cost-effective management of foreign exchange risk includes identifying opportunities to increase value by taking advantage of any opportunities (without speculating) that foreign exchange exposures can provide and/or reducing cost volatility. This process often involves the use of financial derivative instruments but can also involve 'natural' hedges, where exposure to payments/liabilities in one currency are offset by receipts/assets denominated in the same currency.

4.35 AusAID advised ANAO that cost certainty is an unrealistic goal. AusAID noted that it does not expect cost certainty or pursue it as a primary goal and considers that the achievement of cost certainty is only likely if all risk is passed to the contractor whether appropriately or not. If all risk is inappropriately passed to the contractor, AusAID considers it likely that it would face an unnecessarily high risk premium in tender prices. In these circumstances, ANAO notes that sound risk management suggests AusAID may be correct to retain the foreign exchange risk but that there is value in AusAID investigating the merits of managing these exposures. Furthermore, there is a need for AusAID to change its management approaches to recognise that currency markets can be used to increase the Commonwealth's purchasing power as well as to limit negative effects.

4.36 **Finding:** Developing a considered foreign exchange risk policy requires analysis of the risk exposure of the agency and consideration of whether and how such risks should be managed. In this respect, AusAID has not explicitly quantified the extent of its foreign exchange risk exposures in the bilateral aid program and has not identified the degree to which this exposure has increased cost volatility and reduced or increased contract costs. ANAO found that AusAID faces significant foreign exchange exposures in its bilateral aid program as a result of its policy of assuming the currency risk for reimbursing contractors for project components. AusAID's usual approach is to remain exposed to this risk rather than manage the exposures.

4.37 AusAID's present approach to foreign exchange risk in the bilateral aid program does not recognise that active management of foreign exchange exposures, with no forecasting or speculation, can increase AusAID's purchasing power as well as limit negative effects. AusAID's present approach means thatonmany contract costs may increase or reduce as a result of exchange rate movements. In the absence of a considered risk management approach, any gains that are made from exchange rate movements are not the result of a deliberate policy but are windfall gains as a result of a failure to properly identify and manage exposures.

Recommendation No.10

4.38 ANAO *recommends* that AusAID develop and document a considered and consistent policy on foreign exchange risk in the bilateral aid program, that is informed by appropriate specialist advice.

Agencies responded to the recommendation as follows:

4.39 *Agree:* AusAID and Treasury.

Foreign currency translations

4.40 In AusAID's outputs contract, milestones have a single Australian dollar contract price regardless of the mix of Australian dollar and foreign currency payments of the contractor. For inputs contracts, the agreed billing rates for staff cover both Australian dollar and foreign currency staffing costs of the contractor.[104] For inputs contracts, the major foreign currency exposures that arise relate to AusAID reimbursing contractors for their foreign currency payments.

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104 AusAID noted that the mix of currencies agreed between the contractor and staff for remuneration and allowances, the management overheads, profit margins etcetera is of no interest to it, only the billing rate.

4.41 Even where the contract requires reimbursement of foreign currency payments, AusAID generally requires the contractor to convert the amounts into Australian dollars to invoice AusAID. However, reimbursement in Australian dollars of foreign currency contract payments in many instances still involves an open foreign exchange position. This is because AusAID contracts often require conversions to be made using the exchange rate that applied at the date of each foreign currency transaction or the weighted average exchange rate for all such conversions in the month in which expenditure occurred. As a result, the Australian dollar value of individual transactions rises and falls as exchange rates move, meaning that specifying payments in Australian dollars has not necessarily removed foreign exchange risk. AusAID advised ANAO that it does not intend and does not expect to remove foreign exchange risk by specifying payments in Australian dollars.

4.42 ANAO noted considerable variation in AusAID's approach to foreign exchange conversions in the sample of ten contracts reviewed. ANAO considers that these approaches are unlikely to maximise value for money as the following examples illustrate:

- The contract for the Mindanao Community Health Project in the Phillipines did not specify the mechanism the contractor was to use for foreign exchange the Mindanao Community Health Project in the conversions. The contractor has adopted a variety of approaches to converting foreign currency transactions to Australian dollars: the exchange rate on the date of the in-in-country transaction, a two month average exchange rate, a four month average exchange rate, and a nine month average exchange rate. No supporting evidence for these rates was provided to AusAID. ANAO's analysis indicates the rates provided are retail exchange rates, which were substantially less favourable to AusAID than the rates provided by the Reserve Bank to other Commonwealth agencies at the time of the transactions.
- One instance was noted where the conversion methods used by the contractor did not accord with the contractual requirement. The November 1995 contract for the Cambodia-Australia Agriculture Extension Project requires that claims will be paid in Australian dollars and that claims for expenditure in foreign currencies will be made in the equivalent amount of Australian dollars, converted at the exchange rate that applied at the date of the actual foreign currency transaction. However, the rate sheets provided by the contractor with its monthly invoices evidence that the exchange rates being applied are the retail rate quoted by an Australian commercial bank at the end of each relevant month. These rates were 51 basis points worse than the wholesale market average and 57 basis points worse than those available from the Reserve Bank.

- One instance was noted (the contract for the Indonesia HIV and STD Prevention and Care Project) where evidence supporting the exchange rates used for conversion was not provided to AusAID, despite the contract requiring supporting evidence. Accordingly, there was insufficient data available to either AusAID or ANAO to establish whether the exchange rates being applied represent value for money to the Commonwealth.

4.43 An important element of maximising cost-effectiveness in relation to foreign currency transactions is obtaining a favourable exchange rate for the transaction. In this respect, agencies should ensure the rates offered are competitive to those available from the Reserve Bank. Whereas the Reserve Bank sells and purchases foreign currencies to/from Commonwealth agencies at wholesale market rates, ANAO's examination of the exchange rates used by AusAID's contractors found that it is <u>common for retail exchange rates to be used</u>. As a result, the exchange rates being applied to convert foreign currency payments to Australian dollars are often significantly worse than had AusAID paid the contractor in foreign currency through the Reserve Bank. For example, on United States dollar payments, the difference is often 20 to 50 basis points. While on an individual invoice or project basis the deviations may not always be significant, across the bilateral aid program there is the potential for such margins to amount to a significant overall increase in costs.

4.44 In relation to the requirement to undertake foreign currency transactions with the Reserve Bank, AusAID advised ANAO that:

> *The Reserve Bank option is an interesting and useful suggestion for us to consider. There are potential disadvantages to such a system, mainly in terms of AusAID assuming a financial management role for projects,*[105] *but the suggestion is certainly worth further consideration. Our initial view is that the option would not be appropriate for all contracts and that … less universal application is appropriate. It seems to us that the smaller the project, the shorter its duration and the less regular the payments, the less the advantage of such a system. In terms of resource implications, the Reserve Bank may have some difficulty making hundreds of payments every month and there would be some resource implications for us to consider.*

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105 In this respect, AusAID stated that, *as part of the management of aid projects, contractors need to manage the transfer of funds to foreign currencies to finance their project activities. The timing and size of funds transfers are management decisions of the contractor. Under the Reserve Bank option, AusAID would become involved in the management of project finances and could be held responsible for any delays in payment into overseas working capital project accounts. The difference between the Reserve Bank rates and retail rates paid by contractors might be considered part of the price that AusAID pays for contractors to handle in-country financial management.*

4.45 **Finding:** AusAID's administration of foreign exchange risk in payments to contractors does not adequately protect the Commonwealth's overall financial interests. ANAO noted considerable variation in AusAID's approach to foreign exchange conversions in contract payments: conversion mechanisms were specified in some contracts but not others; there were departures from the conversion mechanism specified by the contract; and there was an absence of supporting evidence for the exchange rates used by one contractor to undertake conversions. Of particular concern is that foreign currency conversions are being undertaken using retail exchange rates which are significantly less favourable than the wholesale exchange rates available from the Reserve Bank. Across the bilateral aid program there is the potential for such margins to amount to a significant overall increase in costs. In the future, this can be addressed by undertaking transactions with the Reserve Bank or, where the payments are too small or irregular for the Reserve Bank, by requiring contractors to obtain competitive quotes for foreign exchange conversions of expenses that are reimbursed by AusAID.

Recommendation No.11

4.46 ANAO *recommends* that AusAID, in consultation with relevant agencies, significantly upgrade all facets of its financial management of foreign currency payments in the bilateral aid program to ensure value for money by obtaining wholesale market exchange rates for its foreign currency transactions and conversions.

Agencies responded to the recommendation as follows:

4.47 ***Agree:*** AusAID and Treasury.

4.48 Specific comments by AusAID are set out below:

- **AusAID** commented that the recommended upgrade will require it to examine, in consultation with the Reserve Bank, the costs and practical operational aspects of obtaining wholesale market exchange rates.

Mekong River bridge contract

4.49 AusAID construction contracts are usually denominated and paid in Australian dollars with the contractor responsible for foreign exchange risk.[106] It is standard AusAID practice to use the internationally recognised Federation Internationale Des Ingenieurs-Conseils (FIDIC) contract for major construction projects. AusAID advised ANAO that the FIDIC guidelines are also followed in respect of the treatment of specifying the currency of payment at both the tender and contract stage.

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106 Source: AusAID advice to ANAO dated 15 October 1999.

4.50 The decision whether to contract in the currency of the country or countries where the work will be performed is best made on a case-by-case basis. This recognises that there is a balance to be struck between risk and return. For example, requiring the contractor to bear significant foreign exchange risk can deliver cost certainty but may also result in significantly increased tender prices. There also exists a risk that, although the contractual arrangements may effectively transfer risk from the Commonwealth, the contractor may seek to be reimbursed for any exchange rate losses that it suffers.

4.51 There are a number of reasons that Commonwealth agencies may decide to make payments not required by the contract. For example, services additional to those required by the contract may have been provided, the contract may have been in error or the agency's actions may have led to the contractor suffering loss. In all circumstances, paying claims for foreign exchange losses where the contract does not require payment needs to be carefully considered to ensure that payments reflect efficient and effective use of Commonwealth resources.[107] In addition, settling such claims may render ineffective the intended transfer of risk to the contractor with the result that the Commonwealth has actually retained an open foreign exchange position.

4.52 In the sample of ten contracts examined by ANAO, one instance was noted where AusAID had negotiated on a foreign exchange loss incurred by a construction contractor. AusAID advised ANAO that, as far as it is aware, this is the only instance where this had occurred. The instance identified by ANAO related to an $A78.38 million June 1997 contract for the construction of a major bridge across the Mekong River at My Thuan in southern Vietnam.[108] The contract unequivocally allocated foreign exchange risk to the contractor. It is a useful example to illustrate the impact of decisions taken and what can be learnt from the experience.

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107 Section 44 of the Financial Management and Accountability Act requires agency Chief Executives to manage the affairs of the Agency in a way that promotes efficient, effective and ethical use of Commonwealth resources.

108 The cost of designing and building the bridge is to be shared between Australia and Vietnam on a 66:34 ratio.

4.53 In April 1999, AusAID agreed to settle for $A1.95 million a number of claims from the construction company, including payment of $A800 000 relating to foreign exchange losses. The $A800 000 payment (of which the Commonwealth's share was $A520 000)[109] was the result of an October 1998 claim from the construction contractor for Commonwealth reimbursement of $A5.95 million[110] in foreign exchange losses it claimed it had suffered.[111]

4.54 The requirement to make contract payments is, in the first instance, determined by the actual and implied terms of the contract. The construction contract for the Mekong River bridge stated that *the currency of account shall be, and the Contract Price is in, Australian dollars* ($A78.38 million).[112] The contract further stated that, except where relevant legislation is changed after the submission of tenders, *the Contract Price will not be subject to any adjustment for any exchange rate fluctuation in the Australian Dollar or the currency of Vietnam as against each other or against any other currency*. Accordingly, the contract expressly excluded any liability or responsibility of the Commonwealth for any currency fluctuation or exchange rate loss on the Project.[113]

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109 AusAID advised ANAO that the payment from Commonwealth appropriations was $A520 000 of the settlement amount with the Government of Vietnam paying the remainder in accordance with the project cost sharing arrangements.

110 AusAID's financial investigator calculated the maximum foreign exchange loss it believed would have been incurred by a prudent contractor to be between $A0.789 million and $A1.302 million. Legal advice to AusAID was that there was no basis upon which the construction company would be entitled to maintain a claim under the contract in relation to between $A0.199 million and $A0.300 million of this amount. This left an amount of $A0.590 million to $A1.002 million in foreign exchange losses to be investigated further.

111 This claim followed an earlier claim for foreign exchange losses that AusAID had rejected, partly because the contract unequivocally allocates this risk to the contractor. AusAID advised ANAO on 22 March 2000 that this earlier claim had different factual and legal contentions put forward by the contractor and that AusAID considered it had no relevance to the position with the later foreign exchange claim.

112 AusAID advised ANAO that: *the contract price is in Australian dollars but makes provision for 35 per cent of this amount to be payable in Vietnamese Dong from contributions of the Government of Vietnam. This was consistent with the understanding that all payments by the Contractor to Vietnamese parties would be in Dong and that there were constraints on convertibility of the curreny, which is not subject to commercial trading.*

113 Indeed, AusAID's project engineer (who prepared the contract) advised AusAID that it considered the construction company was not eligible under its contract with AusAID to claim for foreign exchange losses. In addition, AusAID's claims adviser advised AusAID that the construction company had no rights, under the contract or otherwise in law or equity, which would support an entitlement to its claim. The claims adviser noted, however, that if AusAID did not make some form of voluntary payment to the construction company, the construction company may seek to recover monies elsewhere under the contract.

