

CONTRACTING FUNDAMENTALS

Introduction

- 3.1 Some of the key duties of contract managers include drafting effective specifications, developing performance measures and monitoring outcomes, ensuring payment schedules relate to work completed, and resolving contract disputes.
- 3.2 Drafting appropriate and effective contract specifications is considered to be the key element from which all other contracting responsibilities are tied. Some groups have stressed that the quality of contract specifications governs the success or otherwise of the contract objectives. This chapter will examine agency approaches to developing contract specifications, and examine the preference for developing process or functional specifications.
- 3.3 A related feature of effective contract specifications is the quality, and monitoring of performance measures. The key agency approaches will be examined.
- 3.4 Payment schedules are a key part of any contract. They must, at the same time, ensure that they adequately reflect work completed, and provide adequate incentive for the contractor. Some of the examples will show that the Commonwealth has paid contractors in excess of work completed or has made payments with little knowledge of whether contracted tasks have been completed.
- 3.5 Effective monitoring and communication protocols are vital processes in identifying and resolving contract disputes. Some of the key approaches to managing contract disputes will be examined, and the performance of agencies will be assessed.

- 3.6 The final part of the Chapter will examine risk management practices and their application to contracting responsibilities.

Contract specifications

- 3.7 The importance of contract specifications was highlighted during the inquiry. The Department of Foreign Affairs and Trade stated:

The specifications of any tender and procurement process are paramount for us. It keeps people off the phone. It is easier. The crisper, cleaner and more unambiguous criteria are for tenders, the easier the whole process becomes.¹

- 3.8 Similarly, the Ombudsman commented that 'the better the contractual arrangements that are specified in the contract in the way of performance and so on, the better the administrative process is and the fewer complaints that you have.'²

- 3.9 The initial tender documents including the request for offer (RFO) and statement of requirements (SOR) provide a link to the final contract specifications. The Management Advisory Board/Management Improvement Advisory Committee (MAB/MIAC) reported that 'there is a direct link between what is specified in the SOR and what is required in the contract'.³ MAB/MIAC stated that the essential matters to be dealt with in a contract include:

- the identity of the parties;
- the specification of the services to be provided;
- the fees and allowances to be paid, preferably linked to milestones in delivery; and
- the date of commencement and the timeframe within which the services are to be provided.⁴

1 Mr Keith Hardy, Department of Foreign Affairs and Trade, *Transcript*, p. 213.

2 Mr Oliver Winder, Commonwealth's Ombudsman's Office, *Transcript*, p. 194.

3 Management Advisory Board/Management Improvement Advisory Committee (MAB/MIAC), *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, Commonwealth of Australia, 1997, p. 35.

4 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 36.

Functional specifications

- 3.10 The two areas of attention in the inquiry were the use of outcome or functional/performance specifications versus process specifications, and the use of standard clauses. The Department of Finance and Administration (DoFA) stated:

Tender documents should specify activities in terms of outputs or outcomes, rather than processes or inputs. This enables tenderers to develop innovative approaches to the way they deliver outcomes. Requirements should incorporate performance targets, as well as any assumptions or constraints.⁵

- 3.11 The use of performance specifications was generally supported. The Industry Commission (IC), as part of its report, advised all agencies to 'adopt performance specifications wherever possible.'⁶ The IC stated that the 'benefits of performance specifications may be particularly important where the contracting agency is unaware of the full range of possible ways to achieve the desired end result.'⁷

- 3.12 Domberger stresses that effective contract specifications are essential because 'without them competition may stall and the contract may come to a sticky end.' Domberger indicates that performance based specifications are preferred but 'in cases where output or outcomes are hard to define, it may be more effective to use a task based specifications.' For example, the output of 'cleaning activities' is difficult to define.⁸

- 3.13 The inquiry evidence was divided between the merits of performance specifications versus highly detailed process specifications. It was the building and allied industries that mainly supported the use of process specifications, and the need for bills of quantities. The Master Builders Australia (MBA) commented that the recent trend has been for design professionals to minimise their design risk liability by dispensing with both scopes of works and bill of quantities when preparing specifications, resorting instead to references to general standards.⁹ This view was supported by the Royal Australian Institute of Architects which

5 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, pp. 23–24.

6 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, 325.

7 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, 323.

8 Domberger, S. *The Contracting Organisation, A Strategic Guide to Outsourcing*, Oxford University Press, 1998, p. 162.

9 Master Builders Australia, *Submission*, p. S108.

commented that buildings 'are costing up to 11 per cent more to build and taking 11 per cent longer, because the contractors are forced to work on the basis of inadequate documentation'.¹⁰

- 3.14 The Department of Civil and Environmental Engineering, University of Melbourne, however, suggested that the use of bills of quantities are still being used:

In my opinion, there has certainly been a significant reduction in the use of bills of quantities and measurements supplied by the owner, not just on government jobs, though—all jobs. But they are still being used. I saw an example last week of a \$30 million project in Melbourne which was substantiated with a bill of quantities. The bill was there certainly to assist tenderers but particularly to assist in variations. They are still being used. My observation, from taking the opportunity through the Master Builders to keep myself fresh as to what is happening, is that certainly there has been a reduction in fully documented projects as the Commonwealth and the states used to do them. But they are still alive and well. Both of these jobs I mentioned to you at the lower range were fully documented projects. There is a shift wherever possible to document, design and construct innovation. It is really at the top end. There are plenty of traditional jobs still out there.¹¹

- 3.15 The Department of Defence (Defence) indicated that it is moving down the path of functional and output based specifications although a mix of specifications was still required. Defence stated:

But at some stage you still need to include in the contract a more precise technical definition of how you are going to actually achieve the job because you cannot build every single requirement into your output or your functional specification. We would be looking to something that was performance based for the system, but we would also want to go down a level or two into defining overall architectures and so on.¹²

- 3.16 In contrast, Australian Business commented that Defence is 'rather process driven'. Australian Business stated:

We often find that Defence contracts rarely specify an outcome. They go into excessive detail and specify not only what the

10 Mr Michael Peck, Royal Australian Institute of Architects, *Transcript*, p. 32.

11 Mr Neil Noonan, Department of Civil and Environmental Engineering, University of Melbourne, *Transcript*, p. 62.

12 Mr Michael Roche, Department of Defence, *Transcript*, p. 264.

contractor must do, but how that contractor must do it. They would say that an item has to be cleaned with a certain product so many times a day to a certain standard, rather than simply to specify that a certain workplace item or equipment must be presented in a clean condition.¹³

