

The Auditor-General
Audit Report No.63 2001-02
Performance Audit

Management of the DASFLEET Tied Contract

Australian National Audit Office

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of Australia 2002

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Canberra ACT
27 June 2002

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a 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 *Management of the DASFLEET Tied Contract*.

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

A handwritten signature in black ink, appearing to read 'P. J. Barrett'.

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

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Abbreviations/Glossary

ALS	Asset and Liability Statement
ANAO	Australian National Audit Office
BSTA	Business Services Trust Account
CALS	Completion Asset and Liability Statement
CPA	Commonwealth Public Account
DAS	Former Department of Administrative Services
Finance	Department of Finance and Administration
FMA Act	Financial and Management Accountability Act 1997
FMB	Fleet Monitoring Body
JCPAA	Joint Committee of Public Accounts and Audit
Macquarie Bank	Macquarie Bank Limited
Macquarie Fleet	Macquarie Fleet Leasing Pty Limited
OASACS	Former Office of Asset Sales and Commercial Support
OASITO	Former Office of Asset Sales and IT Outsourcing
RBA	Reserve Bank of Australia
RRF	Residual Risk Fee
RV	Residual Value

Summary and Key Findings

Summary

Background

1. The Government announced in the August 1996 Budget its intention to realise the Commonwealth's investment in the vehicles then owned and managed by the former Department of Administrative Services (DAS) Business Unit, DASFLEET. The Government indicated this would be accomplished either by a trade sale of the whole business or by external refinancing of the vehicles. Sale and refinancing tender processes were conducted in tandem by the then Office of Asset Sales¹ and its Business Adviser.
2. On June 1997, the then Office of Asset Sales asked the Minister for Finance, on the basis of the Business Advisers' advice, to endorse its recommendation that DASFLEET be sold rather than refinanced and that final negotiations should be pursued with one party, Macquarie Bank Limited (Macquarie Bank). The then Minister accepted the recommendation. Following further negotiations with Macquarie Bank, OASACS provided a brief to the then Minister on 30 June 1997 asking him to agree to sell DASFLEET to Macquarie Fleet Leasing Pty Ltd (Macquarie Fleet), a wholly owned subsidiary of Macquarie Bank, for \$407.9 million and to agree to the Commonwealth entering a Tied Contract with Macquarie Fleet for the provision of leased cars and fleet management services to the Commonwealth for 5 years. OASACS' 30 June 1997 brief also advised the then Minister that OASACS' Business Adviser had said 'we believe that the transaction reflects an appropriate balance between achieving what is an attractive purchase price for the Commonwealth and mitigating the commercial risks of claims under the contract.'
3. On 17 July 1997, a sale agreement was signed between the Commonwealth and Macquarie Fleet for the sale of DASFLEET for \$407.9 million. However under the sale agreement the sale price was subject to adjustment once completion accounts for DASFLEET at the point of sale had been finalised. On 1 September 1997, the five-year Tied Contract for vehicle leasing and fleet

¹ The DASFLEET transaction was managed by the then Office of Asset Sales. The Office of Asset Sales (OAS) was established in October 1996 to manage the Commonwealth Government's major asset sales and it reported directly to the Minister for Finance. In November 1997, information technology outsourcing functions formerly managed by the then Office of Government Information Technology transferred to OAS, which became the Office of Asset Sales and IT Outsourcing (OASITO). On 1 July 2001, following a change in Government policy on the approach to outsourcing of IT, the agency became known as the Office of Asset Sales and Commercial Support (OASACS) and is referred to as OASACS throughout this report. OASACS continued as a separate agency in the Finance and Administration portfolio until after the settlement of the DASFLEET commercial disputes. On 26 November 2001, as a result of changes to the Administrative Arrangements Orders, this role was re-assumed by the Department of Finance and Administration.

management services was also signed between the parties. The Tied Contract with Macquarie Fleet was a finance lease at the whole of Government level and an operating lease at agency level.² Each vehicle leased under this Tied Contract was the subject of a separate operating lease and individual Commonwealth agencies were responsible for managing these operating leases. This audit's focus is on the monitoring and management by Finance of the Tied Contract with Macquarie Fleet and not on the management of the operating leases that individual Commonwealth agencies have with DASFLEET.

4. A number of commercial disputes arose out of the 1997 sale of DASFLEET to Macquarie Fleet and the operation of the five-year Tied Contract with Macquarie Fleet. These commercial disputes were the subject of substantial negotiation between the Commonwealth and Macquarie Fleet and an independent arbitration process.

Audit scope

5. By the time the 1998 ANAO audit of the DASFLEET sale process had been completed, the Commonwealth was already in dispute with Macquarie Fleet in relation to the Sale Agreement and it was clear that Finance was also encountering difficulties in monitoring Macquarie Fleet's performance of the Tied Contract and in managing the Commonwealth's financial exposure under this contract. Macquarie Fleet advised ANAO in May 2002 in response to a draft report on this audit that 'the FMB [Fleet Monitoring Body] was of the view that there were substantial problems with reporting and monitoring of [Macquarie Fleet's] performance. [Macquarie Fleet's] view was always that it complied with its contractual obligations under the Tied Contract.'

6. It was in the above context that the ANAO included a performance audit of the management of the DASFLEET Tied Contract in its 1999–2000 Audit Work Program. However, commencement of the audit was delayed pending the resolution of the various disputes relating to the DASFLEET transaction. The disputes having been finally settled on 5 July 2001, the audit commenced in August 2001.

7. The objectives of the current audit were to:

- assess the administrative and financial effectiveness of Finance's management of the Commonwealth's exposure under the DASFLEET Tied Contract;

² See Hansard Joint Committee of Public Accounts and Audit *Review of Auditor-General's reports third and fourth quarters 1998-99* Friday, 13 August 1999.

- assess the effectiveness of Finance’s monitoring of performance of the DASFLEET Tied Contract with Macquarie Fleet; and
 - review the action taken by Finance in response to the recommendation of Audit Report No.25 1998–99, *DASFLEET Sale*, that Finance, in consultation with relevant Commonwealth agencies, undertake a comprehensive risk assessment of the Commonwealth’s exposure under the Tied Contract.
8. The scope of the audit did not extend to auditing the management of the Amended Tied Contract with Lease Plan Australia that commenced on 5 July 2001. Accordingly, the audit coverage was of specific past events and the lessons to be learned from these were largely identified by Finance during the course of the Tied Contract with Macquarie Fleet and the negotiation of the settlement of the commercial disputes. Finance implemented these lessons learned, as far as was possible in the circumstances, in the negotiation of the Amended Tied Contract with Lease Plan Australia. In this circumstance, the audit report does not include any recommendations.

Overall conclusions

9. A series of complex commercial disputes arising out of the 1997 sale of DASFLEET were resolved by the parties in July 2001. During the Tied Contract, Commonwealth Public Account (CPA) agencies made payments totalling some \$191 million to Macquarie Fleet. Throughout the course of the Tied Contract with Macquarie Fleet, Finance was not in a position to be able to effectively monitor Macquarie Fleet’s performance under the Contract, or to effectively manage the Commonwealth’s exposure under the Contract. This situation developed because almost immediately after the commencement of the Tied Contract serious issues arose in relation to operation of the Contract and the completion statements for the Sale Agreement. As a result, commercial disputes between the Commonwealth and Macquarie Fleet arose in relation to both the Tied Contract and the Sale Agreement for DASFLEET.
10. The whole of dispute settlement process completed by Finance for the disputes with Macquarie Fleet/Macquarie Bank in relation to both the DASFLEET Sale Agreement and DASFLEET Tied Contract:
- involved significantly lower outlays by the Commonwealth to Macquarie Fleet in settlement of the disputes than had been sought by Macquarie Fleet at various points or would have been payable if the Arbitrator’s interim award was implemented;
 - provided the ability to arrange an orderly transfer of the Tied Contract away from Macquarie Fleet in the first instance to Lease Plan Australia

and then to a more competitive service delivery model at the end of the shortened Amended Tied Contract with Lease Plan Australia;

- transferred residual risk from the Commonwealth to Lease Plan Australia as the vehicle lessor for vehicles leased after the commencement of the Amended Tied Contract, at the cost of an additional 50 basis points for Lease Plan Australia's margin compared to that of Macquarie Fleet;
- generated various operational improvements through amendment of the Tied Contract particularly in relation to improved reporting to Finance and agencies, specific audit provisions, improved dispute resolution provisions, and the establishment of minimum performance criteria; and
- reduced ongoing fleet management costs.

11. Under the whole of dispute settlement, several payments were made between the parties. Macquarie Fleet paid \$2.503 million to the Commonwealth in respect of the Completion Asset and Liability Statement. Finance paid Macquarie Fleet \$1.73 million to purchase, as required under the Sale Agreement, outstanding uncollected DASFLEET book debts transferred on sale. In addition, Finance transferred \$14.65 million (\$12.067 million plus interest) to Macquarie Fleet for deposit in the Reserve Account in satisfaction of a 9 March 1998 Agreement³ between Macquarie Fleet and Finance. In settlement of the disputes, Finance paid Macquarie Fleet \$15.7 million and Macquarie Fleet paid Finance \$8 million. The funds for the payments made by Finance in settlement of the DASFLEET disputes were not separately appropriated by the Parliament. Finance obtained legal advice from the Australian Government Solicitor in October 2000 that these amounts could be paid from the standing appropriation relating to the Business Services Trust Account (BSTA). The \$8 million settlement payment from Macquarie Fleet was also paid into the BSTA.

12. During the course of the arbitration and negotiation of the disputes on the DASFLEET Tied Contract with Macquarie Fleet it became clear that the relevant Commonwealth agencies (OASACS and Finance) and Macquarie Fleet had very different conceptions of the basis of the contractual arrangement. As

³ The 9 March 1998 agreement between Finance and Macquarie Fleet was that, in order to forestall an otherwise large increase in the deficit of the Reserve Account and consequential Residual Risk Fees payable by agencies as part of their lease payments, the Commonwealth would deposit into the Reserve Account the amount necessary to cover the write down in the value of the existing DASFLEET vehicles transferred to Macquarie Fleet between the Asset and Liability Statement as at January 1997 and the completion of the sale on 31 August 1997. Although the substance of this matter was not in dispute, the correct amount payable in satisfaction of the 9 March 1998 agreement could not be determined until the correct amounts for all the components of the Completion Asset and Liabilities Statement (CALs) were finally agreed between Finance's and Macquarie Fleet's expert advisers in February 2001. The final amount was reviewed by ANAO on 6 June 2001 prior to Finance arranging for the payment to Macquarie Fleet of \$14.655 million (\$12.067 million plus interest) by electronic funds transfer on 22 June 2001. This amount was then off-set against the Reserve Account balance.

the Commonwealth understood the deal, it considered it had undertaken a sale of the DASFLEET business for \$407.9 million, including its assets, and separately entered into a contract with Macquarie Fleet for the supply of vehicles and fleet management services. Macquarie Fleet's view of the transaction was that it had purchased the DASFLEET business for some \$15 million and that the remaining \$392.9 million related to the refinancing of the vehicles in a sale and leaseback transaction with the Commonwealth.⁴ The financing by Macquarie Fleet of the Commonwealth vehicle fleet was at a higher interest rate than the Commonwealth could have financed the transaction using Treasury Notes.

13. Finance sought extensive legal, commercial and other expert advice to inform its strategy in relation to the disputes and in terms of developing future options for the Commonwealth for the supply of vehicles and fleet management services. Finance advised ANAO that the total external provider costs for the management of the Tied Contract and the disputes on it and the Sale Agreement totalled more than \$9.6 million to 31 October 2001, including nearly \$7 million for professional advice. Finance advised ANAO that its estimate of the total staff costs (excluding OASACS costs) for managing the Tied Contract and the DASFLEET disputes between August 1997 and October 2001 was \$1.5 million. However, given the overwhelming affect of the disputes on the management of the Tied Contract, Finance advised it was unable to determine accurately the amount of these costs that related to the management of the disputes and the amount incurred for the normal contract management activities required.

14. Audit Report No.25 1998–99, *DASFLEET Sale*, recommended that Finance, in consultation with relevant Commonwealth agencies, undertake a comprehensive commercial risk assessment of the Commonwealth's exposure under the Tied Contract with Macquarie Fleet. Finance agreed with the recommendation and advised ANAO that it had already commissioned such a review from a commercial adviser, which was due to be completed in late December 1998. The final draft of this review was provided to Finance in February 1999 but was never finalised as events had overtaken it.

15. There are lessons to be learnt from the commercial disputes arising from the Tied Contract with Macquarie Fleet and the successful efforts to resolve the disputes. These were generally implemented by Finance in negotiating the whole of dispute settlement and the Amended Tied Contract with Lease Plan Australia and include the:

⁴ Finance advised ANAO in April 2002 that 'Finance's view of the transaction is as it was in 1997, that the Commonwealth sold a business to Macquarie Bank for \$407 million. The Arbitrator's Interim Award was not appealed due to settlement of the dispute. It would be incorrect to interpret this as an acceptance by the Commonwealth of Macquarie's views, assertions and interpretations.'

- need to ensure, as far as possible, that the Commonwealth's understanding of the contractual arrangements which are being entered into accords with that of the other party's;
- importance of agreeing performance standards to be achieved by the contractor prior to finalisation of the contract;
- need to ensure that reporting requirements are also specified and agreed as part of the development of the contract;
- importance of ensuring the contract includes comprehensive audit provisions for the Commonwealth;
- benefits of including in the contract specified penalties for non-achievement of performance standards and for non-compliance with reporting requirements;
- desirability of requesting Ministers to execute an instrument authorising Commonwealth officers to settle material commercial disputes; and
- benefits of engaging a qualified Probity Adviser to assist agencies in resolving material commercial disputes.

Key Findings

Commonwealth exposures

16. The Commonwealth considered that in disposing of DASFLEET it had engaged in a trade sale of the DASFLEET business together with a five year Tied Contract for the provision of vehicles leasing and fleet management services to CPA agencies. The alternative of externally refinancing the fleet had been specifically explored and rejected. However, during the arbitration process for the DASFLEET Sale Agreement and Tied Contract disputes, it became clear that, contrary to the Commonwealth's view, Macquarie Bank had bid for DASFLEET on the basis that some \$150 million of the total price tendered was for the purchase of the business and the remaining \$392.9 million related to the sale and lease-back of the vehicle fleet.⁵

17. Macquarie Fleet argued that the only return to it was to be the interest margin charged on the individual leases with the risk borne by the Commonwealth in relation to the vehicles under the Tied Contract. Macquarie Fleet's evidence to the arbitration was that it:

regarded the transaction from a financial perspective as a loan and therefore if we didn't receive back all the moneys that we were advancing, part of which would be through the Reserve Account mechanism, then that would be, you know, we wouldn't be getting part of our principal back.⁶

18. In the course of the arbitration process, and in light of the Arbitrator's October 2000 Interim Award, it became clear that, through the operation of the residual risk management mechanism, the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract with Macquarie Fleet.

19. The operation of the DASFLEET Tied Contract with Macquarie Fleet was an external refinancing of the Commonwealth's fleet. Commonwealth agencies, as part of the leasing rates for the individual vehicles, paid a finance charge to Macquarie Fleet that was 45 basis points⁷ above the relevant bank bill rate in order to fund this refinancing. Had the Commonwealth funded the financing of the fleet itself, the financing cost would have been equivalent to the 5-week Treasury Note rate.

⁵ Finance advised ANAO in April 2002 that 'Finance's view of the transaction is as it was in 1997, that the Commonwealth sold a business to Macquarie Bank for \$407 million. The Arbitrator's Interim Award was not appealed due to settlement of the dispute. It would be incorrect to interpret this as an acceptance by the Commonwealth of Macquarie's views, assertions and interpretations.'

⁶ Testimony provided by Macquarie Fleet to the arbitration of the DASFLEET disputes.

⁷ A basis point is a one hundredth of a percentage point.

20. During the period of the Tied Contract, the relevant bank bill rate was on average some 22 basis points higher than the 5-week Treasury Note rate. The total interest rate payable under the Contract (that is the relevant bank bill rate plus Macquarie Fleet's margin of 45 basis points) was on average some 67 basis points higher than the 5-week Treasury note rate. In October 1998, Finance was advised that the value of 10 basis points on the fleet as it then stood was around \$275 000 per annum. Using this estimate, the difference between the Commonwealth funding the refinancing of the vehicle fleet itself compared to refinancing it through the Tied Contract with Macquarie Fleet was around \$1.8 million per annum or some \$6.9 million over the total life of the Tied Contract (1 September 1997 to 4 July 2001).

Risk weighting

21. The DASFLEET Tied Contract with Macquarie Fleet specifically required the Commonwealth to bear the risk associated with any decision of the prudential regulator (initially the Reserve Bank of Australia (RBA)) to assess a different capital adequacy requirement for the DASFLEET transaction to the 10 per cent requirement assumed by Macquarie Fleet in its bid for DASFLEET.⁸ This was not a requirement of any of the other bidders for DASFLEET.

22. Macquarie Fleet claimed in September 1997 that a 100 per cent risk weighting would require an increase in its margin of 150 basis points. The additional costs such a margin increase could have resulted in were up to \$25.7 million (nominal dollars) over the Contract's life. It was only after OASACS made a joint submission with Macquarie Fleet to the RBA in April 1998, arguing that the transaction was a finance lease, that the RBA agreed in June 1998 that a 10 per cent risk weighting would apply to individual leases entered into under the Tied Contract with Macquarie Fleet and which were to expire before the Tied Contract matured. However, for vehicle leases that were to expire beyond that date, the RBA considered that a 100 per cent risk weighting would apply. Accordingly, under this assessment by the RBA, the Commonwealth remained exposed to an increase in Macquarie Fleet's margin for those vehicle leases due to expire after 31 August 2002.

23. In June 2000, it came to Finance's attention that the risk weighting for government loan risk and, accordingly, the leases entered into under the Tied Contract with Macquarie Fleet and expiring before 1 September 2002, had been adjusted in the last quarter of 1998 from 10 per cent to zero. Macquarie Fleet's advice in August 2000 in response to Finance's queries about this issue confirmed that the risk weighting for these leases had reduced to zero but that Macquarie

⁸ At that time, the RBA's capital adequacy guidelines allowed assets of a bank which represent government risk to be risk weighted at 10 per cent for capital adequacy purposes

Fleet had not been required under the Tied Contract to notify Finance of this because there had been no change in Macquarie Fleet's costs (that is, they had not decreased as a result of the change in the risk weighting). Macquarie Fleet advised that Macquarie Bank did not currently charge group companies for capital usage although it might in the future. Macquarie Fleet also noted that although there were then a number of leases on its books with a maturity post 1 September 2002, and that the number of these would increase significantly post 1 September 2000, there were currently no increased costs for Macquarie Fleet. Therefore there was no Adjustment Event requiring notification of the Commonwealth, because Macquarie Bank was not currently charging for capital usage. Macquarie Fleet stated that it expected the Commonwealth to be better off as a result of these facts. This issue was not separately resolved. Finance advised ANAO that it was one of the issues identified for inclusion in the whole of dispute settlement negotiations.

Invoicing errors

24. The November 1999 audit report commissioned by Finance noted that Price Risk Margins had been charged in error to customers by Macquarie Fleet. The Price Risk Margin had been part of DASFLEET's pricing methodology before its sale. The margin, calculated at 1 per cent of the vehicle purchase price (as held in DASFLEET's reference database) was incorrectly added to the opening Vehicle Principle Outstanding of the vehicles and resulted in an increased lease rate to the customer. In March 2002, Finance advised ANAO that the error in charging the 1 per cent Price Risk Margin was originally raised by Finance in August 1998. Macquarie Fleet subsequently confirmed this in writing in November and December 1998 and stated that affected customers should be credited the amounts that had been charged in error. In May 1999, Macquarie Fleet's estimate of the total effect of the error was \$483 000. The matter was then included in the audit of Macquarie Fleet records commissioned by Finance. However, the auditors stated in their audit report that they had not audited DASFLEET's calculation because the errors in the underlying systems limited the accuracy and reliability of any calculation.

25. Finance also advised ANAO that, as a result of the November 1999 audit report it had commissioned, another accounting firm acting for Macquarie Fleet undertook a further quantification of this error, as well as considering other issues associated with errors in lease payment and the balance of the Reserve Account as at 31 December 1999. The result of these processes was that a cheque was received by Finance from Macquarie Fleet in May 2000 for \$1.64 million for invoicing errors, including \$894 259 for the Price Risk Margin Issue.

