LEGISLATIVE ASSEMBLY FOR THE AUSTRALIAN CAPITAL TERRITORY

REVIEW OF
AUDITOR-GENERAL'S REPORT
NO 9, 1997

Fleet Leasing Arrangements

STANDING COMMITTEE FOR THE CHIEF MINISTER'S PORTFOLIO (INCORPORATING THE PUBLIC ACCOUNTS COMMITTEE)

Public Accounts Committee Report Number 7

September 1998

RESOLUTION OF APPOINTMENT

The Standing Committee for the Chief Minister's Portfolio was appointed by the Legislative Assembly on 28 April 1998 to examine any matter under the responsibility of the Chief Minister's portfolio. The Assembly also resolved that the committee perform the duties of a public accounts committee, specifically:

(a) to examine:

- (i) the accounts of the receipts and expenditure of the Australian Capital Territory;
- (ii) the financial affairs of authorities of the Australian Capital Territory; and
- (iii) all reports of the Auditor-General which have been laid before the Assembly;

(b) to report to the Assembly, with such comments as it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, to which the Committee is of the opinion that the attention of the Assembly should be directed; and

(c) to inquire into any question in connection with the public accounts which is referred to it by the Assembly and to report to the Assembly on that question.

MEMBERSHIP OF THE COMMITTEE

Mr Ted Quinlan MLA Committee Chair

Mr Trevor Kaine MLA Deputy Committee Chair

Mr Greg Cornwell MLA

Secretary: Bill Symington

1. INTRODUCTION

1.1. Auditor-General's Report No 9, 1997 was presented to the Assembly on 4 September 1997.

1.2. Review of this audit report by the Public Accounts Committee in the previous Assembly had not been completed before the Assembly was dissolved prior to the February 1998 election. In accordance with the resolution of the Assembly this committee has exercised its power to consider and make use of the evidence and records of the Public Accounts Committee in the previous Assembly.

1.3. Tenders were called for in February 1996 for a financing facility for the ACT Government passenger and light commercial fleet and, following evaluation of tenders, the fleet was sold to Macquarie Bank Ltd for $26.4m. The ACT leased back the same vehicles under a 10 year lease facility at an upper limit of $35.4m. The audit was undertaken because of the nature and materiality of the leasing arrangements.[1]

2. AUDIT FINDINGS

2.1. The relevant audit findings were:[2]

(i) risks arising from future changes in circumstances were not subjected to a complete and accurate evaluation, nor were these risks adequately disclosed to the Government

(ii) improvements could have been made to the process of cost assessment

(iii) the ACT is exposed to significant financial risk through the lease arrangement

(iv) immediate financial benefits from the lease were minimal and there is no certainty they will be maintained into the future

(v) the lease was not correctly accounted for in accordance with Australian Accounting Standards

(vi) the annual $1m insurance premium could have been significantly less.

Committee approach

2.2. Comment on the audit findings was sought by the Public Accounts Committee (PAC) in the previous Assembly from the Minister for Urban Services. The Minister (at the time, Mr Trevor Kaine) provided to the committee a Government Action Plan.[3] The committee sought

[1] Audit report p1
[2] Audit report p3
[3] Minister for Urban Services, letter to the committee dated 4 December 1997

the views of the Auditor-General on the Action Plan and, where appropriate, the Auditor-General's comments are indicated.[4]

2.3. Mr Kaine stood aside from the committee's review of this audit report.

3. GOVERNMENT COMMENTS ON THE AUDIT FINDINGS

Risk evaluation and disclosure

3.1. With regard to the audit finding that risks arising from future changes in circumstances were not subjected to a complete and accurate evaluation, nor were these risks adequately disclosed to the Government, the Minister advised that the financial advisers Oxley Corporate Finance Limited were engaged by the Steering Committee to provide expert assistance and advice in the assessment and evaluation of tenders. Oxley were acknowledged in the audit report as being suitably qualified and that they had undertaken similar exercises for other Australian governments.

3.2. The Minister advised that Oxley drafted the tender specification which required tenderers to provide substantial detail on a range of matters such as residual value methodologies and risk position, and rationalisation of fleet size, and to provide a base case lease pricing scenario, a series of sensitivities on residual values, interest rates and tax depreciation rates and two scenarios on early termination benchmark costs.

3.3. The Minister further advised that a summary of the sensitivity analyses on interest rates and residuals were included in a submission to government seeking agreement to the successful tender. The Auditor-General expressed to the committee some doubt as to whether the responsible officials fully understood what the analyses represented or how they were performed.

3.4. In regard to this matter, the Auditor-General advised that while a summary analysis of interest rates and residuals was part of the decision making process, Steering Committee officials were unable to explain the summary to the Audit Office. The Auditor-General also advised that notes taken by the Steering Committee were sporadic and not of an acceptable standard given the importance of the task.

Improvements in cost assessment

3.5. With regard to the audit finding that improvements could have been made to the process of cost assessment, the Minister noted that the audit acknowledged the short listed tenders were evaluation criteria as stated in the Request for Tender and the absence of an executive officer did not detrimentally affect the decision.

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[4] Auditor-General, letter to committee dated 6 July 1998

3.6. The Minister advised the shortcomings were to some degree a matter of judgement and noted that Steering Committee proceedings were recorded and substantive decisions were followed by briefings and submissions to the Government. The Minister advised that the Steering Committee was not a decision making body in the terms of the Purchasing Manual and the decision to proceed with the recommended tender was made by the Government.

3.7. The Minister advised, nevertheless, that the audit comments have been noted for follow up where necessary in respect of tender processes and purchasing guidelines.

Exposure to financial risk

3.8. With regard to the audit finding that the ACT is exposed to significant financial risk through the lease arrangement the Minister noted the audit identified a number of risk factors, viz:

(a) reduction in interest rates

The Minister advised that under the leasing facility the Government is able to finance the fleet at an interest rate that is less than the level at which the Government can borrow and that while the margin is reduced if interest rates fall the Government still obtains a net benefit. By the same token the net benefit increases if interest rates rise.

(b) **reduction in taxation rates**

The Minister advised that a reduction in taxation rates will reduce the tax effectiveness of the leasing facility but the ACT will still obtain a net benefit from the arrangement as the costs of leasing the fleet would still be less than if the fleet was self financed.

(c) **vehicle residual values are less than anticipated**

The Minister advised that the costs to the ACT of changing residual values is not affected by the leasing facility and the situation is the same as if the fleet was owned.

(d) **reductions in size or composition of the fleet**

The Minister advised that for a 10% reduction in the financing facility a net benefit is still gained by the ACT albeit reduced by less than 0.2 of one percent.

(e) **restricted access to alternative forms of finance**

The Minister advised that there is nothing to preclude the lessor and the lessee seeking to obtain advantage of new financial products. The Auditor-General accepted this response as legally the true case but advised that in reality the Government would have to pay a substantial penalty if it were to abandon the lease in order to access benefits from more attractive alternative financing.

3.9. The Minister further advised that the arrangement has not exposed the ACT to significant financial risks and stated that the lease arrangements provide that if interest rates fall the discount margin would decrease in order that the overall margin to the owner of the fleet is maintained, given that Macquarie Bank Limited bears the significant risks of ownership. Conversely if interest rates rise the discount margin would increase.

3.10. The Minister noted that other risks relate to changes in corporate tax rates and residual values and that a reduction in tax rates would reduce the benefits available to the ACT and stated this is the nature of the arrangement and the risks were clearly assessed. Similarly, the Minister noted that motor vehicle residuals relate to the market and the ACT is exposed to those circumstances whether or not the facility had been put in place.

Immediate and future financial benefits

3.11. With regard to the audit finding that immediate financial benefits from the lease were minimal and there is no certainty they will be maintained into the future, the Minister advised that this finding was based on the assertion that for a $30m financing facility the saving of $200,000 represents only 0.67% or 67 interest basis points, which is a relatively minor saving. The Minister further advised that the floating interest rate arrangement adopted has enabled the Government to save over $600,000 through a combination of falling interest rates and margin savings over the (1997) year.

3.12. The Auditor-General pointed out that in the normal course of managing borrowings savings from falling interest rates would not be dependent upon a lease agreement and that, as indicated in the audit report, the only savings which should be accepted as being derived through the lease arrangement are the margins.[5]

3.13. In respect of insurance the Minister advised that the estimated direct cost of claims for 1995-96 (the year immediately before the fleet insurance) was assessed at $842,000, excluding any administrative cost to either ACT Fleet or the Government Solicitor's 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. Estimated administrative costs were approximately 10% of the value of claims (about $84,200) so the ACT's self-insurance costs would have been in the order of $926,000.

3.14. The Minister advised that the estimated insurance premium for 1996-97 was $889,000 and covered the bulk of costs previously met by ACT Fleet and the Government Solicitor’s Office, plus a public liability cover of $10m and on site client

[5] ibid

assistance program not previously available to the ACT in connection with vehicles. Adjusting for the 1995-96 costs of inflation, the ACT's direct net financial benefit would be in the order of $80,000. In addition, since the implementation of the facility, ACT Fleet's workload had decreased enabling a saving of two full-time staff positions.

3.15. The Auditor-General had a different view about savings, noting that for 1300 vehicles the cost of new insurance arrangements in 1996-97, for which tenders were not called, totalled $889,000 which equated to $684 per vehicle. For 1997-98 tenders were called for 1476 vehicles at an all-up cost of $737,000, or $499 per vehicle, indicating that competitive tendering produced a lower insurance cost with a new insurer. [6] A conclusion to be drawn is that the same insurance deal would have been obtainable in 1996/97 at a saving of some $239,000.

3.16. The Minister stated that the insurance cover protects the ACT from further claims and the Territory's risk was capped to the amount of the premium, which was less than the ACT's potential risk if it continued to fully self insure.

Insurance premium

3.17. With regard to the audit opinion that the annual $lm insurance cost could have been significantly less, the Minister advised that the decision not to call tenders was based on the recent selection of Lumley Insurance by DAS Fleet and noting that the company had also been selected by Queensland and Victoria.

Adherence to Australian Accounting Standards

3.18. With regard to the audit finding that the lease was not correctly accounted for in accordance with the Australian Accounting Standard, the Minister noted that the Office of Financial Management considered the lease to be an operating lease rather than a finance lease. The Minister advised that the accounting firm KPMG and Macquarie Bank are satisfied that the arrangement constitutes an operating lease and this position had been accepted by the Australian Taxation Office for taxation purposes.

3.19. Nevertheless, the Minister acknowledged the Auditor General's strong concerns and stated the accounting standard is open to interpretation. However, the Minister noted discussions with the Auditor General's office prior to entering into the operating lease agreement and that the arrangements were included in the Department's 1995-96 audited financial statements.

3.20. The Minister advised that although the Office of Financial Management believed the lease to be an operating lease, it accepted scope existed for ambiguity in applying the Accounting Standard. Therefore, given the Auditor General's concerns, for accounting purposes, the 1996-97 financial accounts recognised the facility as a

[6] ibid

finance lease. This was not considered to affect the operating lease facility agreement or the benefits accruing from that contract.

4. COMMITTEE COMMENT

4.1. The committee has concerns about the assessment of risk in relation to the leasing arrangements which are reflected in the concerns expressed by the Auditor-General. The committee also has concerns about process in this case and that, in relation to insurance, the benefit to the Territory through non tendering was apparently significantly less than it could have been if the insurance had been put to tender.

4.2. Nevertheless, the committee is satisfied that the audit has given cause for the Administration to examine the shortcomings in process which it revealed. The committee would expect that lessons learned from this venture would not be repeated in any similar arrangement of this type.

5. RECOMMENDATION

5.1. The committee recommends that in exercising any future leasing arrangements of this nature the Government take particular note of the audit concerns expressed in this case.

Ted Quinlan MLA
Chair