1 . REPORT SUMMARY

1.1 INTRODUCTION

In February 1996 tenders were called for a financing facility for the Territory's passenger and light commercial motor vehicles. At close of tenders on 29 February 1996, six tenders had been received.

Evaluation of the tenders was the responsibility of the Department of Urban Services. The Department was advised by a Steering Committee comprising representatives of the Department of Urban Services, Chief Minister's Department and the Territory Solicitors Office. The Steering Committee was supported and guided by a firm of consultants.

On 28 June 1996 the Fleet comprising approximately 1300 vehicles was sold to Macquarie Bank Limited for $26.4 million. On the same day the Territory leased back from the bank the same 1300 vehicles under a 10 year lease facility. The upper limit of the lease facility is $35.4m.

Because of the nature and materiality of the leasing arrangements it was decided that an audit of the arrangements should be undertaken.

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1.2 AUDIT OBJECTIVES

The objectives of the audit were to provide independent opinions to the Legislative Assembly on whether the sale and leaseback of the ACT Fleet:

- was awarded to the successful tenderer based on complete and accurate financial comparisons of the costs and risks associated with the tenders received;
- exposes the Territory to significant financial risks;
- is financially beneficial to the Territory; and

- was accounted for correctly in accordance with Australian Accounting Standards as required by the Financial Management Act 1996.

The independent audit opinions formed from the audit are set out in *page 3*.

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1.3 AUDIT SCOPE AND APPROACH

The audit reviewed all decisions relating to the sale and leaseback of the ACT Fleet. Decisions reviewed included the initial decision to alternatively finance the fleet, the evaluation of tenders received, the evaluation of the risks and benefits associated with the successful tender and the classification of the financing facility for accounting purposes.

The Request For Tender was evaluated to ensure it complied with the Government's decision to seek alternatives for financing the ACT Fleet. The audit then assessed whether all tenders received were evaluated according to the requirements of the Request for Tender.

The successful tender was then reviewed by the audit team to ensure that in fact it did offer the most attractive financing facility to the Territory out of all tenders received. The risks and benefits of the successful tender were evaluated to identify whether the acceptance of the tender exposed the Territory to additional future risks and that there were in fact financial benefits in accepting the tender proposal.

The classification of the successful tender in accordance with Australian Accounting Standards was also reviewed to ensure that the financing facility would be correctly accounted for.

AUDIT OPINIONS

Complete and Accurate Financial Comparisons of Costs and Risks

- *selection of the successful tenderer was justified by a complete and accurate evaluation of the costs of each tender based on the circumstances existing at the time the evaluation was made;*

- *risks arising from future changes in circumstances important to the lease terms were not subjected to a complete and accurate evaluation, nor were these risks adequately disclosed to the Government;*

- *although the process by which the costs were assessed was generally sound, improvements could have been made;*

Exposure to Financial Risks and Benefits

- *the Territory is exposed to significant financial risks through the lease arrangements;*

- *immediate financial benefits from the lease of the ACT fleet were minimal and there is no certainty the benefits will be maintained into the future;*

Accounting for the Transaction

- *the lease of the ACT Fleet was not correctly accounted for in accordance with Australian Accounting Standards.*

Other Issue

- *the annual $1m insurance cost for the vehicles could have been significantly less.*

1.4 BASES FOR AUDIT OPINIONS

The bases on which each audit opinion was formed are set out following:

1.5 COMPLETE AND ACCURATE COMPARISONS OF COSTS AND RISKS (Chapter 3)

The opinion that ***selection of the successful tenderer for the sale and leaseback was justified by a complete and accurate evaluation of the costs of each tender based on the circumstances existing at the time the evaluation was made*** is supported by the following findings**:**

- Tenders were evaluated by a Steering Committee whose members included officers with fleet management, financial and legal expertise;
- The Steering Committee was assisted by consultants in evaluating the tenders; these consultants were suitably qualified and had undertaken similar exercises for other Australian governments;
- The Steering Committee, assisted by the consultants, performed comprehensive analyses of the financial costs and benefits of each tender; and
- The audit's review of the Steering Committee's analyses supported the Committee's selection of the successful tenderer.

Comment

As the findings show, a suitably qualified and experienced group was assembled to conduct the tender and evaluation process and the group was supported by qualified consultants. The Steering Committee reported to a Senior Executive of the Department of Urban Services.

The consultants' were paid over $100,000 for their assistance.

The composition of the group combined with the consultants' assistance was appropriate to produce a sound selection decision. To ensure this was the case the audit reviewed the analyses prepared by the Committee and concluded that the analyses were a complete and accurate evaluation of the costs involved with each tender based on the circumstances existing at the time the evaluation was made.

The opinion that ***risks arising from future changes in circumstances important to the lease terms were not subjected to a complete and accurate evaluation, nor***

were these risks adequately disclosed to the Government is based on the following findings:

- The Steering Committee did not undertake sensitivity analyses or quantifications of the potential effects of the risks to which the various tenders, if accepted could expose the Territory; and
- Risks from the transaction were only briefly discussed in written advice to the Government.

Comment

The Steering Committee did not undertake any formal or detailed analysis of the risks which each tender may expose the Territory to. The evaluation criteria used by the Steering Committee to assess the tenders did not specifically include as a criteria, potential risks to the Territory of accepting a tender. The emphasis in the evaluation process was assessing and quantifying the costs and financial benefits of each tender on the basis of no change occurring in existing circumstances. The alternative of maintaining the status quo (i.e. not entering any financing arrangement) does not appear to have been seriously contemplated in the selection process.

Although some sensitivity analyses of the financial effects of potential changes in existing circumstances (e.g. interest rate and/or taxation rate changes) were performed by the consultants the results of the analyses were not evaluated by the Steering Committee.

The need to identify risks and conduct appropriate sensitivity analyses is an established standard procedure used widely by private and public sectors in evaluation of alternatives. It is now also a requirement for ACT Agencies. Had the requirements contained in the recently issued Office of Financial Management memorandum titled *"Business Case Requirements for Capital works Proposals for 1998-99"* been followed in the evaluation of the ACT Fleet lease arrangement all significant risks would have been identified and appropriate sensitivity analyses applied and results evaluated.

In the Department of Urban Services' written advice to the Government the possible risks attached to entering into this transaction arising from changes in existing circumstances, were not given the same attention or prominence as were the anticipated immediate financial benefits of entering into the transaction. The risks when mentioned were not quantified nor were any comprehensible financial sensitivity analyses presented for the Government's information.

The opinion that ***the process by which the financial costs and benefits of each tender were assessed could have been improved*** is based on the following findings:

- The criteria used by the Steering Committee to initially shortlist tenders did not correspond to the criteria stated in the Request For Tender; this could have resulted in tenders which complied with the selection criteria being prematurely eliminated from the selection process;

- The Steering Committee did not keep minutes of all meetings held, nor documentation of why certain decisions were made; the Steering Committee relied upon informal processes to progress its task;

- While the shortlisted tenders were evaluated on the evaluation criteria as stated in the Request For Tender, the results of this evaluation process were not formally signed off by each member of the Steering Committee; and

- The Steering Committee did not contain an Executive Officer as required by the ACT Purchasing Manual.

Comment

As shown by the findings the process by which the financial costs and benefits of each tender were assessed could have been improved.

While it is not considered that the shortfalls in the process ultimately effected the most financially attractive tender being selected, the possibility exists that the shortfalls

could have resulted in a less financially attractive tender being selected.

The lack of documentation in the assessment process meant that there is no complete trail of decisions and evaluations made by the Steering Committee. This is clearly unsatisfactory for accountability purposes.

The absence of an Executive Officer from the Steering Committee, although a case of non-compliance with the requirements of the ACT Purchasing Manual, did not detrimentally affect the decision in the opinion of the audit team.

It needs to be acknowledged that the task facing the Steering Committee was a complex one. It also needs to be acknowledged that the Steering Committee members worked long hours and diligently throughout the selection process. All continued to perform their normal duties during the process. It is probable that the limited time available to the Committee contributed to some of the weaker aspects identified in the audit.

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1.6 EXPOSURES TO FINANCIAL RISKS *(Chapter 4)*

The opinion that the ***Territory is exposed to significant financial risks through the lease arrangements*** is based on the following findings:

Reductions in Interest Rates

- Under the contractual arrangements the discount from the reference interest rate varies when the reference interest rate changes; the Territory bears a risk that interest rate decreases will reduce any expected benefits to the Territory in that the discount is reduced if interest rates fall;

Reductions in Taxation Rates

- Under the contractual arrangements the Territory bears the risk from reductions in taxation rates; reductions in the rate of corporate taxation rates will result in the Territory paying higher lease payments;

Vehicle Residual Values Less than Anticipated

- If vehicles realise lower than expected amounts when sold for at least 8 out of 10 years of the lease arrangement the Territory will have to recoup to the lessor, through higher future lease payments, the shortfalls in the expected sale amounts of vehicles;

Reductions in Size or Composition of Fleet

- The contractual arrangements provide that if the funds utilised from the finance facility fall 10% from the initial advance ($26.4m) additional costs will be imposed; the risk exists that if the size and/or composition of the fleet changes so that the Territory's financing requirements are reduced by 10% or more, financial penalties will be incurred;

Restricted Access to Alternate Forms of Finance

- The lease arrangements bind the Territory to a specific form of financing for a long period (10 years); a risk exists that the Territory will not be able to access less costly forms of finance which may become available.

