



2009

PARLIAMENT OF TASMANIA

**AUDITOR-GENERAL  
SPECIAL REPORT No. 80**

**Hydro hedges**

**May 2009**

*Presented to both Houses of Parliament in accordance with the provisions of Audit  
Act 2008*

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21 May 2009

President  
Legislative Council  
HOBART

Speaker  
House of Assembly  
HOBART

Dear Mr President  
Dear Mr Speaker

**SPECIAL REPORT NO. 80**

**Hydro hedges**

This report has been prepared consequent to examinations conducted under section 26 for submission to Parliament, under the provisions of section 30 of the *Audit Act 2008*.

The report centres on investigating allegations made to the Ombudsman to the effect that Hydro Tasmania was grossly negligent to hedge Basslink before a firm contract was signed. The Ombudsman referred this matter to the Auditor-General.

Yours sincerely

H M Blake  
**AUDITOR-GENERAL**



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## Foreword

Standards Australia's standard AS/NZ 4360:1999 *Risk Management* defines risk management as 'the culture, processes and structures that are directed towards the effective management of potential opportunities and adverse effects'. It goes on to note that risk management is recognised as an integral part of good management practice.

In appropriate circumstances, hedging is an effective risk management mechanism.

A key aspect of this investigation related to the timing that Hydro Tasmania chose to enter into arrangements to hedge interest rate and foreign currency exposures arising from the Basslink project. In my view, this boiled down to whether or not, by signing the Basslink Preliminary Agreement in February 2000, Hydro Tasmania committed itself, and the state, to significant economic and financial exposure. While the Preliminary Agreement may not have represented an irrevocable commitment to the final Basslink undertaking, based on the audit work conducted, I formed the view that Hydro Tasmania was sufficiently committed to the Basslink project that it had to take steps to mitigate risks arising.

The investigation did not assess whether or not the hedges entered into were the most effective risk management strategies to apply in the circumstances. However, I concluded that Hydro Tasmania's risk management practices were appropriate, a sound commercial decision was made at the time and that it complied with the Treasurer's Instruction.

However, in view of the economic and financial significance of Basslink to the state, I would have expected a requirement that Hydro Tasmania inform the Parliament about aspects of Basslink while in its construction phase. Those aspects include information about the hedges entered into and their outcomes as well as details about the facility fee.

H M Blake  
Auditor-General  
21 April 2009

## List of acronyms and abbreviations

Deloitte	Deloitte Touche Tohmatsu
GBE	Government Business Enterprises
Hydro Tasmania	Hydro-Electric Corporation
Macquarie	Macquarie Risk Advisory Services
NGIL	National Grid International Limited
TI	Treasurer's Instruction
Treasury	The Department of Treasury and Finance



## **Independent auditor's conclusion**

## Independent auditor's conclusion

This independent conclusion is addressed to the Speaker of the House of Assembly and the President of the Legislative Council. It relates to my investigation of the Basslink interest rate and foreign exchange hedging transactions (the Basslink hedging transactions) entered into by Hydro-Electric Corporation (Hydro Tasmania), which is the subject of this Report. My investigation was based on the audit objectives, audit scope and audit criteria detailed in the Introduction to this Report.

In developing the scope of this investigation and completing my work, Hydro Tasmania provided me with all of the information that I requested. There was no effort by Hydro Tasmania to limit the scope of my work. This Report is a public document and its use is not restricted in any way by me or by any other person or party.

### Responsibility of the Directors of Hydro-Electric Corporation

The Directors of Hydro Tasmania were responsible for designing, implementing and maintaining risk management and other internal controls relevant to the contracts and hedges entered into in relation to the Basslink hedging transactions. This included ensuring that there were systems and controls in place to detect fraud or error and to avoid any mismanagement of Hydro Tasmania's resources.

### Auditor-General's responsibility

In the context of this investigation, my responsibility was to express a conclusion on whether or not Hydro Tasmania, in its capacity as a state entity, engaged in a substantial mismanagement of public resources, as that term is used in the *Public Interest Disclosures Act 2002*, by entering into the Basslink hedging transactions before signing a firm contract. In doing so, I conducted sufficient work to enable me to express a conclusion as to the reasonableness of Hydro Tasmania's risk management systems and processes as they related to the Basslink hedging transactions.

I conducted my investigation in accordance with Australian Auditing Standard ASAE 3500 *Performance Engagements*, which required me to comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether Hydro Tasmania engaged in a substantial mismanagement of public resources.

In this circumstance, my work involved performing procedures to obtain evidence about the Basslink hedging transactions based on the audit objectives and audit criteria outlined in the introduction to

this Report. The audit criteria were established by me without influence. Therefore, the audit procedures selected depended on my judgement, based on these criteria and on my assessment of the risks of material misstatement of the information obtained by me as part of this investigation.

