S O U T H A U S T R A L I A

Report

of the

Auditor-General

for the

Year ended 30 June 2000

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Fourth Session, Forty-Ninth Parliament

Supplementary Report

Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations

By Authority: M. G. O'Callaghan, Government Printer, South Australia

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2000

Auditor-General's Department

29 November 2000

The Hon J C Irwin, MLC
President
Legislative Council
Parliament House
ADELAIDE SA 5000

The Hon J K G Oswald, MP
Speaker
House of Assembly
Parliament House
ADELAIDE SA 5000

Gentlemen,

Pursuant to the provisions of section 36(3) of the *Public Finance and Audit Act 1987*, I herewith provide to each of you a copy of my Supplementary Report 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations'.

Yours sincerely,

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EXECUTIVE SUMMARY

PART 1
INTRODUCTION

1. This Report is one of a series of reports prepared by the Auditor-General pursuant to the *Public Finance and Audit Act 1987* in relation to the disposal of the South Australian government-owned electricity assets. This Report examines the process by which the Government disposed of the electricity distribution business (ETSA Utilities), and its electricity retail business (ETSA Power).

2. There are a number of matters discussed in this Report that, in my opinion, have a relevance to the arrangements for any future disposal of government-owned assets. Although at the time of the preparation of this Report the disposal of government-owned electricity businesses is complete, I am aware that the disposal of other government-owned assets is currently being pursued.

3. The ERSU have indicated in their responses to the issues raised by me that in some instances their approach to the conduct of the Disposal Process reflected their commercial judgement, which they acknowledge led them to decisions that differed from my recommended approach. I agree that it is quite legitimate for differences to exist in relation to the approach to commercial issues. However, the recommendations contained in this Report reflect my view regarding those governmental values of accountability, transparency and auditability etc that should always be the basis upon which governmental activities are predicated.

4. This Report comprises an introductory Part followed by four other Parts, namely the:

   - bidding process for the above businesses, including the bidding process followed for the receipt of Expressions of Interest (EOIs) and indicative bids;
   - information gathering and due diligence process;
   - final bid process;
   - development of the Project Documentation.

5. Over the past decade in Australia there has been an increasing trend towards privatising or contracting out functions and services previously undertaken by Government. With respect to those processes associated with these matters the fundamental principle is one of fairness, the denial of which lies at the heart of procedural impropriety. Failure to accord with the appropriate requirements regarding procedural fairness may result in the contractual arrangements being set aside and the Government being liable for damages.

6. I have identified several key issues that I believe to be of fundamental importance from reviewing the disposal process for ETSA Power and ETSA Utilities. These include:

- the ERSU's opinion that the Treasurer can, as a matter of law contract out of an obligation to ensure procedural fairness. This is, in my opinion, an unsound basis upon which to structure the administrative processes that govern the electricity assets disposal arrangements;
- the ERSU's management arrangements for the disposal of ETSA Utilities and ETSA Power have significantly diluted the accountability obligations normally required of Advisers in a transaction of this nature;
- the failure by the ERSU and the Evaluation Committee to develop and settle the guidelines necessary for the conduct of the evaluation until the last days of the bid evaluation gave rise to unnecessary risks to the State. I found no documented evidence that the ERSU and the Evaluation Committee analysed the risks associated with the adoption by the Government of a process intended to elicit improved bids on 'risk' and 'price', which was not contemplated in the Bidding Rules;
- the ERSU did not require it's Advisers to provide a formal sign-off on the final form of the Project Documentation.

PART 2
ARRANGEMENTS FOR THE CONDUCT OF THE BIDDING PROCESS

7. Throughout the disposal arrangements the bidding process has been managed by the ERSU and its advisers. A number of protocols/rules/procedures have been adopted by the ERSU to govern these arrangements.

8. In my opinion, all of the protocols/rules/procedures may be capable of discovery by proper legal process. For this reason it is important that they not only be drafted in terms that are capable of being understood by all persons to whom they apply, but also, that the management of the disposal process by the ERSU ensures compliance.

9. The principles to be followed by Government employees and consultants participating in the disposal process are set out in the Probity Rules. The principles are designed to ensure that the bidding arrangements are conducted, and are seen to be conducted, in a fair and impartial manner and with the utmost integrity.

10. Although the Probity Rules require file records of all communications with bidders to be kept, there is no requirement for the maintenance of complete written records of any advice provided by independent experts to the Government. Where there is inadequate documentation, it is not possible to attribute responsibility in the event of the State incurring liability through placing reliance upon the advice received. This is particularly important with respect to legal advice.

11. The Bidding Rules constitute a 'process contract' between the Treasurer and a potential bidder and set out the respective rights and obligations of each of the parties.

12. Although there are advantages and disadvantages to a government adopting a process contract approach, there is no auditable evidence of the advice provided to the Government concerning the adoption of such an approach that outlines the risks involved.

13. Under the Bidding Rules a number of discretions, or reserved rights, are available to the Treasurer. In my opinion, there is a tension or conflict between some of the reserved rights of the Treasurer and the obligation to act in a fair and transparent manner. Such a conflict also potentially means uncertainty may arise for bidders. The more bidders are left uncertain as to how the evaluation process will be carried out, the more potential there is for a dispute to arise.

14. With respect to the evaluation by the ERSU of the EOIs received, Audit noted that:

- there was no evidence that the process was either controlled or monitored by any of the disposal process committees;
- different approaches were adopted in evaluating EOIs against the stated evaluation criteria;
- regard was had to other factors which were not contemplated in the stated evaluation criteria;
- for parties lodging EOIs, evidence was not available to indicate whether a further assessment had been conducted to confirm any previously assessed suitability.

15. With respect to the evaluation of Indicative Bids, I am of the opinion that the information requested was not sufficient, as it was possible for each bidder to present financial information in a different manner and with different underlying assumptions. This in turn meant that it would be difficult for evaluators to compare the prices offered by different bidders in order to determine which bid maximises the disposal proceeds.

PART 3
ARRANGEMENTS FOR INFORMATION GATHERING AND DISSEMINATION

16. In the context of an asset sale or disposal, the process of due diligence conducted by a vendor is generally undertaken in such a way that the process minimises the exposure of the vendor to liability, in particular, to those parties invited to participate in that process as bidders.

17. Vendor due diligence was conducted in two distinct phases. First, the Disaggregation Due Diligence, conducted between July 1998 to October 1998, and secondly, the due diligence in relation to the disposal of the distribution and retail businesses, which commenced in June 1999.

18. Audit's review of due diligence process adopted by the ERSU and its advisers, through the various committees established to conduct the sale/disposal process, did not identify any detailed documented focus on the potential liability to the State arising from its actions in the disposal process and the specific measures or procedures required to be adopted by the State to address any such liability. In the absence of specific legal advice as to the overall effectiveness or otherwise of such measures and processes, the Lease Committee would have been unable to assess the risks to the State and other parties associated with the issue of the Information Memorandum and due diligence undertaken by bidders and consider whether additional measures should be undertaken in order to mitigate such risks.

19. When developing a due diligence process in a sale/disposal of assets, regard should be had to the need to provide a bidder with warranties on issues which are fundamental to the disposal process. Further, a warranty review program should be undertaken to determine whether the provision of such warranties might expose the vendor to liability.

20. The failure to consider the requirement for a warranty review program at the time of developing the sale/disposal due diligence process can potentially expose the State to liability in respect of the warranties provided to the successful bidder through the Project Agreements.

21. The due diligence processes required sign-off opinions and certificates to be provided by parties and committees involved in the conduct of due diligence and in the preparation of the Information Memorandum. It is important that each adviser and other party engaged in the conduct of due diligence on behalf of the State provide appropriately structured and comprehensive opinions or 'sign-offs' on the conduct and outcome of the due diligence investigations undertaken and address the identified risks to the State arising from the conduct of the due diligence process.

PART 4
ARRANGEMENTS FOR THE CONDUCT OF THE FINAL BIDDING PROCESS

22. An Evaluation Committee was formed to consider and evaluate the Final Bids. The Committee, which was chaired by the Under Treasurer, comprised representatives of the Department of the Premier and Cabinet, the ERSU, Crown Solicitor's Office, and the Lead Advisers. It first met on 2 December 1999.

23. On Monday 6 December 1999 Final Bids for ETSA Utilities and ETSA Power were received by the ERSU.

24. Prior to the receipt of the Final Bids the Evaluation Committee considered a document that provided a summary of the arrangements intended to apply to the evaluation of the Final Bids. That document did not, however, address how the Committee was to deal with certain risks identified during the evaluation and issues which may arise in the event that a bid failed to conform with the State's benchmark/ preferred positions.

25. Further, the document included an indicative timetable for Final Bid evaluation that, in my opinion, allowed insufficient time for the Advisory Team members to undertake a full evaluation of the Final Bids by the proposed date of 7 December 1999, and provided little opportunity (short of amending the timetable) for those members to consider options for progressing the disposal in the event that no bid was a clear 'winning' Final Bid which satisfied the evaluation criteria.

26. Following receipt of the Final Bids, the Evaluation Committee recommended to the Treasurer that in order to 'improve' the terms of the Final Bids on both risk and price, negotiations should be commenced with each bidder using 'negotiation protocols'.

27. Whilst it is arguable that the bidders agreed to the 'negotiation protocols' by agreeing to and participating in the negotiations with the negotiation team, there is no written/documented evidence that they understood and acknowledged the terms of the protocols as communicated by the negotiating team. Unless very clearly communicated and documented, although it may not in practice have occurred on this occasion, it is possible that some bidders could have argued that they have not been treated equally and fairly as required by the terms of the process contract encapsulated by the Bidding Rules.

28. With respect to the evaluation of the Final Bids, Audit noted that:

- it is unclear from the adviser reports how each adviser assessed risk in respect of certain issues and what they intended by the terminology adopted in their reports. In some cases a risk analysis was provided in respect of an issue for one bidder but not for another, or a risk assessment was provided with no reason given for the assessed level of risk;

- consideration should have been given by the Evaluation Committee as to whether comprehensive legal and accounting advice was required before a decision was made to make a flat 10 percent deduction from the rental component of each bid which did not make allowance for GST, especially when some bidders were arguing that GST was not payable;

- there was no contemporaneous evidence that the Evaluation Committee fully considered the impact of the Year 2000 indemnity cap, in particular whether it sought advice from other appropriately qualified experts such as independent insurance consultants on whether the advice from ETSA Utilities and ETSA Power provided a proper basis for taking the approach adopted;

- comprehensive probity investigations were not undertaken on each bidder shortlisted to proceed to the Final Bid process.

29. In my opinion, the delay of almost two months in the certification of the minutes of the Evaluation Committee is unacceptable and could give rise to claims that the minutes do not represent an accurate record of the proceedings of the meetings of the Evaluation Committee.

PART 5
REVIEW OF PROJECT DOCUMENTATION

30. The ERSU has conducted the management of the disposal process through a committee structure which, whilst it has ensured a full exchange of views, has, in my opinion, made it difficult for the State to both identify and place reliance upon specific advice in relation to the disposal process received from these advisers.

31. In addition, the failure to require the provision of sign-offs having regard to their respective responsibilities from all key advisers coupled with the committee structure adopted by the ERSU for the management of the disposal process means, in my opinion, that the accountability of the respective advisers has been diluted and that the State's ability to seek to place reliance upon the advice provided by these advisers for the preparation of the Project Documentation has been similarly reduced.

32. With respect to the final Project Documents, Audit noted that:

- in the event that the lessee fails to operate, repair and maintain the distribution network in accordance with all applicable laws, the lessee is provided with a period of up to three months to rectify the situation. Reliance only on the lease termination events where there are such long cure periods could lead to the situation arising whereby the ongoing distribution of electricity in the State may be threatened;

- whilst I have not conducted a line by line review of each of the Project Documents my review has noted and identified an error in the drafting of the Distribution Network Land Lease. In my opinion, a full review of the Project Documentation must be undertaken by the ERSU and it's advisers to ensure that this form of error is isolated to this particular instance.

SUMMARY OF RECOMMENDATIONS

The following recommendations have been made in this Report.

Audit Recommendation 1

I recommend that the Government consider obtaining clear and definitive advice concerning its obligations to accord potential bidders procedural fairness during the conduct of future asset disposals. This advice should consider specifically the obligations upon the Government to act fairly in respect of its dealings with bidders; (a) in the context of there being a statutory scheme for the disposal of this State's assets and (b) in the event that a statutory scheme is found not to exist, in the context of the Government's exercising its prerogative powers to effect the asset disposal.

I further recommend that this advice also consider the extent to which the Government can, through the adoption of a 'process contract', limit and potentially disclaim its obligations to provide procedural fairness to bidders.

Finally, I recommend that this advice be obtained as a matter of urgency from a public law expert in this area. (Advice has been obtained - See Appendix).

Audit Recommendation 2

I recommend the Probity Rules for future asset disposals explicitly describe the manner in which the discussions at the roadshow presentations are to be documented as a formal record of the communications with potential bidders.

I also recommend that roadshow presentations should not be conducted until the Probity Rules intended to cover such presentations have in fact been formally adopted.

Audit Recommendation 3

I recommend that for future asset disposals the Probity Rules be simplified and that the concept of Internal/External rules not be used.

Audit Recommendation 4

I recommend that for future asset disposals the Probity Rules require that supporting documentation be created contemporaneously for all advice received.

Audit Recommendation 5

I recommend that for future asset disposals, Bidding Rules detailing the information to be supplied by bidders be settled prior to the commencement of the disposal process and be further refined if necessary at the commencement of each subsequent stage of that process.

Further, I recommend that Supplementary Bidding Rules be issued to only address unforeseen circumstances.

Audit Recommendation 6

I recommend that for future asset disposals:

- **all pre-qualification criteria and information requirements be clearly identified, documented and applied;**
- **a clear methodology be developed for the evaluation of EOIs;**
- **EOIs not be evaluated on a 'rolling' or sequential basis but be evaluated at the same meeting.**

Audit Recommendation 7

I recommend that for future asset disposals the process for acceptance of late EOIs be identified to potential bidders and that where a discretion is exercised to accept a late EOI, this fact be recognised in the approval given.

Audit Recommendation 8

I recommend that appropriate documentation be retained to support the evaluation of all EOIs lodged, including those lodged by potential bidders pre-approved by the Treasurer.

Audit Recommendation 9

To enable the Evaluation Committee to undertake the evaluation of the Indicative Bids received, I recommend that the Bidding Rules require bidders to provide sufficient detailed information.

Audit Recommendation 10

To enable an assessment to be undertaken of the risk that a bidder cannot sustain a business operating the relevant assets where the assets concerned relate to essential services, I recommend that information concerning the bidders' long term plans for developing and maintaining the business as a viable concern be requested from bidders.

Audit Recommendation 11

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process on behalf of the State, prior to issuing any Information Memorandum or disposal document relating to the entity identified for disposal, identify the risks, if any, to the State and those parties involved in the preparation of the document arising from or in connection with the issue of the Information Memorandum and ensure that appropriate specific processes are implemented to address such risks. The decision making processes and rationale underlying the methodologies adopted by that committee or body to identify and address such risks must also be documented.

Audit Recommendation 12

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process on behalf of the State, prior to conducting any due diligence process on the entity identified for disposal:

- **seek to identify the risks to the State and its advisers arising from or in connection with the conduct of the due diligence process;**
- **ensure that in developing that process consideration is given to the use of measures or procedures to mitigate any such risks;**
- **document the identified and considered risks.**

Audit Recommendation 13

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process should:

- **have regard during the development of the due diligence process to the possible requirement to provide warranties to bidders (in particular as to title to the assets) when determining the information to be released to bidders in data rooms;**
- **prior to the execution on behalf of the State of any document with the purchaser of the entity containing warranties given by the State:**
  - **undertake a review of the State's ability to satisfy or comply with any such warranties;**
  - **require any party who assists or undertakes that review or any part thereof on behalf of the State, to sign-off to the State in relation to their participation in that review.**

Audit Recommendation 14

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process carefully consider, prior to agreeing the terms of a due diligence process:

- **the protection or comfort that the State is afforded by the due diligence process in the event of a claim or litigation being instituted against the State which is related directly or indirectly to the conduct of due diligence, and the provision of due diligence information to prospective purchasers;**

- **the recourse available to the State and the State's potential exposure to liability (including the provision of indemnities by the State to parties for liability arising from claims in connection with the conduct of the due diligence, including the issue of an Information Memorandum) in the event of such a claim or litigation being instituted. This review to include but not be limited to, an examination of the operation and impact of any liability exclusion clauses in due diligence planning documents to which the State is a party, for the benefit of parties who are engaged, as experts, to advise the State on the development, conduct and outcomes of due diligence processes.**

Audit Recommendation 15

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process incorporate into the due diligence process an effective mechanism for identifying, addressing and monitoring the resolution of material issues which may impact upon the conduct of the disposal process and appointing responsibility for resolution of that issue to a nominated party or parties.

Audit Recommendation 16

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process, ensure that as far as possible material provided to bidders in a data room or by other means at the commencement of bidder due diligence be up-to-date and be regularly updated during the conduct of bidder due diligence.

Audit Recommendation 17

I recommend that for future business and/or asset disposals the methodology to be applied for the evaluation of Final Bids including the practical approach to the assessment of variations to nominated benchmark positions be fully developed and finalised before the commencement of the bid evaluation process.

Audit Recommendation 18

I recommend that for future business and/or asset disposals the agency responsible for conducting the Final Bid evaluation ensures that:

- **in advance of the evaluation, each specified or proposed action relating to the evaluation process that can be reasonably anticipated, is included in the timetable and can be performed pursuant to the Bidding Rules;**
- **consideration is given to amending the Bidding Rules to provide for flexibility of timing for dealing /negotiating with bidders after the receipt of bids.**

Audit Recommendation 19

I recommend that for future business and/or asset disposals that the agency responsible for conducting the Final Bid evaluation give consideration to ensuring the Bidding Rules provide:

- **that the period during which Final Bids remain open and capable of acceptance be in excess of seven days; or**
- **for mechanisms which have the effect of controlling the parameters for changes in the Final Bids without allowing bidders to fully withdraw their bids after the seven days.**

Audit Recommendation 20

I recommend that for future business and/or asset disposals that adopt a process contract with bidders, the negotiation processes adopted with bidders comply with the terms of the process contract.

I also recommend that bidders be advised in writing of any negotiation processes which are proposed to be adopted by the State and that such processes be agreed to by bidders and confirmed by them in writing.

Audit Recommendation 21

I recommend that for future business and/or asset disposals that the appointed Evaluation Committee ensure that adequate documented instructions are provided to those advisers responsible for conducting the detailed evaluation as to the form and contents of the reports required to be submitted.

Further, I recommend that advisers' reports be reviewed by the appointed Evaluation Committee for compliance with the adopted evaluation methodology and any deficiencies be addressed prior to the completion of the bid evaluation process.

Audit Recommendation 22

I recommend that for future business and/or asset disposals that:

- **comprehensive and fully documented advice be sought during the development of bid evaluation methodologies for any element of that methodology, that when applied, may result in the adjustment of bid prices;**
- **where bid price adjustment methodologies of the type referred to above are proposed, legal advice be sought as to whether bidders need to be advised of the proposed application of such methodologies in the evaluation of their bids to enable them to consider the implications of such methodologies when preparing their bids.**

Audit Recommendation 23

I recommend that for future business and/or asset disposals, ('assets' in this context meaning assets of public interest importance) full and comprehensive probity checks on short listed bidders:

- **be undertaken in accordance with the approved plan;**
- **include not only the actual proposed purchasers of the asset but also their ultimate beneficial owners;**
- **be undertaken and completed prior to completion of the Final Bid evaluation.**

Audit Recommendation 24

I recommend that where an evaluation methodology similar to that adopted with respect to the electricity assets is to be adopted for future business and/or asset disposals, the overall assessment of the bids be supported by a consolidated or summary evaluation matrix identifying each risk and price issue with details of the evaluation undertaken in respect of each issue, applying the approved methodology or guidelines, and the reasons for the decisions reached.

Audit Recommendation 25

I recommend that for future business and/or asset disposals, the minutes of meetings of the evaluation and other asset committees be finalised and certified by the respective committees at the following meeting of that committee or if this is not possible at the earliest practicable date thereafter.

Audit Recommendation 26

I recommend that for future business and/or asset disposals, briefing papers provided in support of recommendations and proposed decisions clearly summarise and identify all material issues relating to that recommendation or decision.

Audit Recommendation 27

In future asset disposal processes, I recommend that the State ensure that there is a clear audit trail of the advice provided to the State by its advisers in relation to the drafting of documents to give effect to that disposal process.

Audit Recommendation 28

I recommend that in future asset disposals, the State ensure that all the advisers with primary responsibility for assisting the State in preparing documents to give effect to the disposal process be required to provide to the State effective sign-offs in relation to those documents before these documents are executed by the State.

Audit Recommendation 29

I recommend that in future asset disposals involving significant competition, where the State is to provide warranties to the potential purchasers, where commercially possible, consideration be given to putting as the State's position a low monetary cap on the State's liability under these warranties particularly in circumstances where there is significant competitive tension in the disposal process.

Audit Recommendation 30

In future asset disposals, where it is intended that the State retain certain liabilities in the disposal process, I recommend that in addition to a consideration of the legal position, to the extent possible, a full analysis of the potential cost to the State of retaining those liabilities be undertaken and documented before any decision is taken.

Audit Recommendation 31

I recommend that in future asset disposals that involve the sale and/or lease of essential services, consideration be given to ensuring that the provision of 'cure' periods for the lessee/owner of these assets equate with other applicable legislative requirements.

Audit Recommendation 32

I recommend that a full review of the Project Documentation for the disposal process for ETSA Utilities and ETSA Power be undertaken to ensure that the Project Documentation contains no inadvertent errors or omissions which may affect the State's position under those documents.

GLOSSARY OF TERMS

It is noted that terminology peculiar to the disposal process for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd is used in the documentation produced by the Electricity Reform and Sales Unit and its advisers. For clarity in this Report the following terms are used:

ASIC	Australian Securities and Investment Commission.
Benchmark Project Agreements	The sets of agreements, including leases, prepared by the ERSU for each bidder which set out the State's preferred terms and conditions for the disposal of ETSA Utilities and ETSA Power.
Data Room	Data room established for the benefit of bidders containing information and documents relating to the electricity entities.
Data Room Index	The index of documents provided to bidders in the data rooms which opened on 4 October 1999.
Disaggregation Due Diligence	The due diligence conducted by the advisers to the ERSU on the electricity corporations between July and October 1998 in accordance with the Prior Memorandum.
Disposal Act	*Electricity Corporations (Restructuring and Disposal) Act 1999*.
Distribution Lessor Corporation	The corporation established by the State to assume ownership of the distribution network of ETSA Utilities.
Distribution Network Lease	An annexure to the Distribution Network Lease Sale/Lease Agreement between the Treasurer of the State of South Australia and South Australian Utilities Partnership.
Due Diligence Sub-Committee	A sub-committee of the Lease Committee, comprising representatives of the Legal Consortium, KPMG, the ERSU, ETSA Utilities, ETSA Power and the Lead Advisers formed on 29 July 1999.
Electricity Corporations	SA Generation Corporation (trading as Optima Energy), ETSA Corporation, ETSA Power Corporation, ETSA Energy Corporation and ETSA Transmission Corporation.

Electricity Entities	ETSA Utilities, ETSA Power, Optima Energy Pty Ltd ACN 083 202 831, Flinders Power Pty Ltd ACN 082 988 270, Synergen Pty Ltd ACN 083 203 070, the transmission business conducted by ETSA Transmission Corporation trading as ElectraNet SA and Terra Gas Trader Pty Ltd ACN 083 078 693.
EOI	Expressions of Interest sought from potential bidders for ETSA Power and ETSA Utilities.
ERSU	Electricity Reform and Sales Unit of the Department of Treasury and Finance.
ETSA Power	ETSA Power Pty Ltd.
ETSA Utilities	ETSA Utilities Pty Ltd.
Evaluation Matrix	Final Bid Evaluation matrix — Annexure 2 of the Evaluation of Final Bids — Summary.
Evaluation Methodology	The evaluation methodology as set out in a document titled 'Evaluation of Final Bids — Summary' dated 6 December 1999 and endorsed by the Evaluation Committee at its meeting held at 12:30 pm on 6 December 1999.
GST	Goods and Services Tax.
Information Memorandum Sub-Committee	Information Memorandum and Verification Sub-Committee, a sub-committee of the Lease Committee, formed on 23 June 1999 comprising representatives of Legal Consortium, KPMG, the ERSU, ETSA Utilities , ETSA Power and the Lead Advisers.
Information Memorandum	ETSA Utilities and ETSA Power Information Memorandum dated 30 August 2000.
Information Requests	Information requests prepared by those parties conducting due diligence which were directed to the electricity entities.
Lead Advisers	Morgan Stanley Dean Witter and Pacific Road Corporate Finance - the business and financial advisers to the ERSU.
Lease Committee	The committee formed on 22 June 1999 comprising representatives of the Legal Consortium, KPMG, the ERSU, ETSA Utilities, ETSA Power and the Lead Advisers.

Legal Consortium	Allens Arthur Robinson (including Finlaysons) and Johnson Winter & Slattery - the legal advisers to the ERSU.
Negotiation Protocols	The protocols, proposed by the Evaluation Committee and approved by the Treasurer on 7 December 1999, for the conduct of negotiations with bidders, as described under the heading '4.4 — Negotiation Protocols' in this Report.
Offer Deed	The Deed signed on or about 11 December 1999 by the Treasurer of the State of South Australia and CKI Utilities Development Limited, HEI Utilities Development Limited, Utilities Management Pty Ltd, Cheung Kong Infrastructure Holdings Limited and Hong Kong Electric Holdings Limited.
Parties	The parties to the Planning Memorandum, namely the Treasurer of the State of South Australia through the ERSU, the Lead Advisers, the Legal Consortium and KPMG.
Planning Memorandum	Due diligence Planning Memorandum, entered between South Australia (acting through ERSU), Morgan Stanley, Pacific Road Corporate Finance, KPMG and the Legal Consortium dated 28 September 1999.
Prior Memorandum	Disaggregation due diligence Planning Memorandum entered between the Treasurer, Morgan Stanley, Pacific Road Corporate Finance, KPMG and the Legal Consortium dated 9 September 1998.
Project	The program established by the South Australian Government for the reform of the electricity supply industry in the State and the disposal of the government-owned electricity assets.
Project Agreements	Electricity Distribution Business Sale Agreement, Distribution Network Lease, Distribution Network Land Lease and Electricity Retail Distribution Business Sale Agreement.
Sale/Lease Due Diligence	The due diligence process conducted for the disposal of each of the electricity entities or their businesses as at 30 June 1999.

SEC	United States of America - Securities and Exchange Commission.
South Australian Utilities Partnership	CKI Utilities Development Limited, HEI Utilities Development Limited, Utilities Management Pty Limited, Cheung Kong Infrastructure Holdings Limited and Hong Kong Electric Holdings Limited.
Supplementary Due Diligence	The due diligence undertaken in respect of the electricity entities for the period 1 July 1999 to 31 August 1999 and for each monthly period thereafter up to the financial close of the sale and lease of the electricity entities or their businesses.
Transfer Orders	Orders made by the Treasurer under section 8 of the Disposal Act, dated 12 October 1998 and 30 July 1999
Year 2000	The potential failure of equipment or information technology owned by, leased or licensed to, or subject to other rights of use by ETSA Utilities or ETSA Power to deal properly with a series of specified circumstances including the transition from 31 December 1999 to 1 January 2000 and to recognise Year 2000 as a leap year (as defined in both Sale Agreements - clause 1.1 in each Agreement). The term also includes any damage to such equipment or information technology caused by such a failure or by a failure of equipment or information technology which is not owned by, leased or licensed to, or subject to other rights of use by ETSA Utilities (in the case of Distribution Business Sale Agreement) or ETSA Power (in the case of Retail Business Sale Agreement) but which is used or relied upon by any person to provide goods or services to that company.

ELECTRICITY BUSINESSES DISPOSAL PROCESS IN SOUTH AUSTRALIA: ARRANGEMENTS FOR THE DISPOSAL OF ETSA UTILITIES PTY LTD AND ETSA POWER PTY LTD: SOME AUDIT OBSERVATIONS

PART 1
INTRODUCTION

1.1 SCOPE OF THE REPORT

This report is one of a series of reports prepared by the Auditor-General in relation to the disposal of the South Australian government-owned electricity assets.

This Report examines the process by which the Government disposed of its electricity distribution business (ETSA Utilities Pty Ltd), and its electricity retail business (ETSA Power Pty Ltd). The process for the disposal of the remaining government-owned electricity businesses will be the subject of a separate Report(s).

In reviewing the disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd I have subdivided the process into four main phases:

- Bidding process for the above businesses, including the bidding process followed for the receipt of expressions of interest (EOIs) and indicative bids.
- Information gathering and due diligence process.
- Final bid process.
- Development of the Project Documentation.

Each of these phases is covered by a separate Part within the body of this Report.

There are a number of matters discussed in this Report that, in my opinion, have a relevance to the arrangements for any future disposal of government-owned assets. Although at the time of the preparation of this Report the disposal of government-owned electricity businesses is complete, I am aware that the disposal of other government-owned assets is currently being pursued.

1.1.1 Matter of Emphasis

The ERSU have indicated in their responses to the issues raised by me that in some instances their approach to the conduct of the Disposal Process reflected their commercial judgement, which they acknowledge led them to decisions that differed from my recommended approach. I agree that it is quite legitimate for differences to exist in relation to the approach to commercial issues. However, the recommendations contained in this Report reflect my view regarding those governmental values of accountability, transparency and auditability etc that should always be the basis upon which governmental activities are predicated.

1.1.2 Audit Mandate

Subsection 36(3) of the *Public Finance and Audit Act 1987* provides:

> *The Auditor-General may, if the Auditor-General thinks fit to do so, prepare a supplementary report (and annex documents to it) relating to a matter required to be dealt with in an annual report and deliver that report to the President of the Legislative Council and the Speaker of the House of Assembly.*

This Report has been prepared on the basis of the mandate provided by subsection 36(3) of the *Public Finance and Audit Act 1987* as described above.[1]

1.1.3 Major Issues

I have identified several key issues that I believe to be of fundamental importance from reviewing the disposal process for ETSA Power and ETSA Utilities.

1.1.3.1 Obligation for Procedural Fairness

In this Report under the heading '2.4 — Bidding Rules' I have expressed the view that the approach adopted by the ERSU for the electricity businesses disposal process has been to create a process contract between the Treasurer and each bidder participating in that process. The terms of the process contract are the Bidding Rules established by the Treasurer for the disposal of ETSA Utilities and ETSA Power.

Further, in my opinion, the process contract contains statements that could lead a bidder to believe the Treasurer would exhibit fair dealing in the performance of the process contract. In particular, clause 1.4 of the Bidding Rules states that 'The Treasurer wants the Disposal Programme to be conducted and seen to be conducted in a fair and impartial manner and with the utmost integrity'.

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[1] Obligations of the Auditor-General in respect of section 22 of the Disposal Act will be dealt with in a later report.

In respect of the view expressed by the ERSU regarding the implications of a process contract, there is one matter where the view taken by me is fundamentally at variance with the view expressed by the ERSU. Discussion on this matter is to be found in the ERSU's response to me as outlined later in this Report under the heading '2.4.1.3 — Implications of a Process Contract':

> *There is no explicit promise that the process, in all circumstances, will be fair. Consequently we contend that it is open to a Court to make a finding that a term as to fairness of process would not be implied.*
>
> *We accept that the Auditor-General may have a different view on this issue.*

It is clear from this statement that it is the ERSU's opinion that the Treasurer can, as a matter of law, contract out of an obligation to ensure procedural fairness.

In my opinion, the holding of such a position by a body/person exercising public functions where the rights and/or legitimate expectations of individual or corporate members of the community may be adversely affected, is untenable, probably, given the process adopted by the ERSU, as a matter of law, but certainly as a matter of public policy.

The fact of the ERSU and the Treasurer holding this view, even though they may state that as a matter of practice they intend to act in a manner that accords procedural fairness to all bidders, in my opinion, raises serious concerns regarding the arrangements that underpin the decision-making processes within the ERSU and by the Treasurer. In essence, the holding of such a view, ie that the Government can divest itself of its public law responsibilities, has the tendency to undermine public confidence in the processes of government.[2] In my opinion, the holding of this position, as a matter of public policy, and to the extent that the ERSU maintain that the Government in managing the disposal process can act unfairly in contravention of bidders legitimate expectations, is an unsound basis upon which to structure the administrative processes that govern the electricity assets disposal arrangements. This is compounded by the apparent lack of any clear written advice to the Government about the process adopted.

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[2] There is long standing High Court of Australia authority that the tendency of an arrangement/practice/agreement is a matter of law and 'must be judged irrespective of the merits of the transaction intended to be promoted'; Knox CJ in *The King v Boston* (1923) 33 CLR 386 at 394.

The matter of the tendency inherent in the procedures of government to undermine public confidence in the processes of public institutions was discussed in the 1996 Report of the Auditor-General — 'Part 3 — SA Water Corporation — Audit Report of the Procedures Associated with the Receipt, Opening and Distribution of the Final Submissions on 4 October 1995' at p. vii.

Any contractual provision that reserves for the Treasurer (or for that matter any Minister of the Crown) the right to act unfairly must raise concerns regarding the integrity of the internal processes of government. No person dealing with the government when there is such a reserve power can have confidence that they will be treated on the same basis as other parties seeking consideration with respect to the same subject matter. Any such arrangement must have a tendency to undermine confidence in the processes of government.

Whether in practice there has been any prejudice occasioned to any bidder is beside the point. Government is the 'moral exemplar' for the community and must ensure that its procedures accord, not only with the law, but also with those standards that right thinking members of the community regard as conducive to the public good.[3]

This is not a matter than can be dismissed on the basis of a 'difference of views'. Given certain factual circumstances the view taken by the ERSU could undermine the entire disposal process. When bringing this issue to the attention of the Treasurer, I recommended that the Government consider, as a matter of urgency, obtaining clear and definitive advice from a public law expert regarding its obligations to accord procedural fairness to potential bidders.

A copy of the advice obtained by the Government is included in this Report as an Appendix.

1.1.3.2 Information Gathering

In relation to the due diligence process, this Report concentrates on the processes for the gathering of information in relation to the electricity entities on behalf of the State and the dissemination of information concerning those entities to bidders for the ultimate purpose of submitting final bids for an interest in the electricity entities.

With respect to those processes, issues were identified relating to the absence of:

- a documented record to indicate that the State's Advisers have comprehensively advised the committees appointed by the State to conduct the due diligence process and to prepare the Information Memorandum as to the risks of litigation or challenge by bidders arising from the processes;
- sufficient comfort from the Advisers that the processes conducted by them affords the State with any protection in the event of a challenge by bidders.

In my opinion, the implication of these issues is that the State is required to accept full responsibility for the processes that its Advisers recommended it adopt, without any apparent clear documented understanding as to the risks associated with adopting those processes and any comfort as to whether those processes would afford it any protection in the event of a challenge by bidders. As a consequence of these arrangements the Advisers are accountable to the State only in respect to their role in the conduct of the processes, the appropriateness and effectiveness of which for the disposal of ETSA Utilities and ETSA Power was not transparently addressed.

Accordingly, I am of the opinion that the ERSU's management arrangements for the disposal of ETSA Utilities and ETSA Power have significantly diluted the accountability obligations normally required of Advisers in a transaction of this nature.

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[3] In *Olmstead v United States* (1928) 277 US 438, Brandis J at 485 observed 'Our Government is the potent, the omnipresent teacher. For good or ill it teaches the whole people by its example'.

1.1.3.3 Final Bid Process Issues

In this Report I have identified a number of issues associated with the process adopted by the ERSU in its preparations for, and the conduct of, the evaluation of the Final Bids.

1.1.3.3.1 Evaluation Methodology

Of particular concern is the process for the consideration and settling of material aspects of the evaluation methodology over a five day period between the receipt of the Final Bids and preparation of a report to the Treasurer dated 10 December 1999[4] containing a recommendation as to the preferred bidder. In my opinion, the failure by the ERSU and the Evaluation Committee to develop and settle the guidelines necessary for the conduct of the evaluation until the last days of the bid evaluation gave rise to unnecessary risks to the State in the conduct of the disposal process and in such circumstances cannot be said to be consistent with the requirements of good administrative practice.

To develop or finalise an evaluation methodology ***during the evaluation of bids***, in particular any aspect of that methodology which may materially affect the evaluation outcome,[5] may result in an inconsistent and possibly an indefensible result. If the time allowed for conducting the evaluation is short, the risks resulting from settling the methodology concurrently with the evaluation of bids will be increased.

1.1.3.3.2 Eliciting Further Bids

With respect to another matter, in my opinion, bidders had a legitimate expectation that if the Government decided not to accept any of the Final Bids it received, and intended to seek further bids from all or some of the bidders, it would follow the process in the Bidding Rules for inviting such bids.[6] During the review, however, I found no evidence that the ERSU and the Evaluation Committee analysed the risks associated with the adoption by the Government of a process intended to elicit improved bids on 'risk' and 'price', which was not contemplated in the Bidding Rules.

1.1.3.4 Project Documentation Issues

There are three major issues arising from my review of the process for developing the Project Documentation that I consider are of fundamental importance and to which I wish to draw particular attention.

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4 Attachment T to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

5 Such as methodologies which may result in the adjustment of bid prices. Refer to comments under the headings '4.6.1 — Treatment of Goods and Services Tax (GST) Liability' and '4.6.2 — Treatment of the State's Year 2000 Liability Cap' in this Report.

6 Section 13.6 of the Bidding Rules.

1.1.3.4.1 Accountability of Advisers

The procedures adopted by the ERSU in managing the key advisers for the disposal process have, in my opinion, led in part to all advisers not being held to be fully accountable to the State for the Project Documentation.

The management arrangements that have been adopted by the ERSU have involved the establishment of a comprehensive committee structure comprising representatives of the Lead, Legal and Accounting advisers and the ERSU. Whilst this committee structure has facilitated an open exchange of views, in my opinion, it has also had the indirect effect of diluting the accountability of these advisers to the State.

In a transaction of such importance as the disposal of ETSA Utilities and ETSA Power, it is common practice to require the advisers with principal responsibility for the preparation of the Project Documentation (the Lead, Legal and Accounting advisers) to provide to the State, prior to execution of the Project Documentation, a sign-off that confirms that the final form of the Project Documentation:

- fully complies with and gives effect to the instructions received by the advisers from the State during the course of the disposal process;
- is fully consistent with all regulatory and legislative requirements;
- appropriately protects the State from potential liability.

The ERSU, however, did not require it's advisers to provide a formal sign-off on the final form of the Project Documentation as outlined above.

1.1.3.4.2 Error in Project Documentation

Although I did not conduct a detailed review of the accuracy of all clauses in the Project Documents, I did identify an error in the drafting of those documents.

Audit understands that the ERSU has confirmed with the successful bidder that it accepts that this was an inadvertent drafting error, and the necessary corrections have been made. Against the background of this and a previous error identified in the Project Documentation, I have recommended that a full review of the Project Documentation for the disposal of ETSA Utilities and ETSA Power be undertaken.

The ERSU has advised me that it does not intend to undertake such a review.

1.1.4 Arrangements for the Communication of Audit Concerns to the Parliament

In relation to the issues identified by Audit during the review of the disposal of ETSA Utilities and ETSA Power, a number of matters have already been discussed with the Economic and Finance Committee of Parliament as follows:

- A number of issues were brought to the attention of the Economic and Finance Committee of Parliament at my appearance before that Committee on 10 November 1999.

- As a result of discussions with the Treasurer and his advisers as to the potential adverse impact on the disposal process through publication of my concerns, I requested that the Economic and Finance Committee hear my outline of the identified issues 'in camera' and then to consider a means whereby I could report to the Parliament.[7]

Following Parliamentary deliberations, a motion, in identical terms, was passed by both Houses of the Parliament providing a mechanism by which any reports prepared by me during the Parliamentary recess could be made available to Members of the Parliament.[8]

Motions were also carried in both Houses of the Parliament to establish a Joint Committee of the Parliament of South Australia (Joint Committee) to provide an appropriate forum in which matters of immediate and/or urgent concern could be raised by me '... throughout the duration of the lease process ...'.[9]

1.1.5 Process for Obtaining Information and Comments from the ERSU

Audit commenced the review process in respect of the disposal of ETSA Utilities and ETSA Power by reviewing material held on the ERSU files. After an initial review, written requests for documents not available from the reviewed files were sent to the ERSU and further documentation and information was obtained as a result.