- 3.17 During the inquiry, an alleged case of over monitoring, as a result of excessive specifications, was reported. Busy Inc, for example, has a contract with DETYA to provide Entry Level Training Support Services. One of the key performance indicators in the contract is that Busy Inc will conduct visits every six to 10 weeks for every client to ensure adequacy of service. DETYA has specified that visits must be personal. BUSY Inc stressed that this requirement is impossible to achieve as it has 20 000 'files' that equate to clients at various development stages and who would require personal visits. BUSY Inc stated:

So, for example, we have got probably about 20 000 files. That means that, between every six and 10 weeks of a traineeship program, we have to go and visit every employer, make sure that we see the employer and the new apprentice. Then mid-term of that as well, we have to go and see every employer and every apprentice.¹⁴

- 3.18 BUSY Inc suggested that, theoretically, its 13 staff would need to make up to 40 000 contact visits every six months. BUSY Inc is in the process of advising DETYA about the impracticality of this monitoring specification.¹⁵

Standard terms and conditions

- 3.19 MAB/MIAC indicates that standard clauses 'can assist managers to achieve consistency and predicability with regard to terms and conditions as well as efficiency in contract administration.'¹⁶ Some of the areas where standard clauses may be useful include:

- dispute resolution;
- indemnity/insurance;
- conflict resolution;

13 Air Vice Marshal Brian Weston, Australian Business, *Transcript*, p. 25.

14 Ms Vivienne Mallinson, Busy Inc, *Transcript*, p. 297.

15 Ms Vivienne Mallinson, Busy Inc, *Transcript*, pp. 299–300.

16 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 37.

- confidentiality;
- ownership;
- intellectual property;
- access to premises; and
- monitoring/inspections.¹⁷

3.20 In supporting the use of standard contracts, the IC concluded that 'standard contracts and other standardised documentation have the scope to reduce tendering costs, while retaining necessary differences in service characteristics and contractual relationship between services, agencies and locations.'¹⁸ The IC suggests that standardisation may also lower the cost for tenders 'who bid for more than one government contract, since they avoid the training and administrative costs required to deal with a variety of contract formats.'¹⁹ This point was supported by Australian Business which commented that 'it would like to see a great deal of improvement in the areas of uniformity of contract procedures and documentations, which often work against our smaller members.'²⁰

3.21 A range of government departments, including Environment and Heritage; Health and Aged Care; Centrelink; and Employment, Training and Youth Affairs, indicated that they use standardised contracts.²¹ The Department of Communications, Information Technology and the Arts, for example, stated:

For day to day contractual arrangements, such as for consultancy services, the Department uses a standard contract. The proforma contract has been developed by the Department's legal staff with the assistance of specialist legal advice from the Australian Government Solicitor. The standard contract covers key issues such as the confidentiality of Commonwealth information, indemnity, insurance, the need for variation of terms to be in

17 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 38.

18 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, 337.

19 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, 335.

20 Mr Graham Chalker, Australian Business, *Transcript*, p. 24.

21 Mr Andrew McKinlay, Department of the Environment and Heritage, *Transcript*, p. 159; Mr Neville Tomkins, Department of Health and Aged Care, *Transcript*, p. 241; Centrelink, *Submission*, p. S301; and Department of Employment, Training and Youth Affairs, *Submission*, p. S458.

writing, dispute resolution and the Auditor-General's access to the contractor's records.

With more complicated contracts, the Department generally obtains services from external legal providers such as the Australian Government Solicitor to draft purpose built contracts.²²

- 3.22 The Australian Council of Building Design Professionals advised that standard forms of agreement, such as AS4122, should be adopted as the contract for publicly funded projects.²³

Conclusions

- 3.23 A persuasive body of evidence already exists supporting the use of functional/performance based specifications over process specifications. Functional specifications help to develop innovative approaches in achieving outcomes. The Committee supports this position. At the same time, there is merit in Defence's view that specifications may need to be a mix of both functional specifications, setting out the performance of a system, and more detailed specifications defining the overall architecture.
- 3.24 Defence, while it indicated a move to functional specifications, should take note of concerns raised by Australian Business that it is still 'process driven'.
- 3.25 While the use of functional specifications is supported, the Committee notes that Master Builders Australia and the Royal Australian Institute of Architects are concerned at increasing disuse of bills of quantities. Those Commonwealth agencies still involved in building construction should note this concern but ultimately agencies will need to determine and set their requirements on a case-by-case basis.
- 3.26 In regard to the use of standard terms and conditions for contracts, again there is value in their use. The Industry Commission, as part of its report, found that standard contracts help to reduce costs for tenderers. A finding supported by Australian Business. The Committee concludes that all agencies should assess the applicability of standard terms and condition for contracts and use them wherever possible.
- 3.27 The Committee's examination revealed a case of excessive monitoring which, based on the evidence, was impossible to comply with. BUSY Inc has a contract with the Department of Employment, Training and Youth Affairs to provide Entry Level Training Support Services. One of the key

22 Department of Communications, Information Technology and the Arts, *Transcript*, p. 112.

23 Australian Council of Building Design Professionals, *Submission*, p. S391.

performance specifications of this contract requires BUSY Inc to visit every employer every six to 10 weeks to ensure adequate service provision. Visits must be personal. The problem is BUSY Inc has 20 000 'files' which relate to clients at various progress stages. The Committee suggests, that if this performance requirement is correct, then BUSY Inc would not be able to complete the task using email let alone by personal visits. The Committee draws this example to the attention not only of DETYA but all agencies as a constant reminder to appropriately specify monitoring exercises that are cost and time effective yet produce adequate decision making information.

Performance monitoring

- 3.28 Chapter Two discussed parliamentary and public aspects of accountability of government contracts. This section focuses on how suppliers account for their performance and results.
- 3.29 A major feature of effective contracts is an agreed list of appropriate performance measures and a monitoring framework to ensure that agreed outcomes are met on time and within budget. If performance is not meeting agreed levels then this provides an opportunity for feedback and improvement. The cost of monitoring and complying with performance should be overlaid against these objectives.
- 3.30 Assessing contract performance is a means of linking payment to performance, and, if necessary, developing strategies to deal with underperformance. DoFA advises that 'where possible contractor payment should be linked to performance.'²⁴ Performance information can be both objective and subjective. The latter can be gathered through client surveys for example. MAB/MIAC suggests that appropriate performance information can include:
- service quality standards for timeliness, accuracy, courtesy, customer satisfaction;
 - existing benchmarks in the industry or an active benchmarking process;
 - accreditation of the provider;
 - setting up a monitoring committee with stakeholder representatives;
 - site visits by the purchaser; and
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24 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 18.

