

Joint Committee of Public Accounts and Audit
Answers to Questions on Notice
Inquiry into the Defence Major Projects Report 2020-21 and 2021-22
and Procurement of Hunter Class Frigates

Department/Agency: Australian National Audit Office

Outcome/Program Group: Defence Major Projects Report 2020-21 and 2021-22

Topic: Defence Major Projects Report 2020-21 and 2021-22 and Procurement of Hunter Class Frigates

Question reference number: 1

Type of question: Written

Date set by the committee for the return of answer: 9 June 2023

Number of pages: 2

Question:

Has ANAO seen a change in how Defence approaches risk management since the 2019-20 MPR?

Answer:

Yes. The ANAO reported on changes in the risk management framework for capability acquisition and sustainment in paragraphs 1.82 to 1.95 of Auditor-General Report No.12 2022–23, *2021–22 Major Projects Report* (the MPR).

Defence advised the ANAO in November 2020 that it had delivered all three phases of the Capability Acquisition and Sustainment Group's (CASG) Risk Management Reform Program (established in May 2017), including the development of risk management policies and toolsets for use by projects. However, Risk Profiles for some CASG Domains remained in draft, and Risk Management Implementation Plans were still being updated (MPR, paragraph 1.86, p.37).

Defence completed the release of tools and risk practices to standardise risk practices across CASG by March 2022 (MPR, paragraph 1.87, p.37). Defence also has in place a system, called Predict!, which is expected to improve the efficiency of Defence's risk management and standardise reporting (MPR, paragraph 1.89, p.37).

All projects included in the 2021-22 MPR had transitioned to Predict!, except for two projects with exemptions due to actual or anticipated project closure. These were Future Subs and MRH90 Helicopters (MPR, paragraph 1.88, p.37 and Table 6, p.38).

The ANAO identified the following issues with Defence risk management (MPR, paragraph 1.94, pp.38-39).

- Variable compliance with corporate guidance. While most of the 21 MPR projects had an approved Risk Management Plan, only the Joint Strike Fighter, Hunter Class Frigate, Combat Recon. Vehicles, Overlander Medium/Heavy, Hawkei, Light Tactical Fixed

Wing, SRGB Air Defence, JORN Mid-Life Upgrade, and Battle Comm. Sys. (Land) 2B, projects had updated their risk management plan within six months as required by the Capability and Sustainment Risk Management Manual (RMM) V1.0.

- The visibility of risks and issues when a project is transitioning to sustainment.
- The frequency with which risk and issue logs are reviewed to ensure risks and issues are accurate and complete, appropriately managed in a timely manner, and accurately reported to senior management.
- Lack of quality control resulting in inconsistent approaches in the recording of issues within Predict!
- Lack of a clear link between allocations against risk in the contingency log and risk log (as discussed in paragraph 1.74 of the MPR).
- Risk management logs and supporting documentation of variable quality, particularly where spreadsheets are being used in conjunction with Predict!

The ANAO made the following observation in the MPR (see Appendix 1, p.75).

- Risk reform activities have moved from manual spreadsheets to a standardised application; common risk language and risk planning and analysis tools have been implemented; and dashboard reporting on the status of risk developed.

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Question reference number: 2

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 1

Question:

ANAO, was value for money considered in Defence's tender process outside of the evaluation report?

Answer:

The ANAO did not find evidence of value for money being considered in Defence's tender process outside of the Source Evaluation Report and the Source Evaluation Report Supplement, neither of which included a value for money assessment (see paragraphs 2.38 and 2.44 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*).

As noted in paragraph 2.61 of the audit report, on 20 February 2018, prior to the receipt of all Offer Definition and Improvement responses by Defence, the Chief of Navy approved recommendations to be made to the Defence Investment Committee (DIC). As noted in paragraph 2.62, on 2 March 2018 the Chief of Navy present to the DIC on the tender process, project timeline and the key differences between the tendered options but did not address value for money nor make a recommendation on the preferred tenderer. The papers presented to the DIC, which included draft advice to government, did not identify a preferred tender or address value for money. As noted in paragraph 2.63, the DIC outcomes (minutes) did not document consideration of whether the 'Global Combat Ship – Australia' represented value for money for the Commonwealth. As noted in paragraph 2.66, the minutes of the Defence Committee's 15 March 2018 meeting were not retained and the senior Defence official's hand-written notes of the meeting, which are discussed in the audit report, did not include references to the relative value for money of the tenders.