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7 The transcript of the evidence on 10 November 1999 has now been made public by the Economic and Finance Committee.

8 House of Assembly Motion dated 17 November 1999; House of Assembly Hansard 1999 at p. 491; Legislative Council Motion dated 18 November 1999; Legislative Council Hansard 1999 at p. 516. The motion was in the following terms:

> *That, if prior to 30 June 2000 and at a time when Parliament is prorogued or this House is adjourned for a period exceeding two weeks, the Auditor-General (acting pursuant to subsection 36(3) of the* Public Finance and Audit Act 1987*) delivers to the Speaker a supplementary report on the probity of the processes leading up to the making of a relevant long-term lease (as that term is defined in subsection 22(8) of the* Electricity Corporations (Restructuring and Disposal) Act 1999*), the Speaker is hereby authorised, upon presentation of the report to the Speaker, to publish and distribute that report.*

9 House of Assembly Motion dated 18 November 1999; House of Assembly Hansard 1999 at p. 559; Legislative Council Motion dated 19 November 1999; Legislative Council Hansard 1999 at p. 592. The motion was in the following terms:

> 1. *That in the opinion of this House, a joint committee be appointed to provide a means by which any concerns of the Auditor-General in relation to the electricity businesses disposal process in South Australia can be expeditiously communicated to the parliament throughout the duration of the lease process;*
> 2. *That in the event of the joint committee being appointed, the House of Assembly be represented thereon by two members, of whom one shall form a quorum of Assembly members necessary to be present at all sittings of the committee;*
> 3. *That joint standing order number six be so far suspended as to enable the chairman to vote on every question, but when the votes are equal the chairman shall also have a casting vote; and (House of Assembly only)*
> 4. *That a message be sent to the Legislative Council transmitting the foregoing resolution and questioning* [sic] *its concurrence thereto.*

In addition, a number of meetings were held between Audit and the ERSU. At these meetings, and in subsequent written responses, information concerning the disposal process for ETSA Utilities and ETSA Power was provided to Audit. This information was relied upon by me to form opinions about issues identified through the review.

As a result of the above process, Audit provided a draft of the issues to the ERSU for comment. The comments received from the ERSU were considered in formulating the observations and recommendations included in this Report.

1.1.6 Structure of this Report

This Report comprises an introductory Part followed by four other Parts.

Part 2 discusses my review of the bidding process for ETSA Power and ETSA Utilities.

Part 3 discusses my review of the arrangements for information gathering and dissemination in relation to the disposal process for ETSA Power and ETSA Utilities.

Part 4 discusses my review of the final bid process for ETSA Power and ETSA Utilities.

Part 5 discusses my review of the Project Documentation prepared for the disposal of ETSA Power and ETSA Utilities.

1.2 STATEMENT OF GENERAL PRINCIPLES CONCERNING PROCEDURES OF GOVERNMENT

1.2.1 Duty to Act Fairly

Over the past decade in Australia there has been an increasing trend towards commercialising and privatising government-owned businesses, and for governments at all levels to contract out, or outsource, functions and services previously undertaken or provided by them.[10] This trend has resulted in governments being involved in conducting competitive tender and other competitive bidding processes at a more sophisticated level than has occurred previously, whilst, at the same time, engaging with many people who have not hitherto contracted or dealt with government in a commercial situation.

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[10] A government commercialises an activity by performing the activity on a commercial basis, ie creating a separate entity or a business unit to perform the activity that keeps accounts of the costs and revenue involved in performing the activity and attempts to operate with a view to profit. Privatisation occurs when the Government entity performing the activity passes into private ownership, either wholly or in part and the private owner is able, on a commercial basis to perform the activity formerly performed by government. In a privatisation the Government retains no responsibility for performing the activity. Outsourcing occurs when the Government, having a responsibility to continue performing an activity contracts another person to perform the activity on the Government's behalf.

The discretionary nature by which the executive power is exercised by government means that it has the potential to favourably or adversely affect the property, rights, or legitimate expectations of others. The position of public bodies in the context of administrative law responsibilities has been succinctly stated by Bradley Selway, QC as follows:

> *(a) Bodies that exercise public functions, whatever the source of those functions, are subject to administrative law.*
>
> *(b) There are three elements of the rules of administrative law; illegality, irrationality and procedural impropriety (or natural justice).*
>
> *(c) A decision made in breach of the rules of administrative law is probably invalid, although may be not for all purposes.*[11]

Public tendering of government contracts, particularly for the sale of government-owned businesses, has become commonplace in the Australia of the 1990s. In this new environment in which government and the private sector find themselves the concept of procedural fairness, when conducting tender and other competitive bidding processes, has been brought into sharp focus as recent cases in Australia have demonstrated.[12]

Since 1967 in the United Kingdom[13] and since 1985 in Australia,[14] the expression 'natural justice' has been used interchangeably with the expression 'duty to act fairly' or, particularly in Australia, 'procedural fairness'.

It has also been stated that the rules of natural justice or, to use the more recent terminology, 'procedural fairness', apply in situations where a public authority conducts a competitive bidding process. The fundamental principle is one of fairness, the denial of which lies at the heart of procedural impropriety.[15]

There are three distinct ways in which this issue impacts upon the disposal process. Firstly, pursuant to the provisions of the *Electricity Corporations (Restructuring and Disposal) Act 1998*, Parliament has, in my view, established a statutory scheme to govern the disposal of this State's electricity assets. The exercise of a discretion by the Treasurer to act in a manner which is 'unfair' and contrary to the legitimate expectations of potential bidders, is, in the absence of express statutory authority, judicially reviewable.

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11 B Selway, QC; 'The Constitution of South Australia' (1997) (Federation Press) p. 235.

12 *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1 and *William Grange Pty Ltd v Yarra City Council* (1997) SC Vic 7427/97.

13 Re HK (An Infant) (1967) 2 QB 617; (1967) 1 All ER 226.

14 *Kioa v West* (1985) 159 CLR 550; sub nom *Kioa v Minister for Immigration and Ethnic Affairs* (1985) 62 ALR 321.

15 Procedural impropriety has been described by Lord Scarman (formerly Lord of Appeal in Ordinary and first Chairman of the Law Commission of the United Kingdom) as 'a humdrum modernism for breach of natural justice'. 'The Development of Administrative Law: Obstacles and Opportunities' (1990) Public Law 490.

Secondly, even if it could be argued that there is not an express statutory disposal regime for this State's electricity assets, the sale involves the exercise of the Government's prerogative[16] power. To the extent that the exercise of that power may override the legitimate expectations of bidders, it may also be judicially reviewable.

Thirdly, although the ERSU has sought to adopt a process contract to govern the disposal process, the terms of the contract are in my opinion unclear as there is a tension or inconsistency between the Treasurer's reserved rights, the ERSU's claim that the process may not in all circumstances be fair, and the Treasurer's own statements to the effect that procedural fairness would be provided. Accordingly, it is, in my view strongly arguable that bidders in the disposal process would have had a legitimate expectation that they would be treated fairly and that there is an implied term, as a matter of law, to this effect which can be read into the process contract.

1.2.2 Legitimate Expectations

Since 1969 a 'legitimate expectation' has also been recognised as an interest that is protected by procedural fairness. A legitimate expectation is something short of a legal right, namely a reasonable expectation that a legal right or liberty will be obtained, or renewed, or will not be unfairly withdrawn without a hearing.

In *Attorney-General of Hong Kong v Ng Yuen-Shiu*, Lord Fraser explained 'legitimate expectations' as justifiably arising on the footing that:

> *When a public authority has promised to follow a certain procedure, it is in the interests of good administration that it should act fairly and should implement its promise, so long as implementation does not interfere with its statutory duty.*[17]

In *Kioa v West*,[18] a case involving an attempt to deport illegal immigrants, Brennan J (as he then was), in reviewing the general principles of law which applied, addressed the treatment of 'legitimate expectations' which he said was a relevant description of the almost infinite variety of interests which are protected by the principles of natural justice. In the course of delivering his judgement, in which his Honour traced the judicial evolution of the concept of legitimate expectations and implied natural justice, he observed as follows:

> *There are interests beyond legal rights that the legislature is presumed to intend to protect by the principles of natural justice. It is hardly to be thought that a modern legislature when it creates regimes for the regulation of social interest — licensing and permit systems, means of securing opportunities for*

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16 The term 'prerogative' is used in this context in a broad sense to encompass not only those powers that are exclusive to the Crown but also those things that it may do in common with its subjects.

17 (1983) 2 All ER at 350.

18 (1985) 159 CLR 550; 62 ALR 321.

> *acquiring legal rights, schemes for the provision of privileges and benefits at the discretion of Ministers or public officials — intends that the interests of individuals which do not amount to legal rights but which are affected by the myriad and complex powers conferred on the bureaucracy should be accorded less protection than legal rights. The protected interests which do not amount to legal rights are nowadays frequently described as 'legitimate expectations'. This seed, which Lord Denning MR planted in* Schmidt v Secretary of State for Home Affairs *[1969] 2 Ch 149 at 170, has grown luxuriantly in the literature of administrative law.*
>
> *...*
>
> *Whatever epithet is used, the importance of the term [legitimate expectations] is that it connotes an interest, not necessarily amounting to a legal right, which is accorded a measure of protection.*[19]
>
> *...*
>
> *A 'legitimate expectation' cannot arise unless an exercise of the power is capable of affecting for good or ill, the interests of the person who holds that expectation.*[20]
>
> *...*
>
> *Once individual interests not amounting to legal rights come under the protection afforded by the principles of natural justice, the application of the presumption cannot be made to depend on the character of the interest protected; rather the application of the presumption depends on factors relevant to the individual's right to insist on an appropriate procedure for considering his interest and his standing to seek judicial review if the repository does not adopt such a procedure in exercising the power.*[21]

In that same case Mason J (as he then was) said as follows:

> *The law has now developed to a point where it may be accepted that there is a common law duty to act fairly, in the sense of according procedural fairness, in the making of administrative decisions which affect rights, interests and legitimate expectations ...*[22]

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19 ibid, (CLR) at 616-617.

20 ibid, (CLR) at 618.

21 ibid, (CLR) at 621.

22 ibid, (CLR) at 584; (ALR) at 346.

Procedural impropriety or unfairness may occur, not just by failing to observe the rules of natural justice, but also, for example, in situations where the decision-maker asserts that one set of rules, guidelines or protocols would be observed and then proceeds to disregard them and observe a different set or a variety of sets.

In the matter of the disposal of the electricity assets, the Treasurer has stated that the integrity and fairness of the process are fundamental and that all bidders can expect that the Treasurer (and the ERSU) will adhere to that public undertaking. Even in the absence of that undertaking, in my opinion, neither the ERSU nor the Treasurer may lawfully conduct their decision making processes in a manner that does not accord with the relevant principles of administrative law that apply with respect to the disposal process.

1.2.3 Can a Government, acting pursuant to the Authority Vested in it under the *Electricity Corporations (Restructuring and Disposal) Act 1999*, Contract Out of its Public Law Responsibilities?

It is a basic principle of the common law that where the Parliament has established a statutory arrangement with respect to a particular matter and has not as part of that legislative scheme specifically abrogated the common law rights of members of the community who may be affected by that statutory arrangement, that those common law rights continue to apply for the benefit of those members of the community who may be affected.[23] In my opinion, Parliament has established a statutory scheme to govern this disposal process. Accordingly, in my opinion, in the absence of statutory authority, the Government cannot, as has been suggested by the ERSU, act unfairly, in breach of the legitimate expectations of bidders. This is not, in my view, an obligation which can be contracted out of by the Treasurer.

1.2.4 The Characterisation of a Process as a 'Tender' or as a 'Request for Proposal/Tender'

The principle behind a tender process is that the competing tenderers are each bidding for the same contract (or business) on the same terms and without knowledge of their competitors' bids.

The ERSU has responded that:

> *We agree that the statement of principle is an accurate statement of what is traditionally characterised as a 'tender' or a RFT. However ERSU would argue that it has no relevance to the disposal programme as it is not a tender process. What applies to a tender process may not apply to different processes, such as the disposal programme.*

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[23] D C Pearce and R S Geddes; 'Statutory Interpretation in Australia'; 4th Edition (1996) at paragraph 5.22. These common law rights would include the right to procedural fairness etc. See also in *Kioa v West* (1985) 159 CLR 550; 62 ALR 321 referred to above.

In my opinion, the matter of the characterisation of the process adopted by the ERSU as a 'tender process' or a 'disposal process', is not a relevant consideration with respect to whether or not the public law requirements associated with the application of administrative law principles apply.[24]

In public law, as distinguished from private law, there is no power other than as may be authorised by statute for a person or body exercising public powers pursuant to a Statutory Scheme to enter into any contract or take any action incompatible with the public law requirements regarding the due exercise of those powers. Where the legislature has not authorised a public body or a person exercising public powers to contract out of its/his/her public law responsibilities then such responsibilities, in my opinion, continue to apply for the protection of those members of the community who may be affected.[25]

Even if it were to be accepted, that the arrangements for the sale of this State's electricity assets do not amount to a statutory disposal regime, the disposal process itself involves the exercise of a prerogative power which is in itself, in my view, also reviewable. There is, in my opinion, an overriding obligation upon the Government in both instances to act 'fairly' in terms of dealing with, and making decisions which impact upon, the legitimate expectations of potential bidders. Whilst I recognise that it will nevertheless be necessary to carefully examine the terms of the process contract adopted for the disposal process in order to determine what in fact these legitimate expectations might be, and noting that the approach adopted by the ERSU and its advisers appears to have been directed at limiting these expectations, there is still, in my view, an overriding obligation upon the Government to act with fairness. This obligation does not appear to either be acknowledged or accepted by the ERSU or its advisers. This, in my view, in turn creates a real risk that the disposal process may be conducted in such a way as to potentially expose the State to liability for a breach of this overriding obligation.

1.2.5 Implied Obligation to Act Fairly

In Australia, the potential for legal challenge for a breach of an implied condition to act fairly was most recently addressed in *Hughes Aircraft Systems International v Airservices Australia*.[26]

The *Hughes* case established for the first time in Australia, legal authority for the existence of a 'process contract', that is, a contract existing between the entity conducting the tender process and each tenderer to govern the conduct of that tender process, and that a breach of that process contract can involve damage to the tenderer for which the latter may seek an appropriate remedy at law. The plaintiff in the Hughes case succeeded in an action based

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[24] The advice obtained by the Treasurer from Senior Counsel on 26 November 1999 concurs with this view.

[25] The obligation by government to act fairly is dependent on an analysis of the factual context involved. Where there is an invitation by a government agency to external parties to lodge an 'Expression of Interest' without there being any obligation by the Government to proceed further to deal with the subject matter of that Expression of Interest no obligation of fairness would arise.

[26] (1997) 146 ALR 1.

upon the breach of the terms of the process contract and on a breach of section 52 of the *Trade Practices Act 1974* (the TPA) which prohibits misleading or deceptive conduct by corporations or government agencies that are carrying on a business.

It was held in the *Hughes* case that the terms of the process contract were a combination of the express terms contained in the conditions of tender and two implied terms, one of which was stated to be implied as a matter of law[27] to the effect that the Government entity would exhibit fair dealing in the performance of the process contract. The decision has implications for the conduct of all tender processes, and in particular where the contract to be let involves the expenditure of 'publicly owned' funds.

The *Hughes* case is authority for the proposition that contracts with public bodies are of a special nature. These contracts carry a term implied by law that the public body must deal fairly in performing its obligations under that contract.

The principles established in the *Hughes* case were followed in *Willow Grange Pty Ltd and Anor v Yarra City Council*,[28] where Byrne J found the Yarra City Council, which was conducting a tender process was contractually bound in its performance of the tender process to act fairly to each of its tenderers. Byrne J commented that relevant factors to him forming his view that a contract was established included that the Yarra City Council had a tendering code of practice; the nature of the tender process was such that tenderers were to a very large extent entirely in the hands of the Yarra City Council given the nature of the tender process itself; and that in exercising its powers in the tender process the Yarra City Council was exercising public functions, which 'the public is entitled to expect will be exercised in a proper and honourable way'.

In my view, the terms of the process contract adopted by the ERSU for the disposal process are such as to create a conflict or 'tension' between the Treasurer's reserved rights and a range of other statements in the contract which propose to represent that procedural fairness will be accorded. I am of the opinion that based on the above mentioned authorities, the process contract adopted by the ERSU for the disposal process, has in it an implied term that the Government would exhibit fair dealing in the performance of the process contract. As noted earlier in this Report, the ERSU does not accept this position albeit advice from Senior Counsel obtained by Crown Law is consistent with my view.

1.2.6 Overseas

In addition to the principles expressed in the abovementioned Australian cases, recent decisions from a number of overseas jurisdictions have shed further light on the possible consequences for government agencies that fail to conduct tendering processes in line with the tender rules they have issued.

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[27] (1997) 146 ALR at 38-42.

[28] Supreme Court of Victoria (1 December 1997) SC Vic 7427/97.

1.2.6.1 Privilege Clauses and Implied Terms

A recent Canadian case also examined the issue of the rights reserved to the agency conducting a process to ultimately not accept the lowest priced tender or any other tender (privilege clause) and how this operates with implied obligations to act fairly. In *MJB Enterprises Ltd v Defence Construction*,[29] the issue turned on whether the inclusion of a privilege clause allowed the decision-maker to disregard the lowest bid in favour of any other tender, including a non-compliant one. The Supreme Court of Canada found that the submission of a tender in response to an invitation to tender may give rise to contractual obligations (Contract A) quite apart from the obligations associated with the contract to be entered into upon the acceptance of a tender (Contract B), depending on the intention of the parties. In the circumstances of this case the Court found it appropriate to find an implied obligation that only compliant tenders would be accepted, although this may not necessarily mean the choice of the lowest compliant tender. The privilege clause must be read in harmony with the rest of the tender document and does not override the obligation to accept only compliant bids.

1.2.6.2 Following the Process

In the English decision of *Blackpool and Fylde Aero Club Ltd v Blackpool Borough Council,*[30] the Court of Appeal considered the issue of whether an implied contractual obligation existed on an invitor to consider a tender if it conformed with the conditions of tender. In this case the bid had actually been submitted before the closing time but marked late due to the failure of council staff to check the letter box. The Court held that in certain circumstances an invitation to tender could give rise to binding contractual obligations on the part of the invitor to consider tenders which conformed with the conditions of tender. Since the Council's invitation prescribed a clear procedure to be followed it was to be implied that if an invitee submitted a conforming tender before the deadline there was an entitlement as a matter of contractual right to have the tender opened and considered.

1.2.7 Summary

Public tendering by government departments and agencies is something that necessarily and justifiably attracts or implies the notion of procedural fairness in its exercise. It is a particularly important issue for government which is publicly accountable for all its actions and decisions. Ultimately, of course, the responsible Minister of State is politically (and, ipso facto, publicly) accountable for decisions made by officers of his or her department and statutory authorities for which the Minister is responsible. Procedural regularity is also important for a government in that it must at all times adopt high standards and principles in the conduct of its commercial dealings. Government must, by its example, present itself as a model for others in the market place to emulate ie there are 'moral exemplar' expectations and requirements placed upon a government.

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[29] (1999) 1 SCR 619.

[30] (1990) 3 All ER 25.

Against this background, natural justice or procedural fairness has increasingly become one of the hallmarks of the Australian and other common law countries' administrative law systems.

A quote from the then Chief Justice of South Australia, the Honourable L J King taken from a speech in 1980 titled 'The Role of the Judiciary in relation to Public Administration'[31] summarises the position well:

> *The citizen is entitled to a fair deal at the hands of the administration, that is to say, to natural justice. ... A denial of natural justice occurs when there is a departure from the standards of fairness which are appropriate in the circumstances.*

Audit Recommendation 1

I recommend that the Government consider obtaining clear and definitive advice concerning its obligations to accord potential bidders procedural fairness during the conduct of future asset disposals. This advice should consider specifically the obligations upon the Government to act fairly in respect of its dealings with bidders; (a) in the context of there being a statutory scheme for the disposal of this State's assets and (b) in the event that a statutory scheme is found not to exist, in the context of the Government's exercising its prerogative powers to effect the asset disposal.

I further recommend that this advice also consider the extent to which the Government can, through the adoption of a 'process contract', limit and potentially disclaim its obligations to provide procedural fairness to bidders.

Finally, I recommend that this advice be obtained as a matter of urgency from a public law expert in this area. (Advice has been obtained - See Appendix).

ERSU Response

A copy of the advice obtained by the Government is included in this Report as an Appendix.

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31 Australian Journal of Public Administration 39(1) March 1980 at pp. 1-17.

PART 2
ARRANGEMENTS FOR THE CONDUCT OF THE BIDDING PROCESS

2.1 OVERVIEW OF THE BIDDING PROCESS

2.1.1 Key Steps of the Bidding Process

The bidding process effectively commenced with the placement of an advertisement in national newspapers[32] in which the Treasurer invited EOIs for ETSA Utilities and ETSA Power.

An overview of the disposal process was set out in a recent Supplementary Report.[33] The key steps undertaken by the ERSU in conducting the bidding process for ETSA Utilities and ETSA Power are as follows:

- Advertisement calling for EOIs was published (June 1999).
- Roadshow conducted (July 1999).
- Receipt of EOIs in response to advertisement (July, August and September 1999).
- Evaluation of EOIs and pre-qualification[34] of parties (as received).
- Execution of Confidentiality Agreements by pre-qualified parties (commencing in July 1999).
- Issue of the Bidding Rules to those parties who were pre-qualified. The parties were required to indicate acceptance of the Bidding Rules in order to proceed to the Indicative Bid stage.
- Release of Confidential Information. The following documents were released to the parties:

    — Lease and Explanatory Memorandum (August 1999) — This document provides an indication of the State's position as to the form, structure and key provisions of any lease relating to the prescribed electricity assets used in the distribution business;

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32 The Australian and The Australian Financial Review.

33 Supplementary Report of the Auditor-General 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Probity Audit and Other Matters: Some Audit Observations' - 28 October 1999 p. 13.

34 To pre-qualify parties were required to demonstrate financial capability and operational or investment experience.

- Tripartite Agreement (August 1999) — The Tripartite Agreement for financiers is intended to set out a framework of rights and obligations between the State of South Australia, the successful bidder and their financier. An agreement of this nature usually covers matters such as the procedure to be followed in the event the financier wishes to foreclose and to prevent disruption to electricity supply as a result, and places obligations on the State to notify the financiers in the event it wishes to exercise certain rights, such as termination of the leases;

- Draft Electricity Pricing Order (August 1999) — This document regulates the pricing of certain transmission, distribution and retail services within the South Australian electricity industry;

- Information Memorandum (August 1999) — This document includes information specific to the businesses being offered for disposal;

- Security Options Paper (September 1999) — This document discusses some of the options which may be available to bidders to provide security for rent and other obligations under a lease of the electricity distribution network;

- Draft Sale Agreement (October 1999) — This document represents a draft of the agreement for the disposal of ETSA Utilities and ETSA Power.

- Issue of Supplementary Bidding Rules (Data Room Access) (September 1999).
- Preliminary meetings with bidders (August 1999).
- Indicative Bids lodged (24 September 1999).
- Data room access commenced (October 1999).
- Release of tailored versions of Project Agreements[35] (November 1999).
- Receipt of bidders formal comments on Project Agreements (November 1999).
- Further meetings with bidders to discuss Project Agreements (November 1999).
- Release of Supplementary Bidding Rules (26 November 1999).
- Release of Benchmark Project Agreements (26 November 1999).
- Meetings with bidders to discuss Benchmark Project Agreements (30 November 1999).
- Release of further set of Benchmark Project Agreements (2 December 1999).
- Receipt of Final Bids (6 December 1999).

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[35] The Project Agreements set out the terms for the disposal of ETSA Utilities and ETSA Power.

2.1.2 Key Documents of the Bidding Process

Throughout the disposal arrangements the bidding process has been managed by the ERSU and its advisers. A number of protocols/rules/procedures have been adopted by the ERSU to govern these arrangements. These protocols/rules/procedures have been incorporated in the following documents:

(a) Roadshow protocols
(b) EOI protocols
(c) Probity Rules
(d) Supplementary Probity Rules (Public Sector Employees)
(e) Supplementary Probity Rules (Internal) issued August 1999
(f) Further Supplementary Probity Rules (Internal) issued early December 1999
(g) Bidding Rules
(h) Supplementary Bidding Rules (Data Room Access)
(i) Supplementary Bidding Rules issued on 26 November 1999.

In my opinion, all of the abovementioned protocols/rules/procedures may be capable of discovery by proper legal process. For this reason it is important that they not only be drafted in terms that are capable of being understood by all persons to whom they apply, but also, that the management of the disposal process by the ERSU ensures compliance.

For the purposes of analysis in this Part of this Report, issues associated with the bidding process documents have been examined under the headings:

- 2.2 — Preliminary Procedures - items (a) and (b) above;
- 2.3 — Probity Arrangements for Government Employees and Consultants - items (c), (d), (e) and (f) above;
- 2.4 — Bidding Rules - items (g), (h) and (i) above.

2.2 PRELIMINARY PROCEDURES

The following describes, and comments on, the key documents associated with the roadshow marketing of the disposal of ETSA Utilities and ETSA Power, and the subsequent processing of the EOIs received.

2.2.1 Roadshow Protocols

The Roadshow Protocols were developed:

...

- *to ensure that members of the Government party do not, and are not perceived to, obtain any improper advantage (actual or preferred) for themselves, their families or associates;*

- *to ensure that potential bidders do not, and are not perceived to, obtain any improper advantage over other bidders.*[36]

The ERSU has advised that the Roadshow Protocols were not issued to potential bidders as they were designed to provide guidance to the officers of the ERSU and their advisers in relation to the participation by both of those parties in the roadshow presentations.

The Protocols deal with:

- the use of government provided services and property
- entertainment
- gifts and other benefits
- disclosure of information.

Clause 4 of the Roadshow Protocols states that 'Information must be released only in accordance with the principles outlined in the Probity Rules'. As noted hereunder, the Probity Rules, as at the date of the first roadshow presentation on 12 July 1999, had not been formally endorsed by the Treasurer.

Audit Comment

There are two issues that, in my opinion, arise from the Roadshow Protocols.

(a) Timing of Document Approval

I note that the Probity Auditor provided comments on the draft Probity Rules in a letter to the ERSU dated 28 July 1999. The Treasurer did not formally approve the Probity Rules until 10 September 1999, ie approximately two months after the completion of the first of the roadshow presentations.

I am of the opinion that regularity in the procedural arrangements in governmental process requires that all antecedent steps relevant to a particular process should be completed before the commencement of that process. As a result, the Probity Rules should have been finalised and approved prior to the commencement of any of the roadshow presentations.

(b) Documentation of Roadshow Communications

The Roadshow Protocols do not deal with the matter of recording information such as representations made to, or questions asked by, potential bidders at roadshow presentations.

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[36] Roadshow Protocols issued by the ERSU.

With respect to this matter the ERSU has responded that:

> *The recording of communications with Bidders, including those to whom Roadshow presentations were made, was covered by the Probity Rules themselves. Clause 5.1.3 requires 'records (sufficient to enable audit) of all communications with Bidders (whether in person, or by telephone, correspondence or otherwise) to be maintained'.*

Following a request by Audit to the ERSU for a copy of communications with potential bidders at the roadshow presentations, Audit has been provided with access to handwritten notes of the discussions with bidders that took place during those presentations. These notes, in the form in which they are maintained, do not allow for auditability of representations made at that time. This is because they do not clearly disclose attribution as to who asked questions/made representations and are only capable of being understood by the persons who made the notes.

Representations made at, or, during a roadshow presentation, are important in that a bidder may place reliance on those representations. If those representations are not honoured, adverse legal consequences can result for the Government.

I am of the opinion that the notes of discussions with bidders at the roadshow presentations need to be transcribed into a formal record of those communications in a manner that permits auditability.

One method of ensuring the completeness of matters associated with roadshow presentations and communications with potential bidders is to arrange for the transcription or video recording of these meetings.

Audit suggested this to the ERSU on Audit becoming aware that the arrangements that had been implemented were inadequate.

ERSU Response

> *Taping or other transcripting of these meetings was not considered necessary. The same presentation ... was provided to each interested party, and questions generally related to the nature of the business and the timetable. It was clear from the circumstances that further information to parties ... would be provided through the Information Memorandum in the period prior to the Indicative Bids.*

Notwithstanding the ERSU's response, I am of the opinion that in matters of the significance of the electricity businesses disposal process there is no room for any potential ambiguity that can give rise to later contention and the possibility of legal challenge. Therefore the formal documentation of all communications with bidders is essential.

Audit Recommendation 2

I recommend the Probity Rules for future asset disposals explicitly describe the manner in which the discussions at the roadshow presentations are to be documented as a formal record of the communications with potential bidders.

I also recommend that roadshow presentations should not be conducted until the Probity Rules intended to cover such presentations have in fact been formally adopted.

2.2.2 EOI Protocols

The EOI Protocols comprise six protocols dealing with:

- the opening and recording of EOIs
- security of EOI documents
- responses to EOIs lodged
- use of proforma letters.

In essence, the EOI protocols prescribe the procedures that the ERSU officers are to adopt in receiving and acknowledging EOIs.

There is no Audit issue that has arisen from these protocols.

2.3 PROBITY ARRANGEMENTS FOR GOVERNMENT EMPLOYEES AND CONSULTANTS

The probity rules (which include supplementary probity rules) set out the principles to be followed by those participating in the disposal process. The principles are designed to ensure that the bidding arrangements, through to completion of the acquisition by the successful bidder, are conducted, and are seen to be conducted, in a fair and impartial manner and with the utmost integrity.

2.3.1 Probity Rules

2.3.1.1 Introduction

The Probity Rules are contained in an instrument titled 'Probity Rules as to South Australian Government's Lease Disposal Program for ETSA Utilities and ETSA Power'.

Drafting of the Probity Rules commenced in June 1999. The Treasurer noted the Probity Rules on 10 July 1999, before these Rules were provided to the Probity Auditor for

comment. The Probity Auditor provided comments on 28 July 1999. The Treasurer formally approved[37] the Probity Rules on 10 September 1999.

2.3.1.2 Application of Probity Rules

The Probity Rules were applicable to those within government and to those appointed as advisers to government. The content of the Probity Rules was not, per se, advised to bidders save that, inter alia, there are some matters in the Probity Rules that are replicated in the Bidding Rules. These matters that are replicated[38] in the Bidding Rules provide an understanding for bidders of the fundamental principles, and the conduct expected of bidders, that will apply in the evaluation of bids by the Government.

The Probity Rules are expressed to be relevant to the Government's relationship with bidders in two ways:

- They are intended to outline the way in which bidders are to be treated by government participants (eg the ERSU and its advisers). These are referred to as Internal Rules.
- Bidders may also be required to '... be bound by certain rules (for example, that bidders keep confidential any information supplied to them by the Treasurer as part of the bidding process)'.[39] These are referred to as External Rules.

Audit Comment

The use of the phrase 'External Rules' is confusing in the context of a document that as drafted, only has application internally within government and to its advisers. The extent to which any of the Probity Rules will become applicable to external parties ie bidders, will be subject to a determination by the Treasurer to be evidenced by way of '... confidentiality agreement, process contract or otherwise'.[40]

The Treasurer has no executive authority to extend the application of the Probity Rules to parties external to government, otherwise than as may be agreed by such persons.

The drafting of the Probity Rules, in my opinion, is confusing as the text in practice needs to be consistent as it does not discern between the concepts of Internal/External Rules. If the Rules contain a section headed 'External Rules' when in fact these rules relate to internal matters then the use of the term 'External' in this context is confusing and misleading. The current Probity Rules in practice are applicable only to the internal arrangements of government.[41]

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37 Minute to the Treasurer from the ERSU dated 10 September 1999.

38 For example that Bidders keep confidential any information supplied to them by the Treasurer.

39 Clause 2.4 of the Probity Rules.

40 ibid.

41 Clauses 2.1, 2.2 and 2.3 of the Probity Rules.

Audit Recommendation 3

I recommend that for future asset disposals the Probity Rules be simplified and that the concept of Internal/External rules not be used.

2.3.1.3 Documentation of Communication with Bidders

The Probity Rules provide that government participants, who include advisers to the Government, must keep file records of all communications with bidders that are sufficient to enable an audit to be undertaken. There is, however, no general requirement for the maintenance of complete written records of:

- decisions made during the disposal process including evaluation decisions;
- advice provided by advisers to the Government;
- recommendations/advice to the Treasurer;
- meetings, including the various committee meetings;
- communications with advisers and with the probity auditor.

Audit Comment

In an environment where a significant number of committees have been established, with a wide range of expertise available to address various issues, I consider that it is important that the contributions of individual experts be documented at the time that the advice is given. In circumstances where this does not occur, individual accountability is diluted through decisions being attributed to the committee as a whole.

Without a complete and timely record of all advice provided, there is no clear audit trail. Further, where there is inadequate documentation, it is not possible to attribute responsibility in the event of the State incurring liability through placing reliance upon the advice received.

ERSU Response

> *Whilst there is no statement that written records by ERSU and others must be maintained as to various matters, the records are maintained.*
>
> *This includes minutes of committee meetings, advice to ERSU from the advisers, and records recommendations to, and decisions of the Treasurer, not only in relation to the regular weekly meeting but on specific matters.*

Further Audit Comment

In relation to the ERSU response, I note that a number of documents were created and provided to Audit in the period 17 to 19 November 1999 as written summaries of advice previously received. Such an approach would not have been necessary if complete written records of advice had been created contemporaneously with the provision of that advice.

Audit Recommendation 4

I recommend that for future asset disposals the Probity Rules require that supporting documentation be created contemporaneously for all advice received.

2.3.2 Supplementary Probity Rules (Public Sector Employees)

The Supplementary Probity Rules (Public Sector Employees) were finalised in August 1999. The purpose of these Rules is to provide guidance to employees, including contract employees of the ERSU, and other public sector employees involved in the disposal process. In particular, these Rules deal with the duties of public sector employees in relation to confidentiality and conflict of interest issues that may arise in relation to the involvement of those employees in the disposal process.

These Rules are expressed to have effect as a direction given to public sector employees pursuant to the *Public Sector Management Act 1995*.

There is no Audit issue arising from the Supplementary Probity Rules.

2.3.3 Supplementary Probity Rules (Internal) Issued August 1999

The Supplementary Probity Rules (Internal) were finalised on 31 August 1999 and include a section on the establishment of a committee (the Evaluation Committee) and the general approach that Committee will adopt to evaluate Indicative and Final Bids.

Clause 4 of the Supplementary Probity Rules (Internal) provides that the Treasurer will appoint an Evaluation Committee to evaluate the bids in accordance with the principal objectives of the Bidding Rules[42] and such other objectives (if any) identified in writing by the Treasurer to the Evaluation Committee prior to it delivering its recommendations to the Treasurer.

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[42] The Treasurer's principal objectives were:

- to maximise the proceeds available from the disposal to reduce State debt;
- to minimise the State's exposure to the risks of participating in the electricity supply industry following introduction of the National Electricity Market.

The Evaluation Committee is to consider each bid in an equivalent manner by:

- identifying those for which there exists, in terms of the Bidding Rules, grounds for rejection without further consideration;
- identifying those bids that, in a material way, fail to include the information requested of bidders in the Bidding Rules and are to be excluded from further consideration;
- ranking the remainder of the bids in order of desirability and identify the basis of that ranking.

The Evaluation Committee is required to minute, with reasons, the ranking of the bids with sufficient information, and keep minutes sufficient to enable audit and process review functions to be carried out.

The Supplementary Probity Rules (Internal) also cover the way in which the bids are to be opened and secured.

Comments relating to issues arising from the conduct of the Indicative Bid stage of the disposal process are included under the heading '2.6 — Issues Arising from the Evaluation of Indicative Bids' in this Report.

2.3.4 Further Supplementary Probity Rules (Internal) Issued December 1999

The Supplementary Probity Rules (Internal) issued December 1999 were developed in conjunction with the evaluation methodology for the Final Bid evaluation. The Rules were issued to amend and supplement the Supplementary Probity Rules (Internal) issued August 1999 to reflect the changed composition and duties of the committee established for the evaluation of the Final Bids.

There is no Audit issue that has arisen from these Supplementary Probity Rules (Internal).

2.4 BIDDING RULES

The Bidding Rules (including Supplementary Bidding Rules) represent a contract between the Treasurer and a potential bidder. They are designed to set out the respective rights and obligations of each of the parties to the contract.

2.4.1 Bidding Rules

2.4.1.1 Background

The Bidding Rules were developed to:

...

- *outline the steps involved in the Disposal Programme.*
- *invite each Bidder to lodge Indicative Bids.*

- *specify the requirements for the content and lodgement of Indicative Bids and Final Bids.*
- *indicate the process by which the Shortlisted Bidder(s) and the Successful Bidder(s) will be selected.*[43]

The 'Disposal Programme' is defined in the Bidding Rules as follows:

> *... the process of the Treasurer calling for bids from those wishing to Acquire* [sic] *the business of a Group Company, the conduct of due diligence, the preparation, submission and completion of Bids, the evaluation of Bids by the Treasurer and entry into and completion of the Project Agreements.*[44]

A 'Group Company' referred to in the definition is a reference to ETSA Power Pty Ltd, ETSA Utilities Pty Ltd and ETSA Capital (No 2) Pty Ltd.[45]

Commencing on 13 August 1999, copies of the Bidding Rules were released to parties who were pre-qualified through the EOI process, after they had executed a Confidentiality Deed. Those parties were required to indicate acceptance in writing of the Bidding Rules as a precondition to proceeding to the Indicative Bid stage of the disposal process.

The Bidding Rules state that they do not cover the whole of the 'Disposal Programme' and that it is expected that Supplementary Bidding Rules will be issued by the Treasurer.[46]

The Probity Auditor, as required by his contract, has reported to the Treasurer, in a letter dated 30 November 1999, that the Bidding Rules (including Supplementary Bidding Rules) '... can be expected to satisfy probity requirements'.

In addition to particulars of the 'Disposal Programme', the Bidding Rules contain specific contractual provisions.[47] A discussion on the effect of these provisions follows.

2.4.1.2 Creation of a Process Contract - Documentation to Support Advice

As set out earlier in this Report,[48] it is an increasingly well understood concept that the way in which government procurement and sales processes are conducted can itself give rise to legal challenge. As discussed previously, the *Hughes* case established for the first time in Australia, legal authority for the existence of a process contract, that is, a contract existing

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43 Clause 1.1 of the Bidding Rules.

44 Clause 19 of the Bidding Rules.

45 ibid.

46 Clause 3 of the Bidding Rules.

47 For example clause 17 of the Bidding Rules which contains provisions relating to waiver, merger and governing law.

48 Refer to discussion under the heading '1.2 — Statement of General Principles Concerning Procedures of Government' of this Report.

between the entity conducting the tender process and each tenderer to govern the conduct of that tender process. A breach of that process contract can involve damage to the tenderer.

In my opinion, the approach adopted by the ERSU for the electricity businesses disposal process has been to create a process contract between the Treasurer and each bidder participating in that process. The terms of the process contract are the Bidding Rules.

Audit Comment

As discussed earlier in this Report under the heading '1.2 — Statement of General Principles Concerning Procedures of Government', there are a number of complex legal and public policy issues for a government to consider in adopting a process contract approach.

A disadvantage associated with the adoption of process contracts is the potential for government liability to exist where the terms of the process contract are found to be breached by the Government or where the Government acts 'unfairly' in breach of the legitimate expectations of potential bidders. For this reason, it is very important to ensure that the terms of the process contract are drafted in as clear and unambiguous a manner as possible and that clear advice is provided to government concerning all of the legal issues for government in adopting such an approach. It is also advisable to set out in the process contract the liability regime to apply in the event the contract is breached.[49] For example, it is common for parties to limit their liability under process contracts. This is particularly advisable given that the law on the damages payable in the event of the breach of a process contract has not yet been settled in Australia.[50]

The necessity to put in place robust probity systems to obviate the potential for liability was also dealt with in my previous Supplementary Report.[51]

Given the significance of creating a process contract, Audit would expect that comprehensive written legal advice is available to support the approach adopted.

