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Performance Audit

## **The Sale of Sydney (Kingsford Smith) Airport**

Australian National Audit Office

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of Australia 2003

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Canberra ACT  
8 May 2003

Dear Mr President  
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit across agencies in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *The Sale of Sydney (Kingsford Smith) Airport*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely



P. J. Barrett  
Auditor-General

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

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## Abbreviations/Glossary

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AGS	Australian Government Solicitor
AOFM	Australian Office of Financial Management
CGS	Commonwealth Government Securities
DOTARS	Department of Transport and Regional Services
Finance	Department of Finance and Administration
IPO	Initial Public Offering
OASACS	Office of Asset Sales and Commercial Support
OASITO	Office of Asset Sales and IT Outsourcing
SACL	Sydney Airports Corporation Limited

# Summary





# Summary

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## Background

1. Sydney (Kingsford Smith) Airport is Australia's busiest passenger and cargo airport and major international gateway airport. In December 2000, the Government announced its intention to privatise the Sydney basin airports, with Sydney (Kingsford Smith) Airport to be sold separately followed by the remaining three airports (Bankstown, Camden and Hoxton Park). After conducting a scoping study, on 29 March 2001 the Government announced it had decided to sell Sydney (Kingsford Smith) Airport by a 100 per cent trade sale with the following sale objectives:

- optimise sale proceeds within the context of the broader Government sales and policy objectives;
- minimise the Commonwealth's exposure to residual risks and liabilities;
- ensure that the airport lessee has the necessary financial and managerial capabilities to operate and provide timely investment in environmentally appropriate aviation infrastructure at Sydney (Kingsford Smith) Airport;
- ensure the sale outcome is consistent with relevant airport legislative, regulatory and policy requirements, including environmental, foreign investment, competition, access and pricing policies;
- ensure fair and equitable treatment of employees of Sydney Airports Corporation including the preservation of accrued entitlements; and
- ensure the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations.

2. Following a competitive tender process, the sale of Sydney (Kingsford Smith) Airport was completed on 28 June 2002. For a purchase price of \$4.233 billion,<sup>1</sup> Southern Cross Airports Corporation Pty Limited acquired all the shares in Sydney Airports Corporation Limited (SACL), the company that holds the long-term lease over the airport site. After deducting sale costs of \$17 million borne by the departments involved in undertaking the sale, the net sale proceeds were \$4.216 billion.

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<sup>1</sup> See paragraphs 4.1 and 4.13.

## Audit approach

3. The audit was conducted under Section 18 of the *Auditor-General Act 1997*. The objectives of the audit were to:

- evaluate the extent to which the Government's sale objectives were achieved, with a focus on those objectives relating to the optimisation of sale proceeds and minimisation of risk to the Commonwealth;
- examine the effectiveness of the management of the sale process to ensure the Commonwealth received fair value; and
- within the context of broader Commonwealth debt management considerations, assess the application of the sale proceeds to repaying Commonwealth debt and the extent to which public debt interest payments may be reduced.

4. The scope of the audit involved the planning for, conduct and completion of the sale of Sydney (Kingsford Smith) Airport. It included the preparation and conduct of the sales process prior to the September 2001 deferral as well as the recommenced tender process that culminated in the June 2002 sale to Southern Cross Airports Corporation. In accordance with the audit objectives, the scope also extended to the receipt of sale proceeds and the application of the proceeds to repaying Commonwealth debt.

## Overall audit conclusion

5. The sale of Sydney (Kingsford Smith) Airport for a purchase price of \$4.233 billion represents a very good financial outcome for the Commonwealth. The sale maximised financial returns on a risk-adjusted basis while achieving optimal outcomes in relation to the other sale objectives. The SACL transaction represents the largest airport trade sale world-wide to date and the most valuable single trade sale by the Commonwealth.

6. The sale process was effectively managed by the Department of Finance and Administration (Finance) and its advisers, in consultation with the Department of Transport and Regional Services (DOTARS). It was undertaken in a tight timeframe which was further complicated by the difficult issues that arose from the September 11 events in the United States and the collapse of Ansett that led to the tender process being deferred in September 2001. The tender process was completed within four months of its March 2002 recommencement, which represents a considerable achievement on the part of Finance and its advisers.

7. In June 2002, when announcing the sale of the Airport to Southern Cross Airports Corporation, the Government stated that the proceeds of the sale would

go to repaying Commonwealth debt with Commonwealth debt to be reduced by \$4.233 billion. This, in turn, would reduce public debt interest payments by around \$250 million every year. A total of \$2.2 billion in sale proceeds was used to finance maturing debt with the remainder invested in deposits with the Reserve Bank of Australia and used on an as required basis to assist seasonal financing requirements, including the financing of subsequently maturing debt. In this context, the Australian Office of Financial Management advised ANAO that the approach adopted to manage the proceeds from the sale of SACL was consistent with established Government policy.

# Key Findings

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## Sale management

8. The sale was managed by Finance,<sup>2</sup> in consultation with DOTARS, whose role focussed on transport policy aspects and the ongoing regulation of the Airport under the provisions of the *Airports Act 1996*. A sound governance framework was adopted for the sale process. This framework included an effective committee and working group structure, a detailed risk management plan and continuous improvement mechanisms designed to address previous audit findings and recommendations. The governance framework that was adopted contributed to an effective overall outcome from the sales process.

## Outsourcing arrangements

9. A feature of the management of the sale was the tight control exercised over sale costs including the management of outsourcing arrangements. ANAO estimates that total costs (including those borne by SACL) for the sale of Sydney (Kingsford Smith) Airport were \$32.36 million, or less than one per cent of gross proceeds. On a comparable basis, the cost of Phase 1 of the airports privatisation program (involving Melbourne, Brisbane and Perth airports) totalled \$58.2 million or 1.8 per cent of gross proceeds with Phase 2 of the privatisation program (involving a further 15 airports) costing \$35.4 million, or 4.8 per cent of gross proceeds received.

10. The first adviser appointments were made in January 2001 when contracts were entered into with Scoping Study Business and Legal Advisers. To assist with the sale, in April 2001, options were exercised under the respective Scoping Study contracts to re-appoint the Business and Legal Advisers. In addition, following tender processes, a Sale Process Adviser and Communications Adviser were also engaged. Value for money in these assignments was promoted by the competitive tendering of each appointment and, in relation to the re-appointment of the Scoping Study Business and Legal Advisers for the sale process, by negotiating reduced fees with each adviser. As part of this re-negotiation, the Business Adviser reduced its fee by \$1.1 million and the Legal Adviser reduced its fee cap by \$25 000.

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<sup>2</sup> At the time of the December 2000 decision to sell Sydney (Kingsford Smith) Airport, responsibility for the sale process was allocated to the then Office of Asset Sales and IT Outsourcing (OASITO). In July 2001, OASITO was re-named the Office of Asset Sales and Commercial Support (OASACS) to reflect its revised functions. The Administrative Arrangements Order of 26 November 2001 resulted in the abolition of OASACS with its functions absorbed by Finance.

11. Overall, management of advisory contracts entered into as part of the SACL transaction was effective. In relation to financial management, fee payments were generally as specified in the respective contracts except for out of scope payments made to each of Finance's major advisers. The majority of these payments were a consequence of the deferral of the sale process in September 2001 with the largest payments being made to the Legal and Business Advisers.

## **Probity arrangements**

12. ANAO considers a comprehensive and rigorous approach was taken to the identification and management of probity issues. Reflecting the complexity and significance of the transaction, a Sales Process Adviser was appointed early in the sale process to provide support and advice on all process and probity issues. This included reviewing and advising on the processes and methodology underpinning the sale tender and tender evaluation processes and preparation of a comprehensive Probity Plan. It was envisaged that the Probity Plan would promote an open and accountable sale process which, in turn, would facilitate a competitive process, thus providing the best environment for a favourable outcome for the Commonwealth.

13. During the sales process, a significant number of written opinions, sign-offs and reports were prepared by the Sales Process Adviser. These included: advice on the initial extension and subsequent deferral of the sale process; a sign-off on the evaluation plan for binding bids; advice on the acceptance of the late receipt of parts of the successful bid; an opinion to the effect that binding bids had been evaluated fairly and consistently with the Request for Binding Bids and the evaluation plan; and a sign-off on the Binding Bid Evaluation Report. In addition, following the completion of the sale, the Sale Process Adviser provided Finance with a positive overall assessment of the probity of the sale process. No probity shortcomings were identified.

## **Tender process**

14. Sydney (Kingsford Smith) Airport was sold via a trade sale in a stepped, three stage tender process designed to maximise Commonwealth financial returns. The tender process was originally due to be completed in late 2001 but was deferred in September 2001. This followed advice that the Government's sale objectives could not be satisfactorily met in 2001 following the September 11 terrorist attacks and the subsequent disruption in global financial markets and the airline and aviation sectors. Subsequent to the deferral, Finance and its advisers monitored market conditions and maintained contact with the

three shortlisted bidders. In March 2002, after Government consideration of advice from Finance and its advisers that market conditions had stabilised, the tender process recommenced at the binding bid stage. All three consortia participating in the tender process, as at September 2001, were invited to participate in the recommenced sale process.

## **Evaluation criteria**

15. At each stage of the tender process, participating bidders were advised in advance of the evaluation criteria that would be applied. The Expressions of Interest stage was necessarily a less demanding stage because no price indications were given so that more general financial strength, airport management experience and regulatory compliance aspects were the focus. In the Request for Indicative Bids, six evaluation criteria were specified, consistent with the sale objectives.

16. The Request for Binding Bids specified eight criteria, drafted to more closely mirror the sale objectives than those applied to the Indicative Bids. As the evaluation criteria other than sale proceeds were qualitative in nature, the Binding Bid Evaluation Committee considered it was not appropriate to apply a pre-specified and mechanistic weighting system in the ranking of bids. Instead, the Request for Binding Bids included a statement weighting the criteria as follows: 'The Commonwealth aims to maximise net sale proceeds on a risk adjusted basis while achieving optimal outcomes in relation to the other criteria'.

## **Successful bidder selection**

17. The evaluation of Binding Bids required the effective coordination of input from a multi-disciplinary evaluation team within a tight time scale. To assist with evaluation, following recommencement of the tender process, the procedure and method of evaluating Binding Bids was set out in an evaluation plan that was approved in advance of the receipt of Binding Bids. Evaluation against the Binding Bid evaluation criteria was carried out based on a series of schedules. This approach enabled: an assessment to be made and clearly documented of whether each bidder had fully responded to, and addressed, the specifications in the Request for Binding Bids; a systematic application of the criteria to each consortium and full documentation of that process; and an assessment of the level of coverage, both qualitatively and quantitatively.

18. Three bids were received on 12 June 2002, although elements of the successful bid were received after the due time. A formal process of acceptance of those late elements (which did not include the bid price) was undertaken. This was overseen by the Sale Process Adviser and was in accordance with the

process for considering late bids set out in the Evaluation Plan. Based on his assessment of the facts, noting that all other members of the committee considered that the late elements of the bid should be accepted and that the Legal Adviser had advised that the Commonwealth had the right to accept late bids, the Chairman of the Binding Bid Evaluation Committee decided to accept the late elements of the bid. No bids were opened until the Chairman had decided to accept the late elements of the successful bid. The decision making process was fully documented. The Sale Process Adviser provided an unqualified sign-off on the acceptance process.

19. The three bids were evaluated against the specified criteria. The successful bid offered a significantly higher purchase price for the shares than the next highest bid and was assessed as equal to, or higher than, both other bids on all remaining criteria. On this basis, the Evaluation Committee unanimously concluded that the bid lodged by the Southern Cross Airports Corporation best met the aim of maximising net sale proceeds on a risk-adjusted basis while achieving optimal outcomes in relation to the other criteria. The sale agreement was signed and the selection decision announced on 25 June 2002, with financial completion occurring on 28 June 2002.

## Sale outcomes

### Financial returns

20. In ANAO's view, the sale proceeds represent a very good financial outcome for the Commonwealth. The purchase price paid by the successful bidder was more than \$600 million higher than the next highest bid, with the highest bid also assessed as equal to, or higher than, both other bids on all remaining evaluation criteria. The financial return from the sale also compares very favourably to Scoping Study and Budget estimates of likely sale proceeds, to current market valuations of previous privatisations of other international airports world-wide, and to the returns achieved from the Phase 1 and Phase 2 sales.

### Debt reduction

21. Recent reductions in Commonwealth net debt have been managed in line with an objective of maintaining the viability of the Commonwealth Government Securities market.<sup>3</sup> This has been achieved by holding surplus budget proceeds not applied to the redemption of Commonwealth Government Securities in deposits with the Reserve Bank. The proceeds from the sale of Sydney (Kingsford Smith) Airport were applied both to finance maturing debt and invested in

<sup>3</sup> *Budget Strategy and Outlook 2002–03*, Budget Paper No. 1, Statement 7, p. 3.

deposits with the Reserve Bank of Australia. This approach is estimated to have resulted in a return of 5.17 per cent in 2002–03, or some \$219 million. Interest savings in future years will reflect the course of market interest rates going forward, amongst other considerations.

## **Risk minimisation**

22. The tender approach addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to shortlisted bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability was assessed as part of the tender evaluation process. In this latter respect, the successful tender was rated equal to or higher than the other two tenders in relation to the risk-related criteria.

23. The major sale documentation comprised a Share Sale Agreement and a Tripartite Deed. Competitive tension through the tender process enabled various changes requested by bidders to the sale documentation to be resisted. In addition, the final signed Sale Agreement contains a number of measures designed to minimise the Commonwealth's post-sale risks and liabilities. The potential liability of the Commonwealth under the Tripartite Deed is significant. It extends to a risk that, in the event the lease is terminated by the Commonwealth and not re-sold, the Commonwealth is required to obtain a valuation of the airport site that would set the basis for a repayment of financier's loans by the Commonwealth, subject to higher ranking claims being met first.