As noted in paragraph 2.69 of the audit report, Defence's advice to government at second pass did not include advice on value for money.

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Question reference number: 3

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 2

Question:

Did ANAO have concerns about Defence's approach to probity during this tender process?

Answer:

The ANAO's assessment of Defence's approach to probity during the tender process is outlined in paragraphs 2.46 to 2.51 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*.

As noted in paragraph 19 of the audit report, not all probity matters were recorded and addressed as required by the November 2016 Legal Process and Probity Plan for the procurement.

As noted in paragraph 2.47 of the audit report, Defence's probity register recorded that 1571 officials received a probity briefing or returned a conflict-of-interest declaration between February 2016 and January 2019. The register did not contain sufficient information to determine whether all members of on-site liaison teams received probity training or briefings prior to commencing their roles.

As noted in paragraph 2.48 of the audit report, ANAO review of Defence records identified that BAE Systems notified Defence that it provided hospitality valued at AUD \$340 to the General-Manager Ships and Director-General Future Frigates. Receipt of this hospitality was not recorded by Defence in the project register, or the departmental gifts and benefits register and there is no record of Defence's management of probity in relation to this event.

As noted in paragraph 2.50 of the audit report, Defence records show that five of the eight recorded probity issues had been reported to the Project Director by project

staff. Of the remaining three incidents, the probity advisor (the Australian Government Solicitor) was aware of two incidents. The remaining incident was reported through the SEA 5000 probity mailbox, although Defence advised the ANAO in December 2022 that the Project Director (at the time) did not have access to the probity mailbox. The three incidents that were not reported to the Project Director were: tender information being stored on the drive of a staff member on a project unrelated to SEA 5000; opening SEA 5000 documentation in an insecure location; and a cleaner accessing an unauthorised area. When contacted on 8 December 2022, the AGS probity advisor recalled the incident of the cleaner, however, the project office has been unable to identify documented evidence of what occurred. As noted in paragraph 2.50, these probity incidents and their treatments were not recorded in any register.

As noted in paragraph 2.52, the ANAO identified the following opportunity for improvement — that prior to obtaining sign-off by the probity advisor in a procurement context, Defence should confirm that all probity matters have been drawn to the attention of the probity advisor.

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Question reference number: 4

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 1

Question:

ANAO, what is the importance of a contract management plan in this situation?

Answer:

As noted in paragraph 3.29 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*, Defence's Capability Acquisition and Sustainment Group's (CASG) Defence Contract Management Handbook sets out that:

The CMP [contract management plan] documents the operational, management and executive governance arrangements for managing performance and risk, provides clarity, accountability, and responsibility for both contract governance and administration activities via a RACI [Responsible, Accountable, Consulted and Informed] matrix, and addresses how the relationship with the contractor will be managed as a key enabler to successful contract outcomes.

As noted in paragraph 3.30 of the audit report, Defence's contract management plan for the head contract states that:

This Head Contract Management Plan (HCMP) provides direction for the ongoing management of the Head Contract, describing and detailing how it will be governed, managed, and administered.

As noted in the key messages section of the audit report, below paragraph 46, entities are better positioned to manage contract deliverables when relevant documentation to support contract management, including contract management plans, are developed early in the procurement process.

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Question reference number: 5

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 1

Question:

Did the ANAO find any instances of potential fraud, conflicts of interest or unethical practices by the Department of Defence in the procurement of the Hunter Class Frigate project?

Answer:

The ANAO's assessment of Defence's approach to probity during the tender process is outlined in paragraphs 2.46 to 2.51 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*. As noted in paragraph 19 of the audit report, not all probity matters were recorded and addressed as required by the November 2016 Legal Process and Probity Plan for the procurement.