4.55 If payments are not required under the terms of the contract, and the contract has not been varied to provide for further payments, the Commonwealth may still be required to make a payment if it has committed a legal wrong giving rise to legal liability. Commonwealth agencies can choose to contest and defend claims of a legal wrong or seek to settle the dispute. Pursuant to directions issued by the Attorney General under the *Judiciary Act 1903*,[114] the settlement of claims is circumscribed by the Commonwealth Policy for Handling Monetary Claims. Under Financial Management and Accountability Regulation 9, a Commonwealth agency cannot approve payment of a settlement amount unless it is satisfied, after making reasonable inquiries, that the proposed expenditure is in accordance with the policies of the Commonwealth, including the Policy for Handling Monetary Claims.

4.56 ANAO considers that there were a number of significant deficiencies in the process by which AusAID negotiated the settlement of this claim, as follows:

- AusAID did not have specific policy guidelines for settlement of contractual claims and did not examine the principles espoused by potentially relevant Commonwealth policies (such as the Commonwealth Policy for Handling Monetary Claims);
- although AusAID required the contractor to substantiate its claim, AusAID decided to settle the claim because of possible pre-tender representations even though the contractor did not allege any pre-tender representations as the basis for its claim.[115] However, AusAID's legal adviser was unable to provide AusAID with a definite opinion on the legal liability of the Commonwealth as it stated that it had not undertaken an investigation and full review of all the tender documentation. Furthermore, AusAID's legal adviser informed AusAID that it had not considered whether such a legal action, although feasible in principle, could actually be validly enforced against the Commonwealth;[116] and

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114 Section 55ZF.

115 The contractor based its claim on the argument that the regional currency crisis was an unforeseen physical condition that had led to extraordinary foreign exchange losses and that it was unjust and inequitable for the Commonwealth to be enriched as a direct result of the devaluation of the Australian dollar at the expense of the contractor. The contractor claimed restitution for this unjust enrichment. The possibility of pre-tender representations being a potential basis for the claim was identified by AusAID's legal adviser who had sought to explore all possible potential bases, even those not used by the contractor as the basis for its claim.

116 For example, ANAO noted that the contract precludes the contractor from relying on any pre-tender representations.

- Where there is a meaningful prospect of liability for the Commonwealth, the factors required to be taken into account in assessing a fair settlement should include: the prospects of the claim succeeding in court and the costs of continuing to defend the claim. Documentation of these factors serves an important accountability function but it also assists the decision making process as the process of preparing a rigorous analysis helps to identify and examine all relevant issues. However, ANAO found that AusAID did not properly document its investigations and calculations.

4.57 In November 1999, AusAID informed ANAO that its decision to negotiate a settlement was based on both legal and commercial considerations.[117] AusAID advised ANAO in May 2000 that the project was practically completed on 31 March 2000, eight months ahead of the contract due date and within the original approved budget. At this time, AusAID also commented that:

> *The Commonwealth never intended the contractor to bear a foreign exchange risk on the element of the contract price denominated in Vietnamese Dong for payments to local Vietnamese subcontractors. However, during construction, despite the assumption by all parties that this element of the contract price would be available for payments of local contractors in Vietnamese Dong, the contractor was required to make US dollar payments resulting in additional costs for which no provision had, or could have, been made in its tender. AusAID's settlement was therefore not a payment to compensate the contractor for any losses as a result of exchange rate movements under the terms of the contract. The contractor's claims in this respect were rejected in whole and the contractor remained fully responsible for exchange rate risk under the contract.*

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117 For example, AusAID has commented to ANAO that: *It is not uncommon in the construction industry that the costs to process, administer, formulate and defend or press counter claims, often outweigh their "technical value" when initially lodged. Furthermore, rejection of significant claims out of hand can lead to a general "claims assault" by the contractor subject to similar considerations. Such actions may also put at risk the project budget, technical quality, progress, or produce other adverse outcomes.*

> *In this matter AusAID settled a contractual claim within the terms of the contract, in accordance with AusAID guidelines[118] and directives and in compliance with relevant Commonwealth policies. The foreign exchange claim was resolved as part of an overall process of settlement of contractual claims and disputes for an amount considered by AusAID and its advisers as justified and favourable to the Commonwealth. The related Deed of Settlement includes a comprehensive release of claims on the Project that represents a significant commercial and contractual benefit to the Commonwealth in terns of the ultimate cost of the project. That this was done in circumstances where the contractor suffered unrecovered losses in completion of the contract is a substantial achievement by AusAID.*

4.58 **Finding:** In the sample of ten contracts examined by ANAO, one instance was noted where AusAID had negotiated on a foreign exchange loss incurred by a construction contractor. AusAID advised ANAO that, as far as it is aware, this is the only instance where this had occurred. The instance identified by ANAO involved an $A800 000 payment in 1999 to the construction company on the Mekong River Bridge project at My Thuan in Vietnam. The Commonwealth's share of this payment was $A520 000.

4.59 The contract expressly excluded any liability or responsibility of the Commonwealth for any currency fluctuation or exchange rate loss on the construction project. However, AusAID settled the claim after receiving legal advice as it considered there was a potential contractual liability and there existed serious contingent risks associated with the contractor's claim. However, ANAO found that there were a number of significant deficiencies in the process by which AusAID negotiated the settlement of this claim.

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[118] On 14 January 2000, AusAID advised ANAO that, before it put a settlement offer to the contractor, it undertook, a analysis of likely financial exposures and other relevant costs of the claims. AusAID was unable to produce any evidence of this analysis or quantify its findings. AusAID further advised ANAO that it gave *consideration and weight to all costs to the Commonwealth and with due regard to project and aid program objectives.* However, again, AusAID was unable to articulate what costs it had identified and considered or the weight that was given to these costs.

Recommendation No.12

4.60 ANAO *recommends* that, where the signed written contract requires the contractor to bear foreign exchange risk, AusAID implement procedures that require:

(a) a rigorous and documented examination of all claims by contractors for foreign exchange losses; and

(b) where payment for foreign exchange losses is proposed, sign-off to be obtained that the payment may properly be made, in accordance with relevant Commonwealth policies governing the expenditure of public moneys.

Agencies responded to the recommendation as follows:

4.61 ***Agree:*** AusAID and Treasury.

5. Foreign Affairs and Trade

Introduction

5.1 Through its network of overseas posts and Canberra-based officials, the Department of Foreign Affairs and Trade (DFAT) seeks to support Australia's interests in international security, contribute to national economic and trade performance, and promote global cooperation.[119] As of 30 June 1999, DFAT was managing a network of 81 overseas posts comprising Embassies, High Commissions, Consulates and Multilateral Missions in 70 countries.[120] DFAT considers its network of overseas posts to be a key asset in maintaining and strengthening the bilateral relations at the core of Australia's national security and economic well-being.[121] The overseas posts also assist DFAT to provide Australians abroad with access to consular and passport services.

5.2 DFAT is the largest overseas operating agency in the Australian Public Service. Approximately one-third of DFAT's running costs are spent overseas, with foreign currency expenditure of some $A209 million in 1998–99. In addition, DFAT is exposed to ongoing payments to international organisations that are denominated in various foreign currencies.

5.3 Unlike capital expenditure based exposures which typically have a defined term, DFAT's exposures represent an ongoing commitment and may be regarded as perpetual. In many ways these exposures are similar to those of Australian importers of foreign goods and services where there is no locally produced equivalent good or service (that is, limited or no import replacement). Any hedging of these exposures would be described as "anticipatory" because the exposure amount is not yet known with certainty. Similar considerations apply to DFAT's foreign exchange exposures.

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119 *Portfolio Budget Statements 1999–2000—Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 15.

120 Department of Foreign Affairs and Trade—*Annual Report 1998-99*, pp. 302–304.

121 *Portfolio Budget Statements 1999–2000—Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 7.

Audit methodology

5.4 Administrative support to Commonwealth agencies operating overseas is provided through the overseas posts network. DFAT has a cross-agency arrangement, the Common Administrative Services Agreement, under which it provides personnel, office, property, financial and communications services to agencies operating overseas on a fee-for-service basis.[122] The Department of Immigration and Multicultural Affairs, Defence and Austrade are the main purchasers of services under this Agreement.[123] ANAO examined the foreign exchange exposure associated with DFAT's overseas operations and the efficiency and cost-effectiveness of the administrative arrangements by which DFAT's overseas budget is prepared and budget supplementation received for exchange rate variations.

5.5 Another important aspect of DFAT's activities is pursuing Australian interests in regional and multilateral forums and negotiation of international treaties. The Department's responsibilities include making payments for Australia's participation in international organisations such as the United Nations and the Organisation for Economic Co-operation and Development (OECD), although such memberships are of whole-of-government interest.[124] ANAO's audit examination focused on a sample of payments to ten of these organisations, which collectively represented 82 per cent of DFAT's payments to international organisations in 1998–99.

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122 *Ibid*, p. 197.

123 DFAT also has purchaser/provider arrangements with agencies that require international telecommunications services for staff at Australia's overseas missions. Source: *Portfolio Budget Statements 1999–2000—Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 75.

124 *Portfolio Budget Statements 1999–2000—Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 8.

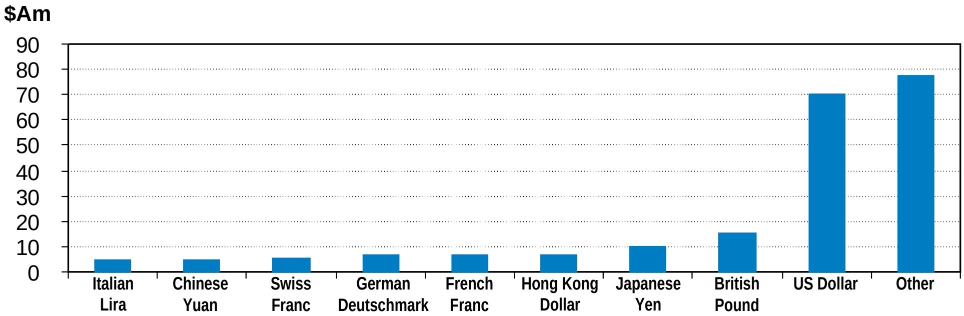
125 One reason for the dominance of United States dollar exposures is that, in many countries in which DFAT operates, expenditure is made in United States dollars rather than national currency.

Overseas operations

5.6 In its overseas operations, DFAT has exposures to some 68 currencies, the most significant exposure being to United States dollars[125] with nine currencies collectively representing more than 62 per cent of total foreign currency operating expenditure in 1998–99 (see Figure 5.1).

Figure 5.1

Foreign Currency Running Costs Expenditure: 1998–99



Source: ANAO analysis of DFAT data.

5.7 Many of the currencies to which DFAT is exposed are not freely-floating but are tied to, or closely correlated with, other currencies. DFAT advised ANAO that, in respect of the vast majority of the 68 foreign currencies, it minimises its risk by only converting into the local operating currency on a needs basis. Nevertheless, ANAO's Strategic Adviser advised ANAO that there could be merit in DFAT examining its exposure to major currency blocs (such as the United States dollar and the Euro) with management attention focused on significant exposures, such as to the United States dollar bloc.

5.8 A management approach that focuses on currency blocs would recognise that the nature of DFAT's exposures provide, to some degree, diversification benefits which are likely to reduce overall <u>net</u> exposure. Such an approach can also reduce management costs by taking a portfolio approach to hedging exposures. In this respect, the Reserve Bank is able to arrange for agencies general cover for a total amount of foreign currency over a period against which individual payments can be made with only a marginal change to the Australian dollar amounts involved. In this way, general cover could be established for a full year's foreign currency payments. Budgeting using forward foreign exchange rates combined with general forward cover would add value by protecting against adverse movements in exchange rates that create budget uncertainty, and therefore require budget supplementation.

5.9 At present, DFAT does not identify, assess and systematically address its foreign exchange exposures because the budget supplementation arrangements transfer this risk to the Commonwealth budget as a whole. In response, DFAT advised ANAO that:

> *The department, conscious of its responsibilities under the Financial Management and Accountability Act, at the commencement of the devolution process took steps to address the foreign exchange management issue. At that time, DoFA gave notice of the termination of its resources agreements which protected agency budgets against the negative effects of foreign exchange movements. In a conscious policy decision, DFAT sought DoFA's agreement for the continuation of the agreement for a period of three years. This recognised that DoFA, and through it the Reserve Bank of Australia, was best placed to make decisions in the Commonwealth's interests in respect of foreign exchange. In response to DFAT's arguments, DoFA formally advised the extension of the resource agreement.*

5.10 The continuation of the agreement for budget supplementation protects DFAT's budget but does not represent an effective and appropriate whole-of-government management approach to foreign exchange risk. In relation to the procurement of goods and services, Financial Management and Accountability Regulations 8 and 9 require a proper assessment of foreign exchange risk, including measures to manage this risk, as part of procurement and expenditure approval processes. The Australian Government Solicitor advised ANAO that:

> *the fact that budget supplementation may exist to cover increases in costs due to adverse currency movements does not affect the operation of these duties under the Regulations. The budget supplementation merely authorises the expenditure of additional money in so far as costs have increased; it does not impliedly repeal or qualify the operation of the Regulations so as to obviate the need to assess foreign exchange risk and manage it, where possible.*

5.11 **Finding:** DFAT is the largest overseas operating agency in the Australian Public Service with approximately one-third of its annual administrative costs spent in foreign countries. Many of the currencies to which DFAT is exposed are not freely-floating but are tied to, or closely correlated with, other currencies. A management approach that focuses on currency blocs would recognise that the nature of DFAT's exposures provide, to some degree, diversification benefits which are likely to reduce overall net exposure. Such an approach can also reduce management costs by taking a portfolio approach to hedging exposures. ANAO considers that the merits of taking a portfolio approach to managing DFAT's net exposures to major currency blocs such as the United States dollar in order to protect against adverse movements in exchange rates that create budget uncertainty should be considered by DFAT and DoFA in the context of Recommendation No.2 (Chapter 2).

