


**Review of Efficiency
Audit—Australian
Wool Corporation
Property Operations**

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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA
JOINT COMMITTEE OF PUBLIC ACCOUNTS

REPORT 282

**REVIEW OF EFFICIENCY AUDIT -
AUSTRALIAN WOOL CORPORATION -
PROPERTY OPERATIONS**

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JOINT COMMITTEE OF PUBLIC ACCOUNTS

SIXTEENTH COMMITTEE

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DUTIES OF THE COMMITTEE

Section 8. (1) of the Public Accounts Committee Act 1951 reads as follows:

Subject to sub-section (2), the duties of the Committee are:

- (a) to examine the accounts of the receipts and expenditure of the Commonwealth including the financial statements transmitted to the Auditor-General under sub-section (4) of section 50 of the Audit Act 1901;
- (aa) to examine the financial affairs of authorities of the Commonwealth to which this Act applies and of intergovernmental bodies to which this Act applies;
- (ab) to examine all reports of the Auditor-General (including reports of the results of efficiency audits) copies of which have been laid before the Houses of the Parliament;
- (b) to report to both Houses of the Parliament, with such comment as it thinks fit, any items or matters in those accounts, statements and reports, or any circumstances connected with them, to which the Committee is of the opinion that the attention of the Parliament should be directed;
- (c) to report to both Houses of the Parliament any alteration which the Committee thinks desirable in the form of the public accounts or in the method of keeping them, or in the mode of receipt, control, issue or payment of public moneys; and
- (d) to inquire into any question in connexion with the public accounts which is referred to it by either House of the Parliament, and to report to that House upon that question,

and include such other duties as are assigned to the Committee by Joint Standing Orders approved by both Houses of Parliament.

PREFACE

This report outlines the findings of the Committee's review of the Auditor-General's efficiency audit of the property operations of the Australian Wool Corporation. The Auditor-General's report was tabled in Parliament on 26 November 1985.

The efficiency audit focused on the commercial management of the wool stores owned by the Wool Corporation. Audit's analysis was based on the assumption that the Corporation should maximise the income obtained from its property operations, arguing for greater risk taking in property investment decisions.

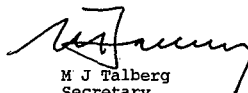
However, the Committee notes that, in its submission to the Committee on the efficiency audit report the Wool Corporation disagreed fundamentally with the Audit analysis. The Corporation did not disagree with the factual accuracy of the report, but rather with Audit's assessment of the commercial risks associated with the redevelopment of its wool stores and Audit's criticisms of the Corporation's commercial judgement.

The scope of the Auditor-General's role and responsibilities in relation to government business enterprises has been raised in previous reviews of Audit reports. The differing views of the Audit Office and the Australian Wool Corporation on the conduct of the efficiency audit has highlighted this issue once again. The Committee has therefore recommended that a detailed review of efficiency auditing guidelines for government business enterprises be undertaken.

For and on behalf of the Committee.



R. E. TICKNER MP,
Chairman



M J Talberg
Secretary
21 October 1987

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CHAPTER 1

BACKGROUND

- . Introduction
- . Overview of the Efficiency Audit
- . The Australian Wool Corporation's Response

Introduction

1.1 The Australian Wool Corporation was established by the Wool Industry Act 1972 with a range of responsibilities associated with the marketing of the Australian wool clip. These responsibilities include:

- . raw wool marketing, which includes the administration of the Reserve Price Scheme for wool through a Market Support Fund designed to achieve more stable and predictable prices;
- . promoting wool products;
- . co-ordinating wool research;
- . encouraging innovation in wool marketing, distribution, processes and products; and
- . other functions, including the administration of wool stores.

1.2 The Corporation's original wool stores were erected during World War II. After war-accumulated wool stocks had been sold, the then Government decided to retain the remaining stores for the use and benefit of the wool industry. The Wool Stores Act 1953 vested all property and rights in the stores with the Australian Wool Bureau, the Australian Wool Corporation's predecessor.

1.3 The Corporation's wool stores are used primarily for storing wool acquired by the Market Support Fund and Wool Marketing Service. The remaining unused stores are leased commercially, generating income for the Corporation's wool marketing and promotional activities.

1.4 The Corporation classified its wool stores into four categories. The percentage shown is the proportion of each type as at 3 June 1983.¹

1. Report of the Auditor-General on Efficiency Audits, AGPS, Canberra, November 1985, p 44.

Type A - modern clear span warehouse	43.5%
Type B - fully remodelled store	6.8%
Type C - original (WWII) store with concrete floor	25.2%
Type D - original (WWII) store timber floor	24.5%

Overview of the Efficiency Audit Report

1.5 The audit review was commenced in August 1983 and the report tabled in November 1985. Audit considered that there were several areas where the Corporation's policies adversely affected the efficiency of its property operations.

1.6 Audit maintained that the Corporation's failure to achieve the targets of its 1982-85 property development program resulted in its incurring considerable opportunity costs. A major objective of the Corporation's current operating plan for the six year period ending 30 June 1988 had been to reduce its 1982 wool store holding capacity of 854 000 square metres in 218 stores to 722 000 square metres in 132 stores. The Corporation did not achieve the developments proposed for the first triennium of the operating plan. Of the nine projects designated for development during 1982-83 and 1983-84 only six were undertaken, including one project which was brought forward from the third triennium.

1.7 Audit considered that the Corporation:

- failed to take advantage of lower construction costs during the period under review;
- failed to maximise rental income from redeveloped stores; and
- incurred additional maintenance costs, as maintenance costs for undeveloped stores are significantly higher than for redeveloped stores.

1.8 Audit considered that the Corporation failed to achieve its development program targets because of a generally conservative property redevelopment policy, albeit framed in the context of what the Corporation argued was a depressed property market.

1.9 The Corporation's Board required a firm prearranged tenancy on a property before approval was given for its redevelopment. In Audit's opinion this policy led to developments only being undertaken in response to expressions of interest from existing and prospective tenants (largely the former) rather than because the developments would maximise the return to the Corporation.

1.10 Audit also criticised the Corporation's policy of assessing the economic viability of projects by using a minimum rate of return (hurdle rate) based on interest rates applicable at the end of the previous financial year.² In Audit's opinion this method of calculating the hurdle rate failed to take account of the volatility of interest rates.

