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SENATE

STANDING COMMITTEE ON ECONOMICS

Reference: Private equity investment and its effects on capital markets and the Australian economy

THURSDAY, 26 JULY 2007

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SENATE STANDING COMMITTEE ON

ECONOMICS

Thursday, 26 July 2007

Members: Senator Ronaldson *(Chair)*, Senator Stephens *(Deputy Chair)*, Senators Bernardi, Chapman, Hurley, Joyce, Murray and Webber

Participating members: Senators Adams, Allison, Barnett, Bartlett, Boswell, Boyce, Bob Brown, Campbell, Carr, Conroy, Cormann, Eggleston, Evans, Faulkner, Ferguson, Fielding, Fifield, Fisher, Forshaw, Hogg, Kemp, Kirk, Lightfoot, Ludwig, Marshall, Ian Macdonald, Sandy Macdonald, McGauran, Milne, Nettle, O'Brien, Parry, Payne, Ray, Sherry, Siewert, Watson and Wong

Senators in attendance: Senators Bernardi, Chapman, Joyce, Ronaldson, Stephens, Webber and Wong

Terms of reference for the inquiry:

To inquire into and report on:

a. an assessment of domestic and international trends concerning private equity and its effects on capital markets;

b. an assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;
c. an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects;
d. an assessment of whether appropriate regulation or laws already apply to private equity acquisitions when the national economic or strategic interest is at stake and, if not, what those should be; and
e. an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

WITNESSES

Committee met at 9.01 am

BROWN, Mr Colin Leslie, Manager, Costing and Quantitative Analysis Unit, Tax Analysis Division, Treasury

COMLEY, Mr Blair Robert, General Manager, Business Tax Division, Treasury

LOVE, Mr David, Manager, Prudential Policy, Banking, Treasury

CHAIR (Senator Ronaldson)—I declare open this meeting of the Standing Committee on Economics. This hearing has been convened to receive evidence in relation to the committee's inquiry into private equity investment and its effect on capital markets. These are public proceedings, although the committee may agree to a request for evidence to be heard in camera or determine that certain evidence should be heard in camera. I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to the committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such requests may of course also be made at any other time. Any claim that it would be contrary to the public interest to answer a question must be made by a minister, and that should be accompanied by a statement setting out the basis for the claim.

The Senate has resolved that an officer of a department of the Commonwealth or of a state should not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to a superior officer or to a minister. This resolution prohibits only questions asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how policies were adopted.

I welcome officers from Treasury—Mr Comley and Mr Love. I understand that Mr Brown has been delayed and that he will address specific revenue issues. Mr Comley and Mr Love, do you wish to make an opening statement?

Mr Comley—No, we do not.

Senator WEBBER—I was going to ask about revenue, but I have been stymied there. Mr Comley, I am not sure whether you are aware of the evidence that we received from the Reserve Bank of Australia yesterday about the size and capacity of the private equity market in Australia. They indicated that it had got to about the level it was going to stay at because there had been a tightening of the market. Is that Treasury's view as well?

Mr Comley—I did not read the transcript, if it is available, but I saw some general press reporting of the Reserve Bank's coverage and I have seen their PowerPoint presentations. Perhaps I will pass to Mr Love, who deals with the market issues, but in general terms we do not make a forecast of what one particular ownership segment is going to do in terms of its overall proportion of activity. Mr Love may want to comment further.

Mr Love—We have worked through part IVA with the Council of Financial Regulators and the other regulators in looking at this issue. Our view is consistent with that of the Reserve Bank, which is that the market overall is relatively small in Australia and does not seem to be growing significantly. If anything, the number of transactions seems to have reduced in the recent months.

Senator WEBBER—There was also commentary about the level of maturity of the market—that the market in Australia is a relatively new one and, therefore, not as mature as others, and this is having some impact on its size. Is there a capacity for the market to grow?

Mr Love—Obviously capacity is there, given the small relative size of the market at the moment. Australia overall appears to have been following overseas trends, particularly those in the US and the EU. The trend, particularly last year, initially seemed to be driven by foreign investors and local investment houses looking to expand their activity in the marketplace. Again, it is working from a relatively low base and there are no signs at the moment of any significant growth coming through.

Senator WEBBER—Turning to the issue of regulation, most of the evidence we heard yesterday was that the regulatory regime was as good as it needs to be and that everyone should feel assured that they have been safeguarded. However, that was coming from peak groups rather than from those of us who are lay observers. Has Treasury had any other feedback on the need to review the regulation and to look at some specific work for this sector of the market?

Mr Love—The overall approach of Treasury, through its participation on the Council of Financial Regulators, has been that the market requires to be monitored. An important trend has been occurring here and it is appropriate for regulators, along with the policy areas, to monitor these matters and to see where the trends are going. So far there has been no indication of any regulatory failures. The systems, particularly in relation to corporate governance and disclosure, appear to be working as they need to be. Although we continue monitor, we have not seen any need for regulatory change at this stage.

Senator WONG—I was in Queensland yesterday and missed yesterday's hearings, so I may be traversing some of the areas which other senators have traversed previously. On your point about the regulators and monitoring, as I read the press reports of the evidence, it has been quite strongly put by the various regulatory bodies that there is no need to extend any regulation as a result of the increased private equity activity in the market. My first question is: what are you monitoring for? My second question—so you can see where I am going to be fair to you—is: is one of the strong factors around the proposition that we should not increase or alter our regulatory framework to take account of these developments the relative size of that aspect of the market? At what point does that shift?

Mr Love—I am not saying, and I do not think the regulators are saying, that there should never be any regulatory change here. It is not a question of that. What we saw last year with the growing number of deals and the size of the deals that were being proposed was an important market trend out there. The Council of Financial Regulators, in particular, is a forum for looking at and monitoring the way in which the market is developing. The first point to note is that it was felt that it was important to understand what was happening there and what the drivers were and

to look at some of the possible implications that were coming out of those changes and also the trends in the marketplace.

When you look at what is happening with private equity overall you see that it is very much about what happens during a takeover activity. It was a matter of working within the current regulatory environment and the current rules regarding directors' duties and their conflict of interest. The debates around how the offers were being conducted in the takeovers were looked at and perceived in the sense of working within those current rules, which have a more general application. As for the takeover, there was not anything particularly different about the issues that were arising. From the industry's perspective, and particularly for directors and people who were involved in deals, it was important for them to be aware of the possibility of conflict of interest. But that was from the participants' point of view.

CHAIR—Senator Wong, while we had that March review and while there will not be any formal collective monitoring from the council, my recollection of the evidence yesterday was that individual bodies will report back to council where issues are identified over and above those that have been identified to date. I believe that is a reasonable take of what was said yesterday.

Senator JOYCE—Yesterday it seemed that regulations were a bit like Goldilocks's porridge—not too much, not too little but just about right all day. I want to know how we deal with the transparency of you managing the situation on behalf of the nation given that you do not have access to the public reporting standards once a company becomes private.

Mr Love—For companies that become private and go off the market, the key distinction is that they are no longer subject to the continuous disclosure rules of the ASX or whatever part of the market they are listed on. The continuous disclosure rules are all aimed at ensuring that there is market transparency where there is trading. Once a company becomes private it is still subject to annual reporting and other disclosure rules under the Corporations Act. There is no effective change just because a company has gone private in relation to the overall level of their reporting about their financial position. It is in regard to continuous disclosure, but continuous disclosure on the market is aimed at working out pricing signals on a day-to-day basis.

Senator JOYCE—But if you do not have access to the information you are at a disadvantage. For example, let us talk about a proposed buyout of Coles. Currently you have access to all the public quarterly reporting figures. Obviously, if it goes private you will not have that; you will have an annual figure. So you must obviously have less information.

Mr Love—We are talking about information that is principally for the shareholders of the company or the analysts or people advising shareholders or others who might want to purchase shares in those companies. The thing about investment in private equity is that you have focused shareholders who, through the strength of their position, have a strong ability to obtain information that they need to understand the position of the company. Whether or not you are trading the company publicly, that is the distinction.

Senator JOYCE—I understand that. You do not have access to that though, do you? You have access to less information.

Mr Love—Overall, the community as a whole has less access to information, yes.

Senator JOYCE—Yesterday we heard a statement that we have private equity firms borrowing money to finance buyouts and we have the companies that think they might be under the microscope of a private equity firms leveraging themselves up to protect themselves against it. We also heard that this will sort itself out because ultimately, whether driven by the US mortgage rate or not, interest rates will rise and make it unfeasible. Do you concur with the RBA's proposition that the advent of private equity firms increases the pressure on interest rates?

Mr Comley—We do not make any comments on interest rates. That is a matter for the Reserve Bank. Without looking at the transcript, Mr Love and I are not going to make a comment on what the Reserve Bank may or may not have said on interest rates.

Senator JOYCE—I did say that you would have to read it. Are you going to comment on national interest issues?

Mr Comley—Can you expand on what you mean by national interests?

Senator JOYCE—Do you believe that the advent of private equity firms in certain key aspects of the market, such as air transport—because you do not have access to the information that you would if the company were public—should inspire a greater stringency on the national interests test?

Mr Comley—If I go back to what Mr Love said about the access to information, I suppose the issue is what we would be doing with the information that would not be available now under private equity. We certainly do not, for example, monitor quarterly performance of individual companies to see how they are tracking, because that is not our role as shareholders. Where there are national interest considerations of the type I think you are alluding to, obviously the government typically has ways of collecting information other than through the continuous disclosure provisions of the current regime.

Senator JOYCE—Regarding the capital gains tax exemptions that the company holds—and you knew I was going to ask this question, so I am sure you have your notes there ready with the answer—do you stand by your figures of the costing of the capital gains tax exemptions for non-real property assets?

Mr Comley—We are traversing slightly into the area of the revenue issues, but I am happy to take it, given that Mr Brown is not here at the moment. He was, as I understand it, on a 6.45 flight out of Canberra, so in the normal course of events he would have been here at 9 o'clock and was intending to be so.

Senator JOYCE—Have a crack at it. See how you go.

Mr Comley—I think—

CHAIR—Sorry to interrupt. Is there anyone else here who can make some inquiries as to Mr Brown's attendance or where he is?

Senator WEBBER—Yes. Otherwise we can reschedule so that we can ask him rather than put Mr Comley in a difficult position.

Mr Comley—On this issue, I am comfortable answering these questions. I think we should perhaps persist on the basis that he will not be far away, unless you would like to postpone. If you give me a minute, I can make a call.

CHAIR—Flights out of Canberra in the morning and the vagaries of them are no secret to anyone. I am a little bit surprised that Mr Brown was not able to be here on time. There has been plenty of notice and the vagaries of Canberra weather are well known. So I am going to suspend for a few minutes and enable you to see if you can get some indication of where Mr Brown is.

Proceedings suspended from 9.18 am to 9.22 am

CHAIR—We will now resume these hearings. Mr Brown is some 7.3 minutes away. Is that Treasury's estimated time, Mr Comley?

Mr Comley—Treasury does not have expertise in Melbourne traffic estimation.

CHAIR—Had you said yes, I would have been more surprised, Mr Comley. I return to Senator Joyce.

Senator JOYCE—I refer to pie chart No. 8 in the booklet that the RBA gave us yesterday. From their figures, it looks like two-thirds of the financing of private equity is debt. That makes sense out of your thin cap rules. That would have to suggest that, because we have excess negative gearing to what the company already was, there must be a revenue loss to Treasury. Would that be a fair enough statement?

Mr Comley—No, that would not be a fair enough statement. In very broad terms, the issue with the revenue forecasting is that focusing on one aspect of the total transaction can be a misleading picture of the total revenue implications. Indeed, focusing even on all the aspects of one transaction does not necessarily give a full picture of the revenue implications. For example, if I have a new private equity deal—

Senator JOYCE—Talking about private equity, let us take one—

CHAIR—Senator Joyce, just let Mr Comley finish.

Senator JOYCE—I am trying to assist so that we can get a point of clarity. Take one issue in situ and show me what the wider ramifications of that deal are.

Mr Comley—That is what I was trying to go towards. If, for example, I have a new private equity arrangement in a takeover situation, the first thing is that, almost by definition, to take something over, some people have to sell it. So the first question is: what are the capital gains tax implications—or, in fact, it could be the ordinary assessable income tax consequences—of that sale? The specifics of that would depend on the facts and circumstances of the people selling. So it could be either a capital gain or ordinary income.

The next question is: for those people who have just sold those interests in the takeover arrangement, what do they do with the money? It is not as though people who are going to receive money from a private equity transaction do nothing with it. They could do a range of things. They could decide that they are not going to reinvest and they could spend it, or they could reinvest and there could be a range of tax consequences of that.

Secondly, on the other side of the equation you have the source of funds that is going into the private equity arrangement and the question is: where did those funds come from and did they displace some other form of financing somewhere else in the economy? Unless you trace through all the implications that—and that is in the first instance—and then consider what the tax implications are during the period of the private equity holding and any subsequent tax implications on the ending of the private equity arrangement you cannot get a total picture of the revenue implications.

Senator JOYCE—In respect of this debt that comes from overseas, the interest payments would go back overseas so it is not part of your tax take, is it?

Senator BERNARDI—Is it subject to withholding tax?

Mr Comley—It would depend on the circumstances—for example, if there are treaties involved. But the point that is made in a number of submissions as well is that it is going to be a question then of what the net change in foreign financing across the whole economy is. That is the key question, not what the change from a particular transaction is.

Senator JOYCE—Let us look at the capital gains tax implication, and I will walk you through an example. Let us say that I am Piggy Muldoon and I buy myself an airline in Australia. Then I make a $2 billion profit on that airline and sell it to a mate of mine called Helen Clark. Can you tell me how much tax is going to be paid in Australia on that capital gain?

Mr Comley—I think this is precisely the issue that you canvassed with Mr Callaghan in the estimates of 29 May—

Senator JOYCE—Can you tell me how much tax is going to be paid in Australia on that transaction?

Mr Comley—Making the caveat that it is really one of those circumstances where the Treasury does not provide information on the operation of the current law—that is really a tax office thing—what I think you are alluding to is where there might be a transaction between two New Zealand residents, which is the case you raised on 29 May. Generally there would not be an Australian tax consequence of that.

Senator JOYCE—Obviously, if I can conjure up a simple way of how not to pay tax on a multibillion-dollar transaction surely other people could work that out as well and there are people being paid a lot of money to make sure that they do not pay tax.

Mr Comley—Senator, if your proposition is that people will seek to reduce their tax liability, the answer is yes.

Senator JOYCE—To put it more directly: what on earth would make me want to do that transaction in Australia?

CHAIR—I think he did say to you before, yes, which was the answer to your question.

Senator JOYCE—Would Treasury be concerned about that? As an accountant, I have been part of discussions with people about the prospects of what happens if they set up in New Zealand, and this conversation must be going on throughout the corporate world. Why would I stay and base myself in Australia if I am proposing to make a capital gain?

Mr Comley—Part of the reason people base themselves in Australia is to do with a range of things including tax and where the economic activity is going to take place.

Senator JOYCE—It is a global marketplace; I do not have to live here. I can live here and still be part of the global marketplace.

Mr Comley—The question of who owns the assets and where tax is paid is one question. There is also the question of where the economic activity is paid and whether there are taxation consequences of that. Then economic activity will need to be linked to where you have profitable opportunities. So it is not quite the case that you can just have a free choice.

Senator JOYCE—Are you concentrating diligently on that aspect within Treasury and saying, 'We are going to watch this one. We believe that people are going to stay in Australia because they like going to the beach on the weekends but, if they don't, we're going to be watching it very closely'? Are you dedicating yourself to a very clear oversight and watching this absolutely?

Mr Comley—Obviously all the time. One of our concerns is the level of economic activity in Australia and, when it comes to tax implications, we are continually trying to monitor a review as to whether our tax arrangements, including how they fit within our international arrangements, are appropriate. So we are continuing to monitor those issues.

Senator JOYCE—I asked a question of Mr Comley. Have you answered that?

Mr Comley—I do not think so; you went down a different track. Your question, which we did not get to, was: do we stand by the costings of the CGT measure for—

Senator JOYCE—That was the one I wanted to ask.

Mr Comley—I am trying to be helpful.

Senator JOYCE—I am just seeing if you can remember the question. Do you, Mr Brown?

Mr Brown—I can remember it. I can even tell you the numbers, if you want them.

Mr Comley—Mr Brown might want to comment but, as Mr Callaghan said, it is standard practice for us that we do not revise the costing of a measure once the measure comes into effect.

Senator JOYCE—So do the numbers remain $65 million, $50 million, $50 million for the preceding years?

Senator WONG—You never, through a forward estimates process, revise a measure to take into account different economic parameters. That is not correct.

Mr Comley—When we cost an individual measure we are in a forward looking sense looking at the variation to revenue. Once the measure comes into existence then we come back to our standard forecasting approach for estimates, which would not necessarily separately identify that—

Senator WONG—No, but against the various parameters against which you revise the range of forecasts through the forward estimates period, this would form one of them, wouldn't it?

Mr Comley—That is right, but we do not necessarily separately identify it.

Senator WONG—But you could disaggregate it if your modelling—

Mr Comley—Mr Brown might want to comment on that.

Mr Brown—On the revenue forecasts, once a measure has reached what we would call maturity, which means it is growing at the same rate as the revenue base it forms part of, what we forecast is that revenue base. We do not build that up on a measure-by-measure basis. We look at the revenue receipts and then we apply a growth rate to that. The growth rate is derived from forecasts of the growth of the economy.

Senator WONG—Then you are not going to disaggregate them.

Mr Brown—We do not actually do it on—

Senator WONG—We had this argument through Senate estimates, with Senator Sherry et cetera.

Senator JOYCE—Obviously that is one of the key issues and it has been around the press; you know I am going to keep on pursuing it. Will there be any point in the future—the numbers are so perfect; I think they were just put together—when you will come back and give us an appraisal, a disaggregation of those numbers or reconsider them? On behalf of the nation, which is why we ask these questions, I just want to make sure that we have this deal right. Is that ever going to happen in the future?

Mr Brown—I would not be able to commit to such a review.

Senator JOYCE—Fair enough.

Senator WONG—Mr Brown, one of the terms of reference that the Senate passed—as I recall, unanimously, so the government has supported these terms of reference—was that we were directed to inquire into:

c. an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects

Are you able to give us any evidence at all in relation to that term of reference?

Mr Brown—In terms of—

Senator WONG—An assessment of long-term government revenue effects. Do you have the terms of reference?

Mr Brown—Yes, I do.

Senator WONG—Well, you would be familiar with them then. I am asking you to give us some evidence in relation to paragraph C, if you are able to.

Mr Brown—We do not forecast revenue on a transaction by transaction basis in the economy. We look at the overall level of economic activity and actual taxation receipts. Those actual taxation receipts also include a level of activity for transactions such as private equity. We would look at trends in things like particular developments in the economy—whether it is private equity takeovers or whatever—to determine whether they have a material effect on the forecasts we make. But it is not something that we would be building in specific allowances for on a transaction by transaction basis.

Senator WONG—I do not think I asked you about transactions; I asked you about the broader term of reference. So your evidence is that you do consider trends in terms of development in the economy, of which, I presume, the increased private equity activity would be one.

Mr Brown—It is a factor.

Senator WONG—And I am asking you what assessment, if any, has been made of the effect of that trend.

Mr Brown—The assessment that we would make at this stage is—

Senator WONG—So that is a hypothetical. Is it an assessment that you do make, that you have made or that you will make? 'Would' indicates a hypothetical.

Mr Brown—The assessment of private equity is that it is not something that we are in a position at this stage to make a call on.

Senator WONG—In terms of any revenue effect?

Mr Brown—In terms of what the revenue effect is. It is extremely unclear.

Senator WONG—When was that assessment made?

Mr Brown—That was made earlier this year.

Senator WONG—I notice that, a number of times, the Treasurer has made some public statements about these issues. Can you tell me the context of that assessment?

Mr Brown—We have been aware of the developments happening in respect of private equity takeovers and the concerns with them. The issue with something like private equity is that it is very difficult to know what the impact on revenue will be. I think you have had evidence along those lines already. That is because a number of factors need to be taken into account. It is not just the impacts that arise directly from the transactions.

Senator WONG—Yes, I think my question was: when did you make the assessment that you were unable to make an assessment of the revenue impacts of private equity activity. Your answer was earlier in the year. I asked you for the context of that.

Mr Brown—The context of that, as I said, was that there is activity occurring which we keep an eye on.

Senator WONG—No, I am talking about the context internally. Were you asked by the Treasurer to examine this? Was this of your own notion? Was this as a result of the Council of Financial Regulators looking at this issue?

Mr Brown—It was part of our routine process of updating estimates.

CHAIR—Mr Brown, on that point, you are aware of the stability report of March 2007 from the council? Indeed there is a specific reference to the fact that the ATO is, and I quote:

> ... working with some of the businesses where private equity takeovers have been completed or announced in 2006. The aim of this exercise is to understand the tax outcomes of private equity deals at the earliest possible point, particularly given the complexity of some arrangements.

It goes on to list a number of compliance matters that it is looking at. Where is that at?

Mr Brown—My understanding of that is that it has not concluded.

CHAIR—When is it going to be concluded?

Mr Brown—You would have to ask the tax office that. I think what you are referring to is a process that the tax office is involved in.

Senator WONG—And you are not engaged in that at all, Mr Brown?

Mr Brown—I am not, no.

Senator WONG—I am sorry, not you personally; I am talking about Treasury. Is anyone in Treasury liaising with the ATO on this?

Mr Love—I was one of the members of the working group that prepared the report of the Council of Financial Regulators. While not commenting on the details of how the ATO provides its information, our understanding in Treasury through the working group of the Council of

Financial Regulators was that a number of these transactions are occurring either in the last financial year or in the current financial year. At this stage, basically the numbers had not come in. It would take at least a year or so for the numbers to come in as companies report in the normal process of preparing their tax returns for the financial year. So it was simply the case that, with the blip in the significant increase, the tax data collection was not complete. As I understand it, that would still be occurring at the moment.

CHAIR—Mr Love, with the greatest respect, it is hardly a throwaway line in the stability report, is it? There are six key dot points—just for my colleagues' reference—on page 14 of the excerpt. The ATO has also sought as part of its 2006-07 compliance program to ensure that. There are six quite detailed points. I am not going to go through them now, from a time point of view, but, as you wrote part of the report, I am sure you are aware of them. So it is not some sort of general commentary. There are some quite specific compliance issues that they are addressing, aren't there?

Mr Love—This is Treasury speaking, not the ATO. Our understanding is that they are doing that work.

CHAIR—It is not a trick question. You wrote part of the report. There are six dot points there. They are quite significant compliance issues, aren't they?

Mr Love—Yes, from the ATO's point of view. We understand that that data is still being collected. The report mentions that more data needs to be collected with regard to what is happening there. One of the recommendations was to look at additional data. We were looking at that at the time, in March, and it is now only three or four months on.

Mr Comley—I return to Senator Wong's question. I think the point was whether we are in contact with the ATO and whether we will continue to look at this issue. There is ongoing liaison with the ATO as these issues develop. But the point I would make comes back to the point that Mr Brown makes about how we forecast these things. In our regular forecasting arrangements we get intelligence from the ATO, appropriately modified for confidentiality reasons, about developments at, say, the firm level. It informs the forecasting process. But we have to be very careful about individual firm level or transaction based information in the forecasts, because if you are not careful you can focus on one or two large transactions and that misses the point that that money or that transaction did not happen in isolation. So part of our ongoing dialogue is to collect this information about compliance and other revenue issues with a particular transaction but to feed that into a broader appreciation of what that might mean for the economy.

Senator WONG—Clearly. That is self-evident, isn't it? With due respect, you are not going to look at one aspect of a transaction and say, 'There's going to be revenue lost there to the Commonwealth,' without then considering what offsetting revenue increases there might be from other aspects of the deal.

Mr Comley—I am not sure that is self-evident in the debate.

Senator WONG—I think we understand that. But we are coming back to the same issue, which is that we are trying to get some sort of handle on whether you have actually done some assessment—

Senator JOYCE—Homework.

Senator WONG—I was not going to be quite so pejorative, Senator Joyce. We want to know whether you have done some assessment of what revenue effects might arise from increased private equity activity in the Australian economy and, in particular, an increased number of leveraged buyouts of public companies. We are trying to get some sense of whether you have looked at that. Do you consider there are any risks to government revenue and, if so, what are they? As I understand the evidence, your answer has two parts. The first is that it is too early to tell. Can you tell us what you do know to date? You must have done some work on it, given what the chair has pointed out and given the various considerations which have been made by regulators and others that the Treasury has been involved with. The second part is that, even in terms of your economic forecasting, with all the caveats you have put in place, surely you must have had some sense of where the trend would lead. That is what we are trying to get at. Are you able to assist us?