In making this risk assessment, I considered internal controls relevant to Hydro Tasmania's risk assessment systems and processes as they related to entering into the Basslink hedging transactions but not for the purpose of expressing an opinion on the effectiveness of Hydro Tasmania's internal control or risk management processes more generally.

I believe that the evidence I have obtained was sufficient and appropriate to provide a basis for my conclusion.

### Auditor-General's conclusions

Based on the audit criteria, on the work performed and for reasons outlined in the remainder of this Report, it is my conclusion that Hydro Tasmania did not — as it relates to its management of the Basslink interest rate and currency hedges — engage in a substantial mismanagement of public resources as that term is used in the *Public Interest Disclosures Act 2002*.

However, my work resulted in findings leading to a recommendation that government consider setting thresholds relating to capital investment and economic impact for determining public projects for which enhanced reporting is required, that such projects be determined at their commencement and that entities charged with undertaking such projects provide progress reports biannually to the Parliament.

H M Blake  
Auditor-General  
Hobart  
21 April 2009



## **Executive summary**

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## Executive summary

As a result of a referral by the Tasmanian Ombudsman, this audit investigated foreign exchange and interest rate hedging transactions entered into by Hydro Tasmania from 7 March 2000 to 29 November 2002 as they related to the Basslink agreements. Our objective was to assess whether or not there had been a ‘substantial mismanagement of public resources’, as that term is used in the *Public Interest Disclosures Act 2002*, by Hydro Tasmania.

### Audit conclusion

Based on the audit criteria outlined in the Introduction to this Report, on the work performed and for reasons outlined in this Report, Hydro Tasmania did not substantially mismanage public resources by entering into the Basslink foreign exchange and interest rate hedging transactions prior to entering into firm contracts.

This investigation did however lead to making the recommendation that government consider setting thresholds relating to capital investment and economic impact for determining public projects for which enhanced reporting is required, that such projects be determined at their commencement and that entities charged with undertaking such projects provide progress reports biannually to the Parliament.

### Other conclusions

*As to whether or not entering into the Basslink hedging transactions before a firm contract was entered into, was a sound commercial decision.*

The strategy employed by Hydro Tasmania was to limit the costs of the Basslink project so that the parameters defined in the business case were not breached because of adverse changes in interest rates and foreign currency exchange rates. To achieve this Hydro Tasmania employed risk management techniques such as hedging as soon as the risk was identified.

In doing so, there was a risk of Hydro Tasmania incurring costs through adverse currency and interest rate movements should the project not proceed. Nonetheless, we are satisfied that a sound commercial decision was made, for a number of reasons including the high probability that the project would proceed.

*As to whether or not Hydro Tasmania implemented effective risk management.*

Hydro Tasmania's risk management practices for the Basslink hedging transactions were appropriate. It managed risk consistent with risk management practices commonly applied at the time of entering into the hedges.

*As to whether or not Hydro Tasmania complied with Treasurer's Instructions.*

Hydro Tasmania complied with the financial arrangements of the relevant Treasurer's Instruction.

## List of recommendations

The following table reproduces the recommendations contained in the body of this Report.

Rec No	Section	We recommend that ...
1	2.5.2	<ul style="list-style-type: none"> <li>• government set thresholds relating to capital investment and economic impact for determining public projects for which enhanced reporting is required</li> <li>• such projects are determined at their commencement</li> <li>• government require entities responsible for undertaking such projects to provide biannual progress reports to the Parliament.</li> </ul>

## Management responses

### Hydro-Electric Corporation

In response to our invitation to comment on this Report, Hydro Tasmania advised that it will not be providing a response to our audit findings.

### Department of Treasury and Finance

Thank you for the opportunity to comment on the draft Report to Parliament in relation to hedging arrangements entered into by Hydro Tasmania in relation to the Basslink project.

I support the overall finding in the Report that Hydro Tasmania did not engage in any substantial mismanagement of public resources and that it acted prudently to ensure that the overall cost of the Basslink project could not be adversely impacted by unfavourable movements in exchange rates and interest rates.

I note that your Report also recommends the establishment of thresholds for determining projects for enhanced reporting to the Parliament on the progress of public projects with:

- significant capital investment
- significant economic impacts.

While I support the view that Parliament and the public should be better informed about the nature and outcomes of major state projects, I have some concerns in relation to the practicalities of implementing your proposed recommendations.

The accountability and governance arrangements established for government businesses already contain suitable safeguards to ensure appropriate reporting. The *Government Business Enterprises Act*



1995 and enabling portfolio Acts establishing each business provide key accountability and report requirements to “shareholding” Ministers and the wider public, through Parliament. In addition, as you have noted, government businesses are scrutinised on an annual basis through the Government Business Scrutiny Committee of Parliament.