- performance against targets agreed between purchaser and provider.²⁵
- 3.31 In the event that a contractor is not performing to an agreed level then remedial action should be taken. MAB/MIAC state:

The provider should be given formal warning that the current level of performance is not satisfactory and should be given further opportunity to make the necessary improvement. Communication between the parties should increase, more frequent milestones should be set and closer monitoring should occur. Renegotiation of some elements of the contract may be considered.²⁶
- 3.32 Monitoring contractor performance is the chief means of ensuring that agreed outcomes are being delivered and public money is being adequately accounted for. The NSW Premier's Department commented that the benefits of monitoring 'are significant in terms of encouraging improved performance; assisting in future design of specifications and contracts; and ensuring the terms and spirit of the contract are adhered to, including the commitment to service quality.'²⁷
- 3.33 MAB/MIAC suggests that monitoring can be either, or a mix of, 'direct' or 'devolved' approaches. With direct monitoring, the purchaser conducts most of the monitoring exercise. This approach places the purchaser in control but may increase cost.²⁸ Under a devolved arrangement, the purchaser arranges for the supplier or an independent party to conduct monitoring and provide regular reports. In this event MAB/MIAC suggest that the 'provider should be regularly audited to ensure its accuracy and reliability.'²⁹
- 3.34 The importance of contract managers reporting contractor performance to senior managers has been highlighted by the ANAO which commented that managers need some or all of the following to adequately monitor contracts:
 - measurable indicators of performance, including milestones;

25 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 48.

26 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 49.

27 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, p. 359.

28 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 46.

29 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 46.

- a performance monitoring plan;
- a monitoring committee comprising key stakeholders;
- a management information system for tracking expenditure and outputs;
- procedures for reporting on performance;
- systems and processes for ensuring quality; and
- client feedback mechanisms.³⁰

3.35 The ANAO suggested that the level of monitoring adapted will vary from contract to contract and depend on 'the nature of the work, the type of contract and the experience and commitment of the participants.'³¹ In a recent multi-agency performance audit, the ANAO found that timeliness and cost aspects of performance by service providers was considered satisfactory. However, the ANAO found that 'performance measures of the quality of service delivery were not established in many instances.'³² The ANAO stated:

...the contracted service performance requirements relating to quality issues were often so generic, or broad in nature, they were unable to be adequately measured or assessed and, as a consequence, did not contribute to improved contract performance. In many instances, the measures used for performance management were not formally reviewed to ensure they were still appropriate.³³

3.36 In view of the previous finding, the ANAO recommended that agencies 'strengthen policies to ensure they address all phases of the contract lifecycle, including contract management and performance monitoring'.³⁴

30 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 47.

31 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 47.

32 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 14.

33 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 16.

34 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 17.

- 3.37 DoFA advises that when performance criteria are established, they 'should reflect stakeholder's expectations and the wider policy and strategic aims for the Government as well as more conventional internal and operational issues such as the achievement of milestones.'³⁵
- 3.38 In regard to the cost of monitoring, DoFA states that 'as a general rule controls over the provider should relate to assuring quality and monitoring outputs and outcomes, rather than to the details of day-to-day operations.'³⁶ MAB/MIAC state:
- Excessive monitoring can also be costly and can, in worst case scenarios, restrict provider innovation. The key to a successful monitoring regime is to collect the minimum amount of information, by the cheapest means possible, that will allow managers to adequately assess the performance (in outputs and outcomes) of the provider. The information should be functional and not place an unnecessary and costly burden on the provider.³⁷
- 3.39 The ANAO, as part of its performance audit program³⁸, identified several weaknesses with agency contract performance management including:
- not specifying adequate performance information in the contract to allow monitoring of contractual performance;
 - not using the available information to adequately monitor performance; and/or
 - not undertaking regular consultation with the provider of services in respect of contractual performance.³⁹
- 3.40 The ANAO concluded that 'performance assessment and monitoring, although crucial to making informed decisions on policy as well as the oversight of service delivery, is not being undertaken systematically.'⁴⁰

35 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 24.

36 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 18.

37 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 48.

38 See, for example, Report No.15 1999-2000 *AusAid – Management of the Australian Development Scholarships Scheme*, Report No.3 1999-2000 *Electronic Travel Authority System*, Report No.42 1998-99 *The Establishment and Operation of Green Corps*, Report No.29 1998-99 *Provision of Migrant Settlement Services by DIMA*, Report No.18 1998-99 *Accounting for Aid – The Management of Funding to Non-Government Organisations – Follow up Audit* and Report No.13 1997-98 *Third Tranche Sale of the Commonwealth Bank of Australia*.

39 Australian National Audit Office, *Submission*, pp. S135–136.

40 Australian National Audit Office, *Submission*, p. S141.

- 3.41 As part of the inquiry, agencies indicated a range of approaches to managing performance. The Department of Industry, Science and Resources (DISR) indicated that, as part of a current IT contract, it has built in to the contract a number of service level agreements. These relate to 'the responsiveness of the help desk, the speed with which problems when they arise are resolved and the speed with which additions and changes to the system are made.'⁴¹ In addition, DISR indicated that this particular contract requires the contractor to provide weekly reports against all of the identified service level standards.
- 3.42 AusAid indicated that it monitors progress through a formal system of reporting based around Activity Monitoring Briefs. AusAid commented that the 'frequency of reporting is broadly commensurate with the assessed risks of the activity as initially determined by AusAid through its Portfolio Risk Assessment Monitoring Plan.' For high risk activities, for example, 'the reporting frequency may be quarterly.'⁴² AusAid also indicated that its contractors have a role in helping to develop performance measures. AusAid stated:
- In our larger projects, for which we have designs agreed prior to tender and to implementation, it is actually the contractors that do the designs for us. Therefore, they are intimately involved in describing the activity, what is needed and the performance standards, et cetera that are in the design and then in the scope of the documentation.⁴³
- 3.43 DoFA indicated that it adopts a 'balanced scorecard approach' to reporting on contractor performance. This approach 'uses an annual business plan which is developed by the provider and not only looks at financial performance but also addresses aspects of customer and stakeholder satisfaction, internal business processes and innovation'.⁴⁴

Conclusions

- 3.44 A major part of effective contracts is the inclusion of appropriate performance measures, and an effective monitoring framework. The monitoring framework should be cost and time effective for both parties, but at the same time must provide quality information to provide feedback in the event of underperformance.