Contractual disputes

26. The sale of DASFLEET to Macquarie Fleet was based on an Asset and Liability Statement as at January 1997. Under the Sale Agreement, the purchase price for the DASFLEET business was subject to adjustment following the preparation of a Completion Asset and Liability Statement (CALs).⁹ The Commonwealth had asserted that Macquarie Fleet owed \$6.771 million by way of the CALs post-sale adjustment; Macquarie Fleet claimed it was owed \$28 million. After the Arbitrator's Interim Award, the amount owed to the Commonwealth reduced to approximately \$1.938 million plus interest (total amount finally calculated as \$2.503 million). The reduction related to errors identified in the preparation of the CALs.

27. Part of the total amount claimed by Macquarie Fleet related to the write down of the CPA fleet from book value to the recoverable amount. This amount was subsequently found to be covered by a 9 March 1998 agreement between Finance and Macquarie Fleet. The 9 March 1998 agreement was that, in order to forestall an otherwise large increase in the deficit of the Reserve Account and consequential Residual Risk Fees payable by agencies as part of their lease payments, the Commonwealth would deposit in the Reserve Account the amount necessary to cover the write down in the value of the existing DASFLEET vehicles transferred to Macquarie Fleet between the Asset and Liability Statement as at January 1997 and the completion of the sale on 31 August 1997. However although not in dispute, this amount was withheld by the Commonwealth until the other disputes were resolved and the data for the calculation of the correct amount payable could be confirmed. The correct amount payable could not be determined until the correct amounts for all the components of the Completion Asset and Liabilities Statement (CALs) were finally agreed between Finance's and Macquarie Fleet's expert advisers in February 2001. The final amount was reviewed by ANAO on 6 June 2001 prior to Finance arranging to pay \$14.655 million (\$12.067 million plus interest) by electronic funds transfer on 22 June 2001. This amount was then offset against the Reserve Account balance.

⁹ Schedule 2 to the Sale Agreement provided in Clauses 8, 9 and 10 under the heading 'Relevant Assets and Liabilities' that any difference between the parties over the CALs may be referred for resolution in accordance with Clause 25 of the Sale Agreement and that otherwise, after deducting any additional depreciation or amortisation of assets between the date of the A&L Statement (ALS) and the date of completion, the Commonwealth would compensate Macquarie if the net value of the assets disclosed in the CALs was less than that disclosed in the ALS and that Macquarie would compensate the Commonwealth if the converse occurred.

Tied Contract disputes

28. While negotiations were proceeding with Macquarie Fleet in relation to the Sale Agreement dispute and the establishment of an arbitration process for that dispute, the Fleet Monitoring Body (FMB) in Finance continued to encounter significant difficulties in attempting to manage and monitor the Tied Contract. By 23 March 1999, the issues involved had become sufficiently substantial to warrant the lodgement by Finance of a Notice of Dispute under Clause 29 of the Tied Contract.

Purchase price of vehicles

29. The first Tied Contract dispute related to an ambiguity in the Tied Contract in regard to the definition of the purchase price of the vehicles owned by DASFLEET and on lease to CPA agencies at the point of sale of the business to Macquarie Fleet. The definitions set out in the Tied Contract did not make it clear what, for the purposes of the Contract, was the purchase price of vehicles on lease to CPA customers at the time of sale (the so-called Tombstone Fleet). Finance and OASACS contended that it was the price paid by the Commonwealth when it bought the vehicles from the manufacturer. Macquarie Fleet asserted that it was the price it had paid for the vehicles when purchasing DASFLEET from the Commonwealth. The Commonwealth's intention in executing the Tied Contract was that the former would apply. Macquarie Fleet argued that the terms of the Tied Contract provided that the later was correct.

30. Macquarie Fleet's calculation of the purchase price of the vehicles included some \$27 million that the Commonwealth considered Macquarie Fleet had paid as goodwill (that is an amount over and above the value of the net assets) in order to win the tender process for DASFLEET. Macquarie Fleet originally argued that the full amount of \$27 million should be allocated to CPA vehicles. However, it subsequently changed its position and allocated some \$10.1 million to non-CPA vehicles and \$16.9 million was allocated to CPA vehicles.

31. The determination of the purchase price of the CPA Tombstone Fleet was of concern because under the terms of the Tied Contract, losses (or profits) on CPA vehicles disposed of at the end of a lease are held in the Reserve Account. If Macquarie Fleet's purchase price was used (including the \$16.9 million premium allocated to CPA vehicles) a significantly greater loss on disposal of Tombstone Fleet vehicles resulted, generating a greater loss in the Reserve Account. Losses in the Reserve Account were recoverable from the Commonwealth through the payment of RRFs.

32. The Arbitrator's decision on the definition of the purchase price of the Tombstone Fleet vehicles was that he agreed Macquarie Fleet was permitted to allocate across the Tombstone Fleet some \$27 million of what the Commonwealth

had considered to be a \$34.9 million premium offered by Macquarie Fleet over the net assets of the DASFLEET business. Of the total of \$27 million, some \$10.1 million was allocated to non-CPA vehicles and \$16.9 million was allocated to CPA vehicles. The \$16.9 million allocated to CPA vehicles could then be recovered through the operation of the RRFs and the Reserve Account. Consequently, applying the Arbitrator's Interim Award, the purchase price of the CPA Tombstone Fleet vehicles was approximately \$16.9 million more than the Commonwealth had believed it to be. As a result, the deficit in the Reserve Account was also \$16.9 million larger than the Commonwealth had initially understood it to be.

Calculation of Residual Risk Fees

33. Under the Tied Contract, RRFs were payable monthly by CPA customers on each lease entered into under the Tied Contract with Macquarie Fleet (that is on vehicles other than the Tombstone Fleet). The RRFs collected on each lease are paid into the Reserve Account. They were designed to protect against the possibility of a negative balance in the Reserve Account at the end of the Tied Contract. The larger the negative balance in the Reserve Account, the larger the RRFs charged on each new vehicle lease.

34. Macquarie Fleet's final offer for DASFLEET estimated the RRF at \$20 per vehicle per month and this was the amount charged for RRFs on commencement of the Tied Contract on 1 September 1997. However, once the Tied Contract commenced on 1 September 1997, the applicable RRF was required to be derived from the application of the statistical formula set out in the Tied Contract.

35. On 26 September 1997, Macquarie Fleet notified the Fleet Monitoring Body that it intended to increase RRFs from \$20 per vehicle per month to \$101 per vehicle per month. The Fleet Monitoring Body sought the validation of such a substantial increase in the RRFs. It eventually became clear that the Commonwealth and Macquarie Fleet did not agree on the operation of the formula set out in the Tied Contract for the determination of RRFs under the terms of the Contract. The differing interpretations of the formula by the Commonwealth and Macquarie Fleet resulted in differing RRF payments applicable to new leases.

36. Under the Commonwealth's interpretation, the Reserve Account should have gradually trended to a zero balance by the end of the last leases entered into under the Contract (the bulk of which were expected to expire two years after the end of the five year Tied Contract). Under Macquarie Fleet's interpretation, the account would have trended to a figure that, at the end of the Tied Contract term (that is 31 August 2002), would have included a monetary buffer sufficient to ensure a 99 per cent probability of Macquarie Fleet not making

a loss when the last Tied Contract vehicle was sold. This balance would ensure that at the end of a two-year run off period there would still be enough money in the Reserve Account to cover any potential losses on sales of vehicles.

37. Macquarie Fleet argued that it was entitled to charge RRFs sufficient to create such a buffer, estimated in June 2001 at \$18.6 million. This effectively would have constituted a loan to Macquarie Fleet. To recoup any amount of this loan outstanding after the expiry of the five-year term of the Tied Contract, the Commonwealth would have been required to use the Voluntary Early Termination provisions of the Contract.

38. Application of the October 2000 Interim Award would have involved the Commonwealth funding an estimated \$18.6 million for the statistical buffer and what was estimated at the time to be a \$20 million deficit in the Reserve Account. This would have been over and above the some \$12.067 million (plus interest) the Commonwealth had previously agreed to pay into the Reserve Account on 9 March 1998. The Commonwealth would have had to fund these amounts either through direct payments into the Reserve Account, or through extremely high RRFs paid by agencies (of more than \$230 per month on each new lease entered into under the Tied Contract).

Provision of information to Finance

39. The Tied Contract required Macquarie Fleet to provide regular reports and information to enable the FMB to monitor performance of Macquarie Fleet's obligations under the Tied Contract. In lodging its dispute in relation to the Tied Contract, Finance was of the view that Macquarie Fleet had not provided reports or information that were sufficient or accurate enough for the FMB to monitor Macquarie Fleet's performance. In addition, there was evidence that many of the invoices provided to agencies were also inaccurate.

40. In June 1999, Finance, with Macquarie Fleet's agreement, commissioned an accounting firm to undertake an audit of Macquarie Fleet's records to provide Finance with a report on the reliability of system controls and the accuracy and completeness of the information provided to Finance by Macquarie Fleet since the sale date. The audit was initiated in the context of progressing the resolution of the disputes, and in light of Finance's concerns about the quality of the information provided to it by Macquarie Fleet under the terms of the Contract. The audit was completed in November 1999.

41. There were a number of issues in the arbitration which were not decided by the Arbitrator's Interim Award, including the existence and amount of any damages payable by Macquarie Fleet for alleged breaches of the Tied Contract (in relation to the provision of information) and whether or not the Commonwealth's Notices to Rectify were valid.

Whole of dispute settlement

42. As a result of the arbitration process and the Interim Award, the total potential exposure of the Commonwealth to possible payments to Macquarie Fleet was reduced from the around \$100 million originally claimed by Macquarie Fleet to around \$50 million. Various attempts at negotiating a resolution of the DASFLEET matter had occurred over the course of the disputes, most significantly between June 2000 and the 26 October 2000 handing down of the Interim Award. However, when a settlement could not be secured prior to the Arbitrator's decision on the Interim Award, both parties withdrew all settlement offers. Negotiations were recommenced between the parties in early November 2000.

43. On 3 February 2001, the then Minister approved the 'whole of dispute' settlement framework approach subject to substantial improvements being obtained in the settlement offer from Macquarie Fleet and Finance obtaining comprehensive legal advice to underpin any view that a commercially sound settlement had been arrived at. Finance was engaged in strenuous negotiations with Macquarie Fleet until late May 2001. Offers and counter-offers were exchanged between the parties. At the same time, Finance commissioned substantial expert advice from its advisers to inform it on the legal, commercial and financial consequences of not only the proposals from Macquarie Fleet for settlement but also the alternative options of termination of the Tied Contract or continuation of the status quo (that is continuation of arbitration, litigation and performance of the Tied Contract by Macquarie Fleet).

44. Macquarie Fleet's 23 May 2001 letter of commercial intent led to the negotiation of a final settlement agreement. Finance prepared a detailed business case to support the final settlement proposal that was submitted to the then Minister on 6 June 2001. The business case outlined the dispute, activities aimed at resolving the dispute and the proposed settlement. All material supporting documents were attached, including drafts of the detailed final sign-offs to be provided by Finance's advisers, including the Department's Probity Adviser. On 29 June 2001, the then Minister approved the settlement basis and signed an instrument authorising a senior Finance officer to approve and execute the settlement documentation.

45. Prior to the authorised Finance officer executing the settlement documentation, Finance obtained specific legal advice from its Legal Adviser that the proposed settlement documentation was in accordance with the Ministerial Instrument. Settlement of the disputes with Macquarie Fleet then occurred on 5 July 2001.

Finance's response to the previous audit report

46. The 1998 ANAO audit report on the sale of DASFLEET found that the financial implications of the five year Tied Contract were such that the Commonwealth was exposed to a range of commercial risks including increased leasing charges to agencies and the potential responsibility for the cost of terminating the contract. In this circumstance, ANAO recommended that Finance undertake a comprehensive commercial risk assessment of the Commonwealth's exposure under the Tied Contract. Finance agreed with the recommendation and advised ANAO that it had already commissioned such a review from a commercial adviser, which was due to be completed in late December 1998. The final draft of this review was provided to Finance in February 1999 but was never finalised as events had overtaken it.

47. In August 1999, the Joint Committee of Public Accounts and Audit (JCPAA) commenced an inquiry into Audit Report 25 1998-99, *DASFLEET Sale*. The Committee held a public hearing on 13 August 1999 and a further hearing, on 26 August 1999. By the time of the JCPAA hearings, commercial disputes had arisen in relation to both the Sale Agreement and the Tied Contract. The Committee was advised that the matters were proceeding to arbitration. In light of the evidence provided by Finance and the then Office of Asset Sales and IT Outsourcing (OASITO) in relation to the disputes with Macquarie Fleet, the Committee resolved to temporarily delay continuation of its inquiry until the arbitration was complete.

Audit Findings and Conclusions

1. Introduction

This chapter details the background to the audit including previous audit coverage of the DASFLEET Tied Contract; the nature of the Tied Contract and the audit approach.

Background

1.1 Until July 1997, a former Department of Administrative Services (DAS) business unit, DASFLEET, supplied passenger and commercial vehicles to the majority of Commonwealth bodies, with the total active fleet managed by the business unit comprising over 16□000 vehicles. The book value of fleet was approximately \$376□million as at 31□January 1997 and DASFLEET returned a net operating profit in its last year of Commonwealth ownership of just over \$23 million. On 17 July 1997, a sale agreement was signed between the Commonwealth and Macquarie Fleet Leasing Pty Ltd (Macquarie Fleet), a wholly owned subsidiary of Macquarie Bank Limited (Macquarie Bank), for the sale of DASFLEET for \$407.9□million. However, under the sale agreement the sale price was subject to adjustment once completion accounts for DASFLEET at the point of sale had been finalised. Included in the DASFLEET deal was a five year tied contract signed between the parties on 1 September 1997.¹⁰

1.2 The Tied Contract was an agreement between Macquarie Fleet and the Commonwealth that, with certain exceptions, all Commonwealth Public Account (CPA) vehicles would be leased and fleet management services would be obtained from Macquarie Fleet for a period of five years ending on 31□August 2002. The then Department of Administrative Services (DAS) initially had responsibility for monitoring and managing the Tied Contract on behalf of the Commonwealth. When DAS and the Department of Finance merged to become the Department of Finance and Administration (Finance) in October 1997, Finance took over that responsibility.

¹⁰ The DASFLEET transaction was managed by the then Office of Asset Sales. The Office of Asset Sales (OAS) was established in October 1996 to manage the Commonwealth Government's major asset sales and it reported directly to the Minister for Finance. In November 1997, information technology outsourcing functions formerly managed by the then Office of Government Information Technology transferred to OAS, which became the Office of Asset Sales and IT Outsourcing (OASITO). On 1 July 2001, following a change in Government policy on the approach to outsourcing of IT, the agency became known as the Office of Asset Sales and Commercial Support (OASACS) and is referred to as OASACS throughout this report. OASACS continued as a separate agency in the Finance and Administration portfolio until after the settlement of the DASFLEET commercial disputes. It has subsequently been abolished and its functions absorbed into the Department of Finance and Administration.

1.3 The Tied Contract with Macquarie Fleet was a finance lease at the whole of Government level.¹¹ Each vehicle leased under this Tied Contract was the subject of a separate operating lease and individual Commonwealth agencies were responsible for managing these operating leases.¹² This audit's focus is on the monitoring and management of the Tied Contract by Finance and not on the management of the operating leases that individual Commonwealth agencies have with DASFLEET.

1.4 A number of commercial disputes arose out of the sale and the operation of the Tied Contract. These were the subject of substantial negotiation between the Commonwealth and Macquarie Fleet and an independent arbitration process. Settlement of these long-standing disputes was finalised in July 2001 under a whole of dispute settlement framework including payments between the parties, the signing of a mutual deed of release from all causes of action relating to the commercial disputes on both the Sale Agreement and Tied Contract, and the novation of the Tied Contract from Macquarie Fleet to Lease Plan Australia Pty Ltd (LPA).¹³ Apart from payments acknowledged by the parties as remaining unpaid but not subject to dispute, the settlement of the disputes involved a payment of \$8 million from Macquarie Fleet to the Commonwealth and a payment of \$15.7 million by the Commonwealth to Macquarie Fleet.

Previous audit coverage

1.5 In December 1998, a compendium of four ANAO performance audits relating to the sale of former DAS Business Units was tabled in Parliament. Included in the compendium was Audit Report No.25, *DASFLEET Sale*. The audit found that the then Office of Asset Sales (OAS) and its advisers succeeded in negotiating the sale of DASFLEET and a five year Tied Contract for vehicle fleet services broadly within the indicative sales timetable which had been set for the transaction. However, effective administrative actions were not taken to identify and specifically quantify the financial risks in the Tied Contract

¹¹ See Hansard Joint Committee of Public Accounts and Audit *Review of Auditor-General's reports third and fourth quarters 1998-99* Friday 13 August 1999.

¹² Finance Circular 1993/14 states:

Finance Leases' are those under which all the risks and benefits incidental to ownership of property are transferred to the lessee (whose obligation to make payments under the lease arrangement continues even if the property is lost, destroyed or disposed of).

'Operating leases' on the other hand, are those under which the risks and benefits implicit in the asset remain with the legal owner of the asset (eg, the lessor). Australian Accounting Standards do not currently require the recognition in the financial statements of the lessee of any assets or liabilities associated with operating lease arrangements.

¹³ Macquarie Fleet entered into a sub-contracting agreement with the Serco Group on 1 September 1997 for the provision of certain Tied Fleet management arrangements for DASFLEET. In August 1998, Macquarie Fleet announced that from 21 September 1998 LPA would take over responsibility for the operation of the DASFLEET business from the Serco Group.

associated with the Commonwealth accepting exposure to the variations in the Reserve Bank of Australia (RBA) assessment of the required risk weighting for capital adequacy purposes. The 1998 audit report also noted that final proceeds for the DASFLEET sale would not be known until a dispute which had arisen in relation to completion statements for DASFLEET at the point of sale had been resolved.

1.6 The ANAO also found that the financial implications of the five year Tied Contract were such that the Commonwealth was exposed to a range of commercial risks including increased leasing charges to agencies and the potential responsibility for the cost of terminating the contract. In this circumstance, ANAO recommended¹⁴ that Finance undertake a comprehensive commercial risk assessment of the Commonwealth's exposure under the Tied Contract. Finance agreed with the recommendation and advised ANAO that it had already commissioned such a review from a commercial adviser, which was due to be completed in late December 1998. A final draft of the report on this review was provided to Finance in February 1999, but it was never finalised because events had overtaken it.

1.7 In August 1999, the Joint Committee of Public Accounts and Audit (JCPAA) commenced an inquiry into Audit Report 25 1998-99, *DASFLEET Sale*. The Committee held a public hearing on 13 August 1999 and a further hearing, on 26 August 1999. By the time of the JCPAA hearings, commercial disputes had arisen in relation to both the Sale Agreement and the Tied Contract. The Committee was advised that the matters were proceeding to arbitration. In light of the evidence provided by Finance and the then Office of Asset Sales and IT Outsourcing (OASITO) in relation to the disputes with Macquarie Fleet, the Committee resolved to temporarily delay continuation of its inquiry until the arbitration was complete.

1.8 Finding: The 1998 ANAO audit report on the sale of DASFLEET found that the financial implications of the five year Tied Contract were such that the Commonwealth was exposed to a range of commercial risks including increased leasing charges to agencies and the potential responsibility for the cost of terminating the contract. In this circumstance, ANAO recommended that Finance undertake a comprehensive commercial risk assessment of the Commonwealth's exposure under the Tied Contract. Finance agreed with the recommendation and advised ANAO that it had already commissioned such a review from a commercial adviser, which was due to be completed in late December 1998. The final draft of this report was provided to Finance in February 1999 but was never finalised as events had overtaken it.

¹⁴ Recommendation No. 6, Audit Report No.25 1998-99, *DASFLEET Sale*.

1.9 In August 1999, the Joint Committee of Public Accounts and Audit (JCPAA) commenced an inquiry into Audit Report 25 1998-99, *DASFLEET Sale*. The Committee held a public hearing on 13 August 1999 and a further hearing, on 26 August 1999. By the time of the JCPAA hearings, commercial disputes had arisen in relation to both the Sale Agreement and the Tied Contract. The Committee was advised that the matters were proceeding to arbitration. In light of the evidence provided by Finance and the then Office of Asset Sales and IT Outsourcing (OASITO) in relation to the disputes with Macquarie Fleet, the Committee resolved to temporarily delay continuation of its inquiry until the arbitration was complete.