In addition, the accountability and governance arrangements require that government business must comply with a range of matters, including entering into hedge arrangements. As noted in the Report, Hydro Tasmania complied with the financial arrangements requirements of the Treasurer’s Instructions.

In any event, the establishment of fixed reporting times prior to the financial close of a project would not be in the commercial interests of the government business. However, consistent with the government’s contracts disclosure policy of openness and transparency, there may be a case for government businesses to publish a project summary of each major project within three months of the financial close of the project, including summaries of:

- the key project features, providing a snapshot of the rationale for the project; and
- the key commercial features of the project and risks, based on the project contract.

Such an approach would require further consideration by the government and consultation with government businesses.

### **Tasmanian Ombudsman**

The report represents a very careful and considered appraisal of the matter of referral, and leaves me in no doubt that the decision to hedge was appropriately taken and managed. I very much appreciate the quality of the investigation that has been carried out.



## **Introduction**

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## Introduction

### Background

Based on a referral by the Tasmanian Ombudsman, we conducted an investigation under section 44(a) of the *Financial Management and Audit Act 1990* into certain hedge transactions initially entered into by Hydro-Electric Corporation (Hydro Tasmania) on 7 March 2000. The matter referred related to allegations received by the Ombudsman that alleged Basslink hedge losses amounted to \$148 million. Specifically, it was claimed that Hydro Tasmania was grossly negligent to hedge Basslink before a firm contract was signed with the request that this matter should be referred to the Australian Securities and Investments Commission for investigation.

The Ombudsman formed the view that:

*Prima facie* the disclosure tends to show that Hydro Tasmania engaged in ‘improper conduct’ in its capacity as a public body, as that expression is defined in s3 of the Act’ — namely, ‘a substantial mismanagement of public resources’.

The Act referred to here is the *Public Interest Disclosures Act 2002*. The Ombudsman referred the matter to the Auditor-General, under section 41 of that Act.

### The Basslink project and associated risks

Basslink is an undersea power cable linking the Tasmanian and Victorian electricity grids and enabling Tasmania to participate in the national electricity market (NEM).

Hydro Tasmania originally entered into the Basslink Preliminary Agreement with National Grid International Limited (NGIL) to build, own and operate Basslink. That agreement evolved into the Basslink Services Agreement between Hydro Tasmania and Basslink Pty Ltd (then a wholly owned subsidiary of NGIL).

Under this agreement, Hydro Tasmania contracted to receive Basslink services, the Inter Regional Revenues, as well as other revenue streams, in return for a facility fee. The facility fee was calculated using an agreed financial model, and involved payments over an initial term of 25 years with an option for a further 15 years.

Basslink Pty Ltd is now owned by CitySpring Infrastructure Trust.

## Audit objectives

The objective of this investigation was to assess whether or not there had been a ‘substantial mismanagement of public resources’ by Hydro Tasmania, as that term is used in the *Public Interest Disclosures Act 2002*.

## Audit scope

The scope of this investigation covered the hedging transactions entered into by Hydro Tasmania from 7 March 2000 to 29 November 2002 which was the date of financial close. In addition, any financial impacts of these transactions up to and including 30 June 2008 were examined.

## Audit criteria

We applied the following criteria to allow us to form an opinion regarding the audit objective:

- Was the hedging of Basslink, before a firm contract was entered into, a commercially sound decision?
- Did Hydro Tasmania implement effective risk management?
- Was Hydro Tasmania in breach of legislation or Treasurer’s Instructions (TIs)?

## Audit methodology

The investigation was conducted by:

- examination of documentation, including relevant agreements and business cases, supporting the hedging transactions
- examination of minutes of the Hydro Tasmania Board, Board Risk Committee and Management Treasury Committee meetings
- examination of independent advice received including from the Department of Treasury and Finance (Treasury)
- interviews with staff directly involved in the hedging transactions.

## Timing

The audit plan for this investigation was finalised in March 2008 with field work conducted over the period March 2008 to November 2008. This report was finalised in April 2009.

## Resources

The total cost of the audit, including use of contractors but excluding production costs was \$57 500.

## **1 Commercial soundness**

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# 1 Commercial soundness

## 1.1 Background

Some risks are clearly implicit in the nature of a business. For example, the risk of oil prices decreasing is a natural risk for an entity in the business of drilling and refining oil. Similarly, a natural risk of trading in the National Energy Market is movements in electricity prices and price differentials between the Tasmanian and Victorian electricity markets.

Some other forms of risk are less implicit and where possible a business will often choose to pay a price to avoid the risk. Many such risks can be avoided or mitigated by ‘hedging’.