41 Mr Philip Noonan, Department of Industry, Science and Resources, *Transcript*, p. 223.

42 AusAid, *Submission*, p. S123.

43 Mrs Catherine Fettell, AusAid, *Transcript*, p. 18.

44 Dr Diana Wright, Department of Finance and Administration, *Transcript*, p. 102.

- 3.45 As part of this discussion, the Committee reviewed a range of better practice guides which provide useful information on performance measures and other matters related to contract management. While agencies have access to these sources and training opportunities, problems persist.
- 3.46 The Australian National Audit Officer advised the Committee that, through its performance audit program, it had revealed several weaknesses with agency contract performance management. These included not specifying adequate performance information, not using the information to adequately monitor performance, and not undertaking regular consultation with the service provider.
- 3.47 In view of the ANAO's findings regarding agency contract performance management, the Committee suggests that all major contracting agencies, as part of their 2001–2002 internal audit program, conduct a review of the adequacy and effectiveness of contract key performance measures and monitoring frameworks, taking into account:
- cost and time effectiveness for both agency and contractor;
 - adequacy of performance information as a decision making tool;
 - level and quality of consultation between agency and contractor; and
 - merits of using disclosure clauses in contracts which provide for agencies to examine contractor price estimates.

Payment schedules

- 3.48 An important part of forming a contract is selecting the payment option which provides certainty for both purchaser and supplier, and, if possible, influences performance and completion times. The IC highlighted the following types of contracts:
- **fixed price contracts:** this is where the government and the contractor determine a mutually agreeable price for a given quantity and quality of the service to be provided. This form of contract is most suitable where there is a good understanding of the likely cost of the service, where the level of demand is predictable, and where the activity can be clearly defined.

- **incentive contracts:** these may include provisional payments linked to a range of performance criteria, including timeliness of delivery, achievement of agreed quality standards or client satisfaction as determined by client surveys.
- **cost plus incentive contracts:** this provides for contractors to receive a fixed fee, plus a set proportion of the amount by which the contractor's actual costs are below a prespecified cost level. With this contract, an agency may be able to access a proportion of the benefits from an unanticipated cost reduction, due to, for example, the introduction of a new supply technology or process.
- **management fee contracts:** these can apply where project costs cannot be estimated with any precision. The price paid to contractors may be determined by reference to either the costs of inputs or the achievement of specified outputs, depending on the nature of the outputs.
- **period contracts:** these apply when a contractor is engaged to provide services or expertise in a specified discipline on an 'as required' basis at a pre-negotiated fee.⁴⁵
- **BOO and BOOT operations:** build, own and operate and build, own, operate and transfer refer to arrangements in which a private sector entity constructs a facility and operates that facility under contract to a public sector entity for a period of time. Under BOOT arrangements, the facility is eventually passed to the public sector entity which continues to operate it. In most cases, the private sector entity finances the construction, extension or renovation of a facility, and the private sector entity specifies the operating features of the facility and/or the services to be provided by the facility. In providing services, the private sector entity usually receives revenue in the form of user charges.⁴⁶

3.49 The IC suggested that agencies should select the contract type based on the characteristics of the service and the nature of penalties and incentives required to achieve the outcome. The IC suggested that incentive and penalties can be introduced into all types of contracts 'to secure a range of project objectives, including expediency and innovation.'⁴⁷

45 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, pp. 327-330.

46 Public Sector Accounting Standards Board of the Australian Accounting Research Foundation, *Private Sector Provision of Public Infrastructure, Accounting by Public Sector Entities for 'BOO' and 'BOOT' Arrangements*, Australian Accounting Research Foundation, 1997, pp. vi-2.

47 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, p. 330.

- 3.50 The IC, however, reported that there was a preference by agencies to use penalties rather than incentive payments.⁴⁸ Domberger notes that there is an ongoing debate about the effectiveness of incentives versus penalties.⁴⁹ He suggests that the preference for using penalties is based on a loss aversion characteristic. That is, the 'prospect of losing a sum of money appears to be more daunting than the opposite, satisfying effect of winning an equivalent sum.'⁵⁰ Domberger notes, however, that penalties can create an adversarial climate between the contracting parties.
- 3.51 Centrelink indicated that for some of its contracts, it has a debit credit system related to performance. Where a supplier underperforms and debits reach a certain level, then penalties apply. In one case, Centrelink indicated that it withheld payments of about \$250 000 which was accepted by the contractor.⁵¹
- 3.52 Domberger suggests that if an incentive payment scheme is selected then the most preferable is a 'fifty-fifty cost saving split of any productivity improvement achieved by the contractor during the contract term.'⁵² Domberger states:

...many contracts now contain a provision which says that the purchaser shall share with the contractor any realised productivity gains. This form of contract, known as a 'gainsharing contract', creates incentives for the contractor not only to achieve continuous improvements in efficiency, but to communicate it to the purchaser...The sharing formula can vary, but a fifty-fifty division is common, and has the advantage of parity and the appeal of fairness.⁵³

48 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, p. 331.

49 Domberger, S. *The Contracting Organisation, A Strategic Guide to Outsourcing*, Oxford University Press, 1998, p. 119.

50 Domberger, S. *The Contracting Organisation, A Strategic Guide to Outsourcing*, Oxford University Press, 1998, p. 120.

51 Mr Alan Welburn, Centrelink, *Transcript*, p. 236.

52 Domberger, S. *The Contracting Organisation, A Strategic Guide to Outsourcing*, Oxford University Press, 1998, p. 121.

53 Domberger, S. *The Contracting Organisation, A Strategic Guide to Outsourcing*, Oxford University Press, 1998, p. 103.

- 3.53 DoFA advises that the 'form and type of contract (standing offer, period, fixed price, lump sum, performance based, cost plus performance, and so on) should be appropriate to the circumstances and the amount of flexibility and control required.'⁵⁴
- 3.54 ANAO performance audits have highlighted problems with contract financial management. In 1995-96, the Auditor-General reviewed the Jindalee Operational Radar Network (JORN). The Committee followed up this audit with its own inquiry and reported that the project had fallen four years behind schedule and had incurred cost overruns of over \$600 million.⁵⁵
- 3.55 In relation to the New Submarine Project, the Auditor-General calculated that, in December 1997, 95.7 per cent of the contract sum had been spent yet only three of the six submarines had been launched.⁵⁶ The Committee reviewed this matter as part of *Report 368*.⁵⁷
- 3.56 More recently, the ANAO reported on the Commonwealth management and regulation of plasma fractionation.⁵⁸ In regard to financial controls and payments, the Auditor-General stated:

There has been an absence of adequate financial controls over payments made by DHAC under the Plasma Fractionation Agreement (PFA). Between 1 January 1994 and April 1999, DHAC paid out more than \$400 million of Commonwealth funds under the PFA without a formal process in place to confirm that the products it was invoiced for had actually been received by the designated recipients.⁵⁹

54 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 25.