CHAIR—I suspect from the look you are giving that the answer to that is yes.

Mr Comley—We obviously have looked at the issue. The point of our consideration is that, yes, we think it is too early to say what the specific impact is. But the other way of turning it around is to say that we have not felt the need to specifically modify our forecasts on the basis of private equity activity, on the basis of looking at all the considerations and the balance of considerations.

Senator WONG—But there is an assessment which occurs prior to the modification of forecasts, isn't there? That is not the test I am asking for.

Mr Comley—There has been an assessment of the various factors that would feed into the overall revenue implication; there is not precise hard data. However, based on that assessment, at this stage we have not felt the need to modify the forecasts on the basis of private equity but we will continue to monitor it.

Senator WONG—Fair enough; it has not reached a threshold where you would want to modify your forecasts. However, what does the assessment disclose? What are the trends?

Mr Love—I will just come in here as well. This is more from the macro side on the impact. Overall, in our report, we found that private equity investment represented about five per cent of equity investment in Australia at the time the report was done. Since that time the trend in regard to new deals seems to have gone down, if anything. Looking at it in the context of overall equity investment in Australia, five per cent is still a very low amount of the threshold.

Senator WONG—But at some point it may be more than that.

Mr Love—This is the point about the monitoring. I will leave it to my colleague to speak about that.

Senator WONG—Are you monitoring simply for percentage of activity? Presumably, with your monitoring, you have ascertained some sort of trend through your assessment and you want to see where that goes. I am asking you what the trends are and what the assessment is. I

appreciate that it has not reached a level where you want to revise your forecasts, but there is a range of determinations prior to that action.

Mr Comley—There is. If I disaggregate the point, you could say, 'Okay, does private equity in itself'—whatever that means, and there is great diversity in private equity deals—'lead to the prima facie case that there is a revenue implication?' That is the first question. The second question is: if you thought that was the case, is the quantitator of that so significant that you would incorporate it into the forecasts?

Senator WONG—At five per cent, probably not; I appreciate that. But what is the answer to the first question?

Mr Comley—The point with the first question is that we have not formed a definitive view that there is a revenue implication one way or the other with the private equity phenomena.

Senator JOYCE—Did you have a definitive view when you put out the first lot of figures—the $65 million, the $50 million and the $50 million figures? When that capital gains tax exemption position was brought into parliament—which was supported by both sides, by the way—did you take into account the private equity effect in that calculation?

Mr Brown—That forecast was based on a number of factors, including the level of capital gains tax collection that existed at that time from nonresidents. In addition, it included what also had previously been included in the forward estimates for previous changes that were going to be undertaken in respect of capital gains tax.

Senator JOYCE—Did it take into account private equity—yes or no?

Mr Brown—Not specifically, no.

Senator WONG—Why not?

Mr Brown—It took into account the level of existing transactions by nonresidents.

Senator JOYCE—But that is a big hole, isn't it?

Senator WONG—You did not separately disaggregate private equity in terms of the costing of that measure, but that would be included in terms of how you costed it.

Mr Brown—When we cost it, we look at what revenue we expect to receive over the forward estimates period ahead.

Senator WONG—So it may not be disaggregated but it is included.

Mr Brown—It is implicitly included, yes.

CHAIR—Mr Brown, to go back to Mr Colmer's point earlier on about what is the net effect on revenue after taking everything into account—I appreciate that there will be a time delay with that transaction trail, as it cannot be addressed overnight—have there been any discussions with

the ATO as to what would be an appropriate point for you to look at that transaction trail and make a determination about what impact there might be on revenue? I refer back to those dot points, which are fairly wide and all encompassing, about the potential risk to revenue. What is the reporting mechanism internally or, from your discussions with the ATO, what would be an appropriate time frame to ascertain what may come out of that transaction trail?

Mr Brown—As part of the revenue forecasting process, we conference with the tax office and keep current developments under review. We look at the trends in revenue receipts and at what we can see impacting on those as well as potential impacts. However, again, with individual transactions such as private equity, you have to be very careful, as Mr Comley has pointed out already. Not only can you point to potential impacts on the revenue from a particular transaction but also you have to look at what the flow-on effects of that transaction are elsewhere in the economy. Those impacts are often offset elsewhere.

CHAIR—I understand that. I will go back. If the ATO has a compliance program, are you aware of the normal reporting time frame for such a compliance program? There is a reference in the stability report to the ATO's 2006-07 compliance program. I accept the first dot point, 'tax deductions related to financing arrangements are appropriate'. I appreciate that there is a time lag with that. However, with these compliance programs, when does the ATO start receiving data that enables it to make a value judgement about the integrity of the compliance?

Mr Comley—I do not think there is a stock standard answer to that, because it depends on the nature of the transactions. I am talking beyond the private equity sphere here. Some transactions are relatively straightforward to unpick and the tax office may come to a compliance view. Whether they inform us of the broad implications of that compliance program will depend partly on their judgement of how significant and systemic it is. I really think this is one where it is horses for courses, if you like. The tax office continually monitors through a range of compliance programs and then brings to our attention, subject to confidentiality requirements, issues it thinks are of significant substance or that raise policy questions.

Senator BERNARDI—Mr Brown, you might be best placed to answer this question. Are any measures available to private equity firms or private equity investors that are not available to any other foreign investor in Australia, or are our tax laws consistent irrespective of the description of the vehicle used to invest in this country?

Mr Comley—As far as I am aware, there are no specific rules for private equity.

Senator BERNARDI—If you strip away the emotion attached to the term 'private equity' and refer to it just as foreign investment, would it be reasonable to assume that you have done modelling on the implications of an increased level of foreign investment in this country?

Mr Comley—Often, in such talk as this, private equity is synonymous with foreign investment. My understanding is that that is not correct. If you look at the volume of deals by quantity and not necessarily by value, a large number of private equity arrangements are domestic.

Senator BERNARDI—I accept that, but I come back to the RBA having submitted that a lot of the equity that comes into these deals is from overseas—about 50 per cent. I am saying that is no different to any other foreign investment in this country.

Mr Comley—That is no different. I think what you are driving at generally is that our general view is that foreign investment in Australia is positive for economic activity and, therefore, positive for taxation revenue.

Senator BERNARDI—Overall?

Mr Comley—Overall.

Senator BERNARDI—When you talk about taxation revenue—this comes back to another point Senator Joyce made about why anyone would base their business in Australia—is Australia's taxation regime, in your opinion, competitive with like markets internationally?

Mr Comley—I am not sure that I can give a blanket opinion on that point. I think it goes to a matter of policy in terms of its nature because a range of factors will affect that. However, obviously we have observed that we have a continual flow of foreign investment into Australia on an ongoing basis. You can observe that simply by looking at the current account position and the balance of payments.

Senator BERNARDI—Has an estimate been made of the flow-on effects to our economic growth from every billion dollars of foreign investment that comes into this country? Have you ever done that sort of modelling?

Mr Comley—I would have to take that on notice. Within our macroeconomic area we have a macroeconomic model that would model the sorts of impacts of those things, but I am not familiar with the precise modelling.

Senator JOYCE—On what Senator Bernardi said, the private equity firms have stated that they are a definitive part of the market. They are not buying corner stores; they are buying supermarket chains. But they are in the market for two to five years before they sell the company. They are an entity that buys and sells companies. When do you get to the point where you say that the company you hold is more a trading stock than a capital asset?

Mr Comley—That is a question of fact in circumstances which the ATO would have to deal with in a particular case. So that would come to the question of whether it is on capital account or revenue account.

Senator JOYCE—Ultimately, if they buy and sell and buy and sell companies and that is how they make their money, that is no different from buying and selling and buying and selling cattle to make their money.

Senator BERNARDI—Or for individuals with shares. If they hold them for 12 months or more it is deemed a capital gain. If they hold them for less than that it is income.

Senator JOYCE—But, as you know, there are so many share traders who try to get their shares onto income account, don't they, Senator Bernardi?

Senator BERNARDI—I would not be familiar with that.

CHAIR—Would you finish off on this point, Mr Comley, and then I will go to other colleagues.

Mr Comley—I think I have answered the question. I think the point Senator Joyce is making is that whether it is on capital revenue account depends on the nature of the transaction. All I am saying is that that is right, so that is a matter for the ATO and the particular facts and circumstances of a case.

Senator JOYCE—So you are looking at that?

Mr Comley—When you say we are 'looking at it', the issue of what, from a policy sense, should be on capital or revenue account is one of the general issues that we continually have under review as to whether we have the right arrangements.

Senator STEPHENS—I want to take up with you some of the suggestions and proposals that have come through the submissions about how there could be improved transparency in regulation of the private equity sector, acknowledging that yesterday all the regulators said that there was no need for any kind of change, but there are obviously people who think that the regime could be strengthened. So I want to pursue some of these with you and just test them out with you. For example, we have received a submission from Associate Professor Frank Zumbo, who makes a number of suggestions. In relation to the issue of financial stability he makes the following suggestions:

1. That where a major Australian company has been acquired through a leveraged buyout involving private equity investment, the acquirers be required to (a) report immediately to the Council of Financial Regulators any "default" events in relation to the debt or any other aspect of the buyout's funding arrangements; and (b) report levels of debt on a quarterly basis to the Council of Financial Regulators.
2. That the Council of Financial Regulators issue quarterly reports regarding debt levels of Australian companies acquired through a leveraged buyout involving private equity investment; and
3. That the Council of Financial Regulators issue quarterly reports regarding the level of leveraged buyouts in Australia involving private equity investment.

Given the conversation we have had about the lack of information, the lack of transparency, can you respond to those suggestions as to how they would perhaps strengthen confidence, I suppose, in the private equity sector?

Mr Comley—I will ask Mr Love to respond to those comments.

Mr Love—The first point I would make about the professor's suggestions is that probably the Council of Financial Regulators has misperceived its particular role. They look at reporting data to a particular regulator there. Data collection for the financial sector is basically a function of APRA in the marketplace.

Accepting that, what he is suggesting in principle is that people would be interested in that type of aggregate information, but there are significant practical issues with data collection. For a start, there are difficulties in trying to identify what the deals are and how you define them.

There are a series of practical issues which we face constantly in relation to the Financial Sector (Collection of Data) Act, which is the framework for APRA to collect data from the financial sector. There is quite an extensive consultation process and it takes a couple of years before any new type of data is collected from the financial sector. His suggestion mainly raises a set of practical issues—not the principle of the desirability of understanding in more detail what is happening in the marketplace.

Senator STEPHENS—Professor Zumbo's concern is really about the impact of the practice of leveraged buyouts of major Australian companies, that it could have quite a significant impact on Australian taxpayers. It could have ripple effects throughout the economy. His suggestion goes to the issue of default events, which would perhaps send signals that things were going awry. Do you think that has merit, even if, as he suggests, it is the Council of Financial Regulators? You suggest that it should be APRA.

Mr Love—Default events are basically of interest to the creditors of the particular company and the investors in the particular company. One of the features of private equity is that you tend to get a much closer alignment between management and the shareholders of the company in keeping a much closer eye on what is happening. The assumption from that is that the people whose economic interests are most directly affected by the possible default of a large company which has been taken private would be getting clear signals about those events much earlier maybe than if the company were public.

Senator STEPHENS—He also makes some suggestions in relation to transparency and disclosure issues. Perhaps I can test those proposals with you as well. He suggests that the council—or whoever you might think is the appropriate organisation—be asked to prepare and release for comment a discussion paper outlining alternative mechanisms for promoting greater transparency and levels of disclosure in relation to private equity investment in Australia and, in particular, promoting greater transparency levels of disclosure regarding major Australian companies that have been acquired through a leveraged buyout involving private equity investment. I think that reflects the general public's concern about the impacts of this kind of structure. Do you have a comment about the potential for alternative mechanisms that could be part of that long consultation process you have just referred to?

Mr Love—As I understand it, the professor was really talking about having a discussion paper to look at these transparency issues and to think about them. The main issue in the Australian market—we are just looking at Australia at the moment—is that relatively few deals and matters have been consummated. You would be looking at very particular cases; you would not have the breadth of experience that you might get from other markets. There is such a process, which sounds like what Professor Zumbo is suggesting, occurring in the UK at the moment. A discussion paper has been put out—it is referred to as the Walker report, and the committee may be aware of it—to look at those types of issues. Looking at this new type of experience in the UK, there will be a far greater breadth of information coming through from there which we could learn from over the next year or so. You can learn much more from foreign experience given that we have relatively little direct experience of large deals of this nature being consummated here.

Senator JOYCE—There is talk of a code of conduct for disclosure. That is correct, isn't it?

Mr Love—That is one of the issues that have been put up for discussion in the paper.

CHAIR—The evidence yesterday was that there are probably greater disclosure requirements on private equity companies than there are on publicly listed companies because of the nature of the shareholding, particularly the large exposure of superannuation funds where the trustees have quite significant obligations in relation to their members and where there are probably greater financial reporting requirements than there may have been before.

Mr Love—I think that reflects a point I referred to earlier. In private equity arrangements the shareholders have got a far more focused interest and, given the size of the shareholdings, normally they have got the ability to obtain information from management that is probably superior to that of more dispersed shareholders in a publicly owned company who are really relying on the market disclosure rules under the regulations. It is basically a matter of economic power within the company to obtain information.

Senator STEPHENS—Professor Zumbo makes some recommendations about the ATO and about the ACCC. I do not know whether you have any comment to make about whether there has been discussion about how private equity mechanisms might have some relevance or impact upon the trade practices issues.

Mr Love—In relation to competition policy issues, obviously it works for their current trade practices environment. I am not familiar with what Professor Zumbo might have said specifically about any issues relating to the Trade Practices Act but, as always, any particular investment in relation to a deal that is going through will receive the normal level of scrutiny from the ACCC under the current competition provisions of the Trade Practices Act. I am not quite sure what he was suggesting or what needs to change there.

Senator STEPHENS—I will take it up with the ACCC. Yesterday Senator Bernardi raised several questions about national interest issues and I am wondering whether you can comment on how the national interest—

Senator BERNARDI—I think Senator Joyce was more focused on national interest. I, of course, am committed to it but we have a different perspective on it.

Senator STEPHENS—It is an important issue where there are sensitive industries or sectors—and I am sorry, Senator Joyce, if I verballed you. Have national interest issues been considered by Treasury?

Mr Love—There are particular national interest tests on certain types of legislation—for example, the Financial Sector (Shareholding) Act. I am less familiar with the airline regulatory environment and the tests that apply in those matters. Depending on what particular company is subject to a takeover offer in this environment it will be subject to existing legislative tests, some of which include national interest considerations, but that is focused on existing regulation.

Senator BERNARDI—Let me clarify what my question was. It was to a private equity fund manager and it was: do private equity firms take into account the regulations and the Foreign Investment Review Board and those sorts of compliance things before making bids or do they just seek to make the bid and then chance their arm with it? It was in that context. Are they

mindful of these restrictions in some sensitive areas that are declared in the national interest, specifically with Woodside, which I touched on?

Mr Love—You would think though that, if they had appropriate legal advice on these matters, they would take those matters into account. There would be significant legal consequences for them if they did not.

Senator BERNARDI—Indeed that was reflected in the answer. I would like to clarify that.

Senator JOYCE—We have been having discussions about there being greater knowledge by entities who lend to private equity companies because they are keeping close track of their funds and therefore the debt instrument is heavily laden. Are you doing a summary of when these debt instruments just by their nature control ipso facto equity instruments, especially when we find out that there are certain parameters of bonuses that flow back to those people upon certain successes of the equity in the company? How heavily can a debt instrument be laden before it becomes an equity instrument?

Mr Comley—This is a tax issue. This is the debt-equity borderline. There are tests in the Income Tax Assessment Act, division 974, about the debt-equity borderline. Essentially the test revolves around the level of contingency of the payment. It is a little difficult to be more specific because you actually have to go—

Senator JOYCE—In division 974 how are you getting transparency to see exactly what is going on?

Mr Comley—This is really part of the tax office's ongoing audit and compliance activity. The tax office will either be approached by individuals who seek a private ruling on whether a particular instrument falls on one side or the other of the debt-equity line or say in their compliance or audit activity, 'On the terms of this instrument, after examining it, we think it falls on one side of the line or the other.' Treasury have a relationship with the ATO where if there are trends emerging then they will let us know in terms of a policy response.

Senator JOYCE—I understand the process. I will get more specific. Have rulings been sought on the issue of division 974 with regard to private equity firms?

Mr Comley—I would have to take that on notice and refer it to the tax office.

Senator JOYCE—Thank you.

Senator WONG—Because we are almost out of time I will put some of my questions on notice. You were not asked any questions about the examination of the tax structures of offshore private equity funds operating in Australia, were you?

Mr Comley—No, not specifically.

Senator WONG—The secretariat has suggested a question. The committee understands that Treasury is examining the tax structures of offshore private equity funds operating in Australia as part of a wider review—such a wider review was reported in the *Australian* in terms of

comments by the Treasurer on 2 July. Could you tell us on notice what the wider review is and what conclusions if any have yet been drawn. Could you also on notice perhaps provide us with some information as to whether Australia's thin capitalisation laws and debt equity rules have made Australia less or more attractive to more risky private equity transactions. Can you also provide information on whether or not measures designed to encourage venture capital investment are quarantined from access by buyout firms more generally? If you need further information on the detail of that, please contact the secretariat.

CHAIR—Mr Comley, Mr Brown and Mr Love, thank you all for your attendance.

[10.14 am]

MORRIS, Mr Nigel, Director, Takeovers Panel

CHAIR—Welcome. Mr Morris, have you given evidence before parliamentary committees before?

Mr Morris—I have.

CHAIR—I therefore do not need to go through the normal commentary about parliamentary privilege et cetera. Do you have an opening statement you wish to make?

Mr Morris—Yes. The Takeovers Panel has published a guidance note numbered 19 on insider participation in control transactions. The genesis of that document was that, at the start of 2006, the panel looked at the issue of private equity and saw that it was an increasing phenomenon in Australia. We felt we probably ought to have a look at it to see whether there were any implications for takeovers in Australia, or at least the takeovers process in Australia.

The panel formed a subcommittee and invited some outsiders to make sure we had a range of views. Fairly quickly the subcommittee came to the view that the issues in relation to takeovers that private equity raised were in fact issues that are seen in a lot of other buyer types, and the panel decided that there was not a lot, in particular in relation to private equity, that it wanted to say. It considered that there were a number of aspects of takeovers that private equity threw up into somewhat higher relief and that it was sensible and appropriate to give the market some guidance on the sorts of issues that were probably a bit more common in private equity but which in fact can arise in takeover bids from almost any bidder type. So we submitted the guidance note to this committee as, in essence, the primary submission we had to make.

CHAIR—Do you view the issue of that as a proactive or reactive measure?

Mr Morris—It depends which side of the fence you are looking at it from. We would say that it was reactive, because it was in response to seeing market discussion and an increased incidence of bids from private equity bidders. It was proactive in that, at the time we put the guidance note out, we had not had any particular disputes brought before the Takeovers Panel that involved private equity bids. So, in some ways, it was reactive to market developments and, in other ways, it was proactive in looking at them before we had any disputes. The panel is quite a large body and has 47 part-time members, but when it gets a dispute before it only three of those sit on each individual dispute. What we like to do in areas where decisions might be difficult is to get the views of the wider body so that when any three of their brothers and sisters get to be faced with a particular issue, they have the benefit of the wider body thinking about it at perhaps some more leisure, rather than in the pressured circumstances of a takeover. So it was a bit reactive and a bit proactive.

CHAIR—The question is framed around whether it was in response to potential concerns, as opposed to addressing a specific concern, and you have answered that question for me.

Senator WONG—Mr Morris, perhaps I could start with a real-life issue: the Qantas bid and the perception that was certainly put to various members of parliament of an arguable conflict of interest. I commend you for the fact that the Takeovers Panel jumped on this fairly early. It has been a very useful addition to the discussion. But to what extent do you think your guidance note addresses some of the public concerns which were raised by that particular bid and the policy which arises there?

Mr Morris—The panel thinks that managing those sorts of conflict issues is a job for boards.

Senator WONG—What if the boards do not?

Mr Morris—If the boards do not and there are issues in relation to the competition for the control of individual companies not being efficient, competitive and informed, then people have the right to come to the Takeovers Panel. The first Qantas application was brought by the pilots association. The panel will look at issues that people bring before it. The panel is not a proactive body in terms of individual transactions. We have no surveillance powers; we have no surveillance resources. We have very little ability to act off our own motion. The most that the panel can do is refer a matter to ASIC or ask ASIC whether it wants to refer a matter to the panel. If there are issues, we keep an interest in the media, but we would not be involved.

Senator WONG—In relation to some of the reasonably well-publicised takeover bids where management did have a significant financial interest in the bid succeeding—

Mr Morris—Pre or post our guidance note?

Senator WONG—That is a very good point.

Mr Morris—Or doesn't it matter?

Senator WONG—I am not sure it necessarily matters. To your knowledge, in both circumstances, have there been bids where you would say that, at least from the public reporting, some aspects of your guidance note would not have been complied with? For example:

Insiders should seek the board's consent before they take any action, enter into any discussions or provide any information in relation to any possible bid.

… … …

... insiders should inform the board:

(a) as soon as they are approached by a potential bidder ...

Mr Morris—It is fairly difficult for me to know, because that would be inside company information. I am not sure when people actually went and told the board. It is not the sort of information that is likely to come out.

Senator WONG—To what extent, then, is the guidance note of utility? How effective is it?

Mr Morris—People are going to comply with our guidance note. People are going to comply with the law.

Senator WONG—They are not the same question.

Mr Morris—Indeed.

Senator WONG—Presumably, if you do not comply with the law there are potentially sanctions.

Mr Morris—Yes, and if you do not meet the standards set out in the guidance note and someone brings you to the Takeovers Panel, you run the risk of getting a declaration of unacceptable circumstances and orders.

As for the feedback that we have had, the Law Council of Australia said that they did not think there was any point in our putting the guidance note out. We put the guidance note out for consultation with an issues paper and we published that in our public response document. The Law Council said that it thought that most of the conflict issues were adequately covered by existing law. Most of the market though has said that they appreciated some guidance from the Takeovers Panel. The law firms that we talk to say that it is useful. They like to be able to have the panel guidance note—

Senator WONG—So they know what they are supposed to be doing?

Mr Morris—Yes. Often they say it is useful to hold up to the client and say, 'This is why you have to do it this way.'

Senator BERNARDI—Is it fair to say that this is a best practice that you provide but that some of it is voluntary compliance rather than through the Corporations Act? Yesterday we asked ASIC a very direct question on whether they were in a position to deal with conflict of interest. The answer to that of course is yes—

CHAIR—I do not think that compliance with the Corporations Act is voluntary—

Senator BERNARDI—No, it is not, but is this a best practice manual for voluntary compliance? Is that what you are suggesting?

Mr Morris—We would not suggest that it is entirely voluntary. We would suggest that if you are not meeting those sorts of standards then there is a problem. If someone brings an application to the Takeovers Panel saying that those standards are not being met, you run the risk of a declaration and orders against you.

Senator BERNARDI—Has anyone done that?

Mr Morris—In relation to this particular guidance note?

Senator BERNARDI—Yes.

Mr Morris—No, not yet.

Senator WONG—Just to get the process clear: the Takeovers Panel would be seized of a matter if there was a referral in accordance with the provisions of the Corporations Law?

Mr Morris—Yes.

Senator WONG—So they would be the only circumstances in the context of a private equity buyout, a leveraged buyout, by a private equity firm that you would be required to turn attention to?

Mr Morris—We get a series of phone calls from time to time from lawyers acting for—

Senator WONG—But that is an advice process. I am talking about actually having a formal process where the Takeovers Panel can then make certain recommendations or findings.

CHAIR—Wouldn't it be limited to publicly listed company references though?

Senator WONG—That is what I am trying to get at.

Mr Morris—Absolutely.

Senator WONG—It is the same process—to pick up the chair's point—that relates to a publicly listed company takeover, so there is no qualitative difference in terms of your process between a takeover of a publicly listed company by a private firm compared to a public company takeover of a public company. Is that correct?

Mr Morris—Yes.

Senator WONG—In terms of the guidance note, the only enforcement—for want of a better word—mechanism is really, as Senator Bernardi was saying, where if you are seized of a matter by virtue of the mechanism we have discussed, you may have regard to whether or not one of the parties has complied or not complied with the guidance note. Is that correct?