In finance, a hedge is a position established in one market in an attempt to offset exposure to the price risk of an equal but opposite obligation or position in another market — usually, but not always, in the context of a business’s commercial activity. For example, one of the oldest means of hedging against risk is insurance to protect against financial loss due to accidental property damage or loss.

It is both accepted commercial practice and intuitive that businesses entering into a construction contract should hedge risks that are not implicit to their business such as currency risk. What is perhaps not so intuitive was Hydro Tasmania’s use of hedging prior to a firm contract being signed. This use, and timing, of hedges will be examined in this Chapter.

## 1.2 Basslink timeline

In the period leading up to 2000, Hydro Tasmania finalised a business case which determined that the Basslink project met Hydro Tasmania’s evaluation criteria and should proceed. On that basis, in February 2000 Hydro Tasmania entered into a preliminary, but non-binding, agreement with National Grid International Limited (NGIL) to build, own and operate Basslink. This was the Basslink Preliminary Agreement, which was subject to certain conditions, including adjustment for movement in foreign exchange and interest rates over the period of approval to financial close.

At that time, based on internal and external advice, Hydro Tasmania decided to use hedges to manage some risks in order to ‘lock in’ the business case outcomes. The minutes of a Special Meeting of Hydro Tasmania’s Treasury Committee held on 6 March 2000 noted:

Advice has been received from Macquarie that, in their experience, all projects of this nature have eliminated foreign exchange and interest rate exposure at the earliest opportunity. Consistent with



this advice, the HEC had requested Macquarie to develop strategies as a matter of urgency for consideration by HEC.

Subsequently, supplementary hedges were taken out as considered necessary over an unexpectedly long period leading up to financial close when the final contracts were completed.

In May 2002, Hydro Tasmania entered into the Facility Fee Swap (FFS), a transaction which effectively fixed the costs associated with the interest rate risk for the life of the project. At the same time, the foreign currency hedge was assigned to Macquarie Bank.

Financial close was finally achieved in November 2002.

## 1.3 The hedges

The business case for the project determined its viability based on those known income streams at projected values and the costs of the project to completion. At the time of entering into the Basslink Preliminary Agreement, Hydro Tasmania identified two risks to the agreed financial model, namely interest rates and foreign currency exchange rates that could potentially jeopardise the business case, but could be contained using hedges.

### 1.3.1 Foreign currency risk

Foreign currency risk is the risk that the value of future cash flows will fluctuate because of changes in foreign exchange rates.<sup>1</sup>

In relation to Basslink, an example of currency risk was that significant components used in the construction were sourced offshore, denominated in Euros. Fluctuations in the value of the Australian dollar against the Euro therefore had the capacity to change the capital value of the project and impact the business case.

An effective hedge was achieved by agreeing to swap a fixed number of Australian dollars for Euros at a future date.

### 1.3.2 Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Another definition is the risk that the relative value of an interest-bearing asset, such as a loan or a bond, will worsen due to an interest rate increase. Interest rate risks can be hedged using fixed-income instruments or interest rate swaps.

The Basslink business case divided the interest rate exposures for the project into a short-term exposure for the construction period and a long-term exposure for the production period. The implied

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<sup>1</sup> Australian Accounting Standard AASB 7 Financial Instrument Disclosures

interest cost of the project on this basis was an input into the agreed financial model.

An effective hedge was achieved by swapping a future variable interest rate expense stream for a fixed-interest rate expense stream.

### 1.3.3 The cost of the hedges

The correspondence received by the Ombudsman alleged Basslink hedge losses amounting to \$148 million. This investigation has confirmed that hedging costs incurred by Hydro Tasmania were as follows:

	<b>Hedging cost</b>
	<b>\$M</b>
Initial hedging	24.3
Hedge extensions	69.5
Hedge finalisation at financial close (1.7)	
Interest rate fair value changes to financial close	55.5*
<b>Total cost</b>	<b>147.6</b>

\* This was not a 'cash' cost to Hydro Tasmania but an unrealised accounting adjustment. The interest rate hedge locked in an interest rate of 7.1% for the 25-year period of the Basslink Services Agreement. Whether this eventually is a cost or gain will not be known until the hedge is completed in 18 years' time.

From an accounting perspective, these costs were properly capitalised into the Basslink project. They were not, therefore, losses.

Whilst significant, these hedging costs were relatively small in relation to the total costs of the Basslink project which, based on the projected facility fee payments at 30 June 2004, was \$2.5 billion undiscounted. Also, despite these costs, Hydro Tasmania still achieved the outcomes outlined in the Basslink business case. It is noted, however, that if a binding contract had not eventually been signed, the adverse movement in the hedges could have led to a substantial loss to Hydro Tasmania, without the compensation of what it regarded as a favourable contract.