Tied Contract

1.10 In entering the Tied Contract, Macquarie Fleet acquired at least a 95 per cent monopoly over the provision of fleet leasing and management services to what are now FMA agencies.¹⁵ In that context, the Commonwealth was concerned to ensure Macquarie Fleet did not attempt to take advantage of its position. Accordingly, the establishment of an 'open book' approach and provision of information and reports by Macquarie Fleet to a contract monitoring body within the Commonwealth was a key feature of the Tied Contract. Indeed, in his statement to the arbitration, a Commonwealth senior officer on the DASFLEET sale process commented:

It was the overarching open book feature and accountability features of Macquarie Bank's proposal for the purchase of DASFLEET, that influenced the Commonwealth in agreeing to [the recommendation of OASACS' Business Adviser for the DASFLEET sale process] that Macquarie Bank's final offer for the sale of DASFLEET be accepted. From the Commonwealth's position, it was against this background that subsequent negotiations with Macquarie Fleet took place.

1.11 A Fleet Monitoring Body (FMB) was established under the Tied Contract to monitor the compliance of Macquarie Fleet with the terms and conditions of the Tied Contract, taking into account the interests of the Commonwealth agency customers that were tied by the contract. The FMB was initially located within DAS but became part of Finance when that agency was formed in October 1997. The FMB is essentially the contract management team that has oversight of performance under the Tied Contract.

¹⁵ These Commonwealth agency customers are called in the Tied Contract with Macquarie Fleet 'CPA customers'. This term relates to Commonwealth Public Account Agencies and was relevant to the *Audit Act 1901*. However, in January 1998, a package of legislation to replace the *Audit Act 1901* commenced which included the *Financial Management and Accountability Act 1997* (the FMA Act). The FMA Act is now the relevant legislation applying to the Commonwealth agencies that are tied under the Tied Contract. FMA agencies are generally covered by the Tied Contract.

1.12 The role of the FMB, as provided for under the Tied Contract signed with Macquarie Fleet, included monitoring of future pricing and service levels; consideration of changes to the funding commitments, components and methodologies used in setting the leasing rates; assessing the purchaser's management of the residual risk to ensure no abnormal profit was made on vehicle disposal over the contract term; convening of a customer forum; notifying Macquarie Fleet of any non-conforming leases (upon becoming aware of one); and establishing minimum performance criteria for fleet management services. Finance advised ANAO that Macquarie Fleet disputed the role and function of the FMB from early in the operation of the Tied Contract. Macquarie Fleet advised ANAO in May 2002 in response to a draft report on this audit that:

MFL [Macquarie Fleet] never disputed the role and function of the Fleet Monitoring Body (FMB) under the Tied Contract. The issue giving rise to the dispute on this point was that MFL and the Commonwealth had different views on the scope of the FMB's role. MFL believed the FMB's overseeing role was far less than the Commonwealth believed.

1.13 The number of CPA vehicles leased under the Tied Contract with Macquarie Fleet at the commencement date on 1 September 1997 was established during the arbitration process to be 10 045¹⁶. Finance advised the then Minister for Finance and Administration on 6 June 2001 that as at 30 April 2001 there were 9 395 active leases under the Tied Contract. The then Minister was also advised that the most common lease duration was 24 month/40 000 kilometres, and therefore the fleet 'turnover' is quite high in that approximately 400 new leases were written monthly and almost the entire fleet was replaced over a two year period. Further, the Department advised that the estimated Vehicle Principal Outstanding as at 30 April 2001 (the current value of the fleet) was approximately \$194.437 million. In December 2001, Finance advised ANAO that the total number of vehicles under lease as at 4 July 2001 was 9 177, including 8 943 active leases and 234 inactive vehicles being those which are not currently on lease (they may be either new vehicles just delivered or terminated leases awaiting disposal). Finance advised ANAO that the total Vehicle Principal Outstanding of the fleet leased under the Tied Contract as at 4 July 2001 (including both active and inactive units) was \$193 968 609.

¹⁶ The exact number of CPA vehicles transferred to Macquarie Fleet at the commencement of the Tied Contract was an area of dispute with Macquarie Fleet. The original Completion Asset and Liabilities Statement (CALs) calculations were based on a total DASFLEET vehicle fleet of 16 015 of which 10 787 were considered to be CPA vehicles. This number was subsequently revised downwards to 10 747 as an outcome of the November 1999 audit report commissioned by Finance. During the arbitration it was further revised to 10 072 before the correct number was finally being agreed between Macquarie Fleet and the Commonwealth to be 10 045.

¹⁷ Made up of 234 inactive units with a VPO of \$4 274 486 and 8 943 units with a VPO of \$189 694 123. In addition, there was \$5 987 101 in lease charges payable for July 2001.

1.14 Figure 1.1 below sets out Finance’s December 2001 advice to ANAO regarding the total amount paid to Macquarie Fleet under the Tied Contract in each financial year of the Contract and as broken down into the components paid for Fleet Management Fees, Finance Charges, Principal Reduction and Residual Risk Fees. In providing this advice to ANAO, Finance noted that the responsibility for fleet management rests with each Tied Agency and that the terms of the Tied Contract did not require the routine provision to the FMB of aggregate information of the kind sought by ANAO. Finance advised that it had however been able to source the requested information from a Macquarie Bank report reflecting the position as at 30 June 2001. Finance noted that the results from this report would vary only slightly (1 per cent) from the position at 4 July 2001 when the Tied Contract with Macquarie Fleet concluded.

Figure 1.1

Estimated Total Lease Payments to Macquarie Fleet by Commonwealth agencies under the Tied Contract between 1 September 1997 and 30 June 2001

Financial Year	Fleet Management Fees \$	Interest \$	Principal Reduction \$	Residual Risk Fees \$	Total \$
1997/98	8 205 337	16 778 272	13 100 789	190 739	38 275 137
1998/99	5 700 078	12 781 068	23 086 150	1 068 426	42 635 722
1999/00	5 183 429	11 444 393	28 832 760	2 773 585	48 234 167
2000/01	6 359 871	14 010 102	35 639 371	5 989 030	61 998 374
Total	25 448 715	55 013 835	100 659 070	10 021 780	191 143 400

Source: Department of Finance and Administration advice to ANAO in December 2001, Finance advised data was collected from various sources.

Audit approach

1.15 The objectives of the current audit were to:

- assess the administrative and financial effectiveness of Finance’s management of the Commonwealth’s exposure under the DASFLEET Tied Contract;
- assess the effectiveness of Finance’s monitoring of performance of the DASFLEET Tied Contract; and
- review the action taken by Finance in response to Recommendation No.6 of Audit Report No.25 1998–99 that Finance, in consultation with relevant Commonwealth agencies, undertake a comprehensive risk assessment of the Commonwealth’s exposure under the Tied Contract.

1.16 By the time the 1998 ANAO audit of the DASFLEET sale process had been completed, the Commonwealth was already in dispute with Macquarie Fleet in relation to the Sale Agreement and it was clear that Finance was also encountering difficulties in monitoring Macquarie Fleet's performance of the Tied Contract and managing the Commonwealth's financial exposure under this contract. It was in this context that the ANAO included a performance audit of the Management of the DASFLEET Tied Contract in its 1999–2000 Audit Work Program. However, commencement of the audit was delayed pending the resolution of the various disputes relating to the DASFLEET transaction. The disputes having been finally settled on 5 July 2001, the audit commenced in August 2001.

1.17 The scope of the audit did not extend to auditing the management of the Amended Tied Contract with Lease Plan Australia that commenced on 5 July 2001. Accordingly, the audit coverage was of specific past events and the lessons to be learned from these were largely identified by Finance during the course of the Tied Contract with Macquarie Fleet and the negotiation of the settlement of the commercial disputes. Finance implemented these lessons learned, as far as was possible in the circumstances, in the negotiation of the Amended Tied Contract with Lease Plan Australia. In this circumstance, the audit report does not include any recommendations.

1.18 Audit fieldwork was conducted in Finance and at the premises of its major advisers between August 2001 and April 2002. Issues Papers were provided to Finance for comment in December 2001 followed by a Discussion Paper in April 2002. The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of \$240,000.

2. Contractual Issues

This chapter sets out the issues which arose in relation to the operation of the DASFLEET Tied Contract; the commercial disputes regarding the Sale Agreement and the Tied Contract; the arbitration process and the Interim Award handed down by the Arbitrator.

Background

2.1 The Government announced in the August 1996 Budget its intention to realise the Commonwealth's investment in the vehicles then managed by the former DAS business unit, DASFLEET. In March 1996, the then Department of Finance engaged consultants to undertake a detailed review of the financing and operations of DASFLEET. The consultant's findings were presented in June 1996 and found the best financial outcomes for the Commonwealth to be either a refinancing of the fleet by an instalment purchase arrangement or privatisation of the business as a whole with a five year Tied Contract for what were then called Commonwealth Public Account (CPA) customers. The Government decided to pursue sale and refinancing tender processes in tandem in order to maximise price tension in the market and obtain the best financial outcome for the Commonwealth.

2.2 The Department of Finance's consultants were subsequently successful in tendering for the role of Business Adviser to then Office of Asset Sales (OAS) for both the scoping study and the refinancing/sale processes. Between 1997 and November 2001, the agency charged with Commonwealth asset sales was variously known as the Office of Asset Sales (OAS), the Office of Asset Sales and IT Outsourcing (OASITO), and the Office of Asset Sales and Commercial Support (OASACS). On 26 November 2001, as a result of changes to the Administrative Arrangements Orders, this role was re-assumed by the Department of Finance and Administration. However, during the course of the DASFLEET Tied Contract with Macquarie Fleet the asset sales role was with a separate agency. Accordingly, in this report that agency's final name, OASACS, is used. A Legal Adviser was also engaged by OASACS.

2.3 An Invitation to Tender for the funding of DASFLEET motor vehicles (the refinancing option) was issued on 11 April 1997 inviting tenders by 29 April 1997 for a sale and leaseback¹⁸ on an operating basis, a sale and buyback¹⁹ on an instalment basis or a combined operating lease and sale and buyback basis.

¹⁸ The Commonwealth would sell the existing fleet, other than vehicles currently subject to finance leases or externally managed for another owner, to the Financier and receive immediate payment with the Financier then leasing the fleet back to Commonwealth.

¹⁹ The Commonwealth would sell the existing fleet to a Financier and receive immediate payment and then make instalment purchase payments to the Financier.

Separately an Information Memorandum was issued on 1 April 1997 to 18 prospective purchasers with seven parties lodging complying non-binding preliminary offers for the purchase of DASFLEET on 21 April 1997. The Information Memorandum²⁰ advised prospective purchasers that their offers were to assume that vehicle leasing arrangements post sale will be conducted on an operating lease basis.²¹

2.4 Bids for refinancing of DASFLEET's vehicles were received on 29 April 1997 from two consortia. Three final bids for the purchase of the DASFLEET business were received on 26 May 1997. The bids for both options were then assessed. On the basis of advice provided by the Business Adviser on 9 June 1997, on the same day OASACS recommended to the then Minister for Finance that DASFLEET be sold rather than refinanced and asked that the Minister 'endorse our recommendation of Macquarie Bank as the party with whom we should pursue final negotiations.' The then Minister for Finance agreed to OASACS' recommendation and there were no further negotiations with the second ranked bidder after mid-June 1997.

2.5 Further negotiation over outstanding contractual issues continued with Macquarie Fleet until 30 June 1997. The up front price was not subject to further negotiation but legal and lease rate issues continued to be negotiated. Macquarie Fleet increased its funding margin over the floating benchmark rate²² by 10 basis points²³ as partial compensation for several conditions withdrawn after 9 June 1997.²⁴

2.6 Other changes to the Sale Agreement and the Tied Contract negotiated prior to 30 June 1997 (as reported by the Business Adviser) included:

- the Commonwealth agreed not to unreasonably withhold its consent in relation to possible sell down of Macquarie Fleet's financing arrangement;

²⁰ DASFLEET Information Memorandum, March 1997, p. 5.

²¹ A transaction using operating leases would result in the purchaser of DASFLEET effectively retaining substantially all the risks and benefits incidental to ownership of the vehicles. This contrasts with a transaction using finance leases where the leases would effectively transfer from the purchaser to the Commonwealth all the risks and benefits incidental to ownership of the vehicles. See Australian Accounting Standard AAS17, *Accounting for Leases*.

²² The Floating Benchmark Rate is the rate of discount expressed as a yield per centum per annum which is the average of the bid rates as calculated by the Australian Financial Markets Association and at the time the Tied Contract was signed was shown on the page numbered 'BBSY' on the Reuters Monitor System at or about 10.15 AM (Sydney time) on that date, for a bank accepted bill having a tenor of 30 days.

²³ The additional funding margin reduced the result of Macquarie Fleet's offer by approximately \$0.5 million over 6 years.

²⁴ The major conditions withdrawn by Macquarie Fleet were: utilisation fees payable if the Commonwealth used less than 90 per cent of the predetermined fleet size commitment limits and there was a negative balance in the Reserve Account; and losses associated with non-CPA vehicles acquired after the sale date were to be recovered through lease rates for the CPA customers under the Tied Contract.

- Macquarie Fleet agreed to pass on a significant proportion of cost savings achieved from the fleet leasing and management and a formula to this effect was included in the Tied Contract;
- the Commonwealth elected the floating benchmark interest rate under the Tied Contract with the option of converting it into a fixed rate;
- the Commonwealth would pay up to \$17.45 million as damages if it sought to exempt from the Tied Contract more than 2 per cent of the total CPA fleet; and
- the Commonwealth agreed that Macquarie Fleet may change its funding margin as a result of possible changes in risk weighting imposed by the Reserve Bank of Australia (as an adjustment event under the Tied Contract) where such changes affected Macquarie Fleet's cost of performing the contract with the Commonwealth. If the Commonwealth did not agree to the increase in cost Macquarie Fleet could terminate the Tied Contract and the provisions regarding early termination would apply.

2.7 On 30 June 1997, the Business Adviser confirmed the 9 June 1997 recommendation that the Commonwealth accept Macquarie Fleet's binding offer for DASFLEET, with a five-year Tied Contract for the provision of leasing and fleet management services, based upon a debt funding arrangement and on terms which reflected the pricing schedules as attached to the Tied Contract. On the same day, OASACS provided a brief to the then Minister for Finance recommending that DASFLEET be sold to Macquarie Fleet for \$409 901 000; the Commonwealth enter into the Tied Contract with Macquarie Fleet for the provision of leasing and fleet management services for five years; and signing put and call options with Macquarie Fleet and Macquarie Bank.²⁵ The then Minister was also advised by OASACS that OASACS' Business Adviser had said 'we believe that the transaction reflects an appropriate balance between achieving what is an attractive purchase price for the Commonwealth and mitigating the commercial risks of claims under the contract.'

²⁵ Two pieces of legislation were developed to preserve the benefits of the Commonwealth cars (those with Z-plate registration) and the position of private plated cars in the event of DASFLEET change of ownership, and to exempt the sale/refinancing from State and Territory stamp duty. As both Bills were assented to after 30 June 1997 when the then Minister for Finance agreed to the sale of DASFLEET, put and call options were developed to enable the transfer of DASFLEET to be exempted from State taxes. The put option enabled the Commonwealth to bind the purchaser to purchase DASFLEET before the Bill was passed but to exercise this option after the Bills were assented to. The call option enabled Macquarie Bank to require the Commonwealth to sell DASFLEET to Macquarie Fleet after the Bills were assented to.

2.8 On 1 July 1997, the then Minister for Finance and the then Minister for Administrative Services announced that DASFLEET was to be sold to Macquarie Fleet. The Sale Agreement was signed on 17 July 1997 and the Tied Contract on 1 September 1997⁶

Operation of the Tied Contract

2.9 Almost immediately after the commencement of the Tied Contract issues arose in relation to the operation of the Contract.

Capital risk weighting of the transaction

2.10 Macquarie Fleet's offer for DASFLEET was predicated on its assumption that, for Macquarie Bank Limited Group's capital adequacy purposes,²⁷ the DASFLEET motor vehicle leases would be risk weighted at 10 per cent. At that time, the RBA's capital adequacy guidelines allowed assets of a bank, which represent government risk, to be risk weighted at 10 per cent for capital adequacy purposes. Assets that represented non-government risk were weighted at 20 to 100 per cent depending on the asset. For example, a loan to a bank was risk weighted at 20 per cent, a residential mortgage loan for less than 80 per cent of the property value was risk weighted at 50 per cent; a loan to a corporate was risk weighted at 100 per cent; and a fixed tangible asset, such as a building or a motor vehicle was risk weighted at 100 per cent. In early September 1997, Macquarie Bank advised OASACS that the RBA had indicated that it would treat the transaction as being weighted not at 10 per cent but rather at 100 per cent.

2.11 During negotiations with Macquarie Fleet between 9 and 30 June 1997, the risk that the RBA would determine a capital adequacy requirement for the DASFLEET transaction different to that assumed by Macquarie Fleet in its offer was transferred to the Commonwealth. This issue was not specifically mentioned in the main body of the brief to the then Minister for Finance on 30 June 1997, which recommended that he agree to the sale of DASFLEET to Macquarie Fleet

²⁶ A specific condition of Macquarie Fleet's bid for DASFLEET was the right to sell down its participation in the leasing arrangements to a third party or parties (which may include the assignment of legal title or ownership to the vehicles or a hire purchase arrangement with a third party) and this is reflected in Clause 29 of the Tied Contract. Clause 29 sets out that the Commonwealth acknowledges this and that the Commonwealth will not unreasonably withhold consent to such a transaction. On 1 July 1997, OASACS wrote to Macquarie Fleet formally consenting on behalf of the Commonwealth to BNP's participation in the DASFLEET transaction subject to Macquarie Fleet complying with Clause 29.3 of the Tied Contract. An Assignee Acknowledgment was also put in place between the Commonwealth and BNP.

²⁷ Macquarie Bank Limited is an entity licensed as a bank under the *Banking Act 1959*. At the time of the sale, the RBA supervised banks by a range of mechanisms including that banks risk adjusted capital ratios remain at acceptable levels. The Australian Prudential Regulatory Authority (APRA) assumed responsibility for prudential regulation for deposit-taking, life and general insurance and superannuation institutions from 1 July 1998.

and to enter into the Tied Contract with Macquarie Fleet. However, the Business Adviser's advice, which was attached to the brief, noted this as a risk event. The Business Adviser advised that Macquarie Bank might adjust its funding margin provided to the Commonwealth under the Tied Contract if the RBA changed the risk weighting guidelines of the transaction or imposed any form of reserve or special deposit requirement which resulted in an increased or decreased cost of performing Macquarie Fleet's obligations under the Tied Contract. The Business Adviser stated that, in the event that the Commonwealth did not agree to an increase in costs, Macquarie Fleet may terminate the Tied Contract and the early termination provisions of the contract would apply.²⁸

2.12 On 23 September 1997, Macquarie Fleet wrote to OASACS advising that:

We have conducted an extensive review of the market to determine what additional interest margin is applicable to the financing arrangements under the Tied Contract assuming a 100% risk weighting (for capital adequacy purposes) rather than a 10% risk weighting. From this review we believe that an additional 1.5% per annum margin will be required. This will bring the total interest rate margin to 1.95% per annum.²⁹

²⁸ OASACS advised ANAO during the course of the 1998 audit that Schedule 10 of the Tied Contract was specifically developed to address the Commonwealth's exposure to the potential that the RBA might impose a different capital adequacy requirement on the transaction to the assumed 10 per cent. Schedule 10 provides that, whenever an Adjustment Event (being a change in the RBA's capital adequacy requirements for the DASFLEET transaction) occurs and Macquarie Fleet notifies the Commonwealth of an increase in margin as a result of the Adjustment Event, the parties must meet and negotiate and use their best endeavours for a period of not more than 30 days to restructure the Tied Contract and funding arrangements so that the same, or substantially the same, intended economic effect may be achieved. If the Commonwealth gives notice to Macquarie Fleet that it does not accept the increase in the margin, Macquarie Fleet may terminate the Tied Contract triggering the provisions of Schedule 6.

²⁹ In a letter dated 21 November 1997 to both OASACS and the FMB, Macquarie Fleet responded to earlier letters from the Commonwealth dated 11 November 1997 and 25 September 1997 requesting further justification for any increase in margin that may apply because of an increase in the risk weighting from 10 per cent to 100 per cent. Macquarie said:

We set out a simple example below which explains the rationale for the increase in margin to meet our return on capital requirements.