Initially, Audit was not provided with a copy of any advice canvassing the issues for government in adopting a process contract for the disposal of the electricity assets. In response to a specific request for a copy of such advice, the ERSU advised on 20 October 1999 that:

> *Comments on the first (and subsequent) drafts of the Bidding Rules and the Process Agreement were received by a combination of formal and informal*

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49 In this regard the later discussion of what liability regime was included is set out in this Report under the heading '2.4.1.5 — Liability'.

50 This is because in the *Hughes* case only liability was decided. A further hearing as to the type and quantum of damages payable as a result was to be held at a later date, unless the parties were able to reach a settlement beforehand. It is believed that the parties were able to settle the matter without a further hearing.

51 Supplementary Report of the Auditor-General 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Probity Audit and Other Matters: Some Audit Observations' - 28 October 1999.

meetings, telephone conversation and emails. Those comments were reflected in subsequent drafts of the Bidding Rules and the Process Agreement as issued over the weeks following the issue of the first drafts. Progress was noted in the minutes of subsequent Probity Committee meetings.

Notes of the discussions of the Senior Advisers Group concerning the development of the Bidding Rules and the Process Agreement are reflected in the Minutes of that Group.

Audit has reviewed the relevant Probity Committee and Senior Advisers Group meeting minutes. Based on this review and the ERSU's response, as noted above, I remain of the view that it is not apparent that there is any clear evidentiary trail which outlines in detail the advice provided to the Government concerning the adoption of the process contract approach.

Subsequently, the ERSU provided a copy of a legal advice from the Legal Consortium with their response to the draft of this Part of the Report. That advice, dated 17 November 1999, purported to be a summary of advice previously provided on the adoption of a process contract. The ERSU have confirmed that no written legal advice as to the legal consequences of adopting a process contract was created or requested at the time the process contract was entered into by the Treasurer.

The need for adequate and timely documentation of all advice received by the Government was discussed previously in this Report under the heading '2.3 — Probity Arrangements for Government Employees and Consultants'.

2.4.1.3 Implications of a Process Contract

Given the decision in the *Hughes* case, and the specific adoption of a process contract for the disposal process, an implied term of that process contract is that there is an obligation upon the ERSU/the Treasurer to exhibit fair dealing in the performance of that contract, ie in the assessment/evaluation of bids received.

Audit Comment

Audit considers that the process contract contains statements that could lead a bidder to believe the Treasurer would exhibit fair dealing in the performance of the process contract. In particular, clause 1.4 of the Bidding Rules states that 'The Treasurer wants the Disposal Programme to be conducted and seen to be conducted in a fair and impartial manner and with the utmost integrity'.

In its response to the initial draft of this Part of the Report, the ERSU commented:

In the present process contract, there is an express term that the only obligation and liabilities of the Treasurer 'are as set out in the Bidding Rules' (Bidding Rule 15.1). There is no explicit promise that the process, in all circumstances, will be fair. Consequently we contend that it is open to a

Court to make a finding that a term as to fairness of process would not be implied.

We accept that the Auditor-General may have a different view on this issue.

Further Audit Comment

I note the response of the ERSU referred to above.[52] It is my opinion that this particular approach is clearly inconsistent with public policy requirements that the processes of government must comply with administrative law requirements of according fairness to all parties.

With respect to the relationship with bidders regarding the disposal of the electricity assets the Treasurer expressly stated that he wants the disposal process to be conducted in a fair and impartial manner and with the utmost integrity. To suggest that the Treasurer would be free to exercise any discretionary powers vested in him under the Bidding Rules in a manner that was inconsistent with bidders legitimate expectations or his earlier undertaking regarding the integrity and fairness of the process is to seriously misunderstand the responsibility of government according to established principles of administrative law.

Any such approach to the administrative arrangements under the Bidding Rules as suggested by the ERSU would, in my opinion, give rise to a right by a disappointed bidder to seek redress in the Courts.

Further, I note that legal advice received by the State concurs with my view.[53]

Although it may be argued that the arrangements so far made do not support a pre award process contract, I would consider it probable that the requirement that prospective bidders accept the Bidding rules and sign confidentiality agreements brings into being a process contract and imposes an obligation on the prospective seller of good faith and fair dealing. That result can be reached by employing a number of arguments as to it being an express term of such a contract, or by implying an ad hoc term, or by implication of law.

2.4.1.4 Treasurer's Discretions Under the Bidding Rules

Following on from the decision in the *Hughes* case, a fundamental principle governing the development and application of Bidding Rules such as those written for the disposal process, is the need to ensure that all the bidders are treated in a equal and fair way, and that the procedures laid down for the evaluation and selection of bids are scrupulously followed.

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[52] Refer to comments earlier in this Report under the heading '1.1.3.1 — Obligation for Procedural Fairness'.

[53] Advice to the Treasurer from Senior Counsel dated 26 November 1999.

Under the Bidding Rules, the discretions available to the Treasurer include:

- clauses 7.4, 13.4 and 14.1e: The Treasurer may evaluate bids having regard to the matters listed in clauses 7.1 (Government objectives) to 7.3 (State Development initiatives) and such other matters as the Treasurer, in his sole and absolute discretion, regards as relevant;
- clause 8: The Treasurer will not provide feedback to unsuccessful bidders as to why they were not shortlisted;
- clause 13.6: Further and Final Bids may be sought from some bidders in the Treasurer's discretion;
- clause 14.1a: The Treasurer may cancel the disposal programme at any time by notice in writing;
- clause 14.1b: The Treasurer may provide to all bidders any further information provided to a particular bidder;
- clause 14.1c: The Treasurer may extend bid closing dates;
- clause 14.1eii: Bidders may be requested to amend their bids in the Treasurer's discretion;
- clause 14.1f: The Treasurer may in his discretion invite a person who is not already a bidder to submit a bid at any time;
- clause 14.1g: The Treasurer may decide to enter into further negotiations with any persons whether or not they submitted a bid;
- clause 14.1h: The Treasurer may agree to confidentiality deeds with bidders that are not identical in their terms with those entered into with other bidders;
- clauses 14.1i and 14.1j: The Treasurer may exclude persons and bidders for a number of reasons listed in both clauses;
- clause 15.4: The Treasurer is not obliged to provide evidence to any person of procedural fairness in the evaluation or other aspects of the disposal programme;
- clause 17.4: The Treasurer reserves the right not to answer any question asked by a bidder.

Notwithstanding these discretions, bidders were advised at clauses 1.4 and 18 of the Bidding Rules that the Treasurer wants the bidding process to be conducted in a fair and impartial manner with the utmost integrity and that bidders can expect of the Treasurer that:

- criteria applied will be designed to meet the Treasurer's principal objectives set out in the Bidding Rules;
- those criteria will be applied consistently to all bids and bidders;
- the exercise of discretions will be consistent between bids and bidders.

- bidders were advised that a probity auditor had been appointed whose role was to ensure certain things, including that:
- the bidding process as it affects bidders is fair and fairly managed;
- bidders are afforded equal opportunity to participate;
- the bidding process is transparent;
- bidders have equal access to relevant information;
- decision making is consistent with administrative law principles;
- evaluation criteria and methodology are applied in a consistent manner between bidders.

These clauses effectively cover the manner in which the bidding process was to be conducted in terms of administrative and probity considerations.

Audit Comment

In my opinion there is a tension or conflict between some of the reserved rights of the Treasurer and the obligation to act in a fair and transparent manner. Such a conflict also potentially means uncertainty may arise for bidders.

Any tension or conflict between the reserved rights of the Treasurer and the obligation to act in a fair and transparent manner raises the question of whether individual bidders can understand what process will be adhered to and whether that process will be transparent, fair, and accord with administrative law principles.

The more bidders are left uncertain as to how the evaluation process will be carried out, the more potential there also is for dispute to arise.

The inclusion of discretionary or reserved rights is not in itself a cause for concern - the reservation of such rights are relatively common in these types of contractual arrangements and have been used successfully in past asset sales. It is the coexistence of the reserved rights, along with the detail provided on ensuring procedural fairness in the Bidding Rules, that creates ambiguity.

In addition, any ambiguity will impact on the role of the Probity Auditor. The Probity Auditor's primary role is to determine whether the bidding process is transparent. It is arguable that this may be at odds, for example, with the Treasurer's reserved rights to have regard in the evaluation process to matters not otherwise stated in the Bidding Rules in his sole discretion, or to refuse to provide feedback or to answer questions.

In my opinion considerable care will need to be exercised by the Treasurer when exercising any of the reserved rights available to him under the Bidding Rules.

ERSU Response

> *In considering the exercise of a discretion it will be necessary for an exercise to be on a sound basis and this is likely to require legal advice. There is no difference of view on this point.*

2.4.1.5 Liability

The Treasurer's liability to bidders is dealt with in the Bidding Rules in the following manner:

- clause 15.1: The Treasurer is stated to have the obligations and liabilities set out in the Bidding Rules;
- clause 15.2: All other liability is excluded;
- clause 16.1(d): Liability for the costs, expenses and liabilities incurred in preparing the bid is specifically excluded.

As a result of these clauses, any examination of the potential scope of liability must take into account the entirety of the Bidding Rules. The Bidding Rules make it clear that bidders are to rely on their own enquiries and no warranties or representations are made as to the accuracy of the information supplied.[54]

Audit Comment

The requirement that bidders are to rely on their own enquiries must be balanced, however, with the expectation of bidders that there will be probity and fairness in relation to the conduct of the bid process. Given this expectation by bidders, Audit indicated to the ERSU that it would have been prudent for the Bidding Rules to expressly exclude liability for loss of bargain or loss of profit which might be claimed in the event a bidder was excluded in breach of the terms of the process contract.

With respect to this matter the ERSU have advised that:

> *... to provide further clarity, it is proposed that the Supplementary Bidding Rules amend clause 16.1 to make explicit reference to exclusion of liability for loss of bargain and loss of profit.*

I note that the Supplementary Bidding Rules approved by the Treasurer and issued on 26 November 1999 incorporate an exclusion for the abovementioned liabilities.

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[54] Clause 16 of the Bidding Rules.

2.4.1.6 Indicative Bids

The Bidding Rules[55] specify that Indicative Bids should contain the information and confirmations in the order and under the headings as set out in Annexure A to the Bidding Rules. Further, the Bidding Rules state that the Treasurer will evaluate Indicative Bids on the basis of the information provided by the bidders, the Treasurer's own investigations, and having regard to the matters listed in clauses 7.1 to 7.3 of the Bidding Rules, such other matters as the Treasurer, in his sole and absolute discretion, regards as relevant.[56]

The matters listed in Bidding Rules 7.1 to 7.3 together with such other matters considered relevant form the criteria on which the Indicative Bids will be evaluated as notified to the bidders. The matters are:

- the Treasurer's principal objectives being:
  - to maximise the proceeds available from the disposal to reduce State debt;
  - to minimise the State's exposure to the risks of participating in the electricity supply industry following introduction of the National Electricity Market.
- the way in which the Treasurer intends to achieve the principal objectives, expressed as:
  - maximising the proceeds available from the disposal while minimising the risks that the bidder will be unable to effect financial close or otherwise perform its obligations;
  - ensuring the Indicative and Final bids are received and evaluated in a timely manner and that negotiation of Project Agreements proceed without undue delay and on terms most favourable to the State;
  - endeavouring to ensure the disposal for the electricity business is on terms consistent with section 17 of the Disposal Act.
- State Development initiatives; however, the Bidding Rules note that it is unlikely that this will be significant other than at the time of evaluating any Final Bids that are materially the same.

Annexure A to the Bidding Rules sets out the information and confirmations required for each Indicative Bid. These requirements may be summarised as follows:

- Details of the bidder — including copies of annual accounts and lists of advisers.

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55 Clause 6.4 of the Bidding Rules.

56 Clause 7.4 of the Bidding Rules.

- Acquisition structure — whether it is to be by shares or transfer of lease, granting of new lease.
- Indicative consideration — to include net present value of rent for leased assets and the consideration for assets or shares to be purchased.
- Details of funding for acquisition.
- Release of external financiers to allow them to finance another bidder.
- Project agreements — identifying issues and possible non-compliances.
- Relevant experience.
- Approvals and authorisations — what is required internally and externally and what has already been obtained.
- Conditions likely to be attached to Final Bids.
- State Development initiatives.

Comments relating to issues arising from the conduct of the Indicative Bid stage of the disposal process are included in this Report under the heading '2.6 — Issues Arising from the Evaluation of Indicative Bids'.

2.4.1.7 Final Bids

The Bidding Rules specified[57] that Final Bids were to be evaluated on the basis of the same objectives that applied to Indicative Bids. However, the evaluation at the Final Bid stage was expected to:

- test in greater detail the assessment made at the Indicative Bid stage;
- assess the extent to which bidders are committed and willing to devote resources to successfully complete the acquisition on terms consistent with section 17 of the Disposal Act;
- assess the consideration offered by reference to the amount payable at completion and the net present value of future payments and against the risks retained by the State and inherent in the bidder's preferred Project Agreements (both short term, eg completion risk, and long term eg consequences of the lease not running full term).[58]

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57 Clause 12.4 of the Bidding Rules.

58 Clause 13.1 of the Bidding Rules.

The evaluation may also take into account State Development initiatives in certain circumstances.[59]

Annexure B to the Bidding Rules sets out the information and confirmations required for each Final Bid. These requirements may be summarised as follows:

- Updated information provided in the Indicative Bid.
- Further detail as to the acquisition structure and consideration.
- Evidence of availability of funding.
- Evidence of approvals and authorisations.
- Proposal as to the timing and means of the required superannuation payment.
- A statement that the Final Bid is (other than with respect to the conditions in the bidder's proposed Project Agreements) unconditional and binding on the bidder.

Supplementary Bidding Rules relating to the preparation of Final Bids were issued to bidders on 26 November 1999. Commentary with respect to those Supplementary Bidding Rules is included under the heading '2.4.3 — Supplementary Bidding Rules Issued 26 November 1999' in this Report.

2.4.2 Supplementary Bidding Rules (Data Room Access)

The Supplementary Bidding Rules (Data Room Access) '... supplement, are to be read in conjunction with, the Bidding Rules'.[60] They were prepared in late August 1999 in preparation for the commencement of data room access for shortlisted bidders from 4 October 1999. The Supplementary Bidding Rules (Data Room Access) were released to shortlisted bidders after the Indicative Bid stage was completed.

The purpose of these Supplementary Bidding Rules[61] is to describe the arrangements for allowing shortlisted bidders, namely those who are invited to submit Final Bids, to '... access one of the Data Rooms compiled by the Treasurer for the purposes of the Lease Disposal Programme'.

These Supplementary Bidding Rules cover, in addition to the arrangements for data room access by bidders, the protocols for the bidder question and answer process.[62]

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59 Clause 13.3 of the Bidding Rules.

60 Clause 22 of the Supplementary Bidding Rules.

61 Clause 1 of the Supplementary Bidding Rules (Data Room Access).

62 Clause 12 of the Supplementary Bidding Rules (Data Room Access).

Bidders were required to confirm their acceptance of these Supplementary Bidding Rules to the Treasurer as a precondition to being granted access to a Data room.

These Supplementary Bidding Rules reserve to the Treasurer the following discretions:

- Not to provide a shortlisted bidder with a copy of a requested document.
- As to the manner and extent to which questions are answered.
- Not to answer any question.
- To limit the number of questions a shortlisted bidder may submit.
- To exclude a shortlisted bidder or a shortlisted bidder's representative if the procedures in the Bidding Rules or Supplementary Bidding Rules are not complied with.
- To exclude any person or class of people from the data rooms.

I note that while it is open to the Treasurer to reserve these discretions to himself, it will be necessary to balance the exercise of these discretions with the obligation to treat bidders fairly as required under the process contract regime. The need for care to be exercised by the Treasurer was discussed previously in this Report under the heading '2.4.1.4 — Treasurer's Discretions Under the Bidding Rules'.

2.4.3 Supplementary Bidding Rules Issued 26 November 1999

The Supplementary Bidding Rules, that amend the previously issued Bidding Rules, were approved by the Treasurer on 26 November 1999 and were released to bidders on the same day. The Supplementary Bidding Rules set out the amended timetable and amended rules for the submission of Final Bids.

A draft of the Supplementary Bidding Rules was provided to Audit on 19 November 1999. Audit provided comments to the ERSU with respect to a number of matters, including the:

- sufficiency of the information requested from bidders to assist in the evaluation of the net present value of the consideration offered (ie the basic assumptions used in the calculation of the net present value);
- failure to request a long range Business Plan from bidders;
- way in which the ERSU proposed to deal with the potential for collusive tendering;
- sufficiency of the time for the ERSU to evaluate the bids in the seven day period in which bids were required to remain open following submission;
- release to bidders of Supplementary Bidding Rules ten days prior to the date for lodgement of Final Bids;

- nature of the legal opinions/representations to be procured by bidders and provided to the ERSU, and other areas where legal opinions/representations would be appropriate.

Audit met with the ERSU to discuss these matters on 24 November 1999. A further draft of the Supplementary Bidding Rules was provided to Audit on 25 November 1999. The Supplementary Bidding Rules approved by the Treasurer and issued to bidders on 26 November 1999 incorporate changes to address a number of the abovementioned matters.

Audit Comment

The Supplementary Bidding Rules approved by the Treasurer incorporate changes to address a number of the issues raised by Audit. Changes were not made to the Supplementary Bidding Rules with respect to the following matters:

- **The Need for Long Term Business Plans**

  The matter of long term business plans is also relevant to evaluations conducted at the Indicative Bid stage of the disposal process. Further discussion on the need to receive and assess business plans is included in this Report under the heading '2.6.3 — Evaluation of Risk'.

- **Timing of the Release to Bidders of Supplementary Bidding Rules**

  The Supplementary Bidding Rules seek information from bidders to enable an evaluation to be undertaken against defined evaluation criteria. I consider that the evaluation criteria, together with the plan to evaluate bids, must be determined at an early stage in the disposal process. Once the evaluation criteria have been devised, it is then possible to list the information required from bidders through the Bidding Rules so as to ensure that all nominated evaluation criteria can be appropriately assessed.

  In my opinion, had this course been followed by the ERSU there would have been a limited need to issue extensive Supplementary Bidding Rules at such a late point in the bidding process.

  With respect to the release on 26 November 1999 of the Supplementary Bidding Rules, I note that this occurred some ten days prior to the date for lodgement of Final Bids. The issue of these Rules at such a late time in the disposal process reduces the ability of bidders to fully address the preparation and submission of their Final Bids.

The ERSU advised Audit that it '... did not think that bidders would seek additional time as there is not a great volume of additional information that is being requested'.[63]

Recommendation 5 hereunder addresses this issue.

- **Time Bids Remain Open**

The Supplementary Bidding Rules provide that bids must remain open for not less than seven days. In essence, this means that all evaluations, clarifications and negotiations would potentially need to be completed within a seven day period. I note in this regard that there is a tension between the capacity of bidders to hold bids open for a longer period given the financing approvals from their financiers and the time needed by the ERSU to finalise the evaluation of those bids.

Audit suggested that the risks associated with this tension could be managed by providing a mechanism in the Supplementary Bidding Rules which has the effect of controlling the parameters for changes in the bids without allowing bidders to fully withdraw their bids after the seven days.

Without such flexibility there is the risk that the evaluation of Final Bids will not be completed within the seven day period, or that an incomplete and inadequate evaluation will take place to meet the timeframe.

The ERSU advised Audit that:

> *... particularly at this time, it is difficult to hold bid prices firm and that an evaluation period of less than seven days is not unusual.*
>
> *... The time period has been set on the basis that it is a reasonable period, particularly given the stage that negotiation of project documents have reached with each of the shortlisted bidders.*[64]

Further, the ERSU indicated that '... it has sufficient resources to enable the evaluation to be carried out within the time period proposed'.[65]

I note that no amendments were made to the Supplementary Bidding Rules with respect to this matter but remain of the view that the Supplementary Bidding Rules should provide an opportunity for the Treasurer to seek specific changes to the conditions attaching to Final Bids.

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63 Minutes of Meeting with Auditor-General, 24 November 1999.

64 ibid.

65 ibid.

Audit Recommendation 5

I recommend that for future asset disposals, Bidding Rules detailing the information to be supplied by bidders be settled prior to the commencement of the disposal process and be further refined if necessary at the commencement of each subsequent stage of that process.

Further, I recommend that Supplementary Bidding Rules be issued to only address unforeseen circumstances.

2.5 ISSUES ARISING FROM EXPRESSIONS OF INTEREST

The following considers issues arising from an examination of the processes adopted by the ERSU for the evaluation of Expressions of Interest (EOIs) for the disposal of ETSA Utilities and ETSA Power.

2.5.1 Advertisement Seeking Expressions of Interest

Pursuant to an advertisement in national newspapers the Treasurer invited Expressions of Interest (EOIs) in relation to the disposal of ETSA Utilities and ETSA Power.

Prospective purchasers were advised in this advertisement that the South Australian Government would accept EOIs until the release of a detailed Information Memorandum which was expected to be on 30 August 1999. EOIs were to be forwarded to the ERSU.

The advertisement stated that pre-qualification would be based on the following criteria:

- Financial capability to complete the lease transaction
- Operational or investment experience.

Financial capability was stated in the advertisement as being able to be '... demonstrated by provision of information such as, latest audited balance sheet and profit and loss statements, level of market capitalisation, gearing levels and credit rating'.

Once a party satisfied the pre-qualification criteria they were required to execute a confidentiality agreement before confidential information was released.

The South Australian Government also reserved the right to alter the process and to seek further information at any time.

Audit Comment

The advertisement inviting EOIs for ETSA Utilities and ETSA Power made no mention of the existence of Bidding Rules or the subsequent requirement which was imposed upon parties

selected for pre-qualification that they must provide written acknowledgment of these Bidding Rules before proceeding further in the disposal process to the Indicative Bid phase.

ERSU Response

> *We accept that the EOI advertisement for ETSA Utilities and ETSA Power did not refer to the Bidding Rules. This was altered in relation to the EOI advertisement for generation assets.*

Further Audit Comment

I note that the advertisement seeking EOIs for the disposal of the Government-owned generation businesses states:

> *Prequalified parties will be required to enter into a confidentiality agreement and accept the State's bidding rules in order to be provided with confidential information, site visits and detailed Information Memoranda.*

2.5.2 Evaluation of Expressions of Interest

2.5.2.1 Monitoring of Expressions of Interest Evaluations

The purpose of the EOI process was to identify suitable parties to move onto the next stage in the disposal process and not to allow into that process those parties deemed unsuitable as determined by applying the previously mentioned pre-qualification evaluation criteria.

The ERSU Bidder Communication Committee met on 6 July 1999 to agree principles to apply to '... the qualification process for persons or parties which express interest in response to the Government's advertisement'.[66]

The process adopted by the ERSU for the evaluation of the EOIs was undertaken on a case by case basis. The evaluation process was typically conducted as follows:

- EOIs were received by the ERSU and were then reviewed by the Lead Advisers, who provided advice in writing to the ERSU containing a recommendation as to whether the party should be pre-qualified. The written advice sighted by Audit contained a brief review by the Lead Advisers of the EOI against the stated evaluation criteria.
- The ERSU considered the Lead Advisers' advice and, if it agreed, endorsed the recommendation. In the case of a recommendation by the Lead Advisers to pre-qualify the party, the ERSU forwarded a brief minute attaching a copy of the Lead Advisers' advice to the Treasurer seeking his approval.
- The Treasurer noted his response to the ERSU recommendation (eg his approval) on the minute.

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[66] Minute from the ERSU to the Treasurer titled 'Expression of Interest — Pre-qualification of Potential Bidders' dated 8 July 1999.

- On receipt of the Treasurer's response, either the ERSU or the Lead Advisers notified the party of the outcome of the EOI. Those parties who did not pre-qualify were given reasons for the decisions.

Audit Comment

Audit found no evidence that the process of evaluating EOIs was either controlled or monitored by any of the disposal process committees.

The ERSU have advised that:

> *... lead advisers were to notify ERSU, for each expression of interest, its recommendations as to whether a particular party lodging an EOI should be pre-qualified. ERSU considered the recommendations received. It is accepted that formal meetings to deal with those issues were not held.*

2.5.2.2 Sequential Assessment of Expressions of Interest and Use of Additional Information for their Evaluation

Audit Comment

The ERSU files reviewed by Audit indicate that in making recommendations on the EOIs to the ERSU the Lead Advisers adopted different approaches in evaluating EOIs against the stated evaluation criteria. In conducting evaluations, the Lead Advisers took the approach in one case that the party must be able to demonstrate both 'operational' and 'investment' experience and in other cases it was apparently satisfied if the party demonstrated either 'operational' or 'investment' experience. In some cases the Lead Advisers' advice also indicates differences in the interpretation of 'operational experience'.

Further, the Lead Advisers, in undertaking the evaluation (in particular when making those recommendations not to qualify parties), had regard to other factors which were not contemplated in the stated evaluation criteria. Such matters included the prior involvement of the party in utility privatisations, whether the party's board of directors had approved or endorsed the EOI, and whether the party would lead the consortium or be a consortium member.

I consider that an essential element in the evaluation of EOIs is that they be evaluated consistently against the criteria as set out in the advertisement seeking those EOIs.

In my opinion the development and application of a contemporaneous and comparative evaluation methodology would have identified the occurrence of different approaches taken in relation to the evaluation of EOIs.

While I do not take issue with additional matters being considered in the evaluation process, it is important that all parties are aware of all matters to be considered in the evaluation of their EOI and are given an opportunity to provide such information. In this way all EOIs can be evaluated having regard to the same criteria.

ERSU Response

ERSU accepts the comments that it is important to ensure that all EOIs are evaluated having regard to the same criteria and that extraneous issues should not be taken into account.

We do not see any merit in the evaluation of EOIs at the same time. This is particularly so given the nature of expressions of interest and that they may relate to all four assets which are being offered on a staggered basis. We suggest that consistency of outcome can be achieved without requiring all expressions of interest to be evaluated at the same time.

We agree that a set of evaluation criteria for EOIs should be explicitly developed and applied.

Audit Recommendation 6

I recommend that for future asset disposals:

- **all pre-qualification criteria and information requirements be clearly identified, documented and applied;**
- **a clear methodology be developed for the evaluation of EOIs;**
- **EOIs not be evaluated on a 'rolling' or sequential basis but be evaluated at the same meeting.**

2.5.2.3 Treatment of Late Expressions of Interest

The initial advertisement placed by the ERSU calling for EOIs for ETSA Utilities and ETSA Power stated that EOIs would be accepted up to the time the Information Memorandum was issued. Audit is aware of four EOIs that were received after this cut-off date. The ERSU sought advice from its Legal Advisers as to the procedure to be adopted for dealing with these late EOIs and were advised that pursuant to the Bidding Rules the Treasurer had sufficient reserved rights to accept the late EOIs. The Legal Advisers also noted that care should be exercised in admitting late EOIs to ensure that in doing so other bidders were not prejudiced.[67]

Audit Comment

I note that at the time the EOIs were received by the ERSU, potential bidders had not been asked to sign up to the Bidding Rules which contained the Treasurer's reserved rights to consider late proposals. Accordingly, parties lodging EOIs could not be aware of these reserved rights, nor could they be bound by the Bidding Rules.

[67] None of the parties lodging the late EOIs proceeded to the next stage.

Notwithstanding the above comments, the advertisements seeking EOIs did mention that '... The South Australian Government reserves the right to alter the process ... at any time'.

I also note that in the case of one EOI, the submission to the Treasurer recommending pre-qualification made no mention of the fact that the EOI had been received late. Accordingly, it is possible that the Treasurer, in exercising the reserved right mentioned in the advertisement, was not aware that he was being asked to exercise his discretion to admit a late EOI to the disposal process.

Audit Recommendation 7

I recommend that for future asset disposals the process for acceptance of late EOIs be identified to potential bidders and that where a discretion is exercised to accept a late EOI, this fact be recognised in the approval given.

ERSU Response

> *As seen from the advertisement for the generation sector EOI process, there is no end date for acceptance of expressions of interest. Thus there is no concept of a 'late' acceptance.*

Further Audit Comment

I consider that the approach being taken by the ERSU for the generation sector EOI process raises the practical question of when EOIs for the generation sector will no longer be permitted.

The approach adopted by the ERSU would seem to allow for the lodgment of EOIs up to the closing time and date for the Indicative Bids. This matter will be considered in a forthcoming review of the disposal process for the generation sector assets.

2.5.2.4 Pre-Qualification Documentation

Following the advertisement inviting EOIs for ETSA Utilities and ETSA Power, and after receiving recommendations and advice from the Lead Advisers to the ERSU, the Treasurer[68] pre-approved a number of potential bidders in advance of receipt of their EOI. This was based upon an assessment by the Lead Advisers of the ability of these potential bidders to satisfy the Government's disposal criteria based upon the Lead Advisers' own knowledge of the organisations.

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[68] Minute from the ERSU to the Treasurer approved on 9 July 1999.

The ERSU has advised that:

> *... If an expression of interest was received from a pre-approved party ... the expression of interest was verified as against the Lead Advisers' previous understanding and the recommendation was provided to the Treasurer (subsequent to the receipt of EOI) confirming (or otherwise) the initial pre-approval.*

Audit Comment

Whilst it is not unusual for advisers in a lead up to a disposal process to seek to generate interest in that process from prospective bidders, Audit has been unable to sight evidence of further detailed evaluation undertaken to support the pre-qualification of a number of pre-approved potential bidders who lodged EOIs.

Audit Recommendation 8

I recommend that appropriate documentation be retained to support the evaluation of all EOIs lodged, including those lodged by potential bidders pre-approved by the Treasurer.

2.6 ISSUES ARISING FROM THE EVALUATION OF INDICATIVE BIDS

The following considers issues arising from an examination of the processes adopted by the ERSU for the evaluation of Indicative Bids for the disposal of ETSA Utilities and ETSA Power.

2.6.1 Introduction

Information that the ERSU required potential bidders to provide in their Indicative Bids is set out in this Report under the heading '2.4.1.6 — Indicative Bids'.

The following sections of this Report describe issues arising from the use of that information in the evaluation by the ERSU of the Indicative Bids received.

2.6.2 Provision of Insufficient Information for Evaluation

Audit Comment

The purpose of the evaluation at the Indicative Bid stage was to create a shortlist of those bidders who would be invited to submit Final Bids. It is inherent in the process of shortlisting bidders that some bidders could be excluded from proceeding further in the bidding process by their identification as being a less desirable bid. Therefore it is important that there be adequate information to support the decision made to exclude a particular bidder.

The evaluation of Indicative Bids proceeded on the basis of the information provided by bidders as requested in Annexure A of the Bidding Rules to meet the objectives set out in clauses 7.1 to 7.3 of the Bidding Rules.[69]

I consider that insufficient information was requested of bidders to enable an evaluation of Indicative Bids to be conducted that has regard to the matters set out in Bidding Rules 7.1 to 7.3.

I am of the opinion that the information requested was not sufficient in the following respects:

- Information as to the assumptions on which a net present value of bid prices offered is calculated was not required to be supplied by bidders. Accordingly there was no mechanism available to the evaluators to assess and interrogate the indicative bid prices provided by bidders.
- No set format including an outline of acceptable assumptions was specified in the Bidding Rules for the provision of the financial information (consideration) by bidders.
- The bidders were not required to give any indication as to whether they proposed to pay the consideration over the whole of the period of the lease, or to pay it wholly up front, or some combination in between.

Accordingly, it was possible for each bidder to present financial information in a different manner and with different underlying assumptions. This in turn meant that it would be difficult for evaluators to compare the prices offered by different bidders in order to determine which bid maximises the disposal proceeds. This requirement is one of the objectives of the Treasurer that is set out in Bidding Rule 7.1.

I note that the minutes of Meeting of the Evaluation Committee reveal a difficulty with the information available to evaluate Indicative Bids as follows:

> *The Committee resolved unanimously as follows:*
>
> *a.* .....
> *b.* .....
> *c.* .....
> *d.* *in the absence of sufficient detail to rank bids on any other basis, to rank bids based on price, that ranking being: .....*[70]

ERSU Response

> *It is not accepted there is insufficient information* '... requested of bidders to enable an evaluation to be conducted which has regard to the matters set out in the Bidding Rules 7.1 to 7.3'.

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69 A description of clauses 7.1 to 7.3 of the Bidding Rules and Annexure A to the Bidding Rules is set out in this Report under the heading '2.4.1.6 — Indicative Bids'.

70 Minutes of Meeting of the Evaluation Committee, 26 September 1999.

It is accepted that the information requested for the purposes of Indicative Bids would be insufficient for evaluation at Final Bid stage but that is not intended.

The evaluation required of Indicative Bids is for the purposes of establishing a short list.

It must be remembered that at the time of lodging their Indicative Bids, Bidders had been provided with only limited information in relation to the businesses in question (the data rooms only being made available to Shortlisted Bidders, following the evaluation of Indicative Bids).

Consequently the information provided by Bidders in their Indicative Bids was necessarily indicative and 'broad-brush' and the analysis associated with evaluation reflected the planned nature of the indicative bids.

Audit Recommendation 9

To enable the Evaluation Committee to undertake the evaluation of the Indicative Bids received, I recommend that the Bidding Rules require bidders to provide sufficient detailed information.

2.6.3 Evaluation of Risk

One objective of the disposal process as expressed in Bidding Rule 7.1 is to minimise the State's exposure to the risk of having to participate in the electricity supply industry following the introduction of the National Electricity Market.

Audit Comment

I am of the view that under the current process for evaluating bids there remains a risk that a disposal could be concluded with a bidder who may not be able to sustain a long term business operating the electricity assets. I consider that such a failure has the potential to cause the Government embarrassment and may result in disruption to the State's electricity supply.

To minimise this risk, I consider that information should be obtained from bidders to allow an assessment of their ongoing viability in respect of the operation of the electricity businesses being acquired. Such information would extend beyond past audited accounts and statements of past experience of the bidder (both of which are important). An assessment of the bidders' business plans for the acquired business would, in my opinion, be relevant.

Information concerning the bidders' plans for developing and maintaining the business as a viable concern has not been requested from bidders to enable such an assessment to be undertaken.

ERSU Response

> *The risk ... can be adequately dealt with in the lease without the need to require a review of future business plans for the businesses sold. This is because the rights for the lessee or its financiers to assign the lease will be relatively unrestricted. Therefore if the business is not as profitable as expected by the purchaser it would have economic incentives to dispose of the leasehold interest rather than abandoning the lease.*
>
> *...*
>
> *No sensible business plan could be proposed by a bidder for any significant part of the leases or be analysed/evaluated in an adequate way or be the subject of a contractual commitment by the Bidder to adhere to that plan in a way which has any real contractual consequence.*

Further Audit Comment

I remain of the view that an important element of the Indicative Bid evaluation process is to assess the ongoing viability of a particular bidder and this information can be obtained through understanding their business plans for the future.

Audit Recommendation 10

To enable an assessment to be undertaken of the risk that a bidder cannot sustain a business operating the relevant assets where the assets concerned relate to essential services, I recommend that information concerning the bidders' long term plans for developing and maintaining the business as a viable concern be requested from bidders.

PART 3
ARRANGEMENTS FOR INFORMATION GATHERING AND DISSEMINATION

3.1 OVERVIEW OF DUE DILIGENCE PROCESS

3.1.1 Key Steps in the Due Diligence Process

A summary of the key steps in the process for the acquisition of information by the ERSU and its advisers (ie to facilitate the conduct of vendor due diligence) and the provision of information concerning ETSA Utilities and ETSA Power to shortlisted parties following the EOI and Indicative Bid evaluations (ie to facilitate the conduct of bidder due diligence) is as hereunder.

During the period July 1998 to October 1998 a due diligence process was conducted[71] in order to ascertain the assets and liabilities of, or in connection with, each of the electricity corporations and to identify the assets and liabilities to be transferred to each of the electricity entities.[72] This process is referred to as 'Disaggregation Due Diligence'.

The Treasurer executed Transfer Orders transferring nominated assets and liabilities of the electricity corporations to the electricity entities in the period between 12 October 1998 and 30 July 1999. Advertisements calling for expressions of interest in ETSA Utilities and ETSA Power were published in June 1999.

In late June 1999, a Lease Committee responsible for the conduct of vendor due diligence for the disposal of each of ETSA Utilities and ETSA Power was formed and vendor due diligence was commenced.

At its meeting on 29 June 1999, the Lease Committee considered the updating of the Disaggregation Due Diligence and approved a 30 June 1999 due diligence cut off date with updates to occur on 31 August 1999 and monthly thereafter.[73] Materiality guidelines for the preparation of the Information Memorandum were also accepted at this meeting together with a proposal for three-year financial forecasts to be included in the Information Memorandum. The Lease Committee also at this time approved the protocol for work plans and committee meetings (project management).

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71 Refer to paragraph 3.1 of the Planning Memorandum.

72 Refer to Part 3 of the Prior Memorandum.

73 Refer to item 8 in the Minutes of Meeting of the ETSA Lease Committee held on 29 June 1999.

During July 1999 vendor due diligence continued. In this period, guidelines were developed for commercial, technical and operational information (referred to as Non-Legal Due Diligence — Commercial, Technical and Operational) to be included in the data room.[74]

ETSA Power and ETSA Utilities were also at this time required to review the information previously provided and to update that information as appropriate at 30 June 1999.

At its meeting on 7 July 1999, the Lease Committee endorsed the proposal for a legal compliance review of ETSA Utilities and ETSA Power (also referred to as a material legal risks analysis). It also agreed that due diligence documents would not be made available to bidders on CD-Rom and noted that the Boards of ETSA Utilities and ETSA Power would not be required to formally sign-off on the Information Memorandum.[75]

On 20 July 1999 the Lease Committee adopted the Financial Due Diligence Planning Memorandum and materiality guidelines for due diligence procedures. The KPMG work program for financial due diligence was also adopted by the Lease Committee at this meeting.[76]

In late July 1999 a Due Diligence Sub-Committee was established comprising representatives of the Legal Consortium, KPMG, the ERSU, ETSA Utilities, ETSA Power and the Lead Advisers. This Sub-Committee signed off on the Information Memorandum as at 20 August 1999[77] and the Information Memorandum was issued on 3 September 1999.

By the end of September 1999 members of the Lease Committee signed the Due Diligence Planning Memorandum and the 'Due Diligence Report'. The Lease Committee approved the 'Due Diligence Report' and directed that it be provided to the Treasurer. It had also adopted the final due diligence guidelines and approved a paper submitted by the Legal Consortium on warranty as to title.[78]

Data room access for bidders commenced on 4 October 1999. The Lease Committee subsequently approved arrangements for 'one-on-one meetings' to take place between bidders and management of ETSA Utilities and ETSA Power as part of bidder due diligence arrangements.[79]

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74 Refer to section 6 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

75 Refer to the Minutes of the Meeting of the Lease Committee held on 7 July 1999.

76 Refer to the Minutes of the Meeting of the Lease Committee held on 20 July 1999.

77 Refer to Minutes of Meeting of the Due Diligence Sub-Committee held on 26 August 1999.

78 Refer to the Minutes of the Meeting of the Lease Committee held on 28 September 1999.

79 Refer to the Minutes of the Meeting of the Lease Committee held on 13 October 1999.

During October, the Lease Committee was advised by the Legal Consortium that supplementary due diligence material was being provided to bidder data rooms and a substantial volume of material was being received.[80] A further supplementary request for information was sent to ETSA Utilities and ETSA Power in October 1999 with a request that the entities reply to the information request by 4 November 1999.

Additional material continued to flow to the bidder data rooms in early November 1999. At a meeting of the Lease Committee on 16 November 1999 the Legal Consortium expressed concern to the Lease Committee at the large number of documents going into the data room 'at this late stage' and emphasised the need to bring documents forward as soon as possible in order to permit bidders to have adequate time to assess the information. It was noted that many of the outstanding documents were agreements waiting to be executed.[81]

Final due diligence documents were delivered to bidder data rooms on 30 November 1999 and data room access ceased on 3 December 1999.

Receipt of final bids occurred on 6 December 1999 and the 'Supplementary Due Diligence Report' was approved by the Lease Committee on 7 December 1999.

3.1.2 General Comments Regarding the Documentation

The documentation directly relevant to the evaluation of the Final Bids falls into two categories. The first category concerns the documents provided to bidders, namely the Bidding Rules and the Supplementary Bidding Rules Issued on 26 November 1999. These documents are considered by Audit in under the heading '2.4 — Bidding Rules' in this Report. In addition the bidders were provided with the Information Memorandum, documents in the data rooms comprised principally of documents relating to the assets and liabilities of ETSA Utilities and ETSA Power, an index of information provided in the data rooms and a number of memoranda relating to the bidder due diligence process.[82]

The second category of documents, prepared by the ERSU and its advisers, includes:

- Documents for use by the Lease Committee and its sub-committees, in particular the Due Diligence Sub-Committee and the Information Memorandum Sub-Committee.
- The minutes of the Due Diligence Sub-Committee and the Information Memorandum Sub-Committee.
- Documents for use by the Lease Committee, in particular:
    - — the minutes of the Lease Committee;
    - — its advice and recommendations to the Government.

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80 Refer to the Minutes of the Meeting of the Lease Committee held on 26 October 1999.

81 Refer to the Minutes of the Meeting of the Lease Committee held on 16 November 1999.

82 Particulars of such memoranda and other documents provided to bidders are detailed in section 2.5 of the 'Supplementary Due Diligence Report' prepared by the Lease Committee on 6 December 1999.

3.2 ISSUES ARISING FROM THE DUE DILIGENCE PROCESS

3.2.1 Consideration of Potential Liability

In the context of an asset sale or disposal the process of due diligence conducted by a vendor is generally undertaken in such a way that the process minimises to the maximum extent possible the exposure of the vendor to liability, in particular to those parties invited to participate in that process as bidders and to give rise to the creation of legal defences in the event the process is challenged.

The ERSU has advised[83] that in the disposal process for ETSA Power and ETSA Utilities, the due diligence process was not used as a basis for minimising potential liability because there was a potential liability arising under section 56 of the *Fair Trading Act 1987* for misleading or deceptive statements that could not be avoided by the State relying upon the completeness and accuracy of the due diligence. Instead, reliance was placed on section 14(4) of the Disposal Act which precluded a successful bidder from having an action against the State from the disposal process except for explicit representations and warranties made by the State in the Project Documents.

I note, however, that section 56 of the *Fair Trading Act 1987* is not the only potential source of liability. This is supported by the State's legal advice.[84]

There would, in my opinion, be merit in taking all reasonable steps to ensure the accuracy and completeness of the due diligence, in order to minimise the risk of misleading or deceptive statements.

Vendor due diligence was conducted in two distinct phases. First, the Disaggregation Due Diligence, conducted between July to October 1998 and secondly the due diligence in relation to the disposal of the distribution and retail businesses, which commenced in June 1999.

(a) Disaggregation Due Diligence

The main purposes of the Disaggregation Due Diligence, as set out in the Prior Memorandum,[85] which related to due diligence on the electricity corporations, were to:

- identify assets and liabilities of the electricity corporations for the purpose of the State determining those assets and liabilities to be transferred to any State-owned companies;

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83 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

84 Memorandum from the Legal Consortium to the Lease Committee dated 29 June 1999 titled 'Information Memorandum Materiality Guidelines' at section 4, p.3.

85 Refer to section 3.2.

- identify any legal impediments to the transfer of assets and liabilities of the electricity corporations to the electricity entities;
- identify and provide information to assist the State to determine any action to be taken to address or ameliorate any legal impediments to the transfer of assets and liabilities of any of the electricity corporations to the electricity entities;
- identify and assist the State to consider material legal risks relating to the business functions and associated assets and liabilities of any of the electricity corporations to enable the State to determine whether those business functions will be conducted by, and the assets and liabilities transferred to any of the electricity entities;
- identify to what extent material legal risks are being managed and to assist the State to identify what further action, if any, should be taken to address or ameliorate the material legal risks identified;
- identify and provide information and analysis in relation to assets and liabilities which the State proposes to be transferred to any electricity entities and any function to be performed by any electricity entities to assist the State for purposes of the preparation of an information memorandum and compilation of a data room to enable bidders to conduct their own due diligence on the electricity entities;
- for assets which the State determines will not be transferred to the electricity entities, provide information to assist the State to determine any required 'pass-through arrangements' to the relevant electricity entities;
- for assets and liabilities which the State determines will not be transferred to the electricity entities, and where the State so determines that 'pass-through arrangements' are inapplicable or not possible, provide information to assist the State to determine the procedures to be adopted by it in relation to the management of those assets and liabilities;
- for assets and liabilities which the State determines will not be transferred to the electricity entities, and where required by the State, provide information to assist the State to value any such assets and liabilities for the purposes of assessing the State's overall position in relation to the reform and sale process.

(b) Disposal Due Diligence

The due diligence process to be conducted for the disposal of each of the electricity entities (referred to as the Sale/Lease Due Diligence)[86] is set out in the Planning Memorandum. The Planning Memorandum provides that due diligence in respect of the assets and liabilities of the electricity entities would initially be conducted as at 30 June 1999.[87] Audit understands that this approach would be based on the Disaggregation Due Diligence with an update of

[86] Refer to section 2.8.

[87] Refer to section 5.2.1.

the various matters arising therefrom. The Planning Memorandum also provides that supplementary due diligence would be undertaken in respect of the electricity entities for the period 1 July 1999 to 31 August 1999 and for each monthly period thereafter up to the financial close of the sale and lease of the electricity entities or their businesses.[88]

The Planning Memorandum, entered into by each of the Parties, sets out the scope, objectives and expected outcomes of the Sale/Lease Due Diligence, as well as the responsibilities of the Parties for the different aspects of the due diligence process. The Legal Consortium is responsible for 'Legal and General Due Diligence', the Accounting Adviser for 'Financial Due Diligence', the ERSU for 'Electricity and Energy Industry Due Diligence' and the electricity entities for 'Technical, Commercial and Operational Due Diligence'.

The Planning Memorandum identifies a number of fundamental issues that will be addressed by the conduct of the due diligence process:[89]

- Preparation of guidelines setting out details of the documents and information identified during the Disaggregation Due Diligence and the documents and information identified during the Sale/Lease Due Diligence to be released to bidders for the electricity entities or their business and assets.
- Identification of assets and liabilities of each electricity entity and the information in respect of them to be released to bidders for the purpose of their own due diligence.
- Identification of other documentation or information to be released to bidders.
- Identification of legal impediments to the sale or lease of assets or liabilities of an electricity entity should the business of the any electricity entity be sold or leased to a bidder instead of a sale of shares, to enable the State to take steps to address those legal impediments.
- Provide information, gained from the Disaggregation Due Diligence and the Sale/Lease Due Diligence and information in relation to the assets, liabilities and functions of each electricity entity to assist in the preparation of the Information Memoranda.

It is further noted in the Planning Memorandum that:

> *In general terms, the purpose of the Sale/Lease Due diligence is to disclose to bidders all documents and information that should be made known to Bidders in their deliberations over whether they would make an investment decision in respect of the relevant Electricity Entity.*[90]

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88 Refer to section 5.3.1.

89 Refer to section 3.2.

90 Refer to section 3.3.

The stated purposes for due diligence in both the Prior Memorandum and the Planning Memorandum contain no reference to any protection which may be afforded to the State in the event of any legal action arising from the conduct of the due diligence.

The Lease Committee adopted the Due Diligence Planning Memorandum on 24 August 1999.

Audit Comment

Neither the Prior Memorandum (Disaggregation Due Diligence) nor the Planning Memorandum (Disposal Due Diligence) directly address the potential of claims, demands or litigation against the State or its advisers arising from either of the due diligence processes and whether the measures detailed in the memoranda, if followed may provide the State with any defences to such claims, demands or litigation. Such liability may arise at common law and pursuant to statute.

Audit's review of the due diligence process adopted by the ERSU and its advisers, through the various committees established to conduct the disposal process, did not identify any detailed documented focus on the potential liability to the State arising from its actions in the disposal process and the specific measures or procedures required to be adopted by the State to address any such liability.

Audit has reviewed the minutes of the Lease Committee and its sub-committees, in particular the Due Diligence Sub-Committee and the Information Memorandum Sub-Committee to ascertain the consideration of potential liability to the State arising from:

- the issue of the Information Memorandum;
- financial forecasts in the Information Memorandum;
- the conduct of bidder due diligence;
- the representations and warranties made to the purchaser in the disposal documentation.

The following discussion focuses on these specific issues.

3.2.1.1 Issue of the Information Memorandum

A potential area of exposure to liability to the State may lie in any representations made by it to bidders in the confidential Information Memorandum issued in respect of the sale entities. In particular, the State may be exposed to liability due to the issue of forecast financial information concerning the sale entity's future financial performance.

At its first meeting on 23 June 1999 the Information Memorandum Sub-Committee noted that as bidders will have access to the data room and conduct due diligence prior to submitting a final bid for the sale entities, the purpose of the Information Memorandum was not to provide

bidders with all of the information required to submit a final bid. The Sub-Committee agreed that the key purposes of the Information Memorandum were:

- *to provide prospective bidders with information for the purposes of submitting indicative bids and deciding to spend the time and money to undertake the due diligence and negotiation process;*
- *to act as a sale document to encourage interest in the businesses (subject to liability issues); and*
- *to act as an explanatory document of the more complicated information to be made available in the data room.*[91]

The Sub-Committee noted at the meeting that:

> *Liability issues are relevant in determining the content of the IM because liability can arise from omissions that render the document misleading or deceptive. In general, the document should contain all material information a bidder would require to make the relevant decisions.*
>
> *This is subject to:*
>
> - *audience — it was agreed that bidders would have a reasonable knowledge of the type of business covered in the IM (the IM disclaimer should make it clear the IM is for bidders only);*
> - *disclaimers may assist in ensuring the IM is not misleading or deceptive; and*
> - *materiality.*[92]

The Legal Consortium was also preparing a separate paper in relation to the potential liability arising out of the Information Memorandum.[93] Further a paper prepared by the Legal Consortium to the Lease Committee dated 29 June 1999 titled 'Information Memorandum Materiality Guidelines' refers to a separate memorandum being prepared in relation to the potential liability for the State and its advisers arising in relation to the Information Memorandum. The paper provides that:

> *Broadly, liability could potentially arise:*
>
> - *for misleading and deceptive conduct under section 56 of the Fair Trading Act (SA) (depending on whether or not an exemption is granted by regulation); and*
> - *under the common law torts of negligent misstatement or deceit.*

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91 Refer to item 2 of the Minutes of the Meeting of the Information Memorandum Sub-Committee held on 23 June 1999.

92 Refer to item 2 of the Minutes of the Meeting of the Information Memorandum Sub-Committee held on 23 June 1999.

93 Refer to item 2 of the Minutes of the Meeting of the Information Memorandum Sub-Committee held on 23 June 1999.

Generally speaking, liability can arise as a result of:

- *a positive statement that is misleading or deceptive or a misrepresentation; or*
- *an omission that renders a positive statement misleading or deceptive or a misrepresentation.*

In particular it has been held in relation to section 52 of the Trade Practices Act (of which section 56 of the Fair Trading Act is the equivalent) that where a document such as the IM is provided for the purpose of a particular decision to be made by the recipient, the document should include full and fair disclosure of all material information relevant to the decision to be made. Otherwise the combination of what is said and what is left unsaid may render the document misleading and deceptive.[94]

On 30 June 1999 the Legal Consortium reported to the Information Memorandum Sub-Committee that the liability paper had been provided to the Lease Committee for its meeting on 6 July 1999.[95] The minutes of the Lease Committee meetings held on or subsequent to 7 July 1999 and subsequently make no reference to this paper or to the issue of liability to the State as the issuer of the Information Memorandum.

The ERSU has advised Audit that a draft memorandum titled 'Project Vintage — Information Memorandum — Content, Liability, Materiality, Verification, Disclaimers and Sign-offs' dated 12 November 1998 was tabled for comment at the Due Diligence Sub-Committee meetings in November and early December 1998, but was not settled and finalised by the Legal Consortium or the Due Diligence Sub-Committee before the disposal process was delayed in December 1998.[96] This paper considers potential liability for statements in the Information Memorandum under the Federal *Trade Practices Act*, the *Fair Trading Act 1987* (SA), the Corporations Law and at common law. The ERSU has further advised Audit that a draft memorandum titled 'Project Vintage Information Memorandum Verification Protocol' dated 1 December 1998 was tabled for comment at the Due Diligence Sub-Committee meetings in early December 1998, but was not finally settled before the disposal process was delayed in December 1998.[97] This paper considers civil liability under the Federal *Trade Practices Act* and the *Fair Trading Act 1987* (SA) for misleading or deceptive conduct in the context of the issue of an Information Memorandum. These papers were not reviewed, updated or resubmitted to the Lease Committee or the Information Memorandum Sub-Committee for settling, consideration or noting when the disposal process recommenced in June 1999.

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94 Memorandum from the Legal Consortium to the Lease Committee dated 29 June 1999 titled 'Information Memorandum Materiality Guidelines' at section 4, p. 3.

95 Refer to item 2 of the Minutes of the Meeting of the Information Memorandum Sub-Committee held on 30 June 1999.

96 Attachment 21 to the letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

97 Attachment 22 to the letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

The ERSU has further advised that advice was obtained from the Legal Consortium as to any potential liability by reason of distributing the Information Memorandum to potential bidders in Singapore, the United States, Hong Kong and the United Kingdom.[98] The ERSU has advised that this advice was taken into account in the preparation of the Information Memorandum and the Bidding Rules. The advice is not referred to in the minutes of the Lease Committee.

Audit Comment

Whilst noting the above, there has been no paper, other than the paper dated 29 June 1999 referred to previously, submitted to the Lease Committee and referred to in its minutes that comprehensively documents and describes potential liability to the issuer or any other parties involved in the disposal process arising from the issue of the Information Memorandum.

ERSU Response

> *... it is not correct to view the ETSA Lease Committee as the only forum in which issues relevant to the Information Memorandum and due diligence were discussed and resolved.*
>
> *...*
>
> *The Lease Committee represented a forum at which issues of this nature were discussed. However, the existence of the Lease Committee did not replace the obligations of the advisers to ERSU and the Treasurer concerning the work undertaken by those advisers.*[99]

Further Audit Comment

I remain of the opinion that there should be comprehensive documentation relating to potential risks arising from the disposal process and Audit Recommendation 11 addresses this issue.

3.2.1.2 Financial Forecasts in the Information Memorandum

On 29 June 1999 the Lease Committee was advised that a proposal for three-year forecasts for inclusion in the Information Memorandum had been agreed by the Lead and Accounting

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98 Attachment 25 to the letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

99 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

Advisers.[100] The Committee adopted the proposal[101] contained in the draft Financial Due Diligence Planning Memorandum tabled by the Accounting Adviser for consideration by the Committee.[102] In Section 4.4 of this document it is noted:

> *We have been requested to perform agreed upon procedures on forecast financial information compiled by the entity for inclusion in the Information Memorandum. This will include information for the financial years ended 30 June 2000, 2001 and 2002 and will be sourced primarily from the entity's balance sheet and profit and loss forecasts.*

The draft Financial Due Diligence Planning Memorandum sets out the procedures proposed to be undertaken by the Accounting Adviser and notes that as the procedures do not constitute an 'audit' or 'review', an 'audit' or 'review' opinion will not be given.[103]

The Lease Committee papers of the 29 July 1999 and 20 July 1999[104] meetings reviewed by Audit do not refer to any consideration of legal liability associated with the issue of financial forecasts to bidders in the Information Memorandum or in any other form during the disposal process. Further it is not evident that the Committee considered the implications of the Accounting Adviser not providing an 'audit' or 'review' opinion, either for the benefit of the State or for inclusion in the Information Memorandum, but providing a conclusion as to the reasonableness of the process of preparing, and the contents of, that financial information.

The Information Memorandum contains forecast information for ETSA Utilities and ETSA Power prepared by the management for the years ending 30 June 2000, 2001 and 2002.[105] The forecasts are addressed in the Accounting Adviser's Report appended to the Information Memorandum[106] and are specifically qualified in the Important Notice in the Information Memorandum.[107]

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100 Whilst the Minutes of the Meeting of the Lease Committee on 29 June 1999 do not specifically refer to the inclusion of the forecasts in the Information Memorandum, it is evident from the draft Financial Due Diligence Planning Memorandum tabled by KPMG and the subsequent issue of the Information Memorandum which included three year forecasts that this was the intention of the Committee.

101 Refer to item 10 in the Minutes of the Meeting of the Lease Committee dated 29 June 1999.

102 Draft KPMG, ETSA Power Pty Ltd and ETSA Utilities Pty Ltd Financial Due Diligence Planning Memorandum dated 24 June 1999 tabled for consideration by the Lease Committee on 29 June 1999.

103 Refer to section 4.4 of the Draft KPMG, ETSA Power Pty Ltd and ETSA Utilities Pty Ltd Financial Due Diligence Planning Memorandum dated 24 June 1999.

104 Lease Committee adopted the Financial Due Diligence Planning Memorandum, the Materiality Guidelines for Due Diligence Procedures and the KPMG Work Program for Financial Due Diligence. Refer to item 3 of the Minutes.

105 Information Memorandum, Volume 1, section 8 at p. 120.

106 Information Memorandum, Volume 1, Appendix 2, section 3.3 at p. 176.

107 Information Memorandum, Volume 1 at p. v.

Audit Comment

The issue of an Information Memorandum or similar document in any sale or disposal process may expose the issuer and others associated with the preparation of that document to liability from bidders and others to whom the Information Memorandum is provided. Accordingly, in preparing the Information Memorandum it is necessary to be aware of the nature of potential liability in order that informed decisions can be made as to what steps can be taken to mitigate the exposure of the issuer and others involved in its preparation to that liability. The nature of the potential liability will differ depending on the nature of the sale or disposal process, the arrangements in place between the bidders and the issuer[108] and the identity of the issuer. The nature of the content of the Information Memorandum will bear on the issue of liability. For example, the provision of prospective or forecast financial information in an Information Memorandum may give rise to particular issues given that such information cannot be verified as being accurate or being capable of being achieved. Further the provision of such information often seeks to highlight the continuing or improved financial performance of the entity to which it relates for some period in the future and may make an investment in that entity more attractive to bidders.

In the circumstances it is important that those parties responsible for the issue of an Information Memorandum are aware of the potential exposure to liability associated with the provision of the document to bidders. Further such parties should be in a position to make an informed decision as to the risks associated with including certain information in the document, such as forecast financial information and the necessity for and adequacy of arrangements for reviewing and 'signing off' on the contents of the information memorandum prior to its release.

On 23 June 1999 the Information Memorandum Sub-Committee identified the need for the provision of legal advice on liability in determining the content of the Information Memorandum; however the issue was taken no further by the Lease Committee. The minutes of the Lease Committee contain no record of any legal advice of this nature having been considered prior to the release of the Information Memorandum to bidders on 3 September 1999.

The advice prepared by the Legal Consortium dated 29 June 1999 titled 'Information Memorandum Materiality Guidelines'[109] and the earlier legal advice referred to by Audit refer to liability which may arise from statements in an Information Memorandum. The draft memorandum titled 'Project Vintage — Information Memorandum — Content, Liability, Materiality, Verification, Disclaimers and Sign-offs' dated 12 November 1998[110] specifically refers to the need to verify forecast information or if it cannot be verified to disclose this information to bidders.

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[108] Including, as in this disposal, the terms of the process contract between the State and bidders.

[109] As noted above there is no mention of this paper in the minutes of the Lease Committee.

[110] Attachment 21 to the letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

Audit has been advised by the ERSU that in August 1999 consideration was given to exempting the State, the State's electricity businesses, the State's advisers and their employees from the relevant provisions of the *Fair Trading Act 1987*. A decision was made by the Treasurer on 10 August 1999 that such action not be taken and the State should rely on due diligence and probity to protect State interests.[111] As this decision was made prior to the issue of the Information Memorandum, it would have been opportune for the Lease Committee to reconsider the legal advice which it had access to, to determine whether further advice was required in order to assess the effectiveness of the due diligence and other processes in place.

The ERSU have advised, however, that there was no need to do this because the Treasurer's decision meant that the State and its advisers would in fact be subject to the *Fair Trading Act 1987*.[112]

Although there is no reference to consideration of any legal advice in the minutes of the Lease Committee it is clear that various measures were taken to verify and 'sign-off' on the Information Memorandum contents prior to its release. Further the Information Memorandum contained an extensive 'Important Notice' which contained a range of qualifications to the information provided (including the forecasts) and use to which the information may be made by recipients.

The ERSU has advised Audit that as a consequence of advice received dealing with potential liability with the issue of the Information Memorandum and the conduct of due diligence by bidders, detailed and systematic measures and processes were adopted in order to minimise any potential liability to the State in connection with the sale/lease program.[113] It is not evident from the minutes of the Lease Committee that such advice was received and considered by the Lease Committee. The Lease Committee was established to, among other things, coordinate and supervise the preparation of the Information Memorandum and the establishment of the data rooms containing information about the electricity entities to which shortlisted bidders would be given access for the purpose of conducting their own enquiries into those entities.[114]

In my opinion, in the absence of specific legal advice as to the overall effectiveness or otherwise of such measures and processes, the Lease Committee would have been unable to assess the risks to the State and other parties associated with the issue of the Information Memorandum and consider whether any other, and if so what additional measures should be undertaken in order to mitigate such risks.

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111 Attachment 24 to the letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

112 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

113 Letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

114 Refer to paragraph 2 of the letter from the Lease Committee to the Treasurer dated 30 August 1999 titled 'ETSA Lease Committee Report — Information Memorandum'.

Audit Recommendation 11

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process on behalf of the State, prior to issuing any Information Memorandum or disposal document relating to the entity identified for disposal, identify the risks, if any, to the State and those parties involved in the preparation of the document arising from or in connection with the issue of the Information Memorandum and ensure that appropriate specific processes are implemented to address such risks. The decision making processes and rationale underlying the methodologies adopted by that committee or body to identify and address such risks must also be documented.

3.2.1.3 Conduct of Bidder Due Diligence

The due diligence process into which the bidders were invited to participate comprised a range of activities any of which, either alone or in combination, may have given rise to circumstances which may have exposed the State to potential liability from bidders. The activities conducted by the ERSU included:

- the provision of information to bidders in data rooms and through a formal question and answer process;
- the conduct of management presentations by ETSA Utilities and ETSA Power to bidders;
- 'one-on-one' meetings between bidders and management of ETSA Utilities and ETSA Power;
- visits to ETSA Utilities and ETSA Power sites.

As noted above the stated purposes for due diligence in both the Prior Memorandum and the Planning Memorandum contain no reference to any protection which may be afforded to the State by the processes contained in those documents in the event of any legal action arising from the conduct of the due diligence.

The memorandum to the Lease Committee from the Legal Consortium dated 10 August 1999 titled 'Disclosure Guidelines, Data Room Index and Data Room Preparation' outlines the process for the disclosure of information to bidders in the data rooms and addresses the disclosure guidelines to be applied for the release of information to bidders. The memorandum, however, does not address the risks to the State associated with the release of information in the data rooms and whether the disclosure guidelines adopted are appropriate to address those risks or may provide the State with any due diligence defences in the event of a challenge to the process. In the memorandum it is noted that:

> *The disclosure guidelines have also been prepared having regard to the need to include in the data room information which it might be misleading not to make available to shortlisted bidders.*[115]

The memorandum also notes that as a consequence of the disposal due diligence being built upon the disaggregation due diligence, which involved a considerable amount of legal due diligence, the non-legal disclosure guidelines had been moulded around the legal guidelines to ensure an overall consistency of approach. The Legal Consortium comments that:

> *One consequence of this, and the large amount of work that has already been undertaken, is that it will be difficult to make substantive changes to the due diligence process or to the disclosure guidelines. In any event , we think this is unnecessary.*[116]

The Legal Consortium does not provide an explanation in the memorandum as to why substantive changes to the disclosure guidelines would be unnecessary and the impact, if any, this decision may have on the State's potential exposure to liability arising from the adoption of this approach compared with revisiting the disclosure guidelines for the disaggregation due diligence, the purposes of which were substantially different to the purposes of the disposal due diligence.

The only paper addressing potential liability for material released in the data room is a paper prepared by the Legal Consortium relating to general industry information[117] which was considered by the Lease Committee on 19 August 1999.[118] This paper recommends measures which should be taken by the State in order to exclude any potential liability under the *Fair Trading Act 1987*.[119] The Lease Committee referred the paper to the Probity Sub-Committee for consideration.[120]

Audit Comment

As with the issue of an Information Memorandum or similar document in any sale or disposal process, the provision of information to bidders in a data room or in management

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115 Memorandum from the Legal Consortium to the Lease Committee dated 10 August 1999 titled 'Disclosure Guidelines, Data Room Index and Data Room Preparation' at paragraph 2.

116 Memorandum from the Legal Consortium to the Lease Committee dated 10 August 1999 titled 'Disclosure Guidelines, Data Room Index and Data Room Preparation' at paragraph 13.

117 Legal Consortium memorandum dated 18 August 1999 titled 'SA/Vintage: Liability for general industry information'.

118 Refer to item 6 in the Minutes of the Meeting of the Due Diligence Sub-Committee meeting held on 19 August 1999.

119 As advised by the ERSU (letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process') on 10 August 1999 the Treasurer had decided that no further action be taken in respect of the Fair Trading Act and the State was to rely on its due diligence and probity processes.

120 Refer to item 6 in the Minutes of the Meeting of the Due Diligence Sub-Committee meeting held on 19 August 1999. Audit is unable to find any reference to the paper in the minutes of meetings of the Probity Sub-Committee held after 19 August 1999.

presentations during bidder due diligence may expose the vendor to liability from bidders and others to whom the information is provided. Accordingly, the agency responsible for implementing and overseeing the conduct of due diligence by bidders must be aware of the nature of the potential liability to the State in order that informed decisions may be made as to what steps may be taken to mitigate the exposure to that liability. Further the document which sets out the due diligence process to be undertaken must address the issue of potential liability arising from the sale or disposal process and ensure that, where possible, the process will provide a basis for due diligence defences.

As noted previously in this Report under the heading '3.2.1.2 — Financial Forecasts in the Information Memorandum' the ERSU has advised Audit that as a consequence of advice received dealing with potential liability with the conduct of due diligence by bidders, detailed and systematic measures and processes were adopted in order to minimise any potential liability to the State in connection with the sale/lease program.[121] Whilst it is clear that some liability issues were considered by the Lease Committee, the framework for the conduct of the bidder due diligence adopted by the Lease Committee was not underpinned with a detailed documented assessment of the risks to the State and others involved in conducting this process on behalf of the State that the measures proposed would address any potential liability arising from this process. Accordingly, in the absence of such a documented assessment, which had been considered and approved by the Lease Committee, it is not possible to determine whether the processes approved or adopted by the Lease Committee, such as the disclosure guidelines, were appropriate to address such risks.

I note the advice from the ERSU[122] that legal advice was received, considered and adopted outside formal Lease Committee meetings, partly through the operation of working groups and the exchange of documents. Nevertheless, in my opinion, it is important that such advice, and the consideration of it, is appropriately documented.

Audit Recommendation 12

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process on behalf of the State, prior to conducting any due diligence process on the entity identified for disposal:

- **seek to identify the risks to the State and its advisers arising from or in connection with the conduct of the due diligence process;**
- **ensure that in developing that process consideration is given to the use of measures or procedures to mitigate any such risks;**
- **document the identified and considered risks.**

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[121] Letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

[122] Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

3.2.1.4 Representations and Warranties Made to the Purchaser in the Project Agreements

In the Project Agreements the Treasurer gave various warranties and indemnities to the purchaser. These warranties addressed such matters as the title to assets and interests in liabilities of ETSA Utilities and ETSA Power.

I note that on 12 August 1999 the Legal Consortium advised the Due Diligence Sub-Committee that investigations were being carried out to assess the issue of network assets in case a warranty as to title was required.[123] On 28 September 1999 the Lease Committee approved a proposal concerning warranty as to title outlined in a document prepared by the Legal Consortium.[124] The document notes that 'the practice' in respect of major public sector privatisations would be not to give a warranty as to title 'but rather rely upon the tender process to avoid value impact' (ie a discount to the bid price offered). The Legal Consortium advised in the document that the State has to elect to accept one of two risks. Either to accept the risk of providing a warranty as to title or if no warranty is given 'the risk inherent as to value impact'. In the former case it is noted in the document that:

> *The real risk to the State is that the successful bidder overstates the discount because it is not in as good a position as the State to make an assessment of what the real risk is.*[125]

The document also notes that the evidence as to title in the data room is 'relatively strong'. The document does not contain comment as to whether the provision of additional information to bidders would have placed the State in a position where it could have been comfortable in adopting 'the practice' of not offering a warranty.

Although the detail of the proposal is not set out in the minutes of the Lease Committee the document recommended that the State on behalf of the entities of the Crown (including the other electricity entities) disclaim any claim or title to the assets purported to be sold or leased.

Audit notes that a later document provided by the Legal Consortium to the ERSU dated 25 November 1999 concerning the provision of warranties by the State provides:

> *In effect, the Treasurer is giving a warranty that, having made reasonable enquiries, the Treasurer is not aware of any lack of title or claim by third party which is inconsistent with the purchaser of the business being able to continue to use the assets of the business in the same way as they have been used since disaggregation (ie 12 October 1998).*

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123 Refer to item 11(c) in the Minutes of the Meeting of the Due Diligence Sub-Committee held on 12 August 1999.

124 Refer to item 3 in the Minutes of the Meeting of the Lease Committee meeting held on 28 September 1999.

125 Refer to section 3 of the Memorandum from the Lease Documentation Sub-Committee to the Lease Committee dated 28 September 1999 titled 'Warranty as to title/extent of assets to be sold/leased'.

The reason for giving any warranty as to title at all is that it is simply impossible to put into the Data Room the entire disaggregation process and the due diligence processes which supported it.. Those due diligence and disaggregation processes constitute 'having made reasonable endeavours' by the Treasurer. The fact that the Treasurer is 'unaware' of a matter simply reflects the fact that all matters of which the Treasurer is 'aware' are disclosed in the Data Room.

In order that the Treasurer can rely upon the due diligence and disaggregation processes as constituting 'reasonable enquiries' the warranties as to title are limited to those assets which have been specifically identified in the various Transfer Orders.[126]

It is unclear whether the Lease Committee were advised of the implications to the State concerning the need to provide a warranty as to title at the time it developed the Sale/Lease Due Diligence process. In particular whether the disclosure by the State in the data rooms of more comprehensive information concerning the Disaggregation Due Diligence may have impacted on any later request from a bidder for the State to provide such a warranty. The Legal Consortium recommended to the Lease Committee that the bidder data rooms comprise only such of those documents referred to in the Transfer Orders which met the proposed disclosure guidelines for the legal due diligence as at 30 June 1999 and not all documents referred to in the Transfer Orders.[127]

In addition the Legal Consortium undertook, at the request of the Lease Committee a legal compliance review of ETSA Utilities and ETSA Power. One of the stated purposes of undertaking the review was to enhance the State's ability to maintain its position of providing limited warranties and indemnities.[128] The review did not, however, focus on the State's ability to provide the specific warranties contained in the Project Agreements, other than the issue of Year 2000 compliance[129] which was the subject of an indemnity in the Project Agreements.[130]

Audit Comment

When developing a due diligence process in a sale or disposal of assets, regard should be had to the need to provide a bidder with warranties on issues which are fundamental to the disposal process. Such matters include the power of the State to transfer title to or lease the

126 Minute from the Legal Consortium to the Lease Committee dated 25 November 1999.

127 Refer to item 8 in the Minutes of the Meeting of the Lease Committee meeting held on 29 June 1999 and item 5 in the Memorandum to the Lease Committee from G McKenzie & C Hinchen dated 29 June 1999 titled 'Due Diligence — Lease of Distribution and Retail Businesses'.

128 Memorandum from the Legal Consortium to the Lease Committee dated 8 December 1998 titled 'Legal Compliance' at paragraphs 3.9 and 11.

129 For example, the report from the Material Risk Team to the Due Diligence Sub-Committee titled 'Material Legal Risks for ETSA Power Pty Ltd' dated 8 September 1999.

130 Clause 13 of the Electricity Distribution Business Sale Agreement and clause 11 of the Electricity Retail Business Sale Agreement.

assets and the State's ownership of or title to such assets. The issue of title is highlighted in any process which involves the statutory transfer of assets by the State where bidder uncertainty may exist as to whether the State has title to the assets to be disposed of. The need for the State to provide such warranties may be obviated by the provision of detailed information to bidders on such matters in the due diligence process.

The purpose of a warranty review program is to address each of the warranties and any related indemnities to be provided by the vendor in the disposal agreements to determine whether the provision of such warranties may expose the vendor to liability. The review may necessitate the release of additional information to bidders on the issues being the subject of the warranty.

In my opinion, it is common practice to include a warranty review program as part of the due diligence arrangements for a disposal process such as the disposal of ETSA Power and ETSA Utilities. The failure to consider the requirement for a warranty review program at the time of developing the Sale/Lease Due Diligence process and to include such a program as part of these arrangements can potentially expose the State to liability in respect of the warranties provided to the successful bidder through the Project Agreements.

The ERSU have indicated[131] that they did not regard a warranty review program as necessary because of the nature of the warranties given and the extensive nature of the disaggregation due diligence process on which the warranties were based. In my opinion, the nature of the warranties did not remove the need to review them in the lead up to the disposal.

Audit Recommendation 13

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process should:

- **have regard during the development of the due diligence process to the possible requirement to provide warranties to bidders (in particular as to title to the assets) when determining the information to be released to bidders in data rooms;**
- **prior to the execution on behalf of the State of any document with the purchaser of the entity containing warranties given by the State:**
  - **undertake a review of the State's ability to satisfy or comply with any such warranties;**
  - **require any party who assists or undertakes that review or any part thereof on behalf of the State, to sign-off to the State in relation to their participation in that review.**

[131] Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

3.2.2 Due Diligence Certificates and Sign-Offs

The due diligence processes provided for sign-off opinions and certificates to be provided by parties and committees involved in the conduct of due diligence and in the preparation of the Information Memorandum.[132]

3.2.2.1 Due Diligence Certificates

In the case of the due diligence process, the Due Diligence Planning Memorandum sets out the proforma sample certificates to be provided to the Due Diligence Sub-Committee by the parties and consultants engaged in the conduct of due diligence.[133] The certificates relate to each aspect of due diligence. ETSA Power and ETSA Utilities were required to certify that the information and responses provided in response to an Information Request and contained in the data room were accurate and complete. The relevant party (Legal Consortium in the case of Legal Due Diligence and General Due Diligence and KPMG in relation to Financial Due Diligence) were required to certify that the relevant disclosure guidelines contain all relevant categories of information, the party has identified all relevant information that it itself holds, the methodology adopted is consistent with that approved by the Lease Committee and, subject to the assumptions in paragraph 13 of the Due Diligence Planning Memorandum,[134] the party was not aware of any material omission from or inaccuracy in the data room. In relation to Technical, Commercial and Operational Due Diligence, ETSA Power and ETSA Utilities provided certification in relation to both the disclosure guidelines and the responses to the Information Requests. The ERSU provided certification in relation to the Electricity and Energy Due Diligence process.

Certificates were given on 28 September 1999 by parties involved in the conduct of due diligence to the Due Diligence Sub-Committee in relation to the due diligence conducted to 30 June 1999. In particular:

- each electricity entity certified to the Due Diligence Sub-Committee that the information and documents it provided in response to each of the Information Requests received and contained in the data room were accurate and complete.[135]
- each party responsible for conducting due diligence[136] provided a sign-off certificate to the Due Diligence Sub-Committee that, subject to various qualifications, provided:

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132 As provided for in section 8.6 of the Due Diligence Planning Memorandum.

133 Annexure 3 of the Due Diligence Planning Memorandum.

134 This paragraph contains assumptions to the reliance which may be placed on the accuracy and completeness of the information provided by the electricity entities and on reports provided by expert reports engaged by or on behalf of the ERSU in connection with the sale of the electricity entities. It also contains the limitation of liability clause — clause 13.2.

135 Section 8.6.3 of the Due Diligence Planning Memorandum.

136 The Legal Consortium in respect of Legal Due Diligence and General Due Diligence, KPMG in respect of Financial Due Diligence, the ERSU in respect of Electricity and Energy Industry Due Diligence and both ETSA Utilities and ETSA Power in respect of Technical, Commercial and Operational Due Diligence.

— the disclosure guidelines for the due diligence it conducted contained all categories of documents of a specified nature[137] that in its opinion should be made known to a bidder in its deliberations as to whether it should make an investment decision in respect of the business operated by the electricity entity;[138]

— the party had identified all documents held or produced by it which in its opinion should be made known to a bidder in its deliberations as to whether it would make an investment decision in respect of business operated by the electricity entity;[139]

— the methodology adopted by the party in undertaking the due diligence was consistent with that approved by the Lease Committee;

— the party was not aware of any material omission from or inaccuracy in the data room insofar as it contains documents derived from the due diligence conducted by that party.

- other parties involved in the due diligence process provided certificates that they had identified all documents held or produced by them that in their opinion should be made known to a bidder for each of the electricity entities or their business or assets in the bidder's deliberations over whether it would make an investment decision in respect of the businesses operated by each of the electricity entities.[140]

The Due Diligence Sub-Committee provided to the Lease Committee a 'Due Diligence Report' given as at 28 September 1999[141] and signed by members of the Due Diligence Sub-Committee on behalf of the entity they represent. The Report, annexed to which were the sign-off certificates provided to the Due Diligence Sub-Committee, certified to the Committee,[142] subject to various qualifications and assumptions that:

- the disclosure guidelines for the due diligence conducted contained all categories of documents of a legal, financial, technical, commercial and operational nature and relating to or referred to in various Transfer Orders that in its opinion should be made

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137 For example, in the case of the Financial Due Diligence certificate provided by KPMG, all categories of documents of a financial nature.

138 Separate certificates were provided by both the Legal Consortium and KPMG for ETSA Utilities and ETSA Power.

139 This statement was not made in the Legal Consortium Certificate on General Due Diligence given as at 28 September 1999. See Annexure 8 to the 'Due Diligence Report' given as at 28 September 1999.

140 Certificates were provided by Pacific Road Corporate Finance, Morgan Stanley, William M Mercer Pty Ltd, Kinhill Pty Ltd, Hyder (Australia) Pty Ltd, Sinclair Knight Merz Pty Limited, Walmarriningin Pty Ltd, Putman, Hayes & Bartlett — Asia Pacific Pty Ltd and PA Consulting Group.

141 It should be noted that clause 1.2 of the Report provides:

> *It (ie the Report) may not, without the consent of all Parties, otherwise be relied upon by, or disclosed to, any other person or referred to in any public document except as required by law.*

142 Section 4 of the 'Due Diligence Report'.

known to a bidder in its deliberations as to whether it should make an investment decision in respect of the business operated by each Electricity Entity;

- all information and documents provided in response to Information Requests were accurate and complete;
- all information and documents contained in the data room in regard to each paragraph of the disclosure guidelines and the data room index were complete and accurate;
- the methodology adopted by the Due Diligence Sub-Committee in undertaking the due diligence was consistent with that approved by the Lease Committee;
- the Due Diligence Sub-Committee was not aware of any material omission from or inaccuracy in the data room insofar as it contains documents derived from the due diligence.

The 'Due Diligence Report' notes that certificates had not been obtained from all consultants as required by the Planning Memorandum.[143] Of the three certificates that are noted as missing, one is due to an entity refusing to provide a certificate, another is due to the entity not actually producing any documentation for the due diligence process and the other is noted as being 'outstanding'.[144]

The 'Due Diligence Report' was presented to and approved by the Lease Committee at its meeting on 28 September 1999.[145] At that meeting the Lease Committee directed that the 'Due Diligence Report' be provided to the Treasurer.

On 7 December 1999, after receipt of the Final Bids, the 'Supplementary Due Diligence Report' in respect to due diligence as at 12 November 1999[146] was presented to and approved by the Lease Committee. Attached to this Report were a further set of sign-off certificates received from the parties and consultants, in the form as required in the Planning Memorandum in respect of Supplementary Due Diligence conducted as at 12 November 1999.

Audit Comment

It is important that each adviser and other party engaged in the conduct of due diligence on behalf of the State provide appropriately structured and comprehensive opinions or 'sign-offs' on the conduct and outcome of the due diligence investigations undertaken and addressing the identified risks to the State arising from the conduct of the due diligence

143 Section 8.6.2.

144 Section 3 of the 'Due Diligence Report'.

145 Refer to item 3 of the Minutes of the Meeting of the Lease Committee held on 28 September 1999.

146 For the period 1 July 1999 to 12 November 1999. This period comprises Supplementary Due Diligence as at 30 September 1999 (for the period 1 July 1999 to 30 September 1999), 31 October 1999 (for the period 1 October 1999 to 31 October 1999) and 12 November 1999 (for the period 1 November 1999 to 12 November 1999). Refer to section 2.2 of the 'Supplementary Due Diligence Report'.

process. In particular the accuracy and completeness of the information concerning the sale entity released to bidders in a data room. Each adviser must also be accountable to the State for the advice provided concerning the appropriateness and effectiveness of the due diligence and related processes developed for the disposal process. The provision of such sign-offs will provide the State with comfort that the due diligence process has been conducted by the parties engaged in that process with all due care and attention. Ideally the sign-offs will also provide some comfort as to the suitability and/or effectiveness of the due diligence process in meeting its stated objectives or in affording protection or defences to the State should the process be challenged. Accordingly, it follows that should a party fail to exercise such due care and attention or if the processes fail to meet their stated objectives the State may have recourse against that party for any loss that it may suffer as a consequence.

The Planning Memorandum, which was signed by the ERSU and the parties contemporaneously with the provision of the sign-off certificates provided with the 'Due Diligence Report' and shortly prior to the opening of the bidder data rooms due diligence process, reflects the due diligence process as conducted at the time of signature. It contains a set of assumptions to which each party[147] to the Planning Memorandum will have the benefit. The assumptions[148] include:

- Each other party has complied in all respects with the provisions of the Planning Memorandum and the Prior Memorandum.
- Except in limited circumstances, all matters, information, documents and evidence relevant to the reform and sale lease process have been brought to that party's attention by the electricity corporations and electricity entities in response to any request by that party for information and documents.
- Each electricity corporation and electricity entity has complied with their respective due diligence protocols[149] and document management procedures.[150]

The certification by the Due Diligence Sub-Committee in respect of the Sale/Lease Due Diligence in the 'Due Diligence Report', as required by the Planning Memorandum,[151] was provided on the basis of the sign-off certificates and the assumptions as set out in paragraph 13 of the Planning Memorandum.

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147 The Treasurer, the Lead Advisers, the Legal Consortium and KPMG.

148 Section 13.1 of the Planning Memorandum.

149 The protocol in respect of the electricity entities is Annexure 4 to the Planning Memorandum. The protocol requires the electricity entities to comply with the due diligence procedures, including responding to the Information Requests submitted by the parties.

150 Annexure 5 to the Planning Memorandum.

151 Section 12.

The Planning Memorandum, also provides:

> *If a relevant Party conducts Sale/Lease Due Diligence substantially in accordance with this memorandum and, in the case of KPMG its Due Diligence Planning Memorandum (Annexure 1[152]), takes due care in the performance of its due diligence work and acts in good faith, that relevant Party has no liability arising from any cause of action whatever (whether at common law, in equity by statute or otherwise at law) to the State of South Australia, any other Party or any other person in connection with the Sale/Lease Due Diligence.*[153]

The Legal Consortium and KPMG are each referred to as a 'relevant Party'.

A similar provision is contained in the Prior Memorandum.[154]

The certification by the Due Diligence Sub-Committee in respect of the Supplementary Due Diligence in the 'Supplementary Due Diligence Report' was also provided on the basis of the sign-off certificates and the assumptions as set out in paragraph 13 of the Planning Memorandum.[155]

As a consequence, both the Legal Consortium and the Accounting Adviser have no liability to the State or any other party in connection with the conduct of the Sale/Lease Due Diligence and Supplementary Due Diligence if they each conduct their due diligence work in accordance with the applicable memoranda, take due care in the performance of their respective due diligence work, and act in good faith.

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[152] It is Annexure 2 to the Planning Memorandum. The KPMG Due Diligence Planning Memorandum addresses the financial due diligence on ETSA Power and ETSA Utilities. The main purposes of the due diligence are described as follows:

> …
> - *preparation of financial information to assist with the production of information memoranda to be given to potential buyers including information to support historical financial information, completion accounts, and financial forecasts; and*
> - *compilation of comprehensive financial information (and storage of that information in a data room) to which short listed bidders will be given access to enable them to undertake their own investigations and own assessment of the assets.*

[153] Refer to clause 13.2 of the Planning Memorandum.

[154] Refer to section 13.2 of the Prior Memorandum.

> *If a relevant Party conducts due diligence substantially in accordance with this memorandum and any applicable Due Diligence Plan, takes due care in the performance of its due diligence work and acts in good faith, that relevant Party has no liability arising from any cause of action whatever (whether at common law, in equity by statute or otherwise at law) to the State of South Australia, any other Party or any other person in connection with the due diligence.*

[155] Section 5.2 of the 'Supplementary Due Diligence Report'.

The Legal Consortium has confirmed to the ERSU that its Consultancy Agreement requires the Legal Consortium to provide its legal services in connection with the project 'professionally, carefully, skilfully and competently'. Further it has advised that paragraph 13.2 of the Planning Memorandum and the Consultancy Agreement are consistent, as both require the Legal Consortium to act with due care and that it was not intended that paragraph 13.2 would alter the terms of the Consultancy Agreement. The Legal Consortium has further confirmed that if it complies with the requirements of paragraph 13 it would not be liable for the due diligence process.[156]

The Accounting Adviser has advised the ERSU that its obligations to the State are set out in clause 6 of its Consultancy Agreement with the Treasurer dated 6 May 1998 and has confirmed that paragraph 13.2 of the Planning Memorandum 'was simply viewed as a statement of fact with no intention to limit liability'.[157]

The ERSU have also advised that they consider it to be '... inconceivable that the terms of the Planning Memorandum would be read as overriding in any way the terms of the retainers of these advisers'.[158]

As confirmed by the Legal Consortium and contrary to the conclusion reached by the Accounting Adviser and the ERSU, the actual effect of paragraph 13.2 of the Planning Memorandum was, in my opinion, to ensure that each party would not be liable in connection with the conduct of the due diligence if they complied with the requirements set out in that paragraph.

In addition, both the Legal Consortium and the Accounting Adviser have the benefit of being able to rely on the wide ranging assumptions as to the accuracy and completeness of the information provided to it by the electricity entities.

Further, if the due diligence processes and methodologies adopted by the State on the advice of the Legal Consortium and/or the Accounting Adviser as being suitable for the disposal process are subsequently found not to be appropriate or effective and as a consequence the State was to suffer a loss, the Legal Consortium and/or the Accounting Adviser may not be liable to the State in respect of that loss. The Legal Consortium and the Accounting Adviser may only be found to be liable to the State or another Party if they are found not to have conducted due diligence otherwise than in accordance with the Planning Memorandum or acted carefully or in good faith when conducting due diligence. As the State has relied on the advice provided by the Legal Consortium and the Accounting Adviser in developing the legal and financial due diligence processes respectively, it is reasonable to expect that these advisers would accept some responsibility for the suitability or effectiveness of their due diligence processes.

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156 Letter from the Legal Consortium to the ERSU dated 23 August 2000 titled 'Due Diligence Planning Memorandum'.

157 Letter from KPMG to the ERSU dated 24 August 2000 titled 'Due Diligence Planning Memorandum'.

158 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

In my opinion, one possible construction of paragraph 13.2 of the Planning Memorandum is that in circumstances where 'a relevant Party' conducts Sale/Lease Due Diligence as required by that paragraph, the State is obliged to indemnify that party (ie the Legal Consortium and/or the Accounting Adviser) in connection with all liability against that party arising from any cause of action whatever to the State or another person in connection with the Sale/Lease Due Diligence. As noted above as the certification by the Due Diligence Sub-Committee in respect of the Supplementary Due Diligence in the 'Supplementary Due Diligence Report' was also provided on the basis of the sign-off certificates and the assumptions as set out in paragraph 13 of the Planning Memorandum, this indemnity would also apply to the Supplementary Due Diligence undertaken by the Legal Consortium and the Accounting Adviser.[159] The ERSU has advised Audit that it was never intended that the State would so indemnify the Legal Consortium and the Accounting Adviser and advised that this has been confirmed by the letters provided to the ERSU by both parties.[160] The letters referred to by the ERSU from the Legal Consortium[161] and the Accounting Adviser[162]concerning paragraph 13.2 of the Planning Memorandum do not address this issue.

The matter of considering the extent of potential liability is covered in Recommendation 14.

3.2.2.2 Information Memorandum Sign-Off

The Information Memorandum dated 30 August 1999 was prepared by the Information Memorandum Sub-Committee with the assistance of the Due Diligence Sub-Committee.

The Planning Memorandum provided that the ERSU, the Legal Consortium, the Lead Advisers, the Accounting Adviser and the electricity entities were required to disclose to the Due Diligence Sub-Committee any information which:

- had been obtained by them in performing those aspects of Sale/Lease Due diligence for which they are responsible in relation to the sale/lease of each electricity entity;
- meets the materiality guidelines approved by the Lease Committee for disclosure of information in the Information Memorandum;
- has not otherwise been identified for disclosure to members of the Legal Consortium responsible for the preparation of the Information Memorandum.[163]

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159 Section 5.2 of the 'Supplementary Due Diligence Report'.

160 Letter from the ERSU to Audit dated 28 August 2000 titled 'ETSA Utilities and ETSA Power. Questions regarding Project Documentation and Due Diligence Process'.

161 Letter from the Legal Consortium to the ERSU dated 23 August 2000 titled 'Due Diligence Planning Memorandum.'

162 Letter from KPMG to the ERSU dated 24 August 2000 titled 'Due Diligence Planning Memorandum'.

163 Section 8.5 of the Planning Memorandum.

On 30 August 1999 the Due Diligence Sub-Committee provided to the Lease Committee a memorandum titled 'Due Diligence Sub-committee Report — Information Memorandum'. The memorandum, which was given as at 20 August 1999 and signed by members of the Due Diligence Sub-Committee, contains a sign-off opinion on the Information Memorandum. Appended to the memorandum are certificates provided by the ERSU, the Legal Consortium, Accounting Adviser and the electricity entities.[164] Each certificate addresses the disclosure points referred to in the Planning Memorandum.[165] The certificates provided by the Legal Consortium and Accounting Adviser note that they are given on the basis of the assumptions in relation to the undertaking of the Sale/Lease Due Diligence in the Planning Memorandum. This is a reference to the assumptions in section 13 of the Planning Memorandum, referred to in this Report under the heading '3.2.2.1 — Due Diligence Certificates'.

The Due Diligence Sub-Committee memorandum was prepared to provide the sign-off referred to in the letter proposed to be provided by the Lease Committee to the Treasurer. In the memorandum the Due Diligence Sub-Committee advised that it coordinated a program to obtain disclosure of information and reported to the Information Memorandum Sub-Committee.

The Lease Committee provided a letter to the Treasurer in relation to the Information Memorandum dated 30 August 1999. The letter confirms that the Lease Committee was responsible for coordinating and supervising the preparation of the Information Memorandum. It also confirms that the Lease Committee was responsible for the systematic examination of those aspects of ETSA Power and ETSA Utilities that are described in the Information Memorandum to ensure there is no material statement which is false and misleading and no material omissions.[166] The letter confirms its adoption of the materiality guidelines prepared by the Information Memorandum Sub-Committee and the due diligence methodology. The letter concludes with the statement that nothing has come to its attention to cause it to believe that there may be a material statement in the Information Memorandum that is false or misleading, that there may be a material omission from the Information Memorandum, or, that the issue of the Information Memorandum may involve conduct that is misleading or deceptive or likely to mislead or deceive.[167]

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164 Annexure 2.

165 Section 8.5.

166 Paragraph 2.3 of the letter.

167 Paragraph 5.1 of the letter.

The letter provides that:

> *The conclusions of the Committee … are qualified to the extent to which the are based on principles, assumptions and procedures adopted and followed by the Committee.*[168]

Audit Comment

A similar situation exists in relation to the issue of the Information Memorandum as that described previously in this Report under the heading '3.2.2.1 — Due Diligence Certificates' in the context of the Sale/Lease Due Diligence. The Legal Consortium and the Accounting Adviser have no liability arising from any cause of action whatever to the State or any other party or any person in connection with the Sale/Lease Due Diligence. This includes the identification of information to the State in relation to the assets, liabilities and functions of each electricity entity to assist the State in the preparation of the Information Memorandum, if they act in accordance with the applicable memoranda, take due care in the performance of their work in preparing the document and act in good faith. In addition, each party has the benefit of being able to rely on the wide ranging assumptions as to the accuracy and completeness of the information provided to it by the electricity entities for the purposes of fulfilling its obligations.

Audit Recommendation 14

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process carefully consider, prior to agreeing the terms of a due diligence process:

- **the protection or comfort that the State is afforded by the due diligence process in the event of a claim or litigation being instituted against the State which is related directly or indirectly to the conduct of due diligence, and the provision of due diligence information to prospective purchasers;**

- **the recourse available to the State and the State's potential exposure to liability (including the provision of indemnities by the State to parties for liability arising from claims in connection with the conduct of the due diligence, including the issue of an Information Memorandum) in the event of such a claim or litigation being instituted. This review to include but not be limited to, an examination of the operation and impact of any liability exclusion clauses in due diligence planning documents to which the State is a party, for the benefit of parties who are engaged, as experts, to advise the State on the development, conduct and outcomes of due diligence process.**

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[168] Paragraph 5.3 of the letter.

3.2.3 Identification and Management of Key Issues

The focus of the Sale/Lease Due Diligence was the identification of assets and liabilities of the electricity entities which met the disclosure guidelines, including to provide information on the assets, liabilities and functions of each electricity entity in order to assist the State in the preparation of the Information Memorandum. A further object of the due diligence was the identification of any legal impediments to the sale or lease of assets or liabilities of an electricity entity should the business of any electricity entity be sold or leased to a bidder instead of a sale of shares, to enable the State to take steps to address those legal impediments.[169]

The Lease Committee approved a protocol for project management, however, it is evident that this protocol did not address all of material issues identified in the due diligence process and the timetable for their resolution. A memorandum dated 24 June 1999, set out a protocol for work plans and committee meetings which was approved by the Lease Committee on the 29 June 1999.[170] The protocol principally addressed the requirement for sub-committees to prepare a detailed timetable of tasks to be completed, their intended completion date and the person primarily responsible for completing each of those tasks. The Lease Committee was advised that once the task lists had been completed they would be incorporated into a master control chart for the project, which would be regularly circulated to the Committee and to each of the sub-committees.[171] The master control chart dealt with material issues such as US Cross Border Lease consents under the heading 'Miscellaneous'. It is clear that not all issues of this nature identified and addressed by the Lease Committee were specifically referred to in the master control chart.

On 7 July 1999 the Lease Committee endorsed the general proposal submitted by the Legal Consortium for a legal compliance review of ETSA Utilities and ETSA Power (also referred to as a material legal risks analysis).[172] It is understood that this was essentially a legal risk management review of the electricity entities to inform the Lease Committee on the state of legal compliance systems applying within those entities.[173] The rationale for the review was described by the Legal Consortium to the Lease Committee:

> *Legal compliance work is important to the lease process, given its close relationship to due diligence and the need to ensure that the entities are in a position to comply with material applicable laws. In particular, it is necessary to ensure that systems are in place to deal with risk under the trade Practices Act, the National Electricity code, other Electricity Industry regulatory*

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169 Section 3.2.4 of the Planning Memorandum.

170 Refer to item 12 in the Minutes of the Meeting of the Lease Committee meeting held on 29 June 1999.

171 Refer to item 12 in the Minutes of the Meeting of the Lease Committee meeting held on 29 June 1999.

172 Refer to item 3 of the Minutes of Meeting of the Lease Committee dated 7 July 1999.

173 Memorandum from the Legal Consortium to the Sale Due Diligence Committee titled 'Legal Compliance' dated 8 December 1998.

instruments and laws that will begin to apply (or apply differently) when the entities lose Crown status (for example consumer protection provisions of the Trade Practices Act).[174]

The Legal Consortium advised that as a consequence of this review it proposed to provide recommendations to the ERSU in relation to the legal compliance systems in place with the electricity entities in relation to:

- what further work, if any was required;
- whether different priorities should be applied;
- key milestones and deliverables.[175]

The legal compliance review had a particular focus and whilst it may have identified issues which were required to be addressed prior to completion of the sale/disposal it did not provide a comprehensive review of material issues relating to the electricity entities in the context of the disposal process. The methodology adopted for the legal compliance review, if applied generally, may have been effective for addressing material issues.

A further aid to project management, a paper titled 'Sale of ETSA Utilities/ETSA Power Remaining Steps' which identified a number of key issues, was first tabled at a meeting of the Lease Committee on 23 November 1999.[176] It reflected a number of the matters referred to in the control chart. The document did not identify or prioritise those issues which were required to be resolved (as distinct from being scheduled to be finished) prior to execution of the sale agreements or completion or provide an assessment of the impact, if any of a failure to achieve resolution by the nominated finish date.

Audit Comment

The purpose of due diligence should not be limited to the identification of documents and information for inclusion into information memoranda or data rooms. It should also seek to identify issues relating to the sale entity which may impact on the conduct of the sale or disposal within the sale timetable. Such issues may include the operation of change of ownership clauses in material contracts, the unwinding of government loans and guarantees, a requirement to obtain third party consent to the release of information held by the sale entity or the execution of material contracts or agreements by the sale entity prior to completion of the sale. Most of these issues should be identified during the conduct of due diligence. In order to avoid the possibility of delays to a sale/disposal process, which may arise if such issues are not addressed in the early stage in the process, such issues should be identified early in the due diligence process, be recorded, monitored and if necessary, addressed by an appropriate person which could include a member of the due diligence committee.

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[174] Memorandum from the Legal Consortium to the Lease Committee titled 'Legal Compliance' dated 7 July 1999.

[175] Memorandum from the Legal Consortium to the Lease Committee titled 'Legal Compliance' dated 7 July 1999.

[176] Refer to item 7 of the Minutes of Meeting of the Lease Committee held on 16 November 1999.

It is evident that whilst a number of specific issues were addressed by the Due Diligence Sub-Committee during the conduct of the due diligence process, a comprehensive process to identify and address such issues was not implemented until the later stages of the Sale/Lease Due Diligence.

ERSU Response

The ERSU advised that a number of the matters I have identified as examples of issues to be addressed through due diligence, were in fact addressed in the disposal process although not necessarily through the due diligence process.[177]

Further Audit Comment

I remain of the view that the better approach would be to incorporate identification and consideration of these issues into the due diligence process.

Audit Recommendation 15

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process incorporate into the due diligence process an effective mechanism for identifying, addressing, and monitoring the resolution of material issues which may impact upon the conduct of the disposal process and appointing responsibility for resolution of that issue to a nominated party or parties.

3.2.4 Provision of Current Information to Bidders

The due diligence process in relation to the Disaggregation Process was conducted pursuant to the Prior Memorandum. Due diligence work undertaken in 1998 for the distribution and retail businesses formed the basis of the Transfer Orders signed by the Treasurer on 12 October 1998 which gave effect to the Disaggregation.[178]

Between June 1998 and October 1998 information and documents were provided by the electricity corporations in response to written requests which were made in relation to each of the areas of legal investigation and details of each request and responses received were

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177 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

178 Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

entered into a database. Details of the assets and liabilities specified in the Transfer Orders were extracted primarily from information derived from the database.[179]

After October 1998 ETSA Utilities and ETSA Power reviewed the assets and liabilities which had been transferred to them and identified anomalies in the Transfer Orders.[180] On 31 July 1999 Supplementary Transfer Orders were signed by the Treasurer.

The Legal Consortium advised the Lease Committee that the due diligence conducted in 1998 would need to be initially updated as at 30 June 1999 and subsequently through to completion of the lease/sale transaction.[181]

On 29 June 1999 the Lease Committee discussed the scope of the information to be provided to bidders in the data rooms and agreed

> *… that the data room should comprise only those documents referred to in the transfer orders which meet the proposed disclosure guideline for legal due diligence as at 30 June 1999.*[182]

The Minutes do not provide an explanation for this decision of the Lease Committee.

However, the ERSU have since advised[183] that the reason for the 30 June 1999 cut-off date was to ensure the presentation of a data room containing documents that had received appropriate quality assurance testing.

On 29 June 1999 the Lease Committee:

- adopted the materiality guidelines proposed by KPMG in the document, 'Materiality Guidelines for Due Diligence Procedures', being Appendix 1 to the draft Financial Due Diligence Planning Memorandum;[184]
- approved a 30 June 1999 due diligence cut-off date with updates to occur on 31 August 1999 and monthly thereafter.[185]

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179 Refer to section 2 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

180 Refer to section 2 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

181 Refer to section 3 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

182 Refer to item 8 in the Minutes of the Meeting of the Lease Committee meeting held on 29 June 1999.

183 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

184 Refer to item 9 in the Minutes of the Lease Committee meeting held on 29 June 1999.

185 Refer to item 8 in the Minutes of the ETSA Lease Committee held on 29 June 1999.

In a memorandum to the Lease Committee dated 6 July 1999 the Legal Consortium advised:

> *A focus on the end result of the due diligence suggests that the primary document to be settled by the Lease Committee is a set of Disclosure guidelines for legal due diligence, financial due diligence and commercial, technical and operational due diligence. The Disclosure Guidelines set the overall framework within which each stream of due diligence will be conducted (including the issue of Information Requests).*[186]

In developing the Disclosure Guidelines relating to Legal Due Diligence the Legal Consortium advised that they had assessed and included information and documentation which they expected would be asked for by lawyers conducting due diligence for the bidders. A Legal Information Request addressed to ETSA Power and ETSA Utilities was prepared by the Legal Consortium to obtain updated information only in relation to the matters addressed in the Legal Due Diligence Guidelines.[187]

In the memorandum dated 6 July 1999 the Legal Consortium advised the Lease Committee that:

> *Prospective bidders obviously will be interested in the transfer orders in that they provide them with a detailed picture of the assets and liabilities which each entity inherited as at 12 October 1998.*[188]

The Legal Consortium further advised that the primary source of information and documentation for the data room will be the due diligence conducted in 1998, as supplemented by the then current due diligence.[189] It acknowledged the decision taken by the Lease Committee on 29 June 1999 that not all the documents referred to in the various Transfer Orders would be included in the data rooms and noted that:

> *One important aspect for the Lease Committee to consider in settling the Disclosure Guidelines is that information which does not satisfy the guidelines may not be readily available on a timely basis if requested by a bidder.*[190]

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186 Refer to section 3 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

187 Refer to section 5 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

188 Refer to section 2 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

189 Refer to section 3 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

190 Refer to section 4 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

On 7 July 1999, the Legal Consortium advised the Lease Committee that information provided by ETSA Utilities and ETSA Power in response to the Legal Information Request would be analysed to determine whether anything of significance may be relevant to the Information Memorandum. The information would also be used in relation to the compilation of the data room.[191]

When the data rooms opened on 4 October 1999 the information provided to bidders was current as at 30 June 1999. The Disclosure Guidelines specifically directed the electricity entities to identify matters and provide documents up to 30 June 1999. Thereafter, the advisers were engaged in undertaking Supplementary Due Diligence, seeking to update the information provided to bidders.

On 20 October 1999, the Legal Consortium reported to the Lease Committee that the process of updating due diligence requests to 30 September 1999 had commenced resulting in additional documents being included in the data room.[192]

On 26 October, the Legal Consortium reported to the Lease Committee that supplementary due diligence to 30 September 1999, which had resulted in a substantial volume of material being placed in the data room, was generally complete. It was noted that further materials arising from supplementary due diligence were to be placed in the data room on 29 October 1999.[193]

On 28 October 1999, the Legal Consortium reported to the Due Diligence Sub-Committee that legal update due diligence to 30 September 1999 was continuing.[194] KPMG reported to the Due Diligence Sub-Committee that a significant number of documents had not been provided for financial update due diligence as at 30 September 1999.[195] Reports were received concerning other update due diligence.[196] The Due Diligence Sub-Committee noted that a Supplementary Information Request to ETSA Utilities and ETSA Power for October 1999 had been issued and the entities had been asked to reply to the information request by 4 November 1999.[197]

On 9 November 1999, the Legal Consortium advised the Lease Committee that due diligence enquiries to 31 October 1999 would be completed by 12 November 1999.[198]

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191 Refer to section 5 of the Memorandum to the Lease Committee dated 6 July 1999 titled 'Status Report on Due Diligence for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd' prepared by the Legal Consortium referred to in item 3 of the Minutes of the Lease Committee meeting held on 7 July 1999.

192 Refer to item 4 of the Minutes of Meeting of the Lease Committee held on 20 October 1999.

193 Refer to item 4 of the Minutes of Meeting of the Lease Committee held on 26 October 1999.

194 Refer to item 13 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 28 October 1999.

195 Refer to item 14 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 28 October 1999.

196 Refer to items 15, 16 and 17 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 28 October 1999.

197 Refer to item 21 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 28 October 1999.

198 Refer to item 12 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 28 October 1999.

On 16 November 1999, the Legal Consortium expressed concern to the Lease Committee at the large number of documents going into the data room 'at this late stage' and emphasised the need to bring documents forward as soon as possible in order to permit bidders to have adequate time to assess the information. It was noted that many of the outstanding documents were agreements waiting to be executed.[199] It was reported to the Committee that a further 20 folders of information were to be placed in the data rooms on 19 November 1999.[200]

On 25 November 1999, the Due Diligence Sub-Committee noted that the due diligence periods of 30 October 1999 and 12 November 1999 had been merged in order to reflect what was outstanding in relation to the final cut-off date for inclusion of documents in the data room.[201] On 30 November 1999, the final due diligence documents delivered to the data room.[202]

Audit Comment

The data rooms contain the information and documentation upon which bidders would be largely relying in conducting their due diligence inquiries. It is therefore important that the due diligence process ensures that all potentially relevant information is identified and then reviewed to determine whether it should be included in the data rooms to enable bidders to undertake their inquiries. It is equally important that bidders be provided with up to date information in the data rooms. The provision of such information should have the effect of reducing the number of questions asked of management during management interviews and questions asked in the formal question and answer process. Further, the more time bidders have to review information the more able they are to fully consider any issues or matters of importance identified in the documents. The conduct of due diligence is an expensive and time consuming exercise and the timely provision of up to date and complete information can help in mitigating such costs.

When bidders gained access to the data rooms on 4 October 1999 the information provided was three months out of date. Thereafter, it was updated to 30 September and then on a month-to-month basis. At the end of October 1999, one month after the data rooms opened, the information had yet to be completely updated to 30 September 1999. Given the nature of the process adopted in gathering information from the electricity entities it is not surprising that on 16 November 1999 large numbers of documents were reported by the Legal Consortium to be going into the data room 'at this late stage'. The Legal Consortium emphasised the need to bring documents forward as soon as possible in order to permit bidders to have adequate time to assess the information. In these circumstances it is not surprising that prior to 6 December 1999 some bidders asked the ERSU for an extension of time for conducting due diligence.

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199 Refer to item 3 of the Minutes of Meeting of the Lease Committee held on 16 November 1999.

200 Refer to item 3 of the Minutes of Meeting of the Lease Committee held on 16 November 1999.

201 Refer to item 12 of the Minutes of Meeting of the Due Diligence Sub-Committee held on 25 November 1999.

202 Refer to item 2 of the Minutes of Meeting of the Lease Committee held on 25 November 1999.

In my opinion, the Lease Committee should have anticipated the problems associated with gathering and disseminating the information to bidders due to the 30 June 1999 cut-off for the Sale/Lease Due Diligence and the late commencement of the supplementary due diligence. Measures should have been introduced to ensure, that as far as possible, bidders were provided with up to date information in the data rooms on 4 October 1999. Further steps should have been taken to immediately update the information in the data rooms and supplement the material on a continuous basis, rather than be pegged to a specified release date.[203] This process would have been assisted had an effective system[204] been in place for identifying whether material documents had been executed and hence capable of being released (or at least up-to-date drafts being provided).

ERSU Response

The ERSU responded[205] that '...a detailed system was established by the Legal Consortium for the monitoring of material documents not included in the data rooms'.

Further Audit Comment

It is relevant to note that it was the Legal Consortium that raised concern as to the late introduction of large volumes of material.

Audit Recommendation 16

I recommend that for future disposal processes of State owned entities that the agency responsible for conducting that process, ensure that as far as possible material provided to bidders in a data room or by other means at the commencement of bidder due diligence be up-to-date and be regularly updated during the conduct of bidder due diligence.

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203 Documents should be released by the sale entity as they come into existence and any information provided should be updated as incidents occur which render inaccurate information previously provided.

204 Of the type referred to in Recommendation 15.

205 Response to Audit Issues Paper under cover of letter dated 22 November 2000 from the Under Treasurer.

PART 4
ARRANGEMENTS FOR THE CONDUCT OF THE FINAL BIDDING PROCESS

4.1 OVERVIEW OF THE FINAL BIDDING PROCESS

4.1.1 Chronology of the Final Bidding Process

A chronology of the final bidding process managed by the ERSU and its advisers is as follows:

- **Thursday 2 December 1999:**

  As provided in the Supplementary Probity Rules (Internal) issued by the ERSU, an Evaluation Committee was formed to consider and evaluate the Final Bids. The Committee, which was chaired by the Under Treasurer, comprised representatives of the Department of the Premier and Cabinet, the ERSU, Crown Solicitor's Office, and the Lead Advisers. It first met on 2 December 1999.

- **Monday 6 December 1999:**

  Final Bids were received by the ERSU.

  The Evaluation Committee met prior to the receipt of the Final Bids. The Committee discussed the approach to be applied by the Committee for the evaluation of the Final Bids[206] and noted that the approach should not be departed from without taking advice.[207]

  Following receipt of the Final Bids the Evaluation Committee met and considered the circumstances surrounding the receipt of a late bid. Noting that the bidder had notified the ERSU that the bid would be late, and the bid was received within a very short time after the time for Final Bids had closed, the Committee, after receipt of advice from the Lead Advisers and the Legal Consortium, recommended to the Treasurer that the late bid be accepted and considered with the other Final Bids. The Treasurer's Probity Auditor, Mr Stretton, supported this recommendation.[208] The Treasurer exercised his discretion to consider and accept the late bid.[209]

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206 Refer to commentary under the heading '4.2.1 — Evaluation Arrangements' in this Report.

207 Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

208 Refer to 'Preliminary Report Concerning Final Bid Receipt And Evaluation' by S Stretton, Probity Auditor dated 17 December 1999.

209 Minutes of the Evaluation Committee meeting held at 6:00 pm on 6 December 1999.

On the basis of the information provided for my examination concerning the circumstances relating to the receipt of the late bid I am of the opinion that the treatment of the late bid was in accordance with the provisions dealing with late lodged bids as found in the Bidding Rules, and I concur with the Treasurer's decision.

- **Tuesday 7 December 1999:**

The Evaluation Committee undertook a preliminary review of the Final Bids and considered options for the conduct of the Final Bid process.[210] The Committee determined and reported to the Treasurer that its preferred position was to begin negotiation of contract terms with one bidder with the view of reaching a position over the following 24 to 48 hours.[211] The Treasurer reported to the Committee that he wished the Committee to consider negotiations with all bidders.[212] After further consideration the Evaluation Committee resolved that it would advise the Treasurer that it would be proper for all bidders to be contacted and invited to negotiations on the 'price' and 'risk' element of their final bid. The Committee requested and obtained authorisation from the Treasurer[213] to negotiate with each bidder on the following basis:

- *first to negotiate the best risk allocation achievable from that bidder; and*
- *then, unless that risk allocation was unacceptable irrespective of price, to negotiate improvement of the bidder's offered price.*

Following negotiations with the bidders, the Evaluation Committee was required to report to the Treasurer: '… as soon as it achieves an offer which it considers is the best offer reasonably available to the State'.[214]

The above process for the negotiation of the Final Bids was subsequently referred to by the Evaluation Committee as the 'negotiation protocols'.

Each bidder was informed by telephone of the process for concluding the Final Bid process in accordance with a script.[215]

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210 Minutes of the Evaluation Committee meeting held at 12:00 pm and 3:55 pm on 7 December 1999.

211 Minutes of the Evaluation Committee meeting held at 3:55 pm on 7 December 1999.

212 Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

213 Minute to the Treasurer titled 'ETSA Utilities and ETSA Power Final Bids — Initial Evaluation Committee Report and Recommendation' dated 7 December 1999 being Attachment P to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

214 Minute to the Treasurer titled 'ETSA Utilities and ETSA Power Final Bids — Initial Evaluation Committee Report and Recommendation' dated 7 December 1999 being Attachment P to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

215 Attachment B (Lead Advisers file note dated 8 December 1999) to letter from the ERSU to Audit dated 18 February 2000.

- **Wednesday 8 December 1999 and Thursday 9 December 1999:**

  The Negotiating Team[216] appointed by the Evaluation Committee undertook discussions with all bidders. The negotiations were commenced through meetings with each bidder on 8 December 1999[217] first on the identified risk issues of their final bids and subject to a satisfactory resolution of such issues, negotiations were conducted on the price issues of their final bids.[218] The issues, which were specific to each bid, are referred to in the minutes of the Evaluation Committee. The type of risk issues that were the subject of negotiations included:

  - the terms of the financing structure supporting the final bid;
  - the status of approvals from regulatory authorities, financiers and others referred to in the final bid;
  - the proposed quantum of the Year 2000 liability cap;
  - deviations in final bids from the benchmark position in the Benchmark Project Agreements.
  - the principal price issue was the quantum of the consideration of the final bid.

- **Friday 10 December 1999:**

  The Evaluation Committee met and considered the progress reports from its advisers concerning the negotiations with the bidders. The Committee settled its report on the Final Bid evaluation to the Treasurer.[219]

  Further negotiations took place between members of the Negotiating Team and the bidders.

- **Saturday 11 December 1999:**

  The Evaluation Committee met and considered further progress reports from members of the Advisory Group concerning the negotiations with the bidders, which were continuing at that time. The Committee received advice from the Legal Consortium concerning the entering into of an Offer Deed with a bidder if

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216 Paragraph 7 of the Evaluation Methodology contained in a document titled 'Evaluation of Final Bids — Summary' dated 6 December 1999 — Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999 refers to the Negotiating Team, as contemplated by Bidding Rule 13.5. The Negotiating Team comprised members of the Evaluation Committee and members of the Lead Advisers and Legal Consortium.

217 A second meeting was held with one bidder on 9 December 1999 (Minutes of Negotiation Meetings held on 8 and 9 December 1999).

218 Attachment D (Minutes of Negotiation Meetings held on 8 and 9 December 1999).

219 Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999, and Attachment T Minute to the Treasurer titled 'Report by the Evaluation Committee — Final Bids for ETSA Utilities and ETSA Power'.

negotiations reached a stage where the Committee was able to recommend to the Treasurer that an offer be accepted.[220] The Evaluation Committee concluded that the position reached in the negotiations with Hong Kong Electric and Cheung Kong Infrastructure Holdings (HKE/CKI) for the sale/lease of ETSA Utilities and ETSA Power were such as to justify proceeding to the execution of an Offer Deed.[221] An Offer Deed was executed by the Treasurer and HKE/CKI and others.

- **Sunday 12 December 1999:**

  The Evaluation Committee met and settled its Supplementary Report on the Final Bid Evaluation to the Treasurer.[222] Cabinet met and considered the Treasurer's proposed decision to enter into agreements with Hong Kong Electric and Cheung Kong Infrastructure Holdings (HKE/CKI) for the sale/lease of ETSA Utilities and ETSA Power. Cabinet supported the Treasurer's proposal.

  Later that day, the Treasurer and HKE/CKI executed the Electricity Distribution Business Sale Agreement and Electricity Retail Business Sale Agreement.

4.1.2 General Comments Regarding the Documentation

The documentation directly relevant to the evaluation of the Final Bids falls into two categories. The first category concerns the documents provided to bidders, namely the Bidding Rules and the Supplementary Bidding Rules issued on 26 November 1999. These documents are considered by Audit under the heading 'Part 2 — Arrangements for the Conduct of the Bidding Process' of this Report.

The second category represents documents prepared by the ERSU and its advisers for use by the Evaluation Committee and members of the Advisory Group in conducting the Final Bid evaluation, in particular:

- the 'Evaluation of Final Bids — Summary';
- the script for the 'Negotiation Protocols';
- Advisory Group Reports.

It also includes documents created by the Evaluation Committee, in particular:

- the minutes of the Evaluation Committee;
- its advice and recommendations to the Government.

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220 Minutes of the Evaluation Committee meeting held at 4:15 pm on 11 December 1999.

221 Minutes of the Evaluation Committee meeting held at 4:15 pm on 11 December 1999.

222 Refer to Item 4 of the Minutes of the meeting of the Evaluation Committee held at 9:15 am on 12 December 1999, and Attachment A to the Minute to the Treasurer titled 'Evaluation Committee Supplementary Report'.

For the purpose of analysis in this Report, issues associated with the second category of documents have been examined under the headings:

- 4.2 — Development of the Evaluation Methodology
- 4.3 — Finalisation of the Evaluation Methodology
- 4.4 — Negotiation Protocols
- 4.5 — Advisory Group Reports
- 4.6 — Significant Issues arising from the Final Bid Evaluation Process
- 4.7 — Finalisation of the Final Bid Evaluation Process.

4.2 DEVELOPMENT OF THE EVALUATION METHODOLOGY

This section of the Report describes and comments on the development of the evaluation arrangements which underpinned the assessment of the Final Bids for ETSA Utilities and ETSA Power.

4.2.1 Evaluation Arrangements

The document 'Evaluation of Final Bids — Summary' dated 6 December 1999 contains: '… a summary of the arrangements intended to apply to the evaluation of Final Bids for ETSA Utilities and ETSA Power'.[223]

The document included three annexures, namely:

- Annexure 1 — Indicative Timetable for Final Bid Evaluation
- Annexure 2 — Final Bid Evaluation Matrix
- Annexure 3 — Advisory Team Allocation of Tasks.

The Evaluation Committee adopted the evaluation arrangements as contained in the 'Evaluation of Final Bids — Summary' on 6 December 1999.[224]

The 'Evaluation of Final Bids — Summary' was intended to be used by the Evaluation Committee and members of the Advisory Group. It was not intended that the document be provided to bidders.

The document refers to, and contains extracts from, the Probity Rules and the Bidding Rules in so far as they relate to the evaluation of bids. However, to the extent of any inconsistency, the Probity and Bidding Rules prevail over the document.[225]

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223 Section 1 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

224 Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

225 Section 1 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

The 'Evaluation of Final Bids — Summary' notes that an Evaluation Committee had been appointed by the Treasurer to analyse the Final Bids and to make recommendations to the Treasurer for his consideration. It further provides that 'Decisions as to selecting the Successful Bidder(s) for ETSA Utilities and ETSA Power will be made by Cabinet, on the recommendation of the Treasurer.' The Treasurer approved membership of an Advisory Group '… to be available to the Evaluation Committee to assist it with the analysis of the Final Bids and may appoint a Negotiating Team …'.[226]

The methodology for evaluating price and risk is set out in the 'Evaluation of Final Bids — Summary'.[227]

An Indicative Timetable for Final Bid Evaluation forms part of the evaluation arrangements. The timetable details the proposed conduct of the evaluation process, including meetings of the Evaluation Committee until the end of the second day of the evaluation process.[228] Thereafter, the timetable refers to a list of 'Other Events' to occur prior to the execution of the disposal agreements, including negotiations and 'further and final bids'. The timetable provided that the day after receipt of the Final Bids the leaders of the Advisory Team were required to present to the Evaluation Committee a preliminary review of the Final Bids together with their recommendations on matters for clarification and whether negotiations would be needed with bidders.

The Final Bid Evaluation Matrix (the Evaluation Matrix), being Annexure 2 of the 'Evaluation of Final Bids — Summary', identifies the 'three critical factors' to be considered in the evaluation process, namely:

- the proceeds available to reduce State debt (taking into account relevant risks);
- the risks of participating in the electricity supply industry;
- the State development initiatives (but only in limited circumstances, ie in the event that bids are otherwise equal).[229]

The Evaluation Matrix, an internal document which was not provided to bidders, has regard to the information requested from bidders in the Bidding Rules and Supplementary Bidding Rules and '… is to be used by the Evaluation Committee and those assisting it in the

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226 Section 2 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

227 Section 6 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

228 The last scheduled item in the timetable is a meeting of the Evaluation Committee to be held on the evening of Tuesday, 7 December 1999.

229 Section 6.2 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

comparison of the Final Bids'.[230] It sets out, where applicable, the State's base line or 'benchmark position' with respect to price and risk. The 'Evaluation of Final Bids — Summary' provides that 'Risks will be analysed against the Treasurer's level of base line acceptable risk manifest in the Benchmark Project Agreements provided to Shortlisted Bidders'.[231]

Annexure 3, the Advisory Team Allocation of Tasks sets out the respective responsibilities of each Advisory Group member in relation to each item in the Final Bid Evaluation Matrix. The 'Evaluation of Final Bids — Summary' provides that the Evaluation Committee will, after the opening of the Final Bids, determine which members of the Advisory Group are to be provided access to the Final Bids and the extent of that access.[232]

There are two issues that, in my opinion, arise with respect to the Evaluation Methodology. Commentary with respect to these two issues follows.

4.2.2 Timing of the Development of the Evaluation Arrangements

The production of a comprehensive, workable, and defensible approach for the evaluation of bids is essential to the success of any evaluation process. It is, however, important that an evaluation approach is finalised prior to the receipt of bids and that the process for addressing identified issues, in particular risks, is settled in advance of undertaking the evaluation. Further, the approach adopted must adequately explain the process for evaluating every issue, including the impact of each issue on the overall evaluation outcome. For example, in the context of a bid evaluation in an asset disposal, the approach should identify any risk issues that may require an adjustment to be made to the price offered.

Audit Comment

I note that a draft of the 'Evaluation of Final Bids — Summary' was tabled before the first meeting of the Evaluation Committee on 2 December 1999[233] and was revised and adopted by the Committee on 6 December 1999.[234] I also note that the evaluation approach had been under consideration by the ERSU and its advisers for some time prior to 2 December 1999.[235] The 'Evaluation of Final Bids — Summary' does not, however, address how the Committee was to deal with certain risks identified during the evaluation and issues which

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230 Section 6.2 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

231 Section 6.4 'Evaluation of Final Bids' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

232 Section 4 'Evaluation of Final Bids — Summary' being Attachment D to the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

233 Attachment A to the Minutes of the Evaluation Committee meeting held at 1:00 pm on 2 December 1999.

234 Item 4 of the Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

235 The ERSU advised that work on finalising the Final Bid Evaluation Matrix was concentrated in November 1999 and noted that a first draft of the 'Evaluation of Final Bids — Summary' was issued on 1 November 1999.

may arise in the event that a bid failed to conform with the State's benchmark/preferred positions.[236] This matter is further discussed under the heading '4.3.2 — Issues Evaluation' later in this part of the Report. Such matters were left to be resolved during the conduct of the evaluation. For example the 'Evaluation of Final Bids — Summary' did not address the process for evaluating bidders' responses concerning liability for GST and the State's proposed indemnity for an ETSA Year 2000 failure where responses were at variance to the State's nominated benchmark position. Both of these issues are considered in this Report under the heading '4.6 — Significant Issues Arising From The Final Bid Evaluation Process'.

Audit Recommendation 17

I recommend that for future business and/or asset disposals the methodology to be applied for the evaluation of Final Bids including the practical approach to the assessment of variations to nominated benchmark positions be fully developed and finalised before the commencement of the bid evaluation process.

4.2.3 Timetable for the Final Bid Evaluation

The parties responsible for conducting the evaluation of Final Bids need to undertake a detailed analysis of the nature of each of the activities to be performed or likely to be performed in conducting the evaluation, and estimate the time required to perform each task. In so doing, it is possible to realistically estimate the timeframe in which the evaluation could be conducted in advance of its commencement. If the time necessary to conduct the evaluation and related activities exceeds the time allowed for the acceptance of the Final Bids, consideration should be given to revising the evaluation strategy or increasing the period for the acceptance of Final Bids. When estimating the time required to conduct each of the activities it is prudent to plan on the assumption that such activities may, due to unforeseen factors, take more time than estimated and hence allow in the plan for such a contingency.

An analysis of this kind must also consider whether each of the specified activities proposed in the timetable is capable of being undertaken in accordance with the Bidding Rules, and if not, action may be considered and taken at an early stage to amend those Rules to accommodate this need. By conducting an analysis of this nature it is possible to develop a realistic, workable, and defensible timetable for the conduct of the evaluation and the process leading to the execution of a contract with the successful bidder.

Audit Comment

The indicative timetable for the conduct of the Final Bid evaluation did not include a detailed breakdown of the activities to be undertaken from the time of the receipt of the bids to the

[236] The issue of how the Evaluation Committee was to deal with certain risks, including Year 2000 liability and departures by bidders from benchmark/preferred positions was discussed but not settled by the Evaluation Committee at the meeting held at 12:30 pm on 6 December 1999.

execution of the sale/lease agreements with the successful bidder and the estimated or firm timing for the commencement and completion of each activity. Albeit subject to change to take into account actual circumstances, the indicative timetable endorsed by the Evaluation Committee only provided detailed timings of activities up to and including the day after the bids were received.

Whilst recognising that extensive work was undertaken by the ERSU and its advisers to ascertain the likely position of the bidders in respect of key issues prior to the lodgement of Final Bids, in my opinion, if the timetable had been closely considered by the Committee prior to the receipt of Final Bids it would have been evident to the Committee that if, despite its efforts, it did not receive a bid which could be recommended for acceptance (ie satisfied the State's benchmark/preferred position on risk and price) then it would be difficult to successfully conclude the disposal process within the stipulated seven day timeframe for the Final Bids to remain open. The timetable refers to 'negotiations' and 'seeking further and final bids', however there is no assessment as to the effect of implementing such strategies on the overall timetable.

The ERSU explained[237] that the indicative timetable only focused in detail on the first two days of the evaluation timetable whilst the Evaluation Committee only listed those matters that may have needed to be considered after the first two days depending on the circumstances. As noted, the Committee identified that a number of actions were possible after that period, however, it could only decide on such matters after receipt of the Final Bids. In the circumstances the ERSU has advised that there was little point in developing a detailed timetable for the seven day period prior to receipt of the Final Bids. The ERSU has indicated that it did give consideration to extending the acceptance period of the Final Bids for a period in excess of seven days. It concluded that given the size of the transaction, the quantum of the disposal consideration, and the time of year (especially having regard to the Year 2000 issue), it was not possible to ask bidders to leave their offers open for more than seven days.

The ERSU has further advised that prior to the receipt of the Final Bids it was advised that the Bidding Rules provided the Treasurer with the discretion to seek 'further and final bids' after receipt of the Final Bids.[238]

The ERSU has advised that an assessment was made by the ERSU and the Treasurer when the 'Evaluation of Final Bids — Summary' was adopted as to whether the Final Bid evaluation, as proposed, could be undertaken within the timetable.

Whilst noting this assessment was undertaken, given the nature and complexity of the disposal process, the indicative timetable for Final Bid evaluation, in my opinion, allowed insufficient time for the Advisory Team members to undertake a full evaluation of the Final Bids by 7 December 1999 and provided little opportunity (short of amending the timetable)

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[237] The ERSU advised in conference with Audit on 19 April 2000.

[238] The ERSU advised in conference with Audit on 19 April 2000 that no written advice was provided by the Legal Consortium on the actual process that should be adopted to manage this issue prior to the receipt of the Final Bids.

for those members to consider options for progressing the disposal in the event that no bid was a clear 'winning' Final Bid which satisfied the evaluation criteria.[239]

It is evident that the timetable was prepared on the assumption that the Final Bids would be compliant with the Bidding Rules, 'clean' (ie not raising any new issues or departing from the State's benchmark/preferred position including the Benchmark Project Agreements) and capable of acceptance. In this regard, I note that the ERSU had already pursued a detailed iterative approach with the bidders which involved numerous meetings with bidders and their advisers and the receipt of detailed comments/feedback from bidders on draft sale/lease agreements. The timetable for the evaluation process was, in my view, in part adopted because the ERSU believed that it already knew what the likely position of the bidders was in respect of key issues in advance of the receipt of the Final Bids due to the iterative process that had been adopted.

On 7 December 1999, the Evaluation Committee was placed in the position of having to consider the preliminary reports of the Advisory Group and recommend a process for concluding the disposal process without access to all information (eg the probity report),[240] and prior to the Advisory Team members completing their detailed reviews of the bids. At this stage of the evaluation the Committee had not agreed on an approach in respect of adjustments to price where the State's benchmark position was not accepted by a bidder (in particular the treatment of GST and the Year 2000 indemnity)[241] which ultimately had a material impact on the ranking of the final bids on price. This is not to say, however, that the overall ranking of the Final Bids would have changed once both price and risk together were considered. In my view, although the ERSU has advised that there was some consideration of these pricing issues, the evaluation of price at this stage of the evaluation was focused principally on a consideration of the bottom line figures.

Although the indicative timetable contemplated 'negotiations' and 'further and final bids' it is not clear to Audit whether the Committee considered prior to the commencement of the evaluation whether such options would be open to it under the Bidding Rules and the consequences of undertaking such options without rejecting the Final Bids and inviting further or amended bids.[242] The Committee was advised during the Final Bid evaluation that the Treasurer had a limited range of options if he sought to have bidders increase their bid price whilst retaining the option of accepting the then current Final Bids.[243]

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239 Such options could have included seeking further bids from bidders in the event that no acceptable bid was received.

240 Attachment Q titled 'Investigations into Activities of Short Listed Bidders' to the Minutes of the Evaluation Committee held on 10 December 1999.

241 Refer to commentary under the heading '4.3.2 — Issues Evaluation' in this Part of this Report.

242 Attachment O to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

243 Attachment O to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999. The advice provides, inter alia, that the Treasurer may under the Bidding Rules conduct contract negotiations with one or more bidders on price and terms, however he could not invite a further bid whilst retaining the flexibility to accept the Final Bids without first amending the Bidding Rules.

The sequence of events illustrates the unpredictability of a bidding process and the need to ensure that the Bidding Rules provide sufficient flexibility to ensure that the Evaluation Committee may consider a workable, realistic and defensible range of options for continuing the disposal process. For the reasons discussed in this Part of the Report, in my opinion, the arrangements adopted by the ERSU regarding the evaluation arrangements were not consistent with good administrative practice.

Audit Recommendation 18

I recommend that for future business and/or asset disposals the agency responsible for conducting the Final Bid evaluation ensures that:

- **in advance of the evaluation, each specified or proposed action relating to the evaluation process that can be reasonably anticipated, is included in the timetable and can be performed pursuant to the Bidding Rules;**
- **consideration is given to amending the Bidding Rules to provide for flexibility of timing for dealing /negotiating with bidders after the receipt of bids.**

4.3 FINALISATION OF THE EVALUATION METHODOLOGY

4.3.1 Audit's Recommendations and Comments in Part 2 of this Report

In Part 2, I made a number of comments and recommendations relevant to the evaluation of Final Bids against the State's objectives.

A recommendation raised in that Part which was not addressed by the ERSU in the documentation, was the failure to request from bidders their long term plans for developing and maintaining the business as a viable concern.[244] I recommended that such information be obtained from bidders to allow an assessment by the Evaluation Committee of the ongoing viability of bidders in respect of the operation of the electricity assets being acquired. I note that the ERSU did not agree with this suggestion and did not adopt it in the Supplementary Bidding Rules.

Further, in the consideration of the Supplementary Bidding Rules issued on 26 November 1999, in Part 2, I raised an issue arising from the provision that the bids must remain open for not less than seven days. I suggested the possibility of an amendment to those Rules to provide some flexibility to the State in the event that the evaluation of Final Bids could not be undertaken within the seven day period. In particular, I noted the tension between the capacity of bidders to hold bids open for a longer period given their financing approvals, and the time needed by the ERSU to evaluate, clarify and negotiate the Final Bids. To overcome this issue, I suggested that the risks associated with this tension could

[244] Recommendation 10 in this Report.

be managed by providing a mechanism in the Supplementary Bidding Rules which had the effect of controlling the parameters for changes in the bids after the seven day period following submission without allowing bidders to fully withdraw their bids at the expiration of seven days. I note that after consideration of a number of possible mechanisms for managing this issue, given the potential risks identified by the ERSU for the Government (including possible interest rate, exchange rate and Y2K exposures), the ERSU did not seek to extend the seven day period nor adopt any mechanism in the Supplementary Bidding Rules to allow for changes in Final Bids prior to the expiry of the seven day period.

The Indicative Timetable for the Final Bid evaluation appended to the 'Evaluation of Final Bids — Summary'[245] highlights the difficulties in undertaking the evaluation within the seven day timeframe. In particular, the timetable provided that within 18 hours from the opening of the Final Bids (ie from 6:00 pm on Monday, 6 December 1999 to 12 noon on Tuesday, 7 December 1999) the Advisory Team Leaders were required to present to the Evaluation Committee:

- a preliminary review of Final Bids (against relevant parts of Evaluation Matrix);
- recommendations as to matters that require clarification/further information from bidders;
- preliminary recommendation as to whether negotiations will be needed with any bidder.

The day after the Final Bids were received, the Evaluation Committee, after receiving reports from Leaders of the Advisory Team, concluded that limited options were available for progressing the disposal prior to the expiration of the seven day period.[246] The Committee considered three options or 'strategies' which were proposed by the Lead Advisers.[247] Two of the options considered, if either were adopted, may have resulted in a 'delay announcement of (the) successful bidder'.[248] I understand from these comments that the options were identified as posing a risk and that if adopted, they may delay the acceptance of the bids, which were capable of being accepted up until 13 December 1999.

After further consideration of the available options the Evaluation Committee:

> *… formed the initial view that the Treasurer had two primary courses of action which were worthy of consideration:*
>
> *1) To offer each bidder the opportunity to submit a further and alternative bid (Not a Further and Final Bid) by 2pm on Saturday which addresses the points which the Evaluation Committee has identified as needing improvement.*

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245 Refer to commentary under the heading '4.2.3 — Timetable for the Final Bid Evaluation' in this Report.

246 Minutes of the Evaluation Committee meeting held at 3:55 pm and 9:00 pm on 7 December 1999.

247 Attachment K to the Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999.

248 Attachment K to the Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999.

2) *To commence negotiations with one bidder over a short period to secure a better position for the State and if successful to recommend to the Treasurer this bidder as the preferred bidder.*[249]

The Committee determined that its preferred position was to commence negotiations of contract terms with one bidder with the view of reaching a position over the following 24 to 48 hours where the Committee could recommend to the Treasurer that that bidder be the successful bidder.[250] The Treasurer reported to the Committee that he wished the Committee to consider negotiations with all bidders.[251]

As a consequence, the Committee recommended the 'negotiation protocols' to the Treasurer.[252] As previously noted, the 'negotiation protocols', which were intended to elicit improved bids on risk and price, were not arguably contemplated in the Bidding Rules, which constituted the process contract between each bidder and the Government.

Audit Comment

It is essential that the Bidding Rules provide the State with sufficient time and flexibility to conduct its evaluation of Final Bids, including clarifications and negotiations with bidders. The Committee responsible for evaluating the Final Bids should be able to consider and recommend for adoption a range of negotiation or related strategies with bidders which, short of the need to possibly amend the Bidding Rules, can be implemented prior to the expiry of the Final Bids in the event no bid satisfies all the evaluation criteria and can be immediately recommended for acceptance.

Audit Recommendation 19

I recommend that for future business and/or asset disposals that the agency responsible for conducting the Final Bid evaluation give consideration to ensuring the Bidding Rules provide:

- **that the period during which Final Bids remain open and capable of acceptance be in excess of seven days; or**
- **for mechanisms which have the effect of controlling the parameters for changes in the Final Bids without allowing bidders to fully withdraw their bids after the seven days.**

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249 Item 2 of the Minutes of the Evaluation Committee meeting held at 3:55 pm on 7 December 1999.

250 Item 2 of the Minutes of the Evaluation Committee meeting held at 3:55 pm on 7 December 1999.

251 Item 3 of the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

252 Refer to commentary under the heading '4.4 — Negotiation Protocols' in this Report.

4.3.2 Issues Evaluation

The purpose of the Final Bid evaluation process was to select a bid which achieved the Treasurer's principal objectives of maximising proceeds available to reduce State debt and to minimise the State's exposure to the risks of participating in the electricity supply industry following the introduction of the National Electricity Market.[253] As noted, above, the 'Evaluation of Final Bids — Summary' was considered and adopted by the Evaluation Committee on 6 December 1999.

In relation to bid evaluation, the Bidding Rules[254] provide:

> *Bids will be evaluated having regard to the following criteria:*
>
> - *total value of consideration*
> - *pre-signing risks including document settlement risk, verification of funding commitment, pre-signing conditions and duration of offer;*
> - *pre-closing risks including funding conditions, security arrangements, credit risk, other closing conditions, Y2K risk and liability cap and financial markets disruption;*
> - *post-completion risks including bidder credit risk, bona fides, early termination risk, state repayment risk, security of future obligations, GST risk, risk of exposure to the Successful Bidder(s) and third parties, obligations of the State following default or termination.*
>
> *The Treasurer reserves the right to consider other evaluation criteria.*[255]

The Final Bid Evaluation Matrix[256] ('the Evaluation Matrix') appended to the 'Evaluation of Final Bids — Summary' addresses a range of matters for evaluation of the type referred to in the Bidding Rules.

The 'Evaluation of Final Bids — Summary' provides that members of the Advisory Group to the Evaluation Committee were to be allocated responsibility for advising on tasks/issues on the basis of their relevant expertise/experience.[257] The 'Evaluation of Final Bids — Summary' further provides the following:

> *Those analysing are required to provide to the Evaluation Committee a report (including reasoning):*

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253 Section 13.1 of the Bidding Rules.

254 Section 13.1 of the Bidding Rules.

255 The Bidding Rules provide the Treasurer with a range of discretions in relation to the evaluation of bids (refer to Bidding Rule 14.1(e)). The reservation of such discretions is commented upon in Part 2 of this Report.

256 Annexure 3 to the 'Evaluation of Final Bids — Summary'.

257 'Evaluation of Final Bids — Summary' (section 4 p. 6).

- *identifying the relevant issue;*
- *comparing the bid position to that articulated in the benchmark documents/benchmark position;*
- *assessing whether the bid position (if different to the benchmark documents/position), in the view of that member, would nevertheless be acceptable to the Treasurer;*
- *if not acceptable, indicating what amendments might be sought to make the bid position acceptable; and*
- *providing comments as to the relative position of that bid position as compared to other bidders in relation to the same issue.*
- *confirming that he/she or that firm has, in undertaking the tasks, complied with the Evaluation Methodology.*

The Evaluation Matrix identifies each of the relevant issues for evaluation and if applicable the 'benchmark position' in respect of each issue. The benchmark position is defined as: '… the base case level of risk, or base case requirement, established by ERSU and its advisers, from which any deviations are assessed'.[258]

In many cases the benchmark position in respect of an issue was the State's preferred position or outcome in respect of that issue, as evidenced by the terms of the Benchmark Project Agreements provided by the State to bidders. For example, on the issue of GST risk to the State,[259] the State's benchmark position in the Evaluation Matrix was described by reference to the GST provision in the relevant Benchmark Project Agreements, as follows: 'Security Regime (clause 11 of Security Deed)'.[260]

The effect of this provision is that the liability for any GST payable under the lease and other disposal agreements be borne by the purchaser rather than the State. This was the only guidance in the Evaluation Matrix as to how this issue was to be evaluated.

In other cases, the Evaluation Matrix identified that no benchmark position existed or noted that the bid would be assessed on the information provided by the bidder having regard to specified circumstances.[261]

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258 Footnote 1 to Annexure 2 to the 'Evaluation of Final Bids — Summary'.

259 Item 22(d) in the Evaluation Matrix.

260 Clause 11 of the Security Deed provides that if either the Crown or the Distribution Lessor Corporation (the statutory corporation established under the Public Corporation (Distribution Lessor Corporation) Regulations 1999), is required to pay GST in respect of all or part of any relevant payment or transaction (being rent, rent pre-payment or any other payments under the lease or this Deed or the Rent Assignment Deed) then the Lessee and each rent Assignee shall be jointly and severally liable to pay to the Crown such additional amount equivalent to the amount of GST payable. Accordingly, in such circumstances the Crown would be entitled to receive an amount equal to the amount payable by the Lessee had GST not been payable.

261 For example in the case of the Year 2000 agreed Indemnity Cap (item 11 in the Evaluation Matrix) the benchmark position is described as: 'To be bid and assessed against risk likelihood profile'.

Annexed to the 'Evaluation of Final Bids — Summary' is an Advisory Team Allocation of Tasks document[262] which identifies each of the evaluation tasks to be undertaken and the Advisory Team member(s) responsible for undertaking each task.

The 'Evaluation of Final Bids — Summary'[263] provides that:

> *… a comparative analysis of specific categories of risk as set out in the Final Bid Evaluation Matrix will be conducted. This analysis incorporates an assessment of risks under the Project Documents, as well as both pre-completion and post-completion risks.*
>
> *Risks will be analysed against the Treasurer's level of base line acceptable risk manifest in the Benchmark Project Agreements provided to Shortlisted Bidders. Each category of risk will be supported by analysis to be available to the Evaluation Committee based on the base line level of risk and a comparison of the respective levels of risk attributable to each of the bidders. The analysis should record:*
>
> - *differentiation of risk attributable to each bidder;*
> - *the analysis and characterisation of the risk;*
> - *comparison between bidders of the relative level of risks attributable to their bids, and*
> - *a comparison of different categories of risk attributable to different bids.*
>
> *The Evaluation Committee will therefore be equipped with an analysis of the risks attributable to each category of risk and a comparison of the risk attributable to each bidder within that category.*

Audit understands that the base line acceptable risk manifest in the Benchmark Project Agreements was the risk position acceptable to the State, but was not necessarily the minimum risk position. It would have been possible for bidders to have addressed some risk issues in their Final Bids which may have been more favourable to the State than that identified by the Evaluation Committee as the base line position. For example, the State's base line acceptable risk for the ETSA Year 2000 failure was set by the Evaluation Committee at $10 million. It would have been possible for a bidder to have proposed in its Final Bid that the State's liability in respect of risk be capped at a nominal figure, say $1.00, which is substantially below (and better than) the State's base line.

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[262] Annexure 3.

[263] 'Evaluation of Final Bids — Summary', section 6.4.

On 2 December 1999 the Evaluation Committee considered and resolved its approach in relation to the evaluation of two of the issues/risks identified in the Evaluation Matrix.[264] The issues/risks addressed by the Committee were the approach to be taken in the evaluation of information received concerning the bona fides of purchasers[265] and the discount rate calculation to be considered when assessing the value of ETSA Utilities and ETSA Power.[266] On 6 December 1999 the Evaluation Committee on reviewing the Evaluation Matrix considered but did not finalise its approach as to how it would deal with Year 2000 liability and any other departures from benchmark/preferred positions in the Final Bids. The Committee discussed the adopted evaluation approach and noted that it should not be departed from without taking advice.[267]

Audit Comment

The success of any bid evaluation process depends on:

- the adoption of an evaluation methodology or plan which:
  - addresses each of the issues relevant to achieving the disposal objectives, which must be evaluated in order to determine whether the bid satisfies or meets those objectives;
  - provides for an effective comparison between bids;
- adherence by those undertaking the bid evaluation to the agreed evaluation methodology or plan.

Any deviations from, or failure to complete, each stage of that methodology or plan by those parties undertaking the evaluation may result in an outcome which may not have been reached if the methodology or plan had been followed. In particular the evaluation outcome may fail to meet its primary purpose of identifying the bid which best satisfies the disposal objectives.

I note that there is no evidence that there was an agreed or settled methodology for the practical approach to evaluation of each issue identified in the Evaluation Matrix[268] where bid

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264 Minutes of the Evaluation Committee meeting held on 2 December 1999.

265 The Evaluation Committee resolved:

> *… that in all the circumstances such matters are to be considered only from the perspective of how this factor could impact on a potential purchaser's ability to perform under the disposal contract.*

266 The Committee agreed:

> *… that a bid in excess of the DCF (discounted cash flow) would be likely to lead to a recommendation that the businesses be sold/leased subject to completion and other risks in the disposal transaction.*

267 Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999.

268 Audit notes that the evaluation methodology as contained in the 'Evaluation of Final Bids — Summary' (ie the Evaluation Plan provided by the ERSU) was adopted by the Evaluation Committee at its meeting held at 12:30 pm on 6 December 1999. Further, Audit notes that in accordance with the Evaluation Methodology, the Evaluation Committee at its meeting held at 7:11 pm on 6 December 1999 changed the Allocation of Tasks to Advisory Team Members.

responses were at variance to the State's nominated benchmark position. In particular at the commencement of the evaluation there is no evidence that the Evaluation Committee had considered and agreed with its advisers the:

- State's benchmark/preferred position in respect of every issue identified for evaluation in the Evaluation Matrix;
- approach to be taken in evaluating each issue in the Evaluation Matrix in the event that the bid position was different to that articulated in the State's benchmark/preferred position.

In my opinion, the ERSU and its advisers should have considered and agreed such matters in respect of each issue prior to the commencement of the evaluation process.[269] In particular the Committee needed to consider whether:

- the State's benchmark/preferred position and the methodology to be taken by the Advisory Team Members nominated to evaluate the issue, was appropriate and consistent with the Treasurer's disposal objectives and the overall conduct of the evaluation and whether by adopting the methodology the Advisory Team Member(s) would be in a position to advise the Treasurer as to whether the bid position on that issue (if different to the benchmark/preferred position) was acceptable;
- any bid positions different to the State's benchmark/preferred position would have a material impact on risk or price and hence require particular treatment, such as an adjustment (either up or down) to the bid price of that bidder;
- the Treasurer was under any obligation pursuant to the terms of the process contracts with bidders to advise the bidders of the approach to be taken by the Evaluation Committee in evaluating that issue (for example, any methodology which may result in the Committee making a material adjustment, either up or down, to a bid price).

As some issues were to be evaluated by more than one Advisory Team Member it was important that each adviser was apprised of their respective responsibilities in undertaking the evaluation of those issues. The 'Evaluation of Final Bids — Summary' assumes that guidance as to how each issue should be evaluated against the State's baseline level of risk, or as referred to in the Evaluation Matrix, the State's 'benchmark position', where such benchmark was identified would be given to advisers before the evaluation process commenced. This would ensure consistency of approach when the actual evaluations were being carried out.

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[269] Refer to Recommendation 17 of this Report.

It is apparent from my review of the Final Bid evaluation that in respect of a number of issues the approach to be taken by members of the Advisory Group in evaluating bids which departed from the State's benchmark position or where no benchmark position had been specified had not been resolved. The issues identified are discussed in this Report under the heading '4.6 — Significant Issues Arising From The Final Bid Evaluation Process'.

4.4 NEGOTIATION PROTOCOLS

4.4.1 Development of Negotiation Protocols

Following receipt of the Final Bids, the Evaluation Committee was not prepared to recommend to the Treasurer on 7 December 1999 that any of the bids be accepted due to its assessment of the risk issues associated with the bids and the quantum of price offered. The Committee recommended to the Treasurer that in order to improve the terms of the Final Bids on both risk and price, negotiations should be commenced with each bidder.

> *…*
>
> - *first to negotiate the best risk allocation achievable from that bidder, and;*
>
> - *then, unless that risk allocation is unacceptable irrespective of price, to negotiate improvement of the bidder's offered price …*[270]

The Committee further recommended that it report to the Treasurer: '… as soon as it achieves an offer which it considers is the best offer reasonably available to the State'.

The Treasurer approved the Evaluation Committee's recommendations and each of the bidders were advised of the 'negotiation protocols' by a member of the Advisory Group on 7 December 1999.[271] This advice was given in accordance with a script that had been settled by the Evaluation Committee. The script was not confirmed in writing with the bidders. Negotiations subsequently commenced with each bidder on Wednesday 8 December 1999.

The negotiations continued with bidders until 11 December 1999.

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[270] Attachment P Minute to the Treasurer titled 'ETSA Utilities and ETSA Power Final Bids — Initial Evaluation Committee Report and Recommendations' dated 7 December 1999 attached to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

[271] The ERSU advised Audit on 18 February 2000 that the script, which was used to invite bidders to participate in discussions, was read on 7 December 1999 to all bidders who lodged Final Bids and was repeated at the first meeting with each bidder held as a consequence of those invitations.

On 11 December 1999 the Evaluation Committee considered advice from the Legal Consortium concerning the use of an Offer Deed,[272] which could be entered into with a bidder if negotiations reached a stage where the Committee was to recommend to the Treasurer that an offer be accepted.

At that meeting the Evaluation Committee endorsed the use of an Offer Deed with one bidder if '… the negotiations were such as to justify proceeding to an Offer Deed' with that bidder.[273] An Offer Deed was entered into between the Treasurer and CKI/HKI and others on 11 December 1999.

Audit Comment

As noted in Part 2 of this Report, the approach adopted by the ERSU for the electricity businesses disposal process has been to create a process contract between the Treasurer and each bidder participating in that disposal process. The terms of the process contract are the Bidding Rules. Accordingly, the Government needs to be cognisant of the potential liability it faces should the terms of the process contract be found to be breached by the Government or should the Government act 'unfairly' and thereby breach the legitimate expectations of potential bidders.

I have the following concerns with the approach taken by the Evaluation Committee in its recommendation to the Treasurer regarding the 'negotiation protocols'.

The 'negotiation protocols' were intended to first address '… the best risk allocation achievable from that bidder' and subject to achieving an acceptable risk allocation '… to negotiate improvement of the bidder's offered price'. In this context, I consider, an 'improvement' in price means an increase to the price.

The 'negotiation protocols' as implemented were arguably not contemplated in the Bidding Rules. The legal advice given to the Evaluation Committee prior to the adoption of the protocols provided that if the Treasurer sought to invite a further and final bid, this could be interpreted as rejecting the offer constituted by the Final Bid.[274] On the basis of this advice an invitation by the Treasurer for further and final bids would have resulted in the rejection of the Final Bids and in such circumstances there would be no certainty that any of the parties who had lodged Final Bids would lodge further bids for the electricity assets. The Committee was further advised that the Treasurer had limited discretions to request a bidder to amend

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272 The Minutes of the Evaluation Committee meeting held on 11 December 1999 refer to advice provided by the Legal Consortium concerning 'the mechanics of an Offer Deed' proposed to be entered into by any bidder if negotiations reached a stage where the Evaluation Committee was to recommend to the Treasurer that an offer be accepted. It is recorded in the Minutes:

> *The Offer Deed comprised an unconditional offer by the Bidder (irrevocable before midnight on 13 December 1999, if not earlier rejected by the Treasurer). In consideration of that, the Treasurer would undertake not to conduct further negotiations, etc with other bidders (ie standstill).*

273 Item 2 of the Evaluation Committee meeting held at 4:15 pm on 11 December 1999.

274 Attachment O to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

its bid and could not seek further bids whilst retaining the flexibility to accept the Final Bids without amending the Bidding Rules.[275] To do so would require the undertaking of a number of further steps including seeking the agreement of the bidders to a change to the Bidding Rules, which the Legal Consortium advised if undertaken may allow insufficient time for the Treasurer to be in a position to accept a Final Bid before it lapsed on 13 December 1999.

The Legal Consortium advised that the Bidding Rules permitted the conduct of negotiations with one or more bidder. In conducting such negotiations, the Legal Consortium advised that:

> *It will be important that those negotiations are genuine negotiations even if the expectation of the Treasurer/the negotiating team is that they are likely to be unsuccessful in bringing a particular bid to a position where it is in an acceptable form to the Treasurer.*
>
> *One way of managing this issue is to make clear to all Bidders with whom negotiations are conducted that there are two sets of issues (price and terms) and that price will be considered during the negotiations subsequently to negotiations as to terms and making clear that as between bidders, it will not be a matter of concluding negotiations on terms with all bidders before being able to commence negotiations as to price with any Bidder.*
>
> *Proceeding in this way means that any Bidder is in a position to reach agreement with the Treasurer as to all substantive issues and it is not a situation of negotiations being conducted with some Bidders on matters which could result in them having their bids accepted but with negotiations with other Bidders being conducted on terms such that even if those negotiations were successful, there remained outstanding issues which would need to be settled before their Bids could be accepted by the Treasurer.*[276]

The advice of the Legal Consortium did not canvass in detail how the negotiations on price and terms should be conducted. In particular, the advice did not consider whether during the negotiations the negotiating team would be precluded under the Bidding Rules from inviting bidders to amend their bids by increasing the bid price offered or by changing the position contained in their bids on risk issues. If the advice of the Legal Consortium that the Bidding Rules provided the Treasurer with limited discretion to request a bidder to amend its bid is accepted, the discretion afforded to the Treasurer's negotiating team to make such requests to bidders during negotiations would also be limited.

The ERSU has advised that in adopting the 'negotiation protocols' the Evaluation Committee relied on the provision in the Bidding Rules that enabled the Treasurer to enter into contract

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[275] Attachment O to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

[276] Attachment O to the Minutes of the Evaluation Committee meeting held at 9:00 pm on 7 December 1999.

negotiations with one or more bidder during the evaluation of Final Bids.[277] According to the ERSU, it did not want to do any act that could be construed as rejecting a Final Bid. The position taken by the ERSU was that the 'negotiation protocols' provided a means whereby further negotiations could be conducted with bidders whilst ensuring that the Final Bids remained open for acceptance.

In my opinion, the 'negotiation protocols' envisaged a process which would, if successful, result in the bidders making material changes to their Final Bids. Indeed, following the implementation of the 'negotiation protocols', and in the negotiations with a bidder who had apparently satisfied the State on the issue of risk, the negotiating team invited the bidder to increase its bid price.[278] It is therefore arguable that the strategy was designed to invite bidders to make further and alternative bids, whilst at the same time seeking to retain the flexibility to accept the Final Bids. As noted in the advice from the Legal Consortium, the Bidding Rules allowed for negotiations to be conducted as to all matters pertaining to a bid so long as it is clear the discussions are conducted as negotiations. The Legal Consortium also observed that there was no prohibition upon receiving as part of those negotiations a concession from a bidder on terms and/or process. The Legal Consortium however further advised:

> *We believe that there is an alternative strategy that, from a legal perspective, would place the Treasurer in a position of being told to invite a further bid whilst retaining the flexibility of being able to accept the current Final Bids which are before the Treasurer.*
>
> *This could be achieved by an amendment to the Bidding Rules to the effect that Shortlisted Bidders be invited to submit further and alternative bids which are to exist concurrently with their Final Bids. … One disadvantage of proceeding in this way is the time taken to formulate the proposed rule change, to provide that to Shortlisted Bidders and to enable them an opportunity to decide whether to accept that rule change, and if so lodge a further and alternative bid which could then be the subject of further evaluation. It is conceivable that the time necessary to undertake those tasks would put the Treasurer in a position where there was insufficient time within which to re-commence negotiation with the favoured Bidder in sufficient time to place the Treasurer in a position to be able to accept its current Final Bid prior to it lapsing on Monday 13 December 1999.*[279]

Accordingly, it is also arguable that if the Treasurer intended to seek further and final bids he could only do so in accordance with the specific provisions in the Bidding Rules[280] and his

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[277] The ERSU advised Audit in conference on 19 April 2000 that it relied on Bidding Rule 13.5 which relates to contract negotiations with one or more Shortlisted Bidder.

[278] Refer to Notes of Bidder Negotiation Meeting held at 12:30 pm on 8 December 1999.

[279] Refer advice to ERSU from Allens Arthur Robinson dated 7 December 1999.

[280] Bidding Rule 13.6.

adoption of the 'negotiation protocols' which sought to achieve the same result, without rejecting the Final Bids was in breach of the Bidding Rules.

The bidders were verbally informed of the 'negotiation protocols' and no written confirmation of the protocols was provided to the Bidders. I note that throughout the disposal process the ERSU has sought to advise bidders in writing of actions being taken in accordance with the Bidding Rules. It was therefore a departure from this practice not to advise or confirm with bidders in writing the action proposed in the 'negotiation protocols'. It is important that the disposal process is fully explained to, and understood by, all of the participants in the process, in particular the bidders. Whilst I am not necessarily suggesting it occurred on this occasion, I am of the opinion that the verbal communication of the 'negotiation protocols' and the nature of the protocols themselves had the potential to lead to confusion as to the nature of the proposed process to be followed by the negotiating team in concluding the negotiations and the evaluation of the Final bids. In particular the:

- absence of any deadline under the protocols for conclusion of the negotiations;
- process for concluding the negotiations (ie the use of an Offer Deed);[281]
- intention of the State to negotiate with the bidder who first satisfied it on both risk and price without notice to the other bidders.

Whilst it is arguable that the bidders agreed to the 'negotiation protocols' by agreeing to and participating in the negotiations with the negotiation team, there is no written/documented evidence that they understood and acknowledged the terms of the protocols as communicated by the negotiating team. Unless very clearly communicated and documented, although it may not in practice have occurred on this occasion, it is possible that some bidders could have argued that they have not been treated equally and fairly as required by the terms of the process contract encapsulated by the Bidding Rules.

Audit Recommendation 20

I recommend that for future business and/or asset disposals that adopt a process contract with bidders, the negotiation processes adopted with bidders comply with the terms of the process contract.

I also recommend that bidders be advised in writing of any negotiation processes which are proposed to be adopted by the State and that such processes be agreed to by bidders and confirmed by them in writing.

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[281] The Evaluation Committee determined the process for concluding the negotiation protocols at its meeting on 11 December 1999 at 4:15 pm. Whilst it may not have been practical to advise all bidders of this process at this time, there seems to be no reason why it could not have advised all the bidders of its intention to enter into such an arrangement with the preferred bidder when it briefed bidders on the 'negotiation protocols' on 7 December 1999.

4.4.2 Conduct of Bidder Negotiations

It is evident that during the conduct of the negotiations with bidders pursuant to the 'negotiation protocols' the negotiation team adopted a negotiating tactic that sought to use the Auditor-General's role in the disposal process as a means of seeking an increase in the bid price.[282]

During negotiations conducted on 8 December 1999, one bidder was advised by a member of the negotiating team that its Final Bid had created a 'problem' for the negotiating team. The comment was made during discussions with the bidder on the Final Bid price. In particular the bidder was advised that:

> *The problem is that the Auditor General will review the bids in his review process and may be commenting on the success of the deal. The Auditor General will look at the paper trail and may say that (the bidder) was prepared to pay $X, as indicated in their funding documentation, however they ended up paying much less.*[283]

In my opinion the negotiating team member was using the Auditor-General's role in his review of the Final Bids as a means to pressure the bidder to increase the quantum of its Final Bid up to the quantum of its available banking facilities (as revealed in its funding documentation which formed part of its bid).

Audit Comment

It is inappropriate for the negotiating team to seek to use the role of the Auditor-General in the disposal process as a negotiating tactic to leverage an increase in a bid price or in an attempt to achieve any other 'improvement' in a bid during in its negotiations with bidders.

4.5 ADVISORY GROUP REPORTS

The review undertaken of the reports prepared by members of the Advisory Team indicates that each adviser adopted a different approach to undertaking their responsibilities in the Evaluation of Final Bids. In some cases the advisers merely inserted into the Evaluation Matrix the relevant information from the bid and made no comment as to whether the bidder's position on the issue met the State's benchmark/preferred position or gave rise to matters requiring further consideration as required in the 'Evaluation of Final Bids — Summary'.[284] The Evaluation Methodology required that those advisers analysing the Final Bids provide to the Evaluation Committee a report, (including reasoning):

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282 Minutes of Bidder Negotiation Meeting held at 12:30 pm on 8 December 1999.

283 Minutes of Bidder Negotiation Meeting held at 12:30 pm on 8 December 1999.

284 'Evaluation of Final Bids — Summary', section 5 contains a series of matters required to be reported on by advisers to the Evaluation Committee in relation to those task/issues allocated to them by the Evaluation Committee.

- identifying each relevant issue. The advisers provided separate reports to the Committee on the issues as identified in the Advisory Team Allocation of Tasks document.[285] These reports identified the issues requiring their consideration;[286]

- comparing the bid position to that articulated in the State's benchmark/preferred position. Generally the advisers' reports note the position proposed by each bidder on the issue, however with the exception of the Legal Consortium's reports, the adviser reports do not comment as to whether the bidders' positions on each of those issues as reflected in their Final Bids comply with or deviate from the State's benchmark/preferred position;[287]

- assessing whether the bid position (if different to the State's benchmark/preferred position) in the view of that adviser, would nevertheless be acceptable to the Treasurer. Whilst this matter was addressed in the reports of the Legal Consortium and Lead Advisers, it was not addressed in the KPMG report;[288]

- if not acceptable, indicating what amendments might be sought to make the bid position acceptable. An analysis of this nature in respect of each issue which deviated from the State's benchmark/preferred position was not provided in the adviser reports to the Evaluation Committee;

- providing comments as to the relative position of that bid position as compared to other bidders in relation to the same issue. As previously noted, the advisers' reports note the position proposed by each bidder on the issue, however, with the exception of the reports of the Legal Consortium and Lead Advisers which provide a comparison of some issues,[289] the adviser reports do not provide a comparison between each bidders' positions on each issue evaluated;

- confirming that he/she or that firm has, in undertaking the tasks, complied with the condition set out in the 'Evaluation of Final Bids — Summary'. Confirmation of this nature was provided to the Evaluation Committee by the Legal Consortium[290] and

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285 Each member of the Advisory Team provided various reports to the Evaluation Committee.

286 A review by Audit of the various reports provided to the Evaluation Committee by each member of the Advisory Team has revealed that, with one minor exception each adviser reported to the Committee on each issue allocated to them in the Advisory Team Allocation of Tasks document. It is noted that the Lead Advisers did not specifically provide a report on item 20 (Y2K risk) in the Advisory Team Allocation of Tasks document, however they did report on the Year 2000 risk elsewhere in their reports under related items.

287 The Lead Adviser's reports contain some general comments as to whether all the issues they reviewed in the Final Bids comply with or deviate from the benchmark/preferred position.

288 Letter from KPMG to the Evaluation Committee dated 9 December 1999, being Attachment S to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

289 The comparisons between bid positions provided in the Legal Consortium's reports primarily focus on risk issues. The Lead Adviser's reports compare price and some related issues (eg GST liability) and some risk issues.

290 Letter from Allens Arthur Robinson Johnson Winter & Slattery to the Evaluation Committee dated 10 December 1999, being Attachment Q to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

KPMG.[291] The reports of the Lead Advisers[292] tabled with the Committee do not contain such confirmation.

The 'Evaluation of Final Bids — Summary' also required that members of the Advisory Group provide to the Evaluation Committee a risk analysis.[293] Such an analysis would record:

- differentiation of risk attributable to each bidder;
- the analysis and characterisation of the risk;
- comparison between bidders of the relative level of risks attributable to their bids,
- comparison of different categories of risk attributable to different bids.

In particular the 'Evaluation of Final Bids — Summary' anticipated that the Legal Consortium would identify and advise on the particular risk issues, without regard to price issues. Further, the Lead Advisers and KPMG were expected to analyse risk in respect of those issues allocated to them in the evaluation.[294] Finally, the Lead Advisers were expected to provide recommendations as to the overall risk issues to the Evaluation Committee.

Audit Comment

Audit notes that the Legal Consortium provided comments on risk in respect of specific issues set out in the Evaluation Matrix, a brief risk analysis of each bidder and a comparative risk analysis between the Final Bids of two bidders,[295] including a comparison between the different categories of risk attributable to the two bids. Audit also notes that the Lead Advisers provided comments on risk in respect of specific issues in the Evaluation Matrix and as required by the 'Evaluation of Final Bids — Summary', recommendations to the Evaluation Committee as to overall risk issues.[296] No risk analysis, as contemplated in the

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291 Letter from KPMG to the Evaluation Committee dated 9 December 1999, being Attachment S to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

292 'Project Vintage. Presentation to Evaluation Committee on Final Bids' dated 10 December 1999, being Attachment R to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999 and 'Project Vintage. Presentation to Evaluation Committee on Final Bids' dated 12 December 1999, being an attachment to Attachment V to the Minutes of the Evaluation Committee meeting held at 9:15 am on 12 December 1999.

293 Section 6.4 of the 'Evaluation of Final Bids — Summary'.

294 The 'Evaluation of Final Bids — Summary' required that each of these advisers would analyse risks in relation to those issues allocated to them in the Advisory Team Allocation of Tasks.

295 It is noted in the letter from Allens Arthur Robinson Johnson Winter & Slattery to the Evaluation Committee dated 10 December 1999 that '(w)e are instructed that for value reasons it is not necessary to make any further qualitative assessment as to the extent of the substantial risk differential which exists between Bidder B and Bidder A'. Audit has been unable to find any documented record of instructions of this nature to the Legal Consortium in the minutes of the Evaluation Committee.

296 'Project Vintage. Presentation to Evaluation Committee on Final Bids' dated 10 December 1999 at page 19 (Attachment R to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999) and 'Project Vintage. Presentation to Evaluation Committee on Final Bids' dated 12 December 1999 being an attachment to Attachment V to the Minutes of the Evaluation Committee meeting held at 9:15 am on 12 December 1999.

'Evaluation of Final Bids — Summary', was provided by KPMG in its report to the Evaluation Committee[297] on the issues allocated to it in the Evaluation Matrix.

It is unclear from the adviser reports how each adviser assessed risk in respect of certain issues and what they intended by the terminology adopted in their reports.[298] In some cases a risk analysis was provided in respect of an issue for one bidder but not for another, or a risk assessment was provided with no reason given for the assessed level of risk.[299]

It is possible that the inconsistency in reporting on issues in the Evaluation Matrix and risk resulted from the lack of guidance given to the advisers by the Evaluation Committee as to the form and contents of the reports required in order to satisfy the requirements set out in the 'Evaluation of Final Bids — Summary'. In particular, there was no guidance as to how each adviser was to report on those specific issues which deviated from the State's benchmark/preferred position or where there was no benchmark/preferred position. Nor was there guidance how an issue in one bid should be compared with the same issue in other bids.

There is no evidence that the Evaluation Committee provided any such guidance to its advisers, nor is there evidence that the Committee critically reviewed the adviser reports for compliance with the conditions set out in 'Evaluation of Final Bids — Summary'.

Failure to provide such guidance can result in some issues being overlooked or not fully considered and hence effect the overall outcome of the evaluation. Further, if advisers fail to submit to the Evaluation Committee reports in the form required, the Committee will be unable to properly complete its overall assessment of the Final Bids.[300]

Audit Recommendation 21

I recommend that for future business and/or asset disposals that the appointed Evaluation Committee ensure that adequate documented instructions are provided to those advisers responsible for conducting the detailed evaluation as to the form and contents of the reports required to be submitted.

Further, I recommend that advisers' reports be reviewed by the appointed Evaluation Committee for compliance with the adopted evaluation methodology and any deficiencies be addressed prior to the completion of the bid evaluation process.

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297 Letter from KPMG to the Evaluation Committee dated 9 December 1999, being Attachment S to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

298 Risk was assessed by advisers using various terms including high, medium, moderate and low, which were not defined.

299 'Project Vintage. Presentation to Evaluation Committee on Final Bids' dated 10 December 1999 at page 13 (Attachment R to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999).

300 Section 6.5 of the 'Evaluation of Final Bids — Summary'.

4.6 SIGNIFICANT ISSUES ARISING FROM THE FINAL BID EVALUATION PROCESS

4.6.1 Treatment of Goods and Services Tax (GST) Liability

An issue addressed in the Benchmark Project Agreements was liability for goods and services tax (GST) payable pursuant to the provisions of the A New Tax System (Goods and Services Tax) Act 1999 (Commonwealth). I note that the State's preferred position under the Benchmark Security Deed (one of the documents in the Benchmark Project Agreements) was that any liability for GST arising from rent or any other payments under the benchmark lease would be the responsibility of the lessee and not the State.[301] The 'Evaluation of Final Bids — Summary' adopted by the Evaluation Committee contained evaluation criteria that reflected this position.[302]

The 'Evaluation of Final Bids — Summary' did not address how GST should be assessed as a risk factor in the event that a bid departed from the State's preferred position under the Benchmark Security Deed. Whilst it is evident that the Legal Consortium,[303] KPMG[304] and the ERSU[305] had considered prior to receipt of the final bids the issue of GST liability arising under the Benchmark Project Agreements, I have found no evidence that the ERSU had addressed the approach to be taken in evaluating any final bid which departed from the State's preferred position on GST liability in the development of the evaluation methodology.[306]

On 6 December 1999 the Evaluation Committee determined that the Lead Advisers, KPMG and the Legal Consortium would be responsible for advising on GST risk to the State in the Final Bid evaluation.[307]

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301 Clause 11 of the Benchmark Security Deed provides that if either the Crown or the Distribution Lessor Corporation (the statutory corporation established under the Public Corporations Act (Distribution Lessor Corporation) Regulations 1999), the Lessor is required to pay GST in respect of all or part of any relevant payment or transaction (being rent, rent pre-payment or any other payments under the lease or this Deed or the Rent Assignment Deed) then the Lessee and each rent Assignee shall be jointly and severally liable to pay to the Crown such additional amount equivalent to the amount of GST payable. Accordingly in such circumstances the Crown would be entitled to receive an amount equal to the amount payable by the Lessee had GST not been payable.

Prior to the issue of the Benchmark Security Deed, bidders were advised in the 'Security Deed — Options Discussion Paper' dated 9 September 1999 that 'All payment obligations in the Security Deed will be exclusive of GST'.

302 Minutes of the Evaluation Committee meeting held at 12:30 pm on 6 December 1999, and Attachment D 'Evaluation of Final Bids', Annexure 2 'Final Bid Evaluation Matrix' (evaluation criteria 22(d)).

303 Letter from Arthur Robinson & Hedderwicks to ERSU dated 25 May 2000 attaching a copy of an internal Arthur Robinson & Hedderwicks letter dated 7 December 1999 addressing GST issues.

304 Letter from KPMG to the ERSU titled 'GST and Impact on Security Options' dated 25 November 1999.

305 The ERSU advised Audit in conference on 19 April 2000 advice had been received from the Legal Consortium on the GST risk and that the Benchmark Project Agreements were structured so that the bidder took all the GST risk.

306 The issue of departures from benchmark/ preferred positions was raised during discussion on the Final Bid Evaluation Matrix (Annexure 2 to the 'Evaluation of Final Bids — Summary') at the meeting of the Evaluation Committee held at 12:30 pm on 6 December 1999.

307 Minutes of the Evaluation Committee meeting held at 7:11 pm on 6 December 1999, and Attachment H 'Advisory Team Allocation of Tasks' (evaluation criteria 22(d)).

Not all of the Final Bids received by the ERSU on 6 December 1999 complied with the State's preferred position on GST risk under the Benchmark Security Deed. Some bidders argued that GST was not payable and required that the liability for any GST be borne by the State. On 7 December 1999 the Evaluation Committee considered the GST issue raised by the Final Bids and the approach for dealing with this issue in the Final Bid evaluation.[308] In presentations by advisers, the Committee was informed by:

- members of the Legal Consortium that some bidders had '… not undertaken to pay or provide security against GST on the basis that they do not foresee a GST liability'.[309] The Legal Consortium concluded that the 'risk of GST is therefore placed on the Government';[310]
- the Lead Advisers the quantum of the potential GST liability of the State in respect of those bids which were made on the basis that GST was not payable and '… if it is that it is incorporated in the bid price'.[311]

It is relevant to note that that one of the advisers from the Legal Consortium expressed the opinion that the 'GST has to come off (the bids which did not allow for GST) price'.

In the minute dated 7 December 1999 from the Evaluation Committee to the Treasurer containing the recommendation to undertake the 'negotiation protocols' the impact of GST on each of the bids was not specifically mentioned.

In discussion with bidders on 8 December 1999 conducted in accordance with the 'negotiation protocols' bidders confirmed to the negotiating team their positions on the issue of GST.[312] Each of the bidders who confirmed their position that no security would be offered to the State for GST on the basis that there was no GST payable were informed by the negotiating team that the State had a different view on GST liability.[313] No further information was provided to bidders concerning the treatment of GST liability at that time[314] [315] although Audit notes that there were extensive meetings with all shortlisted bidders prior to the lodgement of Final Bids to discuss the benchmark project documents.

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308 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999. The notes of that meeting made by the Committee's minute taker from which the minutes were prepared (provided by the Department of Treasury and Finance to Audit under cover of letter dated 11 February 2000) contain a discussion on liability for GST and the methodology for evaluating those bids which provided that any liability for GST be borne by the State.

309 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999.

310 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999.

311 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999 and Attachment K 'Presentation to Evaluation Committee on Final Bids' dated 7 December 1999 (Summary of Final Bids). It should be noted that the Minutes do not reveal the basis on which the quantum of GST was calculated. Further no recommendation was made that the estimated GST be deducted from the bid price.

312 Bidder Negotiation Meetings (held on 8 December 1999) minutes.

313 Bidder Negotiation Meetings (held on 8 December 1999) minutes.

314 There is no further reference to the treatment of GST liability in the Bidder Negotiation Meeting minutes.

315 Advice provided by the ERSU to Audit in conference on 19 April 2000.

The ERSU has advised Audit that bidders were not advised of the value weighting which would be given to any item in the evaluation of the Final Bids, including the treatment of GST, but they were told that any departure from the Benchmark Project Agreements which would increase the risk to the State would be adversely evaluated. The ERSU has advised that this was because no value weightings were in fact adopted.[316]

On 10 December 1999 the Evaluation Committee received advice from the Legal Consortium in relation to the GST risk associated with each bidder. The minutes of the meeting record that:

> *The advice was that GST would be payable. The Committee resolved to deduct GST from the nominated bid prices of (name of bidder) and (name of bidder) for the purposes of evaluating the bids pursuant to the advice of the legal consortium.*[317]

The legal advice referred to by the Evaluation Committee is contained in a letter dated 10 December 1999.[318] The advice on GST contained in the advice is brief and does not address the basis on which GST would be assessed on the bids, nor consider the arguments made by bidders that GST would not be payable.[319] The advice recommended, in respect of those bids which required the State to bear the impact of GST on rent payments due under the lease, that bid prices be discounted in respect of the value attributed by bidders for the acquisition of the leases by 10 percent.[320] I have found no evidence that the Committee either requested or considered any accounting advice on this issue.[321]

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316 The ERSU response to Audit dated 5 September 2000.

317 Item 1 of the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

318 Attachment Q to the Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999.

319 Bidder Negotiation Meetings held on 8 December 1999 — bidders confirmed their position that GST would not be payable.

320 The advice given by the Legal Consortium is set below. In respect of one bid the advice notes:

> *However, it (the bidder) has not changed its position on the State bearing the impact of GST on rent payments due under the Lease, representing in broad terms a 10% discount of the value of its bid in respect of the leases.*

The advice further notes in respect of another bid:

> *For the reasons mentioned, if its (the bidder's) bid remains inclusive of GST then, the value attributed to the leases must be discounted by 10% to reflect the GST burden that will fall upon the State.*

321 The ERSU has provided Audit with a letter from KPMG to the ERSU titled 'GST and Impact on Security Options' dated 25 November 1999. As the copy of this letter provided to Audit is incomplete it is assumed that this was a draft advice. KPMG advised that:

> *Given the significant complexities associated with the lease and security options we recommend GST opinion be obtained from the ATO confirming the timing and application of GST under the CRISP, prepayment and rent purchase in the event of both long term and short term leases.*
>
> *Subject to final ruling from the ATO, we recommend that the State's position on requiring the bidder to continue to provide adequate security for the GST be maintained.*

Audit has seen no evidence to suggest that the ERSU requested or obtained an ATO ruling, as recommended by KPMG.

Accordingly, the Evaluation Committee, where appropriate, when evaluating price, deducted estimated GST from the actual or estimated rent component of the nominated bid prices.[322] As the major component of each offer was attributed to rent, this adjustment had a major impact on the price of those bids which were made on the basis that GST would be borne by the State.

Audit Comment

I am concerned that given the significance of the adjustment for GST to the bid prices, consideration should have been given by the Evaluation Committee as to whether:

- comprehensive legal and accounting advice[323] was required before a decision was made to make a flat 10 percent deduction from the rental component of each bid which did not make allowance for GST, especially when some bidders were arguing that GST was not payable;

- pursuant to the Bidding Rules and the terms of the process contract, the bidders should have been advised that such adjustment would be made to their bids to enable them to review the composition of their bids to mitigate or otherwise allow for this potential liability. This is particularly the case given that some bidders assessed the risk of payment of the GST as minimal or non-existent. It is possible that some bidders may have taken the position they did on the GST issue whilst seeking to minimise the risk to the State on other issues (eg Year 2000 liability). I have been unable to identify any analysis of this possibility undertaken by the Evaluation Committee.

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322 It should be noted that in accordance with the Bidding Rules (Annexure B paragraph (d)) each bidder provided with their bid consideration schedules itemising the components comprising the bid price. Each bidder was obliged to provide a figure being that component of the bid which comprised the NPV of rent and security for rent payments under both the Distribution Network Lease and Land Lease. In its presentation to the Evaluation Committee on 7 December 1999 (Attachment K to the minutes of the meeting held at 12 noon) Morgan Stanley used the NPV of rent and security for rent payments figures as the base figure for the calculation of GST in respect of those bids which incorporated any liability for GST in the bid price. After receipt of the initial bids, further increases to bids were provided or confirmed in correspondence from bidders to the ERSU. No consideration schedules or detailed particulars of the components comprising the bids, were provided by bidders in this correspondence, nor was this information requested by the ERSU or the Evaluation Committee from bidders.

In its presentation to the Evaluation Committee on 10 December 1999 (Attachment R to the minutes of the meeting of the Committee) Morgan Stanley apportioned increases in the bid price to the NPV of rent payments for either the Distribution Network Lease or Land Lease. This methodology is also reflected in the calculations in the Morgan Stanley presentation to the Evaluation Committee on 12 December 1999 (Attachment V to the minutes of the meeting of the Committee). Accordingly all increases in a bid price which incorporated any liability for GST were reduced by Morgan Stanley by 10 percent to allow for GST liability. This approach may have had the effect of inflating the assessment of GST payable, if any, as it was unclear as to whether bidders on increasing the bid price intended that the increase be attributed to rent payments for either the Distribution Network Lease or Land Lease.

323 Such advice should have considered:

- did the transactions give rise to any liability for GST?
- what was the extent of the liability?
- how should the liability be treated in the evaluation of the final bids?

By way of contrast it should be noted that during the conduct of negotiations under the negotiation protocols evidence suggests that the negotiating team advised one bidder of the specific evaluation approach to be applied to the Year 2000 indemnity cap proposed in the Final Bids.[324] The evaluation of the Year 2000 indemnity cap also had the potential to result in a financial adjustment to the Final Bid prices.

4.6.2 Treatment of the State's Year 2000 Liability Cap

The Benchmark Project Agreements[325] provided that the Treasurer would be obliged to indemnify the purchaser for a specified sum for certain costs and payments which may be incurred in connection with an ETSA Year 2000 failure.[326] Bidders were required in their Final Bids to specify the amount of the indemnity (the Y2K indemnity cap) which they sought from the Treasurer in respect of this liability. The Benchmark Project Agreements did not specify the State's benchmark/preferred position in respect of this liability.[327]

The Evaluation Matrix[328] provided that the Y2K indemnity cap should be assessed as a risk factor '… against risk likelihood profile'[329] and having regard to bidder conformity with provisions in the Benchmark Project Agreements. In particular the Evaluation Matrix contained no further guidance as to how the quantum of any specified amount of the Y2K indemnity cap should be evaluated. The approach to evaluating this issue was not determined by the Evaluation Committee until after receipt of the Final Bids.[330]

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324 Refer to commentary under the heading '4.6.2 — Treatment of the State's Year 2000 Liability Cap' in this Report.

325 Clause 11 of the Electricity Retail Business Sale Agreement and clause 13 of the Electricity Distribution Business Sale Agreement.

326 This term is defined in both Sale Agreements (clause 1.1 in each Agreement) as being any failure of equipment or information technology owned by, leased or licensed to, or subject to other rights of use by ETSA Utilities or ETSA Power to deal properly with a series of specified circumstances including the transition from 31 December 1999 to 1 January 2000 and to recognise Year 2000 as a leap year. The term also included any damage to such equipment or information technology caused by such a failure or by a failure of equipment or information technology which is not owned by, leased or licensed to, or subject to other rights of use by ETSA Utilities (in the case of Distribution Business Sale Agreement) or ETSA Power (in the case of Retail Business Sale Agreement) but which is used or relied upon by any person to provide goods or services to that company.

327 The amount of the Y2K indemnity cap was left blank in the Benchmark Project Agreements.

328 Items 11 and 20 of the Evaluation Matrix addressed Y2K risk.

329 Item 11 of the Evaluation Matrix.

330 According to the minutes of the Evaluation Committee held on 6 December 1999 at 12:30 pm the Committee considered and discussed the evaluation methodology including Y2K liability. No detail of the approach proposed by the Committee to evaluate this issue is set out in the minutes. A letter provided to Audit from the Legal Consortium to the ERSU dated 6 June 2000 notes that advice was sought from ETSA Utilities and ETSA Power as to their estimates of potential loss arising out of a Y2K event. It further notes that subsequent to the receipt of this advice the Evaluation Committee reached its decision concerning the evaluation of bids with respect to Y2K risk. The advice provided by ETSA Utilities to the Legal Consortium (provided to Audit by the ERSU under cover of letter dated 7 June 2000) is dated 9 December 1999. Accordingly this advice was provided to the Legal Consortium after receipt of the Final Bids. The ERSU has advised that prior advice was, however, provided to the Legal Consortium on this issue by ETSA Utilities.

On 6 December 1999 the Evaluation Committee determined that the Lead Advisers, KPMG and the Legal Consortium would be responsible for advising on Year 2000 risk to the State in the Final Bid evaluation.[331]

On 7 December 1999 the Evaluation Committee considered the Year 2000 issue raised by the Final Bids and the approach for dealing with this issue in the bid evaluation.[332] In presentations by advisers, the Committee was informed by:

- KPMG; that it would be necessary to ascertain the impact of an indemnity sought by one bidder;
- Morgan Stanley; that the 'Expected Y2K liability is estimated to be $10 million, therefore there is no dollar for dollar impact for any liability cap above $10 million'.[333]

The report of the Evaluation Committee to the Treasurer dated 10 December 1999[334] contains the following comment in relation to the risk to the State arising from the ETSA Year 2000 failure indemnity:

> *Advice from ETSA Utilities and ETSA Power indicates that the maximum exposure that could be faced by the businesses after insurance has been assessed as being unlikely to exceed $10 m.*[335]

On the basis of this advice the Evaluation Committee determined that no bid should be discounted compared to other bids for any Y2K indemnity cap above $10 million. The effect of this determination was that if one bid provided for a Y2K indemnity cap of $10 million and another bid provided for a cap of $100 million or more, the Committee determined that the latter bid should not be discounted on a dollar for dollar (or indeed on any other basis) even though the indemnity it sought from the State was $90 million more than that sought in the other bid.

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331 Minutes of the Evaluation Committee meeting held at 7:11 pm on 6 December 1999, and Attachment H 'Advisory Allocation of Tasks' (evaluation criteria 20).

332 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999.

333 Minutes of the Evaluation Committee meeting held at 12:00 pm on 7 December 1999 and Attachment K 'Presentation to Evaluation Committee on Final Bids' dated 7 December 1999 (Summary of Final Bids).

334 Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999 and Attachment T 'Report by the Evaluation Committee — Final Bids for ETSA Utilities and ETSA Power' dated 10 December, 1999.

335 Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999. 'Report by the Evaluation Committee — Final Bids for ETSA Utilities and ETSA Power' dated 10 December, 1999.

In a letter dated 6 June 2000 from the Legal Consortium to the ERSU[336] the Legal Consortium advised that advice was sought from ETSA Utilities and ETSA Power as to their estimates of potential loss arising out of a Y2K event. The advice provided by ETSA Utilities, for both ETSA Utilities and ETSA Power, dated 9 December 1999[337] concluded:

> *The analysis of the exposure provides some level of confidence that ETSA is highly unlikely to be exposed to catastrophic events and even if so, cover exists for all but $100 000 for the property damage exposure.*

The Legal Consortium has advised the ERSU[338] that after receipt of this report and discussions with ETSA Utilities:

> *… it became apparent that, almost uniquely ETSA Utilities and ETSA Power enjoyed a level of insurance in respect of Y2K loss which covered all forms of loss other than direct failure of an item affected by a Y2K failure.*

In that letter the Legal Consortium further advised:

> *It became apparent therefore that the level of risk the State was prepared to bear under the sale arrangements was, to a very large extent, indemnified under the existing insurance policy.*
>
> *The subsequent advice obtained from ETSA Utilities confirmed that the level of uninsured risk was low but the quantification of that risk was relatively imprecise. The report from ETSA Utilities indicated a number of areas in which loss could be suffered and indicated losses of revenue and costs of repairs in each instances (sic) amounting to some multiples of hundreds of thousands of dollars rather than multiple of millions of dollars.*
>
> *For evaluation purposes it was important to adopt a quantitative standard applied equally to all bidders. The individual elements of potential risk referred to in the report from ETSA Utilities allowed for an estimation of that aggregation but, of itself, did not propose an aggregate number.*
>
> *In consultation with … of ETSA Utilities, ERSU and finally members of the Evaluation Committee, we proposed a quantitative assessment of $10 million. This was arrived as a means of rounding up the elements of risk identified by ETSA Utilities in a way that maintained the integrity of the original assessment but put into the context of evaluation of bids expected to be in the range of $3-4 billion. This approach also allowed for the potential multiple Y2K event where the hundred thousand dollars deductible was expended in a number of separate instances.*

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336 A copy of the letter was provided by the ERSU to Audit under cover of letter dated 7 June 2000.

337 This advice is not specifically referred to in the minutes of the Evaluation Committee.

338 Letter from the Legal Consortium to the ERSU dated 6 June 2000 titled 'Y2K Risk — Sale of ETSA Utilities and ETSA Power'.

The final figure adopted of $10 million represented a conservative rounding up which was considered appropriate given the bidding context and the nature of the estimation and assessment process which have been undertaken by ETSA Utilities in producing the initial report.

Audit Comment

The explanation of the development of the methodology to evaluate the Y2K indemnity cap provided by the Legal Consortium is not reflected in the minutes of the Evaluation Committee[339] and is not entirely consistent with the comment contained in the report of the Evaluation Committee to the Treasurer dated 10 December 1999.[340]

Despite the ERSU's comments, I have not seen any contemporaneous evidence that the Evaluation Committee fully considered this risk factor, in particular whether it sought advice from other appropriately qualified experts such as independent insurance consultants on whether the advice from ETSA Utilities and ETSA Power provided a proper basis for taking the approach adopted.[341] The advice provided by ETSA Utilities and ETSA Power noted that, in the limited time available, the information on which they had conducted their review of the potential loss arising out of a Y2K event had been restricted to information gathered from discussions and investigations internal to ETSA Utilities and ETSA Power. In these circumstances and given the difference between the initial assessment of the risk by ETSA Utilities, expressed at $100 000 and the figure adopted as representing the risk for the purposes of the evaluation, namely $10 million, and also having regard to the wide variation between the Y2K indemnity caps nominated in the Final Bids,[342] I consider it would have been prudent for external advice to have been sought.

The risks associated with the provision of any indemnity by the State need to be carefully considered and regard should be had to the benefit to the State in providing the indemnity. In my opinion, the Evaluation Committee's recommendation that an indemnity cap of an amount in excess of $10 million be evaluated as not constituting a greater risk to the State than the provision of an indemnity cap of $10 million required further consideration by the Evaluation Committee.

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339 According to the minutes of the Evaluation Committee held on 6 December 1999 at 12:30 pm the Committee considered and discussed the evaluation approach including Year 2000 liability. No detail of the approach proposed by the Committee to evaluate this issue is set out in the minutes.

340 Minutes of the Evaluation Committee meeting held at 4:00 pm on 10 December 1999 and Attachment T 'Report by the Evaluation Committee — Final Bids for ETSA Utilities and ETSA Power' dated 10 December, 1999.

341 The minutes of the Evaluation Committee do not reveal the nature of the advice provided by ETSA Utilities and ETSA Power on the potential Year 2000 exposure. The minutes do not refer to the 'Y2K Exposure' report from ETSA Utilities dated 9 December 1999 which specifically addressed this risk referred to in the letter from the Legal Consortium to the ERSU dated 6 June 2000. According to the Legal Consortium, this report was considered by it, the ERSU and members of the Evaluation Committee. There is no reference to this process in the minutes of the Evaluation Committee.

342 The difference between the highest and lowest Y2K indemnity caps proposed in the Final Bids was $120 million.

The Committee's approach that any Y2K indemnity cap over $10 million be acceptable to the State may, in my view, have had the effect of unnecessarily exposing the State to potential liability associated with a higher cap which was not otherwise reflected in some equivalent benefit to the State such as a higher purchase price for the assets. Rather than unnecessarily exposing the State to such liability it would, in my opinion, have been preferable for the ERSU to provide guidance to bidders as to the State's assessment of the ETSA Year 2000 failure and the proposed approach for evaluating the liability caps proposed in bids.

It could be argued that the Evaluation Committee, in taking this approach, may not have acted fairly[343] (as required by the terms of the process contract) when dealing with each bidder. In my opinion, the ERSU should have sought specific advice as to whether it was required, under the terms of the process contract, to advise bidders of the methodology to be applied to the evaluation of this issue in order to assist bidders in the preparation of their bids. It is conceivable that a bidder who proposed a smaller cap may be aggrieved if that bidder ascertained that the Evaluation Committee made no allowance of its proposal to accept a greater level of risk compared with a bidder who proposed a higher cap and hence sought that a greater risk be borne by the State. As this issue was presented to bidders under the Benchmark Project Agreements, it would have been reasonable for bidders to conclude that the State was in effect asking bidders to identify the level of risk on this issue they (as opposed to the State) would be prepared to accept. It is possible that some bidders may have placed a low cap on the ETSA Year 2000 liability in return for the State accepting risk in respect of some other element of the disposal, such as GST risk. The adoption of this approach to the evaluation can 'skew' the evaluation process to favour one bidder as against another.

In this regard it should be noted that the negotiating team chose to explain the State's evaluation approach on this issue to at least one bidder during the conduct of the negotiation protocols. In this instance the bidder had proposed a Y2K indemnity cap in excess of $10 million. The bidder was advised:

> *The State has its own view as to what the costs would be, the view is that the maximum cost would be $10 million and therefore it was not intended to discount (the bidder's) price dollar for dollar.*[344]

The same information concerning the Y2K indemnity cap was not provided to the other bidders, despite the fact that one bidder had proposed in its Final Bid a cap in excess of $10 million.

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343 For example, if a bidder assessed the Year 2000 risk in the order of say $100 million but chose to accept $90 million of the risk and hence cap the State's indemnity at $10 million in its bid, it may consider that it should have received some credit in the evaluation for its willingness to accept risk as against a bidder who sought an indemnity cap of $100 million.

344 This comment was made to a bidder in a meeting held on 8 December 1999, prior to the receipt of the written advice from ETSA Utilities dated 9 December 1999. On the basis of the advice provided to Audit (in the letter from the Legal Consortium to the ERSU dated 6 June 2000 titled 'Y2K Risk — Sale of ETSA Utilities and ETSA Power') as at 8 December 1999 a decision on the quantitative assessment of risk for the purposes of the evaluation of this issue had not been settled by the Evaluation Committee.

Audit Recommendation 22

I recommend that for future business and/or asset disposals that:

- **comprehensive and fully documented advice be sought during the development of bid evaluation methodologies for any element of that methodology, that when applied, may result in the adjustment of bid prices;**
- **where bid price adjustment methodologies of the type referred to above are proposed, legal advice be sought as to whether bidders need to be advised of the proposed application of such methodologies in the evaluation of their bids to enable them to consider the implications of such methodologies when preparing their bids.**

4.6.3 Probity Review

I was advised prior to the lodgement of Final Bids that the ERSU's legal advisers intended to undertake probity checks on bidders based on publicly available information in order to verify information provided by bidders at the Indicative Bid stage. I note that in line with the initial Bidding Rules, the Supplementary Bidding Rules provided to bidders on 26 November 1999 required bidders to provide a range of information, including particulars of the legal identity and ownership structure of each bidder group member.[345] Audit has not sighted any advice provided to the ERSU on the objectives of the probity investigations and the nature and extent of such investigations appropriate for this disposal process. Audit has been provided with an undated report titled 'Investigations into Activities of Short Listed Bidders'[346] which is the probity report submitted to the Evaluation Committee for consideration.

The ERSU has advised Audit that the objectives of the probity investigations were to:

- reveal any matters which would preclude bidders from completing the transaction;
- identify any adverse matters concerning the bidders which should be drawn to the attention of the Treasurer.[347]

Audit Comment

It is essential that comprehensive probity investigations be undertaken on each bidder shortlisted to proceed to the Final Bid process. It is important that when the State is

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345 Annexure B Part (b) Details of Each Bidder.

346 Prepared by the Legal Consortium.

347 Advice provided by ERSU to Audit in conference on 19 April 2000.

divesting key assets it is fully aware of the entities bidding for those assets and whether in making a disposal decision there are any probity or related risks associated with the bidders which may impact on the disposal.

In my opinion the probity report submitted to the Evaluation Committee[348] is deficient in the following respects:

- Limited probity investigations were undertaken on the ultimate beneficial owners of each bidder group member. In the case of the successful bidder, it is unclear from the report who are the ultimate beneficial owners of Hong Kong Electric and Cheung Kong Infrastructure Holdings. The ERSU has advised that Mr Li Ka-Shing is the ultimate beneficial owner of both companies.[349] There is no evidence that any investigations were undertaken on Hutchison Whampoa and Cheung Kong Holdings. I understand that the Evaluation Committee had limited probity information on Mr Li Ka-Shing and no information on Hutchison Whampoa and Cheung Kong Holdings. Hence the Committee was required to rely on the material supplied with the Final Bid concerning the entities. Further the probity report does not refer to or provide any information whatsoever on the beneficial owners of the bidder companies.

- Probity investigations were not undertaken on all of the actual companies nominated as the proposed purchasers in the Final Bids. Again in the case of the successful bidder, the report did not address the purchaser companies CKI Utilities Development Limited (Malaysia), HEI Utilities Development Limited (Malaysia) and Utilities Management Pty Ltd.

- The nature and extent of the investigations undertaken on each bidder differs. It is of course recognised that different jurisdictions have different rules.

- Although a number of common searches have been undertaken in respect of each bidder company in Australia and the United States of America (eg with securities authorities (ASIC, SEC)), there is no evidence of equivalent searches having been undertaken on bidder companies registered in other jurisdictions.[350]

- Litigation searches were not conducted on the directors of one of the bidder companies.

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348 Attachment Q titled 'Investigations into Activities of Short Listed Bidders' to the minutes of the Evaluation Committee meeting held on 10 December 1999.

349 On 19 April 2000 ERSU advised that Mr Li Ka-Shing is the ultimate beneficial owner of CKI which owns 49 percent of Hutchinson Whampoa, which owns CKI.

350 It is noted, however, in the probity report that company and director's searches were conducted in Hong Kong in relation to two companies by Allens Arthur Robinson (Hong Kong) however, the only reference to such searches relates to litigation. There is no further reference in the probity report as to the outcome of any searches undertaken with the Hong Kong Securities Commission, stock exchange or other relevant authorities on HKE and CKI, which are Hong Kong based public companies, or the directors of those companies.

- A credit agency search was undertaken on one bidder company only. It is unclear why similar searches were not undertaken on other bidders although this information may have been available from other sources in other jurisdictions.

- An environmental group search was undertaken on all but one bidder company. It is unclear why this search was not documented in relation to this bidder.

- In the case of one bidder 'Auditor-General' searches were undertaken but not documented.[351]

- According to the introduction to the probity report, annual reports supplied with the Bids were inspected. The result of the review of such annual reports is not evident from the probity report. Further the Final Bids contained additional annual reports which have not been reviewed[352] at all as part of the probity investigation.

- There is no reference to media searches being undertaken on company directors. The probity report only refers to media searches on each bidding company. Audit notes that information on directors and their interests in other companies may be revealed by media searches that may give rise to relevant probity issues.

- It is not evident that the additional probity information supplied by bidders with their Final Bids was considered as part of the probity review (eg current annual reports).

- The probity report was incomplete as further information (eg particulars of court proceedings) was outstanding at the time the probity report was submitted to the Evaluation Committee. No explanation is given in the probity report as to why such searches of information on the public record had not been concluded.

Audit Recommendation 23

I recommend that for future business and/or asset disposals, ('assets' in this context meaning assets of public interest importance) full and comprehensive probity checks on short listed bidders:

- **be undertaken in accordance with the approved plan;**

- **include not only the actual proposed purchasers of the asset but also their ultimate beneficial owners;**

- **be undertaken and completed prior to completion of the Final Bid evaluation.**

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351 Audit understands that searches were undertaken by the Legal Consortium of Federal and State Auditors-General's websites to identify any references relating to the bidders.

352 No reference is made to the reports in the probity report.

4.7 FINALISATION OF THE FINAL BID EVALUATION PROCESS

4.7.1 Overall Assessment

The 'Evaluation of Final Bids — Summary' envisaged that members of the Advisory Group would provide the Evaluation Committee with an analysis of:

- price issues;[353]
- the risks attributable to each category of risk and a comparison of risk attributable to each bidder within that category.[354]

According to the 'Evaluation of Final Bids — Summary' the Evaluation Committee, once in receipt of the analysis provided by the Advisory Group members,

> *… will then make an overall assessment of the Final Bids by assessing 'the consideration offered by shortlisted bidders against the risks retained by the State and the risks inherent in the Bidder's preferred Project Agreements' (Bidding Rule 13.1) and the principle objectives (Bidding Rule 7.1).*[355]

Audit Comment

As is noted under the heading '4.5 — Advisory Group Reports' in this Report, the Advisory Group did not provide the Evaluation Committee with a comprehensive comparison:

- between bidders of the relative level of risks attributable to their bids; or
- of different categories of risk attributable to each bid.

In the absence of any comprehensive comparisons the Evaluation Committee was itself required to undertake a comparison of the respective levels of risk attributable to each of the bidders.

The documentation envisaged by the 'Evaluation of Final Bids — Summary' to support the Evaluation Committee's ranking of bidders on risk has not been prepared. There is no evidence that the rankings made on issues in the Evaluation Matrix analysed by advisers were collated and compared by the Evaluation Committee.

In particular, I note that no consolidated or summary Evaluation Matrix was prepared or considered by the Evaluation Committee. As some Evaluation Matrix items were the responsibility of more than one member of the Advisory Team a consolidated Evaluation Matrix would have enabled the Evaluation Committee to identify any significant or unresolved risk and price issues and where variations occurred between bidders. Further, it would have provided a useful guide for the Evaluation Committee to use when undertaking a

353 Section 6.3.

354 Section 6.4.

355 Section 6.5.

comparison between bidders of the relative level of risks attributable to their bids and a comparison of different categories of risk attributable to different bids.

It is also unclear as to the approach used by the Evaluation Committee to undertake the final comparison between risk and price.

Audit Recommendation 24

I recommend that where an evaluation methodology similar to that adopted with respect to the electricity assets is to be adopted for future business and/or asset disposals, the overall assessment of the bids be supported by a consolidated or summary evaluation matrix identifying each risk and price issue with details of the evaluation undertaken in respect of each issue, applying the approved methodology or guidelines, and the reasons for the decisions reached.

4.7.2 Minutes of the Evaluation Committee

The minutes of the meetings of the Evaluation Committee which met between 2 December 1999 and 12 December 1999 were not certified as a correct record of the meeting, as agreed by the committee members present, by the Chair until 11 February 2000.

Audit Comment

It is essential that the minutes of meetings of committees accurately record the issues raised and determined at those meetings. The minutes of a committee responsible for the evaluation of bids need to record the decisions made in the evaluation process and the basis on which the committee reached such decisions. The minutes are key documents that evidence the decision for the selection of the preferred bidder(s).

In a complex disposal process involving the consideration of a wide range of issues it is possible that the recollection of committee members of matters raised at committee meetings may be less clear with the passage of time. Accordingly, it is important that minutes of committee meetings be prepared, circulated, commented upon by committee members, and certified by the committee chair at the earliest practicable date, preferably prior to or at the next meeting of that committee.

In my opinion, the delay of almost two months in the certification of the minutes of the Evaluation Committee is unacceptable[356] and could give rise to claims that the minutes do not represent an accurate record of the proceedings of the meetings of the Evaluation Committee.

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[356] Audit requested a copy of the minutes of the meetings of the Evaluation Committee on 13 December 1999. ERSU supplied the minutes under cover of a letter dated 11 February 2000.

I note that the Probity Auditor has also commented on the effects of the delay in certifying the minutes. In his report dated 19 May 2000 he has advised:

Given the passage of time between the meetings and the finalisation of the minutes it is not possible for Probity Audit to positively assert from its own knowledge the contents thereof in detail. In this respect it would have been preferable for the minutes to have been completed in a more timely way. The comments in this report concerning the minutes are made with that qualification, however with that understood the minutes are broadly consistent with our notes and recollections.[357]

Audit Recommendation 25

I recommend that for future business and/or asset disposals, the minutes of meetings of the evaluation and other asset committees be finalised and certified by the respective committees at the following meeting of that committee or if this is not possible at the earliest practicable date thereafter.

4.7.3 Advice and Recommendations to Government

The Treasurer's minute dated 12 December 1999 provided to Cabinet in support of his proposed decision to enter into agreements with HKE and CKI for the sale/lease of ETSA Utilities and ETSA Power, contained a summary of the Final Bids received and the evaluation outcome. The minute contained particulars of key features of the bids received, the evaluation outcome, and the recommendation of the Evaluation Committee. In respect of each bid, the minute detailed the offer price received (including the impact of GST), a summary of the risk evaluation against the State's benchmark/preferred risk position and the overall ranking. The minute (as opposed to the detailed attachments including the full reports and recommendations of the Evaluation Committee to the Treasurer) did not include the following information:

- details of the ultimate beneficial owners of the preferred purchasers, HKE and CKI;
- the lease term being sought by HKE and CKI was for 200 years, although it was a commonly held public belief that the lease would be for a period of around 100 years;
- the indemnity to be provided by the State to HKE and CKI was capped at $170 million in connection with an ETSA Year 2000 failure. The provision of an indemnity of this nature is material, even though the Evaluation Committee had assessed the State's potential exposure under the indemnity at $10 million.

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[357] Letter from the Probity Auditor to the Treasurer dated 19 May 2000 titled 'Final report concerning final bid receipt and evaluation: ETSA Power and ETSA Utilities'.

The HKE and CKI Final Bid proposed that the State indemnity in connection with an ETSA Year 2000 failure be capped at $170 million whereas the other bidders proposed indemnity 'caps' of $10 million and $30 million. Although the Evaluation Committee assessed the State's potential exposure in the event of an ETSA Year 2000 failure at no more than $10 million, the Evaluation Committee recommended that the State agree to indemnify HKE and CKI up to $170 million for this risk. Accordingly the State's indemnity cap proposed in the HKE and CKI Final Bid was between $140m and $160m more than the indemnity caps proposed in the other bids.

It is clear that the HKE and CKI Final Bid was very different to the other Final Bids received in respect of both the lease term and the State's indemnity for a ETSA Year 2000 failure; however neither of these issues were highlighted in the Treasurer's minute to Cabinet.

Audit Comment

Government relies on the provision of comprehensive and accurate information from its agencies to assist with its decision making processes.

In a disposal process of major government assets it is important that the information provided addresses key issues such as the exact nature of the disposal, the identity of those parties with the ultimate ownership or control over the asset and the nature and extent of any residual liabilities of the State following the completion of the process. The issues that were not addressed in the Treasurer's minute dated 12 December 1999 are key issues requiring further explanation. In particular:

- the identity of those parties with the ultimate ownership or control over the asset is important from a probity perspective — whether the entities have a history of breaches of corporate or other regulatory requirements, are involved in major litigation or are associated with criminal or terrorist organisations;[358]
- the lease term, given the public perception that the lease would be for a period of about 100 years;[359]
- the provision of an indemnity by the State to a third party gives rise to a contingent liability which should be disclosed and accompanied by a risk assessment as to the likelihood of a claim being made against the State by the third party pursuant to the terms of that indemnity;

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358 As mentioned under the heading '4.6.3 — Probity Review' in this Report the probity investigation failed to undertake full enquiries of this nature.

359 I note that the Distribution Network Lease in the Benchmark Project Agreements dated 2 December 1999, which I understand to be the last set of Agreements issued to bidders prior to the receipt of the final bids, specify varying lease terms (in the definition of 'Term') for the shortlisted bidders. On 19 April 2000 ERSU advised that the Treasurer had approved the Benchmark Project Agreements and hence was aware of the proposed lease terms for each short listed bidder.

- in my opinion, Cabinet should have been advised of the above matters which were material elements of the successful tenderer's bid when considering the Treasurer's submission in support of his proposed decision.

Audit Recommendation 26

I recommend that for future business and/or asset disposals, briefing papers provided in support of recommendations and proposed decisions clearly summarise and identify all material issues relating to that recommendation or decision.

4.7.4 Report of the Probity Auditor

The appointed Probity Auditor is required under the terms of his contract with the Treasurer, to provide to the Treasurer a report on the Final Bid Process. That report is to comment on the fairness of the disposal process.

Audit Comment

I note that the Probity Auditor provided to the Treasurer his final report on the Final Bid Process in May 2000, having supplied his preliminary report in December 1999. In his final report dated 19 May 2000 it is noted that the report submitted in December 1999 was: '… expressed to be preliminary as at that time the certified minutes[360] had not yet been provided to Probity Audit'.

I further note that the certified minutes of the Evaluation Committee were provided to Audit on 11 February 2000.[361] I would expect that the final report should have been provided prior to May 2000 given that the certified minutes had been available to the Probity Auditor for some three months.

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[360] This is a reference to the minutes of the Evaluation Committee.

[361] Under cover of letter from the Under Treasurer, Department of Treasury and Finance dated 11 February 2000.

PART 5
REVIEW OF PROJECT DOCUMENTATION

5.1 OVERVIEW OF THE STRUCTURE OF THE DISPOSAL PROCESS

5.1.1 Restructuring and Disposal Act

The disposal process for ETSA Utilities and ETSA Power, is governed by the provisions of the *Electricity Corporations (Restructuring and Disposal) Act 1999*. This Act provided the authority for the disposal of the State's electricity businesses by way of lease, and in some cases, sale.

The Act specifically prohibited the Crown, any instrumentality of the Crown, or a statutory corporation from selling or transferring either 'prescribed electricity assets' or shares in a company that owns (or has a subsidiary that owns) 'prescribed electricity assets'. For these purposes 'prescribed electricity assets' were defined under the Act[362] as any of the following situated in South Australia:

> *(a) electricity generating plant with a generating capacity of 10MW or more;*
>
> *(b) power lines (including their supporting or protective structures or equipment and associated equipment for the transmission or distribution of electricity);*
>
> *(c) sub-stations; and*
>
> *(d) land on or under which infrastructure of the kind referred to above is situated.*

Subject to these prohibitions, the Treasurer was authorised by agreement with the purchaser (the successful bidder) to grant to the purchaser a lease, easement or other rights in respect of the assets of one or more of the State's electricity businesses.[363]

As a result, it was permissible for 'prescribed electricity assets' to be leased to a purchaser.

The Act also made provision for the restructuring of the State's electricity assets prior to any disposal process commencing.[364] As a result of this restructuring process, ETSA Utilities and ETSA Power were established. ETSA Utilities was established to take over and operate the distribution business of the former ETSA Corporation while ETSA Power was established for the purposes of conducting the electricity retail business of the former ETSA Corporation.

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362 Section 13 — *Electricity Corporations (Restructuring and Disposal) Act 1999*.

363 Section 13(3) — *Electricity Corporations (Restructuring and Disposal) Act 1999*.

364 *Electricity Corporations (Restructuring and Disposal) Act 1999* (Part 3).

The main assets of ETSA Utilities constituted 'prescribed electricity assets' and accordingly the disposal process for those assets was restricted to either a lease of those prescribed electricity assets to the successful bidder or alternatively the sale to a successful bidder of shares in a company where that company was the lessee of those prescribed electricity assets.[365] The assets of ETSA Power did not constitute 'prescribed electricity assets' under the Act.

In order to facilitate the proposed disposal of ETSA Utilities, the Distribution Lessor Corporation, a subsidiary of the Treasurer, was established on 29 July 1999 under the Public Corporations (Distribution Lessor Corporation) Regulations 1999. The Corporation was established to hold 'prescribed electricity assets' being powerlines, sub-stations, land on or under which powerlines or sub-stations are situated as well as any other assets that are used in connection with the operation of a distribution network.

Prior to 3 July 1999, these prescribed electricity assets were owned by ETSA Utilities. They were transferred to the Distribution Lessor Corporation via Ministerial Transfer Order made under the Disposal Act and make up the distribution network.[366] In turn, there was a lease back from Distribution Lessor Company to ETSA Utilities of the assets transferred under this Transfer Order.

Prospective purchasers in the disposal process for ETSA Utilities, were given a number of options in relation to what they could bid for. They were able to:

- buy shares in ETSA Utilities, or in it's holding company;
- take a transfer of the lease between ETSA Utilities, and the Distribution Lessor Corporation; or
- enter into a new lease with the Distribution Lessor Corporation (negotiated to replace the existing lease).

The successful bidder for ETSA Utilities, chose the third of the abovementioned options, namely, to enter into a new lease with the Distribution Lessor Corporation and to replace the existing lease between the Distribution Lessor Company and ETSA Utilities.

As the lease entered into with the successful bidder of the distribution network extends for a period of 200 years, it fits within the definition of a 'prescribed long term lease' under the Disposal Act. Section 17 of the Disposal Act, provides that the Minister is to endeavour to ensure that a 'prescribed long term lease' in respect of 'prescribed electricity assets' contains a number of terms, all of which are meant to minimise the risk to the State. These terms include the following requirements:

> *(a) the Lessee's right or option to renew or extend the lease must be exercised not less than 5 years before the commencement of the term of that renewal or extension;*

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365 Section 13 — *Electricity Corporations (Restructuring and Disposal) Act 1999*.

366 Ministerial Transfer Order dated 30 July 1999.

(b) *the risk of non payment of rent (including amounts to be paid on exercise of a right or option to renew or extend the lease) is addressed at the commencement of the lease by the provision of adequate security or other means;*

(c) *the Lessee must provide adequate security in respect of compliance with requirements as to the condition of the leased assets at the expiration or earlier termination of the lease;*

(d) *the Lessor accepts no liability for, and provides no warranty or indemnity as to, a consequence arising from:*

(i) *the Lessee's use of the leased assets, in trade or business; or*

(ii) *pool prices in the National Electricity Market or a similar or derivative market relating to the supply of electricity; or*

(iii) *competition between participants in the National Electricity Market or a similar or derivative market relating to the supply of electricity; or*

(iv) *regulatory change in the Electricity Supply industry; and*

(e) *the Lessee must indemnify the Lessor for any liability of the Lessor to a third party arising from the Lessee's use or possession of the Leased assets;*

(f) *the Lessee must have adequate insurance against risks arising from the use or possession of the leased assets;*

(g) *the Lessee must ensure compliance with all regulatory requirements applicable to the use or possession of the leased assets;*

(h) *the Lessor is entitled to terminate the lease if a breach of the Lessee's obligations of any of the following kinds, or any other serious breach remains unremedied after reasonable notice:*

(i) *failure to obtain or retain:*

(A) *a licence or registration required for the use of the leased assets for their intended purpose in the electricity supply industry under the* Electricity Act 1996 *or the National Electricity (South Australia) Law; or*

(B) *a similar licence, registration or other authority required under subsequent legislation;*

(ii) *non-payment of rent;*

(iii) substantial cessation of use of the leased assets for their intended purpose in the electricity supply industry; and

(iv) the Lessor has a right or option, at the expiration or earlier termination of the lease, to acquire assets that form part of the business involved in the use of the leased assets for their intended purpose in the electricity supply industry.

5.1.2 Key Project Documents

The key project documents which give effect to the disposal of the distribution network of ETSA Utilities and the assets and liabilities of ETSA Power are as follows:

- Electricity Distribution Sale Agreement between the Treasurer, ETSA Utilities, Distribution Lessor Corporation, CKI Utilities Development Ltd, HEI Utilities Development Ltd, Utilities Management Pty Ltd, Cheung Kong Infrastructure Holdings Ltd, and Hong Kong Electric Holdings Ltd.
- Distribution Network Land Lease Sale/Lease Agreement between the Treasurer of the State of South Australia and South Australian Utilities Partnership.
- Distribution Network Lease Sale/Lease Agreement between the Treasurer of the State of South Australia and the South Australian Utilities Partnership.
- Electricity Retail Business Sale Agreement between the Treasurer, ETSA Power Pty Ltd, Utilities Management Pty Ltd, Cheung Kong Infrastructure Holdings Limited, and Hong Kong Electric Holdings Limited.

The disposal process for the retail business of ETSA Power was structured as a sale of business involving the transfer to the successful bidder of identified assets and liabilities.

The disposal process for the distribution network of ETSA Utilities was however, structured in two parts. One part involved the sale of the assets and liabilities of ETSA Utilities (non-prescribed electricity assets) and the other involved the lease of the distribution network and the land on which it was situated.

The Electricity Distribution Sale Agreement and the Electricity Retail Business Sale Agreement accordingly dealt with the following matters:

- The sale of non-prescribed assets, including trademarks and other intellectual property.
- The completion procedures.
- The payment of a deposit.
- The consequences of failure to complete.

- The assumption of liabilities by the purchaser.
- The retention of excluded assets and excluded liabilities by the State.
- The assignment of business contracts to the successful purchaser.
- Warranties given by the State to the purchaser.
- Provisions concerning Year 2000 compliance liability and Goods and Services Tax liability.
- Guarantees securing the successful bidder's obligations.

The physical distribution network was itself leased to the successful bidder in accordance with the requirements of the *Electricity Corporations (Restructuring and Disposal) Act 1999*. The grant of this lease to the successful purchaser was made pursuant to the terms of the Distribution Network Lease Sale/Lease Agreement which was executed between the abovementioned parties on 28 January 2000. Attached as an Annexure to this Agreement was the distribution network lease document. It is this document which sets out the full terms and conditions under which the distribution network was to be leased to the successful bidder. In accordance with the terms of the Distribution Network Lease Sale/Lease Agreement, the successful bidder opted to prepay amounts payable by way of rent under the lease in the total sum of $2 704 300 000.

The land upon which the distribution network of ETSA Utilities is sited was separately leased to the successful bidder in accordance with the provisions of the Distribution Network Land Lease Sale/Lease Agreement. This agreement was also executed between the abovementioned parties on 28 January 2000. Attached as a schedule to this Agreement was the Distribution Network Land Lease which sets out the terms and conditions under which the land upon which the distribution network is sited was leased to the successful bidder. The lease contains a schedule of rent payments for the lease term. In accordance with the provisions of this schedule the successful bidder is required to pay for the period as and from 28 January 2000 to 30 June 2000 one fifth of the amount of $8 078 418. For each year thereafter throughout the course of the term of the lease the successful bidder is required to pay by way of rent one twelfth of $19 872 908 increased in each year by a further 2.5 percent. The lease term is specified to be 200 years as and from 28 January 2000.

5.2 ISSUES ARISING FROM A REVIEW OF THE PROJECT DOCUMENTATION

5.2.1 Introduction

Based upon my review of the Project Documentation for ETSA Utilities and ETSA Power, I have identified the following issues which need to be considered in the context of any future asset disposal process.

In some instances the issues raised reflect a difference of view or alternative approach to that adopted by the ERSU and its advisers in the preparation of the Project Documentation. I agree that it is quite legitimate for differences to exist in relation to the approach to commercial issues. However, the recommendations contained in this Report reflect my view regarding those governmental values of accountability, transparency and auditability etc that should always be the basis upon which governmental activities are predicated. These issues are as follows:

- provision of sign-off opinions
- conduct of warranty review program and assessment of potential retained liabilities
- capping of the State's liability for warranties
- provision of 'cure' periods under lease
- errors in Project Documents.

My specific comments in relation to each of these issues follows.

5.2.2 Provision of Sign-Off Opinions

The disposal of ETSA Utilities and ETSA Power is the largest public infrastructure asset disposal project yet undertaken by the State. As identified in my Report in respect of the Engagement of Advisers,[367] the State has engaged a number of expert advisers to assist it with respect to the conduct of the disposal process in order to ensure that the State's interests are protected.

Audit Comment

As the Project Documentation gives legal effect to the disposal process and formally establishes the rights, obligations and liabilities of the State as vendor and the successful bidder as the new owner of the electricity assets of ETSA Utilities and ETSA Power, it is important that the documents when drafted are effective and protect to the maximum extent possible the State from future liability.

The management approach adopted by the ERSU for the conduct of the disposal process for ETSA Utilities and ETSA Power has, in my opinion, created the potential for the abovementioned key advisers not to be held fully accountable to the State for the Project Documentation. The ERSU has conducted the management of the disposal process through a 'committee structure' which whilst it has ensured a full exchange of views, has, however, in my opinion made it difficult for the State to both identify and place reliance upon specific advice in relation to the disposal process received from these advisers.

In a transaction of such importance as the disposal of ETSA Utilities and ETSA Power, I understand that it is common practice to require the advisers with principal responsibility for input into the drafting of the project documentation and the approach to key issues that this drafting reflects, namely the Lead, Legal and Accounting Advisers, to provide to the State,

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[367] Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations

prior to execution of the project documentation, a formal sign-off which confirms that the project documentation:

- fully complies with, and gives effect to, the instructions received by the advisers from the State during the course of the disposal process;
- is fully consistent with all regulatory and legislative requirements;
- appropriately protects the State from potential liability.

Whilst it is noted that the Legal Advisers provided an opinion to the Treasurer in respect of the project documents on 6 December 1999, none of the other advisers 'signed off' to the State on these documents.

Having regard to the responsibilities of other key advisers, the failure to require the provision of sign-offs coupled with the committee structure adopted by the ERSU for the management of the disposal process means, in my opinion, that the accountability of the respective advisers has been diluted and that the State's ability to seek to place reliance upon the advice provided by these advisers for the preparation of the Project Documentation has been similarly reduced. Given the significant fees paid to the advisers, this process does not, in my opinion, represent good public administrative practice.

In making the above comments, I am not suggesting that the advisers have in any way been negligent in the provision of advice to the State concerning the preparation of the Project Documentation. Without a clear audit trail identifying the specific advice provided to the State leading to the preparation of the Project Documentation in respect of the key issues covered by those documents, there is a lack of transparency in the disposal process making it difficult to ascertain the reasons why a particular approach was adopted with respect to certain issues.

Audit Recommendation 27

In future asset disposal processes, I recommend that the State ensure that there is a clear audit trail of the advice provided to the State by its advisers in relation to the drafting of documents to give effect to that disposal process.

Audit Recommendation 28

I recommend that in future asset disposals, the State ensure that all the advisers with primary responsibility for assisting the State in preparing documents to give effect to the disposal process be required to provide to the State effective sign-offs in relation to those documents before these documents are executed by the State.

ERSU Response

> *… it was not appropriate to require such a sign-off from the State's other advisers. However, the advisers did provide advice on particular matters that were reflected in the final project documentation and that were within their expertise. This advice was provided at meetings and in writing and is advice upon which the State is entitled to rely and to seek remedy should that advice be incorrect.*

Further Audit Comment

Given the issues being dealt with in the Project Documentation, and the positions taken on those issues by advisers, I remain of the view that is would have been appropriate to seek comprehensive sign-offs from all advisers.

5.2.3 Warranty Review Program

Under the Distribution Network and Electricity Retail Sale Agreements, the State has provided a range of warranties to the successful bidder. These warranties are principally focused upon the provision of good title to the assets transferred to the successful bidder by the State, together with confirmation by the State of its authority to effect a disposal of the assets and liabilities of ETSA Utilities and ETSA Power to the successful bidder. As such, the warranties provided are limited.

Audit Comment

In circumstances where the State has provided minimal warranties and the above protections are in place, it is nevertheless essential that the State have in place an appropriate warranty review program as part of the disposal process. Such a program is designed to ensure that as part of the due diligence undertaken in preparation for a disposal, the information necessary to support the provision of warranties by the State is identified, reviewed and confirmed.

It is my understanding that it is common practice to include a warranty review program as part of the due diligence arrangements for a disposal process such as the disposal of ETSA Utilities and ETSA Power.

This issue was discussed earlier in this Report under the heading '3.2.1.4 — Representations and Warranties made to the Purchaser in the Project Agreements'.

5.2.4 Monetary Cap on Liability

The State's potential liability in respect of the warranties provided to the successful bidder under the Project Documents for ETSA Utilities and ETSA Power has been capped at an amount equal to approximately the purchase price paid by the successful bidder.

Audit Comment

Given the competitive nature of the disposal process, and whilst accepting that this is a matter for commercial judgement upon which views can legitimately differ, I am of the opinion that the preferred course would not have been for the State to adopt from the outset such a cap as the benchmark position of the State. In my opinion, consideration should have been given to adopting a much lower cap on the State's potential liability as a benchmark position. Potential purchasers could then have been asked to lodge bids against this cap indicating the likely change to their purchase price which would occur in the event that the cap on warranty liability was increased. In my opinion, this would have provided greater transparency in relation to this aspect of the disposal process and enabled the State to obtain a true view of the value of the provision of the warranties contained in the Project Documentation.

The ERSU responded that they considered that this issue was a matter of:

> *… commercial judgment, … on which views may legitimately differ. In the view of Treasury and Finance and its advisers, the only impact of a cap lower than the value of the assets would have been to reduce the prices bid on those assets on a $1 for $1 basis. This is because bidders would consider themselves exposed to a possible loss equivalent to the difference between the purchase price and the cap, and so would discount their bids accordingly. Therefore, the implication of Audit's recommendation would have been that the State may have received an amount less than the amount actually received, such an amount dependent upon the level of the cap.*

Audit Recommendation 29

I recommend that in future asset disposals involving significant competition, where the State is to provide warranties to the potential purchasers, where commercially possible consideration be given to putting as the State's position a low monetary cap on the State's liability under these warranties particularly in circumstances where there is significant competitive tension in the disposal process.

5.2.5 Retained Liabilities

Under the Project Documents for ETSA Utilities and ETSA Power, the State has retained a range of liabilities in respect of the operation of ETSA Utilities and ETSA Power incurred by those companies in the period prior to completion of the Project Documents. I note that the decision as to what liabilities would be retained by the State was taken primarily at the time of restructure prior to the actual commencement of the disposal process.

A number of these liabilities were either liabilities as between State-owned entities, for example liabilities for stamp duty; or liabilities which it was considered by the ERSU and its advisers could best be managed by the State, and which if passed to the purchaser, could

result in a disproportionate reduction in the bid price (for example, liabilities arising out of the prior exposure of employees to asbestos).

Audit Comment

It is not possible to ascertain what the State's potential contingent liability arising from the disposal arrangements is in the future. Nor is it possible to accurately form a view as to whether or not the disposal proceeds received by the State represent best overall value for money for the State.

In circumstances where as a result of the disposal process the State is to retain certain identified liabilities, the potential value of the liabilities to be retained by the State should be assessed as part of the disposal process. Once assessed, consideration must be given as to whether or not the State's initial benchmark position should be to retain these liabilities or alternatively should be to seek to pass these liabilities on to the successful bidder. Whilst this decision may in part be determined by an assessment of who is best able to manage the risk (ie the State or the purchaser) it is nevertheless important that an assessment of the magnitude of the risk is also made and fully understood.

It is also recognised, that there is an inherent trade-off, between maximising disposal proceeds, and minimising potential on-going liabilities for the State. To the extent that the State retains liabilities this may have the effect of increasing disposal proceeds but at the cost of retaining responsibility for future liabilities. The decision making process in relation to the treatment of retained liabilities needs to be fully transparent, particularly in the circumstances where as noted in my Report on the Engagement of Advisers[368] a number of the key advisers were retained on the basis of being paid, as part of their remuneration, incentive payments based upon the value of the disposal proceeds achieved by the State. It is noted that the State did receive advice from the Legal Advisers on 24 October 1999 in respect of this issue.

In making the above comments, I am concerned that the process lacks transparency as there is not a complete audit trail of the advice received and assessments made to support the State's decisions as to whether or not it would or would not retain a certain nominated liability.

Audit Recommendation 30

In future asset disposals, where it is intended that the State retain certain liabilities in the disposal process, I recommend that in addition to a consideration of the legal position, to the extent possible, a full analysis of the potential cost to the State of retaining those liabilities be undertaken and documented before any decision is taken.

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[368] Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations.

5.2.6 Cure Periods

The Distribution Network Lease makes provision for the State, through the Distribution Lessor Corporation, to effect a termination of the lease in a number of identified circumstances. These include the non-payment of rent; the suspension or cancellation of operating licences; failure to maintain the distribution network and the failure to use the distribution network continuously for the purposes of distributing electricity.[369]

In a number of cases, long 'cure' periods are provided to the lessee to rectify the consequences of the breach. By way of example, in the event that the lessee defaults in its obligation to operate, repair and maintain the distribution network in good operating order, repair and condition consistent with good operating practice, the lessee is provided with a period of up to six months to rectify the situation.

Alternatively, in the event that the lessee fails to operate, repair and maintain the distribution network in accordance with all applicable laws, the breach of which would result in the Distribution Lessor Corporation or the Crown suffering or incurring a material, civil or criminal liability or in the event that the lessee has failed to operate, repair and maintain the distribution network in a manner and to the extent necessary to comply with the requirements specified in any applicable insurance policy, the lessee is provided with a period of up to three months to rectify the situation.[370]

Audit Comment

Reliance only on the lease termination events where there are such long cure periods could lead to the situation arising whereby the ongoing distribution of electricity in the State may be threatened. Under the terms of the Distribution Network Lease, I note that the Distribution Lessor Corporation is not able to enter into the premises until the expiry of the relevant cure periods to take control of the distribution network and to itself rectify the situation (eg by effecting repairs).

Reliance has instead been placed upon the provisions of the *Electricity Act 1996* to ensure that the continued distribution and transmission of electricity in the State is maintained. Pursuant to section 38 of the *Electricity Act 1996*, if an electricity entity such as the lessee contravenes a condition of its licence or any other requirement of the *Electricity Act 1996* or an electricity entity's licence ceases and it is necessary in the Industry Regulator's opinion to take over the entity's operations to ensure an adequate supply of electricity to customers, the Governor may make a proclamation under the Act authorising the Industry Regulator to take over the electricity's entity's operations or a specified part of the electricity entity's operations. In these circumstances, the electricity entity (eg the lessee) must be given a reasonable period in which to make representations to the Industry Regulator as to why such

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369 Clause 12.1 Distribution Network Lease.

370 Clause 12.1(g)(iii) Distribution Network Lease.

a proclamation should not be made.[371] The Act does not provide any guidance as to what would be a reasonable period in the circumstances. Given the critical nature of the service being provided by the lessee to the State, it is likely to be the case that this period would not equate with the long 'cure' periods provided for under the Distribution Network Lease.

Whilst I note the decision to rely upon the regulatory regime to protect the State's interests, I also note that the making of such a proclamation by the Governor is not of itself a termination event identified under the Distribution Network Lease.

The ERSU responded that:

> *… it is entirely appropriate that the Independent Industry Regulator and the regulatory regime established by the Electricity Act, and as passed by Parliament, are the primary mechanisms for ensuring the ongoing distribution of electricity in the State.*
>
> *Reliance on the Distribution Network Lease (which only relates to one participant in the State's electricity supply industry and to one network in the electricity infrastructure within the State) to achieve these purposes is not a satisfactory policy position because it would result in a contractually imposed regulatory regime that applies to one participant (and not other participants) and to some electricity infrastructure (but not other electricity infrastructure). This would distort competitive neutrality between industry participants, potentially contrary to national competition principle agreements.*

Audit Recommendation 31

I recommend that in future asset disposals that involve the sale and/or lease of essential services, consideration be given to ensuring that the provision of 'cure' periods for the lessee/owner of these assets equate with other applicable legislative requirements.

5.2.7 Errors in Project Documentation

Whilst I have not conducted a line by line review of each of the Project Documents my review has noted and identified an error in the drafting of the Distribution Network Land Lease.

Clause 3 in the Distribution Network Land Lease sets out the payments payable by the successful bidder to the Distribution Lessor Corporation in respect of the grant of the lease of the distribution network land.

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[371] Section 12 — *Electricity Act 1996*.

Payment arrangements are set out in detail in clause 3.2 of the Distribution Network Land Lease. Clause 3.2(a) of the Distribution Network Land Lease states:

> *The Lessee must pay:*
>
> *(a) one-fifth of the amount referred to in column 2 of Schedule 1 in respect of the period commencing on the Commencement Date and expiring on 30 June 2000 Rent Payment Date during that period.*

Clause 3.2(b) of the Distribution Network Land Lease sets out the calculation for the remainder of the lease term. This clause states:

> *The Lessee must pay:*
>
> *(b) one-twelfth of each other amount referred to in column 2 of Schedule 3 on each Rent Payment Date during the period referred to in column 1 of Schedule 3 in respect of the amount.*

Audit Comment

From my review of the Distribution Network Land Lease the reference in clause 3.2(a) of the Distribution Network Land Lease to 'column 2 of Schedule 1' should have been a reference instead to 'column 2 of Schedule 3'.

Given the central importance of this clause in the Distribution Network Land Lease, being the clause that establishes the payment arrangements in respect of the rent for the period of the lease, it is of concern that such a cross-referencing error has occurred. Whilst the ERSU has confirmed with the successful bidder that it accepts that this was an inadvertent drafting error, the ERSU has also advised that it does not intend to undertake a review of the Project Documentation in order to ensure that this error is an isolated incident.

In my opinion, against the background of this and a previous error identified in the Project Documentation, I believe that there is no basis upon which the ERSU can maintain their position that a full review is not warranted. In my opinion, a full review of the Project Documentation must be undertaken by the ERSU and it's advisers to ensure that this form of error is isolated to this particular instance.

Audit Recommendation 32

I recommend that a full review of the Project Documentation for the disposal process for ETSA Utilities and ETSA Power be undertaken to ensure that the Project Documentation contains no inadvertent errors or omissions which may affect the State's position under those documents.

APPENDIX

MINUTES forming ENCLOSURE to

TO THE EXECUTIVE DIRECTOR, COMMERCIAL & SALE ELECTRICITY REFORM SALES UNIT

Re: AUDITOR-GENERAL'S REPORT -DUTY TO ACT FAIRLY

I refer to your letter of 22 March, 2000.

It is my understanding of your request for advice that advice is required, not on the actual process undertaken by the State, but on the legal principles involved.

This advice is predicated on a strict legal interpretation of "duty", in the sense that it is a duty which gives rise to a right vested in another party "a bidder", which right is enforceable in a court in legal proceedings. Much of the Auditor-General's comments relate to what he considers to be an obligation of the Government to ensure public confidence in the processes of Government. For example, the expectation that Government be a "moral exemplar" is not a strict duty imposed upon the Government which may be enforced. It is a part of the context in which Government action is judged in administrative law and contractual law matters. I do not think anyone could reasonably disagree with the Auditor-General's premise that Governments should act "fairly" in their commercial dealings. The question is whether this is a moral or a legal duty .

There are two possible sources of the duty to act fairly in the process of asset sales, statute or contract.

Ignoring for the moment the Electricity Corporations (Restructure and Disposal) Act, most, if not all, bodies corporate created by statute have the power to enter into contracts. While the source of this power is the statute, there is no statutory scheme in the sense referred to by the Auditor-General. It is a bare power, and the manner of sale of assets is entirely at large. If there is a process contract either express or implied, the duty to act fairly arises out of the contract. If the process contract is implied, then the contents of contract will be gleaned from the conduct of the parties. It is almost certain that a court would imply a term that the vendor will act "fairly" (as was the case in ***Hughes Aircraft Systems International v Aircraft System International v Air Services Australia*** (1997) 76 FLR 151). In the case of an express process contract all would depend upon the terms of the contract. If the terms of the contract were ambiguous, on the authority of ***Hughes*** I consider a court would imply such a term. Further in ***Hughes***, it was argued that as there were specified obligations of fairness these should be taken to be exhaustive of the matter. Justice Finn found that these obligations were no more than particular manifestations of the general duty which he implied. Accordingly, careful drafting would be required to exclude such a term. Any express term would be construed against the proponent. But what is clear, a court will not imply such a term if it is inconsistent with the express terms of a process contract.

This is the case even where the term is implied as a matter of law in that it is a legal incident of a particular class of contract. ***(Codelfa Constructions Pty Ltd v State Rail Authority (1982) 149 CLR 337 at 345-6)***. An implied term cannot be inconsistent with a lawful express term. I include the adjective "lawful" advisedly. A statutory corporation cannot by contract do things which is beyond what its statute permits or that which its statute prohibits.

If the statute empowering the sale properly construed imposes upon the State the duty to provide fairness as described by the Auditor-General to the bidders, then this duty cannot be avoided by express terms of a process contract.

The Electricity Corporations (Restructure and Disposal) Act 1999 empowers the Minister to lease ETSA assets and provides the mechanism whereby the transactions can be effected. The Act is silent as to how the Minister is to chose the successful bidder.

In my opinion in the absence of any provisions in the Act as to the process of choosing the successful bidder it is difficult to say that the Act imposes a legally enforceable duty upon the Minister to provide "fairness" to the bidders in the sense espoused by the Auditor-General. It is also my view it is the wrong question to ask.

The Minister is exercising powers which are derived from statute. The first question to ask is whether the exercise of these powers is judicially reviewable on administrative law grounds. If the answer is "yes", the next question is upon which grounds. There are a number of powers granted to the Minister under the Act, the exercise of which would clearly be subject to judicial review. For example, the transfer of staff pursuant to section 23 could be successfully challenged on a number of grounds, such as a particular transfer breached the prohibitions contained in section 23(7). (ie the transfer involved a reduction in status or an unreasonable change in duties). Another ground of challenge could be that the decision was unreasonable in the Wednesbury sense. It is also arguable that a transfer could be challenged on the ground that it was made in breach of natural justice.

Generally speaking the exercise of a statutory power to enter into contracts is not subject to judicial review ***General Newspapers v Telstra*** **(1993) 45 FLR 164 at 173**. Any remedies lie in the area of private law. (It is instructive to note that in ***Hughes*** all remedies sought were in the area of private law. No attempt was made to seek public law remedies.) The exercise of such a power is reviewable if there is what has been described as a "public element" which takes it out of the bare exercise of a power to enter into a contract.

There is no doubt that this area of the law is in an uncertain state and awaits a definitive judgment by the High Court. Schoombe in ***Pearson (ed) Administrative Law : Setting the Pace or Being Left Behind*** suggests that the required public element may be supplied by one or more of the following ways:

(i) statutory underpinning or conditioning

(ii) governmental purpose

(iii) use to control access or utilisation of public facilities

(iv) the publicly orientated manner and form of the decision-making

It is fair to say that Schoombe has relied very heavily on English case law and academic comment, and puts the most favourable slant on the reviewability of the exercise of the power to enter into contracts.

As to (i) statutory underpinning, the Act not only empowers the Minister to lease ETSA assets, but also provides constraints upon what may be done. An interested party could base a judicial review application on these constraints. There are, however no statutory constraints or underpinning of how the Minister chooses the successful bidder.

The second source of a public purpose comes from De Smith:

> "Where the contractual power is used for public purposes, and thus amenable to judicial review, the recipient of the power must use it for a lawful purpose and not unreasonably". ***(De Smith Judicial Review of Administrative Action*** 5th ed para 6-036).

It is stated that if contracts are used as a regulatory technique of Government, then administrative law principles apply. With respect to Schoombe, he provides scant authority for this proposition. Even if it is correct, which I doubt, it has no application in this case.

Powers relating to the control of public facilities is the third possibility. This relates to the use of contractual powers, often contractual licences, in relation to the control of public facilities such as race courses, sports fields and public buildings. The High Court has held that procedural fairness must be observed before some-one is disbarred from the use of the facility. This is not relevant here.

The final public element may arise from the publicly orientated manner and form of decisions to exercise contractual powers. Schoombe starts with the proposition, which is correct, that judicial review is not generally available in respect of Government decision-making in the procurement process. (There is no difference in principle in a disposal process). He states that there are exceptions. First, relying on Hughes that there may be an enforceable process contract. This is dealt with above. Such a contract gives rise to private law remedies, not public law remedies. Secondly, the tendering process can give rise to a legitimate expectation that the tendering process will be fair in the sense described by the Auditor-General. The existence of the legitimate expectation makes the process reviewable.

As to the second, there is authority for the proposition that the requirements of natural justice do not apply to consideration by Government of commercial expressions of interest or tenders. (see ***Century Metals and Mining NC v Yeomans*** **(1989) 40 FLR 564 at 588).** On the other hand, it is difficult to suggest that once a detailed sale process is entered into, that the very fact of the sale process does not create a legitimate expectation on the part of the bidders that that process will be fair.

In this I agree with the Auditor-General that in the usual case the bidders will have a legitimate expectation. But the crucial issue where ERSU and the Auditor-General depart is whether it is possible to avoid the creation of the legitimate expectation of procedural fairness in the lease process. The Auditor-General has stated that the Government cannot contract out the obligation not to act unfairly in breach of the legitimate expectation of bidders.

A legitimate expectation is something less that an enforceable right be it statutory or contractual. If acting fairly were either a statutory or contractual right it could not be negated. To do so would either be a breach of statute or breach of contract. It is not the case that the legitimate expectation flows from the exercise of the power to contract and thus procedural fairness is a statutory right, but rather the process adopted creates a legitimate expectation of procedural fairness.

In ***Century Metals and Mining v Yeomans*** the Federal Court found that the obligation to provide procedural fairness arose, not from a statutory provision, but from the fact that the Minister had promised an independent, impartial and thorough assessment of the merits of the competing proposals ((1989 40 FLR 564 at 592).

If the procedure adopted, most likely an express process contract expressly excludes procedural fairness, then there can be no legitimate expectation created of procedural fairness. There is nothing in the Act which makes the process of leasing ETSA assets subject to judicial review unless a legitimate expectation of procedural fairness is created by the process or statements made relating to the process. Absent an express process contract there is a strong possibility a court would find a contract with a "fair dealing" clause implied. Even if there were an express process contract careful drafting would be required to totally exclude the implication of such a clause.

It appears to me that the differences between the Auditor-General and ERSU on this topic are more hypothetical than real. It would be inconceivable for a Government Agency undertaking an asset disposal process of this magnitude to feel free to act unfairly, no matter what was contained within a process contract.

I agree entirely with the sentiments of the Auditor-General expressed in paragraph 2.7 of his draft report at page 16. The only area where I differ from the Auditor-General is that I do not believe that a legally enforceable duty to afford procedural fairness exists which cannot be avoided by contract. I believe that it is theoretically possible to avoid the obligation to provide procedural fairness by contract, however, courts would interpret such clauses very narrowly and attempt to impose such an obligation from the State.

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