Contributions to international organisations

5.12 Administered payments are those that are controlled by the Government and managed by Commonwealth agencies in a fiduciary capacity.[126] This fiduciary responsibility imposes obligations on agencies to manage administered payments in an efficient and effective manner.[127]

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126 Department of Foreign Affairs and Trade, *Annual Report 1998–99*, p. 148.

127 For example, the AOFM in its management of Commonwealth debt—an administered item—has an objective of raising, managing and retiring debt at the lowest long-term cost, consistent with an acceptable degree of risk exposure. Source: Audit Report No. 14 1999–2000, *Commonwealth Debt Management*, p. 44, para. 3.1.

5.13 On behalf of the Commonwealth, DFAT is charged with pursuing Australian interests in the United Nations and other international organisations. In 1998–99, contributions administered by DFAT totalled $A81.9 million (see Figure 5.2). The cost of contributing to international organisations is budgeted to be $A96.0 million in 1999–2000.[128] DFAT's budget supplementation arrangements are limited to its overseas operating activities and do not extend to payments to international organisations administered by DFAT.

Figure 5.2

Administered Payments to International Organisations: 1998–99

Organisation	*Contribution Arrangements*	*Budget ($A)*	*Cost ($A)*
United Nations	United Nations issues annual assessment notice specifying Australia's contribution, which is denominated in $US. The contribution for the United Nations' 1999 budget was $US15.40 million.	25 000 000	24 544 662
Assessed Contributions to United Nations Peace-Keeping Operations	Contributions are periodically advised to DFAT. Contributions are specified and payable in United States dollars.	31 300 000	17 035 965
United Nations Educational, Scientific and Cultural Organisation (UNESCO)	Contributions are assessed partly in United States dollars and partly in French Francs (FRF). The amounts due in 1999 were $US2.05 million and FRF 18.42 million.	7 500 000	8 643 514
Organisation for Economic Co-operation and Development (OECD)	Contributions are specified and payable in Frenc francs. Contributions administered by DFAT to the 1999 OECD budget totalled FRF 19.995 million.	6 000 000	5 337 495
International Atomic Energy Agency (IAEA)	Annual contributions are assessed in two components: a United States dollar component and an Austrian schilling component (ATS). Australia's contribution for 2000 was $US550,739 and ATS 34,423,859.	5 000 000	4 650 479
Commonwealth Secretariat	Annual contributions payable in Pounds Sterling. Australia's assessed contribution of GBP Sterling 1.02 million for 1998–99 was paid in two instalments.	2 500 000	2 715 073

continued next page

128 *Portfolio Budget Statements 1999–2000—Foreign Affairs and Trade Portfolio*, Budget Related Paper No. 1.10, p. 44.

Organisation	*Contribution Arrangements*	*Budget ($A)*	*Cost ($A)*
Contribution to the World Trade Organisation (WTO)	Contributions are assessed in Swiss francs (CHF) on a calendar year basis. Contributions are payable in full on 1 January each year with Australia's 1999 contribution amounting to CHF 1.62 million.	2 200 000	1 851 500
Organisation for the Prohibition of Chemical Weapons (OPCW)	Budgets are established on a calendar year basis with contributions specified in Dutch guilders.	2 420 000	1 152 397
Comprehensive Nuclear Test-Ban Treaty Organisation	Assessed annual contributions are denominated in United States dollars ($US961 095 for 1999).	1 560 000	1 530 162
Wassenaar Arrangement on Export Controls for Conventional Arms and Dual use Goods and Technologies	Contributions are payable in Austrian Schillings with ATS 238 007 paid for 1999.	41 000	29 775
Total ANAO sample		**83 521 000**	**67 491 022**
Other Organisations		13 831 000	14 424 436
Total DFAT Administered Expenditure		**97 352 000**	**81 915 458**

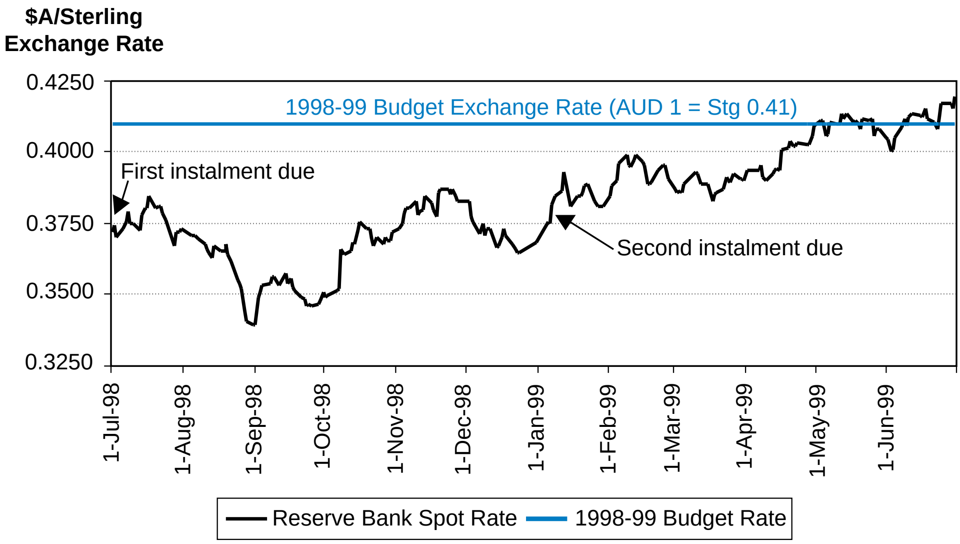
Source: Department of Foreign Affairs and Trade, *Annual Report 1998–99*, pp. 365–367 and ANAO analysis of DFAT data.

5.14 At present, DFAT does not have an explicit policy on foreign exchange risk in its administered payments to international organisations. DFAT retains an open foreign exchange position on contributions, with exchange rate variations either reducing the cost against the budget or increasing the cost. Increased costs compared to the budget requires DFAT to seek additional funds either through the Additional Estimates process or the Advance to the Minister for Finance. In 1998–99, budgets for contributions to nine organisations were increased by a total of $A5.77 million.

5.15 To prepare Australian dollar budget estimates requires DFAT to convert the estimated foreign currency payments to an Australian currency equivalent. To do this, DFAT uses DoFA's Budget exchange rates, which are an average spot rate. ANAO considers spot exchange rates are inappropriate for this purpose because they are unlikely to be achievable over the course of the forthcoming year. This is illustrated by Figure 5.3, which relates to DFAT's 1998–99 contributions to the Commonwealth Secretariat.

Figure 5.3

Australian Dollar/Pound Sterling Spot Exchange Rate: 1998–99



Source: ANAO analysis of Reserve Bank data.

5.16 In relation to payments to some organisations, DFAT increases its Australian dollar budget estimate to compensate for exchange rate volatility. For example, 1998–99 budgets for 13 organisations were increased by 1.5 per cent ($A75 022) during the 1998–99 Additional Estimates process for possible exchange rate variations.[129] Similarly, the 1999–2000 budgets for 12 organisations were increased by 7.5 per cent ($A5.38 million) to cover possible exchange rate variations and other assessment increases. However, DFAT's approach of including a factor for possible exchange rate variations understates the historic volatility of the exchange rates to which DFAT is exposed. For example, ANAO's Financial Adviser informed ANAO that Value at Risk (VaR) statistical analysis indicates that, at a 95 per cent confidence level, the worst-case movement in any one year in:

- the $A/$US exchange rate is 13.2 per cent;
- the $A/Pounds Sterling exchange rate is 20.7 per cent;
- the $A/Euro exchange rate is 22.4 per cent;

[129] This was in addition to $A5.00 million in additional funding sought as part of the 1998-99 Additional Estimates process for exchange rate fluctuations that had occurred since the 1998-99 Budget was prepared.

- the $A/Frenc Franc exchange rate is 22.5 per cent;
- the $A/Austrian Schilling exchange rate is 22.3 per cent;
- the $A/Netherlands guilder exchange rate is 22.4 per cent; and
- the $A/Swiss Franc exchange rate is 24.0 per cent.

5.17 **Finding:** On behalf of the Commonwealth, DFAT is charged with pursuing Australian interests in the United Nations and other international organisations. In 1998–99, contributions administered by DFAT totalled $A81.9 million with $A96.0 million budgeted to be paid in 1999–2000. DFAT's budget supplementation arrangements are limited to its overseas operating activities and do not extend to payments to international organisations administered by DFAT.

Exposure management

5.18 Where foreign exchange risk exposures can have a significant effect on the business of an entity, these exposures should be managed so that operational effectiveness is not adversely affected. Figure 5.3 illustrated the significant impact an open foreign exchange position can have on DFAT's foreign currency administered payments. In this instance, as the spot exchange rates available to DFAT at the time each payment was due was considerably less favourable than DoFA's Budget rate, insufficient funds were available to DFAT from its original budget to meet the January 1999 second instalment payment to the Commonwealth Secretariat. Maintaining an open foreign exchange position on the second instalment rather than hedging the exposure through a forward foreign exchange contract with the Reserve Bank increased the cost of the payment by $A58 261.

5.19 The preparation of budget estimates for administered foreign currency payments to international organisations is, in many instances, complicated by the annual nature of the international organisation's budgeting processes. Indeed, for some organisations, payments are due shortly after the contribution amount has been advised to the Commonwealth. Nevertheless, ANAO analysis of foreign currency payments over recent years revealed that there is a reasonably consistent level of foreign currency expenditure for most of the international organisations. For this reason, DFAT's Australian dollar budgets are often based on: the previous year's foreign currency payment; Australia's historical burden share and the organisation's indicative foreign currency budget; or the previous year's Australian dollar budget.

5.20 The perpetual nature of these exposures means that the exposure to foreign exchange rate movements cannot be fully hedged—that is, the exposure cannot be hedged forever. ANAO's Financial Adviser noted that, in these circumstances, the typical foreign exchange hedging strategy of an importer is focused on those exposures where they are "at risk".[130] DFAT payment exposures to international organisations can be considered "at risk" during the current budget period. This suggests that DFAT should consider hedging budgeted exposures in the current budget year and adjust this exposure for the possible forecast error. Such an approach would assist effective management on a year-by-year basis.

Currency options

5.21 Most of the contributions administered by DFAT require funding to be provided in a specified foreign currency. The ability of a donor to choose which currency it will make payments in is known as a currency option. Currency options exist in some of DFAT's contribution obligations to international organisations and may shortly exist in others:[131]

- The 1999 contribution arrangements for UNESCO provided DFAT with two options[132] for contributions:
  - first, the French Franc component could have been paid either in French Francs or in Euros, with the French franc amount converted into Euros at the rate of exchange irrevocably fixed on 1 January 1999; and
  - second, where contributors wished to pay in a currency other than United States dollars or the French Franc/Euro, they could lodge a request with the Organisation which would determine the amount that would be accepted in another currency and the manner in which the payment could be made.

[130] It is important to note that these exposures are only based on estimates of the foreign currency amounts payable. Typically, while the foreign currency price of goods is known, the volume of goods sold is based on forecast sales. ANAO's Financial Adviser advised that, depending on the type of exposures, the forecasting error can be in the order of 10 to 20 per cent and that the most common approach to managing forecasts error is to limit the total amount of a forecast exposure which can be hedged to 100 per cent minus the forecast error (for example, 90 or 80 per cent).

[131] In relation to the Comprehensive Nuclear Test Ban Treaty Organisation, DFAT advised ANAO that subsidiary bodies are examining the possibility of moving to a split currency budgeting system of United States dollars or Euros.

[132] A third option of specifying contributions in national currency existed for those contributors who were in arrears with their payments.

- Contributions to the Organisation for the Prohibition of Chemical Weapons (OPCW) are payable in Dutch Guilders (NLG) or Euros (calculated at the conversion rate between Guilders and Euros irrevocably fixed on 31 December 1998).

5.22 A decision whether to exercise financial options is best made following an assessment of the financial outcome of the various alternatives. For DFAT, this would require analysis of the required foreign currency contribution, the due date of the payment and the spot and forward exchange rates for the alternative currencies in which contributions may be paid. This analysis is presently not undertaken although the currency options can provide DFAT with risk-free opportunities to make financial savings, for example:

- In relation to OPCW, on 9 July 1999 DFAT was advised by OPCW that the amount payable to it for the 2000 budget year was NLG 906 368 or the equivalent amount in Euros. The payment was due by 1 January 2000. The effect of the payment arrangements is to grant DFAT a free risk-less option which it can exercise in hindsight to minimise the Australian dollar cost of Australia's payment obligations. This opportunity arises because, whereas the exchange rate between the Euro and the Guilder was irrevocably fixed on 31 December 1998, the exchange rate between the Australian Dollar and these two currencies has not been fixed.