Assuming a \$100 loan

Risk Weighting	100%	10%
Risk Weighted Exposure	\$100	\$10
Required Capital	\$8	\$0.80
(RBA 8% minimum requirement)		
Target Return on Capital	30%	30%
Return Required on Capital	\$2.40	\$0.24
Equivalent Return as % of Total Exposure	2.40%	0.24%

The ten per cent risk weighting return (0.24%) was increased to allow for fixed transaction costs. These are covered in the 100% risk weighted return.

A 30% pre tax return on capital both reflects a standard market benchmark, as well as an approximation of Macquarie's target of a 20% to 25% return on shareholders funds, after tax.

As you are aware, the interest rate margin initially documented in the Tied Contract represents a financing return only on an asset which is 10% risk weighted for capital adequacy purposes. A 100% risk weighting is a large user of balance sheet capacity and also suggest to the mark [sic] that they are taking asset risk.

2.13 On 15 October 1997, OASACS advised the then Minister for Finance and Administration of developments in relation to the DASFLEET transaction including the risk weighting issue. The then Minister was asked to note that OASACS and the FMB were in disagreement with Macquarie Fleet and were currently holding discussions with Macquarie Fleet. OASACS further advised the then Minister that:

The Commonwealth is contractually obliged to pay higher lease charges to compensate for the cost to Macquarie of holding a higher level of deposits for capital adequacy purposes, unless an alternative can be agreed to maintain the 10% risk weighting. [OASACS] is currently discussing possible alternatives with Macquarie.

2.14 OASACS also advised the Minister that the margin increase suggested by Macquarie Fleet would have increased average lease rates by about \$30 per month, equating to an annual cost of \$4.3 million.³⁰ The additional costs such a margin increase could have resulted in were up to \$25.7 million (nominal dollars) over the Contract's life. The potential equivalent, on a Net Present Value basis, of these additional costs were calculated by OASACS' Business Adviser. The Business Adviser advised ANAO in November 1998 that, applying its valuation models, after increasing the cost of funds by 150 basis points (taking into account the expected diminution in the size of the CPA fleet; the tax effects; and the time value of money) results in increased costs over the Tied Contract of \$7.3 million on a Net Present Value basis.³¹ The Business Adviser's June 1997 financial evaluation of the bids for DASFLEET had identified the net present value of Macquarie Fleet's bid to be \$6 million better over six years than that of the second ranked bidder, Lease Plan Australia.

³⁰ OASACS further advised the Minister that:

the increased interest rate margin could have changed the ranking of the bidders [for DASFLEET] on price alone. However:

- it is not valid to compare alternative bids on the basis of the Tied Contract with Macquarie, as specifics of the leasing facility were negotiated with Macquarie after it was selected as the preferred party with which to proceed with detailed negotiations; and
- the sophistication of Macquarie's bid and residual management procedures placed it ahead of other bidders in non-price terms.

³¹ The Business Adviser's advice of 9 June 1997 outlined that a plus or minus of 50 basis points (that is 0.5 per cent) change in the lease benchmark cost of funds would result in an increase or decrease of \$2 million in the Net Present Value for each of the three bids evaluated. Any increase in the RBA's risk weighting above the 10 per cent assumed by Macquarie would have increased its cost of funds margin but would not have altered the base lease benchmark cost of funds which was derived from the financial markets.

2.15 In February 1998, OASACS (on behalf of the Commonwealth) and Macquarie Bank made a joint submission to the RBA on the issue of the appropriate capital risk weighting for capital adequacy purposes that should apply to the DASFLEET Tied Contract transaction. The joint submission noted that a finance lease, where the lessor has recourse to the lessee for the full lease receivable, was risk weighted at 10 per cent for government lessees. The parties argued that in their opinion ‘the Tied Contract leasing arrangement is, in substance, a finance lease which should be risk weighted at 10%.’ The joint submission set out the details of the parties’ case for why Macquarie Bank (and Macquarie Fleet) had full recourse to the Commonwealth for the entire lease receivable.

2.16 In June 1998, the RBA agreed to treat individual leases entered into under the Tied Contract with Macquarie Fleet, and which were to expire before the Tied Contract matured on 1 September 2002, as finance leases because the arrangements established by Macquarie Fleet would transfer the risks of owning the vehicles to the Commonwealth. The RBA concluded that vehicle leases which were to expire beyond that date were operating leases which should be risk weighted at 100 per cent. The RBA concluded this on the basis that it considered that the risks of owning these vehicles rested with Macquarie Fleet and as such these leases should attract the normal risk weighting applied to a fixed tangible asset such as a motor vehicle.

2.17 In June 2000, Finance’s Legal Adviser wrote to Macquarie Fleet’s solicitors noting that the Commonwealth had recently been advised that the relevant risk weighting for leases entered into under the Tied Contract with Macquarie Fleet and expiring before 1 September 2002 was adjusted in the last quarter of 1998 from 10 per cent to zero. The Legal Adviser noted that if this had had an impact on the costs to Macquarie Fleet of providing fleet leasing services under the Tied Contract then it may amount to an adjustment event of which Macquarie Fleet may be required to notify the Commonwealth pursuant to Schedule 10 of the Tied Contract. Advice was sought as to whether or not there had been a change in the risk weighting for any leases under the Tied Contract expiring prior to 1 September 2002 and of the amount of any decreased costs as a result of any such change in the risk weighting.

2.18 In addition, Finance’s Legal Adviser noted that Macquarie Fleet had now entered into a number of leases that were to expire after the term of the Tied Contract with Macquarie Fleet (that is after 1 September 2002). Accordingly, Macquarie Fleet’s solicitor was requested to advise how Macquarie Fleet was accounting for those leases — as finance leases or as operating leases. Justification of the accounting classification was requested along with details of how Macquarie Fleet was treating the leases for the purposes of capital adequacy requirements.

2.19 Subsequently, the FMB referred these questions directly to Macquarie Fleet on 27 June 2000. On 28 June 2000, Macquarie Fleet wrote to the FMB confirming that during the last quarter of 1998 all leases expiring before 1 September 2002 became risk weighted at zero (previously being weighted at 10 per cent) but that the decrease in risk weighting did not result in any decrease in Macquarie Fleet's costs and any material decrease in Macquarie Bank's costs. Macquarie Fleet further advised that it currently treated all leases under the Tied Contract as finance leases. Macquarie Fleet noted that this included leases expiring after 1 September 2002, on the basis that the number of such leases was not material (although it soon would become so). Macquarie Fleet advised that it was currently applying a risk weighting of zero to all leases that were due to expire after 1 September 2002.

2.20 On 11 July 2000, the FMB wrote to Macquarie Fleet seeking further information and explanation as well as advice regarding the impact that any changes to risk weighting going forward (that is a change to 100 per cent in accordance with the RBA's view on leases expiring after 1 September 2002) would have on funding costs under the Tied Contract. On 25 July 2000, the FMB again wrote to Macquarie Fleet seeking a substantive response given the importance of this issue to the ongoing management of the Tied Contract. The FMB noted that if there were particular issues which needed to be resolved it may be appropriate to jointly brief the Australian Prudential Regulation Authority (APRA) to seek an opinion on the matter as it had taken over responsibility from the RBA for setting the risk weighting.

2.21 On 15 August 2000, Macquarie Fleet responded advising that:

- Macquarie Fleet had not been obliged to advise the FMB of the change in risk weighting from 10 per cent to zero as Schedule 10 of the Tied Contract only required notification following an Adjustment Event and an Adjustment Event did not occur because there was no change in Macquarie Fleet's costs (that is they did not decrease as a result of the change in the risk weighting);
- there was no decrease in Macquarie Fleet's costs following the change in risk weighting because Macquarie Bank does not charge group companies for capital usage. However, Macquarie Fleet noted that it was anticipated that such a system would be introduced by Macquarie Bank in the future on a prospective basis;
- there were leases on Macquarie Fleet's books with a maturity post 1 September 2002. The number of these leases would increase considerably post 1 September 2000. The RBA advised on 15 June 1998 that these leases should be risk weighted at 100 per cent. However, there is currently no

Adjustment Event associated with these leases, as there would be no increased costs of Macquarie Fleet for the reason noted above. However, if Macquarie Bank commenced charging group companies for capital usage there would be an Adjustment Event; and

- Macquarie Fleet currently expected the Commonwealth to be better off as a result of these facts.

2.22 Finance advised ANAO in March 2002 that Macquarie Fleet's letter demonstrated that it was not clear that Macquarie Fleet was wrong in relation to the 10 per cent to zero argument, but that if Macquarie Fleet was wrong, it would necessarily lead to increased costs for those leases which, in accordance with the RBA determination, should be treated as 100 per cent risk weighted. If Macquarie Fleet were correct in relation to this issue, then there was a risk the 100 per cent risk weighting could still arise for leases expiring after 31 August 2002 if Macquarie Bank changed its internal processes for charging for capital. This had to be off-set against any claims by the Commonwealth for an Adjustment Event relating to Decreased Costs that, in any event, Macquarie Fleet denied in terms of the Tied Contract.

2.23 Accordingly, on 1 September 2000, the FMB wrote to Macquarie Fleet noting Macquarie Fleet's advice of 15 August 2000 including that there was no relationship between risk weighting and the costs of Macquarie Fleet and that it appeared that this had been the case at all times in the past. Macquarie Fleet did not subsequently during the remaining term of the original Tied Contract (which ended on 5 July 2001 with the novation of the Tied Contract to Lease Plan Australia) notify the Commonwealth of any Adjustment Event relating to either an increase or decrease in the margin applying to leases under the Tied Contract as a result of any change in the risk weighting for capital adequacy purposes applying to leases.

2.24 Finance advised ANAO in March 2002 that the FMB's letter of 1 September 2000 to Macquarie Fleet was an attempt to break the nexus between risk weighting and Macquarie Fleet funding. Finance further advised that:

intensive negotiations were also being conducted during this period and that risk weighting was one of the issues identified for inclusion in the settlement negotiations. The settlement proposals being considered by the parties included options for addressing the risk weighting of the leases. One option identified for addressing this issue was the proposal to substitute Lease Plan Australia Pty Ltd for Macquarie Fleet Leasing Pty Ltd. The Lease Plan option did ultimately form part of the whole of dispute settlement. Risk weighting was addressed in the settlement through:

- amendments to Schedule 10 of the Tied Contract which removed changes in risk weighting as an Adjustment Event;

- Lease Plan itself was not subject to capital adequacy requirement;
- Lease Plan's leases after the date of substitution would be operating leases rather than finance leases; and
- mutual releases from all claims (refer clause 3.1 of the Deed of Release).

2.25 Finding: The DASFLEET Tied Contract with Macquarie Fleet specifically required the Commonwealth to bear the risk associated with any decision of the prudential regulator (initially the Reserve Bank of Australia (RBA)) to assess a different capital adequacy requirement for the DASFLEET transaction to the 10 per cent requirement assumed by Macquarie Fleet in its bid for DASFLEET. This was not a requirement of any of the other bidders for DASFLEET.

2.26 Macquarie Fleet claimed in September 1997 that a 100 per cent risk weighting would require an increase in its margin of 150 basis points. The additional costs such a margin increase could have resulted in were up \$25.7 million (nominal dollars) over the Contract's life. It was only after OASACS made a joint submission with Macquarie Bank to the RBA in April 1998 to argue that the transaction was a finance lease that the RBA agreed in June 1998 that a 10 per cent risk weighting would apply to individual leases entered into under the Tied Contract with Macquarie Fleet and which were to expire before the Tied Contract matured. However, for vehicle leases that were to expire beyond that date, the RBA considered that a 100 per cent risk weighting would apply. Accordingly, under this assessment by the RBA the Commonwealth remained exposed to an increase in Macquarie Fleet's margin for those vehicle leases due to expire after 31 August 2002.

2.27 In June 2000, it came to Finance's attention that the risk weighting for government loan risk and, accordingly, the leases entered into under the Tied Contract with Macquarie Fleet and expiring before 1 September 2002, had been adjusted in the last quarter of 1998 from 10 per cent to zero. Macquarie Fleet's advice in August 2000 in response to Finance's queries about this issue confirmed that the risk weighting for these leases had reduced to zero but that Macquarie Fleet hadn't been required under the Tied Contract to notify Finance of this because there had been no change in Macquarie Fleet's costs (that is they had not decreased as a result of the change in the risk weighting). Macquarie Fleet advised that Macquarie Bank did not currently charge group companies for capital usage although it might in the future. Macquarie Fleet also noted that although there were then a number of leases on its books with a maturity post 1 September 2002, and that the number of these would increase significantly post 1 September 2000, there were currently no increased costs for Macquarie Fleet. Therefore there was no Adjustment Event requiring

notification of the Commonwealth, because Macquarie Bank Limited was not currently charging for capital usage. Macquarie Fleet stated that it expected the Commonwealth to be better off as a result of these facts. This issue was not separately resolved. Finance advised ANAO that it was one of the issues identified for inclusion in the whole of dispute settlement negotiations.

Residual Value Risk

2.28 Volatility in the price of second hand vehicles has a major impact on the financial returns of fleet owners. Under the Tied Contract with Macquarie Fleet, the total lease charge comprised:

- the lease rental as a result of applying the rental formula³²;
- a Residual Risk Fee (RRF);
- a fixed charge for prepaid expenses (insurance, registration); and
- Fleet Management Charges.³³

2.29 Vehicle residuals are a key determinant of monthly lease rates. To make a profit, the original purchase price of a vehicle (and the cost of funds during the term of the lease) must be recovered out of the sum of the estimated residual received on disposal at the end of the lease and the monthly lease rates paid during the lease. Accordingly, the total lease charge fluctuates with changes in the residual values (RVs) assigned to vehicles and interest rates, both factors that are market driven.

2.30 The Tied Contract provided two avenues for Macquarie Fleet to manage residual value risk. Residual value risk is the risk that the sale price of the vehicle at the end of the lease will be different to the residual value estimated for the vehicle at the start of the lease. The Tied Contract provided flexibility in the setting of RVs to align them with market experience. Under the Tied Contract,

³² Calculated taking into account the purchase price for the vehicle; the finance charge; the lease term for the vehicle; and the residual value for the vehicle.

³³ Under the Tied Contract with Macquarie Fleet the Fleet Management Services to be provided for these charges included:

- Fuel card ordering and customer account management;
- Provision of customer fleet management and usage reports;
- Management of the maintenance of vehicles;
- Provision of roadside emergency services;
- Provision of general fleet management advice and vehicle replacement program;
- Provision of accident loan vehicles, for insured vehicles;
- Provision of maintenance loan vehicle where appropriate;
- Negotiation and provision of membership of a constituent of the AAA; and
- Provision of consolidated national reporting to Government, and to separate CPA customers as required.

Macquarie Fleet was entitled to review RVs each quarter and, where RVs were revised, Macquarie Fleet was required to notify the FMB in writing of the new RVs to apply to future leases.³⁴ The FMB was entitled to object to the revised RVs if it was of the opinion that they had not been determined in accordance with the prescribed Residual Value Setting Criteria. Any dispute as to RVs was then subject to the dispute resolution procedures set out in Clause 24 of the Tied Contract.

2.31 The second residual value adjustment mechanism available to Macquarie Fleet under the Tied Contract was the RRF. The RRF provided a further opportunity, during the term of the Contract, for Macquarie Fleet to recover the difference between the RV set for a vehicle and the market price actually received on disposal.

2.32 Agencies were charged a RRF in the monthly lease charge for each vehicle. The RRFs were deposited in a special account called the Reserve Account. The Reserve Account was also credited or debited with any excess or shortfalls between the vehicle principal outstanding at the time of disposal of a vehicle and the actual net sales proceeds from the vehicle, as appropriate. Interest was credited or charged to the Reserve Account on the net balance. There was provision under the Tied Contract to adjust the RRFs payable by agencies under a complex formula that aimed to ensure, to a 99 per cent statistical confidence, that the balance of the Reserve Account would at least be zero at the end of the relevant period.³⁵ Accordingly, through the calculation of RRFs, Macquarie Fleet was virtually guaranteed that any losses on disposal of vehicles acquired during the term of the Contract would eventually be paid by the Commonwealth.

³⁴ Clause 14 of the Tied Contract permitted revision of the residual values in accordance with the Residual Value Setting Criteria in Schedule 2 to the Contract. Schedule 2 required that the residual value with respect to each vehicle must be calculated in accordance with the Residual Value Formula and the Residual Value Letter and having regard to:

- the Lease term;
- the make and model of the vehicle;
- the use to which the vehicle is to be put;
- the past history of sales prices achieved for vehicles of similar description and age; and
- the then prevailing market conditions;

being the Residual Value Setting Criteria. These criteria could not be changed without the Commonwealth's consent.

³⁵ At the time the Tied Contract was signed, the Commonwealth's understanding was that the RRFs imposed under the Tied Contract would target a zero balance in the Reserve Account at the end of the five year term of the Tied Contract. This issue was one of those subject to commercial dispute and the Arbitrator accepted a different view put forward by Macquarie Fleet. Accordingly, for negotiations between the parties after the Arbitrator's October 2000 Interim Award, it was accepted that the Reserve Account used a calculation of Residual Risk Fees to target a positive balance at the end of the run off period (or more precisely a point in time two years after the last date on which new leases could be written under the Tied Contract). This 'buffer' was designed to ensure that, if Macquarie Fleet were to end up with responsibility for the Reserve Account at the end of the deal, Macquarie Fleet would have only a 1 per cent chance of losing any money. In June 2001, the 'buffer', that is the necessary positive balance required in the Reserve Account at 1 September 2002, was calculated to be \$18.6 million.

2.33 In tendering for DASFLEET, Macquarie Fleet's original binding offer of 26 May 1997 proposed that the RRF would be a nominal \$1 per vehicle per month. During further negotiations between 9 June 1997 and 30 June 1997, the arrangements for the calculation of the RRF were finalised with Macquarie Fleet estimating it at \$20 per vehicle per month. On commencement of the Tied Contract on 1 September 1997, the RRF charged by Macquarie Fleet was \$20 per vehicle per month.

2.34 Less than four weeks after the commencement of the Tied Contract, in accordance with Schedule 2 of the Tied Contract, Macquarie Fleet wrote to the FMB on 26 September 1997 notifying it of revised RVs and increased RRFs to apply from 1 October 1997. Macquarie Fleet's proposal involved a reduction across most of the fleet in RVs (averaging 8 per cent for the most popular vehicle classes) on the basis that there had been a long-term adjustment in the market for second hand vehicles and an increase in the RRF to \$101 per vehicle per month.

2.35 The FMB objected to the scale of the increase Macquarie Fleet proposed for the RRF and requested Macquarie Fleet substantiate the increase in accordance with the terms of the Tied Contract. This issue was the subject of substantial correspondence and negotiation between Macquarie Fleet and the FMB and eventually became part of the dispute on the Tied Contract lodged by Finance on 23 March 1999.

Sale Agreement dispute

2.36 The sale of DASFLEET to Macquarie Fleet was based on an Asset and Liability Statement as at January 1997. Under the sale agreement, the purchase price for the DASFLEET business was subject to adjustment following the preparation of a Completion Asset and Liability Statement (CALS).³⁶ The CALS was prepared as at 1 September 1997. The CALS was intended to be based on the same approach and policies as had been applied in the preparation of the Asset and Liability Statement (ALS).

2.37 One of the key calculations required for the preparation of the CALS was a 'recoverable amount test' to ensure that the various lease assets were at values that did not exceed the amount that would be recovered over the term of the lease. It was OASACS' understanding that it was agreed that no such test should

³⁶ Schedule 2 to the Sale Agreement provided in Clauses 8, 9 and 10 under the heading 'Relevant Assets and Liabilities' that any difference between the parties over the CALS may be referred for resolution in accordance with Clause 25 of the Sale Agreement and that otherwise, after deducting any additional depreciation or amortisation of assets between the date of the A&L Statement and the date of completion, the Commonwealth would compensate Macquarie if the net value of the assets disclosed in the CALS was less than that disclosed in the ALS and that Macquarie would compensate the Commonwealth if the converse occurred.

be undertaken for the CPA fleet vehicles, as these would be dealt with by way of the Tied Contract.