Mr Morris—Yes.

Senator WONG—In those circumstances the panel still has a discretion about what weight it places upon the failure to comply?

Mr Morris—Yes.

Senator WONG—So in that sense it is discretionary—it is guidance.

Mr Morris—It is discretionary within the panel's power, yes.

Senator WONG—How many other guidance notes has the panel put out? Is it a reasonably common event?

Mr Morris—Nineteen.

Senator WONG—How often would you have considered non-compliance in the context of your activities? Is that regular—

Mr Morris—We probably try to cover most of the field with our guidance notes eventually. At least 50 per cent of the matters that come to the panel would have someone saying, 'Those people over there did not comply with your guidance notes.'

Senator WONG—For example, I have some sense of the ASX listing rules and the level of compliance with those—which are, technically: if not, why not? But, in general, people comply, and they disclose if they are not able to or if there is a sound business reason for it. So in the 50 per cent of cases or in those cases where there has been a noncompliance with the guidance note issued—

Mr Morris—Alleged noncompliance.

Senator WONG—No. I am asking about where there has been noncompliance. We are moving on from alleged situations. You get the allegation. Presumably, the panel then makes a determination as to whether or not it considers that that allegation has been established.

Mr Morris—Yes.

Senator WONG—In those circumstances, when you have found that there has been some noncompliance with the guidance note, how often do you then act upon that, or how often do you not? I am trying to get a sense of how often you say, 'They didn't comply, but it doesn't matter.'

Mr Morris—There are a lot of cases where the allegations are a bit tenuous.

Senator WONG—That is the first question. I am not particularly interested in that, because that is a question of fact.

Mr Morris—The panel, if it considers that noncompliance with a guidance note is material, always acts or is given a solution before it acts.

Senator WONG—So would it be your evidence that, in most circumstances, noncompliance with the procedures in the guidance note would result in some form of action by the panel or action offered by one of the participants?

Mr Morris—Yes.

Senator JOYCE—Mr Morris, if I were able to convince somebody overseas to lend me $11 billion, even though I did not have a feather to fly with, and I decided that I would buy Qantas, would that concern you at all?

CHAIR—Senator, that is a very large and broad brush.

Senator JOYCE—I am trying to paint a picture for Hansard so that the people watching this do not fall asleep.

Senator WONG—Are you suggesting I am putting everyone to sleep?

Senator JOYCE—No. I am suggesting you are putting some of them to sleep, not all of them.

Senator WONG—Outrageous!

Senator JOYCE—Is the level of debt ever taken into consideration by the Takeovers Panel? Is it considered that you can have excessive debt that puts unnecessary strain on the business structure and that, therefore, if the deal falls over, you are putting at risk a vital component of the nation's infrastructure?

Mr Morris—Is the panel's concern about vital infrastructure? No. That is just not our role and responsibility. We would be concerned about making sure that in fact you did have the $11 billion so that if shareholders accepted your offer they would get paid. The panel's second concern would be that, if some of those shareholders were going to remain in the company when you were running it, they had adequate disclosure of the sort of leverage that you had taken on and the risks for them in staying as shareholders if you became a controller of their company. The panel's concern is the takeovers process. Our concern is an efficient, competitive and informed market. Our concern is information to target shareholders. Our concerns would be that the people who accepted were going to get paid and that the people who did not accept or were thinking of not accepting were aware of the level of gearing and what the consequences for them as future shareholders might be.

Senator JOYCE—So leverage is not the issue. The issue is: if you have a reliable term of credit then that is all that really matters and it goes on from there.

Mr Morris—In terms of payment and gearing, shareholders who stay in need to understand what the level of gearing is and what the risks are.

Senator JOYCE—I am going to go through two things that you have just brought up: adequate disclosure and an efficient, competitive and informed market. Do you believe at a period of takeover that people who hold the position of director inherently have a greater access to disclosure and have a far more informed position on the market than the shareholder and therefore have a conflict of interest if they are a participant in the process because of the ultimate superiority of their knowledge of what is going on?

Mr Morris—Clearly, the target directors will have better information on the company than their shareholders; they are privy to all sorts of non-public information which, for various reasons, is not made public. You would have to assume that that is in compliance with their continuous disclosure obligations. When it comes to takeover, there is an obligation on the target directors to put into the target statement all material information. The problem with a target statement is that, if you publish a 1,000-page target statement, who is going to read it? The problem for directors in those circumstances is always what they leave out while still making it informative for their shareholders.

Senator JOYCE—Do you think that inherently there is always a suspicion when someone says, 'This is a great offer for you to take, but I'm staying in'?

Mr Morris—I would always wonder why someone was staying in and recommending that I get out. It would be appropriate for the directors to explain why they were staying in.

Senator JOYCE—With the Takeovers Panel work, is there a comparative analysis with your colleagues who do similar work in New Zealand or the US? Do you ever cross-reference with them and find out the issues they take into account, the issues we take into account and whether there is uniformity of culture—that we are not missing anything or maybe they are not missing anything?

Mr Morris—New Zealand is a good case. A member of the New Zealand Takeovers Panel, who is a member of our panel, was in Sydney on Monday at one of our roundtable conferences between panel members. The SEC in the US is a difficult comparison. They have such a different regime. We talk with the SEC. In Melbourne in 2002 we started off the first conference of international takeover regulators that had ever been run. The SEC attended that. We talk to the SEC on a regular basis. We talk to the London panel on a regular basis. London's regime, in many ways, is probably closer to our regime. Australia has a unique regime; nobody else runs quite the same thing. Nobody else quite runs the front-line regulator, ASIC, as well as the Takeovers Panel. We talk with the US, London and New Zealand. Hong Kong talks to us from time to time.

Senator JOYCE—Do any of those countries take into account the level of debt in a takeover or do they just take into account whether your debt is valid? You say that in Australia we say: 'We don't care how much debt you have got, as long as it is bona fide. The business is yours.' Is it the case that other countries say: 'We do take into account how much debt you have. If you are overgeared we have serious concerns about whether this will work in the long term'?

Mr Morris—If you are talking about takeovers regulators, I think that we are consistent with the rest of the world. There will be other parts of government in all of those different jurisdictions who have exactly the concern and thinking that you are talking about. I do not think the takeovers regulators have an approach that is any different from ours.

Senator JOYCE—Obviously banks are of a national interest. You cannot have a takeover of one of the four major banks by a foreign entity. Are you in a position to say, 'Why would four banks be of national interest but not two retailers?'

Mr Morris—That is fully outside my area of competence.

Senator BERNARDI—On the conflict of interest issue, the Corporations Act ensures that transactions by directors and officers of both the target corporations and the bidding vehicles comply with comprehensive conduct and disclosure rules. It also applies to intermediaries and advisers involved in the transaction. In your opinion, do you believe that the regulations already in place to deal with appropriate conduct of bidders, bidding vehicles, target corporations by directors, officers and intermediaries under the Corporations Law and also with reference to the Takeovers Panel are adequate, and do we need to make any regulatory changes?

Mr Morris—Based on our experience so far, we do not see any particular need. We will continue to look. At least since the guidance note was published, we have not seen any matters come before us that have caused us concerns.

Senator BERNARDI—So it seems to be working. Where there have been conflicts of interest or perceived ones, ASIC has been doing its job by intervening appropriately.

Mr Morris—ASIC and other market participants. One of the things about the Takeovers Panel is that it is not just ASIC that can bring applications before it. Rival bidders, unhappy shareholders as well as ASIC can bring issues before the Takeovers Panel. There are additional layers of surveillance and scrutiny with other people out there acting in their own commercial interests. At the moment—touch wood—it seems to be adequate.

Senator BERNARDI—So there is no cause for alarm, but people are monitoring ongoing changes in this area and it is an ongoing process.

Mr Morris—It is an ongoing process. Whenever you get market changes, people just increase their focus a bit.

Senator WEBBER—Yesterday, we received some detailed information about how relatively small the private equity market in Australia is and its percentage in the overall market. We heard about the impact that the Qantas deal would have had on the market and how much that market would have grown. Given complexity of these issues, do we have enough trained staff to manage this conflict of interest? If Qantas had gone ahead, would it have been able to buy up all of the expertise in the Australian legal-financial market that deals with these issues? Would we have to get countervailing advice from elsewhere?

Mr Morris—In terms of professional advisory services, we have a pretty deep market in Australia. In terms of the market in general, the people who are looking at this and are supposed to deal with it are the board of directors of the range of companies that might become targets. I think Australia has got a very good and deep professional advice industry. In terms of boards of directors, we have a lot of good people out there and, hopefully, they have got some assistance from the panel's guidance note on these issues.

Senator JOYCE—In relation to a management lockout or a professional advice lockout, do you think it is valid that people can come into a deal and tie up in one form or another the key legal firms in the town? You can always find spare lawyers in Canberra, by the way—lots of opinions.

Mr Morris—There have been suggestions that that has been tried. The advisory fees and the like on the other side are frequently going to be as big as the advisory fees for the bidder. I doubt that the professional firms in Australia would accept the lower retainer fee. It would be like saying, 'You're locked up but we're not going to use you,' compared to saying, 'We're not prepared to be locked up if there is the possibility of getting the advice work for the other side.' There is always advice work for a rival bidder in lots of these transactions. We have had competition because we have had rival bidders. If you tie yourself up for one bidder then you miss out on the possibility of doing that other work. I have heard anecdotally that it has been

tried, but I do not think that you should stand between lawyers and investment banks and a pile of money.

Senator JOYCE—There are management lockouts and legal lockouts. Are there other forms of lockouts employed as a tactic in the dirty world of takeovers?

Mr Morris—It is not a dirty world.

CHAIR—I think it is actually state premiers and a bucket of money—

Senator JOYCE—In the intriguing world of takeovers, what other forms of lockouts have you seen? There are management, legal and finance lockouts.

Mr Morris—I do not think that we have seen successful legal or finance lockouts. I think that, with the panel's guidance note, the boards will be very careful in not allowing management to be locked out. A board will need to address very carefully the costs and potential benefits to their shareholders of decisions about access to management. I hope that we do not see that as an issue.

Senator JOYCE—How is the Takeovers Panel lobbied? Are you lobbied? How do you regiment, control and keep a clarity and consistency in how you deal with what would be immense pressures at times?

Mr Morris—We manage interaction between parties and panel members. Our model is that the panel makes its decisions based on written submissions. Parties have interaction with the panel executive. We are fairly used to people lobbying from both sides. We are a government agency—

Senator JOYCE—What form does that lobbying take? How do they lobby generally?

Mr Morris—It is generally by trying to persuade us of the policy merits of their arguments and why the things that their client is doing meet the tests of an efficient, competitive and informed market and why the things that the other side is doing do not.

Senator JOYCE—Is that all done in the office, by appointment and with minutes, or is it done informally?

Mr Morris—The submissions that go to the Takeovers Panel are written. They are copied to all parties in the proceedings and, almost invariably, ASIC is a party to the proceedings. The panel is obliged to conduct itself within the rules of procedural fairness. Parties are told regularly and routinely that the panel executive is not a decision-making body. Its views are not binding. Its views are its views but the important views are those of the panel members.

Senator JOYCE—Do they ever approach you informally?

Mr Morris—When you say 'informally', yes, they ring us up.

Senator JOYCE—Out of hours and invite you out to dinner—that sort of stuff?

Mr Morris—Yes. Do I go? No.

Senator JOYCE—That is the question I am getting to. On something that is so clear, how do you maintain that integrity—and I am not doubting your character for one moment—or even the perception that there would be any question of it?

Mr Morris—You only do things in public.

Senator JOYCE—So people do approach you. They do say, 'Come out to tea and we'll have a yarn about this.' It is a statement of the culture within the Takeovers Panel that you say, 'No.' If someone breaches that, do you kick them out?

Mr Morris—We have not had that example.

CHAIR—Thank you, Mr Morris.

Proceedings suspended from 10.51 am to 11.15 am

HODGES, Mr Brian William, Managing Director, Bradken

PORTER, Mr John, Chief Executive Officer and Managing Director, Austar

Evidence was taken via teleconference—

CHAIR—Mr Porter, welcome. Thank you for joining us via teleconference. A warm welcome also to Mr Hodges, who is with us in person. I gather that you wish to table a document, which has been distributed.

Mr Hodges—Yes.

CHAIR—I assume that neither of you have appeared before a parliamentary inquiry until now. Is that correct?

Mr Hodges—On my part, yes.

Mr Porter—I appeared before one about 10 years ago, but my memory of it is very vague at this point.

CHAIR—I might need to refresh your memory, so I will just go through the standard opening statement. This hearing has been convened to receive evidence in relation to the committee's inquiry into private equity investment and its effect on capital markets. It is a public proceeding, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera.

I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, they should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer, the witness may request that the answer be given in camera. Such a request may also be made at any other time.

Mr Porter, for your information, Senator Joyce, Senator Bernardi, Senator Stephens, Senator Webber and Senator Wong are also in attendance. Mr Hodges, would you like to make an opening statement?

Mr Hodges—I am pleased to be here and to make this contribution. I am currently Bradken's managing director and have run this particular manufacturing company now for 10 years. I have submitted to the committee a presentation that I gave to an AVCAL conference here in February. It is a public document and is on the Bradken website. It might be useful both for me to refer to a couple of slides in it and for you later on.

I have had the unique experience of running a business unit for a major public company that needed to dispose of that business unit; it sold it to private equity. I lived through that experience and I am still normal. For three years now, I have been running a public company that is growing and expanding quite rapidly. Today it is at about 160 or 165 on the ASX. I think there are some learnings there that might not be revolutionary but might be useful to the group and I was keen to come and present them to this committee. That is my opening. It is in that area that I can probably contribute rather than in some of the other more technical or financial areas that others have presented on.

CHAIR—Would you like to go to the pieces in your presentation to which you would like to refer?

Mr Hodges—Yes. I will just precis my presentation for a few minutes. Please turn to page 6. For those who have never heard of Bradken, we are Australia's major foundry and heavy engineering group and we make the products pictured on this page. We make about half of the number of freight rail wagons that are needed with the expansion of the mining industry. You can see in the bottom left-hand corner all our ware products on the front of a big mining excavator shovel. We make all those ware parts and sell them to all the mines. There are various other products there. The thing that looks like large marbles is quite large; it is two or three feet across and grinds coal in a power station. It is those highly differentiated ware parts, which are quite technical to make, for which we have the IP, the foundries and the steel-making manufacturing capability. We do a lot of product development on them. We sell direct to the mining industry, both here and overseas. The business has been around for about 85 years.

Looking at page 7, each of the slides has a red section, which is the private equity section. There are a couple of pages here that are useful, but I will just spend a little time on page 7. We belong to the ANI Corporation.

CHAIR—We do not have colour.

Mr Hodges—On this particular slide, 2001 shows where it is private equity. There was a period when we belonged to Smorgon's ANI Corporation. Smorgon sold us those companies as it was looking to reduce its debt. Those companies had not been invested in Bradken. We went to private equity for three years and then floated on the Stock Exchange in 2004.

If you look at sales revenue on page 9—again you do not have colour—there is the number 162. After December 2001, it goes through to the 226 period at December 2003. In the middle of the private equity period, there is quite a turning point in this business's revenue. In all businesses, the simple adage of 'get good and then get big' is really the role of the leadership and the CEO. Quite a lot of work went on, as is required by businesses, in the Smorgon-ANI time to improve this business. That work was coming to an end back in December 2002 and the business started to expand and grow throughout that period. Turning the page, you will see that the EVDO, which is basically the profitability of the business, is doing the same. It is tracking the same. In fact, it is stronger and on the graph it is the highest slope.

The next slide is on capital and it is at page 11. One of the things that private equity could do here that the previous ownership could not do was to make some capital available. Senator Joyce, do you have that page?

Senator JOYCE—No, unfortunately I do not.

Mr Hodges—You can see that in the latter stages of the public companies that were struggling at the time the capex was getting lower and lower. Private equity then came with enough investment to allow us to open that. In this particular operation, that was the enabler that started the growth.

CHAIR—Is that capex for the year 2002 or the year 2003 under private equity?

Mr Hodges—It is a full year with a June-30 year end, so effectively it will be from June 2001 to June 2002. On page 12 you will see the number of employees. What is not quite as obvious in that slide is that, in the years up to and including 2001 where there were roughly 1,450 employees, we retrenched 1,000 people. That was the phase of getting good, where we shut down a number of plants. We had no capital to spend, but we became more efficient through work practices and a lot of change.

Nobody ever made a big company without increasing employment, I think. You can make a better company by having some initial reduction in staff, which we did. We lost 1,000 staff out of 1,400 so that was quite a lot. From that 2002 year on, we have increased staff levels. Today we are just tipping 3,000 staff. We have not had any further reductions in staff. One of the real secrets here is shown by this next slide. This is an interesting slide for those with a financial background. We are talking about profit per dollar of sales and working capital so how much money is employed in running the business and how efficiently it is being used. You can see from slide 13 that there is a long-term trend through the three periods. Management has been quite active here in doing that. That was kept going through the private equity period. They are areas that private equity really focuses on: the efficient management of funds with high gearing and no waste in financial management. Then again, that is the currency of what you buy and sell businesses in so obviously they are going to look at that efficiently. Bradken has become very efficient and almost crossing those lines over is a good result—and that is the reason it is growing so well now, having lots of money to grow with and funding its growth with debt. So we have changed this business from having a huge gap in terms of how much money it needs to operate to now being able to grow and generate money at the same time.

I will not go through all these slides. I will just take you now to what we have learnt from the three periods at slide 20—and there is some good information in between but I will not take up the committee's time. Often the focus of the business unit in ANI and Smorgon, although it did vary a little, was more on revenue than on the generation of cash or profit. The organisation structure initially was quite steep—it was not very flat—and the internal measures were not correct in terms of focusing on growing the business. So we were a business unit within a very big company. The measures at the top of that company were probably correct for the company but they were not down at the business unit level. So we did see some improving business performance, as you saw on the graph. Management did understand the consumable products business model. The Bradken brand was not developed; the actual hire company brand was there. There was not a brand for employees to really focus on, gather around and be wedded to so the culture was less defined. People were not really aligned to the business. What happens in private equity ownership? The first thing that happens is that there is a lot less non-value adding work. People become very focused. You do not do as much reporting. You do not do as much filling out of monthly reports to send up through the levels of an organisation; you are at the top

of the organisation and you talk directly to the people involved. So the non-value adding work for the senior people goes down.

CHAIR—By 'people involved' do you mean the shareholders?

Mr Hodges—Yes, they are shareholders, but they are also the senior management. So the senior management have less non-value adding work than you do in a public company or a business unit sense. There is equity ownership for management. There is one focus—that is, generating cash. So it becomes very simple. You do not have a whole plethora of things to focus on; you start focusing on EBITDA, effectively. The owners now share a very healthy interest in the business and they get quite involved, whereas in the public company sense, while there is continuous disclosure, no shareholder can get anywhere near that close or involved and add value or question things at that level. For senior people there is now a defined employment period and a clear target. This is a period of three to five years with specific things to do and targets to meet. So you are able to break that up into units of time and say, 'I need to be here by this time and there by that time.' That is very important in planning, testing if you are sticking to the plan and seeing how you are going. Management are encouraged to act as though they own the business.

What was very important for Bradken was the re-establishment of this 80-year-old brand, which was well known in the mining industry but had been superseded. Now we have a focus company and the brand being re-put, with the employees knowing the brand and becoming proud to belong, which is the vision for the company. We learnt to manage higher debt levels. The business moved from this improvement phase into the growth phase before we exited.

We are now a public company. We spend more time on reporting and on some non-value-added activities. Our short-term results are critical because our owners are now traders. So time and effort are spent thinking about the impact of continuous disclosure. Even small changes in the performance of the company can have a significant impact on what is happening. Earnings per share and growth are now clear targets. The target moves a little. There is the ability to plan for the longer term and for larger changes to sustain that growth over a long period. We can think in the longer term. Ownership change is now a constant reality. Shares are traded every day and the people involved are changing. We still have a very strong focus on cash.

I have included slide 23. I asked what the lasting contribution was that I saw coming out of private equity. I saw an improved business in many aspects by challenge, focus and support for management. I found that the private equity owner was very much closer to the business and challenged many of the known norms—the things people always said were 'the way it has to be done'. Often he was not right. But by challenging them he made people re-understand what was really the bottom line, what they needed to do and how they could get a better result. By being focused and challenging—and there are many smart, young, high-energy type people involved, in our sense—it was very useful for older management, who had maybe lived with concepts for a long time, to have those concepts challenged. That was really important. They added the missing element, which was capex, in our context. They created this culture of ownership. When I say 'management', this was the top 20 people in our company. They all gained equity, which they had to purchase, but they became real shareholders. That had a really big impact on the culture and on how the business went forward. That was critical in being able to lead the company forward.

Share options were introduced for the first time in that period, which was very good. We continue to this day to flow them lower and lower in our organisation to try and get our employees involved in share ownership. We have found that is beneficial to the culture and to people becoming part of our 'proud to belong' vision. We flowed the company on to the public markets at an excellent time.

Senator JOYCE—Can you explain briefly what you mean when, at page 22, you say that from 2004 onwards more time has been spent on reporting and on non-value-added activities?

Mr Hodges—From 2004 onwards we became a public company again. A lot of my work is external—spending time with customers, bankers and so on. Now 30 per cent of my time would be spent dealing with analysts and on reporting and the management of those issues.

Senator JOYCE—So your statement compares your time in private equity to now.

Mr Hodges—It is a matter of being properly geared up to do that. I think that for our company the private equity time was valuable. It brought the things that I have put in this presentation. I am certainly enjoying my time now as well.

CHAIR—Thank you. Mr Porter, you have had a long wait but you got a free plug for Austar while we were on hold before, so it has not been a complete waste for you. Do you have an opening statement to make? We will then move to questions from the committee to both of you.

Mr Porter—I will try to be brief and concise and not repeat some of the major points that Brian made. I want to give you some context on Austar's involvement in private equity. I have been the chief executive of Austar since its inception in early 1995. Austar is a company that focuses exclusively on regional and rural Australia. It is also a company which has essentially had to go out and raise every dollar that it has spent growing this business.

By the time we began to speak with private equity or were attracted to private equity as a capital option for the company, which was in the 2001-02 time frame, we had raised about $1.4 billion in capital markets in the form of, initially, high-yield debt or public debt, which was raised in the US; secondly, commercial debt, which was raised by a consortium of international banks out of Australia; and, finally, through our initial public offerings and secondary offerings in 1999. The situation that we faced on the back of the so-called tech wreck and the structural impediments in the development of the subscription television industry—some of which were of our own making but many of which related to the fall of Australis and the shareholder issues within Foxtel, which affected our business—had resulted in the company being in breach of the operational covenants of its commercial debt and the financial obligations of its high-yield debt.

There was essentially no access to capital for non-investment grade companies in Australia around that time frame. We pursued an option, through private equity, to try to restructure our balance sheet to put the company in a position to move forward and to continue to grow. During 2001-02 the company substantially pared back its capital activities, did not add any subscribers and restructured its operations, essentially going from about 1,100 employees to about 600 full-time equivalents, with about 400 outsourced resources in the regional areas, primarily in technical services and installation.

That was prior to CHAMP becoming involved with the company. CHAMP were attracted to the opportunity to come in and help us restructure our balance sheet. They saw a company which had a good fundamental operating environment—essentially a franchise in the category of subscription television in regional and rural areas—but which was severely upside down in terms of its capital structure. They brought new money and invested about $100 million in the company at that time. But, primarily, they brought real leadership and credibility in the capital raising and with our existing debt holders.

I had been spending a substantial amount of my time fending off 15 commercial banks in our bank syndicates. My biggest problems were with two out of the 15 banks, both of which were Australian based—Macquarie and CBA—who were quite intent on perfecting their security at that time. So CHAMP took a bit of a risk. Most capital market participants at the time would have picked up the paper and pretty much considered Austar to be a dead duck. CHAMP looked beyond the headlines and came in and took the time to understand about the business. They negotiated an exclusive period in exchange for a commitment to do about $1 million worth of due diligence. Ultimately, they invested the money and provided the real focus at the board level with our banks and in the public markets to give the company the opportunity to turn around and grow.