  On 2 September 1999, DFAT paid Australia's contribution to the OPCW 2000 budget. DFAT paid in Guilders without examining the Australian dollar cost of paying in Euros. When DFAT was advised of its payment obligation on 9 July 1999, it could have entered into a forward foreign exchange contract with the Reserve Bank of Australia to remove its exposure to exchange rate variations. At that time, the most cost-effective approach would have been to denominate the 2 September 1999 payment in Euros at an Australian dollar cost of $A631 944. This cost is $A48 890 (7.2 per cent) less than the cost of DFAT's 2 September 1999 Guilder payment meaning that potential savings were foregone by the Commonwealth.

- One of the options available in relation to DFAT's contributions to UNESCO is to pay Australia's French Franc component in either French Francs or Euros, with the French Franc amount converted into Euros at the rate of exchange irrevocably fixed on 1 January 1999. Analysis of the relevant forward foreign exchange rates would have revealed to DFAT that, by entering into a forward foreign exchange contract with the Reserve Bank, DFAT could have fixed the cost of its French Franc payment at an amount $A34 652 less than the equivalent Euros amount. Instead, DFAT maintained an open foreign exchange position and paid in French Francs without examining the merits of exercising the option of paying in Euros.[133]

5.23 ANAO considers that realising the potential savings from currency payment options in the future illustrates the benefits of obtaining professional advice and analytical support on contemporary financial risk management techniques. This advice can be a valuable input to the process of identifying and analysing risks and developing appropriate risk management strategies.

5.24 **Finding:** DFAT does not have an explicit policy on foreign exchange risk in relation to its stewardship of administered payments to international organisations. DFAT retains an open foreign exchange position on contributions, with exchange rate variations either reducing the cost against the budget or increasing the cost. Increased costs compared to the budget requires DFAT to seek additional funds either through the Additional Estimates process or the Advance to the Minister for Finance. Furthermore, DFAT has not taken advantage of risk-free currency options which would have enabled it to cost-effectively manage foreign exchange risk and reduce costs.

Recommendation No.13

5.25 ANAO *recommends* that DFAT develop an explicit foreign exchange risk management strategy for administered contributions to international organisations that:

(a) identifies all material exposures and existing currency options;

(b) analyses and quantifies cost savings that can be achieved from different approaches to managing foreign exchange risk, including savings from exercising currency options; and

(c) includes a payment plan for contributions to each international organisation that will enable DFAT to cost-effectively administer Australia's payment obligations for an acceptable level of risk exposure.

133 In this instance, payment (on the due date using spot exchange rates) in French Francs was the most cost-effective choice but, again, DFAT had not examined the alternative of Euros to assure itself that payment in French Francs was the most cost-effective approach.

Agencies responded to the recommendation as follows:

5.26 *Agree:* Treasury.

Agree with qualifications: DFAT

5.27 Specific comments by DFAT are set out below:

- **DFAT** considered that developing an explicit foreign exchange risk management strategy for administered appropriations is contingent upon:
  - (a) that an agreed whole-of-government framework for foreign exchange risk management is put in place, including on hedging activities; and
  - (b) that all costs associated with any centrally managed hedging action, including any losses, are funded through the appropriations for administered items.

6. Overseas Property Development

Introduction

6.1 The Property Group of the Department of Finance and Administration (DoFA) is responsible for managing the Commonwealth's non-Defence overseas property portfolio, most of which is owned rather than leased. As of 30 June 1999, the Commonwealth-owned overseas property managed by DoFA was valued at approximately $A1.3 billion. The overseas estate comprises office and residential accommodation for Australian diplomats and officials posted overseas.

6.2 The Department of Administrative Services (DAS) and the Department of Finance were reorganised in October 1997 to form DoFA. In recent years, DoFA has endeavoured to place the management of the overseas estate on a more commercial footing by, among other things, divesting ownership where it was assessed to be more cost-effective to rent.[134] In April 1999, the Government announced that it would be seeking to establish a strategic alliance with one or more private sector providers to manage the Commonwealth's $A2.8 billion non-Defence property portfolio, both domestic and overseas.[135] The Government's stated intention is to market test options with a view to outsourcing the property management, asset management, development management and portfolio management of the Commonwealth's domestic and overseas property assets. On 18 August 1999, the Minister for Finance and Administration announced the three shortlisted proponents that had been invited to respond to a Request for Tender.[136]

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134 Department of Finance and Administration, *Annual Report 1997–98*, pp. 34—35.

135 Minister for Finance and Administration, *Strategic Alliance for Management of Commonwealth Property*, Media Release 21/99, 12 April 1999.

136 Minister for Finance and Administration, *Commonwealth Property Strategic Alliance—Shortlist*, Media Release 43/99, 18 August 1999.

Washington Embassy refurbishment

6.3 The Property Group funds and manages overseas construction, refurbishment and fitout projects. The nature of these projects can be very different to similar projects in Australia because of different work standards, skills and resources available in some countries.[137] Overseas construction, refurbishment and fitout projects invariably give rise to significant foreign exchange exposures because of the need to procure materials locally and engage local contractors and consultants.

6.4 ANAO's audit examination focused on one overseas construction project; the refurbishment of the Washington Embassy which was completed in 1998–99.[138] The project involved a staged program of internal refurbishment to provide tenancy conditions which meet occupational health and safety requirements, replace outdated and obsolete equipment and provide office accommodation that would meet data and communication needs. Physical security protection was also to be improved.

Project budget

6.5 The refurbishment of the Washington Embassy was originally approved by the Parliamentary Public Works Committee in October 1995 with a preliminary cost estimate of $A16.0 million. The cost estimate was developed by the former Overseas Property Group (OPG) in DAS using a November 1994 spot exchange rate of $A1 = $US0.75.[139] The Committee's report noted that OPG was confident that the project could be completed within the cost estimate.[140] However, OPG did not assess the potential impact of exchange rate variations on the project budget or take any steps to manage this exposure. ANAO notes that exchange rates are highly volatile and, as the project was expected to have a duration of two years, it was unrealistic to assume that there would not be significant foreign exchange gains or losses. Accordingly, the basis for OPG's confidence that the budget would not be exceeded is unclear.

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[137] Audit Report No. 13 1992–93, *Department of Administrative Services—Overseas Property Group*, p. 70.

[138] Department of Finance and Administration, *Annual Report 1998–99*, p. 31.

[139] Parliamentary Standing Committee on Public Works, *Refurbishment of Australian Embassy, Washington*, Twenty-first report of 1995, 19 October 1995, p. 15, para. 65.

[140] *Ibid.* p.15, para 67.

6.6 In 1996, the Government reduced the budget for the Washington Embassy refurbishment to $A14.5 million. This budget was based on OPG's estimate of project costs of $US10.36 million. OPG applied a spot exchange rate of $A1 = $US0.714 to calculate the project budget of $A14.5 million.[141]

Project costs

6.7 To undertake the refurbishment, OPG let a number of contracts with American firms including an $US6.45 million contract for construction work. Accordingly, the project included substantial foreign currency exposures.

6.8 In April 1998, DoFA's project manager advised DoFA senior management that the Asian economic crisis and strong United States dollar had caused a substantial depreciation in the value of the Australian dollar compared to the United States dollar. The project manager noted that, at the budget exchange rate of $A1 = $US0.75, project costs would have been within budget but that at April 1998 spot exchange rates of $A1 = $US0.66 it was expected that costs would exceed the budget by up to $A1.1 million. The project manager recommended that the budget be increased by $A1.5 million to compensate for exchange rate variations to avoid the need to reduce the scope of works. DoFA's project manager also recommended that a mechanism be established for addressing exchange rate variations. The options canvassed were:

- a system by which gains from favourable exchange rate movements in some projects could be used to offset losses in other projects from unfavourable exchange rate movements;
- funding each individual overseas project in the currency required for making project payments (that is, a form of 'natural' hedging);
- funding the difference between the actual and budgeted exchange rates through supplementation arrangements similar to those available to DFAT and Defence; and
- improved market 'intelligence' in relation to exchange rates.

6.9 DoFA did not action the project manager's recommendations or take other possible steps to protect itself from any further depreciation in the exchange rate. For example, no consideration was given to the merits of hedging exposures through the Reserve Bank of Australia. Foreign exchange exposures can be managed in many ways such as forwards, swaps, options and currency revaluation clauses. However, none of these options was considered by DoFA.

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141 The project costs were reduced partly by deferring some items until a later stage when actual costs and exchange rates for required items were expected to be known.

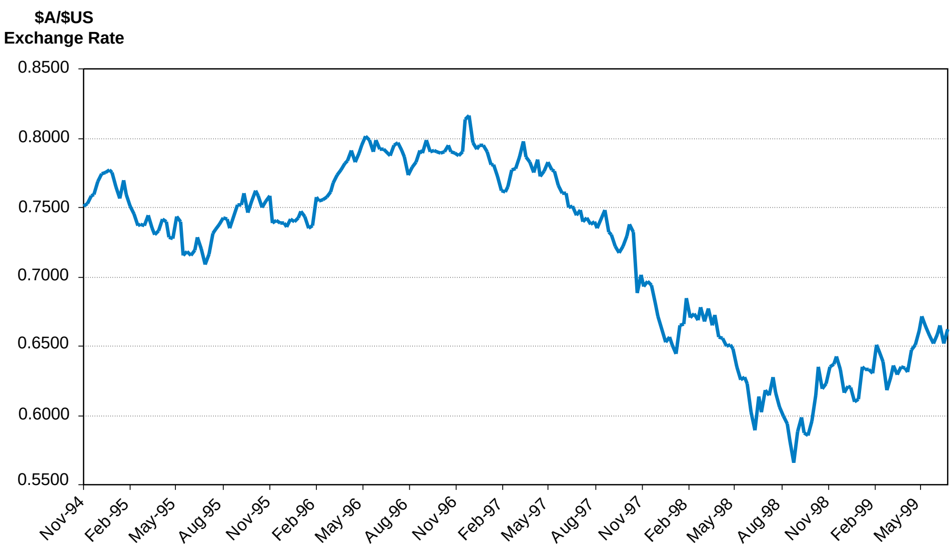
6.10 In June 1998, DoFA's project manager again raised the issue of exchange rate variations. The project manager noted that, since the April 1998 analysis, the exchange rate had depreciated further with costs expected to exceed budget by $A1.5 million. The project manager sought an increase of $A2.0 million to the project budget. Again, no action was taken by DoFA to either increase the budget or seek to manage exchange rate exposure on this project.

6.11 In August 1998, the project manager raised once more the issue of exchange rate variations. The project manager estimated that, applying August 1998 spot exchange rates to forecasted expenditure and taking into account costs to date, project costs would exceed the budget by $A2.0 million. On this occasion, an $A2.0 million increase to the project budget was approved. The total cost of the project, which was completed in 1998–99, was $A18.6 million comprising construction costs of approximately $A15 million with fees representing the balance.

6.12 Subsequent to the decision to increase the project budget by $A2.0 million because of the depreciation in the spot exchange rate, the spot exchange rate has improved (see Figure 6.1). However, DoFA did not reduce the budget to reflect the improved spot exchange rate. ANAO considers that increases in project budgets to reflect deteriorating exchange rates but leaving budgets unadjusted where exchange rates improve reduces incentives to identify, analyse and cost-effectively manage foreign exchange risk.

Figure 6.1

Australian Dollar/United States Dollar Spot Exchange Rate



Source: ANAO analysis of data from Oakvale Capital.

6.13 Finding: DoFA's overseas property developments, including construction activities, are undertaken mainly using foreign currencies resulting in significant foreign exchange exposures. Although DoFA is aware of the potential for adverse exchange rate movements to significantly increase project costs above budget, it has not developed and articulated a considered exposure management policy.

6.14 In relation to the Washington Embassy project, DoFA remained exposed to foreign exchange risk, even after it had identified that a depreciation in the Australian dollar had increased project costs well above budget. Eventually, the cost of the open foreign exchange position became so large that the project budget had to be increased by $2.0 million, or 14 per cent. Subsequent to the decision to increase the project budget by $A2.0 million, the spot exchange rate has improved. However, DoFA did not reduce the budget to reflect the improved exchange rate. ANAO considers that increases in project budgets to reflect deteriorating exchange rates but leaving budgets unadjusted where exchange rates improve is an opportunistic approach that reduces incentives to identify, analyse and cost-effectively manage foreign exchange risk.

Recommendation No.14

6.15 ANAO *recommends* that DoFA develop a considered foreign exchange risk management policy with explicit consideration given to:

(a) revising project budgeting processes to develop market-based estimates of likely project costs by using forward exchange rates; and

(b) the level of acceptable foreign exchange risk and how to manage this risk.

Agencies responded to the recommendation as follows:

6.16 *Agree:* DoFA and Treasury.

6.17 Specific comments by DoFA are set out below:

- **DoFA** noted that Finance Circular 2000/3 issued in May 2000 (see Appendix 1) stipulates that: agencies may incorporate foreign exchange impacts into estimates construction on the basis of exchange rate parameters issued by Treasury at the time budget estimates are finalised; and agencies have responsibility for managing foreign exchange risk within the constraints of their annual Budget allocations. DoFA stated that it has recently approved a policy for management of foreign exchange exposures that is consistent with Finance Circular 2000/3 and with advice received from professional treasury risk management advisers.

Private financing initiatives

6.18 As a general rule, the Commonwealth finances its property development activities on-budget and on-balance sheet. However, the then OPG adopted private financing initiatives for three overseas property developments as well as two domestic property developments (see Figure 6.2).