On the other hand, as it turns out, a better outcome than that outlined in the business case would have been achieved if Hydro Tasmania had decided, in March 2000, not to hedge. With the benefit of hindsight, it is estimated that hedging added approximately \$90 million to the cost of the Basslink project.

However, not hedging would have required Hydro Tasmania to take other risk management steps to manage costs within the criteria set for the business case. Hypothetically, for example, Hydro Tasmania could have pre-ordered equipment. However, this would have incurred interest costs and impacted borrowing limits. In this hypothetical circumstance, Hydro Tasmania could have faced even greater risks had the project not proceeded.

#### 1.4 Was hedging a sound commercial decision?

In preparing the business case for Basslink, Hydro Tasmania measured it against the investment criteria it had set for the project. The risk assessment prepared and approved by the board in March 2000 identified financial risks which could cause the project to breach those criteria if they were not managed.

The question of whether or not to hedge from the time of a preliminary (non-binding) decision was essentially a commercial decision, which involved a choice between two risks:

- not-hedging risk: the risk that not hedging currency and interest rate risks could result in a worse outcome than that outlined in the business plan or even to the project becoming unviable, or
- hedging risk: the risk that, for some reason, the project does not proceed and the hedges results in a loss.

Hydro Tasmania determined that the risk of not hedging was the greater. A number of factors suggest that the correct decision was made:

1. The Basslink Preliminary Agreement between Hydro Tasmania and NGIL to proceed with the project had already been signed on 16 February 2000. While this preliminary agreement did not bind NGIL to complete the project, it indicated significant commitment to the project by both parties, subject to satisfactory completion of the conditions precedent. It followed that there was a high degree of certainty that the project would go ahead, and accordingly hedging risk was low.
2. Both internal and external advice supported the decision to hedge. Specifically the advice stated that:

there were sound commercial reasons for the HEC's physical [foreign exchange] and interest rate exposures to be closed out as soon as practicable<sup>2</sup>.

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<sup>2</sup> Our emphasis

3. It is normal practice to use hedging to ‘lock in’ a business case particularly for large projects. Prior to and after 2000, Hydro Tasmania used hedging to manage risk. It was entitled to do this, as long as it complied with TI *Financial Arrangements* issued in 1997 (this is discussed in Section 3.2).
4. The period until contracts were signed was expected to be only six months. Ultimately, that expectation was not realised with final approval taking two years and eight months. The extended timeframe increased the period of time that Hydro Tasmania was exposed to those risks. Nonetheless, we consider that the original expectation was a reasonable one in the circumstances.

It should also be noted that the intended objective of delivering the outcomes projected in the business case was actually achieved. As it turned out, a better outcome could have been achieved by not hedging, but that potential outcome was deliberately accepted upfront, for the sake of putting an upper limit on the cost of the project. In other words, Hydro Tasmania was satisfied with the business case outcome and chose not to speculate on the possibility of achieving an even better outcome.

## 1.5 Conclusion

The strategy employed by Hydro Tasmania was to limit the costs of the Basslink project so that the parameters defined in the business case were not breached because of adverse changes in interest rates and foreign currency exchange rates. To achieve this Hydro Tasmania employed risk management techniques such as hedging as soon as the risk was identified.

In doing so, there was a risk of Hydro Tasmania incurring costs through adverse currency and interest rate movements should the project not proceed. Nonetheless, we are satisfied that a sound commercial decision was made, for a number of reasons including the high probability that the project would proceed.

## **2 Effective risk management**

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## 2 Effective risk management

### 2.1 Background

Hydro Tasmania's governance framework is determined from a number of sources including:

- *Hydro-Electric Corporation Act 1995*
- *Government Business Enterprises Act 1995*
- Corporate Governance Guidelines for Government Businesses
- Treasurer's Instructions
- Internal policy and procedures.

In particular, the Treasurer has the power<sup>3</sup> to issue TIs. That includes the TI on financial arrangements (Appendix A) that is relevant to this investigation and explicitly calls for the Board of Hydro Tasmania to have in place appropriate risk management systems.

To enable us to determine whether Hydro Tasmania had implemented effective risk management, we researched risk management standards and frameworks in use over the period of the hedges and benchmarked Hydro Tasmania's approach against these. Relevant standards and frameworks identified were:

- Standards Australia's Risk Management Standard AS/NZ 4360:1999
- corporate governance guidance issued by Ernst & Young
- corporate governance guidance provided in the Uhrig review relating to risk management in Commonwealth entities<sup>4</sup>.

The Uhrig review draws the following conclusion:

As all activities involve an element of risk, a well-governed organisation will recognise that not all decisions will lead to successful outcomes. However, an appropriate provision and limitation of power should ensure that the impact of poor decisions will not cause serious damage. In this regard, governance should have a strong focus on the management and oversight of risk, particularly in areas that are essential to the success of the entity.

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<sup>3</sup> Section 48(3) *Government Business Enterprises Act 1995*

<sup>4</sup> Uhrig, J. *Review of the Corporate Governance of Statutory Authorities and Office holders*

We have reviewed Hydro Tasmania's risk management approach under the subheadings:

- Risk management structure
- Risk evaluation
- Internal reporting and monitoring of risk treatment transactions
- External reporting of risk treatment transactions.

## 2.2 Risk management structure

At Hydro Tasmania, the financial, accounting and risk management aspects of Basslink came in for repeated scrutiny involving three separate committees:

- the Treasury Committee (a management committee with board representation) between March 2000 and November 2000
- the Risk Management Committee (a board subcommittee with management representation) from November 2000
- the Business Risk Committee (a board subcommittee with management in attendance) from January 2002.

On each occasion that these committees met, their reports were made to the full board with all decisions made by the full board.

Throughout this period, a small team of Hydro Tasmania employees, referred to as the Basslink project team, worked full time on the Basslink transactions. They used internal resources, such as the Treasury function, and board-approved external advisers. The project team reported to senior management who in turn reported to the board. To assist management and the board, external expert advisers were called upon to provide advice relating to risk identification, risk management, hedging proposals and accounting. The advisers included Macquarie Risk Advisory Services (Macquarie), who had been appointed as the board's risk advisers prior to the Basslink project, and PricewaterhouseCoopers, who provided further risk advice. Deloitte Touche Tohmatsu (Deloitte) was the Accounting and Taxation advisers to the project.

The project team and the external advisers developed numerous proposals and options for board consideration. As the proposals were prepared, their potential impact on the business case was considered. At each major decision point in the project, the business case was updated and assessed to ensure that the project still met the established benchmarks.

## 2.3 Risk evaluation

Following the signing of the Basslink Preliminary Agreement in February 2000, Hydro Tasmania instructed the Basslink Issues Management Team and Macquarie to complete an evaluation of the risks inherent in the agreement.

The Basslink Issues Management Team was in constant communication with Macquarie and integrally involved in developing the risk assessment. During that time, this team ensured that Macquarie had all of the relevant information it needed.

Macquarie, in association with the Basslink Issues Management Team, provided a report to the Hydro Tasmania Treasury Committee detailing the short-term options for managing the identified risks. The major risks to the Basslink business case identified were the interest rate and foreign exchange exposures. The advice was clear that the exposures should be hedged.

In March 2000, Hydro Tasmania wrote to Treasury outlining actions taken to hedge foreign exchange and interest rate exposures arising. Confirmation was sought that the hedging transactions entered into were in accordance with the TI that applied to Hydro Tasmania's financial arrangements.

The department replied noting its satisfaction that:

- there were sound commercial reasons for Hydro Tasmania's foreign exchange and interest rate exposures relating to Basslink to be hedged
- given the nature of the contractual arrangements between Hydro Tasmania and the Basslink developer, the financial obligations of Hydro Tasmania could be regarded as a physical commitment.

## 2.4 Internal reporting and monitoring of risk treatment transactions

From the date of entering into the hedging transactions, they were included within the internal Treasury reporting framework of Hydro Tasmania. The fair value of the transactions was also reported to the Treasury Committee, Board Risk Committee and Board Risk Management Committee in the prescribed way. Our investigation confirmed that this reporting was regular with each report resulting in a re-assessment of the hedges and their impacts on the business case.

On occasions, Treasury was informed about developments and where considered necessary by Hydro Tasmania, its advice was obtained.



## 2.5 External reporting of risk treatment transactions

### 2.5.1 External financial reporting

Our review of the Hydro Tasmania Board minutes indicated that the board had a robust debate regarding the level of disclosure it should make regarding the transactions. The board ultimately adopted a policy of making the minimum statutory disclosure. An important reason for this approach was the perceived need to limit knowledge of the detailed Hydro Tasmania risk management strategy in order to preserve commercial advantage.

During the period 2000 to 2006, Hydro Tasmania regularly sought accounting advice from its accounting and taxation advisers, Deloitte, regarding the appropriate minimum accounting treatment and disclosure in its annual financial statements. On each occasion, the treatment was agreed by the Auditor-General. As a result, at each financial reporting date Hydro Tasmania prepared general purpose financial reports in accordance with Australian Accounting Standards receiving unqualified audit opinions.

In 2006, following the introduction of Australian Accounting Standards Board standard ASB139 *Financial Instruments: Recognition and Measurement*, Hydro Tasmania modified its reporting of the transactions to comply with the new standard. This standard changed the financial reporting requiring the recognition on the balance sheet of the significant assets and obligations that all of the Basslink transactions gave rise to. Previously, this information was disclosed in the notes to the financial report.

### 2.5.2 External reporting to Hydro Tasmania's 'owners'

Basslink was a significant project particularly in the Tasmanian context and in 2000 even in the Australian context. In view of this, we would have expected regular contact between Hydro Tasmania and its owners.

We found evidence of relevant reporting to Treasury and through this department to the stakeholder Minister(s).

However, other than reporting after the event in Hydro Tasmania's annual reports, there was no reporting to the Parliament or to the public of Tasmania, on changes to costs or risks. Nor was such reporting envisaged or required. However, opportunities were available for Hydro Tasmania to be

scrutinised through the Government Businesses Scrutiny Committees of Parliament.

It is our view that there is a strong public interest argument, recognising the need to respect commercial-in-confidence in limited appropriate circumstances, for enhanced reporting to the Parliament on the progress of public projects with:

- significant capital investment
- significant economic impacts.

Such reporting should include details of risks identified for the project, how these are being managed and their outcomes with reports made more often than annually, at least six monthly.

In our view, any public project with a capital investment greater than 10% of budgeted General Government Sector (GGS) expenditure (\$378 million as at 30 June 2008) or 5% of budgeted GGS net worth (\$453 million) should qualify.

Projects captured by these thresholds might include:

- the Basslink project
- a new Royal Hobart Hospital.

If such a reporting requirement had existed in 2000, it is likely that the Parliament would have been informed much earlier on matters such as:

- the risks faced by the Basslink project and how these were to be addressed
- the ultimate cost of Basslink compared to the initial business case, including the quantum of the facility fee.

#### **Recommendation 1**

**We recommend that:**

- **government set thresholds relating to capital investment and economic impact for determining public projects for which enhanced reporting is required**
- **such projects are determined at their commencement**
- **government require entities responsible for undertaking such projects to provide biannual progress reports to the Parliament.**

## 2.6 Conclusion

Hydro Tasmania's risk management practices for the Basslink hedging transactions were appropriate. It managed risk consistent with risk management practices commonly applied at the time of entering into the hedges.

There is a public interest argument for greater reporting to the Parliament regarding progress of significant public projects.



### **3 Compliance with Treasurer's Instructions**

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## 3 Compliance with Treasurer's Instructions

### 3.1 Treasurer's Instructions

Prior to the commencement of the Basslink project, the Treasurer had already issued a TI to Hydro Tasmania under the *Government Business Enterprises Act 1995* dealing with financial arrangements it enters into. The full text of this TI is included at Appendix A. In summary, it authorised Hydro Tasmania to enter into financial arrangements, provided the following requirements were met:

- The financial arrangements were not for speculative purposes or result in the taking of leveraged positions.
- Appropriate Treasury, risk management and reporting systems were put in place supported by written procedures approved by the board and used only by suitably trained staff.
- Hydro Tasmania was always able to close out the position in relation to a financial arrangement by issuing physical securities or by paying cash to obtain such securities.
- Appropriate monitoring against relevant benchmarks was in place.

Each of these requirements is examined in the following sections of this Report.

### 3.2 Transactions not to be speculative

In the absence of a signed contract, hedging transactions might be argued to be speculative.

However, in our view, the purpose of the transaction was an important consideration in determining whether the transactions were speculative. Clearly, Hydro Tasmania's purpose was not to speculate but rather to manage the risk that the business case outcomes might not be achieved. Our viewpoint was reinforced by the fact that the Basslink Preliminary Agreement had already been signed, indicating significant bilateral commitment.

We also noted that Hydro Tasmania obtained confirmation from Treasury in March 2000 that entering into the hedges was compliant with the TI. We agree with that conclusion.

### 3.3 Appropriate Treasury, risk management and reporting systems

The existence of appropriate Treasury, risk management and internal reporting systems is dealt with in Chapter 2.

### 3.4 Hydro Tasmania is always able to close out the position

This situation did not eventuate because the hedges were rolled and wrapped up into the Basslink Facility Fee at financial close. Had Hydro Tasmania decided not to proceed at or prior to financial close, it would have had to pay out obligations arising from the hedges.

### 3.5 Appropriate monitoring against relevant benchmarks

Appropriate monitoring is dealt with in Chapter 5 where internal reporting arrangements are outlined. The only relevant benchmarks were the criteria for the Basslink business case which were regularly assessed and updated.

### 3.6 Conclusion

Hydro Tasmania complied with the financial arrangements requirements of the relevant TI.





## **4 Recent reports**

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## 4 Recent reports

<b>Year</b>	<b>Special Report No.</b>	<b>Title</b>
2005	53	Follow-up audits
2005	54	Compliance audits
2005	55	Gun control in Tasmania
2005	56	TT-Line: Governance review
2005	57	Public housing: Meeting the need?
2005	58	FBT Payment of accounts Asset management: Bridges
2006	59	Delegations in government agencies Local government delegations Overseas Travel
2006	60	Building security Contracts appointing Global Value Management
2006	61	Elective surgery in public hospitals
2006	62	Training and development
2006	63	Environmental management and pollution control act by local government
2006	64	Implementation of aspects of the <i>Building Act 2000</i>
2007	65	Management of an award breach Selected allowances and nurses' overtime
2007	66	Follow-up audits
2007	67	Corporate credit cards
2007	68	Risdon Prison: Business case
2007	69	Public building security
2007	70	Procurement in government departments Payment of accounts by government departments
2007	71	Property in police possession Control of assets: Portable and attractive items
2008	72	Public sector performance information
2008	73	Timeliness in the Magistrates Court
2008	74	Follow up of performance audits April – October 2005
2008	75	Executive termination payments
2008	76	Complaint handling in local government
2008	77	Food safety: safe as eggs?
2009	78	Threatened species
2009	79	Follow up of performance audits: April – August 2006

## **5 Current projects**

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## 5 Current projects

Performance and compliance audits that the Auditor-General is currently conducting:

<b>Profitability, and economic benefits to Tasmania, of Forestry Tasmania</b>	Evaluates Forestry Tasmania's long-term financial and economic performance.
<b>Speed detection devices</b>	Evaluates Tasmania's speed detection devices enforcement program looking at the efficiency and effectiveness of the program.
<b>Communications by the government</b>	Tests whether advertising, public surveys and websites are used for the benefit of Tasmanians and not for political purposes.
<b>Teaching of science in public high schools</b>	Examines how well Tasmania teaches science in public high schools.
<b>Public servants not working</b>	Looks at the trends, prevention and management of stress leave, long term sick leave, suspension and poor performance.

## 6 Appendices

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## 6 Appendix

### APPENDIX A

#### **GOVERNMENT BUSINESS ENTERPRISES ACT 1995 TREASURER'S INSTRUCTIONS**

In accordance with section 114 of the *Government Business Enterprises Act 1995*, I, the Honourable Anthony Maxwell Rundle, hereby issue a revised Treasurer's Instruction relating to the Financial Arrangements pursuant to section 48(3) of the Act.

This Instruction is in addition to any Instructions presently in force under the Act, and remains in force until revoked.

Dated this            day of            1997.

Tony Rundle MHA  
TREASURER

GBE 07-48-01P

## **TREASURER'S INSTRUCTION**

### **GOVERNMENT BUSINESS ENTERPRISES ACT 1995**

#### **FINANCIAL ARRANGEMENTS**

#### **BACKGROUND**

Section 48 of the *Government Business Enterprises Act 1995* provides that a Government Business Enterprise (GBE) may enter into and deal in financial arrangements.

The section also provides that the Treasurer, by a notice provided to a GBE, may specify that the GBE must not enter into or deal in a financial arrangement as provided by, or in the circumstances specified in, the notice.

The board of a GBE is required by the section to ensure that any financial arrangement entered into or dealt in, by the GBE, is entered into and performed, or dealt in, in accordance with the Treasurer's Instructions.

#### **DEFINITIONS**

'Financial arrangement' is defined in section 3 of the GBE Act and, for the purposes of this Instruction, shall include:

- forward commodity agreements;
- commodity swap agreements; and
- commodity options.

#### **TREASURER'S INSTRUCTION**

The Board of the Hydro-Electric Corporation is to ensure that Hydro-Electric Corporation has in place appropriate treasury, risk management and reporting systems relating to the entering into and performing, and dealing in financial arrangements and that these systems are supported by written procedures approved by the Board and used only by suitably trained staff.

Hydro-Electric Corporation may only enter into or deal in financial arrangements:

- for risk management or hedging purposes which enable a desired risk exposure to be achieved with respect to any underlying physical position; and
- for which there is a liquid market.

The Hydro-Electric Corporation must not;

- enter into or deal in financial arrangements
  - for speculative purposes, that is, purely to profit from trading; or
  - for which there is no underlying physical position; or
- enter into a deal in financial arrangements by taking a leveraged position. The Hydro-Electric Corporation must always be able to close out the position in relation to a financial arrangement by issuing physical securities or by paying cash to obtain such securities.

Financial arrangements are only to be entered into, performed or dealt in, in accordance with the written procedures approved by the Board.

The Board of the Hydro-Electric Corporation is to ensure that, in relation to financial arrangements:

- appropriate delegation arrangements made to suitably trained staff only, commensurate with the levels of exposure and financial risk involved in particular transactions, are in place;
- its systems are subject to regular internal and external audit;
- appropriate monitoring against relevant benchmarks is carried out; and
- appropriate data and information security systems are in place.