1.11 Audit isolated the Corporation's policies on prearranged tenancies and hurdle rate as underpinning its conservative approach to development. It was these policies which led to the development program targets not being met and to opportunity costs being incurred.

1.12 Audit further commented that in a number of instances the Corporation's management of wool stores had not been to the overall benefit of Australian woolgrowers. The most notable practice in this regard was where the Market Support Fund had been charged market rental rates for the storage capacity dedicated to its use even though this capacity had at times significantly exceeded the storage space actually used.

1.13 Audit also found that:

- the Government had not given the Corporation a direction on the minimum storage capacity which should be maintained; and
- the only apparent authority to support the Corporation's policy of managing property on a commercial basis was a statement by the then Minister for Primary Industry when introducing the Wool Stores Bill 1953.

The Australian Wool Corporation's Response

1.14 The Corporation regarded several aspects of the Audit Report as detracting from the validity of its findings. The Corporation did not believe that the Audit Report gave enough consideration to the complexity of the wool marketing environment in which it operated and also stated that the findings of the Report reflected an incomplete appreciation of its corporate responsibilities.

1.15 The Corporation stated that its property operations did not take place in isolation from its other responsibilities, which involved competing demands for funds for wool promotion and for market support activities under the Reserve Price Scheme. The Corporation's market support activities are influenced by external rates and rural production conditions determining wool supply.

2. Hurdle Rate - denotes a minimum projected rate of return which must be met before investment proceeds.

1.16 The Corporation noted that in some situations reported by Audit there was a significant difference between the management decisions preferred by Audit and those actually taken by the Corporation. The Corporation observed that the differences between its and Audit's views on the management of the Corporation's property operations;

...comes down to the question of whether commercial judgements and business decisions, which are the essence of the property operations, have been assessed better by the staff of the Auditor-General or by the Board of the AWC advised by its Property Sub-committee and management. AWC believes that its performance in the areas under review has met relevant commercial criteria as well as statutory requirements, and that it has been well advised.³

3. Australian Wool Corporation, Submission to the Committee, 24 April 1986, para 9.2, p. 7.

CHAPTER 2

AUDIT ANALYSIS AND RECOMMENDATIONS

- . Commercial Redevelopment of Wool Stores
- . Pre-arranged Tenancies
- . Hurdle Rate
- . Requirement for Public Works Committee Approval
- . Utilisation of Wool Stores
- . Management of Wool Stores

Commercial Redevelopment of Wool Stores

2.1 In its report Audit emphasised the commercial attractiveness of redeveloping wool stores. Audit arrived at this position by analysing the impact of the Corporation's wool stores development program on its financial results. This study included a comparative analysis of the Corporation's outgoings and property financial results with the projected financial results had development not taken place. The analysis indicated that the Corporation's financial results had been favourably affected by the property development. In particular, Audit's analysis revealed that, during the period November 1980 to December 1983:

properties which showed the greatest increases in rental income were in the main those where some redevelopment had taken place. For example, monthly rental for the redeveloped Gillman (South Australia) and Brooklyn (Victoria) properties increased by 34.5 per cent and 43.3 per cent respectively, whereas the monthly rental income from the undeveloped Palmyra (Western Australia) property, fell by 3.5 per cent during the period; and

the increased rental income for partially redeveloped sites was attributable to the improvements which had been made. For example, monthly rental earned on the type D stores at Gillman remained unchanged and the income of the type C stores at Brooklyn increased by only 26.5 per cent compared with the 43.3 per cent increase for redeveloped stores at Brooklyn.

2.2 The 1983 and 1984 annual reviews of the rental value of the Corporation's stores by a national firm of property consultants stated that the rental growth potential was generally related to the Corporation's modern stores rather than to its older undeveloped stores. These independent reviews supported Audit's analysis.

2.3 Audit also argued that failure to undertake development led to the Corporation incurring disproportionately high and increasing repairs and maintenance costs for its old, undeveloped wool stores. Expenditure on maintenance in the Western Australian and New South Wales (except Yennora) stores, which were mainly old and undeveloped, accounted for 41 per cent of total outlays whereas the stores accounted for only 24 per cent of the total storage capacity at December 1983.

2.4 Audit regarded the contribution of income from wool stores to the Corporation's overall property financial results to be directly related to the relative numbers of modern and obsolete stores. Audit concluded that the financial results of the Corporation would be further improved if the old obsolete stores were replaced by modern stores and regarded the results of the audit as highlighting the importance of an active redevelopment plan.

Pre-arranged Tenancies

2.5 Audit regarded the policy of not approving construction or redevelopment of a wool store without a firm prior tenancy arrangement as resulting in foregone income and as inhibiting the Corporation's ability to market development projects to prospective tenants. Audit also noted that the policy meant that the Corporation was not able to take advantage of a decline in the cost of construction (as measured by tender values) during 1982-83.

2.6 Audit recommended that:

- the Corporation review its policy of arranging a tenancy prior to the construction of a store.

2.7 The Corporation replied that in the building recession of the previous few years it had adopted a conservative policy of not engaging in speculative construction activity. The Corporation had also adopted a policy of not undertaking a development without a formal leasing commitment from a prospective tenant in order to avoid losses due to possible extended periods of vacancy after completion. This approach was maintained in recognition of the Corporation's obligation to maintain liquid reserves in order to meet possible funding shortfalls in international wool promotion and in providing services to the wool industry. The Corporation considered that Audit had not taken these other funding responsibilities into account in framing its observations and recommendation.

2.8 The Corporation has continued to review its pre-arranged tenancy policy and in April 1985 modified it to allow for some redevelopment, subject to:

- project justification in prevailing market conditions;
- a favourable independent evaluation; and
- the achievement of a satisfactory hurdle rate.

2.9 The Corporation believes this policy is still appropriate for the commercial environment in which it operates, and reflects an awareness of the difficulties involved in maintaining a balance between its warehousing and commercial development activities.