Figure 6.2

Private Financing of Property Developments

Project	*Financing Arrangements*	*Total Payments*
51 staff apartments in Bangkok, Thailand	12 annual instalment payments totalling $US27.628 million to be paid between November 1994 and November 2005. The construction cost for this project was $US12.759 million.	$A41.876m[142]
Australian Chancery in Geneva, Switzerland	8 annual instalments totalling $A28.800 million between November 1998 and November 2005. These payments relate to a construction contract with a value of CHF 14.680 million.	$A 28.800m
Six-storey complex of ten staff apartments in Shanghai, China	Five annual instalments totalling $A14.500 million between June 1998 and June 2002. The construction cost for this project was $A8.046 million.	$A14.500m
Flagstaff Building in Melbourne, Australia.	DoFA advised ANAO that the construction costs were $A100.800 million.	$A163.000m
Refurbishment of the Administrative Building (renamed the John Gorton Building), Canberra, Australia.	Twenty semi-annual instalments totalling $A79.400 million between June 1999 and December 2008. The construction cost for this contract was $A53.546 million.	$A79.400m
		$A327.576m

Source: ANAO analysis of DoFA data.

142 December 1999 Australian dollar estimate based on spot exchange rates for payments actually made between November 1994 and November 1999 and forward foreign exchange rates for payments due between November 2000 and November 2005.

6.19 The private financing arrangements were initially adopted for the construction of 51 apartments in Bangkok. In late 1995, this approach was refined[143] with the intention of adopting it for proposed projects in Geneva, Shanghai, Kuala Lumpur and Jakarta. The Geneva and Shanghai projects proceeded (Kuala Lumpur and Jakarta did not). Each of these privately financed overseas projects had the potential to involve significant foreign exchange risk exposures (see Figure 6.3). ANAO's audit examination focused on the Geneva chancery project and the management of its foreign exchange exposures.

Figure 6.3

Privately Financed Overseas Property Developments: Foreign Exchange Exposures

Project	*Contract Payments*	*Contract Receipts*
Bangkok apartments (1993)	Substantial open foreign exchange position with $US27.628 million to be paid between November 1994 and November 2005. Position was **not hedged**.	Open foreign exchange position that was **not covered**.
Geneva Chancery (1997)	Foreign exchange position on instalment payments **hedged** through a currency swap arrangement with the End Financier.	Open foreign exchange position that was **not covered** with the result that DoFA made a gain of $A1.33 million.
Shanghai apartments (1997)	Foreign exchange exposure **avoided** by specifying instalment payments in Australian dollars.	Foreign exchange exposure attempted to be **avoided** by specifying receipts in Australian dollars.

Source: ANAO analysis of DoFA data.

6.20 On 13 March 2000, DoFA advised ANAO that all the private financing initiatives referred to in Figure 6.2 were contracted by the DAS. DoFA advised that it inherited these arrangements, that it does not use such arrangements and has no intention of entering into such arrangements in the future.

143 The main difference from the Bangkok project was that it was proposed to procure, through a tender process, a major bank to act as End Financier for the projects rather than have the construction contractor arrange the long-term financing through its bank as occurred with the Bangkok project. OPG expected that this change would enable OPG to take full advantage of the Commonwealth's favourable credit rating in order to ensure the best possible interest rates for the long-term financing arrangement.

6.21 Finding: As a general rule, the Commonwealth finances its property development activities on-budget and on-balance sheet. However, private financing initiatives have been adopted for three overseas property developments as well as two domestic property developments with estimated total contract payments of $A328 million. Each of these privately financed overseas projects had the potential to involve significant foreign exchange risk exposures. DoFA's approach to these exposures differed markedly, with the inconsistent approaches reflecting the absence of a documented corporate policy on foreign exchange risk. DoFA has advised ANAO that it inherited these arrangements, that it does not use such arrangements and has no intention of entering into such arrangements in the future.

Geneva Chancery project

6.22 On 14 May 1997, DAS signed five contracts[144] in relation to the construction and financing of a new Chancery in Geneva, Switzerland to house the Australian diplomatic mission offices. The stated[145] objectives in relation to the funding of the Geneva project were to:

- pay for each new project by annual instalments over time in a manner which achieves budget neutrality;
- have the Construction Contractor bear most of the pre-completion risks, including critical risks in construction cost escalation, interest rate movement in relation to the construction funding, and currency fluctuations during construction;
- fix in advance the total project cost, including interest during construction;
- defer any payment by OPG until Practical Completion of construction during each project; and
- make any payment by OPG in relation to the project conditional upon Practical Completion of the project.

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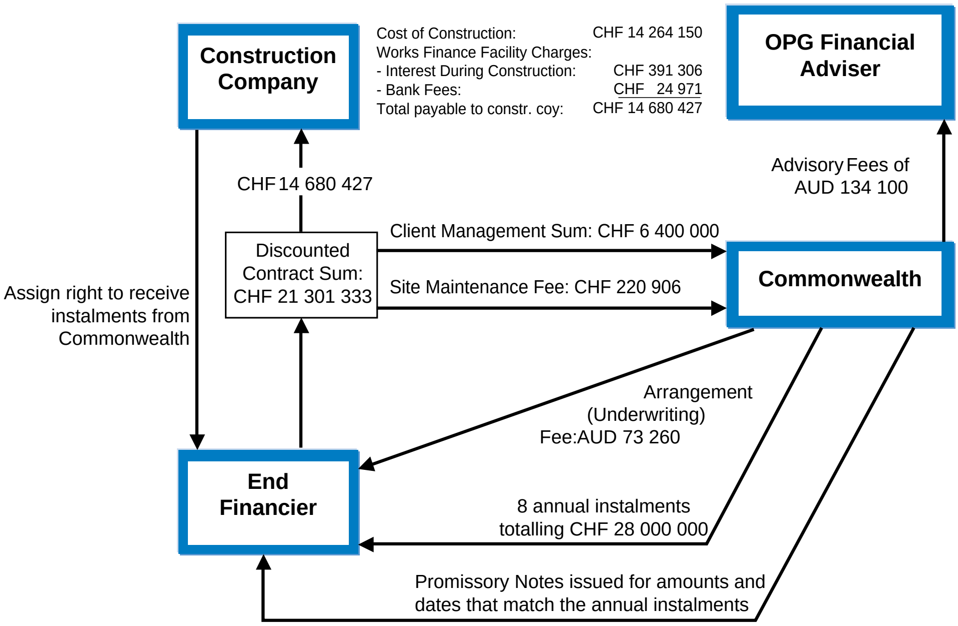
[144] Comprsing a Construction Contract with the Construction Company, a Formal Instrument of Agreement with the Construction Company, an Instalment Payment Deed with the Construction Company, a Deed of Assignment between with the Construction Company and the End Financier, and a Contract Support Deed with the End Financier.

[145] Overseas Property Group, Australian Department of Administrative Services, *Information Memorandum and Invitation for Offers by Financial Institutions in relation to the funding of Commonwealth Property Projects in Geneva, Switzerland; Kuala Lumpur, Malaysia; and Shanghai, China*, 31 May 1996, p. 7.

6.23 Under private financing arrangements, the Department organised long-term funding for the Geneva Chancery project (and, at the same time, another project in Shanghai, China) with the Commonwealth paying for the project through deferred instalments, payment of which commenced on completion of construction. Figure 6.4 summarises the arrangements for the Geneva project.

Figure 6.4

Geneva Chancery Project Financing Arrangements



Source: ANAO analysis of DoFA data. The Swiss Franc annual instalments were 'swapped' into Australian dollars at the time of contract signature.

6.24 The financing arrangements require the Construction Company to finance the construction until completion[146] with the End Financier financing the payment to the Construction Company on completion. In addition, the End Financier paid to DoFA in 1998 a Site Maintenance Fee and Client Management Sum (for DoFA's project management role). In return for the payment to the Construction Company and the cash payment to DoFA, DoFA pays 8 annual instalments to the End Financier. The end result is that the DoFA pays the End Financier for financing the payment of Construction Costs as well as a payment to DoFA.

[146] The price received by the builder is its cost of construction and the cost of financing the works (known as the Total Project Sum). The End Financier pays the builder the Discounted Contract Sum, which is the present value of the instalment payments. The Total Project Sum exceeds the Discounted Contract Sum by what is known as the Site Maintenance Fee. The Site Maintenance Fee is paid by the builder to OPG supposedly to reflect its costs of oversighting construction.

6.25 The financing arrangements adopted for the Geneva Chancery project were recommended to OPG by the Financial Adviser that had advised on OPG's original private financing project in Bangkok, Thailand.[147] In August 1995, this firm was asked by OPG to submit a proposal to act as Financial Adviser in relation to a proposed multi-project financing arrangement which the Adviser had recommended be used to fund new projects in Shanghai, Kuala Lumpur and Geneva.[148] OPG did not conduct a competitive tender or otherwise seek alternative proposals from other possible advisers. In addition, a contract was not signed for advice in relation to these projects. OPG agreed to fees of up to $A156 000 for advice on a funding facility for the proposed projects.

6.26 The private financing arrangements adopted for the Geneva project involved two loans: a loan to pay for construction of the building and an additional amount of CHF 6.62 million which was paid to DoFA in 1998. ANAO's strategic Financial Adviser advised ANAO that:

- in relation to the building loan, the financing arrangements adopted by OPG requires an **additional** $A4.02 million in cash payments compared to the Commonwealth's usual debt funding arrangements; and
- the additional borrowing of CHF 6.62 million for payment to DoFA resulted in a 45 per cent increase in the principal borrowed. Exchange rate movements aside, this would have significantly increased the additional costs of the arrangements compared to the Commonwealth's usual debt instruments. DoFA maintained an open position on these Swiss Franc receipts with a significant depreciation in the exchange rate reducing the additional financing costs. Nevertheless, DoFA's financing arrangements still cost the Commonwealth $A290 904 more than the Commonwealth's usual debt funding arrangements.

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147 The Financial Adviser was selected by the then OPG General Manager on the basis of his knowledge of suitable consultants with the necessary expertise. A tender was not conducted and alternative proposals were not sought as OPG considered that previous discussions with other possible providers had failed to identify any other suitable candidates. A consultancy contract was not prepared and signed. Instead, OPG indicated its acceptance of the Adviser's offer of services by signing the letter that offered these services to the Commonwealth. Fees of $A51 050 were paid and expenses of $A1891 reimbursed.

148 OPG did not examine alternative financing approaches to that recommended to it by the Bangkok Financial Adviser.

6.27 In August 1996, when OPG sought advice from Treasury on the evaluation of tenders from potential End Financiers, Treasury advised OPG that its proposal was likely to be significantly more expensive than on-budget funding. This is because Treasury can borrow at much more advantageous rates than are available through the commercial banking system. As it eventuated, the financing arrangements did prove to be significantly more expensive than the Commonwealth's usual debt financing arrangements with ANAO's Strategic Adviser calculating that the Commonwealth is, on average, overpaying interest by 36 basis points (0.36 per cent) per annum.[149] On 20 January 2000, DoFA advised ANAO that there is no evidence of other financing methods being evaluated, apart from funding from the Commonwealth Budget.

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[149] The general objective of private financing arrangements is to transfer risk from the public to the private sector and provide better value for money than can be achieved through public funding. In relation to risk allocation, ANAO's legal adviser informed ANAO that:

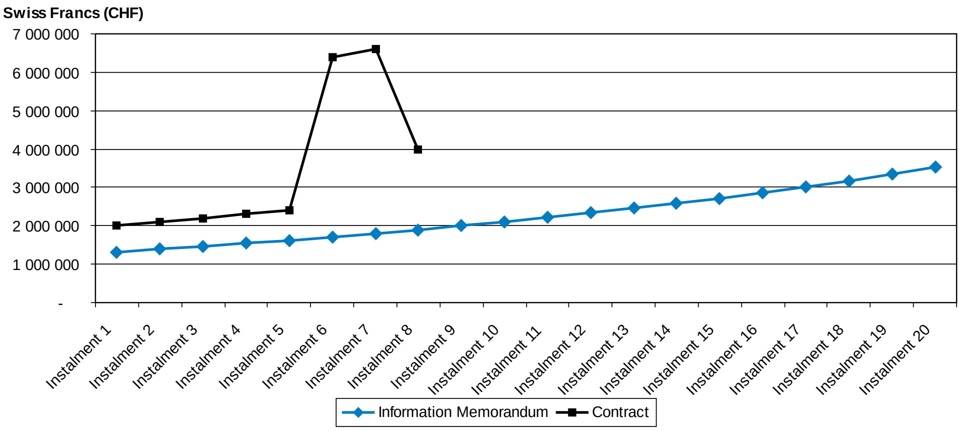
- the introduction of the End Financier uncoupled certain of the obligations owing between OPG and the builder which resulted in the loss of certain set-offs and deductions leading to an increase in the Commonwealth's risk position. For example: the Commonwealth's financial costs of any delays in construction may not have been fully addressed by the liquidated damages payable to the Commonwealth by the builder and the End Financier;
- the financing arrangements exposed OPG to counterparty credit risk in relation to the End Financier paying the Client Management Sum and Site Management Sum at completion and OPG's obligations to pay and receive money from the builder were independent of one another;
- the construction contract is expressed to be governed by Swiss law, whilst the remaining contractual documents (which purport to override and substitute obligations under the construction contract) are governed by Australian Capital Territory (ACT) law. However, OPG did not obtain Swiss legal advice to provide assurance that the ACT law provisions effectively operate to override the Swiss law provisions; and
- the layers of contracts also create potential opportunities for the End Financier to generate additional margins and/or profit and that these opportunities may not have arisen in a more simplified and streamlined arrangement. For example, ANAO's legal adviser noted that the End Financier may have made a credit spread profit from using a discount rate that was too high (the swap rate plus 0.08 per cent) for discounting what is, in effect, Commonwealth debt.