The ANAO's review of payment and cost assurance arrangements under the head contract is outlined in paragraphs 3.58 to 3.60 of the audit report. As noted in paragraph 3.59, Defence has processes for validating actual costs against monthly invoice data, controls testing and sample-based transaction testing. As noted in paragraph 3.60, Defence has documented instances where the head contractor (BAESMA) has invoiced disallowable costs. Footnote 144 reports on: disallowable costs identified by Defence; Defence's management of instances where it has queried the reasonableness of costs; and Defence's management of certain costs identified by the ANAO.

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Question reference number: 6

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 2

Question:

Has the ANAO identified any deficiencies or weaknesses in the cost estimation process by Defence?

Answer:

The ANAO's assessment of Defence advice to government on cost issues at second pass is outlined in paragraphs 2.77 to 2.81 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*.

Paragraph 2.78 of the audit report notes that the acquisition cost estimate provided in the second pass advice to government included a 10 per cent cost reduction to the tendered production costs, valued at \$2.1 billion. Defence did not document the basis for this advice and did not disclose, in the advice, that a cost reduction had not been negotiated with the tenderers. As noted in paragraph 2.79, the Department of Finance (Finance) prepared an assessment that was included in the draft advice provided by Defence to its ministers at second pass. Finance drew attention to the 10 per cent cost reduction on the tendered production costs and what it considered to be limitations in Defence's advice on cost. Finance noted that a sustainment provision had been provided in place of a sustainment cost estimate and that the requirement in the Budget Process Operational Rules applying to Defence had not been met. Finance also noted that the selection of the preferred tenderer was based solely on capability, in the absence of whole of life cost estimates.

The ANAO's review of Defence's ongoing development of project cost estimates is outlined in paragraphs 3.85 to 3.94 of the audit report. Paragraph 3.87 notes that as of January 2023, Defence's internal estimate of total acquisition costs, for the project as a whole, was that it was likely to be significantly higher than the \$44.3 billion (2018–19 Budget out-turned) advised to government at second pass in June 2018. As

further noted in paragraph 3.87, as of March 2023 the government had not been advised of Defence's revised acquisition cost estimate, which Defence has been refining in preparation for returning to government for approval of the batch one build scope.

Paragraphs 3.95 to 3.97 of the audit report outline observations on project costs made by internal reviews of the project, including the impact of lack of design maturity on cost estimation.

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Question reference number: 7

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 1

Question:

What measures does the ANAO suggest for the Department of Defence to improve their accuracy of cost estimates and budget processes?

Answer:

The ANAO audits the Department of Defence's financial statements and administration against framework requirements. The question is best directed to the Department of Finance (Finance), which has responsibility for budget processes.

As noted in in paragraph 2.79 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates*, at second pass Finance identified what it considered to be limitations in Defence's advice on cost. Finance noted that a sustainment provision had been provided in place of a sustainment cost estimate and that the requirement in the Budget Process Operational Rules applying to Defence had not been met.

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Question reference number: 8

Type of question: Written

Date set by the committee for the return of answer: 16 June 2023

Number of pages: 1

Question:

Does the ANAO plan to monitor Defence's efforts to address the issues involved with the Hunter Class Frigates project?

Answer:

Project SEA 5000 Phase 1 — Hunter Class Frigate Design and Construction has been included in the annual Defence Major Projects Report (MPR) since the 2019–20 edition. The JCPAA has requested that the project be included in the 2022–23 MPR.

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Question reference number: TBC

Type of question: Hansard

Date set by the committee for the return of answer: 16 June 2023

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Question:

CHAIR: I want to ask a safety net question. We have asked for evidence from BAE Systems and we can talk to them in due course. Did you identify transactions which were paid that should not have been paid, because well done to you in identifying those disallowable transactions and not paying them.

Dr Ioannou: This is the second paragraph of footnote 144. Defence accepted a number of costs after querying the reasonableness of a number of them. There was a leadership conference valued at \$100,000, which Defence considered, at best, marginal as an allowable claim and excessive in terms of total activity cost, and something related to a tax efficient scheme relating to the Medicare levy surcharge. Defence accepted these costs. We've just sought to provide some factual material here.

