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

Tabled in the House of Assembly and ordered to be published, 14 March 2001

Fourth Session, Forty-Ninth Parliament

Supplementary Report

Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of Optima Energy Pty Ltd, Synergen Pty Ltd, Flinders Power Pty Ltd, Terra Gas trader Pty Ltd and ElectraNet SA: Some Audit Observations

By Authority: J. D. Ferguson, Government Printer, South Australia

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2001

Auditor-General's Department

13 March 2001

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 Optima Energy Pty Ltd, Synergen Pty Ltd, Flinders Power Pty Ltd, Terra Gas trader Pty Ltd and ElectraNet SA: Some Audit Observations'.

Yours sincerely,

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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 businesses. This Report examines the disposal processes for the generation sector businesses (Optima Energy, Synergen, Flinders Power and Terra Gas trader) and the electricity transmission business (ElectraNet SA).

2. In an earlier Report relating to the disposal of ETSA Utilities and ETSA Power, I identified a number of issues of relevance not only to those disposals but also to the future disposal of other Government assets.

   I am pleased to report that my review of the conduct of the disposal processes for the businesses that are the subject of this Report has indicated that a number of the fundamental issues I raised previously have been addressed.

3. In addition, 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. The recommendations contained in this Report, however, reflect my view regarding those governmental values of accountability, transparency and auditability 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 arrangements for the conduct of the disposal processes that are the subject of this Report;
   - issues arising from the bidding process;
   - general observations about the leases for the generation businesses as reflected in the Project Documentation;
   - issues arising from a review of the Project Documentation prepared for the disposal of the electricity businesses.

5. I have identified key issues that I believe to be of fundamental importance when reviewing the disposal process for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA. These are the:

- dilution of the accountability of advisers;
- Crown's immunity associated with the Leigh Creek Township lease.

PART 2
ARRANGEMENTS FOR THE CONDUCT OF THE BIDDING PROCESS

6. 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.

7. The disposal processes that are the subject of this Report were conducted using documents that mirrored, to a large extent, those used for ETSA Utilities and ETSA Power.

8. The ERSU was concerned that the market for the disposal of Flinders Power was not strong and, therefore, the State should consider subsidising the costs of due diligence incurred by each unsuccessful bidder.

   A cost subsidy was approved by the Treasurer and meant that qualifying final bidders who were unsuccessful would be reimbursed 80 percent of qualifying expenses up to a maximum of $1 million.

9. With respect to the disposal of ElectraNet SA, the Treasurer decided that, given the limited range of parties expected actively to seek to lodge Final Bids, there would be no Indicative Bid stage. After acceptance by the Treasurer of an EOI, interested parties would receive the Information Memorandum and would be invited to submit 'required information'.

PART 3
ISSUES ARISING FROM THE BIDDING PROCESS

10. In an earlier Report relating to the disposal of ETSA Utilities and ETSA Power, I recommended that EOIs in a disposal process not be evaluated on a sequential or rolling basis as this gives rise to the potential risk that EOIs will not be evaluated on a consistent basis.

Although the ERSU improved its documentation of the evaluation of EOIs for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, and the Audit review of the documentation did not reveal inconsistencies in the evaluation process, the evaluations were again undertaken on a rolling basis.

I remain of the view that for future asset disposals, EOIs should not be evaluated on a rolling or sequential basis but be evaluated at the same time.

11. The advertisement seeking EOIs for the generation and transmission sector businesses did not specify a date by when the EOIs were to be lodged. Although this meant that no EOI could be considered to have been lodged late, it raised the practical question of when EOIs would no longer be permitted.

In my opinion, the specification of a set date by which EOIs must be submitted would constitute a more certain administrative arrangement than the approach adopted by the ERSU, which ran the risk of confusion arising as to whether or not it was still possible to submit an EOI.

12. In an earlier Report on the disposal process for ETSA Utilities and ETSA Power, I recommended that full and comprehensive probity checks be undertaken on shortlisted bidders and the results of those checks be taken into account in any bid evaluation.

During the disposal process the probity checks on one bidder revealed adverse information concerning that bidder had been published by an international environmental organisation on its Internet website.

Notwithstanding the discovery of this adverse information, no request for further information was put to the bidder in an endeavour to investigate the truth of the information.

In my opinion, the appropriate way of dealing with such issues would have been to seek the bidder's comment on the circumstances giving rise to the adverse information.

13. In the ElectraNet SA disposal process it was identified that the Lead Advisers had also been an adviser to one of the final bidders in relation to that bidder's attempt to acquire an electricity asset in another State. Advice was obtained from Crown Law and from Queen's Counsel as to whether or not a conflict existed and whether the arrangements and protocols designed to manage and minimise any risk of possible bias, or allegations of bias, resulting from a conflict were adequate.

Measures taken to manage conflict risks included the use of an independent reviewer of the Lead Adviser's advice in the ElectraNet SA disposal process.

The ERSU also sought Crown Law advice as to whether the State could recover from the Lead Advisers the cost of engaging the independent reviewer and, were advised that it would be difficult to prove that the Lead Advisers were in breach of their agreement to provide consultancy services.

In my opinion, the issues raised in the advice of Queen's Counsel concerning the types of conflict that could occur supports my previously expressed view that the contracts under which advisers are engaged should comprehensively deal with measures to be used to manage conflicts of interest including the resolution of actual and perceived conflicts of interest.

PART 4
OBSERVATIONS ARISING FROM A REVIEW OF THE PROJECT DOCUMENTATION

14. The generating plants and the associated land are currently prescribed electricity assets within the meaning of the *Electricity Corporations (Restructuring and Disposal) Act 1999* and therefore cannot be sold or transferred.

Although the generating plant leases have a nominal fixed term, it is likely that the lessee will surrender the lease once the assets reach the end of their useful life.

Further, there is no credible prospect that the physical capacity of the plant would allow operation for the full term of the lease. The ERSU has stated that the purpose of setting a long term lease was to ensure that the lessee had all of the incidents (benefit and burden) of ownership of the plant consistent with a legal structure that constituted a lease.

In my opinion, it is clearly contemplated that the generating plant leases would not run their full term, and that it is likely to be the case that the lessees would in fact surrender these leases after a much shorter period. The leases also provide for the automatic transfer to the lessee of the land and plant (after dismantling) once the leases are surrendered.

15. The leasing arrangements for Flinders Power, Optima Energy and Synergen contemplate a phased reduction in generating capacity over a period of years.

This reduction in capacity recognises the fact that over time the plant will naturally become less efficient and less productive (ie meet it's use-by date) and assumes that alternative power supplies to meet the gap can be expected to come through market forces.

The arrangements entered into with the successful bidders do not, in my opinion, provide for any long term certainty of continued supply of power in South Australia from the current generation sites.

I note and accept that this was a policy decision for the Government to make in the context of the disposal process.

PART 5
ISSUES ARISING FROM A REVIEW OF THE PROJECT DOCUMENTATION

16. The failure to require the provision of sign-offs from all key advisers, having regard to their respective responsibilities and the committee structure adopted by the ERSU, means, in my opinion, that the accountability of the advisers has been diluted with the substantive consequence that they may not be able to be held responsible for advice given in the course of their consultancy services.

17. Under the Business Sale Agreements, the purchasers have agreed not to make, and waive any right they may have to make, any claim against both the Treasurer or any Government Party (which includes advisers to the Government) whether in respect of the State's warranties or otherwise in connection with the Project Documentation.

    I am of the opinion, that it is inappropriate to extend protection to the State's advisers in these circumstances.

    The protection afforded to the advisers under the Business Sale Agreements is a protection from a possible liability arising under Statute. The advisers agreed with the State that they must comply with the laws in force in South Australia in the course of performing the consultancy services. Accordingly, the purported effect of the protection afforded by the Business Sale Agreements is to now exempt the advisers (at least in part) from this contractual obligation, whether or not they have acted with bad faith or negligently.

    There is no objective evidence to show that any of the advisers agreed to reduce their fees in return for the inclusion of such an undertaking in their favour.

18. As part of the supporting infrastructure for Flinders Power and the associated Leigh Creek coal mine, the State has granted to the successful bidder a lease of the Leigh Creek Township.

    The Township Services that are required to be provided by the lessee and the standard to which those services are to be provided are set out in the lease.

Good public administrative practice dictates that the rights and interests of Leigh Creek residents were a factor to be considered in the context of the overall disposal process for Flinders Power.

Residents will, however, have to rely upon the Generation Lessor Corporation to ensure that their rights are protected in the event of a breach of the lease by the successful bidder.

The position is significantly impacted upon by the terms of the Proclamation of immunity from liability pursuant to section 35 of the *Electricity Corporations (Restructuring and Disposal) Act 1999* obtained by the State. Under this Proclamation, the Generation Lessor Corporation and the Crown are both given immunity from any statutory, civil or criminal liability with respect to the Leigh Creek Township Lease, including any liability for loss, damage, injury or death suffered by a person through any cause whatsoever while or as a result of being in the Leigh Creek Township.

I am of the opinion that it is not appropriate for the State to exempt itself from liability to the residents of Leigh Creek Township from its own negligent or criminal acts, and I am not convinced that Leigh Creek Township residents understand this position.

19. The disposal process for Flinders Power did not focus on the ability of the successful bidder to provide township services.

The ERSU advised that the provision of township services was not an expertise reviewed in the selection process because it was not an expertise that it was expected to be found amongst the bidders.

No actual assessment was ever undertaken to ascertain if the successful bidder was capable of ensuring that these services will continue to be provided. I regard the failure to undertake such an assessment as poor public administrative practice.

SUMMARY OF RECOMMENDATIONS

The following recommendations have been made in this Report.

Audit Recommendation 1

I recommend that for future asset disposals a closing date for Expressions of Interest be nominated.

Audit Recommendation 2

I recommend that for future asset disposals the agency responsible for conducting the process for disposal ensures that the measures put in place to manage potential conflicts of interest are sufficient to deal with both conflicts of duty and interest and conflicts of duty and duty.

Audit Recommendation 3

I recommend that for future asset disposals where it is intended to extend protection to advisers from possible statutory liability to a successful bidder, a review of the advisers' existing contractual arrangements with the State be undertaken together with a detailed cost/benefit analysis of adopting this course of action.

Audit Recommendation 4

I recommend that advice be obtained from Crown Law or Senior Counsel as to the operation of the Proclamation issued under section 35 of the *Electricity Corporations (Restructuring and Disposal) Act 1999* in so far as it may operate to affect the rights of Leigh Creek Township residents to take action against the State to receive compensation for loss or damage incurred as a result of the negligence or criminal acts of the State in the Leigh Creek Township.

I also recommend that in future asset disposals involving the sequential sale of multiple assets, consideration be given to reviewing the suitability of the chosen evaluation criteria so as to ensure that those evaluation criteria are tailored to the particular circumstances pertaining to the disposal.

GLOSSARY OF TERMS

The following terms are used in this Report:

Disposal Act	*Electricity Corporations (Restructuring and Disposal) Act 1999*
ElectraNet SA	Transmission Lessor Corporation (previously ETSA Transmission Corporation) trading as ElectraNet SA
EOI	Expressions of Interest sought from potential bidders for the relevant government-owned electricity business
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
Flinders Power	Flinders Power Pty Ltd
Generation sector businesses	Comprises the entities Optima Energy, Flinders Power, Synergen and Terra Gas trader
kV	Kilovolt
Lead Advisers	Morgan Stanley Dean Witter and Pacific Road Corporate Finance - the business and financial advisers to the ERSU
Legal Consortium	Allens Arthur Robinson (including Finlaysons) and Johnson Winter & Slattery - the legal advisers to the ERSU
MW	Megawatt
NEMMCO	National Electricity Market Management Company Ltd
Optima Energy	Optima Energy Pty Ltd

Project Documentation	The sets of agreements, including leases, prepared by the ERSU for each bidder which set out the contractual terms and conditions for the disposal of the relevant electricity business
Synergen	Synergen Pty Ltd
Terra Gas trader	Terra Gas trader Pty Ltd

ELECTRICITY BUSINESSES DISPOSAL PROCESS IN SOUTH AUSTRALIA: ARRANGEMENTS FOR THE DISPOSAL OF OPTIMA ENERGY PTY LTD, SYNERGEN PTY LTD, FLINDERS POWER PTY LTD, TERRA GAS TRADER PTY LTD AND ELECTRANET SA: SOME AUDIT OBSERVATIONS

PART 1
INTRODUCTION

1.1 SCOPE OF THIS REPORT

In a Supplementary Report tabled in Parliament on 28 October 1999,[1] I indicated that I would be preparing further reports on specific matters during the course of the disposal process[2] of the government-owned electricity businesses. This Report relates to the disposal processes for Optima Energy Pty Ltd, Synergen Pty Ltd, Flinders Power Pty Ltd, Terra Gas trader Pty Ltd and Transmission Lessor Corporation (trading as ElectraNet SA).

In this Report I identify issues raised previously that were not addressed in the conduct of the disposal processes for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, as well as further issues that have arisen during the disposal of those businesses.

1.2 MATTER OF EMPHASIS

In my earlier Report relating to the disposal of ETSA Utilities and ETSA Power,[3] I identified a number of issues of relevance not only to those disposals but also to the future disposal of other Government assets.

I am pleased to report that my review of the conduct of the disposal processes for the businesses that are the subject of this Report has indicated that a number of the fundamental issues I raised previously have been addressed, including the:

- requirement on the Treasurer to treat bidders fairly, notwithstanding the reservation of broad rights within the process contracts governing the bidding processes for the disposal of the assets;

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

2 The disposal process refers to the process adopted and managed by the ERSU for the disposal of the government-owned electricity businesses.

3 Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

- need to adequately document the conduct of the process, including advice received from advisers, discussions, decisions and instructions;
- need to formulate an evaluation methodology prior to commencement of the evaluation of bids and to seek appropriate information from bidders commensurate with the matters to be considered in applying the evaluation criteria; and
- value in undertaking and documenting probity checks of bidders as part of the evaluation of their bids.

With respect to a number of the other issues, 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. The recommendations contained in this Report, however, reflect my view regarding those governmental values of accountability, transparency and auditability that should always be the basis upon which governmental activities are predicated.

1.3 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.[4]

1.4 MAJOR ISSUES

There are two major issues arising from my review of the process for the disposal of Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA that I consider are of fundamental importance and to which I wish to draw particular attention.

1.4.1 Accountability of Advisers

The management arrangements that have been adopted by the ERSU for the disposal processes for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA have involved the establishment of a comprehensive committee structure

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[4] My obligations in respect of section 22 of the Disposal Act will be dealt with in a later Report.

comprising representatives of the Lead, Legal and Accounting Advisers and the ERSU. The arrangements mirrored those effectively in place for the disposal process for ETSA Utilities and ETSA Power. As I observed in my earlier Report on the disposal of ETSA Utilities and ETSA Power, this committee structure has facilitated an open exchange of views but, in my opinion, it has also had the indirect effect of diluting the accountability of advisers to the State. In a transaction of such importance as the disposal of the electricity businesses I understand 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 the 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.

For the disposal of the entities that are the subject of this Report, the ERSU did not, in line with my previous recommendations, require its advisers to provide a formal sign-off on the final form of the Project Documentation.

The accountability of the advisers has, in my opinion, also been further diluted by the inclusion of a provision in the Business Sale Agreements whereby the purchasers have agreed not to make, and waive any right they may have to make, any claim against the Treasurer or any government party (noting that the advisers are covered by the definition of 'government party').

The protection afforded to the advisers under the applicable Business Sale Agreements is a protection from a possible liability arising under statute. This in my view runs contrary to the provisions contained in the advisers' contracts, which required those advisers to comply with the laws in force in South Australia. I am also concerned that the protection applies whether or not the advisers have acted with bad faith or negligently.

In my opinion, there is no objective evidence to show that the advisers agreed to reduce their fees in return for the inclusion of such an undertaking in their favour. Nor is there any evidence to show that any objective assessment was made of the possible cost to the State in terms of reduced disposal proceeds that the inclusion of this undertaking in favour of the advisers may have given rise to.

1.4.2 Leigh Creek Township Lease

The State has granted to the successful bidder a lease of the Leigh Creek Township as part of the disposal process for Flinders Power.

I note that pursuant to the terms of this lease the Lessee is required to use the township to provide:

- township services for the permanent residents living in the township;
- water for the permanent residents of the surrounding communities;
- disposal of waste services for the permanent residents of Copley.

Whilst I understand, that significant consultation was undertaken with Leigh Creek Township residents in relation to the proposed lease arrangements and I note, that the vast majority of Leigh Creek Township residents are employed at the Leigh Creek coal mine, of specific concern to me are the provisions of the Proclamation of immunity from liability which was made pursuant to section 35 of the *Electricity Corporations (Restructuring and Disposal) Act 1999*.

Under this Proclamation, the Generation Lessor Corporation and the Crown are both given immunity from any statutory, civil or criminal liability with respect to the Leigh Creek Township Lease including any liability for loss, damage, injury or death suffered by a person through any cause whatsoever while, or, as the result of being in the Leigh Creek Township.

For the State to seek to exempt itself from liability to the residents of Leigh Creek Township from its own negligent or criminal acts represents a failure by the State to act responsibly to protect the public interest. Accordingly, I believe consideration needs to be given to urgently obtaining legal advice as to the relevant construction to be placed on the Proclamation and, if necessary, amend the Proclamation so as to ensure that the legal rights of the citizens of Leigh Creek Township are no less vis-à-vis the Crown than other citizens of this State.

1.5 STRUCTURE OF THIS REPORT

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

Part 2 discusses the bidding arrangements for the conduct of the disposal processes that are the subject of this Report.

Part 3 discusses issues arising from the bidding process.

Part 4 contains general observations about the leases for the generation businesses as reflected in the Project Documentation.

Part 5 discusses issues arising from a review of the Project Documentation prepared for the disposal of the electricity businesses.

PART 2
ARRANGEMENTS FOR THE CONDUCT OF THE BIDDING PROCESS

2.1 DESCRIPTION OF ENTITIES

The government-owned electricity businesses, whose disposals are the subject of this Report are:

- Optima Energy, which owned and operated the Torrens Island Power Station, a 1280 MW natural gas fired steam power station, consisting of eight steam turbines. Torrens Island Power Station is the largest power station in South Australia.

- Synergen, which owned and operated nine gas turbine units, at four locations, with a total installed capacity of 359 MW. Synergen's portfolio comprises both gas-fired and distillate-fired stations.

- Flinders Power, which owned and operated the brown coal fired steam turbines at Port Augusta, with a total installed capacity of 760 MW (Northern and Playford Power Stations). Flinders Power also owned and operated the Leigh Creek brown coal mine located 260 km north of the Northern Power Station. Flinders Power also had exploration licences for coal at other locations.

- Terra Gas trader, which sold gas, predominantly to electricity generators in South Australia.

- ElectraNet SA, which owned, operated and maintained the high voltage transmission network in South Australia. The network consists of approximately 5565 kilometres of 275kV, 132kV and some 66kV voltage transmission lines. ElectraNet SA was also responsible, as agent for NEMMCO, for the operation of the South Australian power system and for ensuring system integrity.

2.2 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 into documents, including:

- EOI protocols
- Probity Rules
- Bidding Rules

In a previous Report[5] I provided an analysis of the bidding process documents used for the disposal of the businesses operated by ETSA Utilities and ETSA Power. The disposal processes that are the subject of this Report were conducted using documents that mirrored, to a large extent, those used for ETSA Utilities and ETSA Power. For this reason, I have not included an analysis of the documents in this Report, except to the extent that they relate to any specific issues raised.

2.3 EXPRESSION OF INTEREST (EOI) PROCESS

There were separate EOI processes conducted for the generation sector businesses and the transmission business (ElectraNet SA).

2.3.1 EOI Process for Generation Sector Businesses

The invitation to submit an EOI for the four generation sector businesses was advertised on 4 October 1999 in The Australian and The Australian Financial Review.

The advertisement stated that parties may express interest in any or all of the businesses. However, 'the cross-ownership restrictions will prevent a party and its associates from acquiring more than one of the businesses'. Parties were requested to nominate the businesses in which they were interested.

The EOI process involved the ERSU considering each EOI submitted to separately pre-qualify parties for each of the businesses. Pre-qualified parties would 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.

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

- financial capability to complete the transaction;
- operational or investment experience;
- consistency with Federal competition law and South Australian cross-ownership restrictions.

The advertisement further stated that financial capability may 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.

EOIs were not to exceed two pages. The advertisement included a statement that 'the South Australian Government reserves the right to alter the process, to seek further

[5] Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

information at any time and to not prequalify a party (if considered to be in the interests of the disposal process).'

2.3.2 EOI Process for ElectraNet SA

The invitation to submit an EOI for ElectraNet SA was advertised on 18 April 2000 in The Australian and The Australian Financial Review.

The advertisement referred to the fact that ElectraNet SA was the last of the government-owned electricity businesses to be disposed of.

It stated that expressions of interest would be considered and qualified parties would be provided with further information as to participation in the bid process, including information as to the basis on which confidential information, site visits and the detailed Information Memorandum would be made available.

As for the previous government-owned electricity businesses disposals, prequalification was to be based on financial capability, operational and investment experience, and consistency with cross-ownership restrictions.

An indicative timetable for the disposal of ElectraNet SA was included (subject to reservation to the Government of South Australia of the right to change the timetable and process at any time).

2.4 INDICATIVE BID PROCESS

Indicative Bids were received by the ERSU for each of the electricity businesses that are the subject of this Report. The Indicative Bid process for Optima Energy was undertaken in parallel with that for Synergen.

For each bidding process the Bidding Rules outlined the requirements for the evaluation of Indicative Bids, and included the Treasurer's principal objectives in evaluating Indicative Bids, as follows:

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

2.4.1 Indicative Bid Process for Optima Energy and Synergen

Information Memoranda relating to Optima Energy and Synergen were released (from 23 December 1999) to those parties who expressed interest, were prequalified, had signed a confidentiality agreement and who had accepted the Bidding Rules.

The Bidding Rules outlined the requirement with respect to the lodgement of Indicative Bids which were to be received on 18 February 2000.

Following the receipt of Indicative Bids on 18 February 2000, the Evaluation Committee considered reports provided by both the Lead Advisers and the Legal Consortium in undertaking its evaluation. The Evaluation Committee resolved that:

- there is no Indicative Bid which fails, in a material way, to include the information requested in the Bidding Rules;
- based on the indicative consideration outlined in the bids, there exists grounds to reject one bid lodged for Optima Energy and one bid lodged for Synergen and that these bids should not be shortlisted;
- both these bidders be advised that they had not been shortlisted; and
- the remaining bidders who lodged Indicative Bids for either Optima Energy or Synergen be shortlisted and invited to lodge a Final Bid.

The ERSU recommended, subject to the approval of the Treasurer, that the shortlisted bidders be contacted.

2.4.2 Indicative Bid Process for Flinders Power

The Information Memorandum relating to Flinders Power was released (from 31 March 2000) to those parties who had expressed interest, had fulfilled the pre-qualifying criteria as set out in the advertisement for the EOI, had signed a confidentiality agreement and accepted the Bidding Rules.

The Bidding Rules outlined the requirements with respect to the lodgement of Indicative Bids, which were to be received on 6 June 2000.

In late May 2000 the ERSU was concerned that the market for the disposal of Flinders Power was not strong, and therefore the State should consider subsidising the costs of due diligence incurred by each unsuccessful bidder. Legal advice was obtained from the Legal Consortium that addressed the probity of such action, without commenting on the commercial or political merits or otherwise of the proposal. To satisfy the probity issues the Legal Consortium recommended that an offer to subsidise due diligence costs be made to all parties who submitted an EOI for Flinders Power, and that those parties be given sufficient time to consider the offer to decide whether or not to lodge an Indicative Bid.

Advice from the Lead Advisers suggested a mechanism for allowing the application of the disposal proceeds to fund the subsidy to the unsuccessful bidders that addressed the Probity Auditor's stated concern that there be no relationship between the winning and losing bidders.

The costs subsidy was approved by the Treasurer on 26 May 2000 and the ERSU wrote to those who had lodged an EOI for Flinders Power advising that qualifying final bidders would be reimbursed 80 percent of qualifying expenses of making the Final Bid up to a maximum of $1 million, provided that they:

- participate fully in the due diligence and Project Documentation process and attend presentations;
- make a Final Bid that complies with the Bidding Rules;
- are unsuccessful in the Final Bid process.

At that time the mechanism for providing the subsidy was not finalised and the Treasurer advised the ERSU that he wanted to leave the option open for the successful bidder to explicitly fund the losing bidders.

On 6 June 2000 Indicative Bids were received for Flinders Power.

The Evaluation Committee recommended to the Treasurer on 7 June 2000 that all of the bidders who submitted Indicative Bids for Flinders Power be shortlisted to participate in the Final Bid process.

In late June 2000 the Treasurer approved the mechanism for reimbursement of unsuccessful bidders' costs whereby the arrangement would be strictly between the Treasurer and the unsuccessful bidders, with no involvement of the successful bidder.

On 10 July 2000 the ERSU wrote to the four shortlisted bidders providing more detailed information concerning the reimbursement of Final Bid costs and asking the bidders to indicate their acceptance of the reimbursement terms.

2.4.3 Indicative Bid Process for Terra Gas trader

The Information Memorandum was released (from 31 March 2000) to those parties who had expressed interest in Terra Gas trader, had fulfilled the pre-qualifying criteria as set out in the advertisement for the EOI, had signed a confidentiality agreement and accepted the Bidding Rules.

The Bidding Rules outlined the requirements with respect to the lodgement of Indicative Bids, which were to be received on 6 June 2000.

On 6 June 2000 Indicative Bids were received for Terra Gas trader.

The Evaluation Committee recommended to the Treasurer on 7 June 2000 that all of the bidders who submitted Indicative Bids for Terra Gas trader be shortlisted to participate in the Final Bid process.

The ERSU recommended, subject to the approval of the Treasurer, that the shortlisted bidders be contacted.

2.4.4 Indicative Bid Process for ElectraNet SA

The Treasurer decided that, given the limited range of parties expected actively to seek to lodge Final Bids, it would be best to conduct a process which had a Final Bid stage only, ie there would be no Indicative Bid stage. Instead, after acceptance by the Treasurer of an EOI, interested parties would receive the Information Memorandum and would be invited to submit 'required information'. That required information would include much of the information requested in the Indicative Bids for previous disposals, other than an indicative price. In addition, that information would include details of work done by the bidder to date on the bid and a work plan adopted by the bidder for lodging a Final Bid.

The required information submitted was to be assessed only as to its completeness. Where a bidder lodged the material in a form that allowed the ERSU to advise the Treasurer that a bidder had submitted the required information, then that bidder was to be invited to undertake due diligence, receive management presentations and to lodge a Final Bid.

The information provided by a bidder would not be compared with or evaluated against that provided by another bidder. The process would focus solely on the bidder's willingness and ability to provide the required information.

Bidders were invited to submit required information from 17 July 2000.

Required information was received from three bidders on 17 July 2000.

The Legal Consortium reported on 20 and 21 July 2000 that they had 'considered each bidder's required information in an equivalent manner and in accordance with the Bidding Rules and the Supplementary Probity Rules (Internal)' and were satisfied that the required information was complete.

Subsequently, a fourth bidder lodged required information. The ERSU recommended that the Treasurer exercise his discretion under the Bidding Rules to invite this fourth bidder to lodge a Final Bid subject to the ERSU receiving executed confidentiality deeds and acceptances of the Bidding Rules in a form satisfactory to the ERSU representative.[6] A detailed advice from the Legal Consortium was attached to that recommendation and the Treasurer approved that recommendation on 25 July 2000.

2.5 FINAL BID PROCESS

Final Bids were received by the ERSU for each of the electricity businesses that are the subject of this Report. The Final Bid process for Optima Energy was undertaken in parallel with that for Synergen.

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6 Minute dated 21 July 2000 from the ERSU to the Treasurer.

For each of the disposals that are the subject of this Report, the arrangements for the conduct of the Final Bid process were similar to those adopted for ETSA Utilities and ETSA Power.[7] In each case the Evaluation Committee:

- met prior to the receipt of the Final Bids and finalised the evaluation methodology, bid evaluation matrix and the advisory team allocation of tasks;
- reviewed the Final Bids in accordance with the methodology, received documented advice from the advisory groups and documented the results against the evaluation criteria;
- made a recommendation to the Treasurer regarding the disposal of the relevant government-owned electricity business.

The following sections set out the key events, together with a commentary on some specific issues relating to the individual disposals.

2.5.1 Final Bid Process for Optima Energy and Synergen

On 28 April 2000, Final Bids were received for Optima Energy and Synergen.

Following a recommendation from the Evaluation Committee, the Treasurer entered into a contract with TXU Electricity Ltd for the lease/sale of the Optima Energy business on 4 May 2000.

Following a recommendation from the Evaluation Committee, the Treasurer entered into a contract with National Power Australia Pty Ltd for the lease/sale of the Synergen business on 11 May 2000.

2.5.2 Final Bid Process for Flinders Power

On 31 July 2000 Final Bids were received for Flinders Power.

The Evaluation Committee concluded that one bid was superior in terms of price and risk,[8] however, the bid was subject to certain conditions. This bid was accepted on 2 August 2000 after it had been assessed that the offered risk position was acceptable.

Following a recommendation from the Evaluation Committee, the Treasurer entered into a contract with NRG Energy for the lease/sale of the Flinders Power business on 3 August 2000.

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7 Refer to Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

8 The Evaluation Committee Minute to the Treasurer of 2 August 2000.

As a result of the arrangement to reimburse Final Bid costs,[9] the unsuccessful bidder was paid $1 million in respect of the qualifying costs incurred in developing its bid.

2.5.3 Final Bid Process for Terra Gas trader

Prior to the date for the submission of Final Bids, two (out of three) of the bidders withdrew from the disposal process. As a result, on 12 July 2000 the remaining bidder was advised[10] that it was the sole participant remaining in the process.

That bidder submitted a Final Bid on 17 July 2000.

The bid was rejected on 20 July 2000.

Subsequent negotiations were held with the bidder, as well as consideration of a new unsolicited bid.

Following a recommendation from the Evaluation Committee, the Treasurer entered into a contract with Tarong Gas Trader Pty Ltd for the lease/sale of the Terra Gas trader business on 23 October 2000.

2.5.4 Final Bid Process for ElectraNet SA

On 4 September 2000, the date upon which Final Bids were due, only one Final Bid was received that the Evaluation Committee considered was capable of acceptance. Further, the Evaluation Committee concluded that that bid deviated significantly from the State's benchmark risk position. The deviations were analysed by the Legal Consortium in an advice dated 6 September 2000, as follows:

- pre-signing risks included the price bid being subject to adjustment according to movements in interest rates;
- a pre-completion risk in the fact that the bid '... was conditional on the State giving an assurance that everything that had been installed on the transmission network complied with the terms of the cross border lease';
- post-completion risks, arising from amendments sought to the documents by the bidder, as allocating '... cross border lease risk to the State of a nature and to an extent such that the State's risk management of its risk under the cross border lease could not properly be considered to be adequate'.

Two other shortlisted bidders lodged responses but these were assessed as not being offers to acquire ElectraNet SA that were capable of acceptance. The Legal Consortium advised[11]

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9 Refer to commentary earlier in this Report under the heading '2.4.2 — Indicative Bid Process for Flinders Power'.

10 Report to the Treasurer of the Evaluation Committee for the disposal of Terra Gas trader dated 19 July 2000.

11 Letter dated 5 September 2000.

that they did not consider the letter received from one bidder, purporting to be a 'bid for ElectraNet' to 'constitute an offer which, if accepted, would give rise to a valid contract for acquisition of ElectraNet'.

The other bidder forwarded two letters to the ERSU by facsimile transmission. The first was received before the dead-line for bids (4:00 pm on 4 September 2000) and sought 'pursuant to clause 12.3 of the Bidding Rules … an extension of time for the lodgement of its Final Bid by one and a half hours … '. The second letter indicated that the bidder:

- requested 'a 10 day extension in order to lodge a final unconditional bid';
- proposed 'a conditional consideration' figure for ElectraNet SA 'subject to new debt and equity approvals'.

Clause 12.3 of the Bidding Rules reserves the right for the Treasurer 'to consider and accept any late bid not lodged on time', but makes clear, first, that the Treasurer would not do so unless the bidder had given notice prior to the bid closing time that it anticipated that its Final Bid would or may be lodged late, and indicating the approximate date and time of late lodgement and, secondly, that no Final Bids would be opened until the Treasurer had determined whether or not to consider any such late bid.

The Legal Consortium advised[12] that the second letter did not constitute a Final Bid and so, at the time of the advice, no Final Bid had been received from the bidder.

The Evaluation Committee recommended that the negotiating team:

- commence negotiations with the one bidder who lodged a bid capable of acceptance (the first bidder) on the deviations in its bid from risk benchmarks referred to above; and simultaneously
- engage in discussions with the other two bidders (the other bidders), 'to help assess whether either party would be able to put forward a viable alternative'.

The letters inviting discussions were sent on 7 September 2000.

Negotiations with the first bidder did not bring their bid closer to the State's benchmark risk position.

Correspondence was received from the other bidders; one indicated that it would require a further six to eight weeks before it was able to lodge a Final Bid; the other confirmed[13] that they were in a position to lodge an unconditional bid if invited to do so.

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12 Letter dated 4 September 2000.

13 Letter dated 12 September 2000.

The ERSU recommended to the Treasurer[14] that he exercise his discretion to invite one of the other bidders to lodge a Final Bid by 15 September 2000. The Treasurer approved the recommendation and the bidder was invited on 13 September 2000 to lodge a Final Bid by 15 September 2000. The first bidder was advised that the State was dealing with other interested parties, and that the bid it had submitted on 4 September was 'unattractive with regard to risk'. This approach effectively invited the first bidder to amend its original Final Bid so as to 'put forward its best position on both price and risk' also by 15 September 2000.

The 4 September 2000 bid of the first bidder was due to expire on 18 September 2000.

On 15 September 2000 a letter was received from the first bidder indicating that it:

- was still interested in acquiring ElectraNet SA;
- was assessing its price/risk mix to see whether an alternative position would be put; but
- would require an additional one week in order to meet with the US Cross Border Lease counterparties to discuss certain risk issues.

Meanwhile the invited other bidder lodged a Final Bid within the time stipulated (15 September 2000).

The recommendation of the Evaluation Committee to the Treasurer on 18 September 2000 was that the invited other bidder's bid be accepted, on the basis that it accorded with the State's benchmark risk position and was 'clearly the best bid in terms of price and risk'.

Following a recommendation from the Evaluation Committee, the Treasurer entered into a contract with a consortium comprising Macquarie Bank Limited, Powerlink and ABB for the lease/sale of the ElectraNet SA business on 20 September 2000.

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[14] Minute dated 12 September 2000.

PART 3
ISSUES ARISING FROM THE BIDDING PROCESS

3.1 SEQUENTIAL ASSESSMENT OF EOIs

In an earlier Report,[15] I recommended that EOIs in a disposal process not be evaluated on a sequential or rolling basis but be evaluated at the same time. The reasons for that recommendation are set out clearly in that Report. Although the Report was not tabled in Parliament until 30 November 2000, drafts of the Report discussing the recommendation were provided to the ERSU as early as November 1999.

Notwithstanding that recommendation, the disposal process for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA proceeded on the basis that EOIs were evaluated when received with no comparative element to the evaluation.

The ERSU has advised[16] that:

- consistency of outcome can be achieved without all EOIs being evaluated at the same time;
- a sequential process facilitated the creation of a competitive bidding environment, by allowing participants access to the Information Memoranda for the assets as soon as they were pre-qualified;
- only those that did not meet the evaluation criteria were excluded, thus a comparative evaluation was not envisaged or permitted;
- sufficient checks and balances were in place in respect of the evaluation and probity processes to ensure the risk identified by Audit was minimised.

Audit Comment

The conduct of the EOI evaluations on a sequential or rolling basis gives rise to the potential risk that EOIs will not be evaluated on a consistent basis. In the case of the disposal process for ETSA Utilities and ETSA Power, I identified circumstances where inconsistencies in evaluation did occur.

I acknowledge that the ERSU improved its documentation of the evaluation of EOIs for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, and that the Audit review of the documentation did not reveal inconsistencies in the evaluation process.

I remain of the view that for future asset disposals, EOIs should not be evaluated on a rolling or sequential basis but be evaluated at the same time.

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[15] Audit Recommendation 6 in Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process In South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

[16] Response to Audit dated 9 February 2001.

3.2 CLOSING DATE FOR EOIs

The advertisement seeking EOIs for the generation and transmission sector businesses did not specify a date by when the EOIs were to be lodged. Although this meant that no EOI could be considered to have been lodged late, it raised the practical question of when EOIs would no longer be permitted.

The ERSU have stated that:

> *It is not entirely apparent as to how a closing date for EOIs together with a set procedure for dealing with late EOIs is different, and therefore preferable, to an open period for the registration of EOIs.*

Audit Comment

In my opinion, the specification of a set date by which EOIs must be submitted, combined with a set procedure for how late EOIs would be handled would constitute a more certain administrative arrangement for the handling of EOIs than the approach adopted by the ERSU, which ran the risk of confusion arising as to whether or not it was still possible to submit an EOI.

By nominating a closing date it is possible to reserve to the State a discretion as to whether or not to admit late EOIs to the disposal process. As part of any consideration as to whether or not to admit late EOIs it is necessary to consider the potential prejudice to other bidders in admitting the late EOI. By having an open ended process the opportunity to consider the potential prejudice with respect to other bidders is denied because the EOI may only be assessed against the evaluation criteria.

Audit Recommendation 1

I recommend that for future asset disposals a closing date for Expressions of Interest be nominated.

3.3 PROBITY CHECKS

In my earlier Report on the disposal process for ETSA Utilities and ETSA Power,[17] I recommended that full and comprehensive probity checks be undertaken on shortlisted bidders and the results of those checks be taken into account in any bid evaluation. Extensive probity checks were undertaken by the Legal Consortium in respect of shortlisted bidders that submitted Final Bids in the disposal processes for the generation sector businesses and ElectraNet SA.

[17] Audit Recommendation 23 in Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process In South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

During the disposal process the probity checks on one bidder revealed adverse information concerning that bidder had been published by an international environmental organisation on its Internet website. The information also referred to a report of the Attorney-General for Florida stating that the bidder had, among other things, grossly misled that State Government.

Notwithstanding the discovery of this adverse information, no request for further information was put to the bidder in an endeavour to investigate the truth of the information. The Evaluation Matrix recorded the comment 'no adverse indicators' in respect of the bona fides risk.

The ERSU advised[18] that the information gained through probity checks was used for two purposes, namely:

- to assess the risk of the bidder not completing the transaction; and
- to fully inform the Treasurer and Cabinet of any potential for embarrassment in deciding to contract with the bidder.

In relation to the first use of the information the ERSU advised:[19]

> *The information … did not impact upon pre-completion risk and thus the evaluation matrix correctly indicated that there were no adverse indicators in respect of the risk of non-completion.*

In relation to the second use of the information the ERSU advised:[20]

> *… it is noteworthy that the bidder adversely commented on … was not selected as the successful bidder. Whether or not the Treasurer or Cabinet may have determined to seek further information regarding the allegations … is entirely academic. Having decided not to accept the … bid there was no potential for embarrassment and therefore no need to seek clarification from the bidder.*

Audit Comment

The report on the probity check revealed information that potentially raised issues as to whether the State might be embarrassed in the future for having contracted with a bidder against whom there was information that the bidder had in the past misled State Governments. In my opinion, the appropriate way of dealing with such issues would have been to seek the bidder's comment on the circumstances giving rise to the adverse information. The probity report and the bidder's comments could then have been evaluated.

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18 Response to Audit dated 9 February 2001.

19 Response to Audit dated 9 February 2001.

20 Response to Audit dated 9 February 2001.

The information as to the bidder misleading governments in its previous dealings is also relevant to the assessment of pre-completion risk. Without clarification of the adverse information with the bidder it would, in my opinion, be difficult to assess the level of pre-completion risk.

The Evaluation Committee is undertaking the evaluation for the purposes of making a recommendation to the decision-maker. I consider it essential for the Evaluation Committee to pursue all relevant clarifications so as to have complete information to put to the decision-maker. To refrain from undertaking further investigations, on the basis that the recommendation supports selection of another bidder, is to pre-empt the decision to be made by the decision-maker.

I remain of the view that for future asset disposals, full and comprehensive probity checks be undertaken on all bidders.

3.4 PERCEIVED CONFLICT OF INTEREST OF THE LEAD ADVISERS

In an earlier Report relating to the engagement of advisers,[21] I discussed the fact that the contracts under which various advisers were engaged did not adequately deal with the resolution of perceived conflicts of interest.

For those persons associated with the disposal process, the ERSU went to considerable lengths in an endeavour to detect any actual or perceived apparent conflicts of interest. Not only were the various advisers to the Government required to make full disclosure of anything that might amount to a conflict of interest, but each of the electricity businesses to be disposed of were required to provide details of advisers retained in the past. Potential bidders were also required to give full details of their advisers in connection with their bids, with a view to avoiding any suggestion of collusion.

In the ElectraNet SA disposal process it was identified that the Lead Advisers had also been an adviser to one of the final bidders in relation to that bidder's attempt to acquire an electricity asset in another State. Advice was obtained from Crown Law and from Queen's Counsel as to whether or not a conflict existed and whether the arrangements and protocols designed to manage and minimise any risk of possible bias, or allegations of bias, resulting from a conflict, were adequate. The Queen's Counsel identified several ways in which the Lead Advisers were potentially in conflict in respect of the duties they owed to different clients, including the South Australian Government and, in respect of the interests they held and the interests of the South Australian Government. A conflict in respect of duties owed to different clients is known as a 'conflict of duty and duty' whereas a conflict in respect of a duty owed to a client and an interest held is known as a 'conflict of interest and duty'.

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[21] Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations' dated 28 November 2000.

On the basis of Queen's Counsel advice, measures were taken to manage conflict risks in relation to the Lead Advisers including the use of an independent reviewer of the Lead Adviser's advice in the ElectraNet SA disposal process. Other measures included the segregation of duties together with security over information, often referred to as 'Chinese Walls'.

The ERSU also sought Crown Law advice as to whether the State could recover from the Lead Advisers the cost of engaging the independent reviewer of the work of the Lead Advisers. Crown Law advised[22] that it would be difficult to prove that the Lead Advisers were in breach of their agreement to provide consultancy services because it was arguable whether or not an actual conflict had arisen. The ERSU had previously asked the Lead Advisers to bear the cost of the shadow adviser but the Lead Advisers declined to do so.[23]

Audit Comment

The use of 'Chinese Walls' is a measure that attempts to minimise the risk of possible disclosure of confidential information against the interests of South Australia in the disposal process. However, as the advice of Queen's Counsel notes, the conflict between duty and duty and between interest and duty may not only arise in the context of disclosure of confidential information. For example, if an adviser acts for both the South Australian Government and another State Government in respect of assets disposals and the same bidders are likely to bid for both sets of assets, there may be a potential incentive for the advisers to 'talk up' or 'talk down' the value of the assets to attract the best bidders to the State with whom the advisers have the better success fee arrangement. This action does not involve the disclosure of confidential information, but involves a conflict between the duty the adviser owes to each of its clients.

In my opinion, the issues raised in the advice of Queen's Counsel concerning the types of conflict that could occur supports my previously expressed view[24] that the contracts under which the advisers are engaged should comprehensively deal with the measures to be used to manage conflicts of interest including the resolution of actual and perceived conflicts of interest.

In my opinion, it is clear that a perception of conflict would arise where the Lead Advisers advised both the Government and a bidder in the process. I note that had the Lead Adviser's contract provided for the resolution of perceived conflicts of interest, the State may have had grounds for seeking compensation in respect of the costs of engaging the independent reviewer.

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22 Advice from Crown Law dated 25 October 2000.

23 Advice from Crown Law dated 25 October 2000.

24 Refer to Recommendation 11 in Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations' dated 28 November 2000.

I remain of the view that the consultancy contract with the Lead Advisers should have also covered the perception of conflicts of interest.

Audit Recommendation 2

I recommend that for future asset disposals the agency responsible for conducting the process for disposal ensures that the measures put in place to manage potential conflicts of interest are sufficient to deal with both conflicts of duty and interest and conflicts of duty and duty.

3.5 REPORT OF THE PROBITY AUDITOR

The appointed Probity Auditor is required under the terms of a contract with the Treasurer to provide to the Treasurer a report on the Final Bid process for each of the disposals. That report is to comment on the fairness of the disposal process.

Audit Comment

I note that the Probity Auditor provided to the Treasurer a final report on the Optima Energy and Synergen disposal process in September 2000, some four months after that process concluded.

A report on Flinders Power was provided to the Treasurer in December 2000 some four months after that disposal process concluded.

A report on Terra Gas trader was provided in February 2001 some three months after the process concluded.

As at the date of preparing this Report, a report by the Probity Auditor on ElectraNet SA is still to be provided to the Treasurer.

PART 4
OBSERVATIONS ARISING FROM A REVIEW OF THE PROJECT DOCUMENTATION

4.1 INTRODUCTION

I am of the opinion, that a review of the Project Documentation is an important task in the review of the overall probity of the disposal process. The Project Documentation gives legal effect to the disposal process for the electricity businesses and formally establishes the rights, obligations and liabilities between the State and the successful bidder. The Project Documentation also implements the policy underlying the disposal process as set out in the Disposal Act, while the Disposal Act itself imposes certain requirements as to what issues must be covered by the Project Documentation.

Arising from my review of the Project Documentation, in this Part of the Report, I make the following general observations about the leasing process for the generation assets. In making these observations I note the requirements of the Disposal Act which requires the Treasurer to cause a copy of each relevant long term lease of a prescribed electricity asset, and a prescribed report relating to those leases, to be laid before each House of Parliament.[25] These documents were tabled in the House of Assembly on 1 March 2001.

My observations focus specifically on the issue of the arrangements for the continued supply of generating capacity in South Australia as contemplated by the leasing arrangements entered into for Flinders Power, Optima Energy and Synergen. There are three specific areas which my observations address as follows:

- disposal arrangements for the generating plants;
- reduction in generating capacity;
- use of special purpose acquisition vehicle.

Issues arising from my review of the Project Documentation are discussed in 'Part 5 — Issues Arising from a Review of the Project Documentation' of this Report.

4.2 DISPOSAL ARRANGEMENTS FOR GENERATING PLANTS

I note that under the Flinders Power Project Documentation (similar arrangements also apply in the case of Optima Energy and Synergen), the Northern Generating Plant lease which has been entered into by the State requires the lessee to maintain the Northern Generating Plant at an operational capacity of 495 MW during the Minimum Operating Period. The Minimum Operating Period is defined under the lease as the period from the commencement date of the lease until 20 June 2007. Thereafter the lessee is required to continue to maintain the

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[25] Subsections 13(5) and 17(2) of the *Electricity Corporations (Restructuring and Disposal) Act 1999*.

Northern Generating Plant in what the lease defines to be a Minimum Operating Condition. As noted in my comments below, this requirement envisages that over time there will be a substantial reduction in the operational capacity.

Should the lessee fail to maintain the Northern Generating Plant in the defined Minimum Operating Condition in the period between 20 June 2007 and the period which is 10 years after the lease commencement date, the Generation Lessor Corporation has the right to take action to terminate the lease (see clause 13.1). Where this failure to maintain occurs after this date, or alternatively if the lessee gives one month's notice of its intention to surrender the lease, the lessee may be then deemed to have surrendered the lease (see clause 12.2) back to the Generation Lessor Corporation.

The Lease End Date for the Northern Generating Plant Lease is defined to include the date upon which the lease is surrendered by the lessee. Upon the Lease End Date, and subject to the expiry of the leases for other associated assets (boilers) and financing arrangements (generator cross border lease), the Generation Lessor Corporation is obliged to procure the dismantling of the Northern Generating Plant (see clause 18.1(a)). The lessee is obliged to meet the costs of dismantling (see clause 18.1(f)).

Upon the Generation Lessor Corporation giving notice to the lessee that the plant has been dismantled, the dismantled plant and the associated land are then transferred to the lessee. (see clause 18.2(a)). I note that the lessee has covenanted with the Generation Lessor Corporation that the dismantled plant will then not be used for the purposes of electricity generation except as replacement parts in another electricity generating plant. I also note that the lessee will indemnify both the Generation Lessor Corporation and the Crown for any losses they may incur as a result of being obligated to remediate the associated land after the plant has been dismantled.

In an advice from the Legal Advisers, which is attached to a Minute from the ERSU to the Treasurer dated 4 February 2000, the Legal Advisers have noted that although the Northern Generating Plant lease will have a nominal fixed term of 100 years, it is likely to be the case that the lessee will surrender the lease once the assets reach the end of their useful life.

The Northern Generating Plant and the associated land are currently prescribed electricity assets within the meaning of section 13 of the *Electricity Corporations (Restructuring and Disposal) Act 1999*. Accordingly, they cannot be sold or transferred for so long as they remain prescribed electricity assets. They may only be dealt with via a lease. There is, however, no prescribed minimum lease term period set out in the legislation. If the lease confers the use or possession of the assets for a term extending to a time, or commencing, for more than 25 years after the making of the lease (as is the case with the Northern Generating Plant lease) it will be deemed to be a relevant long term lease within the meaning ascribed by the abovementioned legislation.

In my opinion, it is clearly contemplated that the Northern Generating Plant lease (as well as the equivalent generating plant leases under the Optima Energy and Synergen disposal

processes) would not run it's full course and that it is likely to be the case that these leases would in fact be surrendered by the lessee after a much shorter period.

The ERSU advised[26] that although these leases have a nominal term of 100 years, it is nominal in that there is no credible prospect that the physical capacity of the plant would allow 100 years of operation. The ERSU has further stated, that the purpose of setting a 100 year lease was to ensure that the lessee had all of the incidents (benefit and burden) of ownership of the plant consistent with a legal structure which constituted a lease. The ERSU also has advised that this was the basis upon which the Australian Taxation Office was prepared to issue a ruling that the lessee would be entitled to depreciate the plant on the same basis as if it were the owner of the plant thereby assisting to maximise the disposal proceeds.

When read in conjunction with the additional lease provisions dealing with a phased reduction in generation capacity which I comment upon under the heading '4.3 — Reduction in Generation Capacity' in this Report, the consequent effect of these arrangements is that the current leases in themselves provide, in my opinion, no long term certainty that existing generation capacity will be maintained.

I accept that as long as there is an operating generating plant to hand back to the State at lease termination or surrender, the requirements of the Disposal Act have been technically complied with. This is the case even though the generating capacity of the plant will have diminished significantly.

Upon lease termination or surrender, the Crown is obliged to procure the dismantling of the plant. Once dismantled, the lease then provides for the automatic transfer to the successful bidder of both the dismantled plant and the land upon which it is situated. No additional consideration is received by the State for this transfer. As the plant would have been dismantled before transfer, both the plant and the land upon which it is situated cease to be prescribed electricity assets under the Disposal Act.

The outright disposal of these assets in this way however, is, in my opinion, not consistent with the spirit and/or intent of the legislation.

4.3 REDUCTION IN GENERATING CAPACITY

As I have observed under the heading '4.2 — Disposal Arrangements for Generating Plants' in this Report, the leasing arrangements for Flinders Power, Optima Energy and Synergen contemplate a phased reduction in generating capacity over a period of years.

In the case of Flinders Power, pursuant to the terms of the Northern Generating Plant lease, there is an obligation upon the lessee to maintain the Northern Generating Plant at an operational capacity of 495 MW within the first seven years of the lease (see clause 5.1).

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[26] Response to Audit dated 9 February 2001.

Thereafter, the Northern Generating Plant lease requires the lessee to maintain the generation plant in the Minimum Handback Condition (see clause 12.2). Pursuant to clause 6.1(c) of the Northern Generating Plant lease it is recognised that the operational capacity of the generation plant can, over time, reduce significantly whilst still being consistent with the lessee's obligation to maintain the generation plant in the Minimum Handback Condition.

From my review of the lease documentation the operational capacity of the generation plant could reduce significantly from, 495 MW to 440 MW after seven years; from 440 MW to 320 MW after nine years; and from 320 MW to 160 MW after 10 years.

In the case of Optima Energy, pursuant to the terms of the Torrens Island Power Station A and B Generating Plant Leases, there is an obligation upon the lessee to maintain Torrens Island Power Station A at an operational capacity of 480 MW and Torrens Island Power Station B at an operational capacity of 800 MW within the first three years of the lease (see clause 5.1).

Thereafter, the generating plant leases require the lessee to maintain each of the generation plants in the Minimum Handback Condition (see clause 12.2). Pursuant to clause 6.1(c) of the Generating Plant Leases it is recognised that the operational capacity of each of the generation plants can, over time, reduce significantly whilst still being consistent with the lessee's obligation to maintain each of the generation plants in the Minimum Handback Condition.

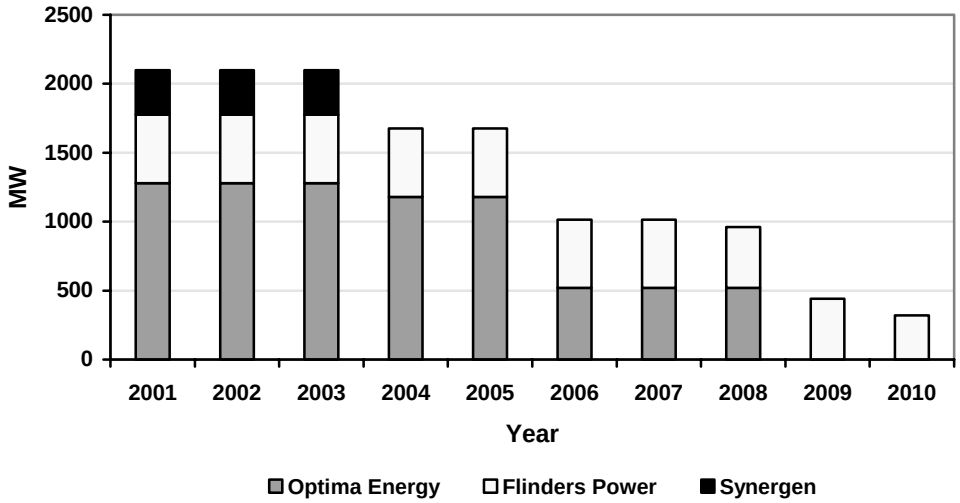
From my review of the lease documentation, the capacity of each of the generation plants could, in the case of Torrens Island Power Station A, reduce significantly from, 480 MW to 300 MW after three years; from 300 MW to 200 MW after five years; and from 200 MW to 100 MW after eight years. For Torrens Island Power Station B, the capacity would reduce from 800 MW to 480 MW after three years; from 480 MW to 320 MW after five years; and from 320 MW to 160 MW after eight years.

Similar provisions apply under the Project Documentation for Synergen. Pursuant to clause 5.1 of the Synergen Generating Unit Lease, there is an obligation upon the lessee to maintain the various generating plants (eg Dry Creek Units 1-3; Snuggery Units 1-4; and Port Lincoln) at the Minimum Operating Period (MOP) Capacity within the first three years of the lease. MOP Capacity is defined under the lease to mean 90 percent of the nameplate rating for each generating unit as described in Schedule 2 of the lease. By way of example, in the case of Dry Creek Units 1-3 the nameplate rating is 52 MW hence the MOP Capacity would be 90 percent of this figure or 46.8 MW.

Thereafter, the Synergen Generating Unit Lease effectively requires the lessee to maintain each of the plants in the Minimum Handback Condition. Pursuant to clause 6.1 of the Synergen Generating Unit Lease it is recognised that the operational capacity of these plants can reduce significantly after this initial three year period whilst still being consistent with the lessee's obligation to maintain each of the generating plants in the Minimum Handback Condition.

From my review of the lease documentation, these reductions could be as follows — in the case of Dry Creek Units 1-3-a reduction from 46.8 MW to 19 MW; in the case of Snuggery Units 1-3-a reduction from 18.9 MW to 8 MW; and in the case of Port Lincoln and Snuggery Unit No 4-a reduction from 22.5 MW to 9 MW.

The following graph demonstrates the effect of the abovementioned reductions in generating capacity leading up to the Minimum Handback Condition for each electricity generation business.



This reduction in capacity recognises the fact that over time the plant will naturally become less efficient and less productive (ie meet it's use-by date) and assumes that alternative power supplies will adequately meet any gap. This issue was also discussed in the Minute to the Treasurer from the ERSU dated 4 February 2000.

Reasons advanced for the approach adopted were a desire to ensure the availability of supply to cover the period during which the particular plant must be available to generate electricity for sale into the National Electricity Market coupled with a view that over time a range of capacity additions can be expected to come under consideration by private investors. The Minute also refers to the fall-back policy alternatives for the Government including facilitation of interconnect and generation options, and more interventionist approaches such as capacity auctions or demand incentive schemes. In other words, reliance is placed on the market, or alternatively on direct Government intervention, to ensure future power supplies in South Australia.

The ERSU advised[27] that the Minimum Handback Condition mechanism was designed to allow the lessees to make the most rational use of its asset particularly as it drew to the end of its physical life. The ERSU also advised[28] that the operators of the generation businesses

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27 Response to Audit dated 9 February 2001.

28 Response to Audit dated 9 February 2001.

do have significant financial obligations under the electricity vesting contracts as authorised by the ACCC that will provide incentives to ensure that capacity is provided to the market. The ERSU has additionally observed that, the generators are entering into commercial contracts with retailers to support contestable customer load thereby providing further incentives to maintain capacity in the market. The ERSU also makes the observation that the National Electricity Market in itself provides incentives to ensure that capacity is maintained.

I accept that the alternative approach of requiring the successful bidders to effectively maintain and even possibly increase the capacity of the generating plants which in themselves are nearing the end of their useful life would have had a very significant impact both on disposal proceeds and possibly bidder interest.

Whilst noting the above comments, when considered in conjunction with the leasing arrangements which contemplate a surrender and transfer of the dismantled plant and the land upon which it is situated to the successful bidders, the arrangements entered into with the successful bidders do not, in my opinion, seek to address or provide for any long term certainty of continued supply of power in South Australia from the current generation sites. Reliance is in effect being placed on market forces (supply and demand pressures) and economic incentives to ensure that sufficient capacity will exist over the longer term.

I note and accept that this was a policy decision for the Government to make in the context of the disposal process. Notwithstanding this, I am concerned that the public may believe that the State has entered into a long term lease of these assets, which, by virtue of the nature of the lease relationship, would require the leased assets to be maintained over the term of the lease. In practice this is not the case and may never have been intended to be the case. The consequent effect of this arrangement is that the current leases provide no long term certainty that existing capacity will be maintained.

In adopting this approach to the leasing of the generating assets, the State has placed reliance upon the principles of supply and demand, and the operation of the National Electricity Market, to ensure that there will be sufficient generating capacity available to the South Australian market in the future.

4.4 USE OF SPECIAL PURPOSE ACQUISITION COMPANY

As part of the arrangements throughout the disposal process, the successful purchasers were permitted by the State to incorporate a special purpose acquisition company and to use that company to act as the vehicle to acquire the businesses and associated land.

No evaluation was undertaken of these Special Purpose Acquisition companies. The evaluation instead focused on the guarantees provided by the parent entities of these companies.

Given the significant price paid for the electricity businesses, there was an assumption that the expertise of these parent entities would be applied to, or made available to, the companies in order to ensure they had the technical expertise to operate the acquired businesses.

The ERSU has advised that reliance was also placed upon the existing electricity industry regulatory regime to ensure monitoring and regulation of safety and technical standards, rather than through the use of contractual arrangements.

PART 5
ISSUES ARISING FROM A REVIEW OF THE PROJECT DOCUMENTATION

5.1 INTRODUCTION

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 need to be reflected in the Project Documentation.[29]

This Part of the Report examines the Project Documentation which was developed by the ERSU and its advisers to effect the disposal of Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA to the successful bidders for those businesses.

Based upon my review of the Project Documentation for these disposals, and in addition to my initial general observations outlined in this Report in 'Part 4 — Observations Arising from a Review of the Project Documentation', I have identified the following issues. A number of these issues were also identified in a previous Supplementary Report.[30]

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. The recommendations contained in this Report, however, reflect my view regarding those governmental values of accountability, transparency and auditability that should always be the basis upon which governmental activities are predicated.

The issues discussed in this Part of the Report are as follows:

- provision of sign-off opinions
- conduct of warranty review program
- assessment of potential retained liabilities
- extension of protection from claims afforded to advisers
- capping of the State's liability for warranties
- Leigh Creek Township Lease.

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[29] Refer to commentary in Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000 pp 129-132.

[30] Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

5.2 KEY PROJECT DOCUMENTS

The documentation that I have selected for review is as follows:

Flinders Power

- Flinders Power Generation Business Sale Agreement between the Treasurer, Flinders Power, Generation Lessor Corporation (GLC), Flinders Power Partnership and NRG Energy Inc; and the associated documents including:

  - Northern Sale/Lease Agreement
  - Northern Generating Plant Lease
  - Northern Generator Sub-lease
  - Northern Unit 1 Boiler Sub-lease
  - Northern Unit 2 Boiler Sub-lease
  - Northern Land Lease
  - Playford B Sale/Lease Agreement
  - Playford B Generating Plant Lease
  - Playford B Land Lease
  - Leigh Creek Sale/Lease Agreement
  - Leigh Creek Railways Sub-lease
  - Leigh Creek Township Lease
  - South Australian Perpetual Crown Leases.

Terra Gas trader

- Terra Gas trader Business Sale Agreement and annexures between the Treasurer, Terra Gas trader Pty Ltd, Tarong Gas trader Pty Ltd and Tarong Energy Corporation Limited.

ElectraNet SA

- Electricity Transmission Business Sale Agreement between the Treasurer, the Transmission Lessor Corporation (TLC), Bluemint Pty Limited, ABB Group Holdings Pty Limited, Queensland Electricity Transmission Corporation Limited and Macquarie Bank Limited.

- Transmission Sale/Lease Agreement between the Treasurer, and Bluemint Pty Limited.

- Transmission Network Lease between the Treasurer, Bluemint Pty Limited and TLC.

- Transmission Network Land Lease between the TLC, the Treasurer and Bluemint Pty Limited.

- Rights and Obligations Pass Through Agreement between TLC and Bluemint Pty Limited.

Synergen and Optima Energy

- Synergen Generation Business Sale Agreement between the Treasurer, Synergen Pty Limited, Generation Lessor Corporation, National Power Synergen Pty Limited and National Power PLC.
- Optima Energy Generation Business Sale Agreement between the Treasurer, Optima Energy Pty Limited, Generation Lessor Corporation, TXU (South Australia) Pty Limited, and TXU Electricity Limited.
- Synergen Sale/Lease Agreement between the Treasurer, National Power Synergen Pty Ltd, and National Power PLC.
- Torrens Island Power Station A and Torrens Island Power Station B, Sale/Lease Agreements between, the Treasurer, TXU (South Australia) Pty Limited and TXU Electricity Ltd.
- Area 3 Land/Sale Agreement between the Treasurer and TXU (South Australia) Limited.
- Synergen Generating Unit Lease between Generation Lessor Corporation and National Power Synergen Pty Ltd.
- Torrens Island Power Station A and Torrens Island Power Station B Generating Plant Leases, between the Generation Lessor Corporation and TXU (South Australia) Pty Limited.
- Synergen Land Lease between Generation Lessor Corporation and National Power Synergen Pty Limited.
- Torrens Island Power Station A, Torrens Island Power Station B, and Area 3 Land Leases between Generation Lessor Corporation and TXU (South Australia) Pty Limited.
- Gas Direction Deed between Terra Gas trader Pty Limited, the Treasurer, and TXU Electricity Limited.
- Amendment Agreement between the Treasurer, Synergen Pty Ltd, Generation Lessor Corporation and National Power Synergen Pty Ltd.

5.3 ISSUES ARISING

Discussion on the issues arising follows.

5.3.1 Provision of Sign-Off Opinions

In an earlier Report,[31] I recommended 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 the Project Documentation, and that the State also ensure that all advisers with primary drafting responsibility for the Project Documentation be required to provide to the State effective sign-offs in relation to these documents before they are executed by the State.

Notwithstanding these recommendations, the process adopted for the preparation of the Project Documentation for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA proceeded on the same basis as that which occurred for ETSA Utilities and ETSA Power.

Audit Comment

In a transaction of such importance as the disposal of Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, I understand that it is common practice to require the advisers with principal responsibility for the preparation of the Project Documentation, namely the Lead, Legal and Accounting Advisers, to provide to the State, 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.

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 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

[31] Audit Recommendations 27 and 28 in the Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

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.

I remain of the view that sign-offs be obtained from all key advisers with responsibility for preparation of the Project Documentation.

5.3.2 Warranty Review Program

Under the relevant Sale of Business Agreements for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, the State has provided a range of warranties to the successful bidders. These warranties are principally focused upon the provision of good title to the assets transferred to the successful bidders by the State, together with confirmation by the State of its authority to effect a disposal of the assets and liabilities of Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA to the successful bidders. As such the warranties provided are fairly limited.

In an earlier Report,[32] I recommended that prior to the execution on behalf of the State of any document with the purchaser of the entity containing warranties given by the State, the agency responsible for conducting that process should undertake a review of the State's ability to satisfy or comply with any such warranties.

Audit Comment

The failure to include a warranty review program can potentially expose the State to liability in respect of the warranties provided to the successful bidders through the Project Documentation. Whilst the due diligence undertaken as part of the restructure of the State's electricity businesses prior to disposal considered these issues, no formal ongoing warranty review program was adopted for the disposal of Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA.

In circumstances where the State has provided warranties, I remain of the view that it is essential that the State have in place an appropriate warranty review program as part of the disposal process.

5.3.3 Extension of Protection from Claims Afforded to Advisers

The definition of 'Government Party' under clause 1.1 of the Business Sale Agreements for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA includes any adviser or consultant to the Treasurer and their respective associated companies or businesses, partners, directors, officers and employees; and any employee, director or other officer of, or contractor to, any of these parties.

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[32] Audit Recommendation 13 in the Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

Pursuant to clause 12.10 of the Business Sale Agreements, the purchasers have agreed not to make, and waive any right they may have to make, any claim against both the Treasurer or any Government Party whether in respect of the State's warranties or otherwise in connection with the Project Documentation, pursuant to section 56 of the *Fair Trading Act 1987* (SA), or any similar provision of any legislation in any other relevant jurisdiction.

The ERSU advised[33] that this position was adopted by the State for the State's own protection. The ERSU has submitted that if the State had only provided an exclusion of liability in its own favour and not in favour of its advisers, then any counterparty to the Project Documentation who claimed to have been affected by false and misleading information would have brought an action against the State's advisers, as the conduit for that information.

In the circumstances where the State has given an indemnity to its advisers when acting with authority and without negligence, the ERSU contends that the net effect of these provisions is that the State would be indirectly liable to the purchaser in any event. For these reasons the ERSU maintains that in all major transactions of this nature the exclusion of liability provided to the vendor is always extended to the vendor's advisers in order to avoid the purchasers being able to bring an action against the vendor through the indirect means of suing the vendor's advisers.

Audit Comment

Notwithstanding the ERSU's response, I am of the opinion, that it is inappropriate to extend protection to the State's advisers in these circumstances.

I note that under the Lead Advisers' contract, the Lead Advisers sought and obtained a limitation on their liability to the State except for any liability for losses, claims, damages, liabilities or expenses suffered or incurred by the State and which:

- result from the bad faith, or negligence of the Lead Advisers; or
- result primarily from a material breach of contract by the Lead Advisers and in that case the liability of the Lead Advisers was strictly limited to $22 million.[34]

The ERSU's response is based on a premise that unless the abovementioned protection was afforded to the advisers the State could become indirectly liable to a purchaser by virtue of the State's obligation to indemnify its advisers when acting with authority and without negligence. Based on my review of the Lead Advisers' contract, I am of the opinion, that any such indemnity could only be said at best to be implied, and in my view this is doubtful. Clause 17.2 of the Lead Advisers' contract deals with the relationship between the parties and in my opinion runs contrary to the ERSU's interpretation.

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33 Response to Audit dated 9 February 2001.

34 Refer to comments in Supplementary Report of the Auditor-General on 'Electricity Business Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations' dated 28 November 2000.

As discussed in my earlier Report,[35] the State's initial benchmark position was that its advisers should have provided an indemnity in favour of the State against any loss or damage which is suffered by the State as a result of any breach by the adviser of any of it's obligations to the State under the Consultancy Agreement. As noted in that previous Report, this obligation to indemnify was not pursued in the case of the Lead or Legal Advisers.

The protection afforded to the advisers under clause 12.10 is a protection from a possible liability arising under Statute. Pursuant to clause 17.10 of the Lead Advisers' contract, the Lead Advisers agreed with the State that they must comply with the laws in force in South Australia in the course of performing the consultancy services. Accordingly, the purported effect of the protection afforded by clause 12.10 is to now exempt the Lead Advisers (at least in part) from this contractual obligation. The protection applies whether or not the Lead Advisers have acted with bad faith or negligently.

There is, in my opinion, no objective evidence to show that any of the advisers agreed to reduce their fees in return for the inclusion of such an undertaking in their favour and indeed, as noted, this runs counter to the terms of the Consultancy Agreement. There is similarly no evidence that any objective assessment was made of the possible cost to the State in terms of reduced disposal proceeds that the inclusion of this undertaking in favour of the advisers in these Business Sale Agreements may have given rise to.

Audit Recommendation 3

I recommend that for future asset disposals where it is intended to extend protection to advisers from possible statutory liability to a successful bidder, a review of the advisers' existing contractual arrangements with the State be undertaken together with a detailed cost/benefit analysis of adopting this course of action.

5.3.4 Monetary Cap on Liability

In an earlier Report,[36] I recommended that in future asset disposals involving significant competition where the State is to provide warranties to the potential purchasers, if commercially possible, consideration should be given to putting as the State's position a low monetary cap on the State's liability under these warranties.

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35 Refer to comments in Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations' dated 28 November 2000.

36 Audit Recommendation 29 in the Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

Audit Comment

The State's potential liability in respect of the warranties provided to the successful bidders under the Business Sale Agreements for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA has been capped at an amount equal to approximately the price paid by each of the successful bidders.

Given the competitive nature of a number of the disposal processes, I remain of the opinion that although the extent of the State's warranties was limited and generally within the State's power to control, in circumstances where there is a competitive bid process, it was not necessary 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.

5.3.5 Retained Liabilities

In an earlier Report,[37] I recommended that where it is intended that the State retain certain liabilities in the disposal process, 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.

Under the Business Sale Agreements for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA , the State has retained a range of liabilities incurred by those entities in the period prior to completion of the Business Sale Agreements. Largely the decision as to what liabilities would be retained by the State was taken at the time of restructure prior to the actual commencement of the disposal process.

Audit Comment

It is not possible to ascertain what is the State's potential contingent liability arising from the disposal arrangements, which makes it difficult 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 must 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.

I also recognise that there is an inherent trade-off between maximising disposal proceeds and minimising potential on-going liabilities for the State. The decision making process in

[37] Audit Recommendation 30 in the Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd: Some Audit Observations' dated 30 November 2000.

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,[38] a number of the key advisers were being paid incentive payments based upon the value of the disposal proceeds achieved by the State.

Based on my review of the disposal process for Optima Energy, Synergen, Flinders Power, Terra Gas trader and ElectraNet SA, I remain of the view that 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.

5.3.6 Leigh Creek Township Lease

As part of the supporting infrastructure for Flinders Power and the associated Leigh Creek coal mine, the State has granted to the successful bidder a lease of the Leigh Creek Township.

The Leigh Creek Township Lease has been entered into by the Generation Lessor Corporation as lessor and NRGenerating Holdings (No3) BV as lessee. The initial term of the lease is for 20 years (see clause 4.1) with an option to extend for a further period of 10 years (see clause 4.2).

I understand that the Township provides accommodation and essential services to the employees of Flinders Power engaged in the operation of the Leigh Creek coal mine.

Pursuant to the terms of the Leigh Creek Township Lease (see clause 5.1), the lessee is required to use the Township to provide:

- Township Services for the permanent residents living in the Township;
- water for the permanent residents of the surrounding communities;
- disposal of waste services for the permanent residents of Copley.

The Township Services that are required to be provided by the lessee and the standard to which those services are to be provided are set out in clause 10 and Schedule 3 of the lease.

The Essential Township Services are defined as including the provision of; water, fire crew and equipment, electricity, housing, doctors, supermarket, sewerage system, garbage collection, aerodrome, public roads maintenance, public toilet maintenance, town lighting, and service station.

The Direct Community Services to be provided include; cemetery; ovals, parks and playground, Henley Beach Flats and Leigh Creek Holiday House.

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[38] Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations' dated 28 November 2000.

The Facilitated Community Services include; the provision of land for a hospital, school, hotel/motel, postal service, and police.

A failure to provide the Essential Township Services or Direct Community Services could lead to termination of the lease by the Generation Lessor Corporation (see clause 14.1). There is no obligation upon the Generation Lessor Corporation to take such action and it is noted that the residents of the Leigh Creek Township are not a party to this lease and hence have no direct ability to enforce these obligations.

The ERSU advised[39] that significant consultation was undertaken with Leigh Creek residents in relation to the proposed arrangements. This included public information sessions, individual letters to all residents of Leigh Creek detailing the Government's policy decision with respect to the future of the town, and ongoing consultation with Flinders Power management at Leigh Creek as to the nature of the services available to residents to assist in the classification of services for the purposes of the Leigh Creek Township Lease.

The ERSU also advised that as the Leigh Creek Township was not a prescribed electricity asset under the disposal legislation, it was in fact open to the State to sell the town outright to the successful bidder.

Audit Comment

Good public administrative practice dictates that the rights and interests of Leigh Creek residents were a factor to be considered in the context of the overall disposal process for Flinders Power. I accept that a process of community consultation was undertaken and that it was not practical for the State to have sought to make every resident directly a party to the Leigh Creek Township Lease. I also acknowledge that the vast majority of Leigh Creek residents are in fact employed at the Leigh Creek coal mine that was also transferred to the successful bidder. Hence there are also industrial relations reasons as to why the successful bidder may have an incentive to ensure that the overall township services continue to be provided.

Residents will, however, have to rely upon the Generation Lessor Corporation to ensure that their rights are protected in the event of a breach of the lease by the successful bidder. For so long as the State is the owner of the Generation Lessor Corporation effectively this means that residents in practice will continue to rely upon the State to enforce these rights.

An alternative to the approach adopted by the State was to retain ownership of the Leigh Creek Township. This option was not adopted by the State and I accept that this would have resulted in the State having an ongoing involvement in and potential obligation to Leigh Creek residents.

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[39] Response to Audit dated 9 February 2001.

In my opinion, the position is significantly impacted upon by the terms of the Proclamation of immunity from liability pursuant to section 35 of the *Electricity Corporations (Restructuring and Disposal) Act 1999* obtained by the State. Under this Proclamation, the Generation Lessor Corporation and the Crown are both given immunity from any statutory, civil or criminal liability with respect to the Leigh Creek Township Lease, including any liability for loss, damage, injury or death suffered by a person through any cause whatsoever while or as a result of being in the Leigh Creek Township.

The ERSU has advised[40] that such a Proclamation was a necessary element of the State's risk limitation strategy as the State no longer has management of the Leigh Creek Township.

Whilst I accept that this Proclamation does not afford protection to the successful bidder, the intent, at least from a legal perspective, seems to be that the State and Generation Lessor Corporation have now effectively sought to ensure that they no longer have any form of exposure in respect of the Leigh Creek Township.

The extent of the operation of this Proclamation is considered to be very broad. By way of example, the Proclamation would appear to cover the situation where, for instance, a Crown employee visiting Leigh Creek Township to inspect the lessee's compliance with the terms of its lease, acted whilst in Leigh Creek Township in a way that caused residents in Leigh Creek Township to suffer some loss or damage (eg an involvement in a motor vehicle accident). In these circumstances, the effect of the Proclamation could be construed that whilst residents could take action directly against the employee, they would effectively be prevented by virtue of the Proclamation from taking action against the Crown for the negligence of the Crown's employee whilst in Leigh Creek Township.

I acknowledge that this may not have been the intent of the Proclamation.

I am of the opinion that it is not appropriate for the State to exempt itself from liability to the residents of Leigh Creek Township from its own negligent or criminal acts, and I am not convinced that Leigh Creek residents understand this position.

Accordingly, I consider that given the potentially very wide application of this Proclamation (possibly extending to exempting the State from liability for the negligent or even criminal acts of its own employees when in the Leigh Creek Township), clear advice on the application of the Proclamation to such situations needs to be obtained and considered.

I also note that the evaluation criteria for the disposal process for Flinders Power did not focus on the ability of the successful bidder to provide township services.

The ERSU advised[41] that the provision of township services was not an expertise reviewed in the selection process because it was not an expertise that it was expected to be found

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40 Response to Audit dated 9 February 2001.

41 Response to Audit dated 9 February 2001.

amongst the bidders. The ERSU also considered that as part of the disposal process the successful bidder was required to acquire the workforce of the business being disposed of and that that workforce included all the people responsible previously for the provision of the township services.

No actual assessment was ever undertaken to ascertain if the successful bidder was capable of ensuring that these services will continue to be provided. Rather than adopt the approach that similar evaluation criteria were appropriate for every electricity business disposal, it would, in my opinion, have been possible for the evaluation criteria for Flinders Power to include criteria that focused on this matter. In my opinion, the bidder did not need to have this expertise; however the bidder could have been required to demonstrate how these services were to be provided. Bidders may well have indicated their intention to continue to use existing people. I regard the failure to undertake such an assessment as poor public administrative practice.

Audit Recommendation 4

I recommend that advice be obtained from Crown Law or Senior Counsel as to the operation of the Proclamation issued under section 35 of the *Electricity Corporations (Restructuring and Disposal) Act 1999* in so far as it may operate to affect the rights of Leigh Creek Township residents to take action against the State to receive compensation for loss or damage incurred as a result of the negligence or criminal acts of the State in the Leigh Creek Township.

I also recommend that in future asset disposals involving the sequential sale of multiple assets, consideration be given to reviewing the suitability of the chosen evaluation criteria so as to ensure that those evaluation criteria are tailored to the particular circumstances pertaining to the disposal.