Budget neutrality

6.28 The financing objective of budget neutrality required that the *debt service related to the funding must not be greater than the recurring expense which OPG would have otherwise incurred in leasing alternative premises.*[150] The Information Memorandum issued to prospective End Financiers included instalment payments which OPG calculated to approximate the cash flow obligations which OPG would have otherwise incurred if it had continued to lease accommodation. However, as illustrated by Figure 6.5, the annual instalment payments specified in the financing arrangements for the Geneva project exceed OPG's estimate of the cost of leasing suitable premises, in some years by as much as much as 274 per cent. In addition, the instalment payments represent an unusual stream of lease payments: they rise by between 4.3 per cent and 5.0 per cent in the initial years before increasing by 167 per cent in year six. This is followed by a 3.1 per cent rise in year seven and a 39.4 per cent reduction in the final year.[151]

Figure 6.5

Geneva Chancery: Instalment Payment Arrangements



Source: ANAO analysis of DoFA data.

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[150] Overseas Property Group, Australian Department of Administrative Services, *Information Memorandum and Invitation for Offers by Financial Institutions in relation to the funding of Commonwealth Property Projects in Geneva, Switzerland; Kuala Lumpur, Malaysia; and Shanghai, China*, 31 May 1996, p. 4.

[151] The last repayment for the Shanghai project is in May 2002. DoFA advised ANAO that repayments increased significantly on the Geneva project in November 2003 due to an internal policy taken at the time to use the funds that would previously have repaid the instalments on the Shanghai project to pay off Geneva financing as quickly as possible. ANAO was advised that there is no documentation available to evidence the basis for the instalment payment stream.

6.29 The ability of OPG's financing arrangement to provide a budget-neutral source of financing was predicated on the Commonwealth's traditional cash-based budgeting system. This was because cash budgets and cash accounts only record a financial flow when cash is exchanged whereas accrual reporting recognises expenses and liabilities when they are incurred, whether or not cash is exchanged at this time.

6.30 The June 1996 report of the National Commission of Audit noted the Government's intention to present information in the budget papers on an accrual basis[152] and that the Parliament seeks a financial reporting and accountability framework that better reveals revenues, expenses, assets, liabilities and contingent liabilities of the Commonwealth Government.[153] The Commission concluded that an accrual accounting framework would provide the desired improvement in reporting as it separates the current and capital transactions of the budget and records expenses and receipts when they are incurred regardless of whether cash is exchanged. Accordingly, the Commission recommended that the Commonwealth adopt accrual principles as the basis for an integrated budgeting, resource management and financial reporting framework. In April 1997, one month prior to the signing of the Geneva Chancery financing documents, the Government announced its decision to adopt accrual budgeting.[154]

6.31 In relation to the Geneva project, adoption of accrual budgeting meant that the 1998–99 Commonwealth Budget would include $A28.8 million in contractual payments from DoFA to the End Financier between 1998–99 and 2005–06 for the construction of a building with a value of CHF 14.68 million ($A15.57 million at settlement date). In comparison, cash budgeting would have only included the $A2.1 million first instalment in the 1998–99 Commonwealth Budget. Accordingly, under an accrual budgeting framework, the Geneva financing arrangement would not provide budget neutral funding when compared to leasing of premises.

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152 See for example, J.W. Howard, *Coalition Policy Launch Statement*, 18 February 1996.

153 National Commission of Audit, *Report to the Commonwealth Government*, June 1996, pp. xix–xx.

154 Audit Report No. 38 1998–99, *Management of Commonwealth Budgetary Processes—Preliminary Study*, p.9, para. 2.

6.32 **Finding:** Under private financing arrangements, OPG organised long-term funding for the Geneva Chancery project which involved two loans: a loan to pay for construction of the building and an additional amount of CHF 6.62 million which was paid to DoFA in 1998. Similar arrangements have been adopted for a number of other projects in Australia and overseas. The cost of the financing arrangements adopted for the construction of a new Geneva Chancery were significantly greater than it would have cost to finance construction through the Commonwealth's usual debt financing arrangements. As a result, on average the Commonwealth is paying above its normal financing rates by 36 basis points (0.36 per cent) per annum on this project. In addition, the financing arrangements failed to achieve the objective of budget neutrality either under the Commonwealth's traditional cash-based budgeting system or the recently introduced accrual budgeting approach.

6.33 The inclusion of Swiss Franc receipts in the financing arrangements represented an arrangement whereby the Commonwealth has paid the End Financier to make a payment to DoFA. The cost to the Commonwealth of the private financing arrangements for the Geneva project would have been much greater but for the fact that OPG maintained an open foreign exchange position in relation to the payment from the End Financier. Excluding this payment to the Commonwealth, for which there appears to be no sound rationale, the financing arrangements adopted by OPG for the building required an additional $A4.02 million in cash payments compared to the Commonwealth's usual debt funding arrangements. Effectively, OPG paid $A134 000 to an adviser to convert what is basically a simple financing exercise into a complex arrangement which significantly increased the Commonwealth's exposure to currency movements.

Foreign currency payments

6.34 The Information Memorandum issued by OPG to potential End Financiers in May 1996 stated that the instalment payments for the Geneva project would be in Swiss Francs. The Information Memorandum did not seek proposals from potential End Financiers to hedge any foreign currency instalment payments. DoFA records made available to ANAO also do not indicate that any analysis was undertaken of the merits of hedging any foreign currency payments and receipts through the Reserve Bank.

6.35 On 14 May 1997, OPG awarded a construction contract to a Swiss contractor for the construction of the Geneva Chancery. The cost of the building was CHF 14 680 427, including the contractor's cost of financing construction. This amount was payable following practical completion of construction. The payment date was expected to be 17 November 1998.

6.36 The CHF 14 680 427 payment to the Swiss builder represented a direct foreign currency exposure. To finance this payment, OPG could have entered into a forward foreign exchange contract on 14 May 1997 to fix the Australian dollar cost of the 17 November 1998 payment to the Swiss builder. This would have converted the CHF 14 680 427 payment to an $A14 069 798 payment and removed all foreign exchange risk from the project financing. As a result, OPG would have been financing an Australian dollar borrowing with Australian dollar repayments.

6.37 OPG did not recognise this opportunity to minimise its foreign exchange exposure. Instead, OPG borrowed in Swiss Francs with a Swiss Franc instalment payment schedule to finance this Swiss Franc borrowing. Nevertheless, in late April 1997 OPG decided to try and minimise its exposure by 'swapping' the Commonwealth's Swiss Franc instalment payment obligations into Australian dollar amounts using forward foreign exchange rates supplied by the End Financier. Figure 6.6 outlines the Swiss Franc instalments and the relevant Australian dollar amounts that are specified in the Instalment Payment Deed signed by the parties on 14 May 1997. As exchange rates are quoted to four decimal places, the 'rounded' nature of the swap amounts raises questions about the swap arrangement.[155] DoFA advised ANAO that it is not clear as to which party proposed the currency swap arrangement and the source of the rates used is not known.

Figure 6.6

Geneva Chancery Project: Foreign Currency Swap Arrangements

Instalment	*Payment Date*	*CHF Amount*	*$A Amount*
1	17 Nov 1998	2,000,000	2,100,000
2	17 Nov 1999	2,100,000	2,200,000
3	17 Nov 2000	2,200,000	2,300,000
4	17 Nov 2001	2,300,000	2,300,000
5	17 Nov 2002	2,400,000	2,400,000
6	17 Nov 2003	6,400,000	6,500,000
7	17 Nov 2004	6,600,000	6,800,000
8	17 Nov 2005	4,000,000	4,200,000
Total		**28,000,000**	**28,800,000**

Source: ANAO analysis of DoFA data.

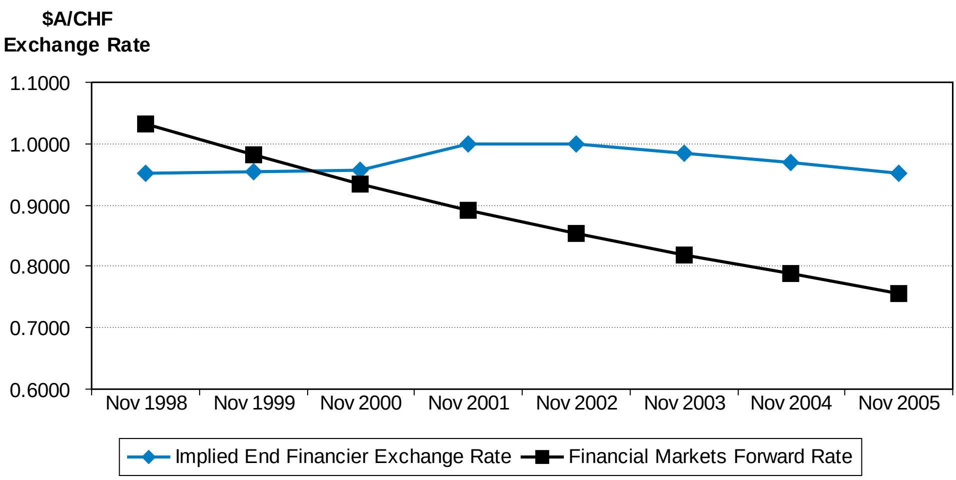
155 As the End Financier was an Australian based financial institution, it could have been expected that the Financier would have funded the Swiss Franc payment to the builder by purchasing Swiss Francs using Australian dollars. This would have resulted in an Australian dollar borrowing that OPG would need to finance. Accordingly, it is unclear why there was a need to swap Swiss Franc instalments into Australian dollar instalments as, presumably, the borrowing from the End Financier should have been denominated in Australian dollars. DoFA advised ANAO that the foreign exchange exposure could have been avoided as suggested by ANAO and that it is unclear why the borrowing was not denominated in Australian dollars.

6.38 Commonwealth agencies are required to undertake their foreign exchange hedging transactions with the Reserve Bank, unless the Bank agrees to selectively allow some hedging contracts to be sought directly from the financial markets. Where the Bank permits certain exposures to be hedged with other counterparties, it is important to ensure value for money by implementing appropriate trading controls including seeking quotes from a number of potential counterparties. This is an accepted element of sound risk management in commercial entities.

6.39 OPG entered into foreign exchange hedging arrangements with the End Financier without seeking the Reserve Bank's agreement. In addition, OPG did not ensure the rates it obtained were competitive market rates: it did not seek quotes from other counterparties and did not verify the rates offered by the End Financier to other sources of market data. Figure 6.7 highlights the significant differences between the forward foreign exchange rates available at the time from the financial markets[156] and the forward rates implied in OPG's swap arrangements. Not only do the outright rates differ markedly, whereas the forward points[157] from the financial markets were at a consistent discount to the spot rate, the implied forward rates from the End Financier were initially at a premium to the spot rate, then they were at parity and then at a discount.

Figure 6.7

Geneva Chancery: Forward Foreign Exchange Rates



Source: ANAO analysis of DoFA data and data from ANAO's Financial Adviser.

156 Provided to ANAO by its Financial Adviser using Reuters data.

157 Forward points are a numerical expression of the interest rate differentials and are added to or subtracted from the spot rate to determine the outright forward rate.

6.40 **Finding:** A significant and unnecessary foreign exchange risk existed in the instalment payments to be made by DoFA to the End Financier. This exposure could have been removed at the outset through a simple hedging contract between OPG and the Reserve Bank. OPG did not recognise this opportunity to minimise its foreign exchange exposure but borrowed in Swiss Francs with a Swiss Franc instalment payment schedule to finance this Swiss Franc borrowing.

6.41 OPG decided to try to minimise its exposure by 'swapping' the Commonwealth's Swiss Franc instalment payment obligations into Australian dollar amounts using forward foreign exchange rates supplied by the End Financier. In breach of Commonwealth policy, OPG took this action without seeking the agreement of the Reserve Bank, which has a mandate to provide foreign exchange hedging services to Commonwealth agencies. Furthermore, OPG did not ensure that it obtained competitive market rates with the rates obtained differing markedly from those available in the financial markets at the time. The lack of an audit trail leaves the Commonwealth open to the risk of receiving off-market and unnecessarily expensive rates.

Foreign currency receipts

6.42 An important aspect of sound management of foreign exchange risk is the adoption of a considered and consistent approach to managing risk. OPG's decision to hedge the Swiss Franc instalment payments through the End Financier was based on a policy position that the Commonwealth should not speculate on currency movements and a desire to minimise the risk of exchange rate movements increasing costs above budget. However, OPG ignored the significant foreign exchange exposure on the CHF 6.62 million in receipts from the End Financier. Of particular concern to ANAO was that, whilst DoFA records included analysis of the exposure on the payments, there are no records that indicate that DoFA was specifically aware of the significant exposure on the Swiss Franc receipts or that any consideration was given to hedging this exposure.