I would certainly echo all the comments that Brian made about the positive elements of participating with local focused directors. It was great to have the opportunity to bring a management team together under a sort of quasi-management buyout incentive structure whereby the management team invested $2.5 million in the company focused on long-term earnings per share growth for the company. I still have the same 12 senior executives with the company today that I had in late 2001 when we initially put this incentive plan together. That has been one of the real underlying strengths of the company. Some of the highlights operationally of the time in which we worked with CHAMP were improved operational reporting and financial accountability. We probably ended up having more meetings than most management teams would like to have, but that brought real discipline and accountability to the company that benefited shareholders and the company alike.

We were with CHAMP for about three years. The turnaround was substantial. CHAMP invested about $3 million of equity value. It is now a $2.5 billion company registered on the Australian Stock Exchange. We remained listed through the entire period. This was something that CHAMP were willing to do. The private equity model gets a bad rap for having one strategy and sticking to it. CHAMP showed a lot of flexibility in terms of the level of their participation, which was not full control. They had negative control on the board but not full control. They also allowed the company to remain listed during the period and gave the public shareholders exposure to the turnaround during that period. Also to their credit, they knew when it was time to go. They certainly recognised that the real value add in their participation had been completed. They said to me, 'We look at a three- to five-year investment horizon and if the company is going very well it's probably closer to three years,' and that is exactly what it turned it to be. The exit was well-orchestrated and timely. It did not involve a lot of management time. Most of the stock ended up back in institutional hands here in Australia in the superannuation funds and with retail investors. That gave them an opportunity to continue to participate in the company, the equity value of which has improved another 80 per cent since the exit of CHAMP in December 2005.

CHAIR—Thank you for that. They were two very interesting perspectives, one on a company that was delisted—for want of a better word—and one on a company that stayed listed: interesting perspectives.

Senator BERNARDI—Mr Hodges, I have a question of clarification before I get to a couple of other issues. You talked about the number of employees and referred to graph 12 in the document you have tabled. You said that there were 1,400 employees and you retrenched 1,000 of those 1,400. So you got back to a base of 400?

Mr Hodges—They will be year end figures. Over that period, there were about 1,000 retrenchments. In that time, we were rolling a number of ANI businesses into this organisation that we call Bradken today and exiting those employees who were in parts of the business that were unprofitable and unworkable. They are year end numbers.

Senator BERNARDI—From this graph, you retrenched 1,000 and 1,000 new employees were added over the course of the year.

Mr Hodges—They were businesses coming in, so there were times when the number might have been closer to 2,000 and then dropped back as we rolled in businesses.

Senator BERNARDI—Thank you for that. I want to discuss how this deal was initiated. Smorgon obviously wanted to dispose of this business. Was it a case of management saying, 'Sort out a private equity partner,' or did they go out and seek financing of some description in order to purchase it or was it Smorgon that sought it? How did it happen?

Mr Hodges—It was obvious to management that eventually the business would have to be sold. One of our major licensees and one of the senior executives outside of the company had discussions and then talked to the private equity people. Then the private equity people took it upon themselves to talk to Smorgon. The thing moved very quickly from private equity going basically to Smorgon. That is effectively how it happened.

Senator BERNARDI—So it was initiated by management or a senior executive.

Mr Hodges—Yes.

Senator BERNARDI—Who did the negotiating after the agreement had been done between CHAMP and Smorgon about management's participation in any equity—ongoing ownership?

Mr Hodges—Right through the negotiation and up until the deal was completed management remained working for Smorgon and were very loyal to Smorgon. So we were very clear not to give over to the private equity people any other information that Smorgon had not sanctioned—other than the opportunity to speak to the principal of private equity—to myself—and say: 'If this deal is ultimately successful, will you be prepared to stay on as CEO and will you be prepared to invest in the operation.' With that simple statement and an answer of 'yes' the private equity was prepared to go forward. But none of the detail of negotiating what the scheme would be like or the amount of involvement et cetera was ever done until after the deal was done.

Senator BERNARDI—It is an interesting dynamic because we have talked a lot about conflict of interest.

Mr Hodges—It was a difficult time for CEOs then. You can make it very clear in your mind that you are still an employee of the current owner. So it is very obvious until a deal is done who you work for.

Senator BERNARDI—How many of the management—maybe I read of 20—participated in the ownership? Is that the correct figure?

Mr Hodges—That is correct.

Senator BERNARDI—What percentage of the final operation—

Mr Hodges—I think we purchased about 2½ per cent of the company. So 'management buyout' is not really true; 'leveraged buyout' is correct. But the scheme allowed that number to double. That was how the scheme worked. You had to invest significantly with your own money but then the private equity firm complemented that by giving you shares to the same amount. So that was the leverage for management.

CHAIR—In relation to that changeover period where there was the potential for conflict, were you driven by an understanding of the requirements under the Corporations Act, or were you driven by other dynamics or was it a combination of all of those?

Mr Hodges—I thought about that many times because it was one of the most intense periods in my working life. I think I am driven by my own core values, to be perfectly honest. I sat back and thought about it and I thought, 'Who do I work for here?' My job as CEO is to create wealth for the owner of the business—and Smorgon in this case were the owner—and that was exactly what I was doing.

Senator BERNARDI—Regarding the capital injection during the period of the private equity ownership, was that external capital? When I say 'external', was it sourced from CHAMP or was it sourced internally through internal leverage within the company?

Mr Hodges—Do you mean the capital investment we made?

Senator BERNARDI—Yes.

Mr Hodges—When they funded the company, we had flagged that one of the issues we wanted to do was to invest more capital. So the amount of funding we gained for the company, plus its profitability as it went forward each month, was enough to do that. That was basically doing forward cash flows and saying, 'When you fund this company you need to add an extra $10 million or whatever it needs to allow that to happen.'

Senator BERNARDI—You went to banks in order to get that or did CHAMP put the money in?

Mr Hodges—The purchase price was about $186 million. I think we funded the company with about $200 million, 30 per cent of which came from equity, management and CHAMP, and 70 per cent from borrowings from banks.

Senator BERNARDI—Did you maintain that ratio as the capital was required to be invested?

Mr Hodges—We did not have to add any more money to that initial $200 million. The company traded profitably and had cash flows to reinvest.

Senator WONG—To clarify, what we are trying to ascertain is how that capex was financed. We are trying to drill down into that.

Mr Hodges—It was financed from the cash flows of the company.

Senator WONG—Also out of the original 70 to 30 debt-equity ratio—yes?

Mr Hodges—Yes, exactly. We funded the company. The company cost $186 million, as I remember, plus costs for doing the transaction plus whatever extra amount of money we thought would be needed to initially have the company with a positive balance in the bank, and then we traded forward from there.

Senator BERNARDI—I want to ask a question and it might test your memory. During this time you show that EBITDA has risen quite well over the course of the trading. What about the net profitability or the tax paid given the high level of leverage during the time of private equity?

Mr Hodges—The company's tax rate has remained at about 30 per cent throughout the period. You can see that the EBITDA did not go down; it actually went up. I have thought about this question as well. We were not paying a lot of tax back in the old public company ownership days because we were not making very much profit. We went through the private equity period not paying much tax either, because there were transaction costs that were a tax deduction and there was increased leverage as well. But since then that has been repaid many times over and now our profitability has gone up by a factor of five or six and we are paying 30c in the dollar tax. So the impact of investing that capital, restructuring the business, gaining the focus and doing all the improvement has maybe delayed the tax payment for a couple of years but the return is enormous.

CHAIR—While Mr Porter is there, we were talking about conflict before. The conflict dynamics have been even more stressful for you, I imagine, with that dual responsibility of still being publicly listed. How did you manage that and what were the dynamics that drove your decision making?

Mr Porter—It certainly was a very important issue during our period. Initially, the management had a turnaround plan, I guess, that it put to its own board made up of independent directors and directors from a US based media company, which is now Liberty Media. It put to the board its requirement of about $100 million in equity to help finance the turnaround plan, which the board passed on. They were not interested in doing a rights offering or shareholder loans or anything of that nature so it was put to the board to pursue the private equity option. I think it would be extremely dangerous for a manager to pursue any sort of capital strategy

without the full support of the board, particularly a private equity strategy which could be interpreted as a conflict of interest. We were also very cognisant of our obligations as a public company and we kept the market informed of our activities once they became reportable.

Because we are in the media business, we had a challenge from competing interests—I guess you could say—which resulted in a review. I cannot recall at what level but it involved the Takeovers Panel and an initial administrative review which was put to the panel by a shareholder who happened to be on the board of Channel 7. We had to tread very carefully in that regard. I believe we met all of our obligations.

CHAIR—I am almost tempted to take this in camera!

Mr Porter—We had the full support of our shareholders. A very high percentage of our shareholders participated in a subsequent offering in support of a transaction.

Senator WONG—Mr Porter, are you able to explain to us in a little more detail exactly how the arrangements were structured through the period you remained listed? I think you said in your opening statement that CHAMP had negative control of the board; is that right?

Mr Porter—At the time of CHAMP's investment 80 per cent of the company was controlled by a company called United Austar Partners, which was in turn controlled by a Denver based media company called United-GlobalCom, which is now Liberty Media. CHAMP effected its investment through United Austar Partners and, of six board members, two were from United-GlobalCom, two were from CHAMP—it might have been three and three—and then we had local independent directors. The 80 per cent was a fifty-fifty partnership and that is how it effected its negative control—through the fifty-fifty partnership.

Senator WONG—Meaning the 80 per cent comprised 50 per cent of CHAMP's investment and 50 per cent of Austar Partners' investment? Is that what you are saying?

Mr Porter—That is right.

Senator STEPHENS—I want to talk to you about when you started on this path. You made the point that you had significant high-yield debt and commercial debt—with 15 commercial banks. That would be quite a widespread risk. Would that be common in the kind of circumstances you were in?

Mr Porter—At the time we had gone through a period of relatively easy capital access, which some people say we may have recently gone through again. But this was back in the run-up to the dotcom boom in 1998-99 when there was a fair bit of capital around for emerging media and telecommunications companies. In a commercial bank syndicate or leverage finance syndicate, 15 is probably a slightly large number but it is not that unusual. In fact, we have a syndicate today in our commercial banking group of about 10 banks. So it is not that unusual. I guess the key thing in our capital structure which was unusual was the high-yield debt. But, given the fact that many companies in our industry, in media, ultimately have to gravitate towards the moguls if they want to grow their business, we just did not have access to that capital or that type of sponsorship. In order to carve out our market in our territory we had what was, in hindsight, a reasonably risky capital structure.

Senator STEPHENS—You spoke about the exit strategy and said that it was very well organised. Was that something that was negotiated at the beginning?

Mr Porter—Yes. It was always anticipated that, assuming that the company management's turnaround plan could be effected on a timely basis, CHAMP's optimal timetable would be the three- to five-year timetable. The form of exit was not negotiated, although there was plenty of discussion about the fact that if the company was to remain public a selldown could be one relatively easy form of exit. One of the things that attracted CHAMP to the investment was the variety of exit strategies that a growing Austar could provide it, one being a selldown and another being to sell its position back to United Global Com. The perception at the time, and to some extent that continues to this day, was that Foxtel is the logical of Austar's assets, so CHAMP as an investor felt that there was a range of very attractive liquidity options should they be able to effect the operational turnaround. They did not specify which one it would be until the end.

Senator STEPHENS—Thank you for that. Mr Hodges, I ask you the same question about the exit strategy and how that was negotiated for your company.

Mr Hodges—There certainly was not a clear exit strategy going in. That was not something that was set. In fact, management was asking that question and private equity was saying: 'The exit will appear in three to five years time; it's not something we need to worry about today.' And that certainly became the case. As the mining industry started to boom, though, late in the period—or we could see the early start of that—it was quite clear that there was a change coming to the market and private equity, not management, decided that that was the appropriate time. That suited us as well, because we have gone on to invest quite heavily and expand the company. It was not something that management was involved in, in the Bradken case.

Senator STEPHENS—The thing that you both have in common is CHAMP, which is quite interesting to me. It seems to me to be counterintuitive that the time when a company is transformed and is just hitting its straps is the time that the private equity owners get out.

Senator JOYCE—Why wouldn't you double up?

Senator STEPHENS—Yes. It seems to me that they exit just when the growth phase is really getting interesting, and your graphs show that very clearly. I wonder if either of you can make some comment on the short-term strategy. We heard yesterday some evidence that some private equity arrangements are five to seven years, but both of your experiences have been quite short.

Mr Porter—Sure. CHAMP's attitude is that it wants to be involved with companies where it is really effecting change and where it is not a passive investor. Public equity is better suited to a company that is getting growth through its fundamental market position and execution. Once it sees that its value add in terms of its management focus, capital structure, increased accountability and support of management has been achieved then it feels that it can derive better returns—because it does not have an unlimited amount of capital—with new companies which it can provide that kind of acumen and focus for. Once we got to a point where our growth going forward was not going to be outperforming the market exponentially the way it had been in the previous three years but still deliver a nice return, it is a logical transition to get that equity back out into the public market, which is more suited to long-term growth.

Mr Hodges—I think private equity—CHAMP in particular—would not like to be perceived as selling businesses at the top of the cycle and having them fall away the next year, because they are in the business of buying and selling businesses. I think it is a great result for them as well that the majority of the companies that they put out into some other ownership are successful. They can argue that they have put some lasting improvement into these companies. I do not think that is necessarily a bad result, and I am sure that that is the way that the CHAMP people, in particular, see it.

Senator STEPHENS—I have one final question to both of you. I will start with Mr Hodges and then, Mr Porter, you might like to comment. The other difference in your opening narratives was that Austar remained listed but your company did not, Mr Hodges. We had evidence yesterday, and through some of the submissions, about the issue of due diligence processes, exclusivity agreements and exclusivity times where shareholders do not get the same information as the private equity due diligence process might determine for investors. So the questions that I would like you both to consider are: what are the strengths and weaknesses of remaining listed during that due diligence effort and what are the outcomes for shareholders? It has been a real concern in many of the submissions we have received that the kind of lockdown of information and the lack of transparency that can occur disadvantage shareholders in the decision making.

CHAIR—Gentlemen, before you answer that, I am mindful of the time. Please could you keep your answers reasonably short because there are a number of senators who have questions, and I am afraid that time constraints are always upon us.

Mr Hodges—I do not have a lot of comment on that because I was the business unit of a public company rather than a public company, so I did not have that view. Maybe I ought to leave that question to John.

Senator STEPHENS—Fair enough.

Mr Porter—I certainly have a perspective on it. This is an issue that came up a few times between our institutional shareholders, who are always interested in getting as much information as possible. If our institutional shareholders had their way, we would put every activity of our company on the web every day and they could pick up all that information. They challenged the fact that CHAMP sat on the board and had exposure to more works in progress than they did.

I would say that our public reporting machine was quite diligent during CHAMP's participation. We reported quarterly; a lot of companies do not. We reported a lot of subscriber activity even more than quarterly. We were quite active in terms of the amount of communication that we did with our institutional shareholders and in straight reporting through the ASX. But this was an issue for some of our larger institutional shareholders, who felt that, with CHAMP sitting on the board, they should get access to more information.

CHAIR—Did you do that to specifically address those transparency issues?

Mr Porter—Yes, we did. We tried to almost overreport during that period. For our institutional shareholders we provided substantially more access during CHAMP's stewardship than we had previously or have subsequently.

Senator JOYCE—My colleagues have asked most of the questions, but there are a couple that I would like to drill down on. Both of you, John and Brian, have something in common. I think this is right. I will put this statement to you: the capital nature, the intrinsic nature, of your business at the start and the intrinsic nature of your business at the end of the process was the same. It was the same business. There was not a break-up of it into businesses of a different nature. Would that be a fair statement: the nature of your business at the start and at the end was the same?

Mr Hodges—Correct.

Mr Porter—There was one exception for us. Where we were recapitalising during CHAMP's initial participation we exited a telecommunications piece of our business in New Zealand. We sold our half of TelstraClear to Telstra at that time. That was a minor change; it represented about 10 per cent of the business.

Senator JOYCE—So it is inherently different to the process of someone buying a business and then breaking it up into its many component parts, selling it and saying, 'That is our business: to buy it and break it up.'

Mr Porter—Yes.

Senator JOYCE—What I am looking at, obviously, is that there is a differentiation in private equity between those who have a bona fide purpose for wanting to be part of a process of making an organisation better as opposed to those whose prima facie process is to break the organisation up and make money from the break-up. What was Foxtel's ownership through the process with Austar—at the beginning, during the process and at the end—and their say in what was going on?

Mr Porter—Foxtel never owned any equity in Austar, and still does not to this day. We have key contractual relationships with them for sharing of the satellite platform and we distribute some channels to them, and they to us. Certainly I think that, if anything, CHAMP's participation strengthened that relationship. But in terms of equity I think there was some speculation that CHAMP was ultimately there just to sell their piece of it back to Foxtel or whatever—but that was never the case. CHAMP was acting in its own interest and not Foxtel's.

Senator JOYCE—John, the transparency that you talk about would solve so many of our problems in that there is the ability for the market to understand. Without being rude, if something had gone tragically wrong with your organisations—and I am glad that it did not; they are both good news stories and obviously have the runs on the board—if either of them had fallen over the world would have kept turning, as opposed to other organisations where, if private equity had been involved, there may have been a completely different effect. How did you encourage a company that was—and this follows on from Senator Stephens' question—

CHAIR—I think we will take that last comment as a statement of opinion as supposed to a statement of fact in relation to the relativities of the companies.

Senator JOYCE—Okay. You had an organisation which bought into you when there was risk, the organisation turned around and is making a profit. They obviously have shareholders

whose view it is to continue making a profit. What would have happened if they had said: 'No, we don't want to get out. This is a great deal. We are going to stick with you.'

Mr Porter—I think the fundamental nature of private equity is that they are accountable to their investors. They cannot just continue to have unrealised gains; they have to realise their gains at some point in time. In fact most of their structures, I think virtually all of them, have a mandate in that the equity has to be returned to shareholders within a specific period of time. I know that in the case of funds invested in Austar that was seven years. I think it was the same with Bradken. So they are under a mandate to realise gains and to return capital to shareholders, which in many cases are insurance companies.

Senator JOYCE—They are in the business of buying and selling companies. Did you have anything in your debt instrument to say, 'Once these KPIs are reached we have the right to ask you to roll it back off into the market?' How do you come to the point in time where you want to be rid of them and you want to go back to your own way?

Mr Hodges—I come back to the fundamental principle: management's job is to work for the owner, not to dictate to the owner whether he buys or sells the business ultimately. I think the private equity company has its own shareholders that are telling it how long it should hold businesses for ultimately and how long its funds should be opened and that sort of thing. But the role of management in my mind is very clear here. It is about creating wealth within all the legal and other cultural and value bases but, in essence, to create wealth for the owner.

Senator JOYCE—In your view of how private equity works in the economy do you believe that there are issues with regulation? John has shown that he could deal with regulation—and obviously you had a different view—but you obviously have a problem with that. You have found the reporting issues onerous and that was one of the reasons you went towards it, and you have also stated that it was an issue after it was finished.

Mr Hodges—No, I have just said that it is less onerous within private equity. It is quite manageable on either side, and companies do manage it and they manage it very well. There is continuous disclosure and we manage it every day. That is not necessary. I have got thousands of shareholders now, whereas in the private equity period I had 20 management people and a private equity firm. Obviously, if the private equity firm rings up on a particular day and asks for some details about an issue, the person is able to provide that information. He is likely to be quite intelligent and knowledgeable about the business because he is ringing up every day and so he is able to give you some input. That is just not available when you have got 4,000 shareholders in either direction. Shareholders cannot be as knowledgeable and know the right questions to ask and management does not have the time to respond with the answers. So it is just a completely different model. When private equity firms are staffed with intensely focused, capable people really trying to effect improvement and change, that can be a very powerful thing.

Senator JOYCE—So you are reporting but you are just reporting to a different body?

Mr Hodges—Yes, but the reporting is easier because there is one shareholder rather than 4,000 of them so the amount of time you could give any individual is obviously quite different.

CHAIR—You are still reporting to the owner, aren't you? It is just in a different guise.

Mr Hodges—You are reporting to the owner, yes.

CHAIR—That additional debt that was taken on during the period of the private equity involvement, was that repaid or was it by way of non-amortising debt? What was the debt repayment structure of the two organisations?

Mr Hodges—In my case the debt level was 3½ times our then ABITDA. That was the level of debt and it was both interest and amortising in the period. That was considered relatively high. Things have moved on today and that would not be considered overly high in a public sense today. The banks have lifted their view in terms of risk. That is effectively what we did. Prior to that, as a business unit of a large public company, the debt was managed at the corporate level and you would have an allocation of that debt depending on how the corporation was going overall. It was a less focused arrangement.

Mr Porter—In our case, the first thing we did was to retire the high-yield debt, which was $US400 million at face value. We actually reduced our debt initially and then we restructured our existing $400 million commercial facility into a two-tiered instrument: $US400 million of commercial debt and another $100 million of hybrid security, which is listed here in Australia. We changed the amortisation period to a 10-year reducing and lowered the interest, which reduced the actual cash outflow to the company of interest and this enabled us to move forward in the business. At the end of the day there was probably a net reduction in total debt and a restructuring of the facility that allowed us to get our feet under us and move forward to the benefit of all stakeholders.

Senator JOYCE—Did your proportion—not the amount—of non-Australian debt increase?

Mr Porter—No, non-Australian debt was eliminated completely.

Senator WEBBER—Firstly, I have a general question for both of you. Mr Hodges, I am from Western Australia, so I have seen a lot of your product; in fact, I am going up to Port Hedland next week, where I will seek even more of it I know. Given the different industries and circumstances both companies found themselves in, which was a real opportunity for economic growth—in your case with the resources boom, but also with the eventual take-up of subscription television, which took a long time to start off—is it your view that private equity was the only way you were able to maximise the opportunities that were presented by that growth?

Mr Hodges—A lot of our growth has occurred after private equity. The public markets are very unforgiving on companies that have hit a flat spot, that are not growing. In fact, the major measure of your share price and the buoyancy of your share price is the fact that you can continue to grow. There is a real value in the niche which says: 'Here's a public company or an element of a public company that, for some reason, is not growing. Maybe it hasn't been able to be funded properly; maybe it needs a different direction; maybe it needs a whole host of things.' If a strong leadership management team can come in, take that company for a period of years, make it good and then allow it to start to grow, then yes, there is a valuable position in the market for that.

Mr Porter—I would agree. The ability of private equity to really drill down into a company that is facing operational challenges or has a complex capital structure or balance sheet puts private equity in a position to find a diamond in the rough, if you will, from time to time. That was certainly the case with Austar. The public markets do not have the patience or the wherewithal to dig that deep into complex situations, and that is why private equity is always going to be the right capital for certain companies at certain periods in their evolution.

Senator WEBBER—Mr Hodges, in the material you provided to us, slide 22 talks about 2004 onwards. One of the issues you raised there is 'more time spent with reporting and non-value added activities'. How many of those supposed non-value added activities are complying with the additional regulatory requirements that listed companies have that the private equity entities do not?

Mr Hodges—Not very many.

Senator WEBBER—It has been a real concern that has been raised in the media about the lack of transparency and access.

Mr Hodges—No. Most of the regulatory things are the same. I do not think we had to submit a six-monthly report, but in my organisation, which is now 300 people, we may have an extra commercial resource employed to provide that six-monthly report and a little more information. But in terms of running the company, that resource is not taking the decisions of running the company. I do not think regulation is really the issue; it is more the amount of time that the capital markets require of me informing them, spending time with them and trying to get thousands of shareholders to be well-informed and to understand the company and to be positive about the company and to understand its growth story et cetera.

CHAIR—Mr Porter, do you have any comments to make in response to Senator Webber's question?

Mr Porter—We are all subject to the Corporations Law. We all have reporting obligations, whether we are public companies or non-public companies. I think we all work pretty diligently to meet those obligations. I have not found a big discrepancy in my experience.

Senator BERNARDI—I think we should differentiate for the record between the reporting requirements for a public company which is derived by the Australian Stock Exchange for disclosure and the regulatory requirements under the Corporations Law. They are two different things. The reporting requirements are much more onerous for management than the regulatory requirements, I think. Is that a fair statement, Mr Hodges?

Mr Hodges—I need to report anything material to the ASX that may have an impact on the share price.

Senator BERNARDI—Which you did not have to do as a private company?

Mr Hodges—Yes, but the number of times I have reported things would not be very high. It would be a couple of times a year. So, again, I do not think that has a big impact. We have six-monthly announcements. We have announcements in between as we make an acquisition or

something like that. Both these areas are not the whole question. I do not think you should overly focus on the fact that there is more non-value adding time in the public versus private. That is a difference, but it is not the overriding or big-picture issue.