55 Joint Committee of Public Accounts and Audit, *Report 357, The Jindalee Operational Radar Network Project*, AGPS, Canberra, March 1998.

56 Australian National Audit Office, *New Submarine Project, Department of Defence*, Report No. 34, 1997-1998, pp. 2-3.

57 Joint Committee of Public Accounts and Audit, *Report 368, Review of Audit Report No. 34, New Submarine Project, Department of Defence*, CanPrint, Canberra, 1999, pp.30-37.

58 Australian National Audit Office, *Commonwealth Management And Regulation Of Plasma Fractionation, Department of Health and Aged Care*, Report No. 24, 1999-2000.

59 Australian National Audit Office, *Commonwealth Management And Regulation Of Plasma Fractionation, Department of Health and Aged Care*, Report No. 24, 1999-2000, p. 42.

- 3.57 In another case, the ANAO reported that 'one agency selected a service provider and provided advanced funding of 80 per cent of the contract fee to a contractor without undertaking any financial viability checks on the contractor.' Later the contractor abandoned the project before it was fully completed because of the withdrawal of its financial backers. The agency then 'terminated the contract and has taken legal action in an endeavour to protect any remaining Commonwealth funds held by the contractor.'⁶⁰
- 3.58 The ANAO as part of a multi-agency performance audit commented that 'for an organisation to be sure it 'gets what it paid for', provider performance should be adequately monitored over the duration of the contract.'⁶¹ In particular, the ANAO was concerned at the inadequacy of agencies' management information systems which 'did not record contract milestones nor due dates, with some organisations not maintaining overall contract commitment details.'⁶²
- 3.59 During the inquiry, agencies were asked about their financial controls and contract payment systems. Defence indicated that, for its major equipment projects, it uses earned value management (EVM) as a tool to measure contractor cost and schedule performance against identified baselines.⁶³ In regard to the Hawke aircraft contract with BAE systems, Defence stated:

It is a 75 per cent earned value, 25 per cent milestone contract, by and large—in the order of over \$800 million. I have a milestone coming up in July. I have to have seven aircraft delivered online at Williamtown. My contract has liquidated damages if that milestone is not achieved; there is provision for that. The contract also makes provision to cease all earned value payments if that milestone is not met. So it is pretty severe. We are also in a very intense partnering arrangement. The end result we are after is aeroplanes online, not cash payments in particular.⁶⁴

60 Australian National Audit Office, *Submission*, pp. S132-133.

61 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 35.

62 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 37.

63 Department of Defence, *Submission*, p. S495.

64 Air Vice Marshal Raymond Conroy, Department of Defence, *Transcript*, p. 269.

- 3.60 The Department of Communications, Information Technology and the Arts (DoCITA) commented that under its standard contracting arrangements 'payment is normally made only for work performed and accepted as satisfactory by the department.'⁶⁵ DoCITA indicated that it would have a 'handful' of cases each year involving disputes focusing on meeting milestones.
- 3.61 The issue of monitoring contract performance and price estimates was raised by the Australian Dispute Centre (ADC). The ADC indicated that for large projects, 'a Project Control Group with an experienced industry independent member, maybe technical, legal or financial, should meet monthly with a standard, but flexible, agenda to review reports from the contractor, the contract administrator and other relevant parties and require action.'⁶⁶ In addition, the ADC suggested that they would not sign off on a contract unless it had a complete disclosure clause. The ADC stated:
- If a contractor wants to sign up on a major contract—even if we are talking the Thiesses and the Boulderstones and everybody in this world—they have got to have a total disclosure clause so that I—or whoever—can get their estimate and every piece of paper. They all squealed about that. We put it in 1992 when we did the runway contract. Nobody every bats an eyelid now. All you have to do is say to the contractor, 'We are going to have a person go to your organisation and look at your estimate.' What you, as the government, are told, or what an owner is told, in most cases is just fairytales.⁶⁷
- 3.62 The ADC suggested that the use of disclosure clauses provides a powerful incentive for a contractor to provide more accurate information when requested. The alternative for a contractor is the possibility that their books and estimates will be assessed by an independent person. The ADC suggested that as a result of disclosure clauses final prices have improved and there is less likelihood of contract disputes.⁶⁸
- 3.63 In relation to payment times, Australian Business reported that delays in payments 'are still a great problem for many of our firms.' In particular, Australian Business advised that 'for small firms, waiting periods of

65 Mr Rohan Buetell, Department of Communications, Information Technology and the Art, *Transcript*, p. 118.

66 Australian Dispute Centre, *Transcript*, p. 311.

67 Mr Kenneth Hinds, Australian Dispute Centre, *Transcript*, p. 311.

68 Mr Kenneth Hinds, Australian Dispute Centre, *Transcript*, p. 311.

around two months for payment can be a common occurrence'.⁶⁹ In contrast, the Indo-Chinese Employment Services indicated that payment periods conformed to guidelines, and on average it takes about 14 days to receive payment.⁷⁰

Conclusions

- 3.64 Financial control and contract payment systems are critical elements of overall contract management. Auditor-General performance audits have shown that some agencies are not giving these matters the attention they demand. For example, the Auditor-General found that the Department of Health and Aged Care, as part of its Plasma Fractionation Agreement, paid out more than \$400 million without formal processes to confirm that the products had actually been received by the designated recipients. While there was no fraud or loss of Commonwealth money, this example provides suitable warning to all agencies that there must be adequate monitoring and payments should be tied to achieved milestones.
- 3.65 The contract management of the Collins Class Submarine is a classic example demonstrating the importance of adequately controlling completion schedules and cost to complete. For example, in December 1997, 95.7 per cent of the contract sum had been spent yet only three of the six submarines had been launched. This is a timely reminder for all contract managers to relate effectively completion schedules and cost to complete.
- 3.66 Agencies have a choice between a number of contract payment systems. They must decide, based on the circumstances of each contract, what is the preferred option. In determining whether to use penalties or incentives, agencies should give consideration to the overall improvements that can be achieved in product cost, quality and timeliness. Agencies should seek to maximise their leverage in devising a contract payment system.