2.38 The ANAO signed off the CALS on 5 May 1998. Those accounts showed that Macquarie Fleet owed the amount of \$6.771 million to the Commonwealth as an adjustment to the purchase price. On 11 May 1998, OASACS forwarded the CALS to Macquarie Fleet with a request to pay \$6.771 million to the Commonwealth as a post-sale settlement adjustment to reflect movement between the ALS at January 1997 and the CALS at September 1997.

2.39 On 2 June 1998, Macquarie Fleet lodged a Notice of Dispute under Clause 25 of the sale agreement with OASACS claiming that the CALS were incorrectly calculated and that in fact the Commonwealth owed Macquarie Fleet approximately \$28 million. Macquarie Fleet disputed the approach that had been taken both in relation to the exclusion of the CPA fleet, and also in relation to the mechanics of undertaking the recoverable amount test.

2.40 As required under the dispute resolution procedures set out in Clause 25 of the Sale Agreement, OASACS and Macquarie Fleet first attempted to negotiate to resolve the dispute but then referred it for arbitration.

Tied Contract dispute

2.41 While negotiations were proceeding with Macquarie Fleet in relation to the Sale Agreement dispute and the establishment of an arbitration process for that dispute, the FMB continued to encounter significant difficulties in attempting to manage and monitor the Tied Contract. By 23 March 1999, the issues involved had become sufficiently substantial to warrant the lodgement by Finance of a Notice of Dispute under Clause 29 of the Tied Contract.

2.42 Whilst there were many areas of dispute, there were three substantive areas of dispute under the Tied Contract:

- disputes relating to the purchase price of the vehicles transferred to Macquarie Fleet at the time of acquisition of DASFLEET;
- disputes relating to the calculation of RRFs; and
- disputes relating to the provision of information to the FMB.

Premium allocation: Purchase price of Tombstone Fleet vehicles

2.43 The first Tied Contract dispute related to an ambiguity in Tied Contract in regard to the definition of the purchase price of the vehicles owned by DASFLEET and on lease to CPA agencies at the point of sale of the business to Macquarie Fleet.

2.44 The definitions set out in the Tied Contract did not make it clear whether, for the purposes of the Contract, the purchase price of vehicles on lease to Commonwealth customers at the time of sale (the so-called Tombstone Fleet) was:

- the price paid by the Commonwealth when it bought the vehicles from the manufacturer; or
- the price paid by Macquarie Fleet (including \$27 million which the Commonwealth considered Macquarie Fleet had paid as goodwill (that is an amount over and above the value of the net assets) in order to win the tender process for DASFLEET). Macquarie Fleet originally argued that the full amount of \$27 million should be allocated to CPA vehicles. However, it subsequently changed its position and allocated some \$10.1 million to non-CPA vehicles and \$16.9 million was allocated to CPA vehicles.

2.45 The Commonwealth's intention in executing the Tied Contract was that the former would apply. Macquarie Fleet argued that the terms of the Tied Contract provided that the latter was correct. The determination of the purchase price of the CPA Tombstone Fleet was of concern because under the terms of the Tied Contract, losses (or profits) on CPA vehicles disposed of at the end of a lease are held in the Reserve Account. If Macquarie Fleet's purchase price was used (including the \$16.9 million premium allocated to CPA vehicles) a significantly greater loss on disposal of Tombstone Fleet vehicles resulted, generating a greater loss in the Reserve Account. Losses in the Reserve Account were recoverable from the Commonwealth through the payment of RRFs. Effectively, using the Macquarie Fleet definition of the purchase price of the Tombstone vehicles allowed for Macquarie Fleet to effectively recover from the Commonwealth a significant proportion of the premium it had paid to acquire the business.

Calculation of Residual Risk Fees

2.46 Under the Tied Contract RRFs were payable monthly by CPA customers on each lease entered into under the Tied Contract with Macquarie Fleet (that is on vehicles other than the Tombstone Fleet). The RRFs collected on each lease are paid into the Reserve Account and were designed to protect against the possibility of a negative balance in the Reserve Account at the end of the Tied Contract. During the Tied Contract, the larger the negative balance in the Reserve Account the larger the RRFs charged on each new vehicle lease.

2.47 Macquarie Fleet's final offer for DASFLEET estimated the RRF at \$20 per vehicle per month and this was the amount charged for RRFs on commencement

of the Tied Contract on 1 September 1997. However, once the Tied Contract commenced on 1 September 1997, the RRF applicable was required to be derived from the application of the statistical formula set out in the Tied Contract.³⁷

2.48 On 26 September 1997, Macquarie Fleet notified the FMB that it intended to increase RRFs from \$20 per vehicle per month to \$101 per vehicle per month. The FMB sought the validation of such a substantial increase in the RRFs. It eventually became clear that the Commonwealth and Macquarie Fleet did not agree on the operation of the formula set out in the Tied Contract for the determination of RRFs under the terms of the Contract. The differing interpretations of the formula by the FMB and Macquarie Fleet resulted in differing RRF payments applicable to new leases.³⁸

2.49 Under the Commonwealth's interpretation, the Reserve Account should have gradually trended to a zero balance by the end of the last leases entered into under the Contract (the bulk of which were expected to expire two years after the end of the five year Tied Contract). Under Macquarie Fleet's interpretation, the account would have trended to a figure that at the end of the Tied Contract term (that is 31 August 2002) would have included a monetary buffer sufficient to ensure a 99 per cent probability of Macquarie Fleet not making a loss when the last Tied Contract vehicle was sold. This balance would ensure that at the end of a two-year run off period there would still be enough money in the Reserve Account to cover any potential losses on sales of vehicles. Macquarie Fleet argued that it was entitled to charge RRFs sufficient to create such a buffer, estimated in June 2001 at \$18.6 million.

Provision of information to the Fleet Monitoring Body

2.50 The Tied Contract required Macquarie Fleet to provide regular reports and information to enable the FMB to monitor performance of Macquarie Fleet's obligations under the Tied Contract. In lodging its dispute in relation to the Tied Contract, Finance was of the view that Macquarie Fleet had not provided reports or information that were sufficient or accurate enough for the FMB to monitor Macquarie Fleet's performance. In addition, there was evidence that many of the invoices provided to agencies were also inaccurate.

2.51 In June 1999, Finance, with Macquarie Fleet's agreement, commissioned an accounting firm to undertake an audit of Macquarie Fleet's records to provide Finance with a report on the reliability of system controls and the accuracy and

³⁷ Finance was advised in February 1999 that, based on application of the statistical formula, the RRF should have been initially priced in September 1997 at \$35–\$40. Finance's adviser's calculation was predicated on the Commonwealth's view as to the starting value of the existing DASFLEET vehicles transferred to Macquarie Fleet.

³⁸ Macquarie Fleet increased RRFs to \$58 in July 1999 but this increase was not agreed to by Finance.

completeness of the information provided to Finance by Macquarie Fleet since the sale date. The audit was initiated in the context of progressing the resolution of the disputes, and in light of Finance's concerns about the quality of the information provided to it by Macquarie Fleet under the terms of the Contract. The audit was completed in November 1999.

2.52 Among other things, the audit report noted that Price Risk Margins had been charged in error to customers by Macquarie Fleet. The Price Risk Margin had been part of DASFLEET's pricing methodology before its sale. The margin, calculated at 1 per cent of the vehicle purchase price (as held in DASFLEET's reference database) was incorrectly added to the opening Vehicle Principal Outstanding of the vehicles and resulted in an increased lease rate to the customer. In March 2002, Finance advised ANAO that the error in charging the 1 per cent Price Risk Margin was originally raised with Macquarie Fleet by Finance in August 1998. Macquarie Fleet subsequently confirmed this in writing in November and December 1998 and stated that affected customers should be credited the amounts that had been charged in error. In May 1999, Macquarie Fleet's estimate of the total effect of the error was \$483 000. The matter was then included in the audit commissioned by Finance. However, the auditors stated in their November 1999 audit report that they had not audited DASFLEET's calculation because the errors in the underlying systems limited the accuracy and reliability of any calculation.

2.53 Finance also advised ANAO that as a result of the audit report it had commissioned, another accounting firm acting for Macquarie Fleet undertook a further quantification of this error, as well as considering other issues associated with errors in lease payment and the balance of the Reserve Account as at 31 December 1999. The result of that process was a cheque received by Finance from Macquarie Fleet in May 2000 for \$1.64 million for invoicing errors, including \$894 259 for the Price Risk Margin Issue.³⁹

2.54 On 16 November 1999, the FMB wrote to Macquarie Fleet (attaching a copy of the Audit Report) noting that the auditors had concluded that there

³⁹ Macquarie Fleet's accounting adviser calculated the net total amount of \$1.64 million taking into account both adjustments in the Commonwealth's favour and in Macquarie Fleet's favour.

were serious deficiencies in the information and reports provided to the Commonwealth by Macquarie Fleet since 1 September 1997.⁴⁰ The FMB noted that an essential feature of the Tied Contract was the Commonwealth's ability to monitor Macquarie Fleet's performance under, and compliance with, the terms of the Tied Contract and that the FMB had serious concerns arising from the conclusions of the Audit Report. In particular, the FMB was of the view that Macquarie Fleet's inability to provide accurate, reliable and complete reports and information was a serious failure to perform fundamental obligations under the Tied Contract. The FMB advised Macquarie Fleet that, in order to protect the Commonwealth's position and pursuant to Clause 25.3 of the Tied Contract, a notice was attached requiring Macquarie Fleet to remedy the specified failures within 28 days.⁴¹

2.55 The issuance of a Notice to Rectify is the first step in a contractual termination process pursuant to the Tied Contract.⁴² Macquarie Fleet disputed the validity and effectiveness of the Notice to Rectify. Consequently, the question of whether the issuing of the Notice to Rectify had established a right for the Commonwealth to terminate the Tied Contract with Macquarie Fleet became an issue that the Commonwealth referred to the Arbitrator for consideration. In light of developments during the arbitration hearings and process, the FMB issued a further Notice to Rectify to Macquarie Fleet on 1 September 2000 which sought to address any shortcomings alleged by Macquarie Fleet in relation to the first notice.

⁴⁰ The FMB drew Macquarie Fleet's attention to the following conclusions of the auditors:

- data provided by Macquarie Fleet in the As At, New Vehicle and De-Hires Reports was 'inaccurate, unreliable and incomplete';
- the extent of errors in the reports provided by Macquarie Fleet meant that it would not be possible to accurately quantify the impact on, or the balance of, the Reserve Account until the data errors were corrected;
- the information in the reports provided by Macquarie Fleet since the date of sale did not fulfil Macquarie Fleet's obligations under the Tied Contract;
- it was not possible to be certain that the formulae for the calculation of Leasing Rates and the Reserve Account balance and the Vehicle Principal Outstanding had in all cases been correctly applied; and
- the extent of data errors in underlying systems meant that calculation and balances in the Reserve Account were incorrect.

⁴¹ The FMB's letter to Macquarie Fleet went on to state that its advice was that the matters disclosed in the Audit Report demonstrated that Macquarie Fleet had failed in a material manner to carry out a provision of the Tied Contract and that, furthermore, the FMB understood that the breaches outlined in the Audit Report were capable of remedy by Macquarie Fleet.

⁴² Clause 25.3 of the Tied Contract with Macquarie Fleet.

2.56 Finding: While negotiations were proceeding with Macquarie Fleet in relation to the Sale Agreement dispute and the establishment of an arbitration process for that dispute, the FMB continued to encounter significant difficulties in attempting to manage and monitor the Tied Contract. By March 1999, the issues involved had become sufficiently substantial to warrant the lodgement by Finance of a Notice of Dispute under Clause 29 of the Tied Contract.

2.57 The Tied Contract required Macquarie Fleet to provide regular reports and information to enable the FMB to monitor performance of Macquarie Fleet's obligations under the Tied Contract. In lodging its dispute in relation to the Tied Contract, Finance was of the view that Macquarie Fleet had not provided reports or information that were sufficient or accurate enough for the FMB to monitor Macquarie Fleet's performance. In addition, there was evidence that many of the invoices provided to agencies were also inaccurate.

2.58 In June 1999, Finance, with Macquarie Fleet's agreement, commissioned an accounting firm to undertake an audit of Macquarie Fleet's records to provide Finance with a report on the reliability of system controls and the accuracy and completeness of the information provided to Finance by Macquarie Fleet since the sale date. The audit was initiated in the context of progressing the resolution of the disputes, and in light of Finance's concerns about the quality of the information provided to it by Macquarie Fleet under the terms of the Contract. The audit was completed in November 1999.

2.59 The November 1999 audit report commissioned by Finance noted that Price Risk Margins had been charged in error to customers by Macquarie Fleet. The Price Risk Margin had been part of DASFLEET's pricing methodology before its sale. The margin, calculated at 1 per cent of the vehicle purchase price (as held in DASFLEET's reference database) was incorrectly added to the opening Vehicle Principle Outstanding of the vehicles and resulted in an increased lease rate to the customer. In March 2002, Finance advised ANAO that the error in charging the 1 per cent Price Risk Margin was originally raised by Finance in August 1998. Macquarie Fleet subsequently confirmed this in writing in November and December 1998 and stated that affected customers should be credited the amounts that had been charged in error. In May 1999, Macquarie Fleet's estimate of the total effect of the error was \$483 000. The matter was then included in the audit of Macquarie Fleet's records commissioned by Finance. However, the auditors stated in their audit report that they had not audited DASFLEET's calculation because the errors in the underlying systems limited the accuracy and reliability of any calculation.

2.60 Finance advised ANAO that as a result of the audit report commissioned by Finance, another accounting firm acting for Macquarie Fleet undertook a further quantification of this error, as well as considering other issues associated with errors in lease payment and the balance of the Reserve Account as at 31 December 1999. The result of that process was a cheque was received by Finance from Macquarie Fleet in May 2000 for \$1.64 million for invoicing errors, including \$894 259 for the Price Risk Margin Issue.

2.61 There were a number of issues in the arbitration which were not decided by the Arbitrator's Interim Award, including the existence of and amount of any damages payable by Macquarie Fleet for alleged breaches of the Tied Contract (in relation to the provision of information) and validity of the Commonwealth's Notices to Rectify.

Arbitration

2.62 On the basis of legal advice, Finance and OASACS sought Macquarie Fleet's agreement to combine the arbitration processes for the two disputes.⁴³ Macquarie Fleet finally agreed to this on 1 June 1999. In July 1999, Sir Daryl Dawson AC agreed to act as Arbitrator but negotiation of the Arbitration Agreement was not completed until 12 November 1999. On 17 November 1999, there was a Directions Hearing at which the Arbitrator set the arbitration timetable. The first part of the arbitration hearing, which related to the Sale Agreement dispute, took place in early April 2000.

2.63 The Commonwealth and Macquarie Fleet agreed in late June 2000 to attempt to resolve the disputes through further negotiations. The then Minister for Finance and Administration directed in June 2000 that all negotiations were to be on a without prejudice basis and any outcome was to be approved by the Minister. The Commonwealth and Macquarie Fleet exchanged settlement position papers in early July 2000. During negotiations over the next four months the parties were unable to agree on a settlement package. In the meantime, the arbitration process proceeded.

2.64 Separately, on 30 June 2000, the Commonwealth lodged a claim under the *Trade Practices Act* in the Federal Court against Macquarie Bank alleging misleading and deceptive conduct in relation to the DASFLEET deal. This was done to ensure that the Commonwealth's rights to commence such an action were not compromised by statute of limitation issues. Part 2 of the arbitration

⁴³ Finance and OASACS received legal advice that, in light of the differing arguments which Macquarie Fleet was running in relation to the Sales Agreement dispute and several Tied Contract issues, there was the potential for Macquarie Fleet to claim the same amount of alleged loss twice, but that the potential for this possibility to translate into an actual outcome would be minimised if both disputes were arbitrated at the same time before the same arbitrator.

hearing, relating to the Tied Contract dispute, took place between 14 and 25 August. Final submissions by both parties were made on 12 September 2000. Both the Commonwealth and Macquarie Fleet then withdrew all previous settlement offers ahead of the Arbitrator delivering an Interim Award on 26 October 2000.

2.65 Further to numerous briefs provided throughout the course of the dispute, on 6 June 2001 Finance advised the then Minister for Finance and Administration that during the arbitration process, and before the Interim Award was handed down, Macquarie Fleet made a series of concessions as follows:

- Macquarie Fleet agreed it was not entitled to claim tax on RRFs via the reserve Account (December 1999)—value: \$3 million (approx.);
- Macquarie Fleet agreed to drop its claim to double recovery (under both the provisions of the Sale Agreement and the Tied Contract) of a portion of the loss on the Tombstone Fleet (April 2000)—value \$19 million (approx.);
- Macquarie Fleet provided a cheque for \$1.64 million to compensate the Commonwealth for errors in invoices delivered to CPA customers (May 2000);
- Macquarie Fleet provided details of its methodology for calculating the balance of the Reserve Account and RRFs (May 2000);
- Macquarie Fleet effectively agreed with the conclusions of the November 1999 Audit of Macquarie Fleet’s reporting under the Tied Contract commissioned by Finance (May 2000);
- Macquarie Fleet agreed it had not calculated RRFs in accordance with the Tied Contract and agreed to adopt a more ‘open book’ methodology (June 2000);
- further errors were uncovered in the calculation of the Reserve Account (July 2000)—value: \$3 million (approx.);
- Macquarie Fleet agreed the CPA fleet was 600 cars smaller than it had previously asserted (July 2000)—value \$2 - \$3 million; and
- Macquarie Fleet agreed to reduce its purchase price of the Tombstone Fleet vehicles (August 2000)—value \$13 million (approx.).

2.66 Macquarie Fleet advised ANAO in May 2002 in response to a draft report on this audit that the above paragraph:

lists a series of ‘concessions’ made by [Macquarie Fleet]. However, a number of the items listed are not in fact concessions or incorrectly state [Macquarie Fleet’s] position:

- [Macquarie Fleet] never claimed 'double recovery' as asserted and therefore never 'agreed to drop its claim to double recovery'. The 'double recovery' argument was a view held by the Commonwealth.
- The provision of details and methodology by [Macquarie Fleet] for calculating the balance of the Reserve Account and RRFs was not a concession. This was merely the provision of information.
- [Macquarie Fleet] did not agree with the conclusions of the November 1999 audit of [Macquarie Fleet's] reporting under the Tied Contract. This was why [Macquarie Fleet] commissioned its own audit.
- [Macquarie Fleet] did not concede that 'further' errors were uncovered in the calculation of the Reserve Account. This was the result of the audit commissioned by [Macquarie Fleet] to quantify the impact of various known errors, a process that the Commonwealth's auditors concluded was not possible in their draft report.
- [Macquarie Fleet] and the Commonwealth jointly agreed the correct number of vehicles comprising the CPA Tombstone Fleet.

By couching the above as being 'concessions' made by [Macquarie Fleet] implies that [Macquarie Fleet] 'backed down' on these issues believing its position to be unsupported. This was not the case.

Interim Award

2.67 During the course of the arbitration hearings it had been agreed that the Arbitrator should make initial findings by way of an Interim Award and the parties were invited by the Arbitrator to agree upon questions in order that the answers might form the basis of such an interim award. However, the parties were unable to agree upon a single set of questions and submitted separate sets. In his Interim Award, the Arbitrator noted this but stated it was in any case possible to infer from the questions the basic concerns of the parties. Accordingly, the Arbitrator's Interim Award dealt with three main issues:

- the correct methodology for calculating the post-sale adjustment under the Sale Agreement;
- whether the correct interpretation of the definition of the purchase price of vehicles was Macquarie Fleet's or the Commonwealth's; and
- whether the RRF formula was required to trend to zero.

2.68 The Interim Award handed down general principles. It did not decide precise dollar amounts owing by the parties as a result of the Interim Award. The parties had to agree on dollar amounts on the basis of 'general principles'.

Significantly for the Commonwealth, there were also a number of issues in the arbitration which were not decided by the Arbitrator's Interim Award, including the existence of and amount of any damages payable by Macquarie Fleet for alleged breaches of the Tied Contract (in relation to the provision of information) and validity of the Commonwealth's Notices to Rectify.⁴⁴

Post-sale adjustment under the Sale Agreement

2.69 Macquarie Fleet asserted there were 12 errors in the CALS. The Arbitrator concluded that only three of the 12 adjustments asserted by Macquarie Fleet should be made to the CALS. Each of these adjustments was not overly contentious and had been all but conceded by the Commonwealth during the arbitration. The Commonwealth had asserted that Macquarie Fleet owed \$6.771 million by way of the CALS post-sale adjustment. Macquarie Fleet claimed it was owed \$28 million. After the Arbitrator's Interim Award the amount owed to the Commonwealth reduced to approximately \$1.938 million plus interest. The reduction related to the errors identified in the preparation of the CALS.