Senator BERNARDI—Thank you. Mr Porter, I have a very quick question for you. In regard to Austar, you started with a large tranche of foreign capital—is that correct?

Mr Porter—That is right.

Senator BERNARDI—Was that because the capital was not available for your company in Australia or simply because it was more efficient to get it from overseas?

Mr Porter—No, it was not available in Australia. It would have been far better to have raised Australian dollars at that time in 1996. Private equity might have been an attractive option back then but there was not really any mezzanine financing available for emerging companies in our industry at that time.

Senator BERNARDI—My final question is: in relation to the capital markets in Australia, are they deep enough, in your opinion, for companies not to use foreign capital to expand over the course of time?

Mr Porter—I think that that has changed dramatically in the last two years. There is certainly exponentially more capital available and forms of capital available than there was in the time when we were growing our company. However, over a certain amount, even in our commercial debt syndicate, we are required to engage overseas banks to fully fund the operations of our company.

Senator BERNARDI—Thank you very much.

CHAIR—Mr Porter and Mr Hodges, thank you. We have gone well over time but I think that, from my colleagues' point of view, it was very interesting and we are very grateful to you both. On behalf of the committee, I wish you both well with your future endeavours. Thank you for sharing your experience with us today.

Mr Hodges—Thank you.

Mr Porter—Thank you.

[12.28 pm]

DRENTH, Mr Frank, Executive Director, Corporate Tax Association of Australia Inc.

CHAIR—Have you appeared before a parliamentary committee before?

Mr Drenth—Yes, several times.

CHAIR—So you are aware of the requirements. I welcome you to the committee. Would you like to make an opening statement before we go to questions?

Mr Drenth—Yes. You have our brief submission?

CHAIR—I do.

Mr Drenth—As we have indicated in the submission, although we are aware that there is a strong interest in private equity investment at a number of levels, our focus is on the tax issues that are raised in the terms of reference. They are the ones that we have tried to address. We have also referred to some discussion that we continue to see about the measures affecting gains derived by nonresidents in Australia. That was the subject of a Senate inquiry late last year. I realise it may not have been resolved to everyone's satisfaction. I am happy to discuss those issues again today if senators would like to.

CHAIR—Only if they are relevant to the inquiry.

Mr Drenth—Yes, I accept that they would be. I am happy to take questions, Mr Chairman.

Senator WONG—We had some difficulty with Treasury in getting some sort of sense of whether or not there could be some revenue effects of increased private equity activity. I was unclear, to be honest, from Treasury's answers whether that was a matter of principle or simply a matter of a comparatively low level of private equity activity in the broader Australian economy. I notice in your submission that you are essentially putting a similar view that you do not believe that there is much impact on revenue. I wonder if you could comment on that and also comment on some sort of prognosis. If we get to a situation in a number of years down the track in terms of the level of private equity investments with all the caveats and various structures that might actually involve are there likely to be significant revenue implications and, if so, in what areas would that occur?

Mr Drenth—Let me stress that we agree in our submission that it makes sense for the government through its agencies to monitor and review what happens to the revenue as a result of these kinds of transactions. I had a look at a number of the other submissions before preparing for the hearing today. There was an interesting one from Robin Speed from Speed and Stracey. His submission concludes, rather alarmingly, that based on what seemed to be reasonable assumptions around the theoretical takeover of five major Australian companies there would be a significant loss to the revenue. Without necessarily tearing it to shreds, it is useful because there are some plausible numbers in there taken from the public accounts of those companies. But

looking at some of the assumptions that are made and some other factors that have not been taken into account might be a useful way of shedding light on it.

CHAIR—It was absolutely hypothetical for starters.

Mr Drenth—Two of them were not that hypothetical.

CHAIR—It did not take into account any foreign ownership requirements for starters.

Mr Drenth—It is a useful approach to look at the numbers and the way the tax laws work. I have assumed that the numbers are right, that these companies pay about $1.4 billion in tax overall and that about $1.2 billion of that might be Australian tax. They are all members of the CTA. I could have asked them but then I would get into a tangle about what I can say here and what is confidential, so I have accepted all these things at face value. The major concern that arises is the leveraging of the transaction. Private equity tends to use more debt and it is possible through the consolidation regime for the debt deductions that arise from the borrowings that are made to offset the debt deductions against the cash flow in the taxable income of the target company. On the face of it, there is an issue.

I have a slight quibble with the numbers that Mr Speed came up with on the borrowings. It is not a huge one, but on page 15 he suggests that the maximum permissible debt under Australia's thin capitalisation rules would be 75 per cent of the $91 billion paid for those five companies. In my view that is really a stretch. Most people use what is called the 'safe harbour rule' in division 820 of the act, the thin capitalisation rules that have been in place since 2001. That gives you 75 per cent of Australian assets that are on your balance sheet, and the assets on the balance sheet were about $56 billion on those numbers, from Mr Speed's research. Seventy-five per cent of that is $42 billion so that is a lot less than $68 billion, being 75 per cent of $91 billion.

But there is an arm's-length test that you can use instead of the safe harbour test where you can justify a high level of debt. The operation of the arm's-length test is pretty uncertain in my view, so suggesting that the maximum allowable debt would be 75 per cent of the amount paid is really a stretch. I am suggesting maybe two-thirds of the way between the two figures—$42 billion and $68 billion on the high side—gets you to a maximum allowable debt figure of just under $60 billion. With interest at eight per cent and taxed at 30 per cent, that only reduces the hit to the tax receipts slightly from $1.2 billion to $1.1 billion, but every $100 billion counts when you are doing these things.

The major issue I had with Mr Speed's analysis is on page 18 where under point 6.4, 'Difficulty of measuring Australian tax payable on takeover premium', he has three dot points, starting with, 'Foreign shareholders pay no tax on premium'. That is right. He goes on to mention that Australian super funds pay tax at a low rate and then for everybody else they get a 50 per cent discount. That is all true but there are still some pretty high numbers. We are talking about $91 billion in CGT proceeds.

So how much is the gain? The current market value of the companies—that is on page 13—is about $65 million. Let us assume that on average shareholders bought in at 60 per cent of that amount. It depends on when they bought and what the share market has been doing since. That gets you a buy-in cost of $39 billion and a sell price of $91 billion. So the average shareholders

in aggregate have made a profit of $52 billion. Mr Speed's analysis does not allow for any tax collections on that amount and I think that is unrealistic. Roughly 40 per cent of Australian public companies are held by foreigners—there are variations but that is the broad average. Of the other 60 per cent let us say 20 per cent are held by superannuation funds and 40 per cent are held by individuals over a range of tax rates. Super funds get a one-third discount but 20 per cent of $52 billion is still a large number—$10 billion and a bit less one-third gets us to $6.9 billion. The headline rate is 15 per cent but they have offsetting imputation credits so let us give them an effective tax rate of eight per cent—that is about half a billion dollars. The individuals between them have got a total gain of about $20 billion and a bit less half—the CGT discount—which gets you a $10 billion gain and with an average rate anywhere from 20 per cent to 45 per cent plus the Medicare levy; let us say that it is an average of 30 per cent. That is $3 billion and a bit plus the amount for the super. That is $3.6 billion and that is an upfront gain. That is assuming that all the super funds and all the individuals are entitled to the one-third or 50 per cent discount, as the case might be, and you only get that if you have held shares for 12 months. A lot of people do not and they do not get it.

So what was the figure that relates to the higher interest from gearing that I set at $1.1 billion? I think that it is reasonable—although people can argue the toss—to suggest that the profitability of the target companies, once they are under private equity ownership, will improve. After all, that is the whole object of the exercise. So let us say that the EBIT figure that Mr Speed uses of $5 billion and a bit is increased by 15 per cent. That number multiplied by the company rate of 30 per cent gets you to about $260 million—and I have got a bit of paper that I can let the secretariat have to run you through this. My point is that there is an interest effect which is negative on revenue, but there is a profit effect which is positive. If you offset the two you end up with about $800 million. That is per annum. The average time of ownership is, say, five years so that is $4 billion. I said that the upfront CGT revenue might be about $3.6 billion or $3.7 billion—not a big difference. There are some other factors—

CHAIR—Have you done these figures on the basis of the Speed and Stracey scenario?

Mr Drenth—I have used his numbers for EBITs and market cap and all those things because I have no reason to doubt them. But I have made assumptions that, I suggest, are more reasonable.

CHAIR—He has made assumptions that there is going to be a buyout of some $80 billion of these five companies.

Mr Drenth—$91 billion.

CHAIR—He has not taken into account any foreign ownership requirements. He has made an assumption in his submission that all the borrowings are from overseas banks—

Mr Drenth—Correct.

CHAIR—which, from what we heard yesterday from the Reserve Bank, clearly is not practice. There was some $15 billion in PE activity in 2006 as opposed to an assumed $80 billion. So, in response to Senator Wong's question and leaving aside Speed and Stracey, what is your view of potential revenue loss? Quite frankly, I do not think the Speed and Stracey figures can be used because, in my view, they are a nonsense notion from which to start.

Mr Drenth—Perhaps I am making an undue reference. I am not trying to discredit the submission per se. I am just suggesting that there is a different way of looking at it.

CHAIR—The underlying assumption just cannot stand up against any scrutiny.

Senator JOYCE—That is not giving due respect to Mr Speed. Mr Drenth has to table some of these figures. I would have to take this home and get back to you tomorrow. With the numbers that have been flying across the table—in a very proficient manner—there is absolutely no way in the world that I can endorse or clarify them or give any statement on them.

Senator BERNARDI—I am not sure that that was the witness's intention.

Mr Drenth—No. I do apologise. I was not attempting to dazzle anyone with numbers.

Senator JOYCE—I realise that but you do understand our position.

Mr Drenth—I do. The key point that I am trying to make in my clumsy way is that there are several huge holes in the analysis, even assuming some of the things that it does assume—that is, the upfront CGT gain that arises on the transaction going through. It is not reasonable just to dismiss that by saying that it cannot be measured with enough precision. That is one point. The other point is what I might call the displacement effect, which we did not think of when we put in our submission, but I noticed it in the Ernst and Young submission when I read it this morning. These five companies—Coles, Woolworths, Tabcorp and Qantas, and I cannot recall who else—were taken over for a total sum of $91 billion. Where does that go: 40 per cent goes to foreigners and 60 per cent goes to Australian investors. That is $55 billion. These people are investors and I suggest that they will not generally treat this as lottery wins or inheritances or anything like that and waste it on home improvements and trips overseas. But let's allocate $5 billion to things like that. That is $50 billion that has to be reinvested somewhere. It still stays as part of the Australian tax base. They could buy new businesses that will generate funds, or they could bid up the price of existing businesses, which will improve future CGT receipts, or they could stick it in the bank, which means that Aussie banks do not have to borrow as much from foreign investors. It enhances the Australian tax base. I do not know what people could earn on $50 billion on average. At the risk of dazzling you with even more figures, six per cent on $50 billion is $3 billion and the average rate of tax is almost 30 per cent so that is almost $1 billion. That is about as much as a reasonable assumption of the extra interest costs on the companies would be.

Senator BERNARDI—For the 120 corporate groups that you represent, do you have a figure on how much tax they pay in this country every year?

Mr Drenth—I rely on the government figures on this. In the current year we do not have the figures for June but company tax will hit close to $60 billion. The group of companies that the large business section of the tax office looks after—according to the commissioner's annual report—covers two-thirds of that, so that is $40 billion. That is not all of my 120 companies but I heard a figure earlier this week from the tax office saying that the top 100 companies pay 40 per cent of all company tax. I have a few more than 100, so it is a large amount.

Senator JOYCE—I want to talk briefly about the Corporate Tax Association. What proportion of the fair market values of the organisations you represent are based overseas?

Mr Drenth—How many of them are subsidiaries of foreign companies?

Senator JOYCE—What proportion of their total value is based overseas?

Mr Drenth—That is a stretch. I would say that anything up to 30 per cent would be foreign owned. A lot of them tend to be large, but not all of them. The oil companies and some of the banks are the main ones.

Senator JOYCE—That 30 per cent is bigger than I expected. If we talk about the fair market value of those companies that are based overseas compared to the value of those based in Australia, the vast proportion of corporate value that you represent is overseas corporate value.

Mr Drenth—I am not sure I understand the statement.

Senator JOYCE—If you added up the total company worth of the companies you represent that are based overseas and compared it to the corporate worth of the companies that you represent that are domiciled in Australia, the corporate worth of the overseas companies would be vastly in excess of the corporate worth of those in Australia.

Mr Drenth—It probably would be.

Senator JOYCE—I would say it definitely would be.

Mr Drenth—Exxon Mobil would be one example. I do not know what they are worth.

Senator JOYCE—We have to clearly get that on the record. I understand that you are talking about the one-off situation. I am not going to question your figures. In fact, I will have to read the *Hansard* record of them. You do acknowledge that what you are talking about is the one-off sale of the capital asset and the ramifications that has domestically, but you do not take into account that the implicit capital gains tax nature has therefore changed. If there is a move towards the purchase and sale of that capital asset in the future by overseas entities then that will be a capital gains tax-free event as far as Australia is concerned.

Mr Drenth—Sorry. If the target company changes hands, there is a CGT event for the existing shareholders.

Senator JOYCE—We buy company A and we sell company A. The 40 per cent of Australian individual shareholders pay their tax. It is then bought by an external entity and bought and sold and bought and sold and so on into the future. From that point forward, there will never be any capital gains tax domestically.

Mr Drenth—While the entity is in foreign hands—unless it is underlying property assets—there will not be any tax.

Senator JOYCE—So there is an intrinsic change there.

Mr Drenth—Could I just briefly point out that not all private equity is Australian owned, so Australian private equity players will pay tax on exit.

Senator JOYCE—You have said that the whole object is the increase in profitability for private equity. That is your statement that you have just given. Do you stand by that?

Mr Drenth—That is my understanding of what the basis for the market is.

Senator JOYCE—So you believe that the nature of private equity is to get an entity, to make it more profitable and then to place it back on the market.

Mr Drenth—Broadly.

Senator JOYCE—If the intrinsic nature of the entity were to change in that period of time, that, in your view, is not the purpose of private equity.

Mr Drenth—To change the intrinsic nature? I do not know whether the new owners would pass up new business opportunities if they arose. But, basically, if a private equity investor bought a brewing company then I imagine that in five years time it would still be a brewing company.

Senator JOYCE—I think it is division 924 of the Income Tax Assessment Act 1997 that deals with the nature of debt instruments and when they become equity instruments. Are you aware of that?

Mr Drenth—Yes. That is what is referred to as the debt-equity rules.

Senator JOYCE—You are aware of the section in the tax act where a document becomes an equity instrument as opposed to a debt instrument?

Mr Drenth—Yes. There is a division—

Senator JOYCE—How do we ascertain, Mr Drenth, without transparency, whether a document issued is a debt instrument or an equity instrument?

Mr Drenth—That is always a matter between the corporate entity issuing the instrument and the tax office.

Senator JOYCE—How are they going to determine it?

Mr Drenth—Facts and circumstances.

Senator JOYCE—They will have to sight the document.

Mr Drenth—Yes. Believe me, the tax office has no particular difficulty in accessing that kind of information, irrespective of the nature of the ownership.

Senator JOYCE—If a client came before you and wanted to minimise their taxes—and that is completely their right; in fact, it is your obligation to try and do it for them—and they are going to go into the business of buying and selling entities, why would you advise them to set up an entity based in Australia when they could do exactly the same thing and get out of tax by basing it, as we have said before, in New Zealand? Why would you give them the advice to stay in Australia?

Mr Drenth—I guess it would depend on who the client was. I should mention that I am not in the business of giving advice. The CTA represents the tax office members by lobbying on tax policy and administration issues. We do not give advice.

Senator JOYCE—We have determined the worth of the organisation and what the motivations would be. Could I pose to you that if I was in your position it would be my duty to try and set up the entity to minimise that client's tax, so I would not be domiciling it in Australia.

CHAIR—I do not think this witness can comment on what you should or should not be doing.

Senator JOYCE—Okay. I will change it around. What circumvents that process being rolled out in multiples or major deals by domiciling the entities overseas?

Mr Drenth—I guess it depends on where the parties associated with the private equity bid come from. If they are Australian based then that is how they would generally approach the transaction, I would have thought.

Senator JOYCE—You have made the statement that the whole object is to increase profitability. Do you think it would be a fair statement by the taxation department in the future, looking at private equity companies, to say that if the intrinsic nature of the organisation has changed on sale then other aspects of the tax deductibility for the time you owned it should be brought into clearer focus? I am thinking about prospective changes.

Mr Drenth—The tax office will have a look at whether there are changes in the business. Where there are significant losses, that could become a critical issue because of the operation of the same business test. However, if there are no significant losses in the entity then there will be a tax on what profit it makes, irrespective of the nature of its business.

Senator JOYCE—We keep on referring to the thin capitalisation rules. Do you think that really at 75 per cent leverage that is a healthy position for an entity to be in?

Mr Drenth—It is a lot higher than you see in the publicly listed sector at the moment.

Senator JOYCE—I would say so. My experience working with credit bureaus and banks is that you have to have a very good reason to be able to sustain something at that level. When we talk about the thin capitalisation rules, we are basically talking about the extremities of where anybody would really go. In the natural business world it is the extremities of where you go in any case.

Mr Drenth—You may know more about the natural business world than I do.

Senator JOYCE—I do not think I do. I think you know as much as I do.

Mr Drenth—Three to one was the government policy decision back in 2001.

Senator JOYCE—I am just saying that it is a statement of the bleeding obvious that if you go beyond that you do not have to worry about the thin capitalisation rules. You are probably in such a tenuous position that you are in trouble anyhow. But even if you wanted to there are other mechanisms, fee structures and other things, that may not be deemed to be interest but certainly are an income flow, possibly back to the same sources where the interest would go in any case.

Mr Drenth—Possibly. However, the deductibility or otherwise of any fees would have to run the gauntlet of the normal principles of deductibility. So if it is just a way of moving profits and the fees do not bear any resemblance to a commercial arrangement then they may not be deductible.

Senator JOYCE—Is it fair to say that, generally, it is not the purpose of private equity to buy and break up an organisation into its constituent parts, so people could question a company's intent when it does that?

Mr Drenth—It all depends on the circumstances. Even when a company is bought by another listed company, there is almost always a process immediately after the sale—sometimes it begins before that—where the buyer will earmark bits of the business that it does not want. Fairly quickly after the transaction is settled, the bits that it does not want get sold. When Rio Tinto bought North Ltd, it did not take them long to get rid of the forestry operations, because they were a mining company and did not think they were interested in running forestry operations. You see those things all the time.

Senator JOYCE—I leave you with one question on notice. Can you get back to us on the value, as determined by the Corporate Tax Association of Australia, of the corporate entities which are foreign based and domestically based, or domiciled in Australia—because I cannot see it here in your submission—so that we have a clear picture of exactly where the wealth or the worth of your representational body is. I could set up five private companies and set it next to Exxon and say that it is predominantly representing Australian interests even though, overwhelmingly, it is not.

Mr Drenth—I am happy to do it. I have not looked at it before. We represent the interests of dozens of significant Australian based listed companies which are multinational.

CHAIR—Following on from a comment which Senator Joyce made previously, if the chairman of a publicly listed company stood up and said that the profit maximisation was not a core objective of the organisation, how long do you think that chairman would be likely to be there?

Mr Drenth—About 2½ minutes, I would think.

CHAIR—In the context of Senator Joyce's question to you, that the motivation of private equity involvement is to maximise profit, I would have thought that was a core fundamental of

any corporation in this country, particularly a listed company with responsibilities to shareholders?

Mr Drenth—But there are of course many other factors that bear on the way you do that. Sometimes companies need to balance competing interests but, in the long term, you serve the interests of your shareholders and other stakeholders by remaining in business and growing and being profitable.

CHAIR—In your submission to the inquiry in relation to a capital gains tax question—this was concerning the Tax Laws Amendment (2006 Measures No. 4) Bill—you make the following reference to real property investments in this country:

As a package, these measures have placed Australia in a similar position as other developed countries and should be a positive factor in attracting investment into Australia.

Can you elaborate on that?

Mr Drenth—The reform of Australia's international taxation measures started with the budget announcements in May 2003. They were made up of a number of tranches and have focused on different things. The main changes to outbound investments have been a broadening of the dividends exemption and also what is called a participation exemption—that is, an Australian investor investing in an active underlying business overseas is not taxed in Australia when they sell that business. The reason for that is that you already have the dividends exemption so you may as well give the capital gains tax exemption; otherwise, the entity will just sell the business and dividend the profits out. Those are a couple of major changes to outbound investment.

The focus within inbound investment has been on making Australia an attractive destination not only for outright investment in the economy but also as a regional hub where foreign companies can use Australia as a base. That has required that we look at the capital gains tax, or the tax treatment generally, of foreigners who use Australia as a conduit to invest in other areas. The exemption for the disposal of non-portfolio Australian companies goes beyond that, but it reflects the capital gains approach that our competitor countries have taken. So the list of taxable things that Australia was taxing foreigners on was a lot longer than it was for other countries prior to last year's amendment. It should be remembered that Australia is now a significant outbound investor, with burgeoning superannuation savings that have to go somewhere, and the Australian market is not big enough for it. When super funds and even our listed companies now invest in overseas companies they get the same treatment that Australian companies get when they invest here, other than in land. It is a reciprocal arrangement.

CHAIR—As far as the CTA is concerned, you are suggesting that the government should keep tax and other aspects of private equity investment under review, and you believe it is unlikely there will be an adverse revenue impact arising from private equity activities?

Mr Drenth—I believe it will be positive. Taking into account the initial capital gains tax and bearing in mind that even failed private equity transactions have generated significant CGT gains, the Qantas share register turned over twice in the period of all that activity. Does anyone really think that Coles would be trading much above $10 but for the private equity run? All of the adverse things that people fear, such as the excessive gearing, will probably not happen in

relation to Qantas and Coles, but the up-front capital gains tax is already, or soon will be, in the Treasurer's pocket.

CHAIR—You also said in your conclusion that the thin cap rules are themselves a break on excessive debt levels?

Mr Drenth—Yes, combined with the debt-equity rules which prevent people from dressing up equity as debt. The feeling of my members is that those rules work pretty well. You can always get more certainty at the margins but, generally speaking, things work well. It is not simply a matter of just flicking a switch and dressing up equity as debt. Let me repeat that the substitution effect or the displacement effect of the money that pours into super funds and to individual investors when these deals go through is that it has to go somewhere. It will stay part of the tax base. I did not see that referred to in Mr Speed's analysis, either.

Senator WEBBER—We received some evidence yesterday from the Reserve Bank and from a number of other organisations about the size of the private equity market in Australia. It was their view that, currently, it is in fact beginning to tighten up because of the cost of overseas debt. Does your association have a view about whether the market has the capacity to grow or are we at the level we will be at for a while?

Mr Drenth—It is not something that we would profess to be experts at. We read the papers, like everybody else, and there does seem to be an impact on the debt side of the funding, which may hose down the rate of increase. But, as we have said in our submission, we do not have a particular view about what the most appropriate ownership structure should be, except to remind the committee that Australia has a regulated free market economy.

CHAIR—Thank you, Mr Drenth, for your evidence.

Proceedings suspended from 1.05 pm to 2.02 pm

GABRIEL, Mr Gary, Head of Private Markets, UniSuper Ltd

ST JOHN, Mr David Campbell, Chief Investment Officer, UniSuper Ltd

CHAIR—This hearing has been convened to receive evidence in relation to the committee's inquiry into private equity investment and its effect on capital markets. These are public proceedings, although the committee may agree to a request for evidence to be heard in camera or determine that certain evidence should be heard in camera. I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to the committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee insists on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time. Welcome, gentlemen. Mr St John, I gather you wish to make an opening statement. If so, please proceed.

Mr St John—I am not going to restate our submission, but there are some contextual comments that I would like to make to assist the discussion. UniSuper have 350,000 members and in excess of $24 billion of funds under management. UniSuper have been investing in domestic private equity since 1993, so for 14 years. We commenced our international private equity program in 2005 following two years of careful deliberation. The fund has a benchmark allocation to private equity of five per cent of total fund assets. That is split 75 per cent to international private equity and 25 per cent to domestic private equity.

CHAIR—I should interrupt you there briefly and indicate to committee members that I think my wife is a member of UniSuper. I need to put that on the record at this point in proceedings. I am sure that is not going to be an issue for anyone, is it?

Mr St John—Our actual exposure to private equity is $600 billion. The actual exposure is split 65 per cent to the domestic market and 35 per cent to the international market. The $600 million figure equates to 2.5 per cent—

Senator WONG—So that is 65 per cent for the domestic market and 35 per cent for the international market?