69 Mr Graham Chalker, Australian Business, *Transcript*, p. 24.

70 Mr Hoang Vu Nguyen, Indo-Chinese Employment Services, *Transcript*, p. 83.

- 3.67 The Committee notes the use of disclosure clauses in contracts as reported by the Australian Dispute Centre (ADC). Such disclosure clauses give the purchaser access to the price estimates and other information retained by the contractor. The ADC reports that it first started using disclosure clauses in 1992 at which time there was some resistance by contractors. Now, however, there is little resistance. The Committee believes there is merit in government agencies including such clauses in their major contracts. Agencies should consider this option as part of the agency audit recommended in the next paragraph.
- 3.68 The Department of Finance and Administration (DoFA) provides, for use by agencies, *Competitive Tendering and Contracting, Guidance for Managers*. These guidelines seek to provide information on the key processes of competitive tendering and contracting (CTC). The Committee considers that, overall, the guidelines are a useful starting point for agencies who in turn develop more detailed guidelines in the form of Chief Executive Instructions. DoFA's guidelines could be improved, however, by ensuring that a revised version gives greater priority to, and more detail on, financial controls and contract payment systems including penalty and incentives.
- 3.69 The Committee, therefore, suggests that the Department of Finance and Administration, in its next edition of *Competitive Tendering and Contracting, Guidance for Managers*, March 1998, give greater priority to, and more detail on, financial controls and contract payment systems.

Contract disputes

- 3.70 The key message in managing contract disputes is having, in the first place, protocols for dealing with disputes and, if possible, a partnering relationship between agency and contractor. Disputes may arise over disagreements with the interpretation of contract specifications, performance measures and monitoring, and the role and responsibilities of the respective parties. MAB/MIAC stress the need for the parties to a contract to establish a non-adversarial relationship which will reflect their mutual interests in achieving contract objectives.⁷¹

71 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 25.

3.71 One method of developing a non-adversarial relationship is through partnering which seeks to create a relationship focusing on communication, commitment and cooperation. MAB/MIAC states:

Partnering provides an opportunity for interaction between purchaser and provider with the aim of continuous improvements for both. It also allows for quick resolution of problems as the provider gains a greater understanding of the purchasing agency and its operations.⁷²

3.72 MAB/MIAC provide a cautionary note that partnering is not a contractual agreement and is not legally enforceable. However, any 'actions that managers take in accord with any partnering agreement made outside the contract may have legal implications and supersede relevant parts of the contract if providers argue that they came to rely on that action.'⁷³

3.73 In the event that contract disputes may arise, MAB/MIAC suggest the need for dispute resolution clauses in contracts 'to provide direction to each of the parties in the event of a breakdown in the contractual relationship.'⁷⁴ The IC discussed the merits of dispute resolution clauses:

The rationale underlying the wide range of dispute resolution provisions available is the desire to resolve problems, where possible, without the use of costly, time-consuming court conflicts and other formal legal processes. The Australian Commercial Disputes Centre argued that non-court dispute resolution is able to provide solutions 90 per cent cheaper and 95 per cent quicker than through available court mechanisms.⁷⁵

3.74 DoFA advises that, in seeking to develop effective contractual relationships, it will be helpful to have 'agreed provisions in the contract covering provider non-performance, dispute resolution, termination and the smooth hand-over of the activity to another provider.'⁷⁶

72 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 26.

73 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 26.

74 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 40.

75 Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48, AGPS, 1996, p. 332.

76 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 30.

3.75 The ANAO, as part of a multi-agency performance audit, found that agency contracts did not provide the best approach to managing and resolving disputes. The ANAO indicated that there was no pro-active or timely identification of contractual issues. The ANAO stated:

For most organisations, dispute resolution processes were limited to standard contract clauses that gave the purchaser the option to terminate the contract. Contract termination, in many instances, may not result in a solution that is in the organisation's best interest or guarantees the continued provision of services.⁷⁷

3.76 In view of this, the ANAO concluded that 'establishing a dispute resolution (and escalation) framework with a hierarchical approach to resolution responsibilities and delegations, are important in a structured approach to successful dispute resolution.'⁷⁸ The ANAO advises that the inclusion of comprehensive dispute resolution procedures in standard contracts should be considered better practice.⁷⁹

3.77 If dispute resolution clauses are included in a contract then the agreed resolution mechanisms 'must be followed before litigation can be considered.'⁸⁰ There may be several stages in the process including:

- negotiation between the contract manager and the provider's appointed representatives;
- mediation involving a neutral third person;
- expert determination to appraise documentation; and
- a Board of Dispute Avoidance can be convened.⁸¹

77 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 33.

78 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 34.

79 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 20.

80 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 40.

81 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 41.

3.78 In the event that contractual disputes degenerate, MAB/MIAC suggest that contract termination should be considered the last option. Termination is particularly serious in cases where the government through its contractor 'must provide certain goods and services to the public without disruption'.⁸² DoFA states:

Where poor performance cannot be resolved, agencies need to consider terminating the contract. Agencies should ensure that they have contingency plans which address migration issues, including ensuring that there is no, or minimal, disruption to services.⁸³

3.79 DoFA warns that termination options can be complex 'if termination can impact on ongoing service delivery to clients'.⁸⁴ In these types of events, DoFA stresses that 'agencies should seek expert legal advice on legal issues'.⁸⁵

3.80 The Australian Government Solicitor (AGS), in discussing options for government agencies in the event of contract disputes, again stresses the need for early remedial attention to a problem.⁸⁶ The AGS advise that 'great care' needs to be given before terminating a contract. In demonstrating this point, the AGS raised the *Amann Aviation* case in which the Commonwealth was found wanting for not following the correct termination procedure, and substantial damages were awarded against the Commonwealth.⁸⁷ In view of these types of cases, Dr Seddon advises that contract termination is 'legally hazardous' and 'for obvious reasons, not used very much and hardly at all by government'.⁸⁸ In regard to the use of liquidated damages, the AGS provide a cautionary note:

Large Commonwealth contracts usually include provision for payment by the contractor of liquidated damages for non-compliance. Liquidated damages are a genuine pre-estimate of the loss which would be suffered by the Commonwealth in the event of non-compliance by the contractor, Under the common law,

82 MAB/MIAC, *Before you sign the dotted line, Ensuring contracts can be managed*, Report No. 23, 1997, p. 39.

83 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 30.

84 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 21.

85 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Manager*, March 1998, p. 21.

86 Submission 71 to the JCPAA inquiry into Australian Government Procurement, p. 5.

87 Submission 71 to the JCPAA inquiry into Australian Government Procurement, p. 5.

88 Dr Nick Seddon, *Transcript*, p. 15.

unless the amount of liquidated damages specified in the contract represent a genuine pre-estimate of loss, the courts will treat the provision of a 'penalty' and will not enforce it.⁸⁹

Conclusions

- 3.81 This chapter has discussed significant features of contract management which all require a high level of attention failing which can lead to serious downstream problems. Appropriate and clearly understood contract specifications are the beginning point. Next is an effective partnering relationship with effective lines of communication, monitoring and feedback. The constant message, in relevant guidelines and Auditor-General performance audits, is a preventative approach in which problems are quickly identified and solutions found.
- 3.82 As discussed, in this final section, dispute resolution processes are essential if issues escalate. But again the theme is still preventative and relies on achieving resolutions through non-adversarial processes. It is incumbent upon all contract managers to make themselves aware of the key approaches to dispute resolution and ensure that contract objectives can be met efficiently and effectively.