Hurdle Rate

2.10 Australian Wool Corporation policy is not to proceed with new stores development unless tenancy is assured against an investment return comparable with investment in Government securities, ie. hurdle rate. From June 1981 to June 1983 the required hurdle rate was the long-term Government bond rate prevailing at the end of the previous financial year plus a margin of 2.5 per cent. After June 1983 this was changed to the yield available on the longest term semi-government securities on issue at the end of the previous financial year.

2.11 Exceptions to the hurdle rate requirement were made in some situations where qualitative benefits were regarded as offsetting the shortfall in expected returns when measured against the hurdle rate.

2.12 Audit regarded the maintenance of a hurdle rate for a year based on an interest rate that applied at the end of the previous financial year as failing to acknowledge the volatility of interest rates. Audit therefore recommended that:

- the Corporation review its policy of maintaining a pre-determined minimum acceptable rate of return (hurdle rate) for a year based on an interest rate that applied at the end of the previous year.

2.13 The Corporation replied that stability of the hurdle rate was important for medium and long term planning. The Corporation stated that in reviewing the chosen hurdle rate annually and applying it for a full fiscal year, it met its investment objectives for the medium to long term regardless of movements in short term domestic interest rates. The margin above the base rate remained at 2.5 per cent, designed to offset short term interest rate fluctuations and to provide a satisfactory income from stores investment.

2.14 The Wool Corporation believes that to use a hurdle rate moving weekly or even daily in line with domestic interest rate fluctuations would be destabilising for planning purposes and prejudicial to the prudent commercial assessment of development projects. The volatility of domestic interest rates in 1985-86 reinforced the Corporation's view on this matter and the hurdle rate policy has been reviewed and re-affirmed.

2.15 The Corporation further stated that Audit provided no justification for its conclusion that the hurdle rate had been a barrier to stores redevelopment and the maximisation of the Corporation's income from property.

2.16 The Committee regards the Corporation's criticism of Audit's views on hurdle rate as valid. The Committee considers to be compelling, the Corporation's argument that projected interest rates must be fixed at a given value in order to estimate medium to long term investment returns provided the projected value reflects informed economic opinion on likely trends in interest rates in the medium to long term. The Committee does not consider that a more frequent adjustment of the hurdle rate would have improved the Corporation's management of its property portfolio in the medium to long term or increased the Corporation's income from its property holdings. Audit's recommendation that the hurdle rate should be adjusted more frequently appeared to be more appropriate to a review of returns from short term investments rather than to longer term property investments.

2.17 Audit also recommended that:

- regular reports on the rate of return from redevelopment projects be prepared to monitor investment performances.

2.18 The Corporation advised that such a reporting system had been in effect for some time prior to the Audit Report being received.

Requirement for Public Works Committee Approval

2.19 At the time of the Audit the Corporation fell within the review activities of the Public Works Committee which then required that public works with an estimated cost exceeding \$2 million be referred to the Committee for consideration. With the passage of the Statute Law (Miscellaneous Provisions) Act 1985 this amount was increased to \$6 million. Although Audit noted that the requirements of the Act up until the time of the audit had not affected development proposals, it nevertheless also noted that delays of up to twelve months can occur in receiving approval.

2.20 Audit then recommended that:

- ministerial and Public Works Committee approval for new warehouse projects be obtained prior to a tenancy being sought in order to minimise the possibility of delay.

2.21 The Corporation replied that the recently announced Government policy on Statutory Marketing Authorities refers to the need for greater commercial flexibility for these authorities, and in this context Ministerial approval requirements are likely to be reviewed in the near future.¹ Recently, the Corporation was exempted from the Lands Acquisition Act. Because of the increase in the Public Works Committee limit to \$6 million since the audit was conducted and because of changes in the pre-construction leasing arrangements, the Corporation did not consider it necessary to take further action in this area, but noted that it was keeping the situation under review.

Usage of Wool Stores

2.22 A proportion of the Corporation's Australian wool stores is dedicated for use by the Market Support Fund. This dedicated storage area is called core storage. The Market Support Fund is charged commercial rental rates by the Corporation for the storage dedicated for its use, whether or not the Fund uses that storage capacity. Audit regarded over-estimation of the Fund's core storage requirements and the resulting underuse of capacity as having led to the Fund incurring significant additional costs.

2.23 Partly because of low core storage use rates, a warehousing review was undertaken by the Corporation in 1983 with the objective of increasing efficiency and reducing the costs of storage and handling. The review developed more accurate methods of determining core storage and recommended that greater emphasis be placed on measuring store capacities. The Corporation advised that many of the review recommendations have been implemented.

2.24 Audit recommended that:

- because of the volatility of the Corporation's wool stock levels, core storage requirements should be reviewed more frequently than at three yearly intervals.

2.25 The Corporation advised that in future reviews of core storage requirements will be undertaken at least once a year.

1. Minister for Finance, 'Statutory Authorities and Government Business Enterprises - A Policy Discussion Paper Concerning the Efficiency and Accountability of Commonwealth Statutory Authorities and Government Business Enterprises', AGPS, Canberra, June 1986.

2.26 The Corporation also defended its policy of charging the Market Support Fund for core storage dedicated to its use, arguing that:

- the volatility of the wool market makes accurate forecasting of core storage requirements difficult. The Corporation regarded the allocation of increased resources to improve the accuracy of the forecasting model as being unlikely to yield tangible benefits because of the continuing volatility of the wool market;
- if core storage was pruned excessively, resulting in the need to rent alternative commercial stores, the additional cost to the Market Support Fund would be substantial;
- the costs of core storage allocation for the Market Support Fund can be viewed as analogous to a stand-by fee paid by the Fund on a line of credit from a lender. In this case, the Fund pays the Corporation for core storage space it may be required to use at short notice; and
- where possible, excess core storage space is placed on short-term lease.

2.27 Audit recommended that:

- the Corporation consider having available more stores suitable for both commercial leasing and for wool storage to enable greater storage flexibility.

2.28 The Corporation advised that this matter will be kept under review.

2.29 Audit also suggested that the Corporation's storage flexibility would be improved by arranging for the leases of stores let to commercial tenants to expire at times when the Corporation's storage requirements are likely to increase, that is, early in the wool selling season. At that time leases could be terminated or renewed according to the then current perception of storage requirements. This enhanced flexibility would allow for a small core storage to be maintained and thereby lessen the likelihood that the Market System Fund would bear the cost of under utilisation.

2.30 Audit then recommended that:

the Corporation's practice of leasing external property to meet short-term capacity requirements rather than terminate a lease of a commercial tenant should be used to maximise the property returns to the Corporation.

2.31 The Corporation replied that the suggestion that commercial tenancies be arranged to expire to coincide with likely wool selling peaks reflected a misunderstanding of the realities of commercial storage arrangements. These involved balancing statutory Reserve Price Scheme wool storage needs with the aim of achieving cost-efficient and income generating assets. An emphasis on one or other activity, as implied in Audit's suggestion and recommendation, would not meet the Corporation's statutory obligations and commercial objectives.

2.32 The Committee noted an apparent contradiction between the suggestion and recommendation above. Audit firstly suggested that the Corporation arrange for commercial leases to expire early in the wool selling season. However, Audit also recommended that the practice of not arranging for commercial leases to expire at the start of the wool season (and the leasing of external property to meet short term requirements) should be used to maximise the Corporation's property return. That is, Audit first criticised the practice of not arranging for commercial leases to expire and then supported the practice, recommending that it be used to maximise income returns from the Corporation's property.

Management of Wool Stores

2.33 Audit considered that the management of the Corporation's large number of stores would be enhanced if either the Minister for Primary Industry issued a directive on the minimum storage capacity required to comply with paragraph 5(1)(d) of the Wool Industry Act 1972, or if the Minister explicitly stated that determination of the storage capacity requirements was the responsibility of the Corporation. The Corporation would then be in a position to plan its redevelopment program more effectively and, in the process, reduce the number of obsolete stores.

2.34 The Corporation advised that the effect of the Wool Stores Act 1953 was to pass over to the Australian Wool Bureau (the Corporation's predecessor) full ownership of the then stock of wool stores property. The Government reserved the right to resume the stores in time of war but otherwise totally relinquished any right or claims over the stores. The Corporation considered it to be an open question whether the Government can direct it on the minimum storage capacity which should be maintained and whether there is a need for fresh confirmation of the policy of managing wool stores on a commercial basis, given the clear intention of the then Government to pass the stores back to the wool industry in 1953.

CHAPTER 3

COMMITTEE COMMENTS

- . Introduction
- . Opportunity Costs
- . Audit as Market Analyst
- . Efficiency Auditing Guidelines
- . Focus of the Efficiency Audit
- . Policy Considerations
- . Conclusion and Recommendation

2.35 Section 75 of the Wool Industry Act 1972 requires the Corporation to manage, control and maintain the land and buildings to which Part VII of the Act covering wool stores applies. The Act does not include the requirement that they be managed in a commercial manner although the Corporation, as expressed in the Operating Plan for the six year period ending 30 June 1988, has embraced the strategy of operating property, stores and other premises as revenue earning enterprises. Audit noted that the only apparent authority to support the Corporation's policy of managing property on a commercial basis was a statement by the Minister for Primary Industry when introducing the Wool Stores Bill in 1953.

2.36 Audit recommended that:

- . the Corporation seek to have its responsibilities for the operation of its property function on a commercial basis clearly defined.

2.37 The Corporation stated that it does not accept unequivocally the proposition that commercial aspects of its property operations should be more clearly defined. Nevertheless, the Corporation stated that, considered in isolation and ignoring the endorsement of the ongoing redevelopment of stores reflected by successive Ministerial approvals, the limited provisions of the Wool Industry Act 1972 could be regarded as an inhibiting factor. The Corporation said that this was under examination and would be taken up with appropriate levels of Government as the review of the next strategic plan for Property Operations (for 1986-87 and beyond) was finalised. The Committee noted the Minister for Finance's statement in the June 1986 policy discussion paper on Statutory Authorities that:

- . the Government's overriding objective is to ensure that SMAs (Statutory Marketing Authorities) are efficient, commercially orientated organisations which can effectively market Australian rural products in international markets.²
-it is the Government's strong policy intention that they (Statutory Marketing Authorities) operate commercially and continue to be financially self-supporting.³

2. *ibid*, para 4.3, p 26.
3. *ibid*, para 4.4, p 27.

Introduction

3.1 The Committee regards the fundamental nature of the Corporation's disagreements with Audit's suggestions and recommendations as raising several issues, both about the conduct of this particular audit and, more generally, about the parameters of efficiency audits of government business enterprises, where commercial performance and public accountability are essential aspects of such enterprises' operations.

Opportunity Costs

3.2 In its submission to the Committee the Corporation stated that its policies had been framed in the context of what it regarded as a depressed property market. In contrast, the Committee regards Audit's criticism, that the Corporation's tenancy and hurdle rate policies led to significant opportunity costs, as involving an alternative assessment, ie that the rental market for warehouse space during the period under review was more buoyant than was so judged by the Corporation. The Committee considers Audit's analysis on the issue of opportunity costs to hinge on its judgement of the ease with which tenants could have been found for redeveloped warehouse space.

3.3 However, despite its importance to Audit's review of the Corporation's property operations, the assessment of the relative buoyancy of the property market is neither stated explicitly nor supported by specific evidence. Audit indicated that in one instance a firm of property consultants had advised the Corporation that they had received enquiries for warehousing space at an 'acceptable rental rate'. The Committee acknowledges that this fact may have indicated that the Corporation could have adopted a less cautious redevelopment policy. However, the Committee does not accept that the single instance cited by Audit alone provides convincing or sufficient evidence of a buoyant property market.

3.4 The Committee regards Audit's analysis on this issue as being founded on a related judgement that, given a supposedly buoyant market, the Corporation should have been prepared to take greater commercial risks in investing in wool stores redevelopment. However, the Committee notes that, while underpinning its analysis, Audit neither explicitly stated nor provided specific evidence for its assessment that the commercial risk of wool store redevelopment was relatively low.

Audit as Market Analyst

3.5 The Committee notes that Audit's assessment that the Corporation's policies led to its incurring opportunity costs was not a criticism of management efficiency. On the contrary, the report indicated that, overall, the Corporation had displayed responsive and responsible management of its wool stores. On this point Audit said:

It should be noted that Audit's recommendations, in the main, suggest that the Corporation review its policies in a number of areas. That is not to say that existing policies were regarded by Audit as generally deficient but rather that there are other approaches to the execution of its statutory functions that should be considered by the Corporation.¹

3.6 This criticism involved an alternative assessment by Audit of market and commercial opportunities which, in Audit's opinion, could have been realised but were not. The Committee notes that with the benefit of hindsight it is easier to decide which investment decisions would have been more profitable. Investment decisions always involve risks and while these risks can be minimised by sound business and management practices they can never be completely avoided in a complex market environment. Given Audit's approval of the soundness of the Corporation's approach to managing its property, the Committee questions the value of Audit's criticism on this point and its relevance to a review of program efficiency.

3.7 The Committee accepts that it is possible that a more aggressive approach to the marketing of the Corporation's development projects may have led to its realising a higher return on its investments. However, as already noted, the Committee does not believe that Audit has provided sufficient evidence to justify this assessment.

3.8 In order to substantiate the judgement that the Corporation should have been prepared to take a higher level of commercial risk, Audit would have had to present a detailed assessment of the property market in the context of the general economy at the time. The Committee does not believe that the Audit Office has particular expertise in assessing either the property

market or the economy, and neither does the Committee expect the Audit Office to have such expertise. The Committee does not consider that Audit's views can be regarded as authoritative or as being based on a professional analysis of the property market.

Efficiency Audit Guidelines

3.9 The Committee notes that the overly broad scope of the first efficiency (or performance) audits conducted in the early 1980's led to significant delays in completing inquiries. Such delays often meant that Audit's recommendations were superseded by changes to the organisation under review before reports were presented to Parliament. In July 1983 the Report of the Inter-departmental Committee Established to Review the Process of Efficiency Audits' recommended, among other things, that future efficiency audits should:

- focus sharply on a well-defined administrative function; and
- be concerned only with program efficiency and not encroach onto policy considerations.

3.10 However, the Committee notes that the report of the efficiency audit of the Australian Wool Corporation has highlighted the implications of the requirement that efficiency audits should be sharply focused. The issue of whether policy considerations can be completely avoided in audits of government business enterprises is also unresolved.

Focus of the Efficiency Audit

3.11 The Corporation's criticisms of the Audit report centred on Audit's concentration on the profitability of its property operations to the exclusion of its other financial responsibilities. The Corporation regarded this approach as leading to a narrow and inadequate analysis of its activities. However, the Committee observes that in focusing on the Corporation's property operations Audit was simply following the recommendation of the inter-departmental committee that efficiency audits should focus on a well-defined administrative function.

3.12 The Committee considers there to be a clear conflict between, on the one hand, undertaking a sharply focused audit which avoids the pitfalls of the early, broadly defined efficiency audits and, on the other hand, developing an accurate analysis of an administrative function which does not exist in isolation but is one element of the operations of a particular organisation and not necessarily its prime function.

1. Correspondence to the Committee from the Auditor-General, Appendix 1.

Avoidance of Policy Considerations

3.13 Audit's analysis in the report also raises the issue of whether the inter-departmental committee's recommendation that efficiency audits should not encroach onto policy considerations can be adhered to in audits of the commercial activities of government business enterprises. In the report Audit argued that the Corporation's conservative policy on wool stores redevelopment led to its incurring significant opportunity costs. This criticism goes beyond an evaluation of administrative efficiency to question the commercial judgements made by the Corporation, an area which could be interpreted as a commercial equivalent of 'policy'.

3.14 Nevertheless, the Committee also acknowledges that the distinction between 'program efficiency' and 'policy' may be difficult to maintain in audits of commercial enterprises. This is because government business enterprises, unlike most departments, are not primarily involved in administering or implementing predetermined government policy but rather are independent, self-managing businesses setting their own commercial and investment policies within the framework of their legislative guidelines.

Conclusion and Recommendation

3.15 The Committee regards the audit of the Australian Wool Corporation as highlighting and clarifying the difficulties of applying present efficiency audit guidelines to government business enterprises. The Committee considers the Corporation's serious disagreement with Audit's analysis and recommendations as reflecting a genuine concern about the legitimate scope and character of the audit.

3.16 Of particular concern to the Corporation were Audit's critical analysis of the Corporation's management policies, the advocacy of a more aggressive approach to property marketing and greater risk taking in investment, and the adoption of an approach which meant that Audit had assumed the role of market analyst.

3.17 The Committee regards Audit's criticisms of the Corporation's investment policies as being founded on the advocacy of a more entrepreneurial approach to property development and a preparedness to make decisions involving a higher degree of commercial risk. This is made clear in the following comment by the Auditor-General:

Audit considered that the Corporation might adopt a more aggressive approach to the marketing of development projects to prospective new tenants (of wool stores). This approach might also secure better returns to wool growers.²

3.18 Nevertheless, the Committee notes that in order to have adequately performed the type of review attempted by Audit in this case would have required the skills of a professional market analyst. Such a review requires specialist skills the Audit Office neither possesses nor is expected to possess and Audit should make use of specialist consultants or advisers in such cases.

3.19 The Committee does not accept that Audit has demonstrated that the Corporation's policies were not the wisest commercial approach in the circumstances. Furthermore, the Committee regards the implicit nature of some of Audit's fundamental assessments as leading to confusion about the intention and direction of its analysis.

3.20 In future audits of government business enterprises the Committee feels that the Australian Audit Office should explicitly state the basis for its evaluations of audited organisations' commercial decisions and should provide specific evidence for critical or alternative assessments of audited organisations' commercial decisions.

3.21 The Committee recommends that:

- a detailed review of efficiency auditing guidelines for government business enterprises be undertaken.

2. *ibid.*

APPENDICES

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JOINT PARLIAMENTARY COMMITTEE OF PUBLIC ACCOUNTSReport on Efficiency Audit of theAustralian Wool Corporation Property OperationsSubmission by the Australian Wool Corporation1. Introduction.

- 1.1. This submission has been prepared by the Australian Wool Corporation (AWC) in response to a request dated 21 March 1986 from the Committee. At that time the Committee also advised that it intended to examine the AWC submission before deciding whether to proceed with a full inquiry into the Auditor-General's report dated 26 November 1985 on an efficiency audit of the Property operations of the AWC.
- 1.2. AWC believes that the subject report accurately summarises AWC policy, objectives and background, in so far as Property operations are concerned, in the introductory pages 43-46. It is assumed no duplication of that information is required here.

2. General

- 2.1. The Committee has asked AWC, inter alia, to address "measures which have been undertaken to overcome the reported deficiencies". This presumes acceptance of the report as the essential judgement on AWC Property operations.
- 2.2. In the main sections of the report there are useful observations on AWC commercial activities. However there are also aspects of concern which, in the opinion of the AWC, detract from the validity of findings in the report. These relate to the style of presentation chosen and to a lack of appreciation of the many elements involved in wool marketing, particularly those to do with the AWC's role. More specifically:
- (a) Some recommendations cover areas where appropriate action had been taken by AWC before and/or independently of audit consideration. However, that is not always made clear since the report retains audit opinion on all matters regardless and the format highlights that opinion ahead of any AWC response. AWC does not believe that the report accounts for the volatility of the wool marketing environment and consequent AWC activity during an audit extending over more than two years.

- (b) In some situations reported there is a significant difference between management decisions which would have been preferred by the auditors and those actually taken by AWC. From an extensive experience in wool marketing and financial matters, AWC strongly believes that many situations occur in which only commercial judgement made in all of the circumstances at the time can determine the necessary course of action. AWC stands by decisions it has taken in such situations.
- (c) Also, referring to various AWC activities which are parallel to Property operations, the findings of the report reflect an incomplete appreciation of corporate responsibilities or of reasons supporting AWC Board decisions.
- 2.3. The AWC's Property operations do not take place in isolation from other responsibilities where these involve competing demands for funds for wool promotion or for market support activities under the Reserve Price Scheme (RPS) which result in wool stock holding. Market support activities are influenced by external factors outside the Corporation's control, such as economic conditions which affect demand from the textile industry of the Northern Hemisphere, the volatility of exchange rates and rural production conditions determining wool supply. Influences such as these lead to the very heart of the issues relating to the forecasting of wool prices and optimum stock levels. It is inevitable that there will always be uncertainty as to absolute storage requirements across Australia because of the external factors which determine the levels of RPS activity and hence stock piling.
- 2.4. Paraphrased from the Wool Industry Act 1972, the three major activities within the AWC's Property function are:
- to manage, control and maintain the land and buildings owned and leased by AWC (Section 75);
 - to erect buildings suitable for, or in connection with, wool stores (Section 78); and
 - to effect improvements to buildings and to remove and demolish buildings (Section 79).
- 2.5. Against the background of the provisions of the Act and in accord with the 1953 Government intent that wool stores be let on a commercial basis to generate funds for the wool industry, including reinvestment, AWC has proceeded with programmes of re-development of wool stores estates. Successive governments have endorsed the AWC's strategy of re-development, which is often a viable alternative to costly maintenance of ageing stores.

3. Audit Findings

- 3.1. The report on AWC's Property focussed on re-development, utilisation and management of wool stores and the financial returns from storage investment. The report then recommended that:
- (1) AWC review its policy of arranging a tenancy prior to the construction of a store,
 - (2) AWC review its policy of maintaining a pre-determined minimum acceptable rate of return (hurdle rate) for a year based on an interest rate that applied at the end of the previous year,
 - (3) regular reports on the rate of return from the re-development projects be prepared to monitor investment performance,
 - (4) Ministerial and Public Works Committee approvals for new warehouse projects be obtained prior to a tenancy being sought in order to minimise the possibility of delay,
 - (5) AWC to review core storage requirements at more regular intervals than the present three-yearly review,
 - (6) AWC consider having available more stores suitable for commercial leasing and for wool storage to enable greater storage flexibility, and
 - (7) AWC seek to have its responsibilities for the operations of its Property function on a more commercial basis clearly defined.
- 3.2. AWC comments, additional to those in the report, follow.
- ### 4. Policy for Arranging a Tenancy Prior to Construction of a Store
- 4.1. AWC philosophy is not to proceed with new store development unless tenancy is assured against an investment return comparable with investment in Government securities. It has been corporate policy to not engage in speculative activity and to adopt a conservative approach in order to avoid losses associated with any extended period of vacancy after completion. This approach has been maintained in recognition of AWC's other obligations to maintain liquid reserves for the purpose of meeting funding shortfalls in international wool promotion and provision of industry services.

- 4.2. The policy has been kept under review and, in fact, in April 1985 was modified to allow for some re-development subject to project justification in prevailing market conditions and supported by a favourable independent evaluation and to the achievement of a satisfactory hurdle rate.
- 4.3. The AWC believes this policy to be still appropriate for the commercial environment in which it operates and also to reflect an awareness of the difficulties involved in maintaining a balance between its warehousing activities and those of the private sector commercial developer.
5. Maintenance of Hurdle Rate
- 5.1. The discussion of hurdle rate is one of the clearest examples of the report maintaining a particular view in the face of reasonable argument defending the AWC record.
- 5.2. In setting the discipline of the hurdle rate to be reached on a discounted cash flow return, AWC established a policy predicated on the long term nature of its stores investments, most of which have a life expectancy of 40 years, as an alternative to liquid investment in semi-government securities.
- 5.3. In reviewing the chosen base rate annually and applying it for a full fiscal year, AWC meets its investment objective for the medium/long term, regardless of the movement in short term domestic interest rates. For 1985/86, the chosen base rate of 14.5% rose to 16.8% by November, falling to 13.4% by April. The margin above the base rate remains at 2.5%, designed to offset short term interest rate fluctuations and provide a satisfactory income from stores investment.
- 5.4. AWC believes that any return to a base rate moving weekly or even daily in line with domestic interest rate fluctuations would be destabilising for planning purposes and prejudicial to prudent commercial assessment of development projects. The volatile domestic interest rate environment of 1985/86 has reinforced AWC's decision in this policy area.
- 5.5. The hurdle rate policy has been reviewed and re-affirmed, as the report says.
- 5.6. As also stated in the report but should be noted here again, in the case of storage requirements of the RPS, qualitative factors sometimes intrude, e.g. at Brooklyn "C" store in Victoria it was necessary to provide a large wool show floor which is not income generating.

6. Ministerial Approval and Public Works Committee Involvement

- 6.1. The recently announced Government policy on Statutory Marketing Authorities (SMAs) refers to the need for greater commercial flexibility for SMAs and in this context Ministerial approval requirements are likely to be reviewed in the near future. The Public Works Committee involvement limit has been increased to \$6 million and, more recently, AWC was exempted from the Lands Acquisition Act. Because of the increase in the Public Works Committee limit and the changes in the pre-construction leasing arrangements, it is not currently considered necessary to take further action in this area but the position will be kept under review.

7. Utilisation of Storage Capacity

- 7.1. The report includes AWC's information that, while the use of wool storage on a dedicated basis may have been less than optimal, this was recognised in AWC's 1982/83 operating plan strategy which led to commissioning of a Warehousing Review. The report goes on: "Terms of reference for that Review were ratified in March 1983, before commencement of the Audit and the review was finalised in August 1983. Many of the Review recommendations have been implemented."
- 7.2. In the 1984/85 wool selling season, core and buffer stock storage came under substantial pressure in several States as the stockpile peaked at 1.6 million bales in December 1984. Against the reference to poor wool stock forecasting and space allocation, several underlying aspects should be noted:
- (a) The cost to the Market Support Fund/RPS could be substantial, if core storage was pruned excessively resulting in the need to rent alternative commercial stores.
 - (b) Given the reactive nature of the RPS AWC inevitably experiences great difficulty in estimating not only total wool stock but also, for core storage estimating purposes, the likely wool selling centres/micron profile which will dictate storage location needs.
 - (c) Core storage allocation costs associated with RPS stocks could be viewed as somewhat analogous to a stand-by fee paid by the Corporation on a line of credit from a lender. The wisdom of hindsight in paying those costs is a poor analytical tool for the future.

- (d) Where possible, excess core storage is placed on short-term lease. There are practical difficulties, however, such as short term tenant availability and partial store letting.
- 7.3. In June 1985, AWC reviewed core storage needs for the 1985/86 wool selling season. Reviews will continue to be initiated on not less than an annual basis in future, as has always been the case, even when a triennial "decision" was taken regarding core storage as part of planning arrangements.
8. Management of Wool Stores
- 8.1. Some references in the report on storage of wool stock indicate lack of understanding of RPS operations, export arrangements and overseas storage costs and benefits. AWC's reaction to them is as follows:
- (a) It is not possible to forecast with any accuracy the regional profile of stock to be held by AWC under RPS arrangements. Further, it is not feasible to move stock between Regions given the attendant costs of handling at both ends, in-transit insurance premiums, etc.
- (b) Export/storage arrangements for wool in Japan, USSR and China are neither practical nor cost-effective. In the case of Japan, AWC relinquished its former leased store at Yokkaichi because of poor support from buyers who traditionally ship on their own account direct from Australia, and Japanese import arrangements requiring sale/disposal of all stock within twelve months. Given the centrally planned economies of USSR and China and AWC's policy to insure political risks for wool with the Export Finance Insurance Corporation, the premiums (non-recoverable) are prohibitive, as would be premiums on normal storage risks in such locations.
- (c) The shipment of RPS wool by AWC to its overseas leased storage locations involves costs of marine freight (an upfront cost ultimately recoverable on sale of wool) as well as in-transit insurance/handling costs (non-recoverable). In any event shipments must be limited to stock of suitable types to be consumed in that particular region. Any "double shipment" would pose an intolerable cost on the RPS.
- 8.2. As with domestic core storage, overseas shipping policy is subject to not less than annual review.

- 8.3. As indicated in the report (page 57), AWC does not unequivocally accept the proposition that commercial aspects of its Property function should be more clearly defined. Nevertheless, AWC is aware that, considered in isolation and ignoring the endorsement of ongoing re-development of stores reflected by successive Ministerial approvals, the limited provisions of the Wool Industry Act 1972 (refer paragraph 2.4 above) could be regarded as an inhibiting factor. This is under current examination and will be taken up with appropriate levels of Government as the review of the next strategic plan for Property operations (for 1986/87 and beyond) is finalised.
- 8.4. Whether amendment of Part VII of the Wool Industry Act, provision of a new function for AWC or preservation of the status quo is appropriate will be the subject of discussion initially with the Department of Primary Industry.
9. Conclusion
- 9.1. The theme of the audit report revolves around the management capacity of AWC in the conduct of its Property operations.
- 9.2. This comes down to the question of whether commercial judgements and business decisions, which are the essence of the Property operations, have been assessed better by the staff of the Auditor-General or by the Board of the AWC advised by its Property sub-committee and management. AWC believes that its performance in the areas under review has met relevant commercial criteria as well as statutory requirements, and that it has been well advised.
- 9.3. The membership of the Property sub-committee of the AWC Board during the period under review was:
- Mr. B.N. Kelman, General Manager and Director, CSR Ltd.
 Mr. E.W. Barr, former Chief Executive, H.J. Heinz (Aust.) Ltd., and Pacific Area Director, H.J. Heinz Co. (USA).
 Mr. W.J. Holcroft, former Managing Director, Brambles Industries Ltd., and Director and Chief Executive, Peko Wallsend Ltd.

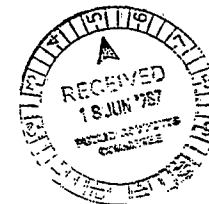
Australian Wool Corporation
 29 April 1986

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15th June, 1987

Mr. M.J. Talberg,
 Secretary,
 Joint Parliamentary Committee
 of Public Accounts,
 Parliament House,
 Canberra, ACT 2600



Dear Mr. Talberg,

Report of the Auditor-General on An
 Efficiency Audit of the Australian Wool
 Corporation Property Operations - November 1985

I refer to your letter of 27 May 1987 requesting additional comments from the Corporation on two issues.

Those issues centre on the Auditor-General's view that considerable opportunity costs have been incurred by delays in the wool stores development programme and that policy on stores tenancy is deficient.

Before commenting specifically, I must reiterate the views expressed by the Corporation in its April 1986 submission to the Committee. In that regard I draw your attention to clauses 2.2, 2.3 and 9.2 of the submission. It is regrettable that the Auditor-General failed to understand the environment within which the Corporation operates, its broader wool industry responsibilities, and investment factors relating to wool stores development.

The conclusion by the Auditor-General that considerable opportunity costs were incurred because of wool stores development programme delays is, at best, subjective.

The Property Plan 1982/83 - 1987/88 referred to in the Report and endorsed by the Corporation in July 1982 was predicated on environmental factors current then, and assessed as likely to continue during the planning period. Those factors included Corporation Reserve Price Scheme (RPS) wool stock storage needs, the state of the commercial storage market, prospective tenant requirements, building costs, funds availability including priorities for Corporation needs, and rates of return on investment. Not unexpectedly, several factors did impinge on the 1982 plans.

The four projects not undertaken during 1982-84 and referred to on page 49 involved construction of two stores at each of the Spearwood (Western Australia) and Gillman (South Australia) estates.

The estate at Spearwood comprised a vacant block of 12 hectares which was to be developed to provide strategic RPS storage as an alternative to stores on land at Palmyra leased from the Fremantle Cemetery Trust until December 1989. Given the run-down in Western Australian RPS wool stock in 1983, assessment of costs of Inground/onground services, changing commercial storage demands and continuing minimal rental at Palmyra, the construction plan was deferred. The complex at Spearwood is now being developed with quite different stores configuration to that planned in 1982, and when completed in 1988 will provide some 59,000 square metres of storage space.

The initial 1982 Gillman plan was dependent upon acquisition by the Corporation of adjacent land, and construction of a standard gauge railway spur to satisfy the then needs of existing and prospective tenants on the estate.

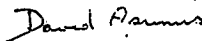
Again circumstances changed, with tenants' preference being linked to road transport arrangements between the estate and the Port Adelaide industrial complex. Two stores have since been completed at Gillman. However, again, the configuration of stores design and size was quite different to that envisaged in 1982, with RPS/wool storage arrangements being ultimately consolidated for most cost-efficient wool storage, handling and shipment.

The Corporation does not accept the conclusion reached by the Auditor-General that considerable opportunity costs were incurred because of development plan delays. The conclusion fails to recognise the opportunity cost of borrowing of funds or income received from retained investments in the interim, and does not take into account the quantifiable benefits the Corporation achieves through its construction costs tendering arrangements.

Concerning the audit reference to tenancy arrangements on pages 55/56, I can only presume that omission of this recommendation from page 60 of the Report was for the reason that the "recommendation" has been Corporation practice since 1980/81, long before the efficiency audit commenced. The suggestion that commercial tenancies expire to coincide with the Corporation's likely wool selling peaks again reflects misunderstanding of the realities of the use of commercial storage arrangements, its interface with statutory RPS wool storage needs, and the aim of achieving cost-efficient, income-generating assets investment.

I should add that the Corporation continues to monitor re-development of its estates, the changing priorities among estate developments which in turn are linked to rates of return, prospective tenancies, and all other factors associated with wool storage/commercial warehousing. Store rentals are reviewed nationally on an annual basis with full commercial rental rates being applied, while investment performance is monitored by the Corporation on not less than a quarterly basis.

Yours sincerely,

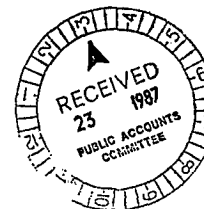


D.J. Asimus
Chairman



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F85/379

19 June 1987

Mr M.J. Talberg
Secretary
Joint Parliamentary Committee of
Public Accounts
Parliament House
CANBERRA ACT 2600

Dear Mr Talberg

REPORT OF THE AUDITOR-GENERAL ON AN EFFICIENCY AUDIT
OF THE AUSTRALIAN WOOL CORPORATION PROPERTY OPERATIONS
- NOVEMBER 1985

Thank you for your letter of 26 May 1987 inviting Audit's comments on the submission by the Australian Wool Corporation of 29 April 1986 on the efficiency audit of its property operations.

The Corporation's submission responds to the Committee's invitation to address 'measures which have been undertaken to overcome the reported deficiencies'. It should be noted that Audit's recommendations, in the main, suggest that the Corporation review its policies in a number of areas. That is not to say that existing policies were regarded by Audit as generally deficient but rather that there are other approaches to the execution of its statutory functions that should be considered by the Corporation.

The Corporation has responded to the Committee on each of Audit's recommendations in a manner which illustrates that such consideration has occurred and has acknowledged, at paragraph 2.2 of its submission, the validity of many of the Audit observations.

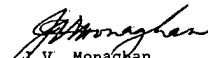
Some difference of opinion exists, however, on the recommendations which bear on certain of the management policies of the Corporation. While such differences of opinion are not uncommon between auditors and auditees, particularly with efficiency audits it is important that the auditee review its decision making processes in the context of the audit findings to ensure that it has adequately addressed the issues raised by Audit. Such differences are not necessarily perceived as criticism of the audit findings which are often accepted in the longer term.

This point is best illustrated by reference to Audit's recommendation that the Corporation review its policy of arranging a tenancy prior to the construction of a store. The Corporation's policy in respect of new store development is not to proceed with development unless a tenancy is assured against an investment return comparable with investment in Government securities. That is, the Corporation will not construct a new store unless it has already entered into an agreement with a prospective tenant to lease that store on completion. While this policy is defensible, Audit expressed the view that a more flexible approach whereby the Corporation might assess the likely demand for warehousing space and construct to meet that anticipated demand warranted consideration. Such an approach might secure better returns to wool growers than the Corporation's present policy. In my report I illustrated this point by indicating that in one instance, despite the fact that a firm of property consultants had advised the Corporation that they had received enquiries for warehousing space at an acceptable rental rate, development did not proceed because a firm tenancy could not be arranged.

In addition, Audit considered that the Corporation might adopt a more aggressive approach to the marketing of development projects to prospective new tenants. This approach might also secure better returns to wool growers. In this regard it is noted that at the time of the Audit Report all property development projects completed since 1982 had been for existing tenants.

Despite these differences I note that, in respect to the recommendations contained in my report, the Corporation has in each case either undertaken the recommended reviews or has indicated that reviews will be initiated and this would appear to be an acceptable outcome of the audit.

Yours sincerely


J.V. Monaghan
Auditor-General