Mr St John—That is correct.

Senator WONG—That is the opposite way around to total private equity assets, which I think was 75 per cent international and 25 per cent domestic.

Mr St John—Yes, that is correct. The $600 million represents 2.5 per cent of the total fund assets and the variations, compared to the benchmark allocations, reflect the fact that we are still building our international private equity exposure. Our private equity investments are spread across more than 60 individual managers and in turn several hundred companies. Wilshire

private markets group and Altius Associates advise us in domestic and international private equity respectively. In addition, UniSuper's investment department comprises 22 staff, including Gary and I. A number of our staff work directly in private equity.

UniSuper expect a premium over listed markets in private equity and as such our benchmark for private equity is a five per cent premium over listed equities. That is on an after-tax and after-fees basis. There are also diversification benefits from investing in private equity. Conversely, private equity entails illiquidity, high levels of risk and higher investment costs. It is for this reason that we have a well-diversified portfolio and a very disciplined investment process. Based on our experience, we have not identified any regulatory changes that need to be made in the private equity asset class. We would be pleased to answer any questions.

Senator WONG—I want to go back to the figures—I apologise if I was not scribbling fast enough—you indicated in terms of your exposure to private equity. What was that five per cent figure? Was that five per cent of total assets under management?

Mr St John—Five per cent is our benchmark or target allocation. That is where we would like to get too.

Senator WONG—So that is how much you would like to be able to invest in private equity of your total funds under management?

Mr St John—That is correct.

Senator WONG—And so the other figures of 75 per cent and 25 per cent were also target figures?

Mr St John—That is correct.

Senator WONG—So is the actual figure 2.5 per cent of total funds under management or assets under management?

Mr St John—It is total funds under management.

Senator WONG—Of which the vast proportion is domestic, for reasons you have outlined.

Mr St John—Yes.

Senator WONG—I suppose that would be rather atypical in terms of domestic versus international investment.

Mr St John—I suspect that most Australian funds would have a bias towards domestic private equity. That is certainly the case for UniSuper at the present time. We are looking to build our international exposure, and that largely reflects the fact that there are capacity constraints in the domestic market for us.

Senator WONG—In other words, there are only so many places to invest. Is that what you mean?

Mr St John—And clearly we only want to invest with the better-performing managers.

Senator WONG—Sure. The evidence in the opening statement was that your benchmark is a return of five per cent above your return on listed investments

Mr St John—Yes.

Senator WONG—Reflecting the higher risk profile, I suppose.

CHAIR—And that is a net figure, isn't it?

Mr St John—That is a net figure after tax and after fees. That is correct.

Senator WONG—You are an industry super fund, aren't you?

Mr St John—That is correct.

Senator WONG—Presumably this investment strategy was something that the trustees agreed to in terms of the broader investment strategy?

Mr St John—Yes, absolutely.

Senator WONG—So the five per cent figure is—

Mr St John—It is part of our investment policy. It is embedded within our investment policy statement, which is also available to our members.

Senator WONG—In the context of that, has the board required any engagements strategies of you or any other fund managers to whom you contract or investment managers who you have a relationship with in regard to private equity investment?

Mr St John—Engagement with investee companies?

Senator WONG—Yes.

Mr St John—The fund has a governance policy. That policy is quite detailed and it is available on our website, should you care to look at it.

Senator WONG—This is engagement with investee companies regardless of whether or not they are listed?

Mr St John—Correct. Embedded within our governance policy is that we adhere to the ACSI guidelines. We communicate with all of our managers and service providers and advise them of our policy and we outline our expectation that they adhere to that policy.

Senator WONG—Who do you make clear to?

Mr St John—All of our managers and service providers.

Senator WONG—Are you one of the funds signed up to the Principles for Responsible Investment?

Mr St John—That is correct.

Senator WONG—Do those ACSI principles and the PRI apply regardless of the nature of the ownership of the investee company?

Mr St John—We only signed up to the UNPRI a couple of months ago. We have already communicated with our listed managers and we will be rolling out that communication with the rest of our managers and service providers.

Senator WONG—But the intention is that that would apply across the board?

Mr St John—Yes.

Senator WONG—The chair suggested that you might want to give us a quick overview of your governance policy because we have not looked at it. I think that might be useful. What I am interested in—I cannot speak for other senators—is that one of the criticisms of private equity, which is a fairly broad term, is that the disclosure requirements which are incumbent on publicly listed companies are not the same for private companies. There are a range of counterarguments to that but one of them is, 'When you have people investing through private equity, they are going to have a much closer engagement.' I was wondering if you could talk to us about that and about your governance policy.

Mr St John—Certainly. As indicated, our governance policy is built around the ACSI guidelines. We make that policy known to our fund managers and any directors who we appoint in any of the investee companies within which we invest. There are a couple of aspects of the governance document that are important to note. One is on proxy voting. All of our listed managers are required to vote either for or against company resolutions, except where they have a conflict of interest.

Senator WONG—Would that only apply to publicly listed companies?

Mr St John—That is correct. Managers are expected to vote in accordance with the ACSI guidelines, except where other commercial considerations come into play. Where they vote contrary to the spirit of the ACSI guidelines, they are now required to report back to us and explain why they have voted contrary to the guidelines. We also communicate with other parties, including our private equity managers and any appointed directors in unlisted companies, the spirit of those guidelines and our expectation that companies will be run consistent with the philosophy underpinning those guidelines.

Senator WONG—Have any private equity investments gone pear-shaped?

Mr St John—The nature of private equity is that, from time to time, some companies will fail. That is why we have a very diversified portfolio. We look at the asset class as a whole and

then we look at the asset class in the context of the wider portfolio. So, yes, it is a high-risk asset class, but it is a very small percentage of the fund's total assets. The private equity allocation is well-diversified across managers and, in turn, different sectors and also the investee companies.

Senator WONG—So as a class how has it performed?

Mr St John—It has performed in accordance with our expectations. Most recently, our domestic equity has performed quite well. It is early days for our international private equity allocation. We have only been investing since—

Senator WONG—'Domestic equity' meaning 'domestic private equity'?

Mr St John—That is correct—my apologies.

Senator WONG—That is all right; I was just clarifying.

Senator BERNARDI—How long have you been in—

Mr St John—We have been in international private equity since 2005.

Senator BERNARDI—And domestic from 1993?

Mr St John—That is correct.

Senator WONG—I am making the assumption that the involvement from the early 1990s was more of what you might class venture capital—

Mr St John—That was—

Senator WONG—rather than the sort of leveraged buyout activity—the, I suppose, more mature kind of investment—that we have been seeing more of lately.

Mr St John—That is right. As a generalisation, venture capital has not performed as well as buyouts.

Senator BERNARDI—I have a couple of questions. In your submission, you talked about how reliant you are on a private equity firm's own assessment of a company and there is not external research. Is there external research available to you about private equity firms before you put money into their fund?

Mr St John—That largely is the role of our advisers. Our advisers serve two very important functions. One is that they help us identify private equity managers that are going to outperform the median. They also assist us to get access to those managers. So we have a very thorough process. It broadly works as follows: we will review the asset class in the context of the wider portfolio, we will make a decision to invest in private equity, we will work out our allocations to the asset class and then within the asset class work out what allocations we want to make to particular sectors—buyouts, venture capital, expansion capital and so forth, how much we want to invest domestically and how much we want to invest overseas. In the portfolio context, too,

we will model the risks associated with the asset class and the impact that it has on the expected returns for the fund. We will then appoint our advisers. As I indicated, domestically we have Wilshire and internationally we have Altius. Those advisers have the two functions that I indicated, which are to find better performing managers for us and to assist us to get access to those managers. They will then identify particular managers and provide us with comprehensive due diligence. Their reports may be 30 to 50 pages in length. Those will be provided to us. Our internal staff will then review them and we will have ongoing dialogue with the advisers. We will invariably have questions of clarification, and we may override the advisers' decisions—we are not wholly dependent on them. We also bring in our own independent tax advisers and our own legal expertise. Having formed a recommendation, we will then put that recommendation up through our approval process within the organisation.

Senator BERNARDI—What were the names of the two advisers that you mentioned?

Mr St John—Wilshire Associates and—

Senator BERNARDI—Let us work on Wilshire. Wilshire are not a fund of funds or anything else like that; they are simply investment advisers.

Mr St John—We have appointed them as an adviser. They do have some fund of fund products also. Altius Associates is contemplating the introduction of a fund of funds product, although we are not investing in it.

Mr Gabriel—They have one fund of fund product. It is a very particular strategy.

Senator BERNARDI—Wilshire or Altius not only would have access to their internal researchers but also could go to S and P or any of those kinds of organisations.

Mr St John—Yes.

Senator BERNARDI—So there are people rating these products; it is not as though they are throwing darts at a dartboard.

Mr St John—Yes.

Senator BERNARDI—That is to reduce the risk.

Mr St John—In terms of ongoing monitoring, if that is of interest, we then get monthly reports from our managers and any other information that we care to access, either on the manager or, if we so choose, on the investee companies. That information is then fed into our regular reporting. We have quarterly investment reports, but we also have weekly performance updates. That information is then fed up to our investment committee and to our board.

CHAIR—Just on that point, is that weekly and monthly reporting driven by the relationship between the fund managers and the particular companies involved? Is there that level of engagement to drive those reports? Is there connectivity between the weekly reports and weekly discussions between the fund managers and the companies?

Mr St John—I will clarify my comments. The weekly reports I was referring to refer to our own internal performance reports that we produce on a weekly basis, but we also produce more comprehensive quarterly performance reports that go through to our investment committee and board. We also get monthly reports from our private equity managers that feed into our reporting systems and also allow our analysts to interact with the fund managers. In addition to that, our analysts—and we have dedicated analysts within the private equity asset class—interact with the fund managers.

CHAIR—Sorry, I might not be making myself clear. Are the monthly reports from your private equity managers driven by direct involvement with the particular companies that they are investing in?

Mr St John—No, they are not. It is agreed as part of the contractual arrangements that we will get reports from our private equity managers on an as agreed basis, which is monthly.

CHAIR—Do the reports back from those companies form the basis of the reports to yourselves?

Mr St John—That is correct. They are intimately involved with those investee companies and work with them all the time.

CHAIR—That was the point I was trying to get to.

Mr St John—My apologies.

CHAIR—No, it was the way I expressed it.

Senator BERNARDI—In your submission you talked about the growth of Australian superannuation and the search for alpha. Can you define 'alpha' for the purposes of the *Hansard*?

Mr St John—Yes. Very simply it is value adding above benchmark.

Senator BERNARDI—You have been in private equity since 1993, albeit in what you acknowledge is a riskier end of it to venture capital. What sort of performance returns have you achieved over the last 14 years in that aspect of your portfolio and how does that compare with, say, the ASX 200 or the All Ordinaries?

Mr St John—We do not have the specific figures at hand. I can talk about the industry more generally.

Senator BERNARDI—Please do—generally is fine.

Mr St John—If you were to look at the 10-year period through to 30 June last year and the combined totality of buyout and venture capital private equity markets, I suggest that you would see that it has matched the listed markets. The research that we have done in international private equity would suggest the same. There may be a small premium against listed markets. However, that highlights a very important fact: in private equity there is a very large dispersion in returns

between the better performing managers and the poorly performing managers. That is why it is very important for funds like ours to be adequately resourced and to be able to (1) identify the better performing managers and (2) access those managers. In private equity it is unique because there is some persistence in the return figures.

Senator BERNARDI—Your investment in private equity is spread across 60 different managers—

Mr St John—Approximately, yes.

Senator BERNARDI—over hundreds of companies. You are scattering your seed quite widely, aren't you?

Mr St John—Yes.

Senator BERNARDI—Is it right then to presume you are going to get the average returns because you are choosing 60 different managers or did you just happen to pick 60 really good ones?

Mr St John—We have hopefully picked 60 very good ones, but invariably not all of them will get it right. It comes back to the conversation we were having before: it is about how the asset class as a whole performs. We think we have the systems and processes in place that will allow our average manager to outperform the median quite significantly.

Senator BERNARDI—And that is the purpose of you being in the asset class. Otherwise you would just match the ASX benchmarks and why would you do it?

Mr St John—That is exactly right. In going forward over a long-term period, if we cannot get our benchmark and we are not going to be compensated for the additional risks that we are taking, we absolutely would not do it.

Senator BERNARDI—Is one of the additional risks that you are taking the fact that they are normally closed-end funds and you cannot get your money out for five years or seven years or whatever the period is?

Mr St John—There is a high degree of illiquidity in the asset class. That is a feature of the asset class and one of the risks involved.

Senator BERNARDI—Is there an exit mechanism in any realistic sense at all in the seven years?

Mr St John—We have various protection clauses within the contractual documentation that we sign so that under certain circumstances for key individuals—for example, leave—then, yes, we are able to stop the flow of funds.

Senator BERNARDI—Because it is such a small part of your portfolio, it is not a real risk in a superannuation type of environment.

Mr St John—It is a minimal risk. It is a managed risk and we are highly aware of the illiquidity risk that we are taking on. In UniSuper's particular circumstance, we have very strong cash flow. We have about a billion dollars of net cash flow a year and we have a defined benefit fund that has a healthy surplus attached to it and that allows us to take on board that small allocation of private equity.

Senator BERNARDI—Given what you have just said, is there any realistic prospect of massive redemptions in your super fund that are going to cause problems with these sorts of investments?

Mr St John—We monitor our cash flow situation on an ongoing basis and we manage the fund very carefully in that respect.

Senator BERNARDI—I am sure you do. I have no doubt at all. I want to turn to a comment you made about the domestic and international part of your portfolio. You made reference to superannuation funds in general and said that the bulk of their private equity investments or exposure was to domestic private equity funds. There is a preference for that. Do I recall that accurately?

Mr St John—I suspect that the historical evolution of the industry has resulted in most funds investing domestically.

Senator BERNARDI—Accordingly, they would be subject to superannuation taxation rules that apply in this country. What about internationally? You said that you get tax and legal advice. If you invest internationally, are the rules similar to those for foreign investors in this country?

Mr St John—Rules vary from country to country. With each particular investment we make we have to get tailored advice on a case-by-case basis.

Senator BERNARDI—That will affect the attractiveness of the investment from your perspective.

Mr St John—Absolutely.

Senator BERNARDI—What is attractive? It is not just the headline tax rate; for example, it might be transparency or the depth of the market or regulatory regimes and those sorts of things?

Mr St John—It could be a whole range of factors but ultimately what we are looking at is the after tax and after fees returns that we get for our members.

Senator BERNARDI—Okay.

Senator STEPHENS—You have brought a different perspective to the inquiry, so it has been quite interesting listening to how you approach the issue. I want to draw to your attention some issues of concern that have been raised in one particular submission, No. 3 from Mr Wynne. He makes a very different argument about investment with respect to the kind of society that we want to have. He raises an important issue for him which is about where we have private investment in what he calls 'vulnerable sectors of society', so in aged care and health. Could you

make some comments on your organisation's thinking about the health and aged-care sectors and whether you have an investment policy in those areas?

Mr St John—We do not have any policies in those specific areas.

Senator STEPHENS—His concern is partly about the idea of financial conglomerates coming in and taking over what should be, in his mind, the role of government funding in health and aged care and the implications that that might have for polarising some parts of society in that regard. He goes into detail about private equity in health and aged care and feels that the government has really abandoned that sector to the private market. He makes a lot of suggestions about legislative change including greater probity or he suggests quarantining certain areas that should not be part of private investment. I would see that as an unnecessary intervention. The point of my question is: do you see that there are areas that private equity perhaps should not focus on?

Mr St John—None spring to mind, besides making the obvious comment that, clearly, private equity can bring benefits to it in the form of an injection of capital and, potentially, the better management and utilisation of assets. Aside from that, we are not really in a position to comment because it is outside our area of expertise.

Senator STEPHENS—I appreciate that. I just wanted to get those issues on the record. In his submission he has made a substantial contribution that perhaps goes in a totally different direction. It is good to have it there. Thanks for your comment.

Senator WEBBER—I appreciate the advice you have given us about how the private equity investment that you have is a small part of your overall portfolio. Given the higher rates of return that those investments attract because of the higher risk, can you foresee a point where people on your board will pressure you to get further exposure so that you increase your returns?

Mr St John—Any decision to increase our allocation to private equity, whether it be domestic or international, would be a considered decision in the context of the wider portfolio. Under no circumstances would the fund take on concentrated forms of risk. We always look to manage risk and optimise our risk return outcomes for our members.

CHAIR—I would assume that, from a corporate point of view, let alone a regulatory or legislative point of view, corporate governance is not negotiable in the striving for increased returns. That risk would be manageable under your normal corporate governance arrangements, I would presume, and the obligations of the trustees.

Mr St John—Our ultimate obligation is to our members and to generate and maximise the returns for their retirement. But, clearly, corporate governance is important and we manage corporate governance in conjunction with our day-to-day investment activities.

CHAIR—What I suppose I am pointing to is that the obligations of your trustees are not negotiable in the context of chasing something that might be higher risk but with higher returns. I presume it is just part of a portfolio suite that the trustees are choosing to invest in.

Mr Gabriel—I think that is right, if I have understood what you are saying. They are not necessarily avoiding risk; it is a question of assessing risk, assessing return and looking at the relationship between the two. There are obviously techniques and various analytical processes we have in place to make sure that when we look at opportunities or look at setting the strategic asset allocation it is done in the context of looking at not only the potential return but also the risk you take on to achieve that. We have things like risk management policies in place. There are risk management statements and so on that, at an overarching level, govern our approach to that and make sure that we stay disciplined in looking at both those dimensions.

CHAIR—How many trustees does UniSuper have?

Mr St John—I could be wrong, but I think it is 11.

CHAIR—Are they from a broad range of community interests?

Mr St John—Yes. We have both employer and employee representatives and we have some independent trustees.

CHAIR—Is there union representation?

Mr St John—Yes.

CHAIR—What is the number of your members?

Mr St John—We have 350,000 members.

CHAIR—There has been some discussion about this and we are trying to see the wood for the trees. The evidence to the committee over the last couple of days has been that, in the main, the regulatory and legislative requirements for both public and private companies do not differ greatly. The financial reporting to the owners and shareholders is certainly different. One is subject to ASX and other rules and the other is not.

There has been evidence put to us by almost everyone from the financial council—my colleagues will tell me if I am misinterpreting this—that there is probably a greater level of financial reporting to owners with companies under private equity management than there is to shareholders under listed companies because of that very close relationship between the owners and the managers. Is that a reasonable assessment of the situation?

Mr St John—I think that is probably a reasonable assessment of the situation. Our private equity managers are intimately involved with the investee companies within which they invest. We are able to get any information that we require from our private equity managers about their own operations and about the companies in which they invest. To the best of my knowledge there has not been a single instance where we were prevented from getting information we requested.

CHAIR—From reading your submission, I take it that you do not believe that there is any requirement for a change in regulatory or legislative arrangements in relation to private equity.

Mr St John—We have not been able to identify any potential changes.

CHAIR—Thank you. It was important to hear evidence from your organisation because it has a very broad suite of trustees and a diverse range of investments.

Proceedings suspended from 2.37 pm to 2.44 pm

AGLAND, Mr Reece, Technical Counsel, National Institute of Accountants

RAVLIC, Mr Tom, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants

CHAIR—Welcome, Mr Ravlic and Mr Agland. You have appeared before parliamentary committees before, so you are aware of the normal requirements, which will save me going through the spiel again. Do you wish to make an opening statement before we take questions?

Mr Agland—Definitely. For the information of members of the committee who may not be completely aware of the work of the National Institute of Accountants, we have in excess of 14½ thousand members, who work across a range of areas in the Australian economy—some are public practitioners, some are academics, some work in corporations and others work in government.

I will make a couple of remarks before we take questions to focus on the issue at hand. Our expertise is in financial reporting and accounting. In our submission to the parliamentary committee, we confined our remarks to those matters. One of the problems that we have noticed over the past 12 to 18 months, particularly given the debate on corporate law reform and financial reporting, is that a lot of focus has been given to which structures—such as proprietary companies or public companies—ought to be reporting in a particular way. When this inquiry came up it was considered by us to be critical that we submit that the parliament ought to look at not just the structure of entities—whether they are a trust, a partnership, a proprietary company, a public company, an incorporated association or whatever other structure—but the nature of their activities when deciding what sort of reporting requirements people should be asked to comply with.

Our core argument in this instance is that, for example, if a private equity consortium is bidding for and successfully gets control of a major infrastructure entity, a transport company or another enterprise, and it is deemed by the government of the day that that industry is important and accountability to the public via financial reports lodged with the corporate regulator or another registrar is critical, that should be specified and they should be asked to report irrespective of the fact that they are a private equity consortium. We are looking at expanding that into the current consultations that federal Treasury is conducting in relation to unlisted public companies and we will also be making the same points to the AASB, the Australian Accounting Standards Board, when we respond to their current exposure draft dealing with a revision to the Australian reporting framework. That is all I wish to offer by way of introductory remarks. I am happy to take questions.

Senator WONG—Mr Ravlic, essentially, as I understand your submission, you are advocating for additional reporting requirements over and above those which currently exist in relation to private—that is, non-listed—companies operating within sectors you regard as economically significant.

Mr Ravlic—Correct.

Senator WONG—Leaving aside the second aspect, what are you suggesting that this committee should do? What is the end point you want? First, what do you say is the gap in the existing financial reporting requirements that are incumbent upon non-listed companies? Second, who is the regulatory body to whom such reports should be made? In your submission you said it was Treasury, but to me it would seem to be an odd process to have a company provide a financial report to Treasury. I would like to understand why you said that.

Mr Ravlic—You mentioned a few issues that I am happy to clarify. First and foremost, when, for argument's sake, you have a listed entity that is listed on the exchange, it has a comprehensive set of reports that are lodged publicly. When an entity is economically significant—an example that has been used by the AASB chairman is the notion of a listed company such as Qantas being delisted and moved into the hands of a private equity consortium—it would seem to us to be anomalous that you can shift a significant entity like that from one ownership structure to another and not have a comprehensive set of reports. We suggest that the parliament should incorporate in the law a suitable means by which a decision could be made by Treasury or the government that an industry was critical. For example, there is a lot of work being done in the water space at the moment and we see it as advantageous to have a situation where, irrespective of the structure of the entity, the public interest criterion that we apply to this is followed—that is, there is a pubic interest in infrastructure and transport entities and if you move them out of a regime where they are reporting comprehensively there may be somewhere along the line a lack of or a lessening of transparency. That is our major concern.

Senator WONG—Yes, I understood that. I understand the proposition about 'economically significant'. I want to start a bit earlier in the discussion. First, in regard to reporting requirements, what are the important things that have to be reported when a company is publicly listed but which no longer have to be reported when a company is owned privately? Presumably they would be things required through the ASX listing rules. Can you take us through that so that we can get some sense of what you are saying is the gap in relation to entities that are economically significant.

Mr Ravlic—If you look at trusts and partnerships, as a general rule they are not always subject to the same reporting requirements or to the same extent of reporting as those entities that are listed or those entities that are public companies.

Senator WONG—What is the gap? What is the mischief you are trying to remedy?

Mr Ravlic—The gap would be that you would not be provided with a full set of consolidated financial statements.

Senator WONG—Do you mean on a quarterly basis or on an annual basis?

Mr Ravlic—For argument's sake, if we took the example of annual financial reporting, the gap would be that the consolidated entity of which any business was a part would not necessarily have to report in the same way as a listed company would have to. There may be within the structure of the private equity network some business units that are registered as companies that get the protection of incorporation, and they would have to report. But whether you get the benefit of the full picture of an entity's operations, as you would in the case of a listed entity and its consolidated financial statements, is something that we would doubt at the present time.

CHAIR—So, in answer to the senator's question, it is the financial reporting aspects, is it?

Mr Ravlic—That is what we are talking about, yes.

CHAIR—So it is limited to that.

Mr Ravlic—Yes.

Senator WONG—I do not particularly want to talk about environmental reporting et cetera. You mention that in your submission as something that some people have lobbied for. But what the NIA is pushing for is, essentially, in relation to economically significant companies.

Mr Ravlic—Correct.

Senator WONG—If they do, through an LBO or some other arrangement, end up in private hands, you are saying that there should be the capacity to require greater financial reporting from them than would otherwise be required under the Corporations Law.

Mr Ravlic—Correct, because at the moment we have a structure that sets reporting requirements largely on the basis of ownership. We would like to see a shift to something where you have an additional public interest component fed into the reporting regime.