Risk Management

- 3.83 Risk management is defined as the 'systematic application of management policies, procedures and practices to the tasks of identifying, analysing, assessing, treating and monitoring risk'.⁹⁰ Risk is a feature of both contractor and Commonwealth performance. It is essential that both contractor and the Commonwealth perform to the highest standard and reduce risk where possible. Better practice suggests that a structured approach to risk can be applied at every stage in the life of an activity, function, project or asset generated by any public, private or community enterprise or group as an essential element of good management practice.⁹¹ Australia/New Zealand Standards suggests that effective risk management will encourage:

- more effective decisions;

89 Submission 71 to the JCPAA inquiry into Australian Government Procurement, p. 5.

90 Management Advisory Board/Management Improvement Advisory Committee (MAB/MIAC), *Guidelines for Managing Risk in the Australian Public Service*, Report No. 22, Commonwealth of Australia, October 1996, p. 11.

91 Australian/New Zealand Standard, *Risk Management AS/NZS 4360:1999*, p. 1.

- the effective delivery of public sector programs;
- the effective allocation and use of resources;
- a high standard of customer service;
- a high standard of accountability;
- creativity and innovation in management practice;
- improved capacity to manage in the face of competing obligations;
- improved organisational morale;
- flexibility in meeting objectives; and
- transparent decision making.⁹²

3.84 Risk management is developing as a specific management technique in Australia as well as internationally in both the private and public sectors. According to MAB/MIAC, 'managing risk is an integral part of both good business practice and the APS reform program'⁹³. Some relevant Commonwealth guidelines on risk management include:

- MAB/MIAC, *Guidelines for Managing Risk in the Australian Public Service*, Report No. 22, 1996;
- Purchasing Australia, *Managing Risk in Procurement – A Handbook*, 1996, AGPS;
- Purchasing Australia, *Applying Risk Management Techniques to Complex Procurement*, 1997; and
- Australian National Audit Office, *Selecting Suppliers, Managing the Risk, Better Practice Guide*, October 1998.

3.85 A key benefit of effective risk management for government agencies as well as business is the optimisation of their opportunities. As MAB/MIAC point out, 'managing risk encourages an agency to manage proactively rather than reactively'.⁹⁴ In doing so, risk management has developed from just a focus on avoiding losses to the identification of opportunities.⁹⁵

92 Australian/New Zealand Standard, *Guidelines for Managing Risk in the Australian and New Zealand Public Sector*, AS/NZS HB143:1999, p. 1.

93 MAB/MIAC, *Before You Sign the Dotted Line, Ensuring Contracts can be Managed*, Report No. 23, Commonwealth of Australia, May 1997, p. 21.

94 MAB/MIAC, *Guidelines for Managing Risk in the Australian Public Service*, Report No. 22, 1996, p. 11.

95 Purchasing Australia, *Managing Risk in Procurement – A Handbook*, 1996, p. 3.

As the Department of Civil and Environmental Engineering, University of Melbourne pointed out during the inquiry:

If I can take the next point in respect to how we view risk, it is not only the negative side of risk. Risk also brings with it opportunity, in that if you carry a risk there is the chance that...had the contractor actually priced a risk factor and nothing went wrong, that is a little bonus for them. They have got some opportunity.⁹⁶

3.86 The former Purchasing Australia stated that, as part of sound contract management, risks that should be managed are found in:

- the different stages of the procurement process, such as writing the specifications and calling tenders;
- factors involved with the contractual relationship, such as delivery and liability for damages;
- factors outside the control of both supplier and buyer, such as industry-wide disputes and changes in interest rates; and
- the goods and services purchased.⁹⁷

3.87 Purchasing Australia indicated that unwanted consequences of risk may affect:

- the cost of procurement;
- the delivery schedule;
- the acceptability of the goods and services;
- human error and unethical or illegal behaviour on the part of the buyers and suppliers; and
- other programs within the agency.⁹⁸

3.88 DoFA stressed that 'early in the planning process agencies need to identify, analyse and evaluate risk and plan for its management.'⁹⁹ DoFA stated:

Risk can be minimised through a rigorous selection process that includes checking the record of past performance, quality

⁹⁶ Mr Duffield, Department of Civil and Environmental Engineering, University of Melbourne, *Transcript*, p. 64.

⁹⁷ Purchasing Australia, *Managing Risk in Procurement – A Handbook*, 1996, p. 4.

⁹⁸ Purchasing Australia, *Managing Risk in Procurement – A Handbook*, 1996, p. 4.

⁹⁹ Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Managers*, March 1998, p. 14.

assurance procedures and corporate capacity. The tender evaluation committee should have a mix of skills, and have access to legal and financial expertise.¹⁰⁰

3.89 However, more recently, the ANAO found that 'agencies had not based their particular outsourcing arrangements on sound risk management practice'.¹⁰¹ For example, the audits of the Green Corps program¹⁰² and the Sydney Airport Noise Amelioration program¹⁰³ found that a comprehensive risk assessment had not been undertaken prior to the commencement of the contracts in question. As well, the audit of Migrant Settlement Services¹⁰⁴ found that there had not been a systematic approach to managing risk over the life of the contract.

3.90 The ANAO suggested that better practice in contract management required the introduction of risk management policies and processes aimed at the entire contract lifecycle: starting from the pre-contract stage, through to the contract management and performance monitoring phase and finally through to the contract succession phase.¹⁰⁵

3.91 The ANAO, however, found that 'organisations generally only considered risk in the context of the initial procurement decision and in the tendering and contract evaluation and negotiation stages'.¹⁰⁶ The ANAO stated:

... the audit found there was minimal consideration of the contract management risks associated with the final two phases of the contract lifecycle – contract administration and performance monitoring, and contract succession.¹⁰⁷

100 Department of Finance and Administration, *Competitive Tendering and Contracting, Guidance for Managers*, March 1998, p. 14.

101 Australian National Audit Office, *Submission*, p. S138.

102 Australian National Audit Office, *Report No. 42, The Establishment and Operation of Green Corps*, 1998-99.

103 Australian National Audit Office, *Report No. 17, Sydney Airport Noise Amelioration Program*, 1997-98.

104 Australian National Audit Office, *Report No. 29, Provision of Migrant Settlement Services by DIMA*, 1997-98.

105 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes*, 1999-2000, p. 15.