6.43 As it eventuated, the open foreign exchange position benefited the Commonwealth as the exchange rate depreciated thereby increasing the Australian dollar value of the receipts and reducing the cost to the Commonwealth of the financing arrangement by $A1.33 million. However, this outcome was the result of good fortune rather than sound risk management and, having regard to the significant variability in the Swiss Franc exchange rate over this period, the exposure could just as easily have increased Commonwealth costs. DoFA advised ANAO that no consideration was given to this exposure as OPG had no official foreign exchange policy at the time.

Funding irregularities

6.44 As illustrated by Figure 6.4, the financing arrangements included payment of CHF 6.62 million by the End Financier to DoFA. This amount comprised a Client Management Sum of CHF 6.40 million and a Site Maintenance Sum of CHF 220 906. The effect of this part of the arrangements was that DoFA paid the End Financier to finance payments to DoFA. This increased the amount raised by 45 per cent.

6.45 According to the contractual documents, the Client Management Sum represents an amount on account of costs and expenses incurred by OPG for design fees, ongoing project costs, management and development costs whereas the Site Maintenance Sum is supposed to represent OPG's costs of oversighting construction. ANAO notes that, if the Client Management Sum was to have been used to pay Swiss Franc costs and expenses, it may have made sense to receive these payments from the End Financier in Swiss Francs. This would have provided a natural hedge to the Swiss Franc payments. However, the timing of the receipt[158] and its payment in an Australian dollar equivalent indicates that the funds were <u>not</u> to be used to fund the Commonwealth's design, project management, development and construction oversight costs during the construction period. DoFA was unable to provide ANAO with records that would explain the rationale for this aspect of the transaction, and in particular the purpose of the Client Management Sum and the Site Maintenance Fee.

6.46 Timely collection and deposit of receipts assists the efficient management of the Commonwealth's financial resources. The amount of CHF 6.62 million was due to be received by the Commonwealth on 24 November 1998. Had this occurred, DoFA would have received $A7.68 million. However, the payment was not received from the End Financier on the due date. DoFA records made available to ANAO by DoFA do not indicate that DoFA identified the non-payment or that DoFA took any action to pursue payment. DoFA advised ANAO that it is unable to provide any records that evidence that DoFA identified non-payment and pursued payment.

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158 The Request For Tender issued to potential End Financiers stated that the first instalment of the Client Management Sum was payable after contract execution. However, the contractual documentation signed on 14 May 1997 specified that the Client Management Sum was to be paid after practical completion.

6.47 On 15 December 1998, the End Financier paid DoFA $A7.99 million. In this instance the delay actually benefited DoFA by $A308 772 because the exchange rate depreciated. However, ANAO notes that this financial benefit was also not the result of sound risk management as the exchange rate could have appreciated, resulting in a financial loss to the Commonwealth from the delay in payment by the End Financier. There is no evidence that DoFA examined whether the delay had, in fact, benefited or disadvantaged the Commonwealth. ANAO considers that any such analysis should have included an assessment of the benefits/ costs of delay, the additional risk associated with delay and what steps DoFA could take to ensure the Commonwealth did not bear any additional costs. DoFA advised ANAO that no consideration was given to exposure analysis of the Swiss Franc receipts as DoFA had no official foreign exchange policy at the time.

6.48 Upon receipt, the Australian dollar equivalent ($A7.99 million) of the CHF 6.62 million was deposited into DoFA's Collectors Receipts Account. However, the amount deposited was $A2585 less than the amount that should have been deposited.[159] DoFA advised ANAO on 13 March 2000 that this shortfall was due to a miscalculation on the End Financier's part and that it has approached the End Financier for payment of the sum of $A2585.

6.49 On 25 January 1999, the $A7.99 million amount was transferred to another DoFA bank account. DoFA advised ANAO that the purpose of the transfer was to *absorb the Supplementary Sum into the DoFA pool account* and that, as far as can be ascertained, these funds were absorbed into DoFA consolidated funds. If this is the case, then this aspect of the transaction has the following financial implications for the Commonwealth:

- the amount raised by DoFA was increased by 45 per cent;
- the funds raised by this aspect of the transaction were to be used to pay for DoFA's design fees, ongoing project costs, management and development costs and cost of oversighting construction. However, the funds raised were received after these costs were incurred and were not applied for these purposes; and
- the administration of the receipt of $A7.99 million was deficient, with no evidence of DoFA identifying non-payment and pursuing payment or of DoFA ensuring the correct amount was received.

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[159] The electronic funds transfer states that CHF 6 620 906 was deposited at an exchange rate of $A1 = CHF0.8285. At this exchange rate, the amount payable to the Commonwealth was $A7 991 438. This is $A2585 less than the amount actually deposited into the Commonwealth's bank account ($A7 988 853).

6.50 On this basis, ANAO could not determine a sound commercial rationale for this aspect of the transaction. DoFA did not receive funds from the private sector financier until after the project had been completed and therefore the funds raised could not have been applied by DoFA to their stated purpose. The audit scope did not include a complete examination of all DoFA expenditure on managing the overseas property estate and DoFA has been unable to advise ANAO as to the use of these funds. Information provided by DoFA to ANAO indicates that DoFA raised funds in a similar manner in two other private financing transactions, taking the aggregate raised in this manner from private financiers to more than $A15 million.

6.51 **Finding:** An inconsistent approach to foreign exchange risk has been reflected in overseas property developments. In the Geneva Chancery project, a significant foreign exchange exposure to CHF 6.62 million in receipts was maintained over an eighteen month period although foreign currency payments in this project had been hedged. In addition, whilst foreign currency payments in the Geneva project were hedged, an open foreign exchange position has been maintained in relation to foreign currency payments on the Bangkok project. Yet another approach was adopted for the Shanghai project where all foreign exchange risk was avoided by specifying all cash flows in Australian dollars.

6.52 The open foreign exchange position on foreign currency receipts maintained in the Geneva project benefited the Commonwealth as the exchange rate depreciated. However, this outcome was the result of good fortune rather than sound risk management and the exposure could just as easily have increased Commonwealth costs. Furthermore, the administration of the revenue receipt was deficient: the End Financier did not pay DoFA on the due date; there is no evidence of DoFA pursuing payment and the amount finally received was less than it should have been.

6.53 The funds raised by DoFA from its End Financier were to be used to pay for DoFA's design fees, ongoing project costs, management and development costs and cost of oversighting construction. However, these funds were received after these costs were incurred and were not applied for these purposes. This aspect of the transaction increased the amount raised by OPG by 45 per cent. ANAO can see no sound commercial rationale for this aspect of the transaction. Information provided by DoFA to ANAO indicates that DoFA raised funds in a similar manner in two other private financing transactions, taking the aggregate raised in this manner from private financiers to more than $A15 million.

Recommendation No.15

6.54 ANAO *recommends* that, where foreign exchange risks arise in future projects, DoFA:

(a) adopt a consistent approach to cost-effectively manage financial risks;

(b) improve its financial administration practices to ensure that payments are made and received promptly in order to protect the Commonwealth's financial interests; and

(c) appropriately account for the receipt and disbursement of Commonwealth financial resources.

Agencies responded to the recommendation as follows:

6.55 ***Agree:*** DoFA and Treasury.

6.56 Specific comments by DoFA are set out below:

- **DoFA** commented that different arrangements (particularly with regard to large-scale property development projects) and different currencies may require different management actions. The fact that the same foreign exchange risk management action was not applied to different transactions does not mean that an inconsistent approach is being applied. DoFA advised that it has implemented procedures to ensure that all foreign exchange payments are made within DoFA's standard terms, that all receipts are banked promptly and that all receipts and disbursements are appropriately accounted for.

Debt issuance

6.57 As a result of recent budget surpluses, the Commonwealth has not needed to borrow funds from the capital markets since 1996–97. Nevertheless, the Commonwealth has retained a modest debt issuance program above the budget funding requirement in order to: maintain a liquid and efficient domestic market for Commonwealth debt securities; refinance maturing debt; and meet short-term cash deficits which occur during the year.[160]

6.58 Consistent with the Government's objective of reducing Commonwealth general government net debt through ongoing budget surpluses and asset sales proceeds, the Department of the Treasury has been repurchasing significant quantities of Commonwealth Treasury Bonds, the Commonwealth's major debt instrument.[161] Treasury Bonds

[160] See further in Audit Report No. 14 1999–2000, *Commonwealth Debt Management*, pp. 66–81.

[161] *Ibid.*

are the premier risk-free debt instrument in the Australian market, with the Treasury yield curve used as a pricing benchmark.[162] At the same time as Treasury has been reducing its debt issuance and repurchasing outstanding debt, OPG was entering into contractual arrangements that increased Commonwealth indebtedness through its private financing arrangements.

6.59 According to DoFA records, the assignment of instalment payments to the End Financier as part of the financing arangements for the Geneva Chancery and Shanghai apartments projects was necessary to comply with a legal impediment to Commonwealth departments other than the Department of the Treasury entering directly into borrowings. Legal advice to OPG was that the assignment of the instalments to the End Financier meant that the financing arrangement did not constitute a borrowing for the purposes of the *Audit Act 1901* because the financial institution was not providing funds directly to the Commonwealth for construction of the project. Rather, the arrangements were concluded to represent deferred payments under a construction contract.

6.60 To ensure that the financing arrangements did not constitute a borrowing by DoFA, they were designed to create a long-term funding liability that was not in the nature of a direct borrowing by DoFA. However, this did not mean that the arrangements do not represent a Commonwealth debt;[163] for example, they were considered a borrowing for Loan Council purposes and are classified as a loan in DoFA's 1998–99 Financial Statements.[164]

6.61 **Finding:** At the same time as Treasury has been reducing its debt issuance and repurchasing outstanding debt, OPG has been entering into contractual arrangements that increased Commonwealth indebtedness through its private financing arrangements. The financing arrangements represent a financial liability, reflected by the contractual requirement to make annual instalment payments to its private financier.

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162 *Ibid*, pp. 35–36.

163 On this point, legal advice to OPG dated 28 August 1996 was that: '*on balance, there is no "borrowing" in the strict sense because the instalments are not a repayment of a sum advance but are a pre-determined contract price for the construction of a building. I believe that the intent of OPG was that the arrangement would be approved by the Department of Treasury and the Department of Finance. This advice and previous advisings have related to the ordinary legal meaning of the term "borrowing". If there are other policy or accounting considerations which are relevant to the approval or sanctioning of the arrangements by the relevant Departments, these should be ascertained and discussed with them.*

164 Department of Finance and Administration, *1998–99 Annual Report*, Financial Statements for the year ended 30 June 1999, Note 12d—Other debt—Agency, p. 170.

Promissory Notes

6.62 OPG was required by its contract with the End Financier to issue Australian dollar Promissory Notes to the End Financier in order to secure the Commonwealth's obligation to pay instalments to the End Financier. The Promissory Notes were issued on the credit of the Commonwealth for amounts and dates that matched the instalments to be paid to the End Financier. The End Financier is able to trade or assign as security the Promissory Notes.[165] The End Financier is required to act as collection agent on the Promissory Notes at no cost to the Commonwealth. ANAO understands that similar arrangements were adopted for all the private financing arrangements which would have resulted in some $A328 million in Promissory Notes having been issued (see Figure 6.2).

6.63 On 17 December 1999, ANAO sought advice from DoFA on the total number and value of Promissory Notes issued and the number and value of Promissory Notes that remain outstanding. On 13 March 2000, DoFA advised ANAO that records were only able to be obtained of issued Promissory Notes for three of the five projects, namely: the Bangkok apartments; the Geneva Chancery; and the Flagstaff Building in Melbourne.[166] Furthermore, DoFA advised that the only project that payment could be confirmed was in relation to the Geneva Chancery.

6.64 Promissory Notes are a financial instrument that involves an unconditional promise to pay a sum of money at a specified future time to a specified person or the bearer.[167] Unlike the Commonwealth's major debt instruments,[168] there are no specific legislative requirements governing the issue of Promissory Notes by agencies covered by the

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165 A feature of promissory notes is their marketability, especially where (as in this case) they bear the name of a trading bank as acceptor.

166 Audit Report No.6 1996–97, *Commonwealth Guarantees, Indemnities and Letters of Comfort*, noted (page 42, para 5.13) the problems that can arise when financial documentation is inadequately controlled. In this case, an agency had misplaced Promissory Notes which had been provided to the Commonwealth under a purchasing agreement.

167 *Bills of Exchange Act 1909*, Section 89.

168 The Commonwealth's major domestic debt instruments are Treasury Bonds and Treasury Notes, which are issued as stock under the *Commonwealth Inscribed Stock Act 1911*, in accordance with prospectuses issued by the Treasurer under this Act. Source: Audit Report No. 14 1999–2000, *Commonwealth Debt Management*, pp. 35 and 41.

Financial Management and Accountability Act. In this respect, Minter Ellison advised ANAO that:

> *Because the issuing of promissory notes by the Commonwealth is not to be regarded as a borrowing, it is not subject to the limitations contained in sections 37 and 38 of the Financial Management and Accountability Act.*[169] *Those provisions have no application to the raising of money by means of the issuing of commercial bills or promissory notes. That conclusion may seem to expose a gap in the Financial Management and Accountability Act.*[170]
>
> *We note that in another jurisdiction, namely the Australian Capital Territory, the relevant legislation is more comprehensive [as it] defines 'borrowing' as including the raising of money or the obtaining of credit, whether by dealing in securities or otherwise. 'Securities' is defined as including promissory notes, bills of exchange and other securities. The extended definition of borrowing is then picked up, [requiring] that the ACT may only borrow in accordance with the Financial Management Act of the Territory or another law of the Territory which confers on the Treasurer the power to borrow money on behalf of the Territory.*

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169 Section 37 of the Financial Management and Accountability Act provides that an agreement for the borrowing of money by the Commonwealth is of no effect unless the borrowing is authorised by an Act. Section 38 of this Act provides that the Finance Minister may, on behalf of the Commonwealth, enter into certain short term borrowing agreements with banks or other financial institutions. The borrowings authorised under the section require repayments to be made within 90 days or 60 days.