2.70 Part of the total amount claimed by Macquarie Fleet related to the write down of the CPA fleet from book value to the recoverable amount. This was subsequently found to be covered by a 9 March 1998 agreement between Finance and Macquarie Fleet. The 9 March 1998 agreement was that, in order to forestall an otherwise large increase in the deficit of the Reserve Account and consequential Residual Risk Fees payable by agencies as part of their lease payments, the Commonwealth would deposit in the Reserve Account the amount necessary to cover the write down in the value of the existing DASFLEET vehicles transferred to Macquarie Fleet between the Asset and Liability Statement as at January 1997 and the completion of the sale on 31 August 1997. However, although not in dispute, this amount was withheld by the Commonwealth until the other disputes were resolved and the data for the calculation of the correct amount payable could be confirmed.

⁴⁴ The Commonwealth wished the Arbitrator to confirm the validity of the Notices to Rectify in order to confirm the Commonwealth's right to proceed to terminate the Tied Contract on the basis of the breaches of the Tied Contract identified in the Notices and Macquarie Fleet's alleged failure to rectify them.

2.71 Finding: The sale of DASFLEET to Macquarie Fleet was based on an Asset and Liability Statement as at January 1997. Under the sale agreement, the purchase price for the DASFLEET business was subject to adjustment following the preparation of a Completion Asset and Liability Statement (CALs).⁴⁵ The Commonwealth had asserted that Macquarie Fleet owed \$6.771 million by way of the CALs post-sale adjustment; Macquarie Fleet claimed it was owed \$28 million. After the Arbitrator's Interim Award the amount owed to the Commonwealth reduced to approximately \$1.938 million plus interest (total finally calculated as \$2.503 million). The reduction related to errors identified in the preparation of the CALs.

2.72 Part of the total amount claimed by Macquarie Fleet related to the write down of the CPA fleet from book value to the recoverable amount. This was subsequently found to be covered by a 9 March 1998 agreement between Finance and Macquarie Fleet. The 9 March 1998 agreement was that, in order to forestall an otherwise large increase in the deficit of the Reserve Account and consequential Residual Risk Fees payable by agencies as part of their lease payments, the Commonwealth would deposit in the Reserve Account the amount necessary to cover the write down in the value of the existing DASFLEET vehicles transferred to Macquarie Fleet between the Asset and Liability Statement as at January 1997 and the completion of the sale on 31 August 1997. However, although not in dispute, this amount was withheld by the Commonwealth until the other disputes were resolved and the data for the calculation of the correct amount payable could be confirmed.

Purchase price of vehicles under the Tied Contract

2.73 The Arbitrator concluded that Macquarie Fleet's interpretation of the definition of the purchase of the vehicles on lease to CPA agencies at the time of the DASFLEET transaction (following the various concessions made by Macquarie Fleet during the arbitration process) was correct. The Commonwealth had argued that the purchase price of these vehicles was the price originally paid by the Commonwealth, as the owner of DASFLEET, at the time of their original acquisition. Macquarie Fleet had argued that the price of these existing vehicles was the amount paid by Macquarie Fleet and allocated for their acquisition on Macquarie Fleet's balance sheet.

⁴⁵ Schedule 2 to the Sale Agreement provided in Clauses 8, 9 and 10 under the heading 'Relevant Assets and Liabilities' that any difference between the parties over the CALs may be referred for resolution in accordance with Clause 25 of the Sale Agreement and that otherwise, after deducting any additional depreciation or amortisation of assets between the date of the A&L Statement and the date of completion, the Commonwealth would compensate Macquarie if the net value of the assets disclosed in the CALs was less than that disclosed in the ALS and that Macquarie would compensate the Commonwealth if the converse occurred.

2.74 Further to numerous briefs provided during the course of the dispute, Finance advised the then Minister for Finance and Administration in June 2001 that, in coming to his conclusion, the Arbitrator appeared to have taken the following into account:

- his interpretation of the plain words of the definition in the Tied Contract;
- the fact that the Commonwealth's interpretation would be inconsistent with the definition of leasing rates in the Tied Contract;
- the evidence from Macquarie Fleet provided during the arbitration as to how it determined the purchase price paid by Macquarie Fleet; and
- the fact that after completion of the sale OASACS and Macquarie Fleet wrote to the RBA stating that the Tied Contract was in fact a finance lease.

2.75 OASACS's 30 June 1997 brief to the then Minister for Finance, which recommended the Minister agree to the sale of DASFLEET to Macquarie Fleet and to the entering into of the Tied Contract, attached OASACS' Business Adviser's final advice making the same recommendation. The Business Adviser's advice identified that \$34.9 million of the consideration offered by Macquarie Fleet for DASFLEET was 'goodwill' (that is a premium to Net Tangible Assets—which in the case of DASFLEET was chiefly the vehicles).⁴⁶

2.76 In his Interim Award the Arbitrator noted that, before submitting its May 1997 offer, Macquarie Fleet had asked to be provided with the original purchase price of the DASFLEET vehicles but that the Commonwealth was unable to provide this information because each of the major vehicle manufacturers would not consent to its release.⁴⁷ By a letter dated 6 June 1997, Macquarie Fleet increased its offer for DASFLEET but (in a further letter on the same date) informed the Business Adviser that, for balance sheet reasons, it was necessary to assign the total cash consideration based on independent valuations of DASFLEET's assets including motor vehicles, property plant and equipment to the assets in accordance with these valuations. OASACS consented to the changes Macquarie Fleet sought to the apportionment of the purchase price in Schedule 1 to the Sale Agreement. Schedule 1 of the signed Sale Agreement therefore showed \$0 allocated to goodwill.

⁴⁶ This advice accorded with the 6 June 1997 letter from Macquarie Bank which increased its offer for DASLFEET to \$407.901 million expressed as a premium of \$34.9 million over net assets of \$373 million. The net assets figure of \$373 million was provided to bidders by the Commonwealth. On 16 May 1997, the Business Adviser wrote to short-listed parties inviting final binding offers. The parties were told these were to include *the binding cash price to be paid for DASFLEET expressed as an amount plus net assets set out in the A&L Statement contained in Schedule 2 of the Sale Agreement and as defined in that document.*

⁴⁷ Finance advised ANAO in April 2002 'we understand that Macquarie Fleet's request for vehicles' purchase cost details was not satisfied for commercial and confidentiality reasons. However, Macquarie Fleet had sufficient information available to it to work backwards to determine the appropriate purchase price.

2.77 A key Macquarie Fleet officer involved in the DASFLEET deal in evidence to the arbitration stated that Macquarie Fleet regarded the transaction in relation to vehicle leasing as being the equivalent of a finance lease, that is to say, the equivalent of a sale and leaseback of the vehicles by the Commonwealth because Macquarie Fleet acquired the vehicles from the Commonwealth and leased them back to the Commonwealth, albeit to individual departments and agencies of the Commonwealth. He argued that the only return to Macquarie Fleet was to be the interest margin charged on the individual leases with the risk borne by the Commonwealth in relation to the vehicles under the Tied Contract. The Macquarie Fleet officer stated that Macquarie Fleet:

regarded the transaction from a financial perspective as a loan and therefore if we didn't receive back all the moneys that we were advancing, part of which would be through the Reserve Account mechanism, then that would be, you know, we wouldn't be getting part of our principal back.⁴⁸

2.78 Macquarie Fleet argued that it was inappropriate to allow any amount for goodwill for a finance lease and that it did not do so in arriving at the price it was prepared to pay for DASFLEET's vehicle leasing business. Macquarie Fleet's evidence was that the only amount paid by Macquarie Fleet for goodwill under the Sale Agreement was for the fleet management business; Macquarie Bank already had a vehicle leasing business and did not need to purchase another. According to Macquarie Fleet the component of the purchase price under the Sale Agreement relating to DASFLEET's vehicle leasing business was the value of the vehicles as disclosed in a valuation of the fleet commissioned by Macquarie Fleet ahead of the sale. The Arbitrator found that the evidence disclosed during the arbitration was that Macquarie Fleet's internal accounting records were kept consistently with the evidence presented by Macquarie Fleet during the hearings.

2.79 The Commonwealth contested much of the evidence put forward by Macquarie Fleet concerning this issue. The most significant aspect of the Arbitrator's decision on the definition of the purchase price of the Tombstone Fleet vehicles was that he agreed Macquarie Fleet was permitted to allocate across the Tombstone Fleet some \$27 million of what the Commonwealth had considered to be a \$34.9 million premium to net assets of the DASFLEET business. The proportion of this amount allocated to CPA vehicles, \$16.9 million, could then be recovered through the operation of the RRFs and the Reserve Account. Consequently, applying the Arbitrator's Interim Award, the purchase price of the CPA Tombstone Fleet vehicles was approximately \$16.9 million more than the Commonwealth had believed it to be. As a result, the deficit in the Reserve Account was also \$16.9 million larger than the Commonwealth had initially understood it to be.

⁴⁸ Macquarie Fleet testimony at the arbitration hearings.

2.80 Finding: The first Tied Contract dispute related to an ambiguity in Tied Contract in regard to the definition of the purchase price of the vehicles owned by DASFLEET and on lease to CPA agencies at the point of sale of the business to Macquarie Fleet. The definitions set out in the Tied Contract did not make it clear what, for the purposes of the Contract, was the purchase price of vehicles on lease to CPA customers at the time of sale (the so-called Tombstone Fleet). Finance and OASACS contended that it was the price paid by the Commonwealth when it bought the vehicles from the manufacturer. Macquarie Fleet asserted that it was the price it had paid for the vehicles when purchasing DASFLEET from the Commonwealth. The Commonwealth's intention in executing the Tied Contract was that the former would apply. Macquarie Fleet argued that the terms of the Tied Contract provided that the latter was correct.

2.81 Macquarie Fleet calculated the purchase price of the vehicles including some \$27 million which the Commonwealth considered Macquarie Fleet had paid as goodwill (that is an amount over and above the value of the net assets) in order to win the tender process for DASFLEET. Macquarie Fleet originally argued that the full amount of \$27 million should be allocated to CPA vehicles. However, it subsequently changed its position and allocated some \$10.1 million to non-CPA vehicles and \$16.9 million was allocated to CPA vehicles.

2.82 The determination of the purchase price of the CPA Tombstone Fleet was of concern because under the terms of the Tied Contract, losses (or profits) on CPA vehicles disposed of at the end of a lease are held in the Reserve Account. If Macquarie Fleet's purchase price was used (including the \$16.9 million premium allocated to CPA vehicles) a significantly greater loss on disposal of Tombstone Fleet vehicles resulted, generating a greater loss in the Reserve Account. Losses in the Reserve Account were recoverable from the Commonwealth through the payment of RRFs. Effectively, using the Macquarie Fleet definition of the purchase price of the Tombstone vehicles allowed for Macquarie Fleet to effectively recover from the Commonwealth a significant proportion of the premium it had paid to acquire the business.

2.83 The Arbitrator's decision on the definition of the purchase price of the Tombstone Fleet vehicles was that he agreed Macquarie Fleet was permitted to allocate across the Tombstone Fleet some \$27 million of what the Commonwealth had considered to be a \$34.9 million premium to net assets of the DASFLEET business. Of the total of \$27 million, some \$10.1 million was allocated to non-CPA vehicles and \$16.9 million was allocated to CPA vehicles. The \$16.9 million allocated to CPA vehicles could then be recovered through the operation of the RRFs and the Reserve Account. Consequently,

applying the Arbitrator's Interim Award, the purchase price of the CPA Tombstone Fleet vehicles was approximately \$16.9 million more than the Commonwealth had believed it to be. As a result, the deficit in the Reserve Account was also \$16.9 million larger than the Commonwealth had initially understood it to be.

Commonwealth exposure under the Tied Contract with Macquarie Fleet

2.84 The Commonwealth considered that in disposing of DASFLEET to Macquarie Fleet it had engaged in a trade sale of the DASFLEET business together with a five year Tied Contract for the provision of vehicles leasing and fleet management services to CPA agencies. The alternative of externally refinancing the fleet had been specifically explored and decided against. However, during the arbitration process for the DASFLEET Sale Agreement and Tied Contract disputes, it became clear that, contrary to the Commonwealth's view, Macquarie Fleet had bid for DASFLEET on the basis that some \$15 million of the total price tendered was for the purchase of the business and the remaining \$392.9 million related to the sale and leaseback of the vehicle fleet. Finance advised ANAO in April 2002 that:

Finance's view of the transaction is as it was in 1997, that the Commonwealth sold a business to Macquarie Fleet for \$407 million. The Arbitrator's Interim Award was not appealed due to settlement of the dispute. It would be incorrect to interpret this as an acceptance by the Commonwealth of Macquarie's views, assertions and interpretations.

2.85 In the course of the arbitration process, and in light of the Arbitrator's Interim Award, it became clear that, through the operation of the residual risk management mechanism, the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract with Macquarie Fleet.

2.86 The operation of the DASFLEET Tied Contract with Macquarie Fleet was an external refinancing of the Commonwealth's fleet.⁴⁹ Commonwealth agencies, as part of the leasing rates for the individual vehicles, paid a finance charge to Macquarie Fleet that was 45 basis points above the relevant bank bill rate in order to fund this refinancing. Had the Commonwealth funded the refinancing of the fleet itself the financing cost would have been equivalent to the 5-week Treasury Note rate.

⁴⁹ Finance engaged a commercial adviser in late 1998 to undertake a comprehensive commercial risk assessment of the Commonwealth's exposure under the Tied Contract. The commercial adviser's report dated 21 February 1999 concluded that one of the risks faced by the Commonwealth was that the DASFLEET deal was an expensive Government loan, as the transaction was now a finance lease.

2.87 During the period of the Tied Contract the relevant bank bill rate was on average some 22 basis points higher than the 5-week Treasury note rate. The total interest rate payable under the Contract, that is the relevant bank bill rate plus Macquarie Fleet's margin of 45 basis points, was on average some 67 basis points higher than the 5-week Treasury note rate. In October 1998, Finance was advised that the value of 10 basis points on the fleet as it then stood was around \$275 000 per annum. Using this estimate, the difference between the Commonwealth funding the refinancing of the vehicle fleet itself compared to refinancing it through the Tied Contract with Macquarie Fleet was around \$1.8 million per annum or some \$6.9 million over the total life of the Tied Contract (1 September 1997 to 4 July 2001).

2.88 Finding: The Commonwealth considered that in disposing of DASFLEET it had engaged in a trade sale of the DASFLEET business together with a five year Tied Contract for the provision of vehicles leasing and fleet management services to CPA agencies. The alternative of an external refinancing of the fleet had been specifically explored and decided against. However, during the arbitration process for the DASFLEET Sale Agreement and Tied Contract disputes, it became clear that, contrary to the Commonwealth's view, Macquarie Fleet had bid for DASFLEET on the basis that some \$15 million of the total price tendered was for the purchase of the business and the remaining \$392.9 million related to the sale and lease-back of the vehicle fleet. Finance advised ANAO in April 2002 that:

Finance's view of the transaction is as it was in 1997, that the Commonwealth sold a business to Macquarie Fleet for \$407 million. The Arbitrator's Interim Award was not appealed due to settlement of the dispute. It would be incorrect to interpret this as an acceptance by the Commonwealth of Macquarie's views, assertions and interpretations.

2.89 Macquarie Fleet argued that the only return to Macquarie Fleet was to be the interest margin charged on the individual leases with the risk borne by the Commonwealth in relation to the vehicles under the Tied Contract. Macquarie Fleet's evidence to the arbitration was that it:

regarded the transaction from a financial perspective as a loan and therefore if we didn't receive back all the moneys that we were advancing, part of which would be through the Reserve Account mechanism, then that would be, you know, we wouldn't be getting part of our principal back.

2.90 In the course of the arbitration process, and in light of the Arbitrator's Interim Award, it became clear that, through the operation of the residual risk management mechanism, the Commonwealth did indeed effectively bear all the risk for the vehicles leased under the Tied Contract with Macquarie Fleet.

2.91 The operation of the DASFLEET Tied Contract with Macquarie Fleet was an external refinancing of the Commonwealth's fleet. Commonwealth agencies, as part of the leasing rates for the individual vehicles, paid a finance charge to Macquarie Fleet that was 45 basis points above the relevant bank bill rate in order to fund this refinancing. Had the Commonwealth funded the refinancing of the fleet itself the financing cost would have been equivalent to the 5-week Treasury Note rate.

2.92 During the period of the Tied Contract the relevant bank bill rate was on average some 22 basis points higher than the 5-week Treasury note rate. The total interest rate payable under the Contract, that is the relevant bank bill rate plus Macquarie Fleet's margin of 45 basis points, was on average some 67 basis points higher than the 5-week Treasury note rate. In October 1998, Finance was advised that the value of 10 basis points on the fleet as it then stood was around \$275 000 per annum. Using this estimate, the difference between the Commonwealth funding the refinancing of the vehicle fleet itself compared to refinancing it through the Tied Contract with Macquarie Fleet was around \$1.8 million per annum or some \$6.9 million over the total life of the Tied Contract (1 September 1997 to 4 July 2001).

Residual Risk Fee Formula

2.93 In August 2000, at the direction of the Arbitrator, the actuarial experts engaged by Macquarie Fleet and the Commonwealth prepared a joint report into the calculation of the RRFs under the Tied Contract. The report was designed to address key issues of principle in the calculation of RRFs. The experts had a fundamental disagreement on the calculation of the RRFs and the report was structured to show the Arbitrator those issues on which the experts agreed and those on which they disagreed. The following was agreed between the experts:

- the RRF formula was complicated and difficult for an expert to understand;
- the RRF formula contained errors and required correction;
- the difference between the parties to the contract with respect to the purchase price of vehicles was the most significant factor affecting RRFs. The Macquarie Fleet purchase price position resulted in RRFs 300 to 400 per cent greater than the Commonwealth position;
- the input data used in the RRF formula contained a number of subjective elements which were at the discretion of Macquarie Fleet and could substantially impact on the level of RRFs;

- the formula prepared by Macquarie Fleet's expert targeted a statistical buffer of approximately \$20 million in the Reserve Account as at 31 December 2002 for a fleet of around 10 500 vehicles;
- the formula prepared by Macquarie Fleet's expert, if applied literally would seek to fund the \$20 million plus any residual value shortfalls in the Reserve Account from RRFs on one month's issues of leases. Macquarie Fleet's expert's methodology adjusted their formula to determine the recommended approach to determine the monthly RRF across the entire fleet; and
- the source data for calculating RRFs was incomplete and contained anomalies. Whilst both Macquarie Fleet's and the Commonwealth's experts acknowledged they had made adjustments for obvious errors and areas of incompleteness, they stated the source data could not be warranted as being appropriate for calculating RRFs.

2.94 The two experts had fundamental areas of disagreement in relation to the calculation of the RRFs. Macquarie Fleet's expert said that the RRF could be interpreted and corrected in isolation, save the use of the definitions in the Tied Contract. The Commonwealth's expert disagreed and said that without further information the RRF formula only provided some general guidelines for a corrected formula.

2.95 The Commonwealth's expert also said that, as the Tied Contract specifically defined RRFs as being a calculation under the Residual Value Formula (as set out in the Tied Contract) in accordance with the Residual Value Letter (attached to the Tied Contract at Exhibit A to Schedule 2), then the interpretation and correction of the formula must necessarily have regard to the Residual Value Letter.⁵⁰ The Commonwealth's expert said that the Residual Value Letter was inconsistent with the RRF formula particularly with respect to the

⁵⁰ The Residual Letter is a letter dated 1 July 1997 that was provided by Macquarie Fleet, at the request of the Commonwealth, to the then Minister for Administrative Services. The letter enclosed copies of Macquarie Fleet's Residual Value Setting Formula and Residual Risk Fee Formula in both electronic and hard copy form. In addition, the letter sets out an explanation of the operation of Macquarie Fleet's Residual Value risk management mechanism to be employed under the Tied Contract. The Commonwealth argued to the Arbitrator that, as the letter was attached to Schedule 2 of the Tied Contract, the letter qualified the terms of the contract. The Commonwealth made specific reference to the part of the letter which stated:

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

statement in the letter that the Reserve Account trends to zero and the statement with respect to the spreading of RRFs. Macquarie Fleet's expert noted its brief had been to express a view on the RRF formula and it had not considered the relationship between the Residual Value Formula and the Residual Value Letter. The experts also disagreed on a range of issues concerning the detailed calculation of RRFs.