Comment

The Territory is exposed to risks from falls in interest rates as continued generation of financial benefit is heavily reliant on interest rates. Movements in general interest rates effect the amount of future lease payments as the amount of discount from the reference interest rate which the lessor passes on to the Territory varies with changes in the rate. In times of high interest rates the discount is greater and in times of low interest rates the discount is lower. The reference interest rate for the lease facility is the 30 day floating 'Bank Basic Swap Rate' (BBSY).

The lease arrangements provide that changes in taxation rates and changes in vehicle residual value will effect the lease rates payable. The effect of movements in these variables can be either favourable or unfavourable to the Territory.

There are provisions in the lease arrangements which impose higher lease payments on the Territory if the facility is not fully utilised. At the time of negotiating the facility the Territory was advised that if the facility was under utilised by $5m this would add 0.15% to the interest rate offered by the lessor to the Territory. If the facility was underutilised by $10m this would add 0.30% to the interest rate offered by the lessor. This increase in interest rates would be passed onto the Territory through higher lease payments.

The financing facility could become underutilised if the size of the fleet was significantly reduced. Fleet reductions could quite feasibly become warranted through initiatives such as outsourcing of services or implementation of efficiency measures, however the additional costs may mitigate against the reductions actually occurring.

Additionally the Government has bound the Territory to the lease arrangements for a 10 year period. Although there are provisions for terminating the arrangements, the provisions provide that termination by the Territory will incur significant financial costs. Consequently if alternative more financially beneficial forms of finance were to become available the Government is almost certainly prevented by the financial penalties from terminating the lease arrangements and accessing the new forms of finance.

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1.7 FINANCIAL BENEFITS TO THE ACT *(Chapter 5)*

The opinion that ***immediate financial benefits from the lease of ACT Fleet were minimal and that there is no***

certainty the benefits will be maintained into the future is based on the following findings:

- Initial advice by the Department of Urban Services to the Government estimated the annual savings from the sale and leaseback of ACT Fleet would be between $140,000 and $280,000; this was subsequently revised in later advice to a saving of at least $200,000 annually;

- As the estimated saving was based on the financing facility being $30m a saving of $200,000 represents approximately 0.67% of the transaction; it therefore was recognised during the Steering Committee's early considerations that the potential savings were relatively minor;

- The requirement for the purposes of the lease that the vehicles must be externally insured was not taken to account in the estimation of the $200,000 saving; the net additional insurance cost for 1995-96 has been estimated at $47,000 reducing the 'saving' to $153,000 or 0.51% of the transaction value;

- Since the commencement of the leasing arrangements interest rates have fallen resulting in erosion of the already small anticipated saving down to $60,000 or, when the insurance cost is taken to account, to almost nil;

- Actual continued receipt of any financial benefit to the Territory is heavily dependent on interest rates, corporate taxation rates and insurance premiums; and

- The Government has no control over interest rates, corporate taxation rates or insurance premiums;

Comment

During the initial considerations on possible financing arrangements for the fleet, consultants were appointed to advise on whether significant cost benefits could be obtained for the Territory through outsourcing the financing for the fleet. It seems that, based mainly on the

consultants' advice, further action was agreed and tenders called.

Negotiations with the tenderer were well advanced when the issue of the fleet being required to be externally insured arose. External insurance apparently was required in order for the tenderer to be able to claim the vital taxation deductions on the fleet. The additional cost of external insurance above the Territory's previously existing self insurance arrangements is assessed by the audit at approximately $47,000 in 1996-97.

Continued generation of any financial benefit is heavily reliant on interest and taxation rates. Movements in general interest rates effect the amount of future lease payments as the amount of discount from the reference interest rate which the lessor passes on to the Territory varies with changes in the reference rate. In times of high interest rates the discount is greatest and in times of low interest rates the discount is lower. As interest rates have fallen significantly since the lease arrangements began the anticipated savings from this source have already significantly reduced.

The estimated $200,000 direct annual saving from entering into the lease arrangement was based on a $30m financing facility and discount of 0.67% from the reference interest rate. With the recent reductions in interest rates the discount has fallen to 0.2% consequently the estimated annual saving from the discount has fallen to $60,000.

It is acknowledged that the recent reductions in interest rates have saved the Territory approximately $600,000 on the lease transaction, according to the Chief Minister's Department. It must also be recognised however that this saving would have been made irrespective of whether the vehicle financing was achieved through the lease arrangement now in place or through any other financing method based on a floating interest rate. The lease arrangement cannot be said to have generated this saving.

The discount on interest rates which the lessor passes on to the Territory from entering into this transaction arises mainly from the lessor being able to claim taxation

deductions for depreciation on vehicles. The taxation deductions claimed reduces the lessor's costs enabling the lessor to provide the interest rate discount while still retaining its required profit margin. Consequently downward movements in taxation rates will increase the Territory's costs, while upward movements will reduce costs.

Under current Federal Government policies the current corporate taxation rate (36c in the dollar) is not likely to increase. If any variation is to occur it is likely to be downward. There is therefore little likelihood of changes in taxation rates benefiting the Territory, however there is risk that reduced taxation rates will increase the Territory's costs.

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1.8 INSURANCE COST (*Chapter 5*)

The opinion that ***the annual $1m insurance cost could have been significantly less*** is based on the following finding:

- only one quote was obtained for the vehicles' insurance cover; there is evidence that if competitive tenders had been called the insurance cost would have been $100,000 less.

Comment

According to Department of Urban Services documentation, due to insufficient available time, only one quote for insurance of the fleet was obtained.

The approval to not call tenders for insurance cover for the fleet was given on 27 May 1997. This approval was on the basis that there was insufficient time to call tenders prior to finalisation of the tender arrangements. As the Office of Financial Management advised the Department of Urban Services on 2 April 1997 that external insurance cover would have to be arranged for the fleet, the Audit Office is of the view that if action had been taken

promptly there was more than sufficient time to call tenders.

The Audit Office believes that for an annual commitment of close to $1m competitive tenders should have been called.

A firm of well qualified insurance brokers were engaged by the Department of Urban Services to review the insurance quote. The broking firm's report stated they were confident that the firm could have secured a significantly lower annual premium (approximately $100,000 lower) by negotiating with several specialist Motor Insurance underwriters.

Based on the lack of competitive tenders and the opinion expressed by the insurance broking firm it can be reasonably concluded that a more economic insurance cover could have been obtained through using standard competitive tendering processes.

1.9 ACCOUNTING FOR THE TRANSACTION *(Chapter 6)*

The opinion that that the ***lease entered into following the sale of ACT Fleet has not been correctly accounted for in accordance with Australian Accounting Standards*** is based on the following findings:

- In brief, Australian Accounting Standard AAS17 'Accounting for Leases' states that an operating lease is a lease in which the *lessor* is exposed substantially to all the risks and benefits incidental to ownership; alternatively if it is the *lessee* which is exposed to the major risks and benefits the lease is a finance lease;
- AAS17 makes it absolutely clear that it is not the legal form of the lease arrangement which provides the basis for classifying leases for accounting purposes; rather it is substance of the arrangements which is important;

- The sale and leaseback of ACT Fleet is predominantly a finance arrangement and the Territory has all the substantial risks incidental to ownership; the lessor is protected from significant risks; and

- As the lease has been accounted for as an 'operating' lease the lease has not been accounted for correctly in accordance with the requirements of the relevant Australian Accounting Standard.

Comment

The importance of accounting correctly for leases is set out in paragraphs 32 and 33 of AAS17 as follows:

> *32. "If transactions involving finance leases are not reflected in the lessee's balance sheet, or statement of financial position, the economic resources and the level of obligations of the lessee will be understated. Accordingly, this Statement requires finance leases to be brought to account by lessees by recognising as assets the rights to use leased properties, and by recognising as liabilities the obligations for minimum lease payments (referred to as the 'capitalisation of leases').*
>
> *33. "Capitalisation of finance leases in the accounts of lessees is justified by a consideration of substance over form. Although the usual legal form of a lease agreement is such that the lessee does not acquire legal title to the leased property, in the case of finance leases the substance is that the lessee acquires the right to most of the economic benefits from the use of the leased property. In return for that right, the lessee enters into an obligation to make periodic payments which in total approximate the fair value of the leased property and the related finance charge."*

The relevant Australian Accounting Standard (AAS17) makes it absolutely clear that it is not the legal form of the lease agreement which provides the basis for classifying

leases for accounting purposes. Rather it is the substance of the arrangements which is important. The audit examination of the Territory's leasing arrangements resulted in a clear conclusion that the arrangement was substantively financing in nature. The arrangements were entered into with the primary intention of reducing the financing charges on the capital being utilised to finance the fleet.

How a lease is to be accounted for in entities' financial statements is covered by AAS17. AAS17 requires leases to be accounted for as either operating or finance leases. Key criteria to be used in classifying leases is "who bears substantially all the risks and benefits of ownership". If the risks and benefits of ownership are with the lessor then the lease is an operating lease. If however the risks and benefits of ownership are with the lessee then the lease is a finance lease.