Senator WONG—Is that on the basis that in some way some might argue that ownership has been a proxy for economic significance? The assumption may well have been, say, 10 years ago that if you were going to be a significant company in terms of the Australian economy you would be publicly listed.

Mr Ravlic—Yes.

Senator WONG—Have you had any discussions about your proposition with anyone from AVCAL or other representatives of private equity companies?

Mr Ravlic—No. We have only canvassed some of our constituents. We have found a range of views, as you always do when you raise issues of reporting in the public domain. Some of our constituents will have the debate with us in relation to private companies or proprietary companies. They would argue that, if something is deemed to be private, why should information be provided to the general community. On the other hand, you have others who will say that these entities that are significant in terms of the nature of their activity ought to report, irrespective of their ownership structure. In one sense, we are arguing for greater examination of the substance of activity rather the form.

Senator WONG—And you have not done any analysis of the cost implications of what you are suggesting?

Mr Ravlic—We have not looked at the cost benefit of the notions. But if at the end of the day you have entities that are already listed and they delist, they may view that their listing provides them some saving in terms of lodgement fees and that type of thing. Quite frankly, what we also

need to bear in mind is that social benefit and social protection are brought about by the provision of information.

Senator WONG—That was my next question. I have asked you whether you have done any analysis of what the cost impact might be. I suppose the next question is: what benefit do you see would result from that?

Mr Ravlic—Something we believe in strongly is the transparency of corporate activity. If you have airlines, for argument's sake, or other similar entities that are in private hands, they are significant by their very nature, and it provides people with confidence that they are being run in an appropriate fashion. You have consumers out there who are users of the services. You have suppliers; you have creditors. They meet, in our view, all the conditions of a reporting entity if we take the concept that is still in place within the accounting framework in Australia. The accounting profession, over many years, has argued that for an entity in which there is a significant public interest, and for which there are users of financial information dependent on that information to understand that entity's state of affairs, the entity is a reporting entity and should be providing general purpose financial reports.

Senator WONG—Can I play devil's advocate for a moment?

Mr Ravlic—By all means.

Senator WONG—The argument about publicly listed companies providing this level of financial information and providing disclosure of any material information is that they are essentially hanging their shingle up and saying, 'Invest in us.' They are operating on the public, capital markets and there is a public interest in making sure they disclose to investors who are relying on that information. The argument is that it is very different if you are dealing with a private company which is dealing with a sophisticated set of investors who have made a decision to engage with the company, to invest in the company, and who presumably, because of the nature of private equity investment, have a very close understanding of the company. So what is the public interest in requiring the sorts of financial information being reported that you have described in that context?

Mr Ravlic—It would be interesting if an entity like that were to collapse at a point in time.

CHAIR—That is not answering the question.

Senator WONG—I think he is. I see what you are saying: you are saying that there is an interest in making sure that it is financially sound.

Mr Ravlic—Correct. If you sit back and say, 'Okay, we have a group of investors that are looking at a closely held investment,' what we have not introduced in that dialogue, in that questioning or in that circumstance, is all the external parties that engage with the entity—the consumers, suppliers, creditors and others—who might have an interest in the entity performing; and the employees as well.

Senator WONG—Okay, so it is a stakeholder argument?

Mr Ravlic—Yes. You have a broad group of stakeholders who have reasons to understand how entities operate.

Senator BERNARDI—Did you say that you had 14,000-odd members in your organisation?

Mr Ravlic—Yes.

Senator BERNARDI—Are they all accountants or do they just work in accountancy associated fields?

Mr Ravlic—They would all be accountants, although they would be working in different roles across the economy.

Senator BERNARDI—When you say that they are accountants do you mean that they are CPAs and chartered accountants? Are those the qualifications necessary?

Mr Ravlic—Our institution is a like body to the CPAs and the ICAA. We have our own designation. Our members can be either associates or full members—as in members of the National Institute of Accountants. Our high qualification designation is for PNAs, which are professional national accountants.

Senator BERNARDI—So you are a professional body that people have to do study to get into.

Mr Ravlic—Correct, we are a professional body for accountants.

Senator BERNARDI—Where do they do that study? Is it at university, TAFE or somewhere like that?

Mr Agland—At the PNA level we require members to have a university degree and to do our own program. At the associate level though they can join with just a TAFE certificate. So we differentiate with CPAs and the CAs in that we do have a pathway for TAFE people to come in. Other than that, at the member level and at the PNA level members need to have a university degree.

Senator BERNARDI—Before making this submission, what level of consultation was made with your 14,000 or so members?

Mr Ravlic—We have tended to rely on a narrow group of members who have engaged with us via committees. One of the issues we always have—and whenever I speak to groups of members I remind them of this—is that we have a technical team that is a fairly close-knit, small group of people. We have 14½ thousand members. We can only get around to a certain number of them. In terms of the consultation process, we have gone to members who are members in the big four firms. We have spoken to members who have traditionally had an interest in accounting and financial reporting matters. It has been a case of conversing with those people that we know have an interest.

Senator BERNARDI—How many people who sit on your various committees would you have consulted about this submission? I am just intrigued about how far these concerns are held within your organisation.

Mr Ravlic—It would be our legislation and standards committee.

Senator BERNARDI—How many people is that?

Mr Ravlic—The members of the LSN, our National Standards Committee, which represents a broad discipline—accounting, tax, audit—has seven people on it that represent a range of views.

Senator BERNARDI—So seven people have put this submission together and approved it. Is that what you are saying?

Mr Ravlic—Yes.

Senator BERNARDI—Okay. I just want to get that in perspective. You talk about significant economic interests or economically significant companies—

CHAIR—Before you move on to that, I just want to pursue that a bit further. Would you agree that what you are proposing in this submission is fairly radical?

Mr Ravlic—In one sense the accounting profession itself has had the reporting entity concept in the conceptual framework for some time. We are suggesting that the way in which the reporting entity concept is interpreted could be done better via the use of other legislative means. At the moment we have size tests on the proprietary company side. We also have some difference in the way public companies report. You would be aware, I am sure, that on the public company side you have got disclosing entities that offer securities required to provide a lot more disclosure than public companies that do not.

CHAIR—I will rephrase it: is it radical to the extent that you are suggesting that parliament actually determines a list of economically significant industries?

Mr Ravlic—I would agree that we are probably asking parliament to think a bit more about the area. What we already have, and parliament has endorsed in its own right, is the notion of thresholds that are determined to be economically significant for the purposes of financial reporting by proprietary companies. It is probably taking that one step further and saying that we have a situation where we may have entities that would otherwise report on the basis of ownership that are probably significant in terms of the economic activity of the company.

CHAIR—Are the thresholds you are referring to in the context of financial reporting time lines? Are those thresholds you are talking about and the difference in thresholds, depending on a particular group of companies, limited to their reporting time lines or the regularity of reporting, or are there are other issues?

Mr Ravlic—Are we referring here to the Corporations Act?

CHAIR—You said before that there is already a threshold there at the moment—

Mr Ravlic—You can look at the recent amendments made to the legislation, Senator, in section 45A of the Corporations Act, where the Corporations Act clearly delineates, rather simplistically in our view, what is a big company and what is a little company. Those amendments were passed by the parliament—

CHAIR—I accept that. What do those differences in threshold mean? Is it in relation to reporting time lines or are there other—

Mr Ravlic—No, it is in relation to who must report and lodge audited financial statements.

Senator BERNARDI—In your view, what are economically significant enterprises? You touched on transport and infrastructure. Are there any others? What about telecommunications? What sorts of industries are you thinking about?

Mr Ravlic—I will answer that in what you might regard as a roundabout way just to illustrate the point. One of the things that we looked at in the process of thinking about this work and this inquiry was the proposal in a discussion paper that was put forward by the International Accounting Standards Board on accounting standards for smaller to medium enterprises. This was a discussion paper that was released in 2004.

Senator BERNARDI—So what sorts of industries? I know that we are going to be pushed for time. What sorts of industries did that paper identify?

Mr Ravlic—What it did in essence was to define public accountability in that discussion paper as applying to listed companies, deposit takers—that is, banks and other entities that take money and hold it in a fiduciary capacity—and utilities. Then it opted for the definition 'economically significant within the home jurisdiction'.

Senator BERNARDI—So the definition—

Mr Ravlic—The focus that we would like to have is one looking at the utilities—the things that are critical for the running of the economy.

Senator BERNARDI—For example, you think that a private toll road should have an obligation to report to the public?

Mr Ravlic—Definitely.

Senator BERNARDI—What about a private transport company or enterprise? Should they have an obligation to report to the public?

Mr Ravlic—Yes. It may be that the extent to which the entity reports is less than a listed company.

Senator BERNARDI—So it is not the same accountability as a listed company, but another level.

Mr Ravlic—You may leave out director remuneration, for example. You may carve out some elements of the reporting requirements, because of the fact that you do not have the same number of owners involved in that capacity. Utilities are the ones that are of major concern to us, but then you get into the woolly area of economic significance in other parts of the economy.

Senator BERNARDI—This is the thing: it is a woolly area. You are talking about economic significance, and that is a subjective and woolly area, as you say. But I want to draw your attention to some of the things that you have put in your submission. You have said that there are individuals or entities within the community that have been seeking for some time to avoid a public reporting obligation for their operations. Can you give me an example of some of those individuals or entities?

Mr Ravlic—I can give you an example of some of the things that we have been hearing from members and others. One of the things that we have—

Senator BERNARDI—I want to know who the individuals or entities are.

Mr Ravlic—I am happy to provide you with the anecdotes. The names of enterprises and individuals have not been mentioned to us. What we have been told is this: under the present reporting regime, people are able to define themselves as a non-reporting entity. The significance of that is that they then are able to not comply with certain parts of the accounting standards in relation to disclosure.

Senator BERNARDI—What are the criteria to declare yourself a non-reporting entity?

Mr Ravlic—You have to be able to justify somehow that you have no users interested in your financial information. The definition of a reporting entity has up to this day rested on there being a group of users who are dependent on knowing about your entity but are unable to demand information from you.

Senator BERNARDI—Are you saying that your members who provide you with these anecdotes assist these entities and individuals to become non-reporting entities? Do I understand you correctly?

Mr Ravlic—All I am hearing are complaints about the standard of financial reporting of some entities. I would not know whether our members are encouraging people to be non-reporting.

Senator CHAPMAN—What is your view of an entity that operates in an industry sector where there is a relatively small number of operators and must disclose, as it is required to, the sort of information that gives its competitors a lot of information about the nature of its operation—its pricing or costing—which militates against its operation? Wouldn't you accept that in that situation they would be justified in not being required to report?

Mr Ravlic—I will add a complexity to your analogy. You have asked whether they would be justified in not reporting. However, we have not explored whether those entities in their own right are lodging financial statements already as a result of Corporations Act obligations or whether they are partnerships.

Senator CHAPMAN—In the particular instance I am thinking of they are. They sought an exemption from ASIC, but ASIC refused to give them an exemption on grounds that I thought were quite specious.

Mr Ravlic—We would have to respond in this way: if you apply a general reporting guideline to any individual industry, it would be very difficult for us to see justification, in principle, to provide relief. I can understand that people would feel aggrieved and at risk in providing certain disclosures. However, if you were to approach the problem with that principle in mind, it would be difficult, without having regard for specific entities, to say, 'Look, two or three companies within a group should receive an exemption because.' It would be interesting to understand your example further, as it would also help us to understand what some people are going through when they approach the regulator.

Senator BERNARDI—I come back to your description of a private equity structure. You do not limit yourself to private companies; you say there are trusts and partnerships that have been in existence for hundreds of years. What effect will a company putting its vehicle into a trust structure have on the corporate environment operating in Australia; what difference will it make?

Mr Ravlic—We approach that question as a matter of principle, from the point of view of asking why should there be a focus on the structure as opposed to the nature of the operation? We have thought about that and struggled with it. You ask: if entities operate in a particular environment and they hold certain particulars, irrespective of their structure, is there a public interest in people knowing that their operations are sound and that certain services will continue to be provided? We, ourselves, have not looked at the examples. It is just a matter of principle. Irrespective of structure, what is the right reporting or accountability outcome here? That is the way we approach that task.

Senator BERNARDI—Further in your submission you contrast your view on the accountability of financial performance to the public and yet you say that, for example, environmental sustainability or environmental issues are subjects simply for the board and owners of the company. Is it just me that identifies that you have two very different arguments about two very serious problems? There is a financial obligation, of course. The people who have a vested interest in the financial obligation are the shareholders and the people who have a vested interest in the environmental issues of a company are probably the broader community. It sits oddly with me. I wonder what your comment is on that.

Mr Ravlic—In one sense when we were considering the issue we were looking at it from the perspective that at the current time there are a lot of mandated financial reporting and environmental reporting obligations and in some circumstances they are being taken on voluntarily by companies. I accept your point that it would appear to be an inconsistency in our approach which is: should not these companies be also required to provide environmental information by virtue of the law? Perhaps they ought to be but via another vehicle. We sought to consider the financial reporting implications more from the point of view that the current reporting obligations in the Corporations Act focus heavily on the financial reporting side.

Senator BERNARDI—What comfort would you take if this were adopted? Do you believe it would result in fewer corporate failures? I can think of a number of publicly listed corporate

failures and I struggle to think of too many unlisted utility failures, but maybe you can identify some for me.

Mr Ravlic—We have approached this task by saying: what is the appropriate level of accountability of entities that operate in particular industries? Will it enhance the performances of people if they provide more information to the community? Will it improve the likelihood of corporate success across the board, utilities or otherwise? The answer to those questions is: there may not be a huge improvement in the running of certain entities but it is transparency and trust in the community that people should be looking at. Our key concern is making sure that people trust the operators at various institutions irrespective of the structure that institutions have.

CHAIR—What has happened in the last 18 months that has led you to take this action?

Mr Ravlic—We have thought about entities such as Qantas and we have thought about a range of others that were contemplating moving into a private equity structure—

CHAIR—Who else?

Mr Ravlic—We also had the obvious tussle over entities such as Coles Myer. The question that we posed to ourselves—

CHAIR—Was it just limited to those two?

Mr Ravlic—It is a question of a matter of principle at the end of the day.

CHAIR—That is my very point. We have had significant private equity involvement in this country for a number of years. In 1989 there was a very significant leveraged buyout of billions of dollars, so when did this principle suddenly become a pressing principle?

Mr Ravlic—In the life of any community there is a growth in understanding of the significance of transparency or of the way in which investment operates. The answer to your question probably lies in the fact that we have had a greater community awareness of investment over the past few years and an understanding of how important investment is to people's futures. If entities that control investments, whether they are super funds or listed companies, are not doing well and there is a lack of adequate transparency—however you may define it—then the trust in those entities has to be impaired.

CHAIR—The retail sector is very small, as you are acutely aware. The great bulk of these investments are by banks and superannuation funds. In fact, we heard from UniSuper before. UniSuper, for example, made it quite clear to us that the level of financial reporting that their fund managers and others come back to them with means that they have probably more intimate knowledge of the financial arrangements of the PE companies they are investing in than they might have with a publicly listed company. So are they wrong?

Mr Ravlic—It would be interesting to read the transcript when—

CHAIR—I am sorry but you do not answer my question with a reflection on the fact that I am not accurately describing it.

Senator WONG—You are asking Mr Ravlic to comment on evidence he has not heard.

CHAIR—I am putting a proposition.

Senator WONG—I am suggesting that if you put to the witness issues that he has not been privy to in terms of evidence, it is quite appropriate for him to say that he does not know what the evidence was.

CHAIR—I am putting a scenario by UniSuper. Are you saying that the trustees of UniSuper and other super funds are not paying sufficient attention to their investments on behalf of their members?

Mr Ravlic—Not having been present during the delivery of the evidence, I would have to say that UniSuper would be able to look at those issues and fulfil its responsibility. I am not aware of the composition of the board of UniSuper and I am not able to comment on an informed basis on the way in which UniSuper conducts its affairs.

Senator BERNARDI—Do you have a general concern with the investment decisions and disclosure that public superannuation funds operate under in this country?

Mr Ravlic—We have not looked at that area in great detail. My colleague Mr Agland deals a lot with superannuation issues but I am not sure whether he has come across anything that would lead him to conclude that he holds any concerns about that.

CHAIR—Are any of your members involved in the superannuation industry?

Mr Agland—No. Most of our members involved with super have self-managed super funds. I would not say I am an expert in the area of industry funds. We have not looked into the issue of UniSuper at all.

CHAIR—Can you give me an example of a sector or an industry that you do not believe is of economic significance?

Mr Ravlic—I was reflecting on this issue today at the office. We have agreed that utilities are of economic significance. We would regard any entity which falls under the 'small proprietary company' test in the Corporations Act as not being economically significant. We will fall back to the Corporations Act definition of 'small proprietary company,' because it is extremely difficult once you move out of the area of utilities to begin to pick off entities that are not economically significant.

CHAIR—Is it activity or turnover which is the driver of this?

Mr Ravlic—It would be a combination of both.

CHAIR—So in that small proprietary company sector you might have someone who was economically significant but the turnover was not sufficient for them to come under your definition?

Mr Ravlic—In thinking further about the proposal since we submitted to the committee, one thing that became apparent was that it may become burdensome for some entities which are that small to have to report the full extent of—

CHAIR—Is it the general community that is your focus or small business? If a small proprietary company is of economic significance and if that financial reporting is too burdensome, you are saying that that would override the economic significance aspect of it?

Mr Ravlic—We may have to give consideration to that. It would depend on whether it fell within the definition of 'utility'. For example, most of us in our office would use the public transport system to come in and go out of the city for work. We could not do without that, but we could do without things like CDs or other things that are a discretionary spend. We would have a discussion about what we deem to be economically significant: what things do people need to operate day by day and what things are not that significant, from the point of view of the operation of the business?

CHAIR—Why is social protection more important in the transport or utilities sector than it might be in another sector, because your criterion is social protection?

Mr Ravlic—It is a good point that you make. I think you also need to add the health sector to the list.

Senator WONG—I will go back to the questions I was asking at the outset. Essentially, I was trying to work out where you say the gap is in disclosure. So we have various requirements on publicly listed companies, which include the financial reports that are required by ASIC by virtue of their incorporation under the Corporations Law, and the registration. Then there are various requirements, both under the Corporations Law and under the ASX listing rules by virtue of their public listing—things such as continuous disclosure being the most obvious. A non-listed company also registered under the Corporations Law still is required, is it not, to provide financial reports to ASIC on an annual basis?

Mr Ravlic—An unlisted public company, yes.

Senator WONG—What about an unlisted private company registered with ASIC? They are still also required to provide a financial statement annually, are they not?

Mr Ravlic—If they are registered as a proprietary company, yes. If they are a large proprietary company, they have to provide audited financial statements to the commission.

Senator WONG—Which is the threshold in the—

Mr Ravlic—Yes.

Senator WONG—Which is a turnover, I think—is it turnover?

Mr Ravlic—It is two of three.

Senator WONG—That is right; it is a range of criteria.

Mr Ravlic—It is the turnover or the asset base or more than 50 full-time equivalent employees.

Senator WONG—So, in terms of their size, a private company would still be required to lodge financial statements with ASIC. I assume they are risk compliant—those statements.

Mr Ravlic—They would need to be, yes.

Senator WONG—So the actual hole, as it were, that we are talking about is trusts, which do not issue securities, in that there is no requirement upon such entities to lodge financial statements.

Mr Ravlic—In the circumstances where those entities that are unlisted have all their partnerships that operate in an area—for example, they happen to be operating a utility—we can use that example.

Senator WONG—Before we get to where you want to go, I am trying to work out where you say the gap is. Is the gap really only in relation to non-corporate entities which are not publicly listed?

Mr Ravlic—Yes.

Senator WONG—So this is not just a private equity issue. This is because there would be private equity corporate entities which would retain the ASIC requirements as to the lodgement of financial statements for the reasons we have outlined.

Mr Ravlic—Yes.

Senator WONG—So we are talking about trusts, which may be private equity trusts or family owned private trusts which have significant economic interests.

Mr Ravlic—Yes.

Senator WONG—I do not know whether you have read Professor Boymal's letter to the committee. It is a very short letter indicating that it is not the role of the AASB to determine which entities report. He simply states:

The AASB would like the Committee to note that, whilst there are comprehensive requirements for the preparation, presentation and lodgement of financial reports by entities incorporated under the *Corporations Act 2001*, including disclosing entities, there are major gaps in the requirements for other types of entities.

That is the point you make. His specific example is trusts. He goes on to say:

If a private equity investment were to be conducted through a trust, for example, and it did not involve the issue of securities to the public, that entity would not be compelled by law to prepare, present and lodge financial reports, regardless of its economic significance.

So are you on the same page in flagging where the gap is?

Mr Ravlic—We agree with the Australian Accounting Standards Board.

Senator WONG—So you are not actually proposing any additional regulation in relation to non-listed private or proprietary limited companies?

Mr Ravlic—No, we are not. We are trying to make sure that there is a consistent level of disclosure where the nature of the operation is the same.

Senator WONG—Do you have any evidence to give us about the scale of activity that would fall into that non-disclosing, non-reporting category?

Mr Ravlic—We have not done any review. In fact, because of the very nature of those entities, they do not provide reports. There is no evidence on record anywhere of the extent to which that is a problem that we are aware of.

Senator STEPHENS—In the time that we have left, I want to go back to the principle that you discussed and the point that you made about public trust in institutions. I draw your attention to a submission that we received from the UTS Centre for Corporate Governance, which raises the issue of the significant changes that are taking place in the health industry and, in particular, the aged care industry with the takeover of non-profit aged care provision by for-profit private equity ventures, which subsequently go to the market. Have you seen that submission? It is submission No. 5 from Ms Marie dela Rama of the UTS Centre for Corporate Governance.

Mr Ravlic—We have not looked at that submission in detail.

Senator STEPHENS—She articulates a very important trend that has occurred in the aged care sector and focuses on the fact that, as this is a rapidly expanding sector, it therefore has a significant impact across the economy. She makes another very important point in the submission—which is different from others on the same issue—about the social change that is engendered by this shift. This has meant that the former benevolent role of the non-profits, which have traditionally been providers such as St Vincent de Paul and the Salvation Army, has been reduced in that they are no longer able to compete in this market and therefore have vacated that space. They have become service providers as opposed to owning and operating those kinds of facilities.

You talked about significant economic activity and the way in which there could be additional reporting. I can see the process where you said to yourself, 'Yes, we should add health to that economic activity.' Have you any thoughts about the aged care sector, given the demographic change that is occurring?

Mr Ravlic—You have hit on an important point there: society changes over time and different things become important at various points in a nation's history. Obviously the Australian community is becoming much older, which is why investment in superannuation funds has become more critical and a range of other issues to do with the provision of social welfare have become more profound. I think your point about the health sector and the ageing sector is very well taken. I think we would support the idea that governance in that area would need to be scrutinised or at least monitored a bit more going forward because of the fact that a lot more

people are getting older and a greater number of people in the Australian community will be using the services of these entities.

Senator STEPHENS—I suppose the nub of this submission is that, unlike other areas where private equity investment tends to be high risk and speculative, this is an area of economic activity that is in essence underwritten by government subsidies and will continue to be because of the nature of aged care provision. Her argument is to quarantine some sectors of the economy from private equity so that it is not available or cannot be used. We would have to think about whether or not that is an option. Whether or not it is to do with health and aged care services, should there be some kind of investment horizon or something else put in place in the future? I do not know whether something can be done about this.

Mr Ravlic—I will confine my remarks to the reporting requirements of the health sector. When government departments provide funding to this sector, the various nursing homes are required to acquit for the funding. So it is one of those areas where there are already reasonably robust reporting requirements. We have had conversations about other aspects of financial reporting with members in the nursing home sector, and they have outlined to us in some level of detail the sorts of accountability mechanisms that they go through in order to acquit for the way in which they use funds that are provided to them by government.

Senator STEPHENS—Those are the service providers who are meeting their accreditation standards. But in terms of the people who own the actual bricks and mortar, such as Macquarie Health, who are moving very tenaciously into that sector, they know that their investment is fundamentally going to be underwritten by government funding to the aged care packages. That seems to be a differentiation for some people, and some of the submissions try to make that point as a matter of concern.

Mr Ravlic—The point about the underwriting is something which we had not reflected on prior to coming here today. It is obvious that people such Macquarie Health have taken an investment decision. They have seen it as a sector in which there is going to be substantial growth. It would be a policy decision for the government or, indeed, the parliament in terms of any regulation.