2.96 The Arbitrator concluded that the interpretation of the formula proposed by Macquarie Fleet was correct and was not modified by apparently inconsistent statements in the Residual Value Letter sent to the then Minister for Finance and Administration on 1 July 1997. Further to numerous briefs provided throughout the course of the dispute, on 6 June 2001, Finance advised the then Minister that in coming to this conclusion the Arbitrator appeared to have taken the following matters into account:

- the formula had been provided to the Commonwealth during the negotiation of the Tied Contract and OASACS' Business Adviser had obtained advice from an expert adviser on its operation;
- after completion of the sale the Commonwealth retained advisers to provide advice on the formula. These advisers had concluded that it was logical and could be applied given the relevant fleet data;
- after completion of the sale OASACS and Macquarie Fleet wrote to the RBA advising that the formula operated to build a buffer in the Reserve Account; and
- the Arbitrator would not accept the Commonwealth's argument that the letter to the then Minister for Finance and Administration dated 1 July 1997 modified the formula by agreeing to the removal of the 99 per cent assurance level that the Reserve Account would not be in deficit at the end of the run-off period.

2.97 In this circumstance, application of the Interim Award would have involved the Commonwealth funding an estimated \$18.6 million for the statistical buffer and what was estimated at the time to be an additional \$20 million deficit in the Reserve Account. This would have been over and above the \$12.067 million the Commonwealth had previously agreed to pay into the Reserve Account on 9 March 1998. The Commonwealth would have had to fund these amounts either through direct payments into the Reserve Account, or through extremely high RRFs paid by agencies (of more than \$230 per month on each new lease entered into under the Tied Contract).

2.98 Under the Arbitrator's Interim Award, which upheld Macquarie Fleet's claim that it was entitled to build a buffer estimated to be \$18.6 million in June 2001 in the Reserve Account, the Commonwealth was essentially required to

provide Macquarie Fleet with a loan of this amount to ensure there was only a one per cent chance that Macquarie Fleet would not make a loss when the last Tied Contract vehicle was sold. In these circumstances, to recoup any amount of this loan outstanding after the expiry of the five-year term of the Tied Contract, the Commonwealth would have been required to use the Voluntary Early Termination provisions of the Contract.⁵¹

2.99 The Voluntary Early Termination provisions of the Tied Contract provided the Commonwealth, at five years and 10 months after the Contract was signed, with the opportunity to exit from the remaining leases issued under the Tied Contract. Termination of the remaining leases under this provision would return any positive amount in the Reserve Account to the Commonwealth but also obliged the Commonwealth to pay Macquarie Fleet any unpaid Leasing Rates and Fleet Management Rates; the Vehicle Principle Outstanding for all the remaining vehicles; and any Break Costs accruing to Macquarie Fleet as a result of the Termination. In return Macquarie Fleet would be required to transfer title to the vehicles to the Commonwealth. Costs would also have accrued to the Commonwealth for stamp duty associated with re-registering the cars transferred to its ownership.⁵²

2.100 Finding: Under the Tied Contract, RRFs were payable monthly by CPA customers on each lease entered into under the Tied Contract with Macquarie Fleet (that is on vehicles other than the Tombstone Fleet). The RRFs collected on each lease are paid into the Reserve Account and were designed to protect against the possibility of a negative balance in the Reserve Account at the end of the Tied Contract. The larger the negative balance in the Reserve Account the larger the RRFs charged on each new vehicle lease.

2.101 Macquarie Fleet's final offer for DASFLEET estimated the RRF at \$20 per vehicle per month and this was the amount charged for RRFs on commencement of the Tied Contract on 1 September 1997. However, once the Tied Contract commenced on 1 September 1997, the RRF applicable was required to be derived from the application of the statistical formula set out in the Tied Contract.

2.102 On 26 September 1997, Macquarie Fleet notified the FMB that it intended to increase RRFs from \$20 per vehicle per month to \$101 per vehicle

⁵¹ Under the Voluntary Early Termination provisions of the Tied Contract, Finance had been advised by its Legal Advisers that an opportunity would exist for the Commonwealth to recover any positive balance in the Reserve Account by exercising its right to terminate the Tied Contract between five years and 10 months after the commencement of the Contract and the sixth anniversary of the Contract or the expiration of the last lease under the Contract (depending on whether or not Macquarie Fleet exercised its right under the Contract to issue a written notice determining the Voluntary Early Termination period to be the former).

⁵² In June 2001, these costs were estimated by Finance's Commercial Adviser to be up to \$4.5 million.

per month. The Fleet Monitoring Body sought the validation of such a substantial increase in the RRFs. It eventually became clear that the Commonwealth and Macquarie Fleet did not agree on the operation of the formula set out in the Tied Contract for the determination of RRFs under the terms of the Contract. The differing interpretations of the formula by the FMB and Macquarie Fleet resulted in differing RRF payments applicable to new leases.

2.103 Under the Commonwealth's interpretation, the Reserve Account should have gradually trended to a zero balance by the end of the last leases entered into under the Contract (the bulk of which were expected to expire two years after the end of the five year Tied Contract). Under Macquarie Fleet's interpretation, the account would have trended to a figure that at the end of the Tied Contract term (that is 31 August 2002) would have included a monetary buffer sufficient to ensure a 99 per cent probability of Macquarie Fleet not making a loss when the last Tied Contract vehicle was sold. This balance would ensure that at the end of a two-year run off period there would still be enough money in the Reserve Account to cover any potential losses on sales of vehicles.

2.104 Macquarie Fleet argued that it was entitled to charge RRFs sufficient to create such a buffer, estimated in June 2001 at \$18.6 million. This effectively would have constituted a loan to Macquarie Fleet. To recoup any amount of this loan outstanding after the expiry of the five-year term of the Tied Contract, the Commonwealth would have been required to use the Voluntary Early Termination provisions of the Contract.

2.105 Application of the October 2000 Interim Award would have involved the Commonwealth funding an estimated \$18.6 million for the statistical buffer and what was estimated at the time to be an additional \$20 million deficit in the Reserve Account. This would have been over and above the \$12.067 million the Commonwealth had previously agreed to pay into the Reserve Account on 9 March 1998. The Commonwealth would have had to fund these amounts either through direct payments into the Reserve Account, or through extremely high RRFs paid by agencies (of more than \$230 per month on each new lease entered into under the Tied Contract).

3. Resolution of the Contractual Disputes

This chapter examines the whole of dispute settlement of the commercial disputes, including the negotiation of an Amended Tied Contract, and the costs incurred by the Commonwealth.

Background

3.1 A strong feature of Finance's approach to the management of the situation in which the Department found itself as a result of the contractual disputes relating to the DASFLEET transaction was the pro-active procurement of extensive legal, commercial and other expert advice to inform the Department's advice to the Minister and other actions. In relation to legal matters, Finance engaged a chief legal adviser but, as required, additional advice was obtained from other firms and substantial advice was received from Senior Counsel on key issues during the arbitration and settlement processes. Finance engaged a commercial adviser who coordinated the procurement of additional expert accounting, actuarial and industry advice during the arbitration and settlement processes.

3.2 Finance advised the then Minister for Finance in the 6 June 2001 business case that, as a result of the arbitration process and the Interim Award, the total potential exposure of the Commonwealth to possible payments to Macquarie Fleet was reduced from the around \$100 million originally claimed by Macquarie Fleet to around \$50 million. However, Finance received advice from Senior Counsel that there remained several legal avenues by which the Commonwealth could seek to improve the outcome of the disputes from its perspective. Namely, that it was considered there were grounds for an appeal in relation to the Arbitrator's Interim Award; scope for further arbitration in relation to those matters not decided by the Interim Award; and reasonable prospects for success in relation to the Commonwealth's action in the Federal Court seeking damages against Macquarie Bank under the *Trade Practices Act* on the grounds of false and misleading conduct during the DASFLEET sale process.

3.3 In addition, various attempts at negotiating a resolution of the DASLFEET matter had occurred over the course of the disputes, most significantly between June 2000 and the 26 October 2000 handing down of the Interim Award. However, when a settlement could not be secured prior to the Arbitrator's decision on the Interim Award, both parties withdrew all settlement offers. Negotiations were recommenced between the parties in early November 2000.

Notwithstanding this, the Commonwealth's *Trade Practices Act* action remained on foot and Finance continued to consider, on the basis of legal advice, an appeal in the ACT Supreme Court from the Interim Award. On 16 November 2000, Finance lodged a notice of appeal from the Interim Award.

3.4 On 6 November 2000, Macquarie Fleet approached Finance with an updated settlement proposal, taking into account the Interim Award made by the Arbitrator. During the earlier settlement discussions, Macquarie Fleet had proposed the substitution of Lease Plan Australia for itself under the Tied Contract. The updated settlement proposal included a discussion paper prepared by Lease Plan Australia setting out its proposal for the company to operate the Tied Contract. The Commonwealth responded to Macquarie Fleet's proposal with a counter-proposal on 16 November 2000. The parties then agreed to an informal period of moratorium during which the parties would negotiate toward a 'whole of dispute' settlement framework. Under this moratorium, the arbitration process was placed on hold. The parties agreed to begin negotiations face to face, on a without prejudice basis, with little exchange of correspondence. Accordingly, from mid-November 2000 the parties met on a regular basis to work toward a proposed 'whole of dispute settlement'.

3.5 In addition, Macquarie Fleet agreed not to increase RRFs during the moratorium period. Macquarie Fleet indicated to Finance that, had the settlement discussion broken down, it would immediately increase RRFs. Due to the negative balance of the Reserve Account and the need to fund the buffer, the increase in monthly rental rates per vehicle that would have applied was estimated to be in excess of \$230 per vehicle per month.

Whole of dispute settlement framework

3.6 Finance considered the settlement negotiations in the context of a business case that included consideration of the various options available to the Commonwealth. The substantive options identified were:

- entering into a 'whole of dispute' settlement;
- termination of the Tied Contract, which may have involved further arbitration or litigation relating to the Commonwealth's right to terminate; and
- status quo, involving the continuation of the arbitration process, a potential appeal from the Interim Award and the pursuit of claims under the *Trade Practices Act*.

3.7 In developing this business case, Finance obtained extensive legal, commercial and other expert advice. The risks and benefits of the different

options were compared and negotiations pursued with Macquarie Fleet aimed at obtaining the best possible outcome for the 'whole of dispute' settlement option. On 31 January 2001, the then Minister for Finance and Administration was briefed by Finance on these issues. Finance advised the Minister that after considering the legal advice it had obtained, considering the likelihood of success if appeal proceedings were instituted against the Interim Award, and competing commercial considerations, Finance had concluded that:

- any proceedings would preclude assignment of the Tied Contract and the Commonwealth accessing the consequential net positive benefit of assignment;
- success in any appeal proceedings could only be seen as possible, not probable;
- any appeal proceedings would cause further delays and increased costs in resolving the matters and bring the matter into a public forum; and
- it is quite possible that any proceedings could result in a less favourable outcome for the Commonwealth.

3.8 Finance went on to advise the then Minister that therefore, whilst still retaining a right of appeal and without detracting from any prospects under this process, it would be more advantageous to seek agreement to the 'whole of dispute' settlement process. On 3 February 2001, the then Minister approved the 'whole of dispute' settlement framework approach subject to substantial improvements being obtained in the settlement offer from Macquarie Fleet and Finance obtaining comprehensive legal advice to underpin any view that a commercially sound settlement had been arrived at.

3.9 The 'whole of dispute' settlement framework included consideration of:

- an inclusive, 'whole of dispute' settlement of all issues in dispute;
- substitution of Lease Plan Australia (who were already sub-contracted to provide fleet management services on behalf of Macquarie Fleet) for Macquarie Fleet under the Tied Contract, resulting in the removal of Macquarie Fleet from the DASFLEET service provision arrangements;
- shortening of the Tied period from 1 September 2002 such that the Commonwealth would be entitled to terminate the Tied Contract at any date after five months from the date of settlement with one month's notice (that is a minimum of six months from the date of settlement—5 January 2002);
- reductions in the whole of government cost of fleet provision and management for the shortened period of the Tied Contract;

- restructuring of the Tied Contract to eliminate substantial operational deficiencies;
- discontinuance of any further legal action in relation to arbitration or the *Trade Practices Act*; and
- payment of agreed amounts outstanding between the parties inclusive of any damages or other amounts payable to the Commonwealth.

3.10 Finance was engaged in strenuous negotiations with Macquarie Fleet until late May 2001. Offers and counter-offers were exchanged between the parties. At the same time, Finance commissioned substantial expert advice from its advisers to inform it on the legal, commercial and financial consequences of not only the proposals from Macquarie Fleet for settlement but also the alternative options of termination of the Tied Contract or continuation of the status quo (that is continuation of arbitration, litigation and performance of the Tied Contract by Macquarie Fleet).

3.11 On 23 May 2001, the negotiations with Macquarie Fleet culminated with a letter of commercial intent from Macquarie Fleet to Finance setting out principles upon which Macquarie Fleet and the Commonwealth would pursue settlement of all disputes between them in relation to DASFLEET. Finance responded on 24 May 2001 notifying Macquarie Fleet of its intention to pursue settlement based on those principles, while noting that this should not be construed as an acceptance of any offer to settle. The principles were:

- the Commonwealth would pay the 9 March 1998 agreement amount into the Reserve Account (\$12.067 million plus interest⁵³);
- Macquarie Fleet would pay the Commonwealth the CALS adjustment amount (\$1.938 million and interest);
- Macquarie Fleet and Macquarie Bank on the one hand and the Commonwealth on the other would give each other (without any admission of liability) mutual release from all causes and actions in relation to the disputes over the Sale Agreement and the Tied Contract;

⁵³ The 9 March 1998 agreement between Finance and Macquarie Fleet was that, in order to forestall an otherwise large increase in the deficit of the Reserve Account and consequential Residual Risk Fees payable by agencies as part of their lease payments, the Commonwealth would deposit into the Reserve Account the amount necessary to cover the write down in the value of the existing DASFLEET vehicles transferred to Macquarie Fleet between the Asset and Liability Statement as at January 1997 and the completion of the sale on 31 August 1997. Although the substance of this matter was never in dispute, the correct amount payable in satisfaction of the 9 March 1998 agreement could not be determined until the correct amounts for all the components of the Completion Asset and Liabilities Statement (CALS) were finally agreed between Finance's and Macquarie Fleet's expert advisers in February 2001. ANAO reviewed the final amount on 6 June 2001 prior to Finance arranging to pay \$14.655 million (\$12.067 million plus interest) to Macquarie Fleet on 22 June 2001.

- Macquarie Fleet and the Commonwealth would agree to amend the Tied Contract to, amongst other things, substitute Lease Plan Australia and remove the requirement for a buffer (this would be achieved through the Commonwealth accepting the full residual risk on vehicles already on lease as at the date of substitution);
- there would be a monetary adjustment, none of which would represent settlement of any particular claim, for the ‘whole of dispute’ settlement comprising:
 - payment then estimated at approximately \$20 million by the Commonwealth to Macquarie Fleet (this amount was to be settled after discussion between Macquarie Fleet and the Commonwealth and was subsequently agreed to be \$15.7 million);
 - payment of \$8 million by Macquarie Fleet to the Commonwealth;
- Macquarie Fleet, Macquarie Bank and the Commonwealth would agree on confidentiality arrangements and joint press releases (if any) relating to the settlement; and
- all amounts were to be GST exclusive.

Final settlement agreement

3.12 Macquarie Fleet’s 23 May 2001 letter of commercial intent led to the negotiation of a final settlement agreement. In advance of this agreement being reached, the Commonwealth, pursuant to the Sale Agreement, paid Macquarie Fleet the amount of \$1.704 million (\$1.398 million plus interest)⁵⁴ for uncollected Book Debts following receipt of the required certifications from Macquarie Fleet. The liability of the Commonwealth for this payment had never been in dispute.

3.13 Finance prepared a detailed business case to support the final settlement proposal, which was submitted to the then Minister on 6 June 2001. The business case outlined the dispute, activities aimed at resolving the dispute and the proposed settlement. All material supporting documents were attached, including drafts of the detailed final sign-offs to be provided by Finance’s advisers. Also attached to the business case was advice Finance had obtained from three Senior Counsel with respect to the options available to the Commonwealth. The three Senior Counsel had each had, at various times, a substantial role on the Commonwealth’s behalf in relation to the DASFLEET matter.

⁵⁴ Finance paid Macquarie Fleet a further amount of \$24 109 for the remaining interest on the Book Debts on 7 June 2001.

Probity Adviser

3.14 To enhance the probity of the legal process of negotiating and finalising a settlement with Macquarie Fleet, Finance engaged the Australian Government Solicitor as its Probity Adviser for this process. The Probity Adviser's brief was to review:

- whether Finance sought and obtained sufficient legal advice from appropriate legal advisers in relation to the outstanding issues [in relation to the DASFLEET matter] and whether the process for obtaining that advice was appropriate; and
- whether, having regard to the advice Finance received from its legal advisers relevant to the outstanding issues, it was appropriate for Finance to make a decision in relation to what action Finance should take regarding the outstanding issues.

3.15 On 5 July 2001, the Probity Adviser provided a final sign-off to the effect that, on the basis of the material which he had considered and the role which he had undertaken, he concluded that:

- (a) Finance sought and obtained sufficient legal advice from appropriate legal advisers in relation to the outstanding issues, and the process for obtaining that advice was appropriate; and
- (b) having regard to the advice it received from its legal advisers relevant to the outstanding issues, it was appropriate for Finance to make a decision in relation to what action Finance should take regarding the outstanding issues.

3.16 This sign-off was provided in the context of a five page letter which set out the Probity's Adviser's role and involvement in the process including: his attendances at meetings; his consideration of documents, including legal opinions; and a description of his other inputs to the process. These other inputs included drawing Finance's attention to any matter on which legal advice had not been, but in his view should appropriately be, requested and any aspects of advices which he believed should appropriately be raised by Finance with its legal advisers. The Probity Adviser stated that he believed that where he had drawn such matters to Finance's attention, Finance had raised them with its legal advisers.

3.17 In addition, during the process of negotiating the settlement with Macquarie Fleet, the Probity Adviser provided Finance with a range of advice. The Probity Adviser's sign-off letter set out the key advices he provided to Finance. The Probity Adviser also stated that, in accordance with the brief, during the process he had made such comments and recommendations as appeared to him to be appropriate with a view to ensuring that, upon a final resolution of the dispute, he would be able to reach satisfactory conclusions in relation to the matters referred to in his sign-off.

3.18 ANAO is unaware of a Probity Adviser previously being employed by a Commonwealth agency to assure the probity of the legal aspects of the process used to resolve a complex commercial dispute. However, the use of a Probity Adviser in such a way is a useful innovation to provide substantial additional comfort to agencies and Ministers that the correct legal steps have been taken to provide a sound basis for a final decision on the resolution of complex commercial disputes.

Ministerial approval

3.19 Finance's brief to the then Minister of 6 June 2001, which accompanied the detailed Business Case prepared to support settlement of the disputes, advised that, based upon the legal advice provided by Senior Counsel, Finance and its legal and commercial advisers jointly undertook analysis of the options. The Probity Adviser also provided advice in relation to its brief. Finance advised the then Minister that, as a result of that analysis, Finance had determined that the proposed 'whole of dispute' settlement was a commercially reasonable settlement.

3.20 Under the final settlement agreement, Macquarie Fleet and the Commonwealth were to pay amounts that were not in dispute and could be quantified as a result of the Interim Award as soon as possible and in advance of the settlement. These amounts were the CALS adjustment and the 9 March 1998 Agreement amount. The correct amounts payable for the CALS adjustment and the 9 March 1998 agreement could not be determined until the correct amounts for all the components of the Completion Asset and Liabilities Statement (CALS) were finally agreed between Finance's and Macquarie Fleet's expert advisers in February 2001. On 19 June 2001, Macquarie Fleet paid OASACS \$2.503 million for payment of the CALS adjustment. The final amount of the 9 March 1998 agreement was reviewed by ANAO on 6 June 2001 prior to Finance arranging for the payment to Macquarie Fleet of \$14.655 million (\$12.067 million plus interest) by electronic funds transfer on 22 June 2001. This amount was then off-set against the Reserve Account balance.