170 The Joint Committee of Public Accounts and Audit is currently conducting an inquiry into the Financial Management and Accountability Act and the *Commonwealth Authorities and Companies Act 1997* to determine, among other things, whether the legislation has met its aims, accountability to Parliament has been maintained under the conditions of increased devolution to agencies and whether there should be consistency with similar legislation in the States.

6.65 In the case of the Geneva Chancery project, Promissory Notes totalling $A28.8 million were issued by DoFA on DoFA letterhead and authorised by a DoFA Branch Head under former Finance Regulation 44A, although this Regulation had been repealed as a result of the repeal of the Audit Act.[171] These instruments were not individually numbered and DoFA has no systems in place to account for the issuance, safe custody and collection of Promissory Notes that have been issued on the credit of the Commonwealth. ANAO considers that, having regard to the rights and obligations Promissory Notes represent, sound administrative practice would involve each Note being individually identified and accountability arrangements implemented that would include: the establishment of a register of Notes and their status; retention of a copy of all Notes on issue; appropriate cancellation procedures; and safe custody arrangements for Note stationery.

6.66 **Finding:** Promissory Notes are a financial instrument that involves an unconditional promise to pay a sum of money at a specified future time to a specified person or the bearer. Unlike the Commonwealth's major debt instruments, there are no specific legislative requirements governing the issue of Promissory Notes by agencies. Of note is that the provisions of the Financial Management and Accountability Act relating to Commonwealth borrowings have no application to the raising of money by means of the issuing of commercial bills or promissory notes. ANAO notes that the ACT Government has covered this issue effectively in its financial management legislation.

6.67 DoFA's private financing arrangements have resulted in more than $A328 million in Promissory Notes being issued. However, procedures for the issuance, collection and safe custody of these instruments have not been developed or documented. ANAO considers that, having regard to the rights and obligations Promissory Notes represent, sound administrative practice would involve each Note being individually identified and accountability arrangements implemented that would include: the establishment of a register of Notes and their status; retention of a copy of all Notes on issue; appropriate cancellation procedures; and safe custody arrangements for Note stationery.

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171 Financial Regulation 44A related to the approval of proposals to spend public moneys. The Promissory Notes were also signed by the OPG Project Manager under former Finance Regulation 44B, which related to entering into commitments to spend public moneys.

Recommendation No.16

6.68 ANAO *recommends* that DoFA:

(a) in consultation with the Treasury, review the current governance arrangements for the issue of debt and like instruments on the public credit of the Commonwealth in order to ensure a consistent approach is adopted that promotes value for money and appropriate public accountability; and

(b) in consultation with Treasury, review the current governance arrangements for the issue of debt and like instruments such as Promissory Notes on the public credit of the Commonwealth in order to ensure a consistent approach is adopted that promotes effective stewardship of Commonwealth resources and public accountability.

Agencies responded to the recommendation as follows:

6.69 ***Agree:*** AOFM and DoFA.

Agree with qualifications: Treasury

6.70 Specific comments by agencies are set out below:

- **AOFM** noted that, under the Administrative Arrangements Order, Treasury has responsibility for *borrowing money on the public credit of the Commonwealth*. The recommended review will need to consider how the current deficiencies in governance arrangements are best addressed – whether through amendment of the *Commonwealth Inscribed Stock Act 1911* (Treasury/AOFM responsibility) or through the Financial Management and Accountability Act (DoFA responsibility). Having two separate legislative references to 'borrowings' can result in inconsistencies. Moreover, unless uniformity is achieved, there may be potential for credit providers to arbitrage between debt issued under the Commonwealth Inscribed Stock Act and pseudo-borrowing arrangements under the Financial Management Accountability Act, such as the issue of promissory notes, finance/ operating leases or sale and lease-back arrangements.
- **DoFA** noted that the recommendation was made in the light of past practices in debt issuance by OPG. All private financing initiatives referred to were contracted by the former DAS. DoFA reiterated that it inherited these arrangements, that it does not use such arrangements and has no intention of entering into such arrangements in the future. DoFA undertook, in conjunction with Treasury, to consider a wider review of the issue of debt and the development of appropriate guidelines.

- **Treasury's** agreement was predicated on the grounds that: standard debt management issues, which are the responsibility of the AOFM, should be outside the scope of the recommended review of governance arrangements; and that the review might look at proscribing other forms of borrowing such as promissory notes other than where their issue is specifically provided for under legislation (such as in the case of international financial institutions). The rationale for Treasury's proposition was that it could see no justification for borrowing outside of standard debt issuance as Treasury considers standard debt issuance will always provide a more satisfactory financial outcome for the Commonwealth. Treasury commented that the evidence suggests that other forms of borrowing (such as promissory notes and financial leases) are used mainly as a device for avoiding budgetary constraints.

Canberra ACT
31 May 2000

P. J. Barrett
Auditor-General

Appendix

Appendix 1

Finance Circular 2000/3: Budget Framework for the Management of Foreign Exchange (FOREX) Exposure

To All Departments of State, Parliamentary Departments and Prescribed Agencies

Introduction

This Circular notifies agencies which come within the scope of the *Financial Management and Accountability Act 1997* (FMA Act) of their responsibilities and opportunities for managing FOREX exposure.

Key Points:

- An agency's FOREX exposure may be incorporated into estimates construction on the basis of exchange rate parameters issued by Treasury at the time the budget estimates are finalised.
- Agencies have responsibility for managing FOREX risk within the constraints of their annual Budget allocations.
- In consultation with the Reserve Bank of Australia (RBA), FMA agencies may enter hedging arrangements with the RBA or a private sector provider to protect against exchange rate movements for their FOREX transactions.

Definitions:

Foreign exchange rate: the price of an Australian dollar expressed in terms of another currency.

Foreign exchange rate exposure: this is the exposure to movements up or down in the price of the Australian dollar relative to the price of another currency in which a fixed financial obligation is expressed (eg under contract).

Foreign exchange spot rate: is the market rate for the exchange of one currency against another for settlement in two business days time.

Foreign exchange forward rate: is the market rate for the exchange of one currency against another for settlement at a future date or a span of future dates.

Foreign exchange forward contracts: represent an obligation on one party to purchase foreign exchange at a predetermined rate and date (or range of dates) by the transfer of value in the $A equivalent to effect that purchase.

A *foreign exchange payment* involves three mechanisms:

- *purchase* – which is the exchange of $A for the foreign currency at the spot rate;
- *delivery* – which is the transfer of a payment or payment instruction in the foreign currency;
- *settlement* – which is the final discharge of obligations between the parties in respect of the foreign currency purchased.

Budget Issues:

1. Except for a limited number of agency specific arrangements, foreign exchange risks have traditionally been borne by agencies. The changed arrangements outlined in these Guidelines apply immediately to all agencies not currently covered by budget funded FOREX guarantees. Where such guarantees currently exist, the relevant Agency Advice Unit contacts will discuss transitional arrangements to move agencies away from these guarantees.

2. The key principle of the arrangements for the management of FOREX exposure is that these arrangements will be budget neutral.

3. In terms of estimates and appropriation management the following arrangements will apply:

- All resourcing to agencies from the Budget will be provided through appropriations in Australian dollars.
- Where payments are made or revenue is received in foreign currency terms, the actual level of resourcing may be calculated taking into account the impact of exchange rates, subject to the normal agreement of costings by the Agency Advice Unit.
- The exchange rates to be used will be the relevant Treasury parameter ***at the time the budget estimates are finalised***.

FOREX Under Agency Banking

4. From 1 July 1999, the transactional banking services provided by the Reserve Bank of Australia (RBA) were opened to competition with the private sector. The Government decided that from 1 July 1999 the RBA would continue to directly service major foreign currency transactions on behalf of agencies financially part of "the Commonwealth" but that agencies could seek competitive provision of FOREX to the maximum extent consistent with the Bank's continued ability to attain exchange rate management objectives. Within this framework the delivery (and settlement) of FOREX payments overseas is contestable. The Finance Minister's banking delegations to Chief Executives require consultation with the RBA which gives the RBA some choice over whether it purchases the foreign currency and delivers payments on behalf of the agency, only purchases foreign currency, or allows the agency to arrange the purchase and delivery through an alternative provider. This may be in respect of an individual payment or (more likely) as part of a standing arrangement or threshold.

5. Similar competitive arrangements operate with respect to forward contracts for the purchase of foreign exchange such as may be entered into by agencies for hedging purposes. These contracts may be authorised by Ministers in accordance with their inherent executive powers under the Constitution.

Managing FOREX—Role of the RBA

6. The RBA is involved in exchange rate management as part of its exercise of monetary policy as a central bank and undertakes market operations in foreign exchange on behalf of the Commonwealth. The Commonwealth has a large volume of FOREX transactions each year, mostly reflecting foreign currency payments associated with purchases of defence equipment and payment by (or through) the Department of Foreign Affairs and Trade. In the past, the RBA has undertaken these transactions on behalf of the Commonwealth by passing them through directly to the market or drawing on their FOREX reserves.

7. Under the agency banking arrangements effective from 1 July 1999, agencies are required to consult with the RBA International Department (Mr Mike Sinclair on (02) 9551 8420) in relation to the handling of FOREX transactions. This includes hedging transactions.[1]

8. Following consultation with the RBA International Department, an agency may choose to seek hedging contracts directly from the market. This will depend on the value of an agency's transactions and the particular currencies involved.

- The primary consideration for the RBA International Department will be any potential for the agency's FOREX purchases to undermine the market operations undertaken by the Bank in pursuance of its exchange rate management role.

[1] Part A-6 of the *"Agency Banking Framework – Guidance Manual"* and the Finance Minister's banking delegations to Chief Executives (Finance Circular 1999/1) refers.

9. The RBA has advised that where the RBA International Department handles the FOREX transactions for an agency:

- hedging activities will be managed within the normal foreign currency services. This hedging will be undertaken using basic forward FOREX contracts;
- it may decide to provide hedging cover on a transaction by transaction basis where settlement dates are known to agencies. It may also provide general cover for a total amount of foreign currency over a given period, potentially up to a full year;
- agencies will only be able to set up hedging transactions for an individual underlying payment/receipt once in a fiscal year.
- In the event that commitments or timing of payments/receipts change during the year, the RBA can adjust forward FOREX contracts to meet the changes but reductions in hedges would need to be closed out at the then current market rate. This could result in a cost or benefit to the agency depending on exchange rate movements over the intervening period.

10. It is not envisaged that agencies would be able to "trade" into and out of hedging transactions for particular commitments.

Further information:

This guidance material will be incorporated into the Department's *Agency Banking – Guidance Manual*.

Financial Framework Branch
Department of Finance and Administration
May 2000

Attachment

How does Hedging Work?

Forward FOREX rates contain two elements:

Current Spot Rate plus *Forward (or swap) Margin*.

An outright forward FOREX transaction replicates what would otherwise be done through cash and spot FOREX markets. For example, an agency wished to hedge FOREX risk of US dollar payments expected to be made over the next 12 months, it could:

- (theoretically) draw down the budget allocation immediately. This would be equivalent to borrowing Australian dollars for 12 months at the current market rate of (say) 5.2%;
- sell the Australian dollars on the spot market at the current rate (say 0.66 for a US dollar);
- invest the US dollars for 12 months at the current US deposit rate for 1 year (say 5.65% pa); and
- At the end of twelve months, or at intervening periods, draw on the US dollar deposit to meet US dollar payments.

This eliminates the exchange rate risk, but also earns the difference between the US deposit and the opportunity cost of investing in Australia (so if the current cash rate in Australia is 5.2%, the return is 0.45% pa).

The Forward Margin is equivalent to the interest rate differential between the two currencies for the relevant maturity, expressed in exchange rate points. This interest differential is the forward margin available for hedging. When local interest rates are lower than the overseas rates, as in the example above, there is a discount for those buying FOREX to avoid foreign exchange exposure. On the other hand, exporters or those receiving foreign exchange pay a premium for their forward sales of US dollars because they give up the high interest rate currency.

Banks cover their forward positions initially by offsetting differing customer interests but with any net positions they would need to actually undertake the physical transactions outlined above. In quoting forward rates, banks price off these physical transactions.

The following illustrates the calculation of the forward rate:

$A1,515,151.15	@	0.6600 *[Spot Rate]*	=	**US$1,000,000**

$1,515,151.15 borrowed at 5.2% pa on 365 day basis = $78,787.88 interest paid		$1,000,000 invested at 5.65% pa on 360 day basis = $57,284.72 interest received
$1,515,151.10 + $78,787.88 = $1,593,939.03	0.663316 *[Forward Rate]*	$1,000,000 + $57,284.72 = $1,057,284.72

Forward Rate = $1,057,284.72 divided by $1,593,939.03 = 0.663316
Forward Margin = 0.663316 minus 0.6600 = 0.003316

Forward contract for US$1 million = $1,000,000 X 0.663316 (*forward rate*) = A$1,507,577.08 = A$7,574.43 less than the equivalent spot transaction.

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