Senator WEBBER—I was not going to ask any questions but, after listening to your earlier discussion, Mr Ravlic, with the chair and Senator Bernardi, the thought occurred to me—and this is a thought that I would appreciate your comment on rather than any concrete view—that potential private equity investment in an entity like Qantas created a great deal of not just media commentary but community anxiety about the future of that entity. Would some additional reporting requirements or regulations be a way of winning public confidence and trust in using private equity investment to sustain these enterprises?

Mr Ravlic—It may assist people to be less nervous about the way in which an entity shifts through one structure to another. Whenever there is a difference in anything, whenever there is change, people will be nervous. It does not matter what the issue is. Whenever things change—whether they be regulation or whether they be structures—it is just a part of the human condition to look at that change and ask ourselves: 'What does that change mean?' Change brings with it uncertainty. Whenever you can eliminate some level of uncertainty, you are probably providing comfort for people somewhere along the line.

Senator WEBBER—Particularly when it is their retirement income that is a potential investment vehicle.

Mr Ravlic—Correct.

CHAIR—I am advised that I was getting close to being cantankerous, so I apologise for that in the light of my discussions yesterday morning. This committee and other parliamentary committees very much appreciate the input of the NIA on a large range of matters. I thank you and Mr Agland for your attendance today. Thank you.

Proceedings suspended from 3.49 pm to 4.05 pm

NOLAN, Mr Greg, Director, Australian Institute of Superannuation Trustees

REYNOLDS, Ms Fiona P, Chief Executive Officer, Australian Institute of Superannuation Trustees

CHAIR—A warm welcome to you, and thank you for attending. Have either of you attended these types of hearings before or given evidence before?

Mr Nolan—I have not, but Fiona has.

Ms Reynolds—Yes, I have.

CHAIR—Ms Reynolds, I take it that you would probably have briefed Mr Nolan on things such as turning off mobile phones, parliamentary privilege and answering questions et cetera—is that right?

Ms Reynolds—That is right.

CHAIR—Terrific. Thank you.

Ms Reynolds—I may have left out the bit about turning off the mobile phone, but I did brief him on everything else.

CHAIR—Then I will dispense with the repetition of my opening statement. Who is leading—Mr Nolan? Ms Reynolds, is it?

Ms Reynolds—I will start.

CHAIR—If you would like to make an opening statement, please feel free to do so. I only asked Mr Nolan because he was on top of the list. Ms Reynolds, that is no reflection on you at all.

Mr Nolan—Ms Reynolds is being very polite in doing that.

Ms Reynolds—Thank you. By way of introduction, AIST is an industry body representing not-for-profit superannuation funds. To clarify that, that is industry, public sector and corporate superannuation funds. The majority of our members invest in private equity. We estimate that somewhere around 75 per cent of the funds who are our members have private equity holdings. On average, it is about five per cent of their strategic asset allocations, but we estimate that during the 2007 year this will grow somewhere closer to seven per cent.

We believe that private equity overall is an important but small part of a superannuation fund's investment portfolio. In the whole superannuation industry, private equity makes up as little as two per cent of total investments. Our members invest in private equity because they believe it is appropriate for them as wholesale, long-term investors and that it provides them with diversification and gives them an opportunity to outperform other funds who do not invest in this

area. Our research shows that private equity has returned about five per cent above listed markets. We would be happy now to discuss anything in our submission or answer any questions that you have, where we are able to.

Senator STEPHENS—Thank you for your submission. We heard this afternoon from UniSuper, so it is a different perspective and a very important one for us. Can you tell the committee how superannuation firms define private equity in investments. Do they include venture capital as well as buyouts?

Mr Nolan—Yes, we would. The funds appoint private equity managers, who then go and seek the investors. Normally we appoint what we call 'fund-to-funds'. So that will be one manager who garners a stable, if you like, typically of 10 to 12 private equity managers, and then seeks the investments throughout the economy. But venture capital buyout funds are typically in that segment, yes.

Senator STEPHENS—Ms Reynolds, did I hear you say that you are looking at trying to grow your investment in this sector to about seven per cent?

Ms Reynolds—No. The amount being invested by our members is growing from around five per cent over the last three years to about seven per cent now.

Senator STEPHENS—As you represent the superannuation funds for the non-profit sector, do you have principles such as ethical investment commitments?

Mr Nolan—Some of the funds do. The funds now tend to invest in what they call a sustainable fashion, which is different from ethical investing. Some years ago, the funds did offer ethical investment choice. The funds have fiduciary responsibilities to their members to obtain the maximum returns possible within the risk profiles they are given. There was and still is a bit of debate about whether you have to give up returns to invest ethically—if that makes sense—so they have tended not to encompass the ethical style of investing in their whole portfolio. However, with choice, they have been able to isolate a segment of their portfolio and invest that ethically, if their members so desire. Some funds have done that; but at this point it is probably only a minority, because it has not been taken up as well as we might have expected it to be. It is like everything: people want a lot of choice but, when you give it to them, they do not necessarily avail themselves of it.

Ms Reynolds—I would add that a growing number of our members, however, have signed up to the UN principles of responsible investing. We see that as a growing trend.

Mr Nolan—That is probably the next step from the ethical side of investing and that is an all-encompassing vision, if you like.

Senator STEPHENS—We took evidence from UniSuper, as I have said. Without verballing them, I think they referred to the pressure on superannuation funds to perform to get returns for their members. Does that pressure translate into an intention to extend, or an interest in extending, the level of investment in private equity higher risk opportunities?

Mr Nolan—I am not sure whether it extends to that degree. All I would say is that funds, because of the competition they are under, continually try to seek returns that will enhance their overall return, in a risk-controlled fashion. That is the critical thing. The funds are taking on some extra risk but in a controlled sense. By that, I mean that it is well and truly diversified, as Ms Reynolds indicated. This segment of the market is only small—it is between two and five per cent—so it is not, in any sense, putting the funds at any undue risk.

Senator STEPHENS—Do you think the proportion might increase over time to more than five per cent?

Mr Nolan—As we have indicated, it looks as though it will. From our perspective or our members' perspective, we want to deliver returns to members that are not as volatile as perhaps those of listed markets may be. We have seen listed markets over the last four years deliver returns in excess of 20 per cent. In the early 2000s, we saw them deliver negative returns. The funds are very conscious of trying to smooth out those returns. Listed equity is one way we can do it. The returns in listed equity, while they are correlated, are not correlated 100 per cent to those of the listed markets. So there is a real desire to diversify in order to try to minimise the volatility while maximising the returns, again within the risk profiles that I speak of.

Senator STEPHENS—Would your trustees consider a ceiling on how much the investment would extend into private equity?

Ms Reynolds—Yes, I think they would. Funds sit down with their advisers, with their asset consultants, and look at their asset allocation and move it around as needed and as advised. I can imagine that the asset consultants, depending on what is happening in the market, would tend to have a ceiling on what they are putting in a number of assets—where they are putting the money—and that would include private equity, with the whole idea of diversification.

Mr Nolan—May I put this in context too. In this spreading of the risks and diversification that I speak of, it is not just private equity; the funds look at other investments that are not listed. The whole objective of the exercise is to get away from the vagaries of the listed markets. They will invest in infrastructure assets, private equity—I think UniSuper has invested in timber plantations—and other long-term investments. That is the other benefit that private equity brings to the table: it is a long-term investment. Private equity horizons are in the five- to 10-year range. Listed stocks are generally held in portfolios for about 12 months. So you can see that the long-term time frame is much more suited to our liability base, if you think of our member benefits being our liabilities.

Ms Reynolds—Going back to your question about the pressure, I think with choice has come competition and also ratings agencies that rate companies. They say, 'This fund got 16 per cent and this got 20 per cent.' In the main, people can move funds. So if they can see a headline that says that their fund got 16 per cent but this fund got 20 per cent, does this mean that they then start thinking about moving? I think there is some pressure on funds to continue to outperform.

Senator STEPHENS—We had some additional material provided to the committee which was a paper from Standard and Poor's about their concerns about the fact that some investments go from being a publicly listed company to being a private equity entity and that avoids their

rating process. This paper really articulated some concerns about the lack of transparency. Has that been a consideration for your group?

Mr Nolan—This is a point that sometimes is brought up. Last year, of the 78 public companies that went private, two were as a result of private equity. So it is not a big percentage. There is a lot of emotion about this subject but it is not a big issue, really—two out of 78.

As for transparency, in many ways I think the private equity market is probably more transparent. It is just not public. There are expert managers and asset consultants, as Fiona alluded to before, and the fund managers themselves, who are crawling all over these companies, and they are not going to make decisions that jeopardise their future. The whole essence of the private equity market is regeneration. They are trying to raise money today to get deals away tomorrow and they want to come back in three or four years time to raise money again. They are not going to do anything to jeopardise their reputation and their returns. I think transparency is not quite as big an issue as it is said to be.

The fund managers we invest in have managers, executives, on the investment committees of the managers they invest with. So it goes right down the trail. The due diligence they do is very extensive. They have briefings, quarterlies, half annual reports and annual reports. They are meeting with them all the time. A big positive for us as investors is that the interests of the private equity managers and the investors—being us—are aligned. They want to make money to stay in business and for themselves; we want them to make money for our members so that we can improve the returns to our members. It is all about transparency, really. It is just not in the public arena.

Ms Reynolds—One of the things that superannuation trustees say about the long-term interest is that you could also say that in the public markets people are having to think short term—for example, about the quarterly returns—because they are worried that people will disinvest. There is an ongoing problem about thinking short term when superannuation funds are long-term vehicles. So being able to work within private equity with companies—even if they are companies that have gone from public to private—has some appeal.

Senator STEPHENS—So how much of your investment is in overseas private equity entities? We heard earlier that one of the issues about investing in this sector is that there are capacity constraints and opportunities are limited in Australia.

Mr Nolan—I am trying to think of our percentage. I hesitate to quote a number because I might be wrong. It is more overseas than locally because of that diversification factor and the spreading of the risk—and the opportunities, also. From memory, in Australia there are only about eight or nine private equity companies. There are not a lot that our asset consultant would consider worth while and recommend.

Senator STEPHENS—That is an important issue: the fact that there are a limited number of valuable investments for Australia.

Mr Nolan—That is right. Just on that, the other thing is that if you invest in a fund of a fund, which certainly we do and I would suspect that most of our constituents do, the fund of a fund might invest in say 10 managers who invest in 10 to 15 private equity companies, so you are

spreading the risk. In the private equity sector, you might be invested in 100-plus companies, so the exposure to each one of those companies is not great. When you think of that being five per cent of your fund, it is diluted again.

Senator STEPHENS—Thank you. That was interesting.

Senator CHAPMAN—Looking at your submission, you seem to broadly divide private equity into two categories, the venture capital category and the corporate raider category. Typically, venture capital is provided for early stage companies and at various stages of early stage companies. Are you therefore defining private equity investment in mature companies as being typically of a corporate raider type?

Ms Reynolds—No. At the time when we were writing these submissions, there was a lot being written in the press. There were a lot of concerns. There was Qantas, Coles et cetera. Some of our members had expressed concern and were asking: 'What's happening? Is Qantas going to be taken over and loaded with debt? We don't necessarily want to be involved in that type of investment; we want to be involved in creating companies and adding value, not devaluing companies.' We wrote that with those comments, which came back from our members when we circulated our draft submission, in mind. That took into account the views of a lot of people who are our members. Our funds in the main are invested in earlier stage—

Senator CHAPMAN—I understood from the submission that that is what your funds are doing. But you would accept that there is also potential value from private equity investment in mature companies. It is not necessarily corporate raider type investment.

Ms Reynolds—Yes.

Mr Nolan—In particular—

CHAIR—Bradken and Austar were here this morning, so there was a lot of evidence about those types of companies.

Mr Nolan—Also there have been a lot of examples of private equity buying an unloved division of a company. It is not the core part of the business, if you like.

CHAIR—That is the Bradken model.

Mr Nolan—So there are examples of that and they do very well and add to productivity along the way.

Ms Reynolds—A number of our members have been involved in buying Pacific Hydro and taking a public company, private. So that is a mature company. So they do invest in other parts as well. There have been inflamed emotions that also affect our industry about private equity.

Senator CHAPMAN—In that context, you have expressed some concern about profitable companies being broken up. I am more interested in your comment about loading them up with debt to provide returns to investors. Can you explain how you believe that happens? I would

have thought that if you load an entity up with debt, you are not going to be left with much of a return unless you add value in excess of that debt.

Mr Nolan—I think the point we were trying to make is that debt can be used to expand the company. Obviously, banks have credit constraints. There is the empirical evidence that I have come across in asking private equity managers about this. Unfortunately, I am old enough to remember what happened back in the eighties and I have actually asked what the difference is between now and then.

Senator CHAPMAN—So am I?

Mr Nolan—Some might not be, but some of us are. The response I have is that now these private equity companies or these entrepreneurial companies are perhaps more disciplined and smarter than they were. I think the trend has really been for a lot of them to knock back—in fact, there might have been an article in the paper this morning—debt from the banks. The banks are trying to give them more debt than they perhaps want. What we are trying to say there—I do not know whether I used the term 'loaded them up', did I?

Senator CHAPMAN—Yes, 'load them with debt to provide returns for investors.' The full sentence was: 'Corporate raiders in this context refer to those who take large profitable companies, break them up and/or load them with debt to provide returns for investors.'

Mr Nolan—That is corporate raiders; that is only one sector. That is I think we have established a pretty small part of the game. But debt can be used well when it is used properly. Management these days are smarter than they have been and I think the banks and the Reserve Bank are also there to monitor debt levels and make sure that they do not get out of hand.

Senator BERNARDI—Talking about the eighties, it was a part of deregulation of the financial industry, so not only were the managers I guess very entrepreneurial but was the banking system as well equipped as it should have been to deal with this free and open market of economic liberalism?

Mr Nolan—In the eighties?

Senator BERNARDI—Yes.

Mr Nolan—I am not an expert on the banks. I cannot perhaps comment. All I would say is that deregulation was new to the economy. A few of the banks got into trouble in the late eighties and early nineties, so maybe the answer is self-evident.

Senator CHAPMAN—You said that you have had discussions with some of the private equity managers. What is your assessment of their approach to risk management?

Mr Nolan—It is pretty strong and pretty good. Money is a great motivator. It seems to me that this is a market where they are able to make significant amounts of money. The rewards are there, they want their business to continue into the future and they are not just here for today, so they are pretty good. My assessment would be—

CHAIR—As you say, in a sense it is pretty easy to make money in the current climate. Do you think they are applying sufficient risk management procedures or a significantly prudential approach to guard against any future difficulties?

Mr Nolan—It is our assessment that they are, but I must confess that I do not meet with them on a daily or weekly basis. We refer to our asset consultants, who do meet with them regularly, and we rely to a large degree on what the asset consultants tell us. Certainly, from the meetings I have had with them, they seem to me to be pretty diligent and conscious of risk, and they are here for the long term. We have been investing in private equity managers for 10 years, so I think they are here for the long term.

Ms Reynolds—Often a manager is looking to raise funds. Then, when they have exited that particular investment, they are looking to raise funds again. So, if their firm is to be able to stay in business—it is not just people coming in for one deal, taking money and going away—and they are here for the long haul, they will want to continue to raise capital from superannuation funds.

Mr Nolan—It is not in our interests to be negligent.

Senator CHAPMAN—Your submission also shows aggressively increasing the percentage of asset allocation going into private equity. Do you see that trend continuing and do you see an upper limit of what percentage private equity might reach as a share of—

Mr Nolan—I think there will be an upper limit. I would not try to guess at what it will be, but it will not be as much as we have in Australian equities or even in international equities. That figure at the moment is 32 per cent. In global equities it is about 25 per cent. Private equity is seen as a small but effective addition to the portfolio, and it is in that context that we should be talking.

CHAIR—It could be related to opportunities as opposed to mismanaged issues as well, couldn't it?

Mr Nolan—That is the other thing, absolutely, yes. Mind you, there are more opportunities now than there were four or five years ago, so it is our role to control that.

Senator WEBBER—I am sorry but I had to leave the room during some of your earlier evidence. But my understanding—and correct me if I am wrong—is that your members have greater overseas exposure than domestic exposure in private equity. Is that right?

Mr Nolan—I said that, from my memory—and I cannot quite remember the percentages—I would think that we would have more overseas than locally. But that would be as a result of opportunities more than anything.

Senator WEBBER—I was going to ask: is that through opportunity? Is there anything we can do to make the domestic market more attractive to your members?

Ms Reynolds—One of the things that we should probably do is check on that figure and provide it—just to make sure that we are talking about the right facts.

Senator WEBBER—I will not hold you to that but, in addition, is there anything that needs to happen in the market to make it more attractive?

Ms Reynolds—I think it is like every other market. The Australian market is just small compared to the rest of the world and, with the advent of compulsory superannuation, there is more and more money in the system looking for deals. With the growing offshore inequities, it is happening in all the other parts of the market as well.

Mr Nolan—I would add to that by saying that there is probably more experience overseas. Private equity has been alive and well in overseas markets longer than it has here, so there is more experience and more depth in the market. The expertise by the people is greater, so there is a natural affinity, or a natural attraction, in that. So it is probably just time.

Senator WEBBER—It is a maturity thing and a size thing.

Mr Nolan—Yes.

Senator WEBBER—Going back to one of the issues that Senator Chapman raised about what the natural ceiling would be in terms of exposure, one of the issues that was hinted at when the committee heard evidence yesterday was the increased demand of liquidity funds have to keep on board because of the new portability arrangements. Therefore, it was suggested that that would have an impact on the degree of exposure that funds would want to have to private equity because it is a more long-term rather than short-term investment. Is that true?

Mr Nolan—I would agree 100 per cent with that. We are looking at that. That is exercising our minds all the time. The issue of liquidity is important—and not so much liquidity in terms of money going out of the system but just being able to price things. We have to declare returns of course and to do that we have to come up with a value. If we cannot come up with a value we cannot determine a return. That in itself will restrict the degree to which we will invest in any alternative asset, not just private equity. It applies to anything not listed in the markets so there is that natural ceiling, yes.

CHAIR—Ms Reynolds, the sector has minimal retail exposure and very heavy exposure via your members. Would that be a reasonable assumption?

Ms Reynolds—Yes. I think there will be very few mum and dad investors in the sector and I think that most funds and most managers do not want to be in deals with retail investors. They see it as something that they want to do as part of a wholesale investment.

CHAIR—And with your members the buck ultimately stops with the trustees?

Ms Reynolds—Yes.

CHAIR—Is it fair to say that there are very significant responsibilities placed on their heads and their decision-making processes both in a regulatory sense and in a legislative sense?

Ms Reynolds—Yes. I think that the superannuation industry is extremely well regulated and a lot of responsibility is placed on trustees. At the same time I think that trustee directors have a lot

of expertise available to them within their funds from investment managers and in particular from their asset consultants.

CHAIR—UniSuper this morning was talking about that expertise from both employers and employees and from an employee representative group as well, so there is a broad mix—

Mr Nolan—And some of the funds are now also importing expertise. UniSuper is a classic case. They have an investment team of up to 20 people, I think, so it is a big team, and other funds in our constituency are doing the same.

CHAIR—We have heard evidence that indicates that the whole private equity area should be viewed as no more or no less than just part of a broad investment portfolio, that there is no element of the bogeyman that perhaps has been referred to as a 'media frenzy' by you guys or somebody else. It is not a bogeyman; it is just part of a prudent investment portfolio. Is that a reasonable—

Ms Reynolds—I think that is exactly right.

Senator WONG—I apologise for having to be outside for the first part of your evidence. I had some questions and I may be traversing issues which have already been discussed. I want to talk about your engagement with private equity companies in which you invest. I noticed in your submission that you talk about corporate governance arrangements and procedures and we had a discussion about this with UniSuper. The thrust of your paragraph 25.3 is essentially that that enables you to assess whether or not it a venture capital type or a corporate raider type company, which I think is really a proxy for asking whether it is a value-generating investment or just about raiding. I am interested in not just the initial decision to invest but also the ongoing operation of the companies in which you invest. To what extent would your members continue to engage with such companies, particularly given that one of the arguments about the benefits of private equity is the alignment between management and shareholder interest and a much greater engagement by the shareholders? I wonder if you can comment on that.

Ms Reynolds—First of all, we think that there is good governance within private equity and we think a bit of a disservice has been done in statements that have been made about private equity, particularly Margaret Jackson's statement that if we made Qantas private we would not have to worry about all of these pesky governance issues, which I do not think really helped governance or the private equity sector. Our member funds certainly meet with private equity managers on a regular basis. A number of them are involved in committees of the companies.

Senator WONG—Which committees?

Ms Reynolds—They generally have their own internal investment policy committees that a number of managers who are involved in these companies end up sitting on, so they have great expertise.

Senator WONG—I will just clarify that before you go on. Company X is a private equity company which, say, five or six of your members have a proportion of investment in. Representatives of your members—presumably their asset consultants or investment managers—would be involved in these committees within the company.

Ms Reynolds—That is right. It would not be our members; it would be the investment managers.

Senator WONG—That is what I said—representatives of your members, presumably investment managers or asset consultants.

Mr Nolan—Investment managers who we employ.

Senator WONG—They are your representatives as well in a legal sense.

Mr Nolan—Yes, in a legal sense. We are just talking of members we do not—

Senator WONG—I understand that. In terms of the trustees' duties, they contract with these individuals and/or entities to provide advice et cetera but those individuals and/or entities represent in terms of the actual investment of the trustees.

Ms Reynolds—Yes. Do you want to go through the reporting that you were talking about before, Greg?

Mr Nolan—I was just saying that often the due diligence and the governance in these sectors is as robust as in the public arena. It is just not public; it is in the private arena. When the investment managers go to look at companies they examine them inside out and upside down because it is not in their interests to take on a company or a venture that they are not going to be able to work out of at some future time. There are regular meetings with the companies. As we were saying before, often the fund managers have members on a strategy or investment advisory committee, so they are talking to them regularly and giving them advice on what they should be doing to get the business—

Senator WONG—That is an anecdotal description, I suppose, of what occurs. In terms of what AIST and/or your constituent members do, do you have guidelines, protocols, best practice or anything that sets out how best to engage with these companies in this way?

Ms Reynolds—Yes, there would be guidelines for investment. There is a set of guidelines for before you invest that sets out all of the rules about investing, right down to things about—

Senator WONG—But this is about postinvestment conduct and engagement, isn't it?

Ms Reynolds—Yes. I am talking about post investment. It sets out postinvestment rules, right down to key person risks, rules about short-term borrowing and things like that. Again, there is quarterly reporting, half-yearly reporting and audited accounts that have to come back to the members and fund managers.

Senator WONG—Where would this be set out? Is this in the investment mandate?

Ms Reynolds—When you invest you set out guidelines for investment. You cover all of these areas. So everybody knows what the rules are.

Senator WONG—But that is up to each board of trustees to determine—correct?

Ms Reynolds—The guidelines for investment will be done with the investment manager.

Senator WONG—Sure. What I am saying is that each super fund will have a different set of criteria or procedures.

Ms Reynolds—Possibly, depending on their manager.

Senator WONG—Do you, as one of the representative bodies, have a best practice model?

Ms Reynolds—No, we do not.

Senator WONG—Would there be differing levels of complexity and sophistication in the investment mandates and procedures associated with them in different super funds?

Mr Nolan—I think there probably would be. A lot of the funds would be guided by the asset consultants, so it would be unique to what that asset consultant's experience had been in these sorts of determinations.

Senator WONG—Would it be possible for us to look at this? I do not need to know which fund it is because there may be commercial-in-confidence issues.

Mr Nolan—Look at an IMA, an individual management agreement.

Senator WONG—Yes, I would be interested to see the extent to which there are some real-life practical examples of how Australian superannuation funds deal with their postinvestment conduct with private equity firms. That is what I am interested in. What are they actually saying? Is it: 'If we are going to make this investment, which is higher risk, we have to have a greater level of engagement. How are we going to do it?' Is that possible?

Mr Nolan—Yes.

Senator WONG—Thank you.

CHAIR—Thank you for attending these hearings and giving evidence. This concludes the public hearings in relation to this inquiry. I thank the secretariat, who have done a remarkable job in providing the committee with an enormous amount of resources in relation to this inquiry. I thank Hansard and all the witnesses who have taken time over the last two days to provide a level of expertise for this committee which has been very important. I particularly thank the deputy chair, Senator Stephens, and Senators Bernardi and Webber, who have been here—that is no reflection on the other senators who have come and gone, because we all have a huge number of commitments. But I do particularly thank those three for their attendance. Thank you.

Committee adjourned at 4.47 pm