3.21 On 29 June 2001, the then Minister approved the settlement basis and signed an instrument authorising a senior Finance officer to approve and execute the settlement documentation. Finance sought specific legal advice on this issue and the draft instrument. ANAO notes that while a specific instrument authorising an officer to exercise the Minister's authority in this way is not an obligatory requirement, it is certainly good practice to document the Minister's authorisation in this way.

3.22 Finding: As a result of the arbitration process and the Interim Award, the total potential exposure of the Commonwealth to possible payments to Macquarie Fleet was reduced from the around \$100 million originally claimed by Macquarie Fleet to around \$50 million. Various attempts at negotiating a resolution of the DASLFEET matter had occurred over the course of the disputes, most significantly between June 2000 and the 26 October 2000 handing down of the Interim Award. However, when a settlement could not be secured prior to the Arbitrator's decision on the Interim Award, both parties withdrew all settlement offers. Negotiations were recommenced between the parties in early November 2000.

3.23 On 3 February 2001, the then Minister approved the 'whole of dispute' settlement framework approach subject to substantial improvements being obtained in the settlement offer from Macquarie Fleet and Finance obtaining comprehensive legal advice to underpin any view that a commercially sound settlement had been arrived at. Finance was engaged in strenuous negotiations with Macquarie Fleet until late May 2001. Offers and counter-offers were exchanged between the parties. At the same time, Finance commissioned substantial expert advice from its advisers to inform it on the legal, commercial and financial consequences of not only the proposals from Macquarie Fleet for settlement but also the alternative options of termination of the Tied Contract or continuation of the status quo (that is continuation of arbitration, litigation and performance of the Tied Contract by Macquarie Fleet).

3.24 Macquarie Fleet's 23 May 2001 letter of commercial intent led to the negotiation of a final settlement agreement. Finance prepared a detailed business case to support the final settlement proposal, which was submitted to the then Minister on 6 June 2001. The business case outlined the dispute, activities aimed at resolving the dispute and the proposed settlement. All material supporting documents were attached, including drafts of the detailed final sign-offs to be provided by Finance's advisers, including the Department's Probity Adviser. On 29 June 2001, the then Minister approved the settlement basis and signed an instrument authorising a senior Finance officer to approve and execute the settlement documentation.

Settlement

3.25 Prior to the authorised Finance officer executing the settlement documentation, Finance obtained specific legal advice from its Legal Adviser that the proposed settlement documentation was in accordance with the Ministerial Instrument. Settlement of the disputes with Macquarie Fleet/Macquarie Bank then occurred on 5 July 2001. This involved the:

- execution of the Deeds of Release, the parties to which were the Commonwealth, Macquarie Bank and Macquarie Fleet. Under the Deed of Release the parties gave each other (without any admission of liability) mutual release from all causes and actions in relation to the disputes over the Sale Agreement and the Tied Contract;
- execution of the Novation Deed, which was included as a schedule to the Deed of Release. The Novation Deed is an agreement which novates the Tied Contract from Macquarie Fleet to Lease Plan Australia the parties to which are Macquarie Fleet, Lease Plan Australia and the Commonwealth;
- execution of the Deed of Amendment, which was included as a schedule to Novation Deed. The Deed of Amendment amends the Tied Contract;
- payment of \$8 million by Macquarie Fleet to the Commonwealth; and
- payment of \$15.7 million by Finance on the Commonwealth's behalf to Macquarie Fleet.

3.26 The funds for payment of the settlement of the DASFLEET disputes were not separately appropriated by the Parliament. Finance obtained legal advice from AGS in October 2000 that these amounts could be paid from the standing appropriation relating to the Business Services Trust Account (BSTA).⁵⁵ The BSTA was originally a component of the Commercial Activities Fund that supported the operations of the former DAS Business Units; it was converted to a Special Account by section 5 of the *Financial Management Legislation Amendment Act 1999*. Accordingly, the following payments totalling some \$32 million were made from the BSTA:

- \$1.728 million (\$1.398 million plus interest) to Macquarie Fleet for repurchase of DASFLEET uncollected book debts as provided for under the Sale Agreement;
- \$14.655 million (\$12.067 million plus interest) to Macquarie Fleet for deposit into the Reserve Account in satisfaction of the 9 March 1998 agreement between Macquarie Fleet and the Commonwealth; and
- \$15.7 million to Macquarie Fleet in settlement of the disputes.

⁵⁵ AGS noted that the relevant purposes of the BSTA are as follows:

For expenditure relating to:

(a)(i) the provision of services and matters incidental thereto, being in the field of transport, printing, publishing, procurement, disposal, protection, guarding, security, storage, warehousing, packaging, analytical testing, laboratory valuation, construction project management, contract administration, real property agency, property management, surveying, land information construction, construction design, information technology, establishments and facilities management, administrative, and related services, and any combination, co-ordination or arrangement of the above mentioned services to the Commonwealth or to a Commonwealth body or to a company over which the Commonwealth or a Commonwealth body is able to exercise control, inside or outside Australia.

3.27 The \$8 million payment made by Macquarie Fleet to the Commonwealth in settlement of the disputes was also paid into the BSTA. Finance advised ANAO in March 2002 that the costs relating to the arbitration and the extensive legal, commercial and other advice the Department required during the Tied Contract with Macquarie Fleet were met from departmental funds.

3.28 Finding: Prior to the authorised Finance officer executing the settlement documentation, Finance obtained specific legal advice from its Legal Adviser that the proposed settlement documentation was in accordance with the Ministerial Instrument. Settlement of the disputes with Macquarie Fleet/Macquarie Bank then occurred on 5 July 2001.

3.29 Under the whole of dispute settlement, Macquarie Fleet paid \$2.503 million to OASACS in respect of the CALS. Finance paid Macquarie Fleet \$1.73 million to purchase, as required under the Sale Agreement, outstanding uncollected DASFLEET book debts transferred on sale. In addition, Finance transferred \$14.65 million to Macquarie Fleet for deposit in the Reserve Account in satisfaction of the 9 March 1998 Agreement. Finally, in settlement of the disputes, Finance paid Macquarie Fleet \$15.7 million and Macquarie Fleet paid Finance \$8 million.

3.30 The funds for payment of the settlement of the DASFLEET disputes were not separately appropriated by the Parliament. Finance obtained legal advice from AGS in October 2000 that these amounts could be paid from the standing appropriation relating to the Business Services Trust Account (BSTA). The \$8 million settlement payment from Macquarie Fleet was also paid into the BSTA.

Amended Tied Contract

3.31 Following the settlement of the disputes and the novation of the Tied Contract to Lease Plan Australia, Macquarie Fleet no longer has any involvement in the provision of fleet leasing services under the Tied Contract. Under the Amended Tied Contract with Lease Plan Australia the term of the Tied Contract was shortened. The term of the original Tied Contract was five years ending on 31 August 2002. As amended, the Commonwealth is entitled to terminate the Tied Contract at any date after five months from the date of settlement upon one month's notice (that is a minimum of six months from the date of settlement).

3.32 In addition, the Commonwealth has assumed the full residual risk on the vehicles currently on lease as at the date of settlement.⁵⁶ This has removed any

⁵⁶ However, under clause 14.6 of the Amended Tied Contract, the Commonwealth has the right, once every six months, to require Lease Plan Australia to make an offer to relieve the Commonwealth of the risk it bears under the Amended Tied Contract that there will be a difference between the net sale proceeds and residual value for a pre-substitution vehicle. Thereby establishing a mechanism to transfer this risk should it prove cost-effective to do so.

need to fund a buffer in the Reserve Account as that was a device designed to protect Macquarie Fleet from the risk that the Reserve Account would be in deficit by the time the lease on the last vehicle leased under the original Tied Contract expired. As at June 2001, the buffer required in the Reserve Account at 31 August 2002 to provide 99 per cent statistical certainty of this was estimated to be \$18.6 million.⁵⁷

3.33 Under the Amended Tied Contract, the Reserve Account has been renamed the Settlement Account and as of the date of settlement had a zero balance. The \$15.7 million payment by the Commonwealth to Macquarie Fleet was the amount calculated to be required to zero the Reserve Account if it was not otherwise to be zeroed as part of the novation of the Tied Contract.⁵⁸ Subsequently, profits and losses on sales of vehicles on lease on the settlement date that are incurred when vehicles are sold at the end of the lease are credited or debited to the Settlement Account. Finance clears the Settlement Account whenever the Account becomes either \$2 million in credit or \$2 million in deficit.

3.34 New leases entered into under the Amended Tied Contract are operating leases and the Commonwealth bears no residual risk on these vehicles. However, Lease Plan Australia's margin is 95 basis points⁵⁹ as compared to the 45 basis points charged by Macquarie Fleet⁶⁰ with the interest rate for each lease fixed at

⁵⁷ Under the Arbitrator's Interim Award, if the Commonwealth had continued with the Tied Contract with Macquarie Fleet it would have been obliged to fund the buffer of \$18.6 million in the Reserve Account. However, Finance's legal advice was that the Commonwealth would have had an opportunity to access any positive balance in the Reserve Account under the Early Termination Provisions of the Tied Contract prior to the expiry of the last lease. Accordingly, the cost to the Commonwealth may only have been that of funding the buffer, either through RRFs paid by agencies or through a direct payment into the Reserve Account, as much of the principal (taking into account the costs involved in exercising the Commonwealth's rights under the Tied Contract) may have been able to be recovered subsequently.

⁵⁸ Under the terms of the Deed of Release, this amount was subject to adjustment once the final figures 'rolling forward' the Reserve Account balance as at 4 July 2001 were available. Accordingly, Macquarie Fleet has subsequently paid the Commonwealth \$59 389 (inclusive of GST). In addition, Macquarie Fleet paid the Commonwealth \$800 000 for the GST on the \$8 million payment it made to the Commonwealth under the settlement and the Commonwealth paid Macquarie Fleet \$1.57 million for the GST on its \$15.7 million payment to Macquarie Fleet.

⁵⁹ Lease Plan Australia's margin of 95 basis points is applied to a different base interest rate than that used during the Tied Contract with Macquarie Fleet. The Amended Tied Contract provides that for leases issued under that Contract, the relevant rate is the bid rate published at or around 5 pm (Sydney time) on the Business Day prior to the date of commencement of the relevant lease on Reuters Screen WBC/SWAPS1 for Bills having a tenor equal to the term of the relevant lease (or if there is no rate published for Bills of a tenor equal to the term of the relevant Lease, for Bills of the next highest tenor in respect of which a rate is published.).

⁶⁰ During the Tied Contract with Macquarie Fleet the Commonwealth had the option to elect either a fixed or floating rate of interest. For the duration of the contract the Commonwealth elected the floating rate option. Macquarie's margin of 45 basis points was applied to the average bid rate on the page numbered BBSY on the Reuters Monitor System at or about 10.15 am (Sydney time) on the relevant date for a bank accepted bill having a tenor of 30 days. On 2 June 1998, the FMB agreed to a slight amendment of this rate in that it agreed to Macquarie Fleet using the rate applicable on day 25 of the previous month. This amendment allowed processing time for DASFLEET to get invoices out by the first day of the month. With prospective billing, the interest rate on day 25 of month one was applied to the lease rates for all leases for month two. Finance advised ANAO in March 2002 that this was the basis for the rate that was used for leases written between September 1997 and 4 July 2001.

commencement. In negotiating the Amended Tied Contract with Lease Plan Australia, Finance also agreed, on the basis of commercial advice, to the removal from the Contract of the prohibition on the lessor claiming Depreciation Allowances.⁶¹

3.35 Finance's Commercial Adviser advised in June 2001 that it must be assumed that Macquarie Fleet would have built into its original bid for DASFLEET the cost of not having access to any timing benefits from tax depreciation on vehicles leased to the Commonwealth. The impact on Lease Plan Australia of having access to these timing benefits is that it effectively obtains an interest free loan from the Commonwealth for the amount of the depreciation claimed for the provision of leasing to the Commonwealth. This has the effect of reducing the costs of funds for Lease Plan Australia compared with Macquarie Fleet. The Commercial Adviser noted that the provision of tax depreciation has a cost to the Commonwealth whilst the reduced interest cost of leases is a benefit to the Commonwealth. The Commercial Adviser argued that the competitive pressures on vehicle leasing companies would help to ensure that the bulk of the benefit, if not all, is passed through to customers. Accordingly, in this circumstance, the overall impact is constant for the Commonwealth whether or not the depreciation benefits are accessed.

3.36 Prior to the substitution of Lease Plan Australia for Macquarie Fleet, Lease Plan Australia had been delivering, under sub-contract from Macquarie Fleet, the fleet management services to CPA customers purchased under the Tied Contract. Under this pre-substitution arrangement, CPA Customers were charged \$63.50 per month for the basic package of fleet management services. After the novation of the Tied Contract to Lease Plan Australia, for all new vehicles leased under the Amended Tied Contract the same basic package of fleet management services is provided at the rate of \$38 per month. On 6 June 2001, the then Minister was advised in the DASFLEET Settlement Business Case provided by Finance that the Macquarie Fleet proposal was expected to generate savings in fleet management costs of some \$3.67 million for agencies as compared to Macquarie Fleet continuing to carry out the original Tied Contract.⁶²

3.37 The Amended Tied Contract also includes various operational improvements aimed at improving the service provided, the accountability of the provider under the contract and the capacity of the FMB to effectively monitor

⁶¹ Under the original Tied Contract with Macquarie Fleet, Depreciation Allowance was defined as depreciation deductions allowable for income tax purposes in accordance with Australian income tax legislation. Neither Macquarie Fleet nor any party to which it sold down any interest in the Tied Contract vehicles was permitted under the Contract to access Depreciation Allowances. This term was included in the original contract to protect the Commonwealth's taxation revenue.

⁶² The Commercial Adviser's final calculation of this benefit in their report of 28 June 2001 was that the Fleet Management Costs under the Amended Tied Contract would be \$3.734 million less than the same costs for continuing the Tied Contract with Macquarie Fleet.

the Contract. A major difficulty for the FMB in attempting to monitor the original Tied Contract was that the Contract did not provide the Commonwealth with any direct right to audit the provider's compliance with the Contract.

3.38 The lesson learnt by the Commonwealth from this situation was addressed in the negotiation of the Amended Tied Contract which, by contrast, contains comprehensive audit provisions for the Commonwealth including:

- the right of access to Lease Plan Australia's premises and material;
- the right to audit the company's compliance with the Tied Contract and each individual lease agreement;
- an obligation for Lease Plan Australia to render assistance including the provision of copies of records and installing and operating audit software necessary to verify their compliance with the Amended Tied Contract;
- an obligation for Lease Plan Australia, at no additional cost to the Commonwealth, to take corrective action to rectify identified errors; and
- an obligation for Lease Plan Australia to pay interest on identified errors.

3.39 Another improvement included in the Amended Tied Contract as the result of the lessons learnt from the problems with the original Tied Contract related to the establishment of minimum performance criteria for, and the type and content of the reports required from, the contractor. Although the original Tied Contract with Macquarie Fleet provided for the FMB to prescribe minimum performance criteria in relation to tied fleet management arrangements and tied leasing arrangements, in the circumstances of the disputes on the DASFLEET transaction these were never established. In addition, there were substantial problems with both the reporting to CPA customers and to the FMB making effective monitoring of Macquarie Fleet's performance of the Tied Contract impossible. Macquarie Fleet advised ANAO in May 2002 in response to the section 19 report on the audit that:

the FMB was of the view that there were substantial problems with reporting and monitoring of [Macquarie Fleet's] performance. [Macquarie Fleet's] view was always that it complied with its contractual obligations under the Tied Contract.

3.40 On 21 February 1999, Finance was provided with a final draft⁶³ of the report the FMB had commissioned on commercial aspects of the Tied Contract with Macquarie Fleet. Included in the draft report's discussion of the risks for the Commonwealth relating to the Tied Contract with Macquarie Fleet, was the following:

⁶³ This report was never finalised as it was overtaken by events.

MFL [Macquarie Fleet] have not agreed to any KPIs as part of the Tied Contract. The Tied Contract covers this in clause 6.3, where the Monitoring Body and MFL will agree various performance criteria. It is not unreasonable to have agreed these up front. This would have enabled the Government to estimate (or even lock in) future savings in the contract. Leaving them for future agreement leaves the Government exposed.

In many transactions, critical functions are documented in such a way to apply monetary penalties for non-performance. For example, MFL has had considerable difficulty in providing financial information on the fleet up until recently. As the Tied Contract has no penalty for MFL's non-performance, MFL has to date not had to perform necessarily under some aspects of the contract. The important point here is that monetary penalties are only applied to ensure adequate priority is placed on meeting the original spirit of the Tied Contract. Using the same example as above, the result of MFL not providing [Finance] with accurate financial information on the fleet until recently, has resulted in a delayed reaction from [Finance] in pro-actively managing its position and communicating the position to the customers. This is clearly unacceptable.

3.41 In negotiating the Amended Tied Contract with Lease Plan Australia, Finance ensured that the Contract specifically required that, prior to the substitution date, Lease Plan Australia and Finance were to have agreed upon the Lease Plan Australia's reporting obligations and the minimum performance criteria to be met by the company. The reporting obligations and minimum performance criteria were agreed and Finance notified them to Lease Plan Australia in writing in a series of letters dated 5 July 2001. The minimum performance criteria also include financial penalties payable by Lease Plan Australia to Finance or the relevant CPA customer for failures to deliver reports to either Finance or CPA customers within the agreed timeframes.

Commonwealth costs

3.42 In light of the complex commercial disputes that arose in connection with the DASFLEET transaction, there have been substantial costs to the Commonwealth in relation both to attempting to monitor and manage the Tied Contract and to resolve the commercial disputes. In addition, both Finance and OASACS incurred substantial costs for legal and commercial advisers and other experts in relation to the management of the Tied Contract and Sale Agreement disputes (see Figure 3.1). In July 1999, management of the two disputes was combined under Finance's administration. From July 1999, OASACS met half the costs incurred by Finance in the management of the disputes.

Figure 3.1**Estimated Commonwealth External Provider Costs for the Management of the Tied Contract and DASFLEET Dispute July 1997 to 31 October 2001**

	<i>Pre July 1999</i> \$	<i>1999/2000</i> \$	<i>2000/2001</i> \$	<i>1 Jul to 31 Oct 2001</i> \$	<i>Total</i> \$
Arbitrator	0	5 765	78 410	0	84 175
Counsel	0	406 236	212 281	111 316	729 834
Disbursements	0	142 848	275 455	9 608	427 911
Litigation support services	0	270 776	34 262	0	305 038
Expert/Witness	0	358 376	850 679	0	1 209 055
Professional Advice	120 000	2 959 572	3 432 203	334 806	6 846 581
Total	120 000	4 143 575	4 883 290	455 730	9 602 595

Notes:

- The table does not include expenditure by OASACS incurred prior to Finance accepting responsibility for the carriage of the sale-related litigation, which occurred around July 1999. Finance advised ANAO in April 2002 that OASACS' adviser costs not already included in the above table are estimated to be \$50 000.
- The table does not include net payments made to Macquarie Fleet for the dispute settlement and non dispute related matters.
- Prior to 1999, a database of DASFLEET specific expenditure was not kept by Finance as the level of expenditure was low, therefore the table includes an estimate for the period prior to July 1999 where the majority of expenses would have been professional advice.

Source: Department of Finance and Administration advice to ANAO

3.43 Finance actively monitored expenditure on advisers in relation to the DASFLEET disputes. All expenditure relating to consultants was tracked on a database to ensure that advisers were not over or under paid and that all invoices were accounted for. Finance has provided ANAO with the estimated costs it incurred for external providers in the financial years 1997–98 and 1998–99 as well as the total costs incurred by both Finance and OASACS from 1 July 1999 to October 2001.

3.44 Finance advised ANAO that its estimate of the total staff costs, excluding OASACS, for managing the Tied Contract and the DASFLEET disputes between August 1997 and October 2001 was \$1.5 million. However, given the overwhelming affect of the disputes on the management of the Tied Contract, Finance advised it was unable to accurately determine the amount of these costs that related to the management of the disputes and the amount that was incurred for the normal contract management activities required. Finance advised ANAO in April 2002 that OASACS' staff costs for the periods September 1997 to July 1999 and July 1999 to October 2001 were estimated to be approximately \$440,000 and \$280,000 respectively.

Canberra ACT
27 June 2002



P. J. Barrett
Auditor-General

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