CHAIR: Can you maybe take that on notice? It sounds like tax avoidance, but I'm sure that's not what was meant by it. It would be helpful if you can take that on notice and provide a supplementary note explaining that. Auditor-General, on the comparison between the three, it was a capability-based assessment that was undertaken and provided. If we take the Holden-Corolla-Ford analogy: you've got three models to choose from, you've got a bunch of capability criteria and an assessment was done. Would it normally be expected that a comparative assessment was undertaken.

Dr Ioannou: The point here is that there was a process which identified potential platforms. Defence rolled into a competitive evaluation process where it set out to compare these platforms. It appears to be fundamentals to such a process that you would compare them because they were seeking a capability solution which was highly specialised and the whole assessment process, at the end of the day, related to the antisubmarine warfare capability. This was the fundamental aspect. Therefore, they were in a very real sense comparing oranges to oranges, therefore why wouldn't you do a comparative assessment of the conventional type?

Answers:

Question 9 part 1:

Paragraphs 3.58 to 3.60 of Auditor-General Report No.21 2022–23 *Department of Defence's Procurement of Hunter Class Frigates* note that monthly and biannual allowable cost reviews are provided for under the head contract. As noted in paragraph 3.60, the ANAO examined six biannual costs reviews conducted to 30 June 2022. Defence documented review outcomes, including instances where BAESMA had invoiced disallowable costs. The reports indicated that Defence had reviewed adjustments required from the prior review period, to ensure these had been credited on the next monthly invoice by BAESMA and documented that the required adjustments had been actioned by BAESMA.

As noted in footnote 144 of the audit report, disallowable costs identified by Defence included: \$54,875 invoiced for Christmas cards and decorations for non-Hunter class personnel; \$1,470 related to gym memberships; and £133 related to corporate purchasing card transactions for travel. These costs were required by Defence to be credited on the next monthly invoice from BAESMA. Defence records indicate that this occurred for the disallowable costs identified by Defence. Defence also queried the reasonableness of certain costs, including \$100,000 claimed for a leadership conference which Defence considered 'at best marginal as an allowable claim' and excessive in terms of total activity cost, and 'a tax efficient scheme to support overall tax cost to the organisation, linked to avoid potential exposure to the Medicare Levy Surcharge'. Defence accepted these costs.

Footnote 144 also notes that the ANAO identified that on 25 July 2022 Defence advised BAESMA that \$3,700 for a Team Hunter social event, including an 'Adventure Room' and dinner at which Defence representatives were to be in attendance, was 'in accordance with the principles and intent of "Team Hunter"' and would 'improve and build upon the collaborative nature of the Supply Chain teams in BAESMA and CoA [Commonwealth of Australia].' Defence records indicate that the Director-General Hunter Class Frigates had verbally 'endorsed Team Hunter activities as an allowable cost.' Defence advised the ANAO in April 2023 that the relevant transactions, which totalled \$2,633, would be examined in the July to December 2022 allowable costs review.

Defence is best placed to assist the Committee regarding the outcomes of the July to December 2022 allowable costs review.

Question 9 part 2:

As noted in paragraph 2.34 of the audit report, paragraph 4.4 of the *Commonwealth Procurement Rules 2017* (CPRs), which applied at the time of the Competitive Evaluation Process, provided that: 'Achieving value for money is the core rule of the CPRs. *Officials* responsible for a *procurement* **must** be satisfied, after reasonable enquires, that the *procurement* achieves a value for money outcome [emphasis in original].'

Paragraph 2.34 of the audit report also noted that the Defence Procurement Policy Manual 2016, which applied at the time, reiterated the CPR requirements, and

highlighted the requirement for comparative analysis of costs and benefits in assessing value for money, as follows:

The CPRs provide that Value for Money is the core principle underpinning Australian Government Procurement and the application of this principle requires a comparative analysis of all relevant costs and benefits of each proposal throughout the whole procurement cycle (whole-of-life costing).

Value for Money is not limited to a consideration of capability versus price, or 'cheapest price wins.' Value for money requires consideration of Australian Government policy, specifically values such as open competition, efficiency, ethics, and accountability. The CPRs outline these policies in further detail. Officials conducting procurement should be aware that the overall goal of the procurement process is to provide a value for money recommendation to the delegate. [emphasis in original]