106 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes*, 1999-2000, p. 25.

107 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes*, 1999-2000, p. 24.

- 3.92 In view of this, the ANAO recommended that 'organisations review and strengthen risk frameworks to address the risks associated with the performance and management of the contract service'.¹⁰⁸ It is important to recognise that risk can be created for contractors if the Commonwealth does not adequately perform.
- 3.93 Risk management issues were discussed during the inquiry. The Department of Education, Training and Youth Affairs (DETYA) indicated it had established a corporate approach to risk management based on the Australian/New Zealand Standard *Risk Management AS/NZS 4360:1999*.¹⁰⁹ Environment Australia stressed that it required its managers 'to follow a risk management approach in developing their contracts'. In addition, Environment Australia has put risk management guidelines on its intranet to assist its contract managers.¹¹⁰
- 3.94 The Department of Civil and Environmental Engineering, University of Melbourne commented that 'anything that can be done to identify and reduce the number of risks that can be identified at the start of the conceptual phase, of the documentation stage, must surely provide a more efficient and more economical facility at the end of the day for the taxpayer'.¹¹¹
- 3.95 One of the major issues, in evidence to the inquiry, was the allocation of risk between the Commonwealth and contractors. According to DoFA, 'as a general rule, risk responsibility should be allocated to the party best able to manage it'.¹¹²
- 3.96 This position was reiterated during the inquiry by a number of organisations. For example, Environment Australia stated 'the basic philosophy is that the party in the best position to control the risk should wear the risk'.¹¹³ DETYA indicated that 'there is a likelihood that, if you put the risk with the party that has got the best capacity to manage it, you will minimise the cost of managing it'.¹¹⁴ Furthermore, the Royal Institute of Architects explained the Abrahamson principle of risk allocation in construction law:

108 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes, 1999–2000*, p. 25.

109 Department of Education, Training and Youth Affairs, *Submission*, p. S457.

110 Mr Andrew McKinlay, Environment Australia, *Transcript*, p. 160.

111 Prof. David Young, Department of Civil and Environmental Engineering, University of Melbourne, *Transcript*, p. 62.

112 Dr Diana Wright, Department of Finance and Administration, *Transcript*, p. 104.

113 Mr Andrew McKinlay, Environment Australia, *Transcript*, p. 160.

114 Mr Stephen Sedgwick, Department of Education Training and Youth Affairs, *Transcript*, p. 155.

Risk is allocated to the party most able to manage it and where that cannot be defined the parties agree how they will share the risk. It is pretty simple, pretty straightforward and it really works.¹¹⁵

3.97 AusAid stressed the need for openness in risk allocation. AusAid explained:

We are also now more explicitly saying to the firms we deal with, 'By and large, we are expecting you to bear quite a few of the risks and we would expect in turn that these will be reflected in the contracts. We understand that. Where there are risks, you might wish to insure yourself against them or you will have to make some actuarial judgements as to how those risks affect you. We understand that. But, instead of it being vague, we want it on the table, open, and we want to talk about it.'¹¹⁶

3.98 Both the Royal Australian Institute of Architects and Canberra Business Council, however, indicated that historically government agencies tended to shift as much risk as they could to private organisations they were contracting with. The Royal Australian Institute of Architects stated:

...what is happening in public sector procurement is that because of the deskilling they just say, 'We have to avoid risk so we will shove it all on to them'. That does not work.¹¹⁷

3.99 Similarly, Canberra Business Council linked risk to reward and stated:

What I think did happen...is that in regard of some contracts, particularly in some areas that had been highly controversial and caused a lot of angst, when that was contracted out the view was, 'Phew, we have got rid of that', not recognising that there is a price to pay for absorbing that. So I think that there needs to be understanding of the link between risk and reward...¹¹⁸

3.100 The Department of Transport and Regional Services (DTRS), on the other hand, commented that 'it is good for government organisations to be seeking to shift as much risk as they can to private organisations they are contracting with.'¹¹⁹ DTRS stated:

115 Mr Michael Peck, Royal Australian Institute of Architects, *Transcript*, p. 34.

116 Dr Peter McCawley, AusAid, *Transcript*, p. 19.

117 Mr Michael Peck, Royal Australian Institute of Architects, *Transcript*, p. 34.

118 Mr Peter Grills, Canberra Business Council, *Transcript*, p. 40.

119 Mr Daryl Quinlivan, Department of Transport and Regional Services, *Transcript*, p. 182.

...as a general commentary on our practices, we have a firm but fair approach to risk allocation with private entities. But I do not have a lot of sympathy for private companies in this because, to me, it is just a normal commercial negotiation issue.¹²⁰

Conclusions

- 3.101 Risk management is recognised as an integral part of good management practice. More recently, risk management is being promoted in Australia and internationally as a good business management practice applicable to both the private and public sectors.
- 3.102 Where risk is managed poorly, together with other aspects of contract management, there can be significant costs for both contractor and the Commonwealth. For example, the *Amman Aviation* case, where significant costs were awarded against the Commonwealth, demonstrates the need to apply sound risk decisions to termination action. The Committee is aware that BAE Systems is currently in a court action with the Department of Foreign Affairs and Trade relating to the Australian Diplomatic Communications Network.
- 3.103 In view of the evidence, the Committee shares with the Australian National Audit Office (ANAO) concerns that overall risk assessment practices in Government organisations were found to be inadequate. The ANAO found that organisations generally only considered risk in the context of the initial procurement decision and in the tendering and contract evaluation and negotiation stages. In view of this, the ANAO recommended that organisations review risk frameworks to address the risks associated with the final two phases of the contract lifecycle – contract administration and contract succession.¹²¹
- 3.104 The Committee, therefore, suggests that the Department of Finance and Administration, in its next edition of *Competitive Tendering and Contracting, Guidance for Managers*, March 1998, ensure that advice and guidance on risk management addresses all phases of the contract lifecycle, including contract administration, performance monitoring and contract succession.**

120 Mr Daryl Quinlivan, Department of Transport and Regional Services, *Transcript*, p. 182.

121 Australian National Audit Office, *Report No. 12, Management of Contracted Business Support Processes*, 1999–2000, pp. 24–25.

- 3.105** In addition, the Committee suggests that all major contracting agencies, as part of their 2001-2002 internal audit program, conduct an audit of the adequacy and effectiveness of risk management practice, policies and guidelines aimed at the entire contract cycle.
- 3.106 In regard to risk allocation, the Committee supports the principle that risk should be managed by the area most capable of controlling the risk. Risk allocation should remain a negotiation issue between the government agency contracting out and the service provider.