A question to be decided is who bears the risks of ownership of the leased vehicles? The answer, based on operations of the lease arrangements is that, it is the Territory which is exposed to substantially all the risks of ownership. This combined with the audit conclusions that the lease is effectively non-cancellable and that the arrangement was entered into primarily for financing purposes shows that the lease arrangement clearly constitutes a finance lease under AAS17 and the arrangements should be accounted for in the Territory's financial statements as a finance lease.

The Audit Office acknowledges that current lease accounting standards in Australia and elsewhere are agreed by many, including the Audit Office, to be unsatisfactory, particularly in relation to accounting by lessees. A Position Paper titled "Financial Reporting in the 1990s and Beyond" issued in December 1993 by the Association for Investment Management and Research (AIMR), the representative body of financial analysts in the United States included the following comment:

"We all have struggled to understand the immense body of detailed rules that govern accounting for leases. Sometimes it seems as if the only persons having sufficient

motivation to study their particulars are those who need to write lease contracts that produce desired outcomes. We know that the criteria for distinguishing between capital lease and operating lease set forth in [FASB] Financial Accounting Standard No 13 and its supplements are arbitrary and their application often is wilfully capricious. Sometimes it seems as if the opportunities to manipulate the rules are in direct proportion to their copiousness."[1]

The Association's comment would apply to current lease accounting standards in several jurisdictions including Australia.

There is general agreement that the existing standards should be simplified and to this end the Australian Accounting Research Board and the International Accounting Standards Board will shortly commence a full scale fundamental review of the basis of lease accounting. It is understood the review will culminate in the issue of a new standard applicable in Australia and elsewhere.

It is anticipated that the forthcoming standard will remove any argument that all arrangements of the nature of the arrangement that is the subject of this audit must be accounted for as financing transactions.

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1.10 SUMMARY

The sale and leaseback of ACT Fleet was a major financial transaction in 1995-96, being the first sale and leaseback transaction in the Government's program of asset sales.

The sale and leaseback of ACT fleet resulted in approximately $26.4m being received into the Territory's bank account on 26 June 1996. The transaction however also committed the Territory to repaying this amount, together with financing and other charges, through lease payments on the vehicles and vehicle sales. By 30 June 1997 the amount to be repaid had grown to over $30m.

[1] See "Accounting or Leases: A New Approach" published by the Financial Accounting Standards Board

While the process by which the successful tenderer was selected included a thorough evaluation of the financial costs and benefits of each tender, the risks arising from future changes in existing circumstances were not subject to evaluation.

From entering into this transaction, if circumstances change, the Territory could be exposed to quite significant, and possibly expensive, risks. These risks were not quantified for the Government at the time the proposal to sell and leaseback the ACT fleet was put to it. Obviously if these risks had been fully disclosed to the Government, the same decision may still have been made. However if decision makers are not made aware of all relevant information at the time decisions are being made, the possibility that a wrong decision is made is increased.

How the lease arrangements should be accounted for has been the subject of considerable debate and correspondence between the Audit Office and the Chief Minister's Department. This lengthy and time consuming exercise possibly could have been avoided if the views of the Audit Office had been requested prior to the transaction being entered into. The Audit Office remains firmly of the opinion that the lease is a finance lease.

In summary the lease arrangements:

- will not deliver significant cost reductions to the Territory and may, in fact, increase costs;
- could expose the Territory to future financial risks;
- limit the Territory's flexibility to enter more beneficial financial arrangements which may become available;
- impose additional cost on the Territory if the size of the fleet is reduced; and
- have been incorrectly accounted for.

An overall conclusion is that the significant Territory resources (i.e. employees' time, consultants' fees etc) used to put the fleet leasing arrangement into place and to

manage it have produced little, if any, financial or other benefit for the Territory.

2. STEERING COMMITTEE AND CONSULTANCY

2.1 INTRODUCTION

On 18 December 1995, the Government agreed to approach the market for expressions of interest for a financing facility through a long term operating lease of up to 10 years or other appropriate means, for the Territory's vehicle fleet.

Prior to the above Government decision being made, a Steering Committee was formed in September 1995 to investigate alternative financing and fleet management options. This Steering Committee comprised officers from the Department of Urban Services, Chief Ministers Department and the Territory Solicitors Office. The Steering Committee was responsible to a Senior Executive of the Department of Urban Services. A consultancy firm was appointed to assist the Steering Committee.

This Chapter outlines the Steering Committee's and the consultants' Terms of Reference and summarises the consultants' assessments of various types of financing options available.

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2.2 STEERING COMMITTEE'S TERMS OF REFERENCE

The Terms of Reference for the Steering Committee were:

- identify the scope of issues involved;
- identify and examine alternative financing and fleet management options;
- identify and examine possible ownership, registration, insurance and taxation issues and economic and other implications;

- determine the extent of interest by financial and fleet management organisations in providing passenger and light commercial hire services to the Territory;
- prepare a report to the Minister of Urban Services and a draft Cabinet Submission on alternative financing arrangements for passenger and light commercial vehicles and comparative costs and options for fleet management arrangements, in accordance with the Government's decision on these matters;
- develop draft specifications for an approach to the market for alternative financing and fleet management options;
- liaise with other Territory agencies, as required;
- develop a work program for the project; and
- oversight the consultant engaged to provide advice to the Committee in connection with the project.

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2.3 ROLE OF CONSULTANTS IN ASSISTING THE STEERING COMMITTEE

To assist the Steering Committee a firm of consultants were employed. The consultants performed two consultancies. The first consultancy required identification of options for financing and management of passenger and light commercial vehicles. The second consultancy was to assist the Steering Committee in evaluating tenders and in negotiations with the successful tenderer.

The Terms of Reference for the first consultancy were:

- the provision of advice on the range and nature of issues involved in the external financing and

management of these vehicles, e.g. possible options suitable for the Territory's specific requirements, possible taxation and economic implications of the various options, practices adopted by external financial and fleet management organisations in connection with such services;

- the provision of advice on issues involved in seeking expressions of interest for external financing and management of the passenger and light commercial fleet and the development of draft specifications;

- arranging, on behalf of the Steering Committee, approaches to financial and other organisations to determine the level of interest and terms and conditions under which these organisations would provide services to the Territory;

- undertaking, following approaches to financial and other organisations, an analysis of and the preparation of advice to the Steering Committee on options and the likely outcome and implications for the Territory of such options;

- providing recommendations to the Steering Committee on preferred options for the Territory; and

- providing advice on the correctness of the data underpinning options being considered by the Steering Committee.

With the encouragement of the consultants' report the Government decided to proceed with seeking tenders for the financing of the fleet. At the same time the consultants were contracted for a second consultancy.

The terms of reference for this consultancy were:

- assist with the preparation of documents for an approach to the market for expressions of interest in providing a financing facility for the passenger and light commercial fleet;

- assist in evaluating the expressions of interest;

- assist in short listing, interviewing and negotiating with respondents;
- assist with the preparation of advice to the Government on a suitable financing package; and
- the preparation of a report, if required, setting out Oxley's recommendations on the issues covered.

The consultants were chosen as consultants to the Steering Committee, without tenders being called, on the basis of their 'expertise' in this area. The consultants had apparently completed similar exercises for the Commonwealth, as well as for the South Australian and Victorian Governments. The consultants were paid in excess of $100,000.

A prominent legal firm was also employed to advise the Steering Committee on taxation issues involving alternative financing arrangements.

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2.4 CONSULTANTS' ADVICE ON AVAILABLE FINANCING OPTIONS

Under the consultants Terms of Reference was the requirement for the provision of advice on the range and nature of issues involved in the external financing and management of the Territory's fleet of vehicles. According to the consultants there were a number of options available to the Territory. These included:

- Maintain the status quo;
- Sell the vehicles and lease them back via a finance lease;
- Sell the vehicles and lease them back via a short term operating lease; and

- Sell the vehicles and lease them back via a long term operating lease.

The consultants' view of each of the options is summarised following:

Maintain The Status Quo

If the Government maintained the current arrangements this would mean that approximately $30m of the Territory's funds would continue to be utilised in the ownership of approximately 1300 vehicles.

While under the existing arrangements the Territory owned all the vehicles, there was still a cost to the Territory in owning these vehicles. This cost was the interest that the Territory could have earned on the funds tied up in owning the vehicles or, conversely, if the Territory was a net borrower then the cost would be the interest on the funds the Territory would need to borrow to finance the fleet.

Sell The Vehicles And Lease Them Back Via A Finance Lease

If the vehicles were sold there would be a one off capital return to the Territory. However under a finance lease the Territory would retain substantially all the risks and benefits incidental to ownership of the vehicles.

Under a finance lease there are no material taxation benefits available to the lessor. Therefore the lessor cannot offer the lessee (in this case the Territory) a lower cost of funds than that at which the Territory could borrow the funds itself. Therefore the lease rates that the Territory would be charged under a finance lease would be higher than the Territory's own cost of funds.

Sell The Vehicles And Lease Them Back Via A Short Term Operating Lease (i.e. Up To 4 Years)

Again under this arrangement there would be a one off return of capital to the Territory. Under an operating lease the lessor and not the lessee (the Territory) retains

substantially all the risks and benefits incidental to the ownership of the leased property.

