

CONTRACTOR PERFORMANCE RISK

2.1 In response to the Audit Report's finding that the submarine contract provided only 'modest recourse' by the Commonwealth by way of financial guarantees and liquidated damages in the event of late delivery or under-performance and that the Commonwealth bore a significant risk in ensuring completion,¹ the Committee questioned Defence about the apparently small performance guarantee of \$56 million and the liquidated damages provision of \$15 million.²

2.2 Defence responded that if a higher level of performance guarantee and provision for liquidated damages had been negotiated, the contract price would have risen:

... there are two parties to the contract and how the risk is divided between those parties ultimately is reflected in the price of the contract. That does not move us away from the position that in some particular case or other there might be a view that damages are too small or too great. I think the answer is that we get to a negotiated outcome.³

2.3 In a submission to the Committee, Defence claimed that appropriate levels of protection of the Commonwealth's interest were provided under the contract, including performance guarantees and encumbrances on the ASC's property.⁴

2.4 In response to questioning by the Committee, the Auditor-General stated that on the basis of his commercial experience elsewhere, the performance guarantee as a

1 *Audit Report No. 34, 1997-98*, pp. xvi, 26.

2 *Transcript, 29 April 1998*, pp. PA 46-7.

3 Cdre Eoin Asker, Director-General, Undersea Warfare Systems, DAO, *Transcript, 29 April 1998*, p. PA 47; Mr Gilbert Watters, Acting first Assistant Secretary, Capital Equipment Program, DAO, *Transcript, 29 April 1998*, p. PA 48.

4 Department of Defence, Submission No. 1, p. 14.

percentage of the project cost would not be anywhere near the benchmark:

*In fact, it would be really very nominal—almost not worth having; neither an incentive nor a disincentive, for that matter.*⁵

2.5 At a later hearing, Defence agreed that it would have been very desirable to have had a higher level of penalties but again made the point that:

*... it is always a nice balance between incentives and penalties. These are always matters for negotiation It is never a separate issue; it is part of a whole web of issues in the contract negotiation ...*⁶

2.6 In response to a question from the Committee, Defence stated that no payments had been made for performance shortfalls because the trials program was still to be completed.⁷

2.7 The Committee inquired whether there were performance shortfall penalties in areas other than submarine speed and endurance.⁸

2.8 Defence replied that there were subsidiary performance specifications but they were not necessarily subject to damages:

*We would expect the contractor to get them right.*⁹

2.9 Defence stressed that it had not waived its common law right to sue the contractor for non-performance.¹⁰

5 Auditor-General, *Transcript*, 29 April 1998, p. PA 49.

6 Mr Garry Jones, Deputy Secretary, Acquisition, Department of Defence, *Transcript*, 5 March 1999, p. PA 129.

7 Cdre Eoin Asker, Director-General, Acquisition Planning, DAO, *Transcript*, 5 March 1999, p. PA 130.

8 *Transcript*, 5 March 1999, p. PA 130.

9 Cdre Eoin Asker, Director-General, Acquisition Planning, DAO, *Transcript*, 5 March 1999, p. PA 130.

10 Mr Garry Jones, Deputy Secretary, Acquisition, Department of Defence, *Transcript*, 5 March 1999, p. PA 130.

Committee comments

2.10 The Committee considers that when fixed price contracts are used in a developmental project of this magnitude, the contractor is asked to accept considerable risk, and to require large performance guarantees is probably commercially unrealistic.

2.11 The Committee acknowledges the dilemma in relation to large penalties for failure to meet performance guarantees and contract cost, and considers that the resolution lies, at least in part, in better project management and cost control systems.

2.12 The Committee notes that the Audit Report was concerned that delays were continuing to occur and the contract provided little recourse to the Commonwealth against delay.¹¹

2.13 Defence admitted that it was concerned about the impact of delays on submarine capability, maintaining the viability of the submarine arm and the ability to train Defence forces in anti-submarine warfare.¹²

2.14 The Committee shares Defence's concern in relation to submarine capability and the viability of the submarine arm and is concerned in addition about the potential loss of personnel through frustration caused by the delays.

2.15 The Committee considers that the Commonwealth remains exposed to significant areas of financial risk until such time as the submarines are accepted into naval service and major defects which affect the operation of the submarines have been satisfactorily resolved.

11 *Audit Report No. 34, 1997-98*, p. 26.

12 Rear Adm. Christopher Oxenbould, Deputy Chief of Navy, *Transcript, 29 April 1998*, p. PA 77.