## **Financial and managerial capabilities**

24. To finance the SACL acquisition, the successful bidder adopted an aggressive financial structure, with one ratings agency noting<sup>4</sup> that this meant there is little room for underperformance in any key operating metric and that any deviation in underlying cash flow expectations or financial accommodation could adversely affect its rating of the entity. Financial strength and managerial capabilities of bidders were explicitly addressed in the tender process, with the successful bidder assessed by the Evaluation Committee to have a very strong financial and management expertise. The tender process also addressed the strength and structure of the financing arrangements backing the bid with the Evaluation Committee concluding that the successful bidder's capital structure and financial coverage ratios (including gearing levels) were reasonable for an infrastructure asset financing.

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<sup>4</sup> Standards & Poors, *Industry Report Card: International Airports*, 18 July 2002.



## Other sale objectives

25. Consistency with relevant airport legislative, regulatory and policy requirements was explicitly assessed as part of the tender process. Each bid was assessed to meet the evaluation criteria relating to this sale objective, with the successful bidder considered by the Evaluation Committee to display a sound understanding of, and consistency with, all relevant legislative, regulatory and policy requirements surrounding Sydney (Kingsford Smith) Airport.

26. The sale objective of ensuring fair and equitable treatment of employees of SACL was addressed through the introduction of executive remuneration arrangements intended to retain top management throughout the sale process, the evaluation of bids in terms of this objective, and the inclusion of redundancy protections for staff in the Sale Agreement.

27. One of the Binding Bid evaluation criteria addressed the Government's sale objective of ensuring the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations. The successful bidder was assessed to fully meet this criterion, including through a proposed capital expenditure programme of \$2.079 billion over 20 years.

## Departmental response

28. Finance indicated that it is comfortable with the accuracy and completeness of the information in the report and with the conclusions and findings made. DOTARS advised that it has no disagreement with the findings and conclusions reached.



# **Audit Findings and Conclusions**



# 1. Introduction

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*This chapter sets the context for the audit; outlines the airports privatisation program; summarises the corporatisation of Sydney (Kingsford Smith) Airport; and explains the audit approach.*

## Background

**1.1** Sydney (Kingsford Smith) Airport is Australia's busiest passenger and cargo airport and major international gateway airport. In December 2000, the Government announced its intention to privatise the Sydney basin airports, with Sydney (Kingsford Smith) Airport to be sold separately followed by the remaining three airports (Bankstown, Camden and Hoxton Park). After conducting a scoping study, on 29 March 2001 the Government announced it had decided to sell Sydney (Kingsford Smith) Airport by a 100 per cent trade sale with the following sale objectives:

- optimise sale proceeds within the context of the broader Government sales and policy objectives;
- minimise the Commonwealth's exposure to residual risks and liabilities;
- ensure that the airport lessee has the necessary financial and managerial capabilities to operate and provide timely investment in environmentally appropriate aviation infrastructure at Sydney (Kingsford Smith) Airport;
- ensure the sale outcome is consistent with relevant airport legislative, regulatory and policy requirements, including environmental, foreign investment, competition, access and pricing policies;
- ensure fair and equitable treatment of employees of Sydney Airports Corporation including the preservation of accrued entitlements; and
- ensure the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations.

**1.2** Following a competitive tender process, the sale of Sydney (Kingsford Smith) Airport was completed on 28 June 2002. For a purchase price of \$4.233 billion, Southern Cross Airports Corporation Pty Limited acquired all the shares in Sydney Airports Corporation Limited (SACL), the company that holds the long-term lease<sup>5</sup> over the airport site. The sale agreement also granted the purchaser a 30 year right of first refusal over the development and operation

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<sup>5</sup> The lease commenced on 1 July 1998 for a term of 50 years, with the lessee having the option to renew the lease for a further term of 49 years.

of a second Sydney airport, if the Government of the day decides it is needed.

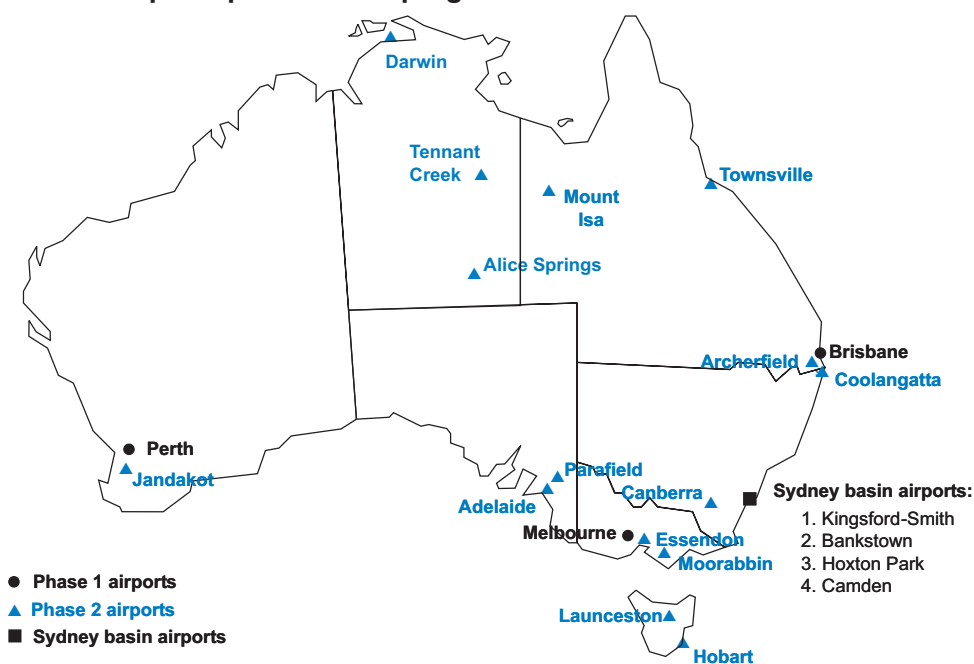
1.3 The sale process was undertaken in a tight timeframe which was further complicated by the difficult issues that arose from the September 11 events in the United States and the collapse of Ansett. In this context, the SACL transaction represents the largest airport trade sale world-wide to date and the most valuable single trade sale by the Commonwealth.

## Airports privatisation program

1.4 The airports privatisation program began in April 1994 when the then Government announced its in-principle decision to sell the 22 airports owned and operated at that time by the Federal Airports Corporation (see Figure 1.1). Legislation to facilitate the sales was passed in 1996 with the *Airports Transitional Act 1996* providing for the leasehold sale of the Federal Airports<sup>6</sup> with the *Airports Act 1996* establishing a framework for the regulation of leased Federal Airports.

**Figure 1.1**

### Federal airports privatisation program: 1997–2002



Source: ANAO analysis.

<sup>6</sup> The February 2001 *Sydney Airports Sale Scoping Study Report* concluded that the Commonwealth was able to sell SACL without the need to enact further enabling legislation.

1.5 The then Government announced in April 1995 its intention to sell all 22 Federal Airports by way of individual trade sales with the first tranche (Phase 1) to be completed by 31 December 1996. Following the March 1996 Federal Election, the new Government announced a revised timetable with completion planned by June 1997. Phase 1 of the airports privatisation program was completed on 1 July 1997 with the sale of separate long-term leases over Brisbane, Melbourne and Perth airports.<sup>7</sup> These sales are reported on in Audit Report No.38 1997–98, *Sale of Brisbane, Melbourne and Perth Airports*. In total, Phase 1 raised proceeds of \$3.31 billion with the direct costs of the sale estimated to be \$153 million, or 4.6 per cent of proceeds.

1.6 On 12 June 1997, the Government announced the commencement of Phase 2 of the airports privatisation program. Phase 2 comprised eight major, or core regulated, airports and seven non-core regulated airports.<sup>8</sup> Between 10 June 1998 and 30 June 1998, long-term leases were granted over 14 of the Phase 2 airports to nine different consortia raising proceeds of \$730 million for the Commonwealth. The total direct sale costs to the Commonwealth were estimated to be \$35.4 million, or 4.8 per cent of proceeds. The Phase 2 sales were reported on in Audit Report No.48 of 1998–99, *Phase 2 of the Sales of the Federal Airports*.

1.7 Essendon Airport was included in Phase 2 but was withdrawn from sale in April 1998 because it was concluded that the tenders received at this time did not adequately address the Government's sales and ongoing privatisation objectives. Subsequently, a separate tender process for the sale of Essendon Airport was conducted in 2001. On 10 August 2001, the sale of Essendon airport was announced for a price of \$22 million.<sup>9</sup> This sale was not audited by ANAO.

1.8 Following the June 2002 sale of Sydney (Kingsford Smith) Airport, the only Federal Airports that remain under Commonwealth ownership are Bankstown, Camden and Hoxton Park. The Government has announced that the sale of these three airports is expected to be completed by the end of September 2003.<sup>10</sup> The airports privatisation program will then have concluded.

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<sup>7</sup> Phase 1 initially comprised Sydney and the proposed Sydney-West, Melbourne, Brisbane and Perth airports. Sydney Airport and the proposed Sydney-West Airport were removed following the March 1996 Federal election. Adelaide was included in Phase 1 for a time but later removed to allow time for resolution of issues related to the extension of the runway.

<sup>8</sup> The Airports Act established the regulatory regime for the major Federal Airports, defined in the Act as core-regulated airports. The Airports Act also allows for the regulatory regime, or parts of it, to apply to the non-core regulated airports.

<sup>9</sup> The Hon. John Fahey MP, Minister for Finance and Administration and The Hon. John Anderson MP, Minister for Transport and Regional Services, Media Statement, *Sale of Essendon Airport*, 10 August 2001.

<sup>10</sup> Senator Nick Minchin, Minister for Finance and Administration, and Wilston Tuckey MP, Minister for Regional Services, Territories and Local Government and acting Minister for Transport and Regional Services, Joint Media Release, *Sale of Bankstown, Camden and Hoxton Park Airports*, 9 April 2003.

To date, the airports privatisation program has realised aggregate sale proceeds of some \$8.3 billion (see Figure 1.2).

**Figure 1.2**

**Proceeds from the airports privatisation program: November 2002**

	\$m	\$m
<b>PHASE 1</b>		
Brisbane Airport	1 378	
Melbourne Airport	1 291	
Perth Airport	639	
Other Sale Revenue	4	
<b>Total Phase 1 revenue</b>		<b>3 312</b>
<b>PHASE 2</b>		
Adelaide, Parafield & Coolangatta Airports	467	
Darwin, Alice Springs & Tennant Creek Airports	108	
Canberra Airport	66	
Hobart Airport	36	
Launceston Airport	17	
Townsville & Mount Isa Airports	16	
Moorabbin Airport	8	
Jandakot Airport	7	
Archerfield Airport	3	
Other Sale Revenue	2	
<b>Total Phase 2 revenue</b>		<b>730</b>
<b>Essendon Airport Ltd</b>		<b>22</b>
<b>Sydney Airports Corporation Limited</b>		<b>4 233</b>
<b>TOTAL PROCEEDS</b>		<b>8 297</b>

Source: Previous ANAO Audit Reports and ANAO analysis of Finance data.

## Corporatisation

**1.9** Following the Phase 1 and Phase 2 airports sales, the Commonwealth reorganised its holding of the Sydney basin airports. On 28 May 1998, SACL was incorporated as an unlisted public company limited by shares with 100 shares issued at \$1 each, fully paid. SACL and three wholly owned subsidiaries entered into sale agreements and acquired 50 year plus 49-year leases over Sydney (Kingsford Smith) Airport and three other Sydney basin airports on 1 July and 2 July 1998 respectively. The total transfer price for the four airports was \$1477.5 million, of which \$1433.5 million related to Sydney (Kingsford Smith) Airport.

**1.10** The sale agreement for Sydney (Kingsford Smith) Airport was signed on 30 June 1998. Under the terms of this contract, the Commonwealth agreed to



grant SACL a 99-year lease over the airport and transfer related assets, liabilities and employees to SACL. In consideration for these actions, the company was required to pay the Commonwealth a purchase price of \$1433.5 million. Of this amount, \$794 million was paid through the issue of 100 million fully paid SACL shares with the remaining \$639.5 million to be paid on 1 February 1999, with interest.

**1.11** As a priority after incorporation, SACL undertook the task of securing a credit rating so that it could arrange finance to repay all debts incurred in the acquisition of the airport and its assets.<sup>11</sup> Within six months of commencing trading, international ratings agency Standard & Poors assigned SACL the investment grade ratings of A+ long-term and A1 short-term.<sup>12</sup> Following a Credit Rating Review, these ratings were reaffirmed in November 2001, but were qualified reflecting the rating agency's assessment of the likelihood of an aggressive capital structure and a weaker financial profile if the airport was privatised.<sup>13</sup>

**1.12** SACL undertook a \$1.9 billion borrowing program during 1999. The borrowing program comprised a \$450 million bank syndicated 3-year revolving facility, \$400 million in 5-year medium term notes maturing in 2004 and a \$600 million short-term note facility supported by a \$450 million bank syndicated standby facility. The proceeds from the SACL borrowing program were used, in part, to repay the \$639.5 million debt portion of the acquisition price to the Commonwealth, as well as the \$100 million Commonwealth loan transferred to SACL from the former Federal Airports Corporation,<sup>14</sup> together with outstanding interest of \$29.7 million.<sup>15</sup> These funds were deposited into bank accounts held by the Department of Transport and Regional Services (DOTARS).

**1.13** In January 2003, the Department of Finance and Administration (Finance) advised ANAO that the sale of Sydney (Kingsford Smith) Airport to SACL was accounted for on the basis that the Finance portfolio was responsible for the equity<sup>16</sup> and the Transport portfolio for the debt, reflecting requirements of policy

<sup>11</sup> Sydney Airports Corporation Limited, *Annual Report 1999*, p. 3.

<sup>12</sup> A long-term issuer credit rating of 'A' means the borrower is assessed to have a strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse affects of changes in circumstances and economic conditions than those rated 'AA' and 'AAA'. A short-term issuer credit rating of 'A1' (which is the highest short-term rating) means the borrower has a strong capacity to meet its financial commitments.

<sup>13</sup> The decision to privatise SACL had been announced on 29 March 2001.

<sup>14</sup> Sydney Airports Corporation Limited, *Annual Report 1999*, p. 11.

<sup>15</sup> Comprising \$26.4 million with respect to the \$639.5 million cash component of the purchase price and \$3.3 million in relation to the \$100 million loan transferred from the former Federal Airports Corporation.

<sup>16</sup> The shareholding investment in SACL was included in Finance's 1998–99 administered financial statements as a \$794 million investment. Source: Department of Finance and Administration, *Annual Report 1998–99*, p. 176.

and Administrative Arrangements Orders. Finance further advised ANAO that, although SACL's capital structure had not been settled, an estimate of \$759.5 million<sup>17</sup> to cover SACL's capital and the interest payment was included in the 1998–99 Budget Papers in the figure for Advances paid (net).<sup>18</sup> Net advances<sup>19</sup> were included as a memorandum item in the calculation of the Headline cash balance for the 1998–99 Budget.<sup>20</sup>

**1.14** SACL's 2001–02 financial results were announced in August 2002, with a 40 per cent lift in earnings and four-fold increase in net profit for the year to 30 June 2002 (see Figure 1.3). This was achieved despite the challenging trading conditions that followed the September 11 terrorist attacks and the Ansett collapse,<sup>21</sup> highlighting the attractiveness of SACL as an investment opportunity.

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<sup>17</sup> Finance also advised ANAO that the 1999–00 Budget documents included an actual outcome of -\$765.9 million in the total of -\$5 511 million for Advances paid (net) for 1998–99 in Budget Paper No. 1 (Table D2: General Government Operating Statement, pp. 9–36).

<sup>18</sup> The figure of -\$15 991 million for Advances paid (net) in Table F2 'Economic Transactions of Commonwealth Government' on p. 2–82 of Budget Paper No. 1 included an amount of -\$759.5 million under Advances Repayments non-Budget PTEs for the Transport and Communications function.

<sup>19</sup> The underlying Budget balance is measured as revenues less outlays (excluding net advances). Net advances consist of net policy lending (new policy lending less repayments of past policy lending) and net equity transactions (equity injections/purchases less equity sales). Source: *Final Budget Outcome 1996–97*, p. 3.

<sup>20</sup> Budget Paper No. 1 1998–99, *Budget Strategy and Outlook 1998–99*, 12 May 1998, Table 1: Summary of Budget Aggregates, pp. 1–3.

<sup>21</sup> Sydney Airport Media Release, *Sydney Airport announces 40% increase in earnings despite lower traffic volumes*, 21 August 2002.

**Figure 1.3****Sydney Airports Corporation Limited—Abridged Financial Results and Financial Position**

	1998–99 \$m	1999–2000 \$m	2000–01 \$m	2001–02 \$m
<b>Financial Results</b>				
Revenue <sup>A</sup>	294.9	312.7	377.6	454.0
Expenses	103.6	122.3	151.1	137.7
Earnings Before Interest, Tax, Depreciation and Amortisation	191.3	190.4	226.5	316.3
Net Profit After Tax	48.0	42.8	22.8	87.1
Payments to the Commonwealth	798.2 <sup>B</sup>	25.7	110.5 <sup>C</sup>	26.5
<b>Financial Position</b>				
Total Assets	2 924.4	3 251.0	3 240.8	3 200.5
Total Liabilities	1 023.7	1 333.2	1 406.6	1 305.7
Net Assets	1 900.7	1 917.8	1 834.2	1 894.8
Note:				
<sup>A</sup> In May 2001, the Australian Competition and Consumer Commission (ACCC) released its decision on SACL's aeronautical pricing proposal of October 2000. The ACCC stated that its decision would increase SACL's aeronautical revenue in 2000–01 from around \$93 million to around \$183 million, an increase of \$90 million or 97 per cent. Source: Australian Competition and Consumer Commission, Decision, <i>Sydney Airports Corporation Ltd Aeronautical Pricing Proposal</i> , May 2001, p. 7.				
<sup>B</sup> Comprises \$29.0 million in dividends and \$769.2 million in receipts associated with the sale of the Airport to SACL.				
<sup>C</sup> Includes a special <i>in specie</i> dividend of \$51.6 million that was declared and paid on 29 June 2001 from the asset revaluation reserve. This dividend was satisfied by the divestment of the subsidiary airport companies being Bankstown Airport Limited, Camden Airport Limited and Hoxton Park Airport Limited. Source: Sydney Airports Corporation Limited, <i>Annual Report 2001</i> , p. 15.				

Source: SACL Annual Reports

**Audit approach**

**1.15** The audit was conducted under Section 18 of the *Auditor-General Act 1997*. The objectives of the audit were to:

- evaluate the extent to which the Government's sale objectives were achieved, with a focus on those objectives relating to the optimisation of sale proceeds and minimisation of risk to the Commonwealth;
- examine the effectiveness of the management of the sale process to ensure the Commonwealth received fair value; and
- within the context of broader Commonwealth debt management considerations, assess the application of the sale proceeds to repaying Commonwealth debt and the extent to which public debt interest payments may be reduced.

**1.16** The scope of the audit involved the planning for, conduct and completion of the sale of Sydney (Kingsford Smith) Airport. It included the preparation and

conduct of the sales process prior to the September 2001 deferral and the recommenced tender process that culminated in the June 2002 sale to Southern Cross Airports Corporation. In accordance with the audit objectives, the scope also extended to the receipt of sale proceeds and the application of the proceeds to repaying Commonwealth debt.

**1.17** Audit fieldwork was conducted between September 2002 and November 2002. Issues Papers and a Discussion Paper were provided to the Department of Finance and Administration, the Department of Transport and Regional Services and the Australian Office of Financial Management. A draft report was provided in March 2003 to these three agencies as well as the Department of the Treasury, the Department of the Prime Minister and Cabinet and the Business, Legal and Sale Process Advisers.

**1.18** From its panel of legal advisers, ANAO engaged the Australian Government Solicitor (AGS) to advise on circulation of the draft audit report.

**1.19** The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of \$362 000.

## 2. Sale Management

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*This chapter discusses the management of the sale process including the outsourcing arrangements, contract management and probity arrangements.*

### Governance framework

**2.1** On 13 December 2000, the Minister for Transport and Regional Services announced that the SACL group would be broken up and privatised as two separate and competing companies: one company would operate Sydney (Kingsford Smith) Airport; and Bankstown, Camden and Hoxton Park Airports would be operated as separate companies jointly managed by one company. The then Office of Asset Sales and IT Outsourcing (OASITO) was allocated responsibility for overseeing the conduct of a scoping study into the sale.

**2.2** The scoping study was undertaken by Business and Legal Advisers, overseen by OASITO in consultation with DOTARS. The scoping study report was completed on 22 February 2001 and provided advice on issues associated with the privatisation of the Sydney basin airports including the value, feasibility and efficiency of alternative sale options for Sydney (Kingsford Smith) Airport namely: an Initial Public Offering (IPO) of shares; a 100 per cent trade sale of shares; and a hybrid cornerstone investor/IPO method. Each option was considered in terms of pricing, timing and likely investor demand, and the conclusion was that significantly higher value to the Commonwealth would result from a full trade sale. The scoping study report recommended a 100 per cent trade sale as the preferred method of sale for both Sydney (Kingsford Smith) Airport and the other Sydney basin airports.

**2.3** Following consideration of the scoping study report, the Government announced<sup>22</sup> on 29 March 2001 that it had decided to sell Sydney (Kingsford Smith) Airport by a 100 per cent trade sale to be completed in the second half of 2001 with the other three Sydney basin airports to be sold in the second half of 2002. The Government also announced that the new owner of Sydney (Kingsford Smith) Airport would be given the first right of refusal to build and operate any second major airport within 100 kilometres of the Sydney Central Business District. The sale was to be managed by OASITO, in consultation with DOTARS, whose role focussed on transport policy aspects and the ongoing regulation of the Airport under the provisions of the *Airports Act 1996*. In July 2001, OASITO was re-named the Office of Asset Sales and Commercial Support (OASACS) to

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<sup>22</sup> The Hon. John Anderson, Deputy Prime Minister and Minister for Transport and Regional Services and Senator the Hon. Rod Kemp, Acting Minister for Finance and Administration, Joint Media Statement, *Sale of Sydney (Kingsford-Smith) Airport*, 29 March 2001.

reflect its revised functions. The Administrative Arrangements Order of 26 November 2001 resulted in the abolition of OASACS with its functions absorbed by Finance.

**2.4** Coordination and strategic oversight of the sale process was the responsibility of a Steering Committee that comprised representatives from OASITO/OASACS/Finance, DOTARS, the Business Adviser and the Legal Adviser. The Steering Committee was chaired by Finance with a Sale Process Adviser attending meetings as an observer and to provide advice on sale process issues. The Committee met regularly, other than during the suspension of the sale process between September 2001 and March 2002. Reporting to the Steering Committee were a number of other committees and working groups that were established to manage specific aspects of the sale process, as follows:

- A Due Diligence Committee was tasked with ensuring that all material information and matters relating to the sale were identified, examined and disclosed to bidders. This Committee was chaired by OASITO/OASACS/Finance with representatives from the Business Adviser, Legal Adviser and SACL.
- A Sale Transaction Documents Working Group whose role was to prepare the various agreements required to execute the sale. It was chaired by OASITO/OASACS/Finance and comprised representatives of the Business Adviser, Legal Adviser, DOTARS and the Sale Process Adviser.
- A Sydney Basin Airports Separation Committee whose role was to oversee the separation and transfer to the Commonwealth of the three subsidiary airport companies owned by SACL.
- Following recommencement of the tender process, Finance established a Project Management Working Group to facilitate day-to-day management of the sale process. This Group was oversighted by, and reported to, the Steering Committee. It was chaired by Finance and involved representatives from the Business Adviser and Legal Adviser with input from DOTARS.
- Evaluation committees for each of the three stages of the tender process.

**2.5** A detailed risk management plan was prepared and implemented as part of the management of the sale process. The plan was an agenda item at each meeting of the Steering Committee. It addressed a wide range of process risks as well as policy risks (for example, the possibility of adverse commercial outcomes from reviews of the economic regulatory framework); third party risks (such as litigation against SACL); company risks (such as a deterioration in the financial performance of SACL); market risks (for example, an insufficient

number of bidders to maximise price tension); and timetable risks. Risk assessments were documented in the plan, as was action to be taken to mitigate the risks. Responsibility for management actions were allocated to specific committees and working groups.

**2.6** The February 2001 scoping study report commented that it was important that the Commonwealth and its advisers be cognisant of past ANAO recommendations to ensure that they would be considered in developing future sales processes. Accordingly, each committee and working group was required to have regard to earlier ANAO audit reports and, where appropriate, take steps to address the issues raised. In addition, a paper outlining action proposed and taken in response to earlier ANAO recommendations and findings was prepared and updated throughout the sale process as an agenda item at each meeting of the Steering Committee. This approach to continuous improvement was reflective of the sound governance approach adopted by Finance and its advisers, which contributed to an effective overall outcome from the sales process.

## Outsourcing arrangements

**2.7** A feature of the management of the sale was the tight control exercised over sale costs including the management of outsourcing arrangements. ANAO estimates that total costs for the sale of Sydney (Kingsford Smith) Airport were \$32.36 million, or less than one per cent of gross proceeds (see Figure 2.1). On a comparable basis, Phase 1 sale costs were \$58.2 million or 1.8 per cent of gross proceeds with Phase 2 sale costs totalling \$35.4 million, or 4.8 per cent of gross proceeds received. Aggregate Phase 1 costs were \$152.6 million but this included \$94.4 million in ex gratia payments to State governments in lieu of stamp duty on the airport leases. In Phase 2, bidders were responsible for stamp duty payments. For the SACL transaction, the purchaser is expected to be responsible for meeting stamp duty costs at the marketable securities rate but the Commonwealth has indemnified the purchaser in the event that stamp duty is applied at the significantly higher 'land rich' duty rate.

**Figure 2.1****Sale Costs as at December 2002**

	(\$m)	(\$m)
<b>Finance</b>		
Business Adviser	8.74	
Legal Adviser	2.97	
Finance staffing and other administrative costs	1.67	
Advertising, marketing and due diligence	1.00	
Communications Adviser	0.71	
Sale Process Adviser	0.21	
Other	0.66	
<b>Total Finance Costs</b>		<b>15.96</b>
<b>Sydney Airports Corporation Limited<sup>A</sup></b>		<b>15.60</b>
<b>DOTARS<sup>B</sup></b>		<b>0.80</b>
<b>Total</b>		<b>32.36</b>
Notes:		
<sup>A</sup> SACL's 2002 Annual Report (pages 53 and 66) reported additional borrowing costs of \$8.604 million due to privatisation and September 2001 advice from SACL to the Business Adviser estimated privatisation costs for the period July 2001 to November 2002 to be \$7 million.		
<sup>B</sup> Comprises \$0.56 million in staff and travel costs and a further \$0.24 million for external legal advice.		

Source: ANAO analysis of Finance data and advice from SACL and DOTARS

**2.8** Separate budgets were approved by the Government for Finance's external scoping study and sale costs. A budget of \$1.7 million was approved in December 2000 for the scoping study, with total actual costs of \$167 471, well within the budget. In March 2001, the Government decided to provide funding of \$18.6 million to meet external costs associated with a trade sale. In aggregate, payments to external parties (primarily the Business and Legal Advisers) totalled \$14.5 million for the sale process, comfortably within the approved budget. The major components of Finance's sale costs were fee payments made to the Business and Legal Advisers. These payments totalled \$11.7 million, or 73 per cent, of Finance's total sale costs.

**2.9** The first adviser appointments were made on 18 January 2001 when contracts were entered into with Salomon Smith Barney Australia Securities Pty Ltd and Freehills to act as Scoping Study Business and Legal Advisers respectively. To assist with the sale, in April 2001, options were exercised under the respective Scoping Study contracts to re-appoint the Business and Legal Advisers. In addition, following tender processes, OASITO also engaged Sparke Helmore as Sale Process Adviser and Gavin Andersen & Company as Communications Adviser. In addition, a number of firms were engaged as sub-contractors by the Business Adviser, as provided by the sub-contracting framework outlined in the Business Adviser's contract with the Commonwealth.



## Scoping study

**2.10** On 22 December 2000, 11 firms were invited to submit a proposal to act as Business Adviser for the conduct of the Sydney Airports Sale Scoping Study. On the same date, 10 firms were invited to tender for the role of scoping study Legal Adviser. The invitees were advised that the Commonwealth may wish to extend the respective engagements and retain the successful firms during any subsequent sale.<sup>23</sup> Accordingly, the invitees were asked to include both proposed scoping study fees and fees for the sale process.<sup>24</sup>

**2.11** Business Adviser expressions of interest were received from eight firms, of which one was assessed as non-compliant in that it was presenting its credentials for a selling syndicate role in a public share offer rather than addressing the scoping study Business Adviser role. The remaining seven firms were interviewed by the selection panel, which was chaired by OASITO and included two business representatives. An officer from the Department of Transport and Regional Services also participated in the selection process as an observer. The selection criteria against which they were assessed were: relevant experience; understanding of the task; the quality of the resources that would undertake the work; proposed fees for both the scoping study and a trade sale; any conflicts of interest; any variations proposed to the draft consultancy contract; the level of insurance cover; and understanding of Commonwealth accountability requirements. The successful candidate was assessed to offer very good value for money. The Business Adviser contract was signed on 18 January 2001, specifying scoping study fees of \$50 000 and fees of \$10 million for the sale of Sydney (Kingsford Smith) Airport. Fees were also agreed for the sale of the other three Sydney airports, although these sales are not being conducted under this contract.

**2.12** Six proposals were received in response to the invitation to tender for the Legal Adviser role. Five<sup>25</sup> of the candidates were interviewed by a panel with the same structure as that used for the Business Adviser and then assessed in terms of their: knowledge and appreciation of the issues involved; strength of the proposed team; proposed fees; experience; professional liability coverage; conflicts of interest and other disclosures; and appreciation of Commonwealth accountability requirements. The successful candidate was considered to offer

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<sup>23</sup> The approach taken addressed the concerns raised by ANAO in Audit Report No.28 1998–99, *Sale of SA Rail, Tasrail and Pax Rail* as outlined on pp. 36 to 38 of that report.

<sup>24</sup> In the event that the Government decided to conduct a public share offering rather than a trade sale, Business Adviser candidates were advised that the successful firm would be provided with the opportunity to tender for both the role of Business Adviser and/or Lead Manager of the selling syndicate, although it would only be able to perform one of these roles.

<sup>25</sup> One of the candidates was not shortlisted for interview as the panel considered the proposed team was insufficiently experienced for the magnitude and complexity of the proposed sales.

the best overall value for money for the Commonwealth. The Legal Adviser contract was signed on 18 January 2001, specifying scoping study fees of \$50 000 and a total fee of \$1.5 million<sup>26</sup> for a SACL trade sale.

## **Sale process**

**2.13** Following the completion of the scoping study, in March 2001, OASITO sought to exercise the option to re-appoint the scoping study Business and Legal Advisers at an estimated cost of \$11 million<sup>27</sup> and \$2.2 million respectively. Following requests from the office of the Acting Minister for Finance and Administration, reductions were negotiated in the fees proposed by both advisers with the Business Adviser reducing its fee by \$1.1 million to \$8.9 million and the Legal Adviser reducing its fee cap by \$25 000 to \$1.475 million.<sup>28</sup> The Acting Minister agreed to re-appoint the Business and Legal Advisers at the reduced fees. Accordingly, each contract was varied on 5 April 2001 to reflect the Commonwealth's decision to exercise the option to re-appoint each adviser for the sales process at the reduced fees.

**2.14** The April 2001 variations to the Business and Legal Adviser contracts also introduced Phase 3 (preparatory work in respect of the other Sydney airports) and, at the option of the Commonwealth, Phase 4 (sale of the other Sydney airports) of the consultancy services. Figure 2.2 summarises the fee arrangements relating to each phase of the consultancy, as outlined in the April 2001 contract variations.<sup>29</sup>

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<sup>26</sup> Disbursements were included in the fees except for domestic and international travel costs, costs of overnight stays away from a place of residence and major printing and other third party expenses approved in advance.

<sup>27</sup> Representing the contractual option for fees of \$10 million with OASITO estimating up to \$1 million in disbursements.

<sup>28</sup> The Business Adviser's fees were inclusive of Goods and Services Tax (GST), the Legal Adviser's were not.

<sup>29</sup> In addition to these fees, the Business Adviser was paid a success fee of \$550 000 (inclusive of GST) by SACL for managing the process to amend the SACL \$400 million Medium Term Note Trust Deed to reduce the notice period for the call option from 90 days to 14 days.

**Figure 2.2****Business and Legal Adviser Proposed Fees and Fee Payments: April 2001**

	<b>Business Adviser (\$m)</b>	<b>Legal Adviser (\$m)</b>
Phase 1: Scoping Study	0.050	0.050
Phase 2: Sale of SACL	8.900	1.475
Phase 3: Preparation for sale of other Sydney airports	Not applicable <sup>A</sup>	0.150
Phase 4: Sale of other Sydney airports	2.500	0.750
<b>Total</b>	<b>11.450</b>	<b>2.425</b>
Note:		
<sup>A</sup> Included in Phase 2 fee.		

Source: ANAO analysis of Finance data.

**2.15** The Business and Legal Adviser contracts both included an option for the Commonwealth to re-appoint the Advisers for the sale of Bankstown, Hoxton Park and Camden airports (Phase 4 of the consultancy services) for a predetermined fee (see Figure 2.2 above). The option was to lapse on 30 June 2002. On 28 June 2002, Finance decided not to exercise these options but rather to competitively tender both roles. Finance considered the existing scope of work specified in the respective contracts would need to be expanded and revised for the purposes of the sale of the other Sydney airports and each Adviser would, as a result, seek increased fees. In this context, Finance's assessment was that value for money was more likely to be achieved by re-tendering based on a revised scope of work and the options were, as a result, allowed to lapse.

## Contract management

**2.16** Commonwealth asset sale projects are undertaken with extensive support from private sector advisers, consultants and project managers. Contracts were signed with each of the advisers outlining the services to be delivered and the fees to be paid. In relation to financial management, fee payments were generally as specified in the respective contracts. The major exception related to \$1.3 million paid to each of Finance's major advisers for work not encapsulated within the scope of services specified in their existing contracts. These payments were made largely as a consequence of the deferral of the sale process in September 2001 and preparation for recommencement in March 2002. The majority of the out of scope payments (\$1.1 million) was made to the Business and Legal Advisers.

## Sale deferral and recommencement

**2.17** Each of the major adviser contracts included provisions addressing the possible need to vary, suspend, or terminate the performance of all, or part of,

the consultancy services. In the light of the decision to defer the sale, Finance sought legal advice on whether it should keep the contracts in place in accordance with their existing terms, terminate the contracts, suspend the contracts or vary the contracts. After considering this advice, Finance formally notified the Communications Adviser that it was suspending its contract with effect from 1 October 2002. The contracts of the Business, Legal and Sales Process Advisers were not suspended, with services continuing to be provided to Finance over the course of the deferral at a lower level.

**2.18** In September 2001, the Legal Adviser proposed new fee arrangements to apply post 31 December 2001, consistent with its original contract that additional fees needed to be negotiated if the sale was not completed by 31 December 2001. Following negotiation, a variation to the contract was made on 5 February 2002, with effect from 15 November 2001. This variation: agreed to the payment of out of scope work up to 15 November 2001 of \$0.33 million; agreed to negotiate the quantum of out of scope work undertaken between 15 November 2001 and 31 December 2001; introduced a new fee for work undertaken in the period 1 January 2002 to 30 June 2002 with total monthly payments capped at \$0.75 million; carried over \$0.34 million in unpaid milestone payments from the original contract; increased the hourly rates charged by key personnel; and agreed that, if the sale was not completed by 30 June 2002, new fee arrangements would need to be negotiated.

**2.19** Subsequent to the 5 February 2002 variation to the Legal Adviser contract, an additional \$157 575 in out of scope payments were made by Finance to the Legal Adviser. A further \$100 574 in out of scope claims were made by the Legal Adviser but rejected by Finance, as Finance considered the relevant work to be encapsulated within the scope of the contracted fees.

**2.20** In May 2002, the Business Adviser wrote to Finance requesting consideration of a revised fee structure for its contract on the basis that the sale process had become considerably protracted and that, consequently, resources had been deployed for much longer than had been anticipated at the outset of the project. The Business Adviser proposed a success fee arrangement as it considered this approach would incentivise it to achieve maximum proceeds for the Commonwealth having regard to the sale objectives and sale process rules.<sup>30</sup> Finance advised the Business Adviser that it was unable to accept the revised fee basis because the Business Adviser had originally tendered, and been appointed, on the basis of a fixed fee structure; and to alter that structure at such a late stage in the tender process could expose Finance to criticism. Had Finance

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<sup>30</sup> The proposal involved: a fixed fee of \$9.8 million for bids up to and including an enterprise value of \$4.7 billion (the top of the Business Adviser's previously estimated range); a fee of 0.5 per cent of the excess over \$4.7 billion enterprise value up to a maximum of \$5.0 billion; and a fee of 1.0 per cent of the excess enterprise value over \$5.0 billion.

accepted the Business Adviser's proposal, ANAO estimates that an additional fee of \$8.28 million would have been paid which, among other things, would have resulted in Finance exceeding the sale budget approved by the Government.

**2.21** In lieu of the success fee proposal, Finance accepted and paid a claim from the Business Adviser for work undertaken between January and March 2002 which the Business Adviser considered to be outside the scope of the contract. These services included preparing for the recommencement of the tender process. In light of the unforeseen protraction of the sale, and the work required to recommence that was not anticipated in the contract, Finance agreed to pay the \$576 591 sought by the Business Adviser for out of scope work.

## Due diligence

**2.22** Due diligence is a process undertaken to verify the accuracy and completeness of information provided to prospective purchasers. It usually involves the gathering of information to assist with vendor disclosure and enabling bidders to undertake their own review of the sale entity. Due diligence for the SACL sale was coordinated by a Due Diligence Committee with the objectives and arrangements for the conduct of due diligence set out in a Planning Memorandum.

**2.23** SACL's Board agreed to participate in and help facilitate the sale process. A Memorandum of Understanding and a Confidentiality Deed between the Commonwealth and SACL were signed. The Commonwealth agreed to indemnify each director of SACL under Deeds of Indemnity. In addition, all bidders were required to enter into Confidentiality Deeds with SACL. This suite of documentation clearly specified the role and responsibilities of SACL and its board in relation to the sale process, as well as providing for the protection of confidential information.

**2.24** The tender process was designed to provide as much high quality information to bidders as possible, while observing SACL's confidentiality concerns, so as to maintain bidder interest and enable the preparation of high quality bids. Accordingly, a full disclosure due diligence model was adopted, the major elements of which were as follows:

- The adoption of flexible data access arrangements. Documents were provided to bidders in CD ROM format with commercially sensitive and legally privileged documents contained in separate data rooms. In addition, as in previous sales: a question and answer process was established for further information requested by bidders; further disclosures were made to the bidders in correspondence following closure of the physical data rooms; and additional disclosures to the successful

bidders were made against the warranties in the sale agreement by way of a disclosure letter.

- The preparation of marketing materials and an Information Memorandum to highlight the investment potential and provide a detailed description of the business. For this purpose, an Information Memorandum drafting group was established early in the sale process to oversee preparation of the document. A marketing brochure was prepared, verified, reviewed by the Minister and distributed during Stage 1 of the tender process. During Stage 2 of the tender process, an Information Memorandum was prepared, verified, approved by SACL, reviewed by the Minister and then distributed to shortlisted bidders.
- The arrangement of SACL management presentations, airport site visits, meetings with relevant Government agencies and meetings with SACL customers.

## Probity arrangements

**2.25** The appointment of a probity auditor or probity adviser to a major transaction represents a means of independently monitoring the conduct of the tender process to ensure it is conducted in accordance with identified probity principles.<sup>31</sup> In April 2001, a tender was conducted for the appointment of a Sale Process Adviser whose role was to independently review the ongoing sale process and advise on probity and accountability issues. Of the six firms invited to tender, two submitted proposals and both were shortlisted for interview by the panel.<sup>32</sup> The successful candidate, Sparke Helmore, was assessed to offer the best value for money based on its experience, track record and quality team combined with a competitive fee capped at \$98 000.<sup>33</sup> The consultancy contract was signed on 29 May 2001.

**2.26** The Sales Process Adviser was contracted to provide support and advice on all sale process and probity issues. This involved the Sales Process Adviser:

- monitoring and advising on issues of probity, accountability and procedural integrity;
- reviewing and advising on the processes and methodology underpinning the sale tender and tender evaluation processes;

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<sup>31</sup> The 'probity adviser' role is distinguished from the 'probity audit' role in that an auditor independently reviews the conduct of the process and comments on the probity of those processes. A probity adviser, on the other hand, provides advice to those conducting the process on how to deal with probity matters, and may also be engaged to identify probity issues as they arise.

<sup>32</sup> The panel was chaired by OASITO and included two business representatives.

<sup>33</sup> Exclusive of Goods and Services Tax but inclusive of all disbursements.

- developing and reviewing appropriate probity protocols;
- reviewing and advising on the tender and sale transaction documents; and
- attending relevant meetings including all meetings of the Steering Committee, all meetings of the evaluation committees and, when required, meetings with bidders.

**2.27** An important element for the defensibility and validity of the Sales Process was the development and implementation of a Probity Plan. Accordingly, following its appointment, the Sale Process Adviser prepared a Probity Plan that proposed the adoption of a series of actions and steps to support a procedurally sound and auditable sales process. It was expected that adopting an open and accountable sale process that met all relevant probity requirements, would facilitate a competitive process, thus providing the best environment for a favourable outcome for the Commonwealth. The Plan included a schedule of key sale events that was regularly updated to reflect action taken to address probity objectives.

**2.28** During the sales process, a significant number of written opinions, sign-offs and reports were prepared by the Sales Process Adviser. These included: advice on the initial extension and subsequent deferral of the sale process; a sign-off on the evaluation plan for binding bids; advice on the acceptance of receipt of parts of the successful bid received after the specified lodgement time; an opinion to the effect that binding bids had been evaluated fairly and consistently with the Request for Binding Bids and the evaluation plan; and a sign-off on the Binding Bid Evaluation Report. Following the completion of the sale, the Sale Process Adviser provided Finance with a Process Adviser's Report, incorporating the following overall conclusions:

- The three-stage Sale Process, as conducted by the Commonwealth, was a complex and substantial exercise, with sufficient policy sensitivities, public and media interest and industry exposure to warrant probity oversight;
- The Commonwealth and the Kingsford Smith Airport Sale Team undertook the Sale Process in a thorough, diligent and professional manner;
- Sufficient and appropriate resources, in terms of time, effort and expertise, were applied to ensure that the Sale Process was conducted in a way most likely to achieve a positive outcome for the Commonwealth, but without creating unreasonable demands or impost on bidders given the size and complexity of the transaction;

- Probity issues that arose during the life of the Sale Process were identified as they arose and the Commonwealth and Kingsford Smith Airport Sale Team sought and accepted the probity advice that was provided, as appropriate. In each case, appropriate action was taken to ensure that the process as a whole was conducted in a manner that was accountable, defensible and fair to all bidders;
- The Sale Process was conducted in accordance with probity principles reflected in law, including the Financial Management and Accountability Act 1997 and Regulations, the APS Code of Conduct and relevant Commonwealth policy relating to accountability; and
- Probity standards identified in the Probity Plan, including those relating to fairness and impartiality; competitiveness of process; confidentiality and security; and avoidance of conflict of interest, have been met and upheld, as required.



## 3. Tender Process

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

### Introduction

**3.1** One of the key scoping study recommendations was that the sale of Sydney (Kingsford Smith) Airport be conducted by way of a 100 per cent trade sale with a target completion date of August 2001. A key underpinning of the recommendation for a trade sale was that estimated proceeds were expected to be higher than if the sale was conducted through a public offering of shares. On the basis of the scoping study recommendations, the Government decided to proceed with the sale of Sydney (Kingsford Smith) Airport as a trade sale. A stepped, three stage process was adopted as follows:

- **Stage 1—Expressions of Interest.** The purpose of this stage was to obtain Expressions of Interest from interested parties and short-list appropriate candidates for the next stage of the process. Advertisements were placed in the Australian and international financial press and invitations to lodge Expressions of Interest were issued to interested parties from 23 April 2001 together with an information pack of publicly available material and a marketing brochure. Expressions of interest were due by 14 May 2001 with thirteen responses received. The responses comprised two declared bidding consortia,<sup>34</sup> four parties that were in the process of forming another bidding consortium and a further seven parties. The then Minister was advised that the strategy was to encourage the development of three, and possibly four, competitive consortia during the course of the indicative bid stage. Accordingly, all thirteen parties that expressed interest were admitted to the next stage, although three did not participate further in the sales process.
- **Stage 2—Indicative Bids.** The primary purpose of this stage was to ensure that serious bidders, who were well qualified to satisfy the sale objectives, were included in the final stage. The Request for Indicative Bids was issued on 4 June 2001 with bids to be lodged by 17 July 2001. Three indicative bids were received. While various issues required further clarification, the indicative bids from all three consortia were considered to be of a sufficiently satisfactory standard when assessed against the evaluation

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<sup>34</sup> Subsequent to shortlisting, one of the consortia formally withdrew after two of the three consortium members withdrew following concerns about the availability of domestic equity. The third consortium participant wanted to proceed and lodge an indicative bid and, as it was assessed to satisfy, in its own right, the shortlisting criteria, it was permitted to continue its participation in the sale process. It subsequently formed a new consortium.

criteria to progress to the binding bid stage. Accordingly, each consortium was admitted to the final stage.

- **Stage 3—Binding Bids.** The primary purpose of the final stage was to allow the preparation and lodgement of unconditional, fully funded, legally binding bids.<sup>35</sup> Requests for Binding Bids were issued on 1 August 2001 to the three shortlisted consortia with Binding Bids due by 17 September 2001 with the aim of finalising the sale in early October 2001. On 13 September 2001, the then Minister for Finance and Administration announced that the date for lodgement of binding bids had been extended by nine days, until 26 September 2001.<sup>36</sup> The decision to extend the lodgement date was made following approaches from bidders, given the September 11 terrorist attacks and the subsequent level of disruption in financial markets. Subsequently, on 24 September 2001, the Minister announced that the sale had been deferred until early 2002, following advice that the Government's sale objectives could not be satisfactorily met in the existing timeframe, in the light of September 11 and the subsequent disruption in global financial markets and the airline and aviation sectors.<sup>37</sup>

**3.2** A Deferment Period Protocol was prepared to outline an operational framework for the sale process during the period of the deferral. Among other things, the Protocol outlined the maintenance of a vendor due diligence process to allow the preparation of additional disclosure material for bidders and required that bidders be reminded of their confidentiality obligations and the need to adhere to the sale process rules. As suggested in the Protocol, during the deferral period, Finance and the Business Adviser monitored market conditions and maintained contact with the three shortlisted bidders.

**3.3** In March 2002, after Government consideration of advice from Finance<sup>38</sup> and its advisers that market conditions had stabilised, the tender process recommenced at the binding bid stage. All three consortia participating in the tender process as at 24 September 2001 were invited to participate in the recommenced sale process. The Request for Binding Bids was reissued on 26 April 2002 with bids due by 4:00pm on 12 June 2002. Three bids were received on this date. Following evaluation of each bid, a successful bidder was selected

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<sup>35</sup> A binding bid was defined as a bid to purchase the SACL shares on a basis that was capable of acceptance by the Commonwealth immediately following receipt.

<sup>36</sup> The Hon. John Fahey MP, Minister for Finance and Administration, Media Statement 41/01, *Sale of Sydney Airport—Extension to Binding Bid Stage*, 13 September 2001.

<sup>37</sup> The Hon. John Fahey MP, Minister for Finance and Administration, Media Statement 43/01, *Deferral of the Sale of Sydney Airport*, 24 September 2001.

<sup>38</sup> In preparing this advice, Finance consulted with DOTARS, the Department of Prime Minister and Cabinet and the Treasury.

and the sale agreement was signed and the selection decision announced on 25 June 2002. Financial completion occurred on 28 June 2002.

## Evaluation committees

**3.4** A comprehensive and well structured evaluation methodology is an important element in the success of any trade sale. In this context, tender evaluation committees can assist in ensuring transparency and accountability in the bid evaluation process as well as leading to possible administrative savings by enhancing coordination of the evaluation process and consolidating the number of evaluation reports.

**3.5** Appropriately structured evaluation committees were employed for each stage of the tender process. Evaluation of Expressions of Interest was undertaken by a Committee that comprised two representatives from each of OASITO, DOTARS, the Business Adviser and Legal Adviser, with OASITO chairing the Committee and the Process Adviser participating as an observer. In Stage 2, evaluation of Indicative Bids was undertaken by a panel that was chaired by OASITO with two representatives from each of OASITO, DOTARS, the Business Adviser and Legal Adviser.<sup>39</sup>

**3.6** In order to assess and rank binding bids, and make an appropriate recommendation to Finance, a Binding Bid Evaluation Committee was established to: agree the proposed evaluation methodology in advance; supervise and monitor the evaluation process; sign-off on the Binding Bid Evaluation Report; and make recommendations to the Sale Process Steering Committee (chaired by Finance) as to the selection of the successful consortium. The Binding Bid Evaluation Committee comprised two representatives from each of Finance, DOTARS and the Legal Adviser and three representatives from the Business Adviser. It was chaired by Finance, with the Process Adviser attending as an observer.

**3.7** Finance's Business Adviser centrally managed the evaluation of Binding Bids, with other Committee members, officers from Finance and DOTARS and advisers providing their input on specific areas of focus, interest and expertise. In this respect, Finance was responsible for overall selection review; the Business Adviser focused on financial strength and commitment analyses; the Legal Adviser addressed probity and security issues (with assistance from a probity and security consultant) as well as regulatory, tax and legal issues; and DOTARS focused on airport management and development capability, commitment to the development of airport services, and consistency and compliance with ownership and control and other legislative, regulatory and policy requirements.

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<sup>39</sup> The Process Adviser observed proceedings.

## Evaluation criteria

**3.8** The tender approach and documentation was based on the Phase 1 and Phase 2 models. At each stage of the tender process, participating bidders were advised in advance of the evaluation criteria that would be applied. The Expressions of Interest stage was necessarily a less demanding stage because no price indications were given so that more general financial strength, airport management experience and regulatory compliance aspects were the focus. In the Request for Indicative Bids, six evaluation criteria were specified, consistent with the sale objectives.<sup>40</sup>

**3.9** The Request for Binding Bids specified eight criteria, drafted to more closely mirror the sale objectives than those applied to the Indicative Bids. The Binding Bid evaluation criteria were:

- maximisation of sale proceeds;
- conformity with transaction documentation;
- strength and structure of the offer;
- certainty and clarity of the offer;
- financial and managerial capabilities;
- consistency with relevant airport legislative, regulatory and policy requirements;
- fair and equitable treatment of employees; and
- commitment to the effective development of airport services.

**3.10** As the evaluation criteria other than sale proceeds were qualitative in nature, the Binding Bid Evaluation Committee considered it was not appropriate to apply a pre-specified and mechanistic weighting system in the ranking of bids. Instead, the Request for Binding Bids included a statement weighting the criteria as follows: 'The Commonwealth aims to maximise net sale proceeds on a risk adjusted basis while achieving optimal outcomes in relation to the other criteria'.

## Price criterion

**3.11** Bidding was conducted in two stages with indicative bids received in July 2001 and binding bids received in June 2002. The primary reason for incorporating an indicative bid stage in the tender process, rather than moving

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<sup>40</sup> These criteria were: maximisation of sale proceeds; conformity with transaction documentation; strength and structure of the offer; certainty and clarity of the offer; satisfaction of the Government's stated objectives; and conformity with the Government's terms of sale.

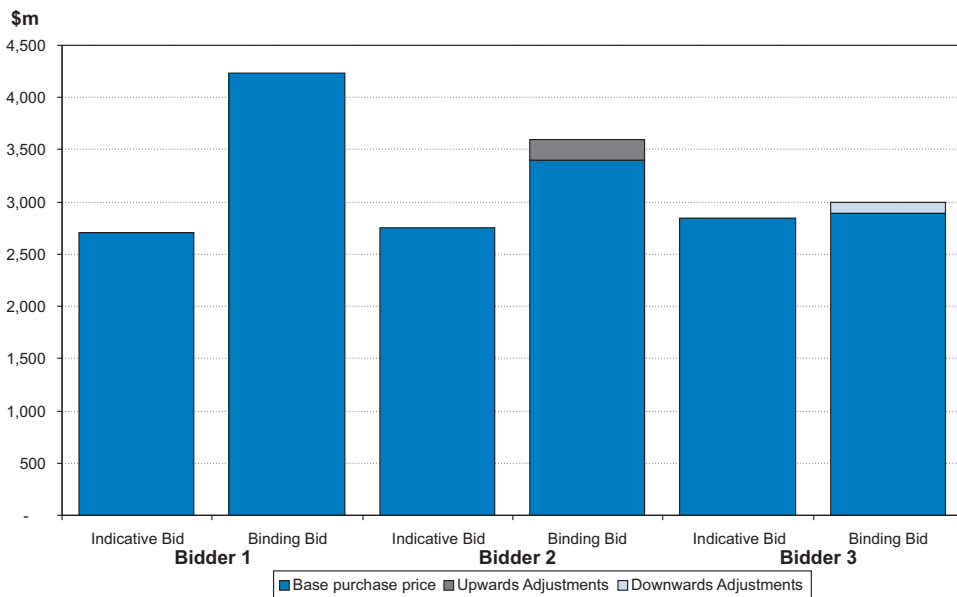
directly to a full binding bid stage, was to ensure a manageable number of bidders entered the full bid stage.

**3.12** The Request for Indicative Bids was issued in June 2001 with shortlisted parties required to state the purchase price offered in Australian dollars, being the amount the bidder was prepared to pay for all the shares in SACL, including the assumption of SACL's forecast net debt of \$1.288 billion as at 30 June 2001. In advice to Finance, the Business Adviser noted that all three of the indicative bids were tightly grouped and strongly supported its advice on the value that binding bids might reach under a well managed competitive tender.

**3.13** The Request for Binding Bids informed the three bidders that the Commonwealth aimed to maximise net sales proceeds on a risk-adjusted basis whilst achieving optimal outcomes in relation to the other criteria. Each binding bid was required to state the purchase price offered in Australian dollars that the bidder was prepared to pay for all the shares in SACL. Each of the three binding bids received met this requirement but they exhibited different methodologies in calculating the numerical value. Accordingly, the Evaluation Committee adjusted the purchase price amounts for the second and third highest bidders to a comparable basis with the purchase price tendered by the highest bidder. The purchase price adjustments did not affect the relative ranking of bids against the price criterion (see Figure 3.1).

**Figure 3.1**

**Indicative and binding purchase price bids (excluding forecast debt)**



Source: ANAO analysis of data from Finance and the Business Adviser.

## Purchase price adjustments

3.14 Bidders were informed that, in order to maximise risk-adjusted proceeds on a whole of government basis, tender evaluation may take into account: the impact of bid structures on future tax revenues;<sup>41</sup> the effect on the purchase price payable to the Commonwealth of any risk transfer to the Commonwealth that result from bidders' proposed amendments to the sale documentation; and the effect on the purchase price payable to the Commonwealth of movements in interest rates between the date the bid was lodged and the Sale Agreement was signed.<sup>42</sup> None of the bids was considered to involve unusual measures to artificially reduce tax and, accordingly, the Binding Bid Evaluation Committee made no purchase price adjustments for this reason. The following purchase price adjustments were made by the Committee to enable the three bids to be compared on a similar basis:

- The assessed purchase price for the second highest bidder included an amount that this bidder proposed to pay to the Commonwealth as a dividend 15 days after the transaction was settled. This necessitated a change to the transaction documentation, which was the only significant change sought.<sup>43</sup> The price effect of other changes to the transaction documentation sought by the two under-bidders that may have reduced the eventual sale proceeds paid to the Commonwealth could not reliably be quantified, and no purchase price adjustments were made, with these changes instead being assessed against the certainty and clarity of offer criteria.
- The Evaluation Committee assessed that the designated interest rate referenced by the second highest bidder in its purchase price matrix had fallen such that an additional amount would have been payable to the Commonwealth. As a result, the purchase price assessed for this bidder was increased by this amount. For the other two of the bidders, the Committee assessed that no purchase price adjustment applied in relation to their interest rate conditions.

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<sup>41</sup> Whilst each of the bids was found to involve tax effective structures, the Binding Bid Evaluation Committee, taking into account advice received from the Legal Adviser, concluded that none of the bids introduced unusual measures to artificially reduce tax. Accordingly, no adjustment was made to any of the bids for the impact of the bid structures on future tax revenues.

<sup>42</sup> To enable the impact on purchase prices to be assessed, each bidder was required to include in its bid a matrix that outlined the effect on the purchase price of any changes in a designated interest rate. This approach was taken to address concerns raised by bidders that the substantial cost of hedging their interest rate exposure during this period would have a significant impact on their ability to lodge their most competitive bid.

<sup>43</sup> The bids lodged by the two under-bidders included proposed amendments to the transaction documents that may have reduced the eventual proceeds payable to the Commonwealth. In each case the Evaluation Committee did not adjust its purchase price assessments, as it was unable to reliably quantify the effect on the purchase price of the proposed changes.

- The assessed purchase price of the lowest bidder was reduced. This bidder had included in its bid a proposal that the Commonwealth undertake post-settlement interest rate hedging<sup>44</sup> and novate it to the bidder upon completion of the sale, with an estimated benefit to the Commonwealth should the hedges be 'in-the-money'. Following discussions between Finance and the Australian Office of Financial Management (AOFM)<sup>45</sup>, the Committee concluded that the hedging benefit proposal submitted by this bidder should not be taken into account, including because: it would be inconsistent with Commonwealth risk management policies; and would create an additional exposure for the Commonwealth, particularly if the sale did not complete.

## Successful bidder selection

**3.15** The evaluation of Binding Bids required the effective coordination of input from a multi-disciplinary evaluation team within a tight time scale. To assist with evaluation, following recommencement of the tender process, the procedure and method of evaluating Binding Bids was set out in an evaluation plan titled 'Approach to Evaluation of Binding Bids' approved on 4 June 2002, more than one week prior to the due date for binding bids. This document outlined the following objectives for the evaluation process:

- establish a clear, defensible and properly documented basis for the selection of the successful purchaser;
- establish a transparent and consistent approach in dealing with bids made by consortia;
- rank all bids received against the published evaluation criteria and in accordance with an agreed methodology;
- assess whether the particulars of any bids require further examination and to establish a predefined methodology with clear definitions of roles and responsibilities to ensure prompt and approved responses;

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<sup>44</sup> Hedging refers to the process of managing risk by eliminating, or at least reducing, the underlying exposure. A hedge is effected by offsetting in part or whole the existing risk exposure associated with an underlying transaction. This is often achieved by financial derivatives but funding offsets are also possible, where exposure to payments/liabilities in one currency are offset by receipts/assets denominated in the same currency. In May 2002, the Minister for Finance and Administration announced a revised Commonwealth Foreign Exchange Risk Management policy that took effect from 1 July 2002. The policy announcement states that the Government has decided to retain the requirement for individual agencies to manage their foreign exchange risk exposures but that agencies will no longer be permitted to hedge except in special circumstances. Source: Senator Nick Minchin, Minister for Finance and Administration, *Revised Government Foreign Exchange Risk Management Policy*, Media Release 20/2002, 28 May 2002.

<sup>45</sup> The AOFM, a prescribed agency under the *Financial Management and Accountability Act 1997*, is responsible for the Commonwealth's debt management activities.



- provide a clear set of recommendations for selection of the successful consortium; and
- identify any major issues requiring resolution or further discussion with bidders.

**3.16** Three bids were received on 12 June 2002, although elements of the successful bid were received after the due time.<sup>46</sup> A formal process of acceptance of those late elements (which did not include the bid price) was undertaken. This was overseen by the Sale Process Adviser and was in accordance with the process for considering late bids set out in the Evaluation Plan. In accordance with the Binding Bid Evaluation Plan, the tender evaluation committee considered the extent to which the late submission was avoidable by the bidder, the reasons for the late submission as outlined in a statutory declaration from the bidder and whether acceptance would constitute fair and equitable treatment of the other bidders.

**3.17** Based on his assessment of the facts, noting that all other members of the committee considered that the late elements of the bid should be accepted and that the Legal Adviser had advised that the Commonwealth had the right to accept late bids, the Binding Bid Evaluation Committee Chairman decided to accept the late elements of the bid. No bids were opened until the Chairman had decided to accept the late elements of the successful bid. The decision making process was fully documented. The Sale Process Adviser provided an unqualified sign-off on the acceptance process.

**3.18** Once lodged, binding bids remained valid and thus capable of acceptance by the Commonwealth for 30 days. Binding bids were submitted in two separate components with the sensitive information comprising the purchase price and full financial model submitted separately to all other required information. The sensitive information was stored separately and provided for review only to selected members of the evaluation team. Members of the evaluation team were required to formally sign-out copies of bid documents they accessed during the evaluation process.<sup>47</sup>

**3.19** Evaluation against the Binding Bid evaluation criteria was carried out based on a series of schedules. This approach enabled: an assessment to be made and clearly documented of whether each bidder had fully responded to, and addressed, the specifications in the Request for Binding Bids; a systematic application of the criteria to each consortium and full documentation of that

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<sup>46</sup> The bidder had advised the Business Adviser at 3:30pm that the tender would be submitted after the due time. The price sensitive elements of the tender were received prior to the 4:00pm deadline with all remaining parts of the tender received by 5:35pm on the due date.

<sup>47</sup> Similar procedures to these were adopted for Stage 1 Expressions of Interest and Stage 2 Indicative Bids.



process; and an assessment of the level of coverage, both qualitatively and quantitatively.

**3.20** A five point rating scale<sup>48</sup> was applied to the Binding Bid evaluation criteria enabling the three bids to be differentiated across the full range of the evaluation criteria. An initial ranking of bids was prepared in decreasing order of risk-adjusted sale proceeds. A further relative ranking of bids was then prepared taking account of the other criteria. The bid offering the highest purchase price was assessed as equal to, or higher than, both other bids on all remaining criteria and, accordingly, the overall relative ranking did not change. On this basis, the Evaluation Committee unanimously concluded that the bid lodged by the Southern Cross Airports Corporation best met the aim of maximising net sale proceeds on a risk-adjusted basis while achieving optimal outcomes in relation to the other criteria. It offered a significantly higher purchase price for the shares than the next highest bid and was assessed as equal to, or higher than, both other bids on all remaining criteria.

**3.21** The Committee's report was finalised on 21 June 2002 and provided to Finance. The Secretaries of the Department of the Prime Minister and Cabinet and DOTARS were advised of the Committee's selection recommendation on 21 June 2002, in order to brief their respective Ministers. On 24 June 2002, Finance briefed the Minister for Finance and Administration. Also on 24 June 2002, representatives of the sale team provided a presentation on the evaluation results to the Prime Minister, the Treasurer, the Minister for Finance and Administration and the Minister for Transport and Regional Services. The recommendation of the Binding Bid Evaluation Committee that Southern Cross Airports Corporation be selected as the preferred tenderer was accepted with the Sale Agreement signed the following day, 25 June 2002.

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<sup>48</sup> The following scale was applied:

- a rating of 'High' indicated that the Binding Bid fully met and exceeded the level considered appropriate;
- a rating of 'High/Medium' indicated that the Binding Bid fully met and marginally exceeded the level considered appropriate;
- a rating of 'Medium' indicated that the Binding Bid fully met but did not exceed the level considered appropriate;
- a rating of 'Medium/Low' indicated that the Binding Bid did not meet in all respects the level considered appropriate, however was of a sufficient standard broadly or marginally acceptable; and
- a rating of 'Low' indicated that the Binding Bid, taking all aspects into consideration, failed to meet the level considered appropriate.

## 4. Sale Outcomes

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

### Financial returns

**4.1** The SACL Sale Agreement signed on 25 June 2002 specified a purchase price of \$4 233 014 000 for the 100 000 100 fully paid ordinary shares in the capital of SACL.<sup>49</sup> This represented a price of \$42.33 per share. Having regard to the following benchmarks, in ANAO's view the sale proceeds represent a very good financial outcome for the Commonwealth:

- The Request for Binding Bids required bidders to submit a purchase price for the Commonwealth's shares in SACL. Three binding bids were received on 12 June 2002. Each of the bids provided a purchase price for the outstanding SACL shares but they adopted different approaches to calculating the actual numerical value that would be payable to the Commonwealth. Following analysis, the Binding Bid Evaluation Committee Report noted that, on a comparable basis,<sup>50</sup> the purchase price offered for the Commonwealth's shares of \$4.233 billion was significantly higher than the other two bids. The highest bid was accepted as it was assessed to best meet the aim of maximising net sale proceeds on a risk-adjusted basis while achieving optimal outcomes in relation to the other evaluation criteria.<sup>51</sup>
- On an enterprise valuation basis,<sup>52</sup> the successful bid involved a multiple of 17.7 times 2002 earnings. This multiple was greater than that estimated in the February 2001 Scoping Study Report, which forecast a multiple range of 14 to 16 times earnings. The Scoping Study report expected lower multiples than those achieved in the Phase 1 and Phase 2 sales as a result of: the size of Sydney (Kingsford Smith) Airport, which was expected to

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<sup>49</sup> Clauses 1.1 and 4.1 of the Agreement.

<sup>50</sup> Specific regard was had to any effect on purchase prices from interest rate movements, possible payment of stamp duty by the Commonwealth and the existence of any unusual measures to artificially reduce tax.

<sup>51</sup> The highest bid was also assessed as equal to or higher than both other bids on all remaining evaluation criteria.

<sup>52</sup> It is common in the airports sector to use earnings multiples based on enterprise value. For these purposes, enterprise value comprises the current market capitalisation plus the net debt position of the entity. In this respect, SACL's debt and external commitments totalling approximately \$1.355 billion remained the company's responsibility following the sale, resulting in an enterprise value of \$5.588 billion at the time of sale. Source for figures: Minister for Finance and Administration, Notice Under Section 45 of the *Commonwealth Authorities and Companies Act 1997*, 21 August 2002.

restrict the field of operators with the resources to manage the airport and add value; unlike Phases 1 and 2, SACL was already moderately geared with potentially large capital expenditure requirements going forwards, thereby reducing financial engineering potential; and there were concerns about the availability of sufficient Australian institutional equity to sustain three or more competing bids.

- The earnings multiple of 17.7 times also compares favourably to current market valuations of previous privatisations of other international airports world-wide and to the returns achieved from the Phase 1 and Phase 2 sales.
- The purchase price of \$4.233 billion significantly exceeded the \$3.2 billion estimate incorporated into the 2001–02 Commonwealth Budget.
- Total proceeds received (\$4.233 billion) represent a \$2.338 billion (123 per cent) premium to the June 2002 value of the net assets transferred (\$1.895 billion) with the business.

## Debt reduction

**4.2** In its March 2001 announcement that the sale of Sydney (Kingsford Smith) Airport would proceed, the Government stated that the sale proceeds would be applied to reduce Commonwealth debt. Prior to the sale, SACL was an equity asset on the Commonwealth's balance sheet.<sup>53</sup> Accordingly, in the Commonwealth's accounts, the sale reduced Commonwealth equity investments by \$794 million<sup>54</sup> and reduced Commonwealth net debt as at 30 June 2002 by \$4.233 billion.<sup>55</sup>

**4.3** AOFM advised ANAO in December 2002 that the approach adopted to manage the proceeds from the sale of SACL was consistent with established

<sup>53</sup> Proceeds from the sale of equity assets do not contribute directly to the underlying cash balance or accrual fiscal balance. However, where proceeds are used to reduce Commonwealth net debt, lower public debt interest payments (where proceeds are used to repurchase debt) and/or higher earnings on financial investments (where proceeds are invested) do affect the cash and fiscal balances.

<sup>54</sup> Although the Government Finance Statistics reporting framework adopted in the Budget Papers requires that assets be valued at market prices, not all assets and liabilities in the Budget Balance Sheet are valued at market prices (see *Budget Strategy and Outlook 2002–03*, Budget Paper No.1, Statement 2, p. 15). In this respect, the SACL investment was recorded at the value of the 100 million shares issued to the Commonwealth on 30 June 1998 as part consideration for the acquisition of the business of Sydney (Kingsford Smith) Airport by SACL. The total price paid to the Commonwealth by SACL for the Airport lease and the transfer of related assets, contractual rights and obligations, liabilities and employees was \$1 433.5 million. As of 30 June 2001, SACL's net assets were valued in its financial statements at \$1.834 billion.

<sup>55</sup> Commonwealth net debt was reduced by the full amount of the sale proceeds received (rather than the difference between the previous Balance Sheet value of \$794 million and the sale proceeds) because the calculation of net debt excludes equity investments. Source: *Budget Strategy and Outlook 2002–03*, Budget Paper No.1, Statement 11, p. 6.

Government policy. The Government's approach was articulated most recently in the 2002–03 Budget Papers wherein it was noted that, while the Government considers questions raised by some market participants about the future viability of the CGS market,<sup>56</sup> it would continue the approach to debt management adopted in recent years, as follows:<sup>57</sup>

The reduction in net debt has been managed in line with the objective of maintaining the viability of the CGS market and its supporting infrastructure. Consistent with this approach, reductions in CGS on issue have lagged the reductions in net debt. This has been achieved primarily by holding surplus budget proceeds not applied to the redemption of CGS as financial assets.

**4.4** In June 2002, when announcing the sale of the Airport to Southern Cross Airports Corporation,<sup>58</sup> the Government stated that the proceeds of the sale would go to repaying Commonwealth debt with Commonwealth debt to be reduced by \$4.233 billion. This, in turn, would reduce public debt interest<sup>59</sup> payments by around \$250 million every year. The estimated public debt interest savings of \$250 million per annum were based on an effective interest rate of six per cent. As it eventuated, the application of sale proceeds is estimated to have resulted in a return of 5.17 per cent in 2002–03, or some \$219 million.<sup>60</sup> Interest savings in future years will reflect the course of market interest rates going forward, amongst other considerations.

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<sup>56</sup> On 30 October 2002, the Treasurer released a discussion paper titled *Review of the Commonwealth Government Securities Market*.

<sup>57</sup> *Budget Strategy and Outlook 2002–03*, Budget Paper No.1, Statement 7, p. 3.

<sup>58</sup> Senator Nick Minchin, Minister for Finance and Administration and John Anderson MP, Deputy Prime Minister and Minister for Transport and Regional Services, Joint Media Release, *Sydney Airport Sells for \$5.588 Billion*, 25 June 2002.

<sup>59</sup> Public debt interest represents the cost of servicing the stock of Commonwealth debt on issue. It does not take into account earnings on financial investments.

<sup>60</sup> These figures comprise a \$89 million reduction in public debt interest and \$130 million of interest earnings calculated as follows:

- A total of \$2.2 billion was initially invested in a term deposit with the Reserve Bank of Australia (Reserve Bank) earning interest at a rate of 5.04 per cent per annum. This term deposit matured on 15 October 2002 and was used to finance maturity of the October 2002 Treasury Fixed Coupon Bond. Had these proceeds not been available to finance this maturing debt, the cost of raising further debt at this time was 5.72 per cent reflecting the weighted average issue yield of debt issued by tender on 15 October 2002. This indicates that realised savings of some \$121 million accrued from this portion of the sale proceeds (comprising \$32 million in interest earnings from the term deposit that matured on 15 October 2002 and a further \$89 million in public debt interest savings for the period 15 October 2002 to 30 June 2003).
- The remainder of the sale proceeds was invested in deposits with the Reserve Bank of Australia (Reserve Bank) and used on an as required basis to assist seasonal financing requirements, including the financing of subsequently maturing debt. Excluding the earnings on the term deposit subsequently used to finance maturity of the October 2002 Treasury Fixed Coupon Bond, the weighted average interest rate earned on the AOFM term deposits is 4.80 per cent per annum. Accordingly, in the absence of an increase in interest rates over the remainder of 2002–03, savings from the investment of sale proceeds in deposits with the Reserve Bank are estimated to be, at most, \$98 million in 2002–03.

## Risk minimisation

**4.5** Residual Commonwealth risks and liabilities can arise primarily through the tender process and the terms and conditions of the sale documentation. Similar to the Phase 1 and Phase 2 sales, the tender approach addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to shortlisted bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability was assessed as part of the tender evaluation process. In this latter respect, the successful tender was rated equal to or higher than the other two tenders in relation to the risk-related criteria which were conformity with the draft transaction documentation and the certainty and clarity of the offer.

**4.6** As part of the tender process, Finance and its advisers also sought to avoid additional post-sale risk to the Commonwealth from SACL's existing debt facilities. To achieve the best possible financial result for the Commonwealth whilst providing an acceptable position for bidders, steps were taken to facilitate the post-sale refinancing of the existing debt by the successful bidder. This involved liaising with SACL to negotiate reduced repayment notice periods on bank debt, monitoring SACL's rollover of short-term notes and procuring a reduction in the call notice period on the medium-term notes. These steps helped to avoid additional risk to the Commonwealth such as from bidders potentially including financial assistance as a condition of their bids.

**4.7** The sale documentation for the sale of Sydney (Kingsford Smith) Airport was based on documentation developed during the Phase 1 and Phase 2 sales, with changes made for the share sale context and new ownership and control regulations. Finance's Legal Adviser was primarily responsible for the preparation of the sale documentation, with input from Finance, DOTARS and the Business Adviser. The major sale documentation comprised a Share Sale Agreement and a Tripartite Deed. The existing airport lease that commenced on 1 July 1998 was retained as the sale involved the sale of all the shares in the airport lessee company rather than the sale of a new airport lease.

## Sale Agreement

**4.8** The parties to the SACL Share Sale Agreement were the Commonwealth, Southern Cross Airports Corporation Pty Limited and the various consortium entities. The Share Sale Agreement set out the terms and conditions on which the Commonwealth agreed to sell, and Southern Cross Airports Corporation agreed to buy, the fully paid ordinary shares in the capital of SACL. The Legal Adviser provided Finance with a written opinion on the Sale Agreement that, among other things, stated that the Sale Agreement represents an appropriate

outcome for the Commonwealth having regard to the nature of the project, the level of risk which the Commonwealth was prepared to accept and the sale objectives.

**4.9** Competitive tension through the tender process enabled various changes requested by bidders to be resisted. In addition, the final signed Sale Agreement contains a number of measures designed to minimise the Commonwealth's post-sale risks and liabilities including: minimal warranties provided by the Commonwealth; most of those warranties that were provided were capped to a maximum exposure of \$1;<sup>61</sup> and no purchase price adjustment clause was included with bidders instead required to price their estimate of SACL profits and cashflows up to the time of completion. Furthermore, a number of administrative steps were taken to reduce risk, including reducing the period from selecting a successful bidder to the signing of the Sale Agreement to less than 24 hours, and a three day completion period from the signing of the Sale Agreement to full financial settlement.

**4.10** There were a small number of significant differences between the SACL Sale Agreement and the Agreements for core-regulated airports sold in Phases 1 and 2 of the airports privatisation program. One of the more significant differences related to the inclusion of a Material Adverse Change clause in the Sale Agreement. As a consequence of September 11, each of the three bidders included a Material Adverse Change clause as a condition of its tender. The various clauses and their effect on the Commonwealth's post-sale risk exposure were assessed as part of the evaluation process. The successful bidder's condition involved the least risk to the Commonwealth compared to other bidders. In particular, this bidder's clause was only to come into effect five business days from the execution of the Sale Agreement. As the transaction was completed three days after the Sale Agreement was signed, the clause did not come into effect.

**4.11** Another significant change from previous sale agreements was the inclusion of a clause providing the purchaser with a right of first refusal over the development and operation of a second Sydney airport. Extensive input into the drafting of this clause was provided by DOTARS, Finance, the Business Adviser and Legal Adviser in terms of balancing the value of the rights being provided to the purchaser against the need to protect the Commonwealth's future position. DOTARS' assessment of the final clause was that, whilst careful and extended negotiation would be required if the purchaser was reluctant to build and operate a second airport, the Commonwealth could not be prevented from having a second airport developed and operated.

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<sup>61</sup> The Commonwealth's maximum liability was limited to the purchase price for warranties given in relation to the Commonwealth's ownership of the SACL shares, ability to sell the SACL shares, the issued capital of SACL and the validity of the airport lease.

**4.12** One of the few changes made to the draft Sale Agreement following the receipt of binding bids related to the payment of stamp duty on the transaction. The successful bid assumed that stamp duty would be paid at rates applicable to marketable securities, with the Commonwealth being required to carry any risk that land rich duty rates would be applied. No purchase price adjustments were made as part of tender evaluation to reflect this change as the risk of land rich duty being payable was considered by the Binding Bid Evaluation Committee to be low, and all bidders approached this issue in the same way. The Minister was advised that the insertion of a stamp duty clause indemnity into the sale agreement did not pose an unacceptable risk for the Commonwealth's net sale proceeds.

**4.13** Under the terms of the Sale Agreement, the Commonwealth indemnified the purchaser against any stamp duty in the event that stamp duty is applied at the 'land rich' duty rate rather than at the significantly lower marketable securities rate. In the event the New South Wales Office of State Revenue finds stamp duty payable at the land rich rate, there will be a part-repayment of the purchase price. In its response to a recent audit survey conducted by ANAO on the management of Commonwealth guarantees, warranties, indemnities and letters of comfort,<sup>62</sup> Finance quantified the range of exposure for the Department as between \$221.2 million and \$282.8 million. In April 2003, Finance advised ANAO that, as part of its consideration as to whether SACL is a 'land rich' company, the New South Wales Office of State Revenue had requested the New South Wales Valuer-General to provide a close estimate of the value of the leasehold interest held by SACL. Finance further advised ANAO that it understood that the New South Wales Valuer-General has not yet responded to that request.<sup>63</sup>

## Tripartite Deed

**4.14** Tripartite Security Deeds were introduced in the Phase 1 sales in response to the concerns of lenders that lease termination would mean that their borrowers' main asset and, thus, a substantial part of the lenders' security value could be lost without the lenders having an opportunity to rectify the problem prior to termination.<sup>64</sup> Tripartite Deeds apply to the 12 core regulated airports,

<sup>62</sup> Audit Report No.27 2002–03, *Management of Commonwealth Guarantees, Warranties, Indemnities and Letters of Comfort*.

<sup>63</sup> On this issue, the Sale Legal Adviser advised ANAO in April 2003 that the parties have not yet tested whether any constitutional basis exists to resist the payment of stamp duty.

<sup>64</sup> The SACL Airport Lease provides the Commonwealth with limited termination rights. Termination may occur following the suspension or cancellation of the airport license for the breach, other than as a result of *force majeure*, of the obligation to provide access to or to use the airport. The lease allows for almost immediate termination upon the occurrence of such an event, although the Commonwealth may prevent or cure any termination event at the cost of the Lessee without terminating the lease.



including Sydney. They provide for step-in and cure rights for the financiers in circumstances where the airport lease may otherwise be terminated.

**4.15** The potential liability of the Commonwealth under the Tripartite Deeds can vary considerably, depending on whether the Airport Lease is able to be sold on to a third party or not.<sup>65</sup> In the event the lease is terminated by the Commonwealth and not re-sold, the Commonwealth is required to obtain a valuation of the airport site that would set the basis for a repayment of financier's loans by the Commonwealth, subject to higher ranking claims being met first. If the Commonwealth were to enter into possession of an airport it would seek to recover its costs from a number of sources including airport revenues and the airport lessee company, in addition to funds obtained from selling on the airport lease. The potential liability to the lessee's financiers is limited to the value received for the lease or the valuation of the airport site.

**4.16** As a consequence of SACL's 1999 borrowing program to, among other things, repay the \$639.5 million debt portion of the airport acquisition price to the Commonwealth as well as the \$100 million Commonwealth loan transferred from the former Federal Airports Corporation, the Commonwealth entered into a Tripartite Deed with SACL and a trustee for SACL's financiers on 8 March 1999. This Deed was to expire after 20 years and was in substantially the same form as that granted as part of the Phase 1 and Phase 2 airport sales. The major difference was that the SACL Tripartite Deed provided for a trustee who accepted limited liability in acting on behalf of the financiers rather than a lender who accepted direct liability to the Commonwealth for all the financiers.

**4.17** The indicative bids submitted by two of the bidders contained comments concerning the existing SACL Tripartite Deed. These comments indicated that both bidders wished to replace the existing SACL Tripartite Deed with one based on the arrangements used in the Phase 1 airport sales. This request was agreed to.

**4.18** During the tender process, bidders sought changes to the various drafts of the Tripartite Deed provided to them for comment. Those changes that would have increased the Commonwealth's risk exposure (such as extending the term of the Deed from 20 to 30 years) were resisted by DOTARS.<sup>66</sup> Other minor suggested amendments, and amendments reflecting the pre-existing SACL Tripartite Deed, were incorporated into the final document, signed on 25 June 2002.

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<sup>65</sup> *Mid-Year Economic and Fiscal Outlook 2001–02*, October 2001, pp. 86 and 87.

<sup>66</sup> DOTARS was closely involved in the drafting of the tripartite deed and was consulted on any amendments suggested by bidders. To assist in protecting the Commonwealth's interest in relation to post-sale risks that could arise from the tripartite deed and related bidder financing documents, the Australian Government Solicitor was engaged by DOTARS to provide legal advice to it.



## Financial and managerial capabilities

**4.19** The third sale objective was to ensure that the airport lessee has the necessary financial and managerial capabilities to operate and provide timely investment in environmentally appropriate aviation infrastructure at Sydney (Kingsford Smith) Airport. In this context, financial strength and managerial capabilities of bidders were explicitly addressed in the tender process. Bidders were required to provide bid financing details (including terms and conditions) and submit a 10 year business plan supported by detailed financial forecasts and a financial model. Each bidder was required to include in its business plan details of its: proposed management structure and approach to managing the airport; strategic assessment of the operating environment and the airport business; planned business strategies that outline how the bidder proposed to enhance the value of the airport; strategy implementation plans and a summary of financial projections and key assumptions.

**4.20** The evaluation criteria included a criterion that addressed bidders' financial and managerial capabilities. Consistent with this criterion, each bidder's financial and managerial capabilities were assessed as part of tender evaluation. In relation to financial capabilities, the evaluation took into account the resources available to the bidder to fund ongoing operation of the airport as well as the capital investment plans outlined in the business plan. For managerial capabilities, evaluation focused on the capability and experience of the bidder including relevant airport management experience. The Binding Bid Evaluation Committee concluded that each bidder met the criterion with the successful bidder assessed as having very strong financial and management expertise.

**4.21** A further evaluation criterion addressed the strength and structure of the financing arrangements backing the bid. This criterion was relevant to the objective of minimising the Commonwealth's post-sale risk exposures as well as to the financial and managerial capabilities objective. For evaluation against this criterion, bidders were required to provide details of: how they proposed to finance the acquisition of SACL; the types, terms and levels of debt, equity and hybrid financing; signed copies of unconditional financing commitments and related approvals.

**4.22** To finance the SACL acquisition,<sup>67</sup> the successful bidder adopted a highly geared financial structure. This included a dual holding company in order to simplify the security mechanisms for the financing arrangements with its banking group and enable the efficient repatriation of profits to the holding company shareholders (see Figure 4.1).<sup>68</sup> The \$6.189 billion in funds raised from external debt and shareholder loans were used to acquire the SACL shares for a purchase price of \$4.233 billion, loan SACL \$1.449 billion to repay existing debt, loan SACL a further \$140 million to establish cash reserves and pay transaction and debt issue costs of \$299 million, with the remaining \$68 million set aside by the holding company as cash reserves.<sup>69</sup>

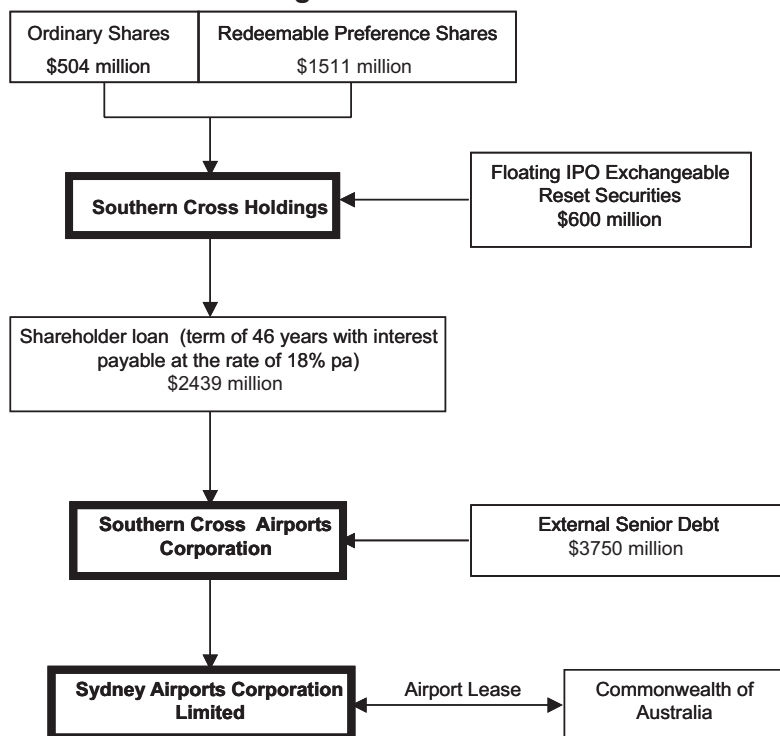
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<sup>67</sup> Macquarie Airports Prospectus dated 18 July 2002 lodged with the Australian Securities and Investments Commission and the Australian Stock Exchange Limited, *Sydney Kingsford Smith Airport and Aeroporti di Roma*, p. 108 stated that the following funding structure was used to effect the acquisition of Sydney Airport:

- Southern Cross Holdings issued ordinary shares to the value of \$504 million stapled to \$1,511 million of redeemable preference shares (together termed 'Ordinary Equity') and \$600 million of Floating IPO Exchangeable Reset Securities (FLIERS);
- Southern Cross Holdings loaned \$2439 million to its wholly-owned subsidiary, Southern Cross Airports Corporation. The term of the loan to Southern Cross Airports Corporation is 46 years and interest is payable at the rate of 18 per cent per annum. Obligations in respect of this loan are subordinated to any payments due to senior debt and Sydney Airports Corporation guarantees this loan. However, the amount recoverable from Sydney Airports Corporation under the guarantee is limited to \$1000 million;
- Southern Cross Holdings set aside \$68 million in cash reserves to establish FLIERS reserves; and
- Southern Cross Airports Corporation obtained \$3,750 million in external senior debt from the senior lenders.

<sup>68</sup> Macquarie Airports Prospectus dated 18 July 2002 lodged with the Australian Securities and Investments Commission and the Australian Stock Exchange Limited, *Sydney Kingsford Smith Airport and Aeroporti di Roma*, p. 108.

<sup>69</sup> *ibid.*

**Figure 4.1****Successful bidder's financing structure**

Source: ANAO analysis of Macquarie Airports Prospectus dated 18 July 2002 lodged with the Australian Securities and Investments Commission and the Australian Stock Exchange Limited, *Sydney Kingsford Smith Airport and Aeroporti di Roma*, p. 108.

**4.23** The Evaluation Committee concluded that the successful bidder met and marginally exceeded the level considered appropriate against this criterion for the following reasons:

- The documentation for equity, senior debt and subordinated debt was complete and executed. The debt raising was supported by a preliminary investment grade rating of BBB from Standard & Poors<sup>70</sup> and Baa2 from Moodys Investor Services.

<sup>70</sup> An rating of BBB means the borrower is assessed to have adequate capacity to meet its financial commitments however adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity for the obligor to meet its financial commitments. In July 2002, Standard & Poors commented that the stable outlook on the BBB senior debt obligations reflects the stability of cash flows from the Airport and longer-term robust growth potential. The ratings agency also noted that the aggressive financial structure means there is little room for underperformance in any key operating metric and any deviation in underlying cashflow expectations of financial accommodation could adversely affect the rating. Source: Standard & Poors, *Industry Report Card: International Airports*, 18 July 2002.

- Cashflow projections were based on less conservative traffic, revenue and capital expenditure forecasts than existing SACL forecasts. However, on the basis that the cashflow coverage requirements under the bidder's financing documents would still be met under the SACL traffic assumptions, the Evaluation Committee concluded that the bidder's capital structure and financial coverage ratios (including gearing levels<sup>71</sup>) were reasonable for an infrastructure asset financing.

**4.24** The Standards & Poors preliminary ratings were confirmed in July 2002<sup>72</sup> with the senior secured debt of Southern Cross Airports Corporation rated BBB<sup>73</sup> reflecting the stability of cash flows from Sydney (Kingsford Smith) Airport and long-term robust growth potential. It was noted that the aggressive financial structure meant there is little room for underperformance in any key operating metric and any deviation in underlying cash flow expectations or financial accommodation could adversely affect the rating.

## Legislative, regulatory and policy requirements

**4.25** A range of legislative, regulatory and policy requirements apply to Sydney (Kingsford Smith) Airport. The more significant of these include:

- The requirements of the Airport Act and associated regulations. Key provisions in the Airports Act include: a Commonwealth-owned airport can only be leased to an airport lessee company whose sole business will be to run the airport; foreign ownership, airline ownership and cross ownership restrictions; the requirement for an airport master plan, major development plans, and environment strategies; quality of service monitoring and reporting; access regimes; and the ability for the Minister for Transport and Regional Services to formulate demand management schemes at the airports. The Act also sets out a number of requirements in relation to the content of airport leases.
- The economic regulatory arrangements under the *Trade Practices Act 1974* and the *Prices Surveillance Act 1983*. During the sale process, the Productivity Commission undertook a review into price regulation at airports with the Government announcing in May 2002 that it had accepted the Commission's recommendation that Sydney (Kingsford Smith) Airport and six other airports be subject to price monitoring for five years, with

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<sup>71</sup> For the purposes of assessing the gearing levels of bidders as part of tender evaluation, shareholder loans and hybrid securities were treated as equity given their subordination to other lenders. On this basis, the debt to equity ratio at the time of the acquisition was 60:40.

<sup>72</sup> Standards & Poors, *Industry Report Card: International Airports*, 18 July 2002.

<sup>73</sup> The subordinated debt at the parent Southern Cross Holdings was rated lower at BBB minus.

effect from 1 July 2002.<sup>74</sup> An independent review is to be carried out towards the end of the five-year period to ascertain the need for future airport price regulation.

- The Government's December 2000 policy announcement<sup>75</sup> that: confirmed its commitment to existing operating arrangements at Sydney (Kingsford Smith) Airport including the curfew, movements cap and guaranteed slots for regional airlines; and outlined its decision to make Bankstown Airport an overflow airport for Sydney (Kingsford Smith) Airport rather than build a second major airport with Sydney's airport needs to be reviewed again in 2005.

**4.26** Consistency with relevant airport legislative, regulatory and policy requirements was explicitly assessed as part of the tender process. In accordance with the relevant evaluation criteria, each bid was assessed in terms of its: compliance with the ownership and control requirements of the Airports Act; understanding of the planning, environmental and non-aeronautical commercial activity elements of the regulatory regime; compliance with competition, access and pricing policies; approach to aviation security issues; and acceptance of existing constraints on Airport capacity and operations. Each bid was assessed to meet the evaluation criteria, with the successful bidder considered by the Evaluation Committee to display a sound understanding of, and consistency with, all relevant legislative, regulatory and policy requirements surrounding Sydney (Kingsford Smith) Airport.

## Employee issues

**4.27** One sale objective was to ensure fair and equitable treatment of employees of SACL, including the preservation of accrued entitlements. This objective was addressed through the introduction of executive remuneration arrangements intended to retain top management throughout the sale process, the evaluation of bids in terms of this objective and by the inclusion of redundancy protections for staff in the Sale Agreement.

**4.28** In May 2001, the Business Adviser provided advice that the retention of SACL's executive team throughout the sale process was important in terms of SACL's participation in the sale process and the maintenance of operational

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<sup>74</sup> The Commission's final report (Report No.19, *Price Regulation of Airport Services*, 23 January 2002) and the Government's response to that report, were both released on 13 May 2002. A key message from the Commission's final report was that strict price controls were not required at Sydney (Kingsford Smith) Airport or the other Australian airports that have substantial market power with the Commission recommending that a 'light-handed' regulatory regime of price monitoring be introduced.

<sup>75</sup> The Hon. John Anderson MP, Deputy Prime Minister and Minister for Transport and Regional Services, *Sydney's Future Airport Needs*, Media Release A197/2000, 13 December 2000.

performance so as to not affect bidders' value perceptions. In this context, the Business Adviser noted that a number of incentives were in place to ensure top management performance and secure retention through the sale process.

**4.29** The Request for Binding Bids included an evaluation criterion that explicitly addressed the objective of ensuring fair and equitable treatment of SACL employees. Each bid was assessed in terms of their: stated commitment to the preservation of employee entitlements; proposed staffing levels over the short term (two years) and medium term (two to five years); proposals to introduce employee incentive plans; and the development of a human resources business strategy. Each bidder was assessed to fully meet this criterion, with each bid ranked equally against the criterion. The successful bidder proposed to broadly retain the existing SACL organisational structure, management and staff for five years while flagging some areas for possible reform.

**4.30** As with the earlier airport sales, each bidder was required to provide a statement in its Indicative Bid<sup>76</sup> as to whether or not it was willing to accept the condition sought by the staff associations that no SACL award staff would be subject to compulsory redundancy for a period of 12 months following sale completion. Bidders were also required to respond to the proposition that there be no forced redundancies for the first six months after sale completion for non-award staff, other than senior executives. In its Binding Bid, the successful bidder stated that it accepted the condition sought by staff associations in relation to award staff and was not contemplating any forced redundancy of non-award staff within the first six months following completion. These undertakings were reflected in the Sale Agreement by the inclusion of a provision whereby award workers received the benefit of a 12 month no forced redundancy pledge by the purchaser with non-award workers receiving the benefit of a six months no forced redundancy pledge.

## Airport development

**4.31** Sydney (Kingsford Smith) Airport has facilities for international, domestic and regional passenger airlines and general aviation traffic. The Information Memorandum released to shortlisted bidders noted that a number of facilities at the Airport had recently undergone a significant upgrade and expansion. This included the SA2000 Project which delivered a 40 per cent increase in passenger facilitation infrastructure at the international terminal, upgrades to the existing domestic terminals and the construction of a domestic express terminal. In this context, capital expenditure for the period 1 July 1998 to 31 December 2000 totalled more than \$780 million.

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<sup>76</sup> This requirement was not included in the Request for Binding Bids.

**4.32** A key feature of the earlier airport sales was that 10 of the core-regulated airports<sup>77</sup> were required to commit in the respective sale agreements to undertake a specified amount of capital expenditure on aeronautical infrastructure development at the airport sites over the first 10 year period of the airport leases. Total commitments of \$758 million were specified in the various sale agreements, representing 20 per cent of the purchase prices paid. The development commitments are phased over the first 10 years of each lease, divided into two five year periods. The airport lessee is required to pay the Commonwealth the amount of any shortfall if actual expenditure is less than 90 per cent of committed capital in the first 5 year period and less than 80 per cent in the second 5 year period. The purpose of this ‘use it or lose it’ contractual mechanism was to provide the strongest possible legal incentive for lessees to comply with their capital expenditure commitments.

**4.33** The merits of including a similar requirement on the purchaser of the Sydney (Kingsford Smith) Airport lease was considered during the sale process. In August 2001, the Business Adviser advised that Sydney (Kingsford Smith) Airport’s future capital expenditure requirements were difficult to specify and quantify as a result of: regulatory and physical constraints at the Airport; the lack of a master plan for future development; the Necessary New Investment cost pass-through regulations,<sup>78</sup> particularly in relation to New Large Aircraft; and the different political environment compared to other Government airport sales. Given these uncertainties and the uncertainty surrounding future airport requirements, the Business Adviser concluded that it would be of little value to the Commonwealth for a purchaser to be obligated under the Sale Agreement to undertake certain future capital expenditure.

**4.34** One of the Binding Bid evaluation criteria addressed the Government’s sale objective of ensuring the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia’s international obligations.<sup>79</sup> This was addressed in the evaluation of tenders through analysis of bidders’ proposed capital expenditure in the short, medium and long term, strategies to address key stakeholders in the process as well as a clear articulation of bidders’ commitment to the ongoing development of the Airport as a world-class facility. In this respect, the successful bidder was assessed to fully meet this criterion, as follows:

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<sup>77</sup> Sydney (Kingsford Smith) Airport is also a core-regulated airport under the Airports Act.

<sup>78</sup> Direction 18 under the Prices Surveillance Act includes a provision that allows an airport operator to increase charges at a rate in excess of the charges that could otherwise be made under the pricing arrangements that apply for that operator.

<sup>79</sup> This sale objective was substantially the same as one of the ongoing privatisation objectives of the Phase 1 and Phase 2 sales.

- The successful bid incorporated a proposed capital expenditure programme of \$2.079 billion over 20 years. This programme was generally lower than that proposed by SACL in its business plans but the Evaluation Committee concluded that it was consistent with developing and maintaining Sydney (Kingsford Smith) Airport as a world-class facility. The Committee also assessed that the capital investment plan was thorough and appeared to be supported by the bidder's traffic and movement projections.
- The successful bidder proposed in its business plan to maintain and foster strong government and community relations, consistent with and building on SACL's pre-sale approach to these issues. A consultative approach was proposed to the development of airline and other customer relationships.
- The successful bidder stated in its tender that it envisaged Sydney (Kingsford Smith) Airport remaining the pre-eminent New South Wales and Australian gateway and maintaining its role as a hub that provides vital access between New South Wales, the rest of Australia and the global air network. The Evaluation Committee concluded that there was sufficient detail in the bidder's business plan strategies and associated implementation plans to engender a reasonable degree of confidence in the successful bidder's commitment to the ongoing development and sustainability of the Airport as a world-class facility.

Canberra ACT  
8 May 2003

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P. J. Barrett  
Auditor-General



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