However under an operating lease there are taxation benefits that the lessor could be entitled to. The lessor can claim depreciation expenses on the lease property as their own tax deduction. As well interest, insurance and registration expenses can also be claimed by the lessor as tax deductions. To encourage entities to enter into operating leases the lessor passes on a proportion of these tax advantages to lessees in the form of a lower cost of funds than that at which the lessee can borrow.

Under a short term operating lease the tax deductions which the lessor can claim are not as generous as those available under longer term operating leases. Therefore the tax benefits that the lessor can pass onto the lessees are reduced, which means that the benefits of a short term operating lease are less then those of a longer term operating lease.

Sell The Vehicles And Lease Them Back Via A Long Term Operating Lease (i.e. Up To 10 Years)

Again under this arrangement there would be a one off return of capital to the Territory. Also under an operating lease the lessor and not the Territory retains substantially all the risks and benefits incidental to the ownership of the leased property.

The same tax advantages that apply under short term operating leases apply under long term operating leases. However the tax advantages are greater under a longer term lease. This means that the benefits that can be passed onto the Territory in terms of lower lease rates are maximised under a long term operating lease.

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2.5 CONSULTANTS' ASSESSMENT OF OPTIONS

The consultants advice was that out of the three options involving the sale and leaseback of the Territory's vehicles, selling and then leasing the vehicles back via a long term operating lease appeared the most attractive from a financial viewpoint. According to the consultants this is because the lessor under a long term operating lease is entitled to tax deductions which they partially pass onto the lessee in the form of reduced lease rates. Such an arrangement becomes attractive to lessees when the interest rates used by the lessor in calculating lease rates is lower than the interest rates the lessor can obtain on their funds. The lessor can offer lower interest rates to the lessee because of the tax advantages they are obtaining through the arrangement. The lessor's return on the lease is effectively that proportion of tax deductions that they are not passing onto the lessee in the form of lower interest rates.

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3. COMPLETE AND ACCURATE FINANCIAL COMPARISONS OF COSTS, BENEFITS & RISKS

3.1 INTRODUCTION

A detailed review was undertaken of the financial analyses the Steering Committee undertook on each tender. The purpose of this review was to ascertain the completeness and accuracy of the analyses performed.

This Chapter outlines the process which led the Government to decide to sell and leaseback the fleet and the audit findings in relation to the process.

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3.2 FINDINGS FROM THIS CHAPTER

Evaluation of Costs

- ***Tenders were evaluated by a Steering Committee whose members included officers with fleet management, financial and legal expertise;***
- ***The Steering Committee was assisted by consultants in evaluating the tenders; these consultants were suitably qualified and had undertaken similar exercises for other Australian governments;***
- ***The Steering Committee, assisted by the consultants, performed comprehensive analyses of the financial costs and benefits of each tender;***
- ***The audit's review of the Steering Committee's analyses supported the Committee's selection of the successful tenderer;***

Evaluation of Risks

- ***The Steering Committee did not undertake sensitivity analyses or quantifications of the potential effects of risks to which the various tenders, if accepted could expose the Territory;***

- ***There was no specific formal or detailed risk analyses of the successful tender; sensitivity analyses were not performed;***

- ***Risks from the transaction were only briefly discussed in written advice to the Government.***

Evaluation Process

- ***The criteria used by the Steering Committee to initially shortlist tenders did not correspond to the criteria stated in the Request For Tender; this could have resulted in tenders which complied with the selection criteria being prematurely eliminated from the selection process;***

- ***The Steering Committee did not keep minutes of all meetings held, nor documentation of why certain decisions were made; the Steering Committee relied upon informal processes to progress its task;***

- ***While the shortlisted tenders were evaluated on the evaluation criteria as stated in the Request For Tender, the results of this evaluation process were not formally signed off by each member of the Steering Committee; and***

- ***The Steering Committee did not contain an Executive Officer as required by the ACT Purchasing Manual.***

****

3.3 SHORTLISTING OF TENDERS

Tenders were called for in February 1996. Six tenders were received, and four were shortlisted by the Steering Committee in March 1996. As previously mentioned the Steering Committee comprised officers with fleet management, financial and legal expertise. The Steering Committee however did not include an Executive Service officer. The Steering Committee was chaired by a Department of Urban Services Senior Officer Grade B. To comply with the Purchasing Policy Manual the Committee should have been chaired by an Executive Service officer.

Tenders were evaluated for shortlisting on the following criteria:

- Financial structure;
- Lease term;
- Residual Values;
- Interest Rates;
- Taxation efficiency;
- Indicative Pricing; and
- Base Rentals.

As a result of assessing tenders for shortlisting, two tenders were deleted from further deliberations.

These two tenders were assessed as uncompetitive on the basis that interest rates above the benchmark were quoted, i.e. above the rates at which the Territory could borrow funds.

The criteria however used in assessing tenders for shortlisting did not correspond to the criteria stated in the Request For Tender. While the two tenders that were not selected to proceed for shortlisting would have also been eliminated if the criteria in the Request for Tender had been used in initially assessing the tenders, this does not excuse the Steering Committee from not assessing the tenders on the criteria stated in the Request For Tender.

The actions of the Steering Committee could have resulted in the rejection of valid tenders and even perhaps the rejection of the most attractive tender.

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3.4 EVALUATION OF SHORTLISTED TENDERS

Method of Evaluation

The four shortlisted Tenders were then evaluated on the following criteria:

Price Comparison: Given a weighting of 50%. Factors considered included the net tax effective interest rate.

Technical, Managerial, Physical And Financial Structures: Given a weighting of 20%. Factors considered included: structure of facility; flexibility of the Lease Facility Limit; drawdown arrangements; sale and leaseback arrangement; compliance with Australian Accounting Standard 17 "Accounting for Leases'; compliance with ACT Government preferred purchasing and disposals processes, insurance and registration arrangements.

Record Of Performance: Given a weighting of 10%. Factors considered included Referees comments.

Ability And Current Volume Of Work: Given a weighting of 5%. Factors considered included: capacity to meet timetable and timing of private tax rulings.

Reputation Within The Industry: Given a weighting of 5%. Factors considered included financial standing of the tenderer.

Conformity To Specifications: Given a weighting of 5%.

Industry Relations And Safety Performance: Given a weighting of 5%.

The evaluation criteria used to assess the shortlisted tenders was the same as the evaluation criteria stated in the Request For Tender. The weightings given to each of the criteria were determined by the Steering Committee. While the weighting given to each of the criteria was subjective, the weightings appear reasonable to the Audit Office.

Results of Tender Evaluation

On the basis of the above assessment criteria one tender was assessed as above or equal to the other three tenders in all criteria. The final evaluation criteria ratings were:

Tender No 1	80%
Tender No 2	63%
Tender No 3	49%
Tender No 4	34%

The above ratings were compiled with the assistance of the consultants.

Members of the Steering Committee did not sign the above evaluation assessment. Thus there is no record of each member of the Steering Committee agreeing to the final evaluation ratings.

The Steering Committee relied upon informal processes among themselves to come to Committee decisions. Such informal processes leave the Committee open to criticism of their decision making processes as well as perhaps even criticism of their decisions.

The Steering Committee and the consultants then held interviews with each of the shortlisted tenderers. The purpose of these interviews was to ask each of the tenderers a number of supplementary questions specific to their tender. This second stage of evaluating the above tenders was based on the Construction Industry

Development Agency (CIDA) *Code of Tendering*, which is classified as an Australian Standard (AS 1420-1994).

On 16 April 1996 the preferred tenderer (Macquarie Bank) was notified that they had been selected as the preferred tenderer.

Comment

A suitably qualified and experienced group was assembled to conduct the tender and evaluation process and the group was supported by suitably qualified consultants. The composition of the group combined with the consultants' assistance was appropriate to produce a sound selection decision. Audit reviewed the analyses prepared by the Committee and concluded that the analyses were a complete and accurate evaluation of the costs involved with each tender based on the circumstances existing at the time the evaluation was made.

****

3.5 LACK OF RISK ANALYSIS EVALUATION

The Steering Committee did not undertake any formal or detailed analysis of the risks which each tender may expose the Territory to. The evaluation criteria used by the Steering Committee to assess the tenders did not specifically include as a criteria, potential risks to the Territory of accepting a tender. The emphasis in the evaluation process was assessing and quantifying the costs and financial benefits of each tender on the basis of no change in existing circumstances. Although some sensitivity analyses involving potential changes in existing circumstance (e.g. interest rate and/or taxation rate changes) were performed by the consultants the results of the analyses were not evaluated by the Steering Committee. There is no evidence that the Senior Executive in the Department of Urban Services oversighting the Steering Committee requested the Committee to evaluate risks.

In written advice to the Government the possible risks attached to entering into this transaction arising from changes in existing circumstances, were not given the same attention or prominence as were the immediate estimated financial benefits of entering into the transaction. The risks when mentioned were not quantified nor were any comprehensible financial sensitivity analyses provided of these risks for the Government's information.

Departmental Response

In respect to this matter the Department of Urban Services has advised:

The committee engaged (consultants) to undertake a number of analyses of the tender submitted by Macquarie Bank Ltd (MBL), including an assessment of the impact of various levels of interest rates, the margins applicable to various levels of residual values, the impact of a significant under utilisation of the facility, that is, a reduction in utilisation of $5m or 16.7%, and an assessment of the impact of changes in the corporate tax rate. During the evaluation, the committee also sought advice from MBL about the financial impact of a full termination of the facility.

The sensitivity analyses of the residual values and interest rate levels were included in the submission to the Government. A detailed assessment of the financial impact of a full termination of the lease could not be accurately made due to the number of variables, such as the timing of the termination, the level of interest rates at the time, the break costs applying, the balance of the residual reserve pool etc. The basis for determining the cost of an early termination to the ACT Government, which is a standard commercial clause in agreements of this nature, is set out in the lease agreement and is designed to preserve the lessor's return from the arrangement. The advice to the Government clearly indicated that the cost of an early termination, particularly in the early stages of the lease, would be significant, without specifically quantifying them.

The corporate tax rate of 36% is a component of the assumptions for the calculation of lease rates. Although they affected lease rates, movements in the tax rate applied equally to all tenderers and consequently were not seen as a significant factor in the overall comparative assessment of tenders for the facility.

Comment

It is not disputed that attention was given to these issues. The major point remains that the results of any sensitivity analyses conducted by the consultants were not used in the decision making process.

The Department advice includes comment that the sensitivity analyses of the residual values and interest rate levels were included in the submission to the Government. It is correct that there was some data supplied to the Government as an attachment to a submission. The audit team reviewed the attachment document and found the information incomprehensible as it was presented.

The Steering Committee was asked to explain the data to the auditors however he could not do so. Therefore while it is true to say that the data was provided to the Government, if the Chairman of the Steering Committee could not adequately interpret the meaning of the data it can be reasonably assumed the data had no bearing on the decision process.

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3.6 IMPROVEMENTS IN EVALUATION PROCESS

The audit found that the process by which the financial costs and benefits of each tender were assessed could have been improved. While it is not considered that the shortfalls in the process ultimately effected the most financially attractive tender being selected, the possibility exists that the shortfalls could have resulted in a less financially attractive tender being selected. The lack of documentation in the assessment process meant that there

is no complete trail of decisions and evaluations made by the Steering Committee. This is unsatisfactory for accountability purposes.

In the opinion of the audit team the absence of an Executive Officer from the Steering Committee, although clearly a case of non-compliance with the requirements of the ACT Purchasing Manual, does not seem to have detrimentally affected the decision made.

Departmental Response

In response to this matter the Department of Urban Services responded:

Notes of the committee's proceedings were taken and any substantive issues decided by the committee were followed by actions, such as briefings and submissions to the Government or senior officers in the Department of Urban Services (DUS) or the Office of Financial Management (OFM), correspondence to tenderers or the committee's financial and taxation advisers. In all cases, these were cleared by the relevant members of the committee or advisers.

The steering committee did not include an Executive, however, its proceedings were closely monitored by Executives from DUS and OFM.

Comment

When the audit team were advised that minutes of meetings had not been kept requests were made for any other relevant documentation which may exist. The auditors were advised that a member had kept notes and these could be reviewed. On review these notes were discovered to be hand written and incomplete and clearly could not be regarded as a reliable record of the Committee's deliberations and/or decisions.

There was no evidence available to the audit which would support a view that the Committee's proceedings were 'closely' monitored by Executives from DUS or OFM.

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4 . EXPOSURE TO FINANCIAL RISKS

4.1 INTRODUCTION

The Territory is exposed to a number of financial risks as a result of entering into the lease arrangements. All of the risks are outside the control of the Government. These risks were subject to little or no analysis or quantification during the evaluation of the tenders.

This Chapter outlines the risk exposures identified during the audit.

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4.2 SIGNIFICANT FINDINGS FROM THIS CHAPTER

Reductions in Interest Rates

- ***Under the contractual arrangements the discount from the reference interest rate varies when the reference interest rate changes; the Territory bears a risk that interest rate decreases will reduce expected benefits to the Territory as the discount is reduced if interest rates fall;***

Reductions in Taxation Rates

- ***Under the contractual arrangements the Territory bears a risk from reductions in taxation rates; decreases in the rate of corporate taxation rates will result in the Territory paying higher lease payments;***

Restricted Access to Alternate Forms of Finance

- ***The lease arrangements bind the Territory to a specific form of financing for a long period (10 years); a risk exists that the Territory will not be***

able to access less costly forms of finance which may become available;

Vehicle Residual Values Less than Anticipated

- ***If vehicles realise lower than expected amounts when sold for at least 8 out of the 10 years of the lease arrangement the Territory will have to recoup to the lessor, through higher lease payments, the shortfalls in the expected sale amounts of vehicles;***

Reductions in Size and Composition of Fleet

The contractual arrangements provide that if the funds utilised from the finance facility fall 10% from the initial advance ($26.4m) additional costs will be imposed; the risk exists that if the size and/or composition of the fleet changes so that the Territory's financing requirements are reduced by 10% or more, financial penalties will be incurred.

****

4.3 CHANGES IN INTEREST RATES

The Territory is exposed to risks from falls in interest rates as continued generation of financial benefit is heavily reliant on interest rates. Movements in general interest rates effect the amount of future lease payments as the amount of discount from the reference interest rate which the lessor passes on to the Territory varies with changes in the rate. In times of high interest rates the discount is greatest and in times of low interest rates the discount is lower. The reference interest rate is the 30 day floating 'Bank Basic Swap Rate' (BBBSY).

For example at the time of the commencement of the lease the BBBSY 30 day floating rate was 7.58% and the discount was 0.57%. At 31 May 1997 the BBSY had declined to 5.6% and the discount to 0.2%.

The BBSY 30 day floating rate has been used as the reference rate in the lease arrangements because this is the rate at which the Territory can borrow funds and is set independently of both the lessor and the Government.

****

4.4 CHANGES IN TAXATION RATES

The Territory is exposed to a risk from changes in the rate of corporate taxation. This is because the value of taxation deductions the tenderer passes onto the Government through the discount from the reference interest rate depends upon the value of taxation deductions the tenderer can claim. The value of these taxation deductions is determined by the prevailing rate of corporate taxation.

A reduction in the corporate taxation rate reduces the value of the taxation deductions the lessor can claim on the lease vehicles. This therefore reduces the value of taxation deductions the tenderer can pass onto the Territory, and, under the contractual arrangements, results in the discount from the reference rate being reduced increasing the lease payments. An increase in the corporate taxation rate would have the opposite effect and result in lower lease payments.

The effect of changes in the corporate taxation rate was not quantified at the time the tenders were being evaluated. Information provided by Macquarie Bank during the audit discloses the following as the effect if corporate taxation rates had been reduced from 1 July 1997.

New Tax Rate	Change in Discount
33%	- 0.08%
34%	- 0.06%
35%	- 0.03%

The current corporate taxation rate is 36%.

Departmental Response

In relation to this issue the Department advised:

The benefits to the lessor are reduced as corporate tax rates reduce and hence the benefits available to the Government under the facility are reduced. This is the nature of the arrangements and the 'risks' were clearly known and understood.

Comment

The Department agrees that this risk exists.

4.5 LOSS OF FINANCING FLEXIBILITY

The Government is now committed to financing its fleet operations through this lease arrangement for at least the next 10 years. By committing to this type of transaction the Government has lost the ability to take advantage of any new financing opportunities which may arise over the next 10 years.

For example, the Government recently entered into an arrangement to purchase Japanese Sumarai Bonds. In May 1997 the Territory was paying 5.41% interest on these Bonds. This compares with the weighted average rate of interest (with the discount deducted) of 5.4% which the Government was paying on the lease financing facility in May 1997. While there is only a very small difference in the interest rates the Territory is paying on the two transactions, a significant difference is that the Territory is not locked into the Sumarai Bonds for 10 years, while the Government is locked into the lease arrangement for 10 years.

When the lease transaction was entered into the Government gained access to a financing facility of up to $35.4m. At April 1997 the Government had utilised $29.4m of this financing facility. The Government under this transaction is not only committed to leasing vehicles from the lessor but also using the lessor's funds to finance the insurance on the vehicles and also fuel for the vehicles.

As a result of entering into this lease arrangement the Government has lost the ability to take advantage of new financing opportunities which may arise over the next 10 years. While the transaction is legally cancellable, in a practical sense from a financial viewpoint the cost of termination prohibits the Government from terminating the transaction. When contrasted to the purchase of the Sumarai Bonds, the reward intended from entering into this lease arrangement, ie. slightly lower interest rates, does not appear significant enough to justify committing to this arrangement for the next 10 years.

Department Response

In relation to this issue the Department of Urban Services has responded:

Whilst the structure of the facility is based on an operating lease arrangement, there is nothing to preclude the lessor and the lessee seeking to take advantage of new financial products. The Bank has twice sought to sell down the facility to take advantage of alternative financial arrangements since the commencement of the lease. On both occasions, the ACT rejected these on the basis that there was no clear advantage to the ACT.

Comment

There is no argument that if the Bank and the Government agree to end or change the arrangements this can be done. The situation is that the Territory cannot change or withdraw without the agreement of the Bank and the Bank will only agree in circumstances favourable to the Bank. The Department's response clearly illustrates that the Bank cannot withdraw without the Territory's agreement. It is the same for the Territory. For the Territory to be able to access alternate more beneficial financing the Bank would also have to stand to benefit through an alternative use of its funds.

****

4.6 CHANGES IN VEHICLE RESIDUAL VALUES

The Government is exposed, for at least 8 out of the 10 years that the lease arrangement runs, to the risk of lower than expected residual values. If leased vehicles realise lower than expected amounts when sold, the difference between the planned and realised amounts will be recouped to Macquarie Bank through higher future lease payments. While the Territory was exposed to this risk under the previous fleet arrangements, the risk continues for the Territory under the new arrangements.

Departmental Response

In relation to this issue the Department of Urban Services has responded:

The lease includes a residual value reserve into which surpluses are paid and shortfalls are deducted. Residual values are set by the Bank based on a formula which is part of the lease agreement. Residuals are set such that over the term of the facility there is a 95% probability that the reserve account will have a nil balance at the end of the lease.

The intention of the parties was the Bank would not use residuals as a revenue source and that these would be jointly managed to achieve a neutral result. Notwithstanding, over the last two years of the lease, when the Bank cannot affect residuals for vehicles during the rundown of the lease, any credit balance accrues to the Bank and any negative balance is met by the Bank. The ultimate risk (and benefits) on residuals accrues to the Bank.

Regardless of the reserve arrangement, clearly if there are shortfalls the Bank would seek to recover these through residual values for subsequent vehicles acquired under the lease. Also, to ensure there is no risk of shortfalls, the Bank could adopt a conservative position on residuals. This arrangement clearly favours the ACT as it is not subject to 'hidden' costs through residuals. It also

represents a rational and transparent means for the Bank to manage its risks exposures.

Comment

The Department's response supports the audit view on the existence of this risk. The reference in the second last sentence to the *"arrangement clearly favours the ACT as it is not subject to 'hidden' costs"*...simply means that when the costs emerge they will be transparent to Territory officials. It does not mean that they will not occur or that they will not be passed on to the Territory.

****

4.7 CHANGES IN SIZE OR COMPOSITION OF THE FLEET

There are provisions in the lease arrangements which impose additional costs on the Territory if the financing requirement is reduced by 10% or more. This effectively means benefits accruing to the Territory will reduce if the fleet size was significantly reduced. Fleet reductions could feasibly become warranted through initiatives such as outsourcing of services or implementation of efficiency measures, however the penalty costs which would have to be paid could mitigate against the reductions ever actually occurring.

****

4.8 CONCLUSION

The lease arrangements provide that changes in interest and taxation rates and changes in vehicle residual values will effect the lease rates payable. The effect of movements in these variables can be either favourable or unfavourable to the Territory. The Territory is therefore exposed to risks outside the Government's control.

Additionally the Government has bound the Territory to the lease arrangements for a 10 year period. Although there are provisions for terminating the arrangements, the

provisions provide that termination by the Territory will incur significant financial penalties. Consequently if alternative more financially beneficial forms of finance were to become available the Government is almost certainly prevented from terminating the lease arrangements and accessing the new form of finance due to the penalty costs.

The new arrangements also impose financial penalties if, for any reason, significant reductions in the size of the fleet occur.

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5. FINANCIAL BENEFITS TO THE ACT

5.1 INTRODUCTION

As detailed in the previous Chapter, the Steering Committee evaluated each tender in respect of financial costs, benefits and risks. This chapter reviews the overall financial benefits to the Government of entering into this transaction. The Chapter also assesses whether in fact these benefits will eventuate.

****

5.2 SIGNIFICANT FINDINGS FROM THIS CHAPTER

- ***Initial advice by the Department of Urban Services to the Government estimated the annual savings from the sale and leaseback of the Fleet would be between $140,000 and $280,000; this was subsequently revised in later advice to a saving of at least $200,000 annually;***
- ***As the estimated saving was based on the financing facility being $30m a saving of $200,000 represents approximately 0.67% of the transaction; it therefore was recognised during the Steering Committee's early considerations that the potential savings were relatively minor;***
- ***The requirement for the purposes of the lease that the vehicles must be externally insured was not taken to account in the estimation of the $200,000 saving; the net additional insurance cost for 1995-96 has been estimated at $47,000 reducing the estimated 'saving' to $153,000 or less than 0.51% of the transaction value;***
- ***Since the commencement of the leasing arrangements interest rates have fallen resulting in***

erosion of the already small anticipated saving down to only $60,000 annually or, when the insurance cost is taken to account, to almost nil;

- ***Actual receipt of any financial benefit to the Territory is heavily dependent on interest rates, corporate taxation rates and insurance premiums;***
- ***The Government has no control over interest rates, corporate taxation rates or insurance premiums; and***
- ***only one quote was obtained for the vehicles' insurance cover; there is evidence that if competitive tenders had been called the annual insurance cost could have been $100,000 less.***

****

5.3 FINANCIAL BENEFITS

The consultants initially estimated that annual savings from entering into the transaction would be between $140,000 and $280,000 per annum. At the time of entering into the transaction these savings had been revised to $200,000 annually.

The financial benefit to the Territory from entering into this transaction comes from access to lower lease payments. As already explained in previous chapters, the Territory gains access to lower lease payments from the tenderer passing on some of the value of their taxation deductions to the Territory through the discount from a reference interest rate.

However the amount of savings passed on to the Territory also depends upon interest rates at the time, as the discount the tenderer passes on to the Territory is not fixed but varies with movements in interest rates.

The estimated $200,000 annual saving was based on a $30m financing facility and discount of 0.67% from the reference interest rate.

Over the life of the transaction there will be movements in interest rates. As mentioned in *Chapter 4* with movements in interest rates the amount of savings through the discount to the Territory will vary. At times of high interest rates the amount of the saving to the Territory is greatest, while in times of lower interest rates savings are smaller or could even be eliminated. With the drop in interest rates in May 1997 the discount had fallen to 0.20%, consequently the estimated savings per annum generated by the discount had fallen to $60,000.

5.4 ADDITIONAL COSTS

There are a number of ongoing additional costs to the Territory which were not considered or quantified at the time the decision was made to enter into the transaction. These additional costs include:

- Cost of new insurance arrangements;
- Costs of maintaining comprehensive information on every vehicle;
- Cost of verifying the lessor's monthly invoice statements which include every vehicle leased; and
- Cost of employing consultants to review on a periodic basis the complex formulas used by the lessor in calculating monthly invoice statements.

The additional costs involved in monitoring the new arrangements as well as the need to employ consultants to perform an oversight function were not considered or quantified at the time the transaction was entered into. These additional costs obviously reduce the estimated savings from the transaction. In fact at current interest

rates the additional costs would be greater than any savings being generated.

The set up costs such as the Steering Committee's salaries and the consultants' fees were also not taken to account.

****

5.5 INSURANCE ARRANGEMENTS

Prior to entering into this transaction all vehicles were covered by the Government's self insurance arrangements. During initial negotiations with the lessor it was the Steering Committee's understanding that this self insurance arrangement would continue. It was not until late in negotiations with the tenderer that the need for new insurance arrangements arose.

The need for the new insurance arrangements was generated entirely by the taxation implications for Macquarie Bank.

The Steering Committee arranged for external insurance on the vehicles from the date of commencement of the transaction with the Bank paying the premium from the financing facility. The Government reimburses the Bank for this payment of insurance on a per vehicle basis each month.

In 1995-96 the cost of vehicle repairs, etc to the Territory under self insurance arrangements was approximately $842,000. In 1996-97 the cost to the Government of entering into new insurance arrangements was $889,000. Thus in 1996-97 there is an additional cost to the Territory of approximately $47,000. This additional cost was not considered at the time the decision was made to enter into the transaction. Nor was this additional cost considered when projected savings from entering into the transaction were estimated.

Tenders Not Called

Approval to not call tenders for insurance cover for the fleet was given by a Senior Executive of the Department of Urban Services on 27 May 1997. This approval was given on the basis that there was insufficient time to call tenders prior to finalisation of the tender arrangements. As the Office of Financial Management advised the Department of Urban Services on 2 April 1997 that external insurance cover would have to be arranged for the fleet, the Audit Office is of the view that there should have been sufficient time to call tenders.

The Audit Office believes that for an annual commitment of close to $1m competitive tenders should have been called.

A firm of well known insurance brokers were engaged by the Steering Committee to review the insurance quote. The broking firm's report stated they were confident they could have negotiated a significantly lower annual premium (approximately $100,000) with several specialist Motor Insurance underwriters.

Based on the lack of competitive tenders and the opinion expressed by the insurance broking firm it can be reasonably concluded that a more economic insurance cover could have been obtained through using standard competitive tendering processes.

Departmental Response to the Additional Cost of Insurance

In relation to the additional cost of insurance the Department has responded:

Under the tax rules relating to an operating lease, the lessor is required to take all ownership risks, including accident damage. The Bank indicated that it would consider an arrangement where it would 'insure' the vehicles through the ACT Government, thus preserving the existing self insurance arrangements, although OFM advised that the Government could not insure assets owned by a third party. This was the reason an external insurance arrangement was adopted.

The estimated direct cost of claims for 1995-96 was assessed at $0.842m, excluding any administrative cost to either ACT Fleet or the Government Solicitors Office in the administration of repair contracts, assessing damage to vehicles, recovery of costs where a third party is at fault, repayment defaults on the part of third parties, cost of legal representation and court fees where legal action is instituted in connection with an accident. The premium for 1996-97 is estimated at $0.889m and covers the bulk of costs previously met by ACT Fleet and the Government Solicitor's Office, plus a public liability cover of $10m and onsite client assistance program not previously available to the ACT in connection with vehicles.

Comment

The Department agrees that there is an additional cost of some $47,000 (i.e. the difference between the insurance premium and repair costs, etc if the vehicles had continued as self insured). The Department contends however that this additional cost is offset by such things as less involvement in legal matters by the Government Solicitor's Office.

This Office is unaware of the savings mentioned actually occurring and the Department has produced no evidence to support that the savings have been generated. It needs also to be noted that if insuring the fleet with a private insurer was better financially for the Territory then it should have been arranged whether or not the fleet leasing arrangements were in place.

Departmental Response To Not Calling Tenders

In relation to not calling tenders the department has responded:

The decision not to call tenders was based on the fact that the Commonwealth DASFlet had recently undertaken a tender process for the insurance of its fleet and had selected Lumley Insurance. This company had also been selected by the Queensland and Victorian Governments' Fleet Managers as the insurer for their respective fleets.

Based on an evaluation of recent tender processes undertaken by fleet managers in other similar jurisdictions, the committee believed that the adoption of Lumley Insurance for an initial term was appropriate.

Comment

The Department's comments that the decision not to call tenders was based on the factors mentioned in their response is not supported by documentation sighted during the audit. The documented approval to not call tenders clearly states that the reason for not calling tenders was that there was insufficient time.

****

5.7 CONCLUSION

Initial advice to the Government was that annual savings from the sale and leaseback of ACT Fleet would be between $140,000 to $280,000 per annum. At the time of the audit, as a result of recent falls in interest rates, the current annual saving is now assessed at $60,000. These savings do not take into account additional administrative costs or the additional cost of the new insurance arrangements required as a result of entering into the lease arrangement. If the additional administrative and insurance costs were taken to account no savings are currently being generated.

Negotiations with the tenderer were well advanced when the issue of the fleet being required to be externally insured arose. External insurance apparently was required in order for the tenderer to be able to claim the vital taxation deductions on the fleet. The additional cost of external insurance above the Territory's previously existing self insurance arrangements is assessed by the audit at approximately $47,000 for 1996-97.

Continued generation of any financial benefit is heavily reliant on interest and taxation rates. Movements in

general interest rates effect the amount of future lease payments as the amount of discount from the reference interest rate which the lessor passes on to the Territory varies with changes in the reference rate. In times of high interest rates the amount discounted is greatest and in times of low interest rates the discount is lower. As interest rates have fallen significantly since the lease arrangements began the anticipated savings from this source have already significantly reduced.

The discount on interest rates which the lessor passes on to the Territory from entering into this transaction arise mainly from the lessor being able to claim taxation deductions for depreciation on vehicles. The taxation claimed reduces the lessor's costs enabling the lessor to allow the interest rate discount while still retaining its required profit margin. The contractual arrangements allow for the discount to be varied if taxation rates change. Consequently downward movements in taxation rates will increase the Territory's, costs while upward movements will reduce costs.

Under current Federal Government policies the current corporate taxation rate (36c in the dollar) is not likely to increase. If any variation is to occur it is likely to be downward. There is therefore little likelihood of changes in taxation rates benefiting the Territory, however there is risk that reduced taxation rates will increase the Territory's costs.

The failure to call competitive tenders for the insurance cover of the fleet is of specific concern as it seems that this has cost the Territory in the vicinity of $100,000.

****

6. ACCOUNTING FOR THE TRANSACTION

6.1 INTRODUCTION

The accounting treatment for this type of transaction is determined by the requirements of the relevant Australian Accounting Standard, AAS17 'Accounting For Leases' (AAS17). AAS17 requires that transactions of this type be classified a either operating or finance leases.

To determine the correct classification of the transaction according to AAS17 a detailed review of the operation of the lease arrangements was undertaken as part of the audit. This Chapter presents the results of the review.

****

6.2 SIGNIFICANT FINDINGS

- ***AAS17 makes it absolutely clear that it is not the legal form of the lease arrangement which provides the basis for classifying leases for accounting purposes; rather it is the substance of the arrangements which is important;***

- ***In brief, Australian Accounting Standard AAS17 'Accounting for Leases' states that an operating lease is a lease in which the lessor is exposed substantially to all the risks and benefits incidental to ownership; alternatively if it is the lessee which is exposed to the major risks and benefits the lease is a finance lease;***

- ***The sale and leaseback of ACT Fleet is predominantly a finance arrangement and the Territory has all the substantial risks incidental to ownership; the lessor has no significant risks; and***

- ***As the lease has been accounted for as an 'operating' lease the lease has not been accounted***

for correctly in accordance with the requirements of the relevant Australian Accounting Standard.

****

6.3 ACCOUNTING FOR LEASES

AAS17 states how the two categories of leases (i.e. finance leases and operating leases) are to be accounted for in the financial statements of the relevant parties.

In respect of *finance leases*, AAS17 requires lessees to record at the beginning of the lease term an initial asset and liability equal in amount to the present value of the minimum lease payments. As lease payments are made they are apportioned between the interest expense and the lease liability. For the Territory's vehicle leasing arrangements this would involve recording a matching asset and liability in the responsible agency's Statement of Financial Position. The asset would be described as 'motor vehicles under lease' while the liability would be described as 'lease liability'. Similar reporting would occur in the Whole of Territory financial statements.

For *operating leases*, AAS17 requires that the lessee charges the minimum lease payments as expenditure in the Agency's Operating Statements each period. There is no requirement to show in the Balance Sheet or the Statement of Financial Position either an asset or a liability. The only transactions which are shown in the financial statements are the lease payments as an expense in each year's Operating Statement. The lease arrangement has been treated as an *operating* lease in the Territory's 1995-96 financial statements and it is currently intended to continue this treatment in 1996-97 financial statements.

****

6.4 IMPORTANCE OF CORRECT ACCOUNTING

The importance of accounting correctly for finance leases is set out in paragraphs 32 of AAS17 as follows:

32. "If transactions involving finance leases are not reflected in the lessee's balance sheet, or statement of financial position, the economic resources and the level of obligations of the lessee will be understated. Accordingly, this Statement requires finance leases to be brought to account by lessees by recognising as assets the rights to use leased properties, and by recognising as liabilities the obligations for minimum lease payments (referred to as the 'capitalisation of leases').

****

6.5 SUBSTANCE OF THE LEASE IMPORTANT

Paragraph 33 of AAS17 makes it absolutely clear that it is not the legal form of the lease agreement which provides the basis for classifying leases for accounting purposes. Rather it is the substance of the arrangements which is important. Paragraph 33 states:

33. "Capitalisation of finance leases in the accounts of lessees is justified by a consideration of substance over form. Although the usual legal form of a lease agreement is such that the lessee does not acquire legal title to the leased property, in the case of finance leases the substance is that the lessee acquires the right to most of the economic benefits from the use of the leased property. In return for that right, the lessee enters into an obligation to make periodic payments which in total approximate the fair value of the leased property and the related finance charge."

The following simple diagram summarises the Territory's involvement and the Bank's involvement in the processes from acquisition to disposal of a leased vehicle.

Leased Vehicle Cycle

The preceding diagram clearly illustrates that the substance of the Territory's arrangements with the Bank is that the Territory acquires the rights to the economic benefits from the use of vehicles and in return for these rights the Territory has entered into an obligation to make periodic payments to the Bank.

AAS17 includes a definition of *'fair value'* as follows:

"Fair value" means the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

In the case of the Territory's right to use the vehicles a logical estimate of fair values would be the initial purchase prices of the vehicles from car dealers less the estimated selling prices of the vehicles at auction or through some other arms length selling process.

Values set as described in the previous paragraph are those used to calculate the principal, and the related finance

charges, to be paid by the Territory to the Bank i.e. the minimum lease payments.

The method of setting the minimum lease payments provides strong support for a view that in substance the Territory's vehicle leasing arrangements are no different from other financing transactions involving regular payments to a financier of amounts of principal directly set from the fair value of the item being financed (i.e. paid for by the financier) with interest charges added. On the basis of the actual processes involved in the lease arrangement it can be reasonably concluded the lease is in substance predominantly a financing arrangement.

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6.6 RISKS AND BENEFITS OF OWNERSHIP

As stated previously how leases are to be accounted for in financial statements relies on the requirements of the relevant accounting standard, Australian Accounting Standard 17 "Accounting for Leases" (AAS17).

AAS17 requires leases to be classified into one of two categories at the inception of the lease, i.e. as either a finance or an operating lease.

Under AAS17 a finance lease is one:

"*in which substantially all of the risks and benefits incident to ownership of the leased property effectively pass from the lessor to the lessee ....*".

Under AAS17 an operating lease is one:

"in which substantially all of the risks and benefits incident to ownership of the leased property effectively remain with the lessor".

It is not a simple task to classify these types of transactions as either finance or operating leases. This is because the legal forms of the leases are structured to

achieve taxation benefits and not to make accounting simple.

The first and most significant test for the classification of leases is whether or not the arrangements can be cancelled. This test, in accordance with the Standard, must be a test of substance. For example, the legal contract supporting a lease arrangement may allow for termination of the lease, however the financial or other penalties which termination would impose on the lessee may be so great that the substantive situation is that termination is not a realistic option for the lessee.

The audit review of the lease arrangements indicates that in a substantive sense the lease is non cancellable because of the size of the additional costs which the Territory would have to meet if the lease arrangements were terminated early. The Chief Minister's Department agrees with this view.

The second question to be answered is whether substantially all of the risks and benefits of ownership of the vehicles are with the Bank or if risks and benefits of ownership are in fact with the Territory?

AAS17 states that the risks of property ownership include those associated with idle capacity, obsolescence, unsatisfactory performance, losses in realisable value and uninsured damage or condemnation of the property; the benefits include those obtainable from use of the property and gains in realisable value. There are of course other risks and benefits of ownership.

Comments on the risks and benefits of ownership mentioned in AAS17 follow:

Risks of Ownership

Idle Capacity:

If the ACT were to lease more vehicles than it requires, or idle capacity in already leased vehicles was created through, say outsourcing of functions, then the ACT must continue to make its payments to Macquarie Bank or alternatively pay 'break costs' if the vehicles are disposed of i.e. idle capacity risks are borne by the ACT; In contrast Macquarie Bank is entitled to its payments even if all the leased vehicles were idle 100% of the time.

There is a clause in the Operating Lease Facility Agreement (Clause 2.4) which states that the lease term for a vehicle may be terminated early if the following circumstance arises:

"*Which you* (i.e. the Territory) *otherwise reasonably consider that the vehicle is no longer reasonably capable of being used for the purpose or purposes for which it was intended.*"

Although this clause could seem to indicate that a lease for a vehicle may be terminated at any time examination of the terminology reveals that this is not actually so.

A lease can only be terminated under clause 2.4 *where a vehicle is no longer reasonably capable of being used for the purpose or purposes for which it was intended.* The vehicles covered by the lease arrangements are almost all passenger vehicles and their intended use is to convey passengers. It is hard to visualise circumstances arising which would make passenger vehicles unsuitable for conveying passengers. Clause 2.4(c) can therefore be considered as redundant in a general sense for passenger vehicles including if vehicles are idle.

Unsatisfactory performance:

The risk of vehicles not satisfactorily performing to specifications and/or expectations is borne by the ACT; If the ACT terminates a lease due to unsatisfactory performance it is legally obliged to pay 'break costs' to the Bank; the ACT cannot obtain replacements from Macquarie Bank and has to meet the costs of rectifying underperforming vehicles unless the problems are covered by the manufacturers warranty; In contrast Macquarie Bank is entitled to its payments, or the 'break costs', which shield it from any risk no matter how the vehicles perform.

Clause 11.8(1) of the Operating Lease Facility Agreement states:

"the Head Lessor will, in respect of each Vehicle, bear and discharge the cost of necessary repairs required in respect of such Vehicle (excluding Fair Wear and Tear), it being acknowledged that any and all such costs may be taken into account by us in our determination of the future Lease Payments payable in respect of future leased Vehicles."

This clause makes the Bank initially responsible to meet necessary repairs however it also makes it clear that the costs can be passed to the Territory. Although the lessor may initially meet the costs of rectification the substantive situation is that the Territory eventually will bear the risk of unsatisfactory performance.

In rare circumstances clause 2.4 could possibly be availed of for terminating a vehicle lease in the unlikely event that the unsatisfactory performance prevented a passenger vehicle from carrying passengers.

Obsolescence:

While it is highly improbable that obsolescence of leased vehicles could occur, nevertheless any risks of leased vehicles becoming obsolete are borne by the ACT; an obsolete vehicle cannot be returned to Macquarie Bank and payments stopped without 'break costs' being legally required to be paid; In contrast Macquarie Bank is entitled to its payments, or the break costs, whether or not vehicles become obsolete. An obsolete passenger vehicle would continue to be able to convey passengers and therefore clause 2.4(c) could not be availed of.

Uninsured Damage:

As the vehicles are covered by an insurance policy generally the risk arising from damage has been transferred to the insurer however it is the ACT which arranged the insurance cover, accepted the premium quoted, is meeting the cost of the insurance and is responsible to ensure all vehicles are covered; In contrast the Macquarie Bank is entitled to its payments whether or not the vehicles are damaged; (insured or not); the Bank

bears no insurance cost or risk through damage to the vehicles. Although the Bank initially pays the insurance premium it is the Territory which meets the cost through being required to pay the equivalent of the premium (plus interest) to the Bank by regular monthly instalments over the period of the insurance.

Losses in Realisable Values:

The ACT bears the full risk of losses in resale values of the vehicles for 8 of the 10 years of the lease arrangement as the Bank can adjust the future lease payments which the Territory must pay in order to recover any losses it may have incurred through it over estimating resale values of vehicles; In contrast because it can adjust future lease payments the Bank bears no risk over the first 8 years; the Bank may bear some risk in the final two years although this is slight as the lease facility is being managed so that there is a 95 percent probability that resale amounts over the life of the facility will at least equal the Bank's planned resale amounts.

Benefits of Ownership

Use of the Property:

The ACT has complete control over the vehicles and can use them in any way it sees fit; the ACT has the same usage rights as if it legally owned the vehicles i.e. its ability to use the vehicles is exactly the same as it was before the lease arrangement commenced; In contrast Macquarie Bank has no rights to use the vehicles.

Gains in Realisable Values:

For 8 of the 10 years of the lease arrangements it is the ACT which should benefit if vehicles' resale values are higher than planned.

Audit Comment

A reasonable understanding of the operation of the lease arrangements leads to a clear conclusion that the contractual arrangements are such that the Bank's planned yield from their investment is protected from both ownership and finance risks. Clearly the risks and benefits identified in AAS17 substantially rest with the Territory and not the Bank.

6.7 CLASSIFICATION OF LEASE BY THE TERRITORY

The successful tenderer provided the Steering Committee with a copy of an opinion from a leading accounting firm regarding the accounting classification of the lease transaction. This opinion stated that the lease the Territory was entering into should be classified as an operating lease.

It was on this opinion that the Territory accounted for the transaction as an operating lease in 1995-96. The Audit Office accepted this accounting treatment at the time, given the lateness of the transaction in 1995-96, and the timeframe for the audit. The Office has since undertaken this audit and come to a different view on how the transaction should be accounted for.

The accounting firm's advice was commissioned for Macquarie Bank, was paid for by the Bank, and was provided to the Bank. The firm's letter of advice to Macquarie Bank contained the following:

"As you are aware the contents of this letter pertain solely to the proposed transaction you have presented to us. The letter is for the sole use of the management and directors of Macquarie Bank Limited. We acknowledge that this letter will be copied to ACT. We also stress that the ultimate responsibility for the accounting treatment of the proposed lease transaction must rest with the management of ACT. Where appropriate, management should consult with their auditors.

We believe that the statements made by us in this letter of advice are accurate, but no warranty of accuracy or reliability is given. In accordance with our Firm policy,

we advise that neither the Firm nor any employee of the firm undertakes responsibility arising in any way whatsoever to any persons other than Macquarie Bank Limited in respect of this letter, including any errors or omissions herein, arising through negligence or otherwise however caused."

The content of these two paragraphs and, also that the advice was commissioned and paid for by Macquarie Bank, and was based on a summary of the lease arrangements presented by the Bank to the accounting firm, reduce significantly the authority and independence of the firm's advice. It would also be noted that the firm advised that '*management should consult with their auditors'* and that no such consultations were conducted with the Audit Office.

While the Taxation Office has agreed that the arrangements satisfy taxation requirements for taxation benefits this does not mean that the transaction is an operating lease for accounting purposes. The Taxation Office uses its own criteria for deciding whether lease arrangements qualify for taxation benefits. It should be noted that the written advice provided by the Taxation Office on taxation implications of the lease arrangements does not contain any reference to the accounting classifications of *finance* or *operating* leases.

6.8 CONCLUSION

The relevant Australian Accounting Standard (AAS17) makes it absolutely clear that it is not the legal form of the lease agreement which provides the basis for classifying leases for accounting purposes. Rather it is the substance of the arrangements which is important. The audit examination of the Territory's leasing arrangements resulted in a clear conclusion that the arrangement was substantively financing in nature. The arrangements were entered into with the primary intention of reducing the financing charges on the capital being utilised to finance the fleet.

How a lease is to be accounted in entities' financial statements is covered by AAS17. AAS17 requires leases to be accounted for as either operating or finance leases. Key criteria to be used in classifying leases is "who bears substantially all the risks and benefits of ownership". If the risks and benefits of ownership are with the lessor then the lease is an operating lease. If however the risks and benefits of ownership are with the lessee then the lease is a finance lease.

A question to be decided is who bears the risks of ownership of the leased vehicles? The answer, based on the actual operation of the lease arrangements is that it is the Territory which is exposed to substantially all the risks of ownership. This combined with the audit conclusions that the lease is effectively non-cancellable and that the arrangement was entered into primarily for financing purposes shows that the lease arrangement clearly constitutes a finance lease under AAS17 and the arrangements should be accounted for in the Territory's financial